Answer-to-Question- 1

1)
International related party transactions:
- Licensing of patents, licences and trademarks to group companies by Raptor plc, the company which owns the group's IP
- Provision of managerial services by Raptor plc to the group companies
- Provision of technical services to Conrad Pte Ltd by Raptor plc
- sales of products to group companies by Conrad Pte Ltd
- provision of R&D by Conrad Pte Ltd to Raptor plc

Also mentioned are group procurement and logistics and product manufacture by Conrad Pte Ltd. Assume that these functions are covered under the sale of products by Conrad Pte Ltd to the group i.e. Conrad procures materials, manufactures product and then arranges the logistics to have them delivered to the group companies around the world for resale. As such, they are not considered separately.

The remainder of the transactions listed are with third parties and so are at arm's length by default and do not need to be considered for TP purposes.

2)
The UK tax authority will need to consider the following:
- that the royalties charged by Raptor plc to group companies is not less than arm's length. Otherwise the taxable profits of Raptor would be understated which would negatively affect the tax revenue collected by the UK tax authority.
- that Raptor plc is charging for the managerial services it is providing to the group and that the charge is not less than arm's length. Again, otherwise the tax base of the UK authority would be negatively affected.
- that the provision of technical services by Raptor plc to Conrad Pte Ltd is price at an arm's length.
- that Raptor plc does not pay an overstated price to Conrad Pte Ltd for products for resale
- that Raptor plc is paying an arm's length fee to Conrad Pte Ltd for the R&D services provided and that it is not being used as a mechanism to shift profits out of the UK
- the UK tax authority is likely to be concerned by the difference in the net profit margin and net profit as a percentage of total assets earned by Raptor plc relative to the other group companies.

The ratios are based on publicly available information so the UK tax authority has access to this financial information and will want to investigate whether transfer pricing is being used as a mechanism by the group to shift profits out of the UK to lower tax jurisdictions.

It could also be considered whether the group are contributing to the IP since the group has a policy of spending 15% of net sales on marketing. All of the IP is held by Raptor plc. A question arises of whether Raptor plc should be paying a fee to the group companies for their contribution to the group's IP. This issue to similar to the LG India case where the court found that the LG Korean parent was deemed to make payments to it's Indian subsidiary for the contributions to the LG brand made by the Indian subsidiary in India.

3)
a) Raptor plc
- Licensing of patents, licences and trademarks to group companies by Raptor plc, the company which owns the group's IP

Involves the payment of a royalty. The Comparable Uncontrolled price is usally the most appropriate method. Need to determine what royalty rate is being paid by comparable entities in comparable circumstances. Databases such as ktMINE and Royaltystat can be used to obtain comparables. The licence agreements should be used as terms regarding exclusivity etc. will impact on the royalty rate.

- Provision of managerial services by Raptor plc to the group companies

cost plus method arguable must appropriate method applicable. It may be possible to use an in-direct method using an appropriate allocation key such as sales if it is too administratively burdensome to determine how much of the cost relates to each group entity.

- Provision of technical services to Conrad Pte Ltd by Raptor plc

May be comparables available that could facilitate the use of the CUP method.

May invovle the use of valuable intangibles. in this case the profit split method could be applied which is suitable for transactions involving unique and hard-to-value intangibles.

b) Isakate Pty Ltd

This company engages in retail sales to third parites in Australia. This is an uncontrolled transaction between third parties. However, the purchase of the products for resale from Conrad is a controlled transaction which is dealt with below.

c) Conrad Pte Ltd

- sales of products to group companies by Conrad Pte Ltd

The Comparable Uncontrolled Price Method (CUP) could be used to set an arm's length price for the sale of products by Conrad Pte Ltd to group companies. The CUP is the most direct of hte TP methodolgies and is the preferred method of the OECD. However, in order to be applied reliably there be must reliable comparables available. Since the Jack's Group invests heavily in the marketing of its products and therefore generats a price premium over its competitors, it sounds as though reliable comparable are not available.

An alternative method could be the resale price method. This method looks at the price charged to the third party and then works backwards by deducting a reasonable margin for the distributor to arrive at an arm's length price for the inital transfer of goods between the related entities. When applying this method, since it is a one-sided approach a tested party must be selected. This should be the group entity which is selling the products to the third parties i.e. Isakate Pty Ltd or Royal, Inc. The margin earned by them should reflect the functions performed taking into account the assets used and risks assumed by them. Since their FAR is relatively straightforward relative to that of Conrad (selling and marketing) they are suitable tested parties. The margin earned by them should cover their costs and leave a reasonable profit based on their FAR. The gross margin should be in line with that earned by entities engaging in similar transactions under similar condiditions.

