THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2017

PAPER 3.03 – TRANSFER PRICING OPTION

SUGGESTED SOLUTIONS

PART A

Question 1

Part 1

The international related party transactions within the multinational group are as follows:

Raptor PLC

Intellectual property being provided for the use by Conrad Pte Ltd. It is likely that there should be a royalty charged by Raptor to Conrad.

Managerial services provided to Isakate Pty Ltd, Conrad Pte Ltd, Lance Ltd and Royal Inc.

Technical services provided to Conrad Pte Ltd.

Purchases of goods from Conrad Pte Ltd.

Isakate Pty Ltd

Receives managerial services from Raptor PLC.

Purchases of goods from Conrad Pte Ltd.

Conrad Pte Ltd

Use of intellectual property owned by Raptor PLC.

Receives managerial services from Raptor PLC.

Receives technical services from Raptor PLC.

Research and development for Raptor PLC.

Procurement and logistics for group.

Sales of goods to all group companies (Raptor PLC, Isakate Pty Ltd, Conrad Pte Ltd, Lance Ltd and Royal Inc).

Lance Ltd

Receives managerial services from Raptor PLC.

Purchase of goods from Conrad Pte Ltd.

Royal Inc

Receives managerial services from Raptor PLC.

Purchase of goods from Conrad Pte Ltd.

Part 2

The transfer pricing risks for the United Kingdom tax authority are as follows:

Raptor PLC is the owner of the key assets which drive profits for the group. This includes patents, licences and trademarks (Intellectual Property) covering brand name, formulation and manufacturing know how. There appears to be reasonable profit's within the multinational group with Conrad Pte Ltd, Lance Ltd and Isakate Pty Ltd earning net margins of in excess of 10%.

These entities appear to be routine functions such as sales and marketing, distribution and services for related parties within the group. Therefore, it appears that Raptor, being a United Kingdom based entity is achieving less than an arm's length return (relative to the functions, assets and risks).

As Raptor owns the Intellectual Property and it is likely that this is driving the non-routine profits of the group. The risk appears to be that Raptor is not being compensated for related parties using its Intellectual Property.

A further potential issue for the United Kingdom tax authority is Conrad Pte Ltd being over compensated for the functions it carries out on behalf of the group as its net profit margin of 19% appears to be excessive given the functions, assets and risks. Raptor appears not to be achieving an arm's length result which indicates that an incorrect transfer pricing methodology has been used to price and test the outcome for Conrad Pte Ltd.

An additional risk for the United Kingdom tax authority is that Raptor PLC is not being appropriately remunerated for the managerial and technical services provided to Conrad Pte Ltd.

<u>Part 3</u>

Purchase of goods by from Conrad Pte Ltd

Raptor PLC

In relation to the managerial and technical services provided by Raptor, the most appropriate methodology is cost plus.

In respect of services, it may also be possible to apply a Transaction Net Margin Method using a total cost mark-up profit level indicator.

In respect of the intellectual property owned by Raptor, Conrad Pte Ltd is utilising this in manufacturing product. Therefore, a licence fee should be payable from Conrad to Raptor. The most appropriate methodology would likely be comparable uncontrolled price (CUP) based on external available data. This is likely to be based on a percentage of net sales.

Profit split method is not appropriate as Raptor owns the Intellectual Property and no other parties appear to contribute to the IP.

In relation to the purchase of goods from Conrad Pte Ltd, refer to below. As Raptor owns the group intellectual property, other group members should be earning routine profits with the entrepreneurial profits returned by Raptor PLC.

Isakate Pty Ltd

Isakate is undertaking a distribution/sales function. The only related party transaction is the purchase of goods from Conrad Pte Ltd. The most appropriate method to apply to this transaction would be CUP, resale minus or transaction net margin method. An internal CUP may be available.

Another group entity, Lance Ltd sells products to third parties. Therefore, it may be possible for CUP to be applied as there may be an internal CUP within the multinational group. Depending on facts, adjustments to the CUP may be required in order to eliminate material differences in transactions (e.g. volumes, currency) to improve reliability.

Alternatively, the resale price method may apply.

A transactional net margin method could also be applied with an appropriate profit level indicator being net profit to sales.

In relation to the managerial and technical services provided by Raptor PLC, the most appropriate methodology is cost plus.

In respect of services, it may also be possible to apply a Transaction Net Margin Method using a total cost mark-up profit level indicator.

Conrad Pte Ltd

Conrad Pte Ltd undertakes functions on behalf of Raptor including research and development and procurement and logistics. Therefore, it is likely that Conrad Pte Ltd is performing these functions in accordance with Raptor's instructions (being the entrepreneur). Conrad Pte Ltd is not carrying out these functions as the entrepreneur or takes on significant risk and is entitled to any profits greater than a routine.

As such, a cost plus methodology should be applied in respect of the service transactions between Conrad Pte Ltd and Raptor PLC.

In respect of the services, it may also be possible to apply a Transaction Net Margin Method using a total cost mark-up profit level indicator.

In relation to the sale of goods by Conrad Pte Ltd to related entities, the resale price method may be applied in respect of its distribution function. The price of the controlled transaction (to related parties) may be determined by reference to the resale price margin that Lance Ltd earns in relation to items sold to third parties.

Alternatively, a Transactional Net Margin Method could also be applied in respect of the distribution function undertaken by Conrad (after removing the expenses and income in respect of the service functions). An appropriate profit level indicator would be net profit to sales.

In relation to the manufacturing function undertaken by Conrad Pte Ltd, the most appropriate methodology is likely to be Transaction Net Margin Method. As the function is likely to be asset intensive, a return on assets net profit indicator is likely to be appropriate.

Question 2

Part 1

In order to undertake a functional analysis of Snare Europe, there is a need to understand the functions that the enterprise performs, whilst taking into account the assets used and risks assumed.

It is essential to identify and compare the economically significant activities of Snare Europe and responsibilities undertaken, assets used and risks assumed by parties to the related party transactions.

The structure of the organisation and how the influence the way in which the business operates.

In this case, key functions of the group may include research and development, marketing, financing, management, assets used in manufacturing process, recipes for beers etc.
It is important to identify all of the significant functions performed by Snare Europe.

Adjustments should be made for any material differences for the differences from the functions undertaken by independent parties.

The types of assets used by the business should also be considered. In this case, intellectual property (brand name, recipe etc.), brewing equipment (land, buildings, plant) could be significant.

The types of risks to consider include market risks such as input cost, price fluctuations, foreign exchange risk, risk of loss, credit risk etc.

The economic substance of the arrangements should also be considered. That is, determine whether the parties are acting in accordance with any contractual terms.

From a practical perspective, a functional analysis is usually undertaken by interviewing key personnel of Snare Europe from a range of key business areas.

Refer to 2010 OECD guidelines D1.2.2 (page 45) for further details.

Part 2

Snare Europe would be characterised as a fully-fledged manufacturer of alcoholic products with a sales and marketing function. Snare Europe would own substantial plant, equipment and other assets.

Part 3

The OECD Guidelines stipulate that there needs to be a comparison between the controlled transaction (Snare Europe) and uncontrolled transaction (third party). The comparability analysis aims to find the most reliable comparables. Uncontrolled transactions with a lesser degree of comparability should be eliminated. In practice, there is limitations in availability of information.

It is usual practice to undertake a comparability analysis to support a transfer pricing analysis.

A typical process is:

Step 1: Determine years to be covered.
Step 2: Broad based analysis of circumstances.
Step 3: Understand controlled transactions.
Step 4: Review any internal comparables.
Step 5: Determine available sources of information on external comparables.
Step 6: Selection of transfer pricing method.

Step 7: Determine potential comparables.
Step 8: Make any comparability adjustments.
Step 9: Interpretation and use data collection to determine arm's length remuneration.

The comparability factors are referenced at para 1.38-1.63. Based on the information provided in the facts, Snare Europe purchases most of the brewing ingredients (with the exception of water) from a related party.

However, it is possible for Snare Europe to purchase these ingredients from Blueharvest who is a third party directly. Therefore, it may be possible for Snare Europe to identify a CUP. However, there may be differences which should be adjusted for including volumes (based on the information provided).

Refer to OECD 2010 Guidelines Chapter III.

<u>Part 4</u>

The Snare transfer pricing policy is for all breweries to return a 2% operating margin, irrespective of the functions, assets and risks of the local brewery. Therefore, it appears that this policy is mandated, despite potentially each brewery being different.

Technically, SnareCo should receive some form of a licence fee for use of the Intellectual Property (brand names, trademarks and copyrights) utilised by Snare Europe. This would usually be benchmarked/price by reference to a percentage of sales. Further, the sales of ingredients would be priced as an independent transaction. Each separate order of ingredients should be priced according to the arm's length principle. Further, Snare Europe would pay SnareCo an arm's length amount for the logistics and procurement function they are performing on behalf of Snare Europe.