- provision of R&D by Conrad Pte Ltd to Raptor plc

Cost plus method is arguably the most appropriate method for contract R&D services. Assume that Conrad is carrying out the R&D under the instruction and supervisions of Raptor. Therefore the risk of the R&D being a success or failure lies with Raptor. Conrad should earn a reasonable mark-up on its costs given the functions it performs, assets used and limited risk assumed.

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Answer-to-Question- 2

1)
A functional analysis seeks to identify the functions performed, assets used and risks assumed by each party to a transaction.

It is one step of a 9 step comparability analysis included in the OCED Transfer Pricing Guidelines.

Its purpose is to identify the economically relevant attributes of a transaction that impact on the price or result. This is to ensure that the tested transactions is compared to uncontrolled independent transactions with similar attributes. Therefore, the functional analysis and comparability analysis must be performed on both the transactions under review and potentially comparable transactions.

They may be differences identified between the transactions under review and the potential comparables that would lead to a material difference in the price or result of the transaction. It may be possible to make accurate adjustments to remove the difference. Otherwise, the comparable is not sufficiently comparable and cannot be used.

The typical steps in carrying out a functional analysis are:
1) Fact finding - company website, annual report, management accounts, group structure, organogram with key personnel and reporting lines
2) Analysis of transactions - identify the inter-company transactions and determine the functions, assets and risks contributed by each party. Review inter-company agreements, interview key personnel, also can use questionnaires.
3) industry and economic analysis - to determine the context in which the transactions are taking

place. Indutry publications, government regulations etc.

Functional analysis of Snare Group:

Snare Co.

Functions:
- purchse of raw materials from Blueharvest and sale of such to group entities
- arranges insurance and transportation of ingredients
- produces manufacturing know-how in automated brewing process used by group companies

Assets:
- owns IP (brand names, trademarkd and copyrights)

Risks:
- market risk

Snare Europe:

Functions:
- purchase of ingredients from Snare Co.
- Manufacture of beer
- Marketing and distribution

Assets:
- plant and machinery, land and buildings used in brewing process
- licences manufacturing know-how from Snare Co. and uses it in its brewing process

Risks:
- market risk
- inventory risk
- credit risk from sale to customers
- financial risks such as interest rate and foreign exchange risks
- product quality risk

- risk of investment in plant & machinery, factory being idle

The Function analaysis usually is complied in a report.

2)
Snare Europe should be characterised as a full fledged manufactuer and distributor of beer.

It manufactures the beer, markets distributes it. It purchases its main ingredient from it's parent company. The amount purchsed is based on projections prepared by its own staff. In addition, SnareCo only takes flash title of the ingredients so the risk of purchasing the holding the raw materials and then finished goods lies with Snare Europe.

3)
The five comparability factors outlined in chapter I of the OECD Transfer Pricing guidelines should be considered. These are:

- The contractual terms of the transaction
how the responsibilities, risk and benefits of the transaction are split between the parties. Where no contract exists, correspondence/written communication between the parties can be used. However, in any case the conduct of the parties should be examined since the divergence of interests that normally motivates independent parties to keep to the terms of a contract do not exist in related party agreements
- Functional analysis
identifies the economically significant activities, assets used and risk assumed. Step-by-step process for analysing risk in a controlled transaction outlined in the new Chapter I which was updated as part of the BEPS project.
- characteristics of property or services
physical feature of products such as quality, the availability and volume of supply, the nature and extent of the provision of services, with regard to intangibles the form of the transaction e.g. licensing or sale, duration and degree of protection etc.
- economic circumstances
circumstances that affect comparability including geographic location, market size, the extent of competition in the markets, availability of subsititute goods and services, consumer purchasing power, market regulation etc.

- business strategies
This characteristic takes into account innovation and new product development, degree of diversification, risk aversion, assesment of political changes etc. Consideration should also be given to whether an entity is engagin in a market penentration scheme which explains why it is willing to put up with short-term losses in order to gain market share in the long-term.

Other attributes which are important are losses, the effect of government policies, location savings, the use of customs valuations and the effect of group synergies.

4)
The transfer pricing policy is arguably not appropriate for Snare Europe. It appears that the Transactional Net Margin Method has been used and that a result of 2% EBIT to sales how the price for the ingredients are to be set.

The margin seems lows considering the functions performed by Snare Europe, and the assets used and risks assumed.

Also, the only controlled transaction it engages in is the purchase of raw materials so the TNMM doesn't seem appropriate. A large part of the COGS (40%) is not related to the controlled transaction.

If comparables are available, the CUP method seems more appropriate especially since the price of local ingredients can be used as a comparable. Adjustments for the volume discount would need to be made however. Also CUP is appropriate for raw material ingredients that have not been processed and are therefore more comparable.

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Answer-to-Question- 4

1)
As set out by Chapter VII (updated by BEPS) a company can only charge for group services

where a benefit has been provided to a group company that an independent enterprise would be willing to pay for (either from a group company or third party) or provide in-house for itself.