In practice, Snare Europe would be the tested party with a possible method being transactional net margin method – net profit to sales with a secondary methodology being assets to sales (due to the manufacturing/asset intensive function).

PART B

Question 3

Reference is made to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (July 2010), Chapter IX – Transfer Pricing Aspects of Business Restructurings and the following sections:

- Part II: Arm's length compensation for the restructuring itself: - B.1: Identifying the restructuring transactions: functions, assets and risks before and after the restructuring; - B.2: Understanding the business reasons for the expected benefits from the restructuring, including the role of synergies; - B.3: Other options realistically available to the parties; - C.1: Profit potential; - C.2: Reallocation of risks and profit potential; - D: Transfer of something of value (e.g. an asset or an ongoing concern); and - E: Indemnification of the restructured entity for the termination or substantial renegotiation of existing arrangements.
- Part III: Remuneration of post-restructuring controlled transactions: - D: Comparing the pre- and post-restructuring situations; and - F: Example: implementation of a central purchasing function.
- Part IV: Recognition of the actual transactions undertaken: - C.2: Determining the economic substance of a transaction or arrangement; - C.3: Determining whether arrangements would have been adopted by independent enterprises; - C.4: Determining whether a transaction or arrangement has an arm's length pricing solution; - D.1: Example (A): Conversion of a full-fledged distributor into a "risk-less" distributor; and - D.2: Example (B): Transfer of valuable intangible to a shell company.

Consideration of the impact of the reallocation by examining the pre and post BR to identify any potential risk areas and these could include:

- Has there been an AL compensation for the transfer of assets?
- What are the contractual terms between the parties (pre and post BR).
- Has there been documentation that demonstrates the decision making process to reallocate risk (including the details the consequence of the profit potential of significant risk allocation)? Is the economic substance in line with the reallocation of risks?

Establishing two new entities, SubB and SubC, in low tax jurisdiction in some countries will either raise the risk of the arrangement being disregarded for tax purposes or lead to an examination to establish the economic substance of the arrangement.

- Is the transfer of intellectual property at arm's length from ParentCo to SubA?
- Valuation issue.
- Buy-out payments?
- Arm's length nature of the cost plus 5% payment for ParentCo?
- Loss of profit making potential.
- Arm's length nature of management fee paid by ParentCo?
- Substance of SubB and associated remuneration? Full FAR analysis.
- Arm's length remuneration for termination of manufacturing function and long term supply agreements?
- Commercial and economic rationale for entering into business restructure by all entities having regard to the arm's length principle.
- What options were realistically available for all entities involved in the business restructure?
- Is the cost plus 30% between SubC and SubB arm's length?
- Exist payments due?
- A full FAR would be required for all entities to establish the global value chain and economic substance of the group pre and post restructure.

Question 4

Reference is made to the OECD Transfer Pricing Guidelines (2010), Chapter VII – Special Considerations for Intra-Group Services; and BEPS Action Item 10 – Transfer Pricing Guidelines covering low value-adding intra-group services.

Part 1

Intra-group services for Lucky Corp that can be charged out:

- Administrative services (planning, accounting, auditing, budgetary control, legal, IT)
- Financial services (cash flows, recaps, loans)
- Assistance in production, buying, distribution & marketing
- Staff services (recruitment, training)
- R&D
- IP administration MNE group arrange for a wide scope of services to be available to its members, in particular administrative, technical, financial and commercial services. Such services may include management, coordination and control functions for the whole group.

The cost of providing such services may be borne initially by the parent, by a specially designated group member ("a group service centre"), or by another group member.

The charge for intra-group services should be that which would have been made and accepted between independent enterprises in comparable circumstances.

Part 2

Intra-group services for Lucky Corp that cannot be charged out:

- Shareholder activities: Shareholder activities are activities performed by a parent company solely because of its ownership interest. Shareholder activities do not justify a charge to recipient companies.
- Duplicative activities. If services performed by a group member or by a third party are duplicated, this is not normally a provision of services unless temporary duplication; Duplication is to reduce risk of making a wrong business decision, e.g. obtaining a second opinion.
- Activities giving rise to incidental benefits: a group member may obtain an economic benefit as a result of a transaction aimed to achieve something else, e.g. a group structural reorganization This would not normally be an intra-group service, as the activities producing the benefit would not be activities for which an independent enterprise would pay.
- Benefits only because of membership of a large group: Benefits obtained solely due to being part or a large group should not constitute a service (as opposed to benefits attributable to specific activity).
- Service availability 'on call': Is the availability of services itself a separate service that justifies an arm's length charge in addition to charges for services actually rendered?

Part 3

A direct charge is generally preferred to an indirect allocation and is required to be made where a service can be charged (both in terms of identifying the service and allocated a cost/mark-up for that service) i.e. when a MNE has the ability to demonstrate a separate basis for the charge (e.g. by recording the work done and costs expended in fulfilling its third party contracts). For example the cost of providing computers, training, legal advice, etc. for a specific entity.

A direct approach is normally required where services are also rendered to third parties. Intra-group services are not different, in principle, to other intra-group transactions, so the standard Arm's Length Principle applies. Lucky Corp should apply the charge that would have been made and accepted between independent parties for similar services under similar circumstances.

Where a direct charge is not possible, then an indirect charge can be made and requires cost allocation and apportionment methods which often necessitate some degree of estimation or approximation. An indirect charge is the allocation of costs for a particular Intra-group service based on an allocation key. (Indirect-charge method = a method of charging for intra-group services based upon cost allocation).

Under what circumstances would you use advise Lucky Corp to use an indirect basis? When the calculation of a direct charge may be too difficult due to administrative burden or complicated processes. An indirect charge or allocation is relevant where the value of services rendered cannot be quantified – e.g. sales promotion activities performed centrally affecting sales for many affiliates; or separate recording of costs related to each beneficiary would involve an administrative burden that would be disproportionately heavy.

Indirect charges normally apply to the vast majority of charges made by MNEs. Any indirect-charge method should be sensitive to the commercial features of the individual case (e.g. the allocation key makes sense under the circumstances), contain safeguards against manipulation and follow sound accounting principles, and be capable of producing charges or allocations of costs that are commensurate with the actual or reasonably expected benefits to the recipient of the service.

Part 4

Allocation keys examples may include:

- Turnover;
- Number of entities;
- Number of staff;
- Number of computers;
- Employee hours.

PART C

Question 5

Part 1

An Advance Pricing Arrangement (APA) is an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (eg. Method, comparables and appropriate adjustments, critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time.

Types of APA's include:

- Multilateral – applies to more than one bilateral mutual agreement.
- Bilateral – based on a single agreement between the competent authorities of two tax administrations under the relevant treaty.
- Unilateral – solely between a taxpayer and a tax administration.

Part 2

A taxpayer would request Mutual Agreement Procedure (MAP) where the taxpayer believes that the actions of one or both contracting states has resulted in or will result in taxation not in accordance with the provisions of the Convention.

Generally, taxpayers approach the competent authority of their country of residence to request relief under the tax convention.

For example, a tax administration may be subject to additional taxation because of a transfer pricing adjustment. This is likely to have resulted in double taxation by two members of the worldwide multinational group.

Part 3

MAP is governed by the mutual agreement procedure of the applicable double tax agreement/treaty and Article 25 of the OECD Model Tax Convention. MAP is a mechanism for eliminating double taxation and resolving conflicts of interpretation of the convention.

The MAP article enables Competent Authorities from governments of the relevant countries to interact with the intent to resolve international tax disputes such as transfer pricing.

There must be a tax treaty with the other country for a taxpayer to request MAP.

The MAP article applies to situations where a taxpayer believes that the actions of one or both contracting states has resulted in or will result in "taxation not in accordance with the provisions of the Convention".

Question 6

Part 1

Country by country reporting requires multinationals to provide tax administrations with specific information including:

1. Master File – contains high level information regarding their global business operations, transfer pricing policies and its global allocation of income and economic activity. This file is available to all relevant tax administrations.
2. Local file – contains more detailed transactional transfer pricing documentation specific to each country. This documentation should identify material related party transactions, the amounts of transactions, and the company's analysis in regards to the transactions (including selection of methodologies and comparability analysis).
3. Country-by-country report – provides aggregate tax jurisdiction wide information relating to the global allocation of income, taxes paid and indicators of the location of economic activity amongst jurisdictions. This contains details such as revenue, profit, income tax paid, number of employees and balance sheet information. The business activities undertaken in each jurisdiction must also be articulated.

Practical implications for multinationals include:

- Increased compliance costs with the requirement to prepare and lodge relevant documentation in a timely manner.
- Potential changes to systems in order to capture relevant data.

Practical implications for tax administrations include:

- Easier to identify potential transfer pricing risk.
- More appropriately allocate resources to cases.
- Access to contemporaneous documentation at an earlier time.
- May encourage multinationals to be more transparent regarding their tax structuring.
- Increased focus on Exchange of Information with automatic exchanges between relevant countries.
- May lead to more Mutual Agreement Procedures with more transparent knowledge for tax administrations.
- Enhanced ability to risk assess cases without the need to request contemporaneous transfer pricing documentation from multinationals.