Services such as financing, administration, marketing and distriubtion and human resources are examples of administrative services that are usually centralised in the parent company or one or more group service centres that can be charged as they are the type of services that independent enterprises would be willing to pay for or to incur costs in providing them for themselves.

2)

Shareholder activities:
These are costs that the parent company incurs in its capacity as a holding company and cannot be charged out as they are not services that independent enterprises would be willing to pay for.
Examples include:
- costs relating to the structure of the parent company itself, issuing of share in the parent company, costs relating to meetings of the shareholders of the parent;;
- costs relating to the reporting requirements of the parent company including parent company's audit, costs relating to the preparation of consolidated financial statements of the group, and
- costs of raising funds for making acquisitions.

Duplication
Where services that are already provided by a third party, another group member or by the group entity itself, no charge for the same services provided by the parent or service centre can be made. The rationale is that independent enterprises would not be willing to pay for duplicate services. Some exceptions can be identified where for example a second legal opion is sought in relation to an important business transaction.

'On call' services
These are where entities pay a fee to have a service 'on-call'. They can be charged where an independent enterprise would be willing to pay for such a service e.g retainer fees to a legal fee. However, when the benefit of such services is negligable and subsitutes are available without the need for an 'on-call' service, then it cannot be said that an independent entity would be willing to pay for such services and thus they cannot be charged.

Incidental benefits

These are benefits which the members of the group receive simply by being members of the MNE group. For example, there may be a restructuring in the group which may indirectly benefit another group entity which was not involved in the restructuring. Another example is a group entity may have a lower credit rating due to its affiliation to the group. Incidental benefits cannot be charged as they are not considered to be services which an independent enterprise would be willing to pay for. The guidelines provide the example of a parent company providing a loan guarantee which lowers the cost of borrowing for a group entity. This type of service is more than an incidential benefit and can be charged for.

3)

Direct charge method:
This is where associated enterprises are charged for specific services. For example a group entity could provide contract or toll manufacturing services to another group company. It is possible to price this transaction on an arm's length basis based on the recommended transfer pricing methodologies outlined in chapter II of the OECD TP guidelines e.g. cost plus method.

Indirect charge method:
This is where services are provided on a general basis so there are few alternative but to use cost allocation and apportionment methods which involve some degree of estimation and approximation. The services are charged out to the group entities using an appropriate base known as an allocation key which should be sensitive to the commercial features of the costs invovled. The allocaiton key chosen should lead to an allocation of costs that is commensurate with what would have been charged under the arm's length principle.

The indirect charge method is typcially used for low value-adding administrative services such a accounting, finance and HR.

Allocation keys include sales, number of employees, floor space etc.

4)
Possible allocation keys to use for charging indirect intra-group services:
- human resources could be allocated on the basis of the number of employees
- marketing costs could be allocted on the basis of sales
- procurement could be allocated on the basis of purchases

- financing could be allocated on the level of debt
- distribution could be allocated on the basis of sales

The allocation key used should reflect the nature of the costs.

The direct charge method does not use allocation keys.

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Answer-to-Question- 5

1)
An advance pricing arrangement (APA) is an arrangement whereby the taxpayer and tax authority(ies) agree in advance that the transfer pricing policies to be used for a transaction or set of transactions between associated enterprises based on agreed assumptions satisfy the arm's length principle. It is valid for a specified period of time (normally 3 to 5 years). The purpose is to provide taxpayers with certainty and protection from audit, investigation or reassessment by the tax authority(ies).

APA's can be unilateral (i.e. between the taxpayer and a single tax authority), bilateral (i.e. between the taxpayeers and the tax authorities relating to both sides of the transaction) or multilateral (i.e. between the taxpayers and multiple tax authorities - used for transactions involving multiple members of the MNE).

2)
The Mutual Agreement Procedure (MAP) is included in Article 25 of the OCED Model Tax Convention. It provides a mechanism whereby the tax authorities of the contracting states can come to an agreement regarding disputes involving double taxation i.e. taxation not in accordance with the DTA.

The main reason why a taxpayer would enter into a request for a (MAP)is where they have suffered double taxation. With regard to transfer pricing, this is usually economic double taxation which has arisen due to the tax authority of one of the contracting states making a transfer pricing adjustment in order to bring a transation in line with the arm's length principle. The purpose of the MAP would be for the other contracting state to agree to make a corresponding secondary adjustment in order to relieve the double taxation. The commentary to Article 25 specifically refers to transfer pricing adjustments (paragraph 10).

3)

The tax authorities would engage together in order to come to an agreement. The process is not defined but they are encouraged to reach an agreement within two years of the start of the process. The taxpayer is not normally involved in the process so does not have much control over the outcome. In addition, it can lead to cash being tied up as normally the additional tax will have be paid to the tax authority which made the transfer pricind adjustment before the MAP commences.