Part 2

If a country does not have an extensive treaty network, this will limit their ability to receive exchanges of country by country reports. This will make risk assessment more difficult for the country as they will not have access to the same information as a country with extensive treaties.

Question 7

Chevron Australia Holdings Pty Ltd v Commissioner of Taxation [2015 FCA 1092]

The relevant borrower was Chevron Australia Holdings Pty Ltd (Borrower), a wholly owned subsidiary of the US-based Chevron Corporation (Parent).

The Borrower entered into a Credit Facility Agreement in June 2003, under which it borrowed from a special purpose subsidiary (Lender) which had been established to raise funds in US bond markets (with the benefit of a guarantee from the Parent). The key features of this credit facility were that:

- the Borrower borrowed the AUD equivalent of US $2.5 billion;
- interest would be paid at one-month AUD LIBOR + 4.14% p.a.;
- the loan was repayable in full after 5 years, but could be repaid earlier at the Borrower's option;
- the loan was not subject to financial covenants; and
- no guarantee or security was provided by the Borrower.

In summary, the Commissioner made determinations under both Division 13 and Subdivision 815-A, based on his view that:

- the arm's length rate of interest for the loan was lower than that charged by the Lender; and
- an arm's length loan agreement would have contained other terms which reduced the amount payable by the Borrower (such as that the loan would have been in USD and would have contained financial covenants).

The decision turned on the evidence before the Court. The Court made a number of findings on legal and factual issues that are likely to impact upon future transfer pricing matters, including that:

- Article 9 of the Australia-United States double tax agreement did not operate "independently of the transfer pricing provisions in the domestic legislation" as a basis for a tax assessment;
- the concept of "consideration" in Division 13 was not limited to the interest rate, and included valuable promises of the borrower (such as restrictive covenants and security);
- Division 13 does not treat a taxpayer which is a subsidiary of entity as a stand-alone entity;
- independent lenders do not rely upon published credit ratings, and instead complete their own credit analysis (as such, the practices and policies of rating agencies are not relevant);
- although it was permissible to take the implicit support of a parent entity into account, it "had very little, if any, impact on pricing by a lender in the real world";
- an arm's length loan may have been made in AUD for commercial reasons, despite carrying a higher interest rate than a loan in USD;
- the transfer pricing rules can be applied irrespective of whether the amount of debt is below the safe harbour thresholds under the thin capitalisation rules; and

Subdivision 815-A was constitutionally valid.

Given the nature of the issues which often arise in transfer pricing matters, the Court was heavily reliant on expert evidence to make the factual findings necessary to determine this matter.

From a practical perspective, experts are selected by the party who wishes to rely upon their evidence. However, the expert is not an advocate for that party, and their paramount duty is to assist the Court to make factual findings which are within their area of expertise.

The selected experts are then briefed with the relevant materials and asked to respond to the questions by the party's legal team. In this case, the Court found that many of the questions that had been asked did not address what the Court interpreted to be the relevant test.

The Court was not persuaded by the evidence of the Borrower's two expert witnesses who were called to give evidence as to the price that would have been paid by the Borrower for an arm's length loan. Therefore, Justice Robertson found that the Borrower had not discharged its onus of proving that the assessments which the Commissioner had issued were excessive.

Much of the evidence held to be irrelevant was led in relation to the credit rating that the Borrower would have been given by a rating agency, which was argued by the Commissioner to be relevant. Once the Court found that the practices of rating agencies were not relevant, it followed that the evidence given about credit ratings was not relevant. One of the immediate and practical implications of this case flows from this finding in that it creates uncertainty as to how the pricing exercise should be performed in practice.

The Commissioner also sought to rely upon the evidence of an expert accountant as to the "ideal" currency of the loan. However, the Court accepted that the choice of currency is a commercial matter and was outside the scope of the accountant's expertise. Though not addressed in the decision, commercial decisions around currency are not black and white. As such, evidence as to the "ideal" currency of a loan is unlikely to address the relevant question for transfer pricing purposes.

Having rejected this evidence, the Court was not persuaded that an arm's length loan would have been made in USD, rather than AUD.

The Commissioner was successful in terms of the outcome of this case. This was because the Court found that the Borrower had not led evidence which addressed the Court's interpretation of the proper statutory question.

Importantly, however, the Court rejected the Commissioner's key contentions that would have affected the arm's length interest rate. In particular, the Court rejected the Commissioner's submissions that:

An arm's length loan would have been made in USD (rather than AUD); and

That the arm's length interest rate would have been reduced because the Borrower would receive a higher credit rating due to the implicit support of its Parent.

The rejection of the Commissioner's position on currency highlights the commercial nature of this decision. The question of whether arm's length parties would borrow in different currencies is broader than asking what the ideal currency for a loan would be.

The rejection of the Commissioner's position on the relevance of credit rating agencies and the relevance of implicit support will give rise to uncertainty going forward, as it is unclear how an arm's length interest rate can be practically determined (without resorting to expert evidence). Taxpayers using an approach based on rating agency guidance will need to consider their positions.

The implications of this decision will be thoroughly considered in at least three contexts:

- applying the arm's length principle to establish and analyse transfer pricing positions;
- negotiating advance pricing agreements with the Commissioner; and
- transfer pricing disputes.

The rejection of the Commissioner's position on the relevance of credit rating agencies and the relevance of implicit support will give rise to uncertainty going forward, as it is unclear how an arm's length interest rate can be practically determined (without resorting to expert evidence). Taxpayers using an approach based on rating agency guidance will need to consider their positions.

The appeal process may change or clarify some of the aspects of this decision. However, there are many aspects of transfer pricing that remain unresolved. Importantly, the case did not require the Court to consider Division 815-B, which sets out a different transfer pricing framework (and applies to all future transactions).

GSK Canada [2010 FCA 201]

The Minister reassessed Glaxo Canada for tax years 1990 to 1993, arguing that Glaxo Canada had overpaid its Swiss affiliate Adechsa S.A. ("Adechsa") under a supply agreement for ranitidine. Ranitidine is the active ingredient in the ulcer medication Zantac, which was manufactured, marketed and distributed by Glaxo Canada under a licence agreement with Glaxo Canada's parent, Glaxo Group Ltd. ("Glaxo Group"). During the years at issue, Glaxo Canada had paid Adechsa between $1,512 and $1,651 per kilogram of ranitidine. The Minister used subsection 69(2) (a precursor to subsection 247(2)) of the Income Tax Act ("ITA")[2] to argue that this transfer pricing was unreasonable based on the fact that other Canadian pharmaceutical companies were paying, at a maximum, just over $300 per kilogram to their non-affiliated suppliers for generic versions of the drug.

Under a separate licence agreement, Glaxo Canada was granted certain intellectual property rights, including the right to sell the medication under the Zantac trademark. In return, Glaxo Canada paid an annual royalty of 6% of its net sales to Glaxo Group.

In the unanimous decision of the Supreme Court, Justice Rothstein's reasons support expansion of the factors that may be taken into account when determining the reasonableness of transfer pricing. Since reasonableness is relative: one must compare the amount paid by the entity to its affiliate to that which would have been reasonable had the parties been dealing at arm's length in similar economic circumstances. In order to assess this hypothetical amount, however, a court should not be restricted to considering a particular transaction in isolation if the facts do not warrant such a narrow inquiry. On these facts, for example, any definition of reasonableness would need to account for agreements between the parties (such as the licence agreement) outside the transaction for the purchase of ranitidine itself.

Noting that subsection 69(2) of the ITA does not define "reasonable", the Supreme Court considered the reliance by the lower courts on the 1995 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the "OECD Guidelines"). The Supreme Court cautions that the OECD Guidelines are "not controlling as if they were Canadian statute"; determination ultimately rests with the provisions of the ITA. Justice Rothstein acknowledged that the OECD Guidelines suggest four methods for determining the reasonableness of a transfer price: (i) the comparable uncontrolled price ("CUP") method; (ii) the cost plus method; (iii) the resale-price method; and (iv) the transactional net margin method. The Supreme Court made no definitive determination as to the appropriateness of any of these four methods in the circumstances, leaving any determination for re-hearing at the Tax Court.

Justice Rothstein rejected the strict application of a "transaction-by-transaction" approach stating: "while a transaction-by-transaction approach may be ideal, [the OECD Guidelines] themselves recognize that it is not appropriate in all cases."[5] Furthermore (and again quoting the OECD Guidelines), Justice Rothstein noted that "an arm's length comparator is only useful if economically-relevant characteristics… [are] sufficiently comparable."

The Supreme Court concluded that the licence agreement between Glaxo Group and Glaxo Canada must be taken into account to determine whether the transfer price for the ranitidine purchase is reasonable. It was because of the licence agreement that Glaxo Canada was purchasing its ranitidine from its parent's preferred source: Adechsa. Without the licence agreement, Glaxo Canada would not have been able to manufacture, market or distribute the ranitidine it received. Also, the licence agreement allowed Glaxo Canada to avoid the risk involved with product development. The Supreme Court concluded that these rights and benefits "could not be irrelevant" in an assessment of whether the higher price was reasonable as compared to generic peers. However, the Supreme Court stopped short of determining whether the transfer pricing was, in fact, reasonable.

The Supreme Court offered the following guidance for the Tax Court in redetermining whether the transfer prices in this case are reasonable. First, as transfer pricing "to use the words of the [OECD Guidelines]… 'is not an exact science'," "reasonable amount" should be interpreted as "reasonable range." If the transfer price used Glaxo Canada is not within this reasonable range, then "the court might select a point within a range it considers reasonable in the circumstances based on an average, median, mode or other appropriate statistical measure, having regard to the evidence that the court found to be relevant." Second, the Tax Court must look at the respective roles of Glaxo Canada and Glaxo Group to determine whether a higher price was justified on the basis of compensation for intellectual property rights. Third, both the interests of Glaxo Canada and Glaxo Group must be considered by the Tax Court having regard to their independent interests. Lastly, the fact that arm's length parties have purchased ranitidine from Glaxo Group suppliers (rather than from a generic source) indicates that some amount of price increase will be justified.

In dismissing the cross-appeal, the Supreme Court held that while Glaxo Canada had successfully demolished the Minister's assumption that the transfer price paid to Adechsa for the purchase of ranitidine should not be greater than the prices paid for ranitidine by the Canadian generic pharmaceutical companies, it had not demolished the Minister's assumption that the amounts paid to Adechsa were unreasonable. On this basis, the Supreme Court remitted the matter to the Tax Court for redetermination.

Generally, the Supreme Court's requirement for a fact-driven, holistic approach to assessing the reasonableness of transfer pricing will give MNEs some leeway in structuring arrangements within their corporate groups. Based on Justice Rothstein's reasons, it seems clear that the OECD Guidelines are not determinative for purposes of interpreting the transfer pricing rules in the ITA. In fact the only statement from the OECD Guidelines that the Supreme Court appears to have confirmed was that determining arm's length transfer prices is not an exact science. As a result, even though the Tax Court favoured the CUP method of transfer pricing analysis, the Supreme Court indicated that this may not be the best method for analysis in this case, due to its narrow focus on particular transactions. Since the Supreme Court declined to elaborate further, the door appears to be open to any, or none, of the four OECD methods being acceptable for determining a reasonable transfer price, depending on the circumstance of the particular taxpayer as compared to that taxpayer's economic comparator group.

<u>DSG [2009 UKFTT 31 (TC)]</u>

The case concerned a dispute between HMRC and a group of companies which form the largest retailer of electrical goods in the UK, comprising Dixons, Currys and PC World. DSG Retail Ltd (DSG) was the retail company. DSG had a subsidiary, CIS. CIS, acting as agent for Cornhill Insurance plc (Cornhill), offered DSG's customers extended warranties on electrical goods. Cornhill paid CIS a sales commission.

From May 1986 to April 1997 Cornhill was the insurer of the extended warranties sold to DSG's customers, retaining 5% of the risk and reinsuring 95% with a subsidiary of DSG that was incorporated in the Isle of Man, DISL. Cornhill ceded 95% of the risk premiums it received to DISL under the reinsurance contract, and in return DISL paid Cornhill a ceding commission of 1.5% of the premiums ceded to it. DSG had no direct contractual relationship with DISL.

In 1993, the arrangements were extended for five years and the profit commission arrangements with CIS were altered so that Cornhill paid CIS a greater commission. Crucially, Cornhill agreed not to seek a corresponding increase in ceding commission from DISL.

From 1 April 1997, the rate of Insurance Premium Tax ("IPT") on the goods that DSG sold rose dramatically from the then standard rate of 2.5% to 17.5%. To avoid IPT, DSG restructured the arrangements so that instead of an insurance policy issued by Cornhill, customers were sold a service contract with ASL, an Isle of Man company independent of DSG. The fee charged for the repair contract did not attract IPT because it was not an insurance transaction. ASL insured its risk with DISL.

As a result of the agreements in place, a large proportion of the profits accumulated tax-free in the Isle of Man subsidiary, DISL. HMRC sought to bring a larger share of the profits into charge in the UK by invoking the transfer pricing rules and contending that the arrangements were not consistent with the arm's length principle. HMRC argued that an analysis of the transactions as a whole indicated that the DSG group had made an indirect provision to DISL of a business facility whereby Cornhill's position relative to DISL was disadvantaged. Cornhill's profit had been "squeezed" by the 1993 contractual changes whereas DISL's profit had not. HMRC argued that DISL's non-arm's length profit continued from 1997 under the new ASL arrangements in the form of an opportunity to enter into an attractive insurance contract. Applying arm's length terms, the DSG group would have required payment from an independent party to enter into the same arrangement.

From a transfer pricing perspective, the following issues were relevant:

- was there a provision between DSG and DISL for the purposes of Schedule 28AA ICTA?
- did the actual provision differ from the provision that would have been made between independent enterprises?
- did the provision confer a potential advantage in relation to UK tax?
- what adjustment is required?

As the period under enquiry included years prior to the introduction of Schedule 28AA ICTA, the prior provisions in section 770 ICTA were also considered.

DSG argued for the use of comparable uncontrolled prices, and relying on transfer pricing reports produced by a number of accounting firms, put forward a number of comparables in support of its argument.

HMRC rejected the comparables for reasons such as:

- time – the first comparable proposed concerned an agreement made in 1982 when the market for extended warranties was quite different to the market in 1997.
- product – the second comparable proposed concerned an agreement related principally to satellite equipment.
- termination – the second comparable was terminable on one week's notice which was interpreted as demonstrating that the parties were not contemplating a long term relationship, unlike the DSG arrangements.
- terms – DSG sought to rely on a 1994 report from the Office of Fair Trading, "Extended Warranties on Electrical Goods", which gave the commission rates paid by three unidentified retailers. There was no evidence as to whether the rates agreed were between arm's length parties or what the other terms were.\
- bargaining position – DSG put forward a comparable involving a bargain between equals. This comparable was rejected because this was not the position with DISL.

On the basis that no comparables could be identified, HMRC's expert witness set out a profit split approach whereby DISL's profits would be compared to a notional "normal rate of return on investors' capital", based on the capital asset pricing model. A "bottom up" approach was preferred whereby it was assumed any profits in excess of capital needed for solvency requirements was paid out as a dividend each year. Solvency requirements were based on those contractually agreed with Cornhill.

It was held that there was clearly provision between DSG and DISL despite there being no direct contractual relationship between these entities. It was clear that in negotiations with Cornhill and with DSG's bargaining power, DISL had been given an advantage in order to provide tax benefits to the group.

The Special Commissioners concluded that the arrangements were not at arm's length and that DSG set a price that "confers a potential advantage in relation to United Kingdom taxation" because DSG's profits did not include income it would have received for its provision of the business facility if DSG and DISL were dealing at arm's length. They also rejected the comparables put forward by DSG and supported the use of the type of profit split formula suggested by HMRC.

It was determined that DSG's profits should be adjusted to that of an arm's length arrangement based upon the above mentioned profit split method. Determination of the actual quantum of the adjustment was referred back to the parties to enable a settlement to be negotiated, but the tribunal held that the adjustment should take the form of a commission payable by DISL to DSG.

Perhaps of most interest for taxpayers are the arguments HMRC employed to challenge the comparables and the tribunal's receptivity to HMRC's arguments on pricing methodology which, although based upon the OECD Guidelines, may upset the traditional hierarchy of suggested transfer pricing methods as set out in the OECD Guidelines. It validates the use of profit based methodologies where reliable comparables cannot be found.

What is apparent from the case is that transfer pricing issues are never clear-cut; this particular hearing lasted 15 days and involved a lengthy and complex analysis of the contracts and transactions involved. It has been suggested that it signals a change in HMRC's previous reluctance to litigate transfer pricing issues, which serves to highlight the importance for groups to re-examine their transfer pricing policies and consider whether the most appropriate pricing methodology has been used. It also reinforces the importance of performing a sound economic analysis of commercial agreements.

<u>GE Capital [2010 FCA 344)</u>

Taxpayer's 1% guarantee fee satisfied arm's length test. Implicit support concept upheld; non-arm's length circumstances relevant.

The Federal Court of Appeal (FCA) has dismissed the Crown's appeal in the GE Capital Canada transfer pricing case. At issue was whether a 1% guarantee fee paid by General Electric Capital Canada Inc. (GECC) to its AAA-rated US parent company (GECUS) exceeded an arm's length price.

The Crown had argued before the Tax Court that implicit support, i.e. the notion that even without a legal guarantee GECUS would have stood behind GECC's obligations, had to be taken into account. Implicit support in the Crown's view resulted in GECC having a AAA credit rating, so that the GECUS guarantee provided no incremental