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Answer-to-Question- 7

DSG

This case involved DSG group, the largest retailer of electronic goods in the UK including Dixons, Currys and PC World. The case involved transactions which occurred between 1986 and 1997. It was the first important transfer pricing case in the UK.

DSG provided extended warranties to its customers through an unrelated insurance provider, Cornhill. Cornhill paid a commission to CIS, a DSG group company for faciltating the insurance contracts. Cornhill retained 95% of the risk and reinsured the remaining 95% with DISL, a DSG related entity registered in the Isle of Man. DISL paid a commission equal to 1.5% of the ceded premiums received from Cornhill. After a few years of this arrangement, CIS increased the commission it charged to Cornhill. Interestingly, Cornhill did not increase its commission charge to DISL.

In 1993, the rate of insurance premium tax increased dramatically from 2.5% to 17.5%. DSG group began to use a service contract instead of an insurance contract in order to avoid this cost. As such, ASL, an unrelated entity based in the Isle of Man steped into the arrangement in place of Cornhill. Otherwise the arrangement stayed the same.

This lead to a build up of profits tax-free in the Isle of Man relating to the warranty business. HMRC believed that the arrangement was not at arm's length and that some of the profits were taxable in the UK under the transfer pricing rules.

HMRC argued that DISL was at an advantage relative to Cornhill as the rate of commission paid to Cornhill was not increased when the rate paid by Cornhill to CIS was. HMRC said that were DSG and DISL unrelated, DSG would have charged DISL a business facilitation fee.

The transfer pricing law in the UK provided that where business faciliation was provided between related entities under condidtions that would not have existed had the transaction occurred between independent parties then the conditions could be adjusted to those that would have existed between related parties. In addition, the law changed around the time ASL came into play so that where a provision existed between related parties that would not have existed between independent parties that gave an advantage to one of more of the related parties in relation to UK tax, then a transfer pricing adjustment could be made.

DSG tried to argue that under the Comparable Price Method the transactions were at arm's length. However, the comparables it put forward were rejected by the court; one was from 1982 which was considered too old and another related to the satielle equipment industry which was considered too different to insurance and also had a one week termination period which contrasted too heavily to the long-term nature of the contracts in this case.

HMRC argued that a profit split method should apply based on a normal rate of return of investors' capital using the capital asset pricing model. DISL would have paid the excess over the capital required for solvency (as defined in the Cornhill contract) as a dividend to DSG.

The court held that a provision did exist between DSG and DISL even though there was no contractual relationship between the companies and agreed with the profit split method approach put forward by the HMRC.

This case was important as it showed that the tax authorities are willing to fully understand complex agreements and to apply profit based transfer pricing methods in a novel way. Also, it showed that transfer pricing rules can still apply where a group entity engages a third party on the agreement that the third party enters into an agreement with another group entity.

GE Capital

This case invovled General Electric Capital Canada (GECC) who had paid $136 million in loan guarantee fees to its US-based parent which had been incurred over several years denied in its tax returns. The Canadian tax authority denied the fees on the basis that there was no benefit received by GECC. GECC benefitted from the parent's AAA credit rating merely be affiliation to the GE group i.e. implicit support. There was no service provided by the parent and no benefit to GECC. Therefore under the transfer pricing rules the arm's length price was nil.

The guarantee fee was equal to 1% of the amount of debt outstanding.

In court, GECC provided expert evidence that the credit rating of the company without the guarantee was not AAA but was BB+/BBB- and that with the guarantee the rating increased to BB-/BBB+. The guarantee resulted in interest savings of 1.83%. In addition, the investors in GECC would have less confidence in the company taking on the debt in the absence of the guarantee.

The Tax Court ruled in favour of the taxpayer. This was appealled to the Federal Court which upheld the decision of the Tax Court.

It was found that there was a clear benefit being provided to the taxpayer. Application of the arm's length principle dictates that the companies should be treated as if they are independent enterprises. This may lead to the conclusion that implicit support should be ignored. However, this is not the case. All the circumstances surrounding the transaction should be taken into account. This was in agreement with the GSK case where it was found that an inter-company transaction should not be considered in isolation from another inter-company agreement that impacted on the transfer price set in the inital agreement.

Implicit support should not be ignored but it should not be charged for i.e. it is still in agreement with the arm's length principle. It is the benefit of the explicit loan guarantee that should be charged for as there is a real benefit to the taxpayer in the form of reduced interest costs.

The Federal Court upheld the decision of the Tax Court to value the service based on the benefit to the tax payer. An interest rate yield spread analysis was used to determine the savings. Since the benefit (1.83%) exceede the fee (1%), it did not exceed arm's length.

This is an important case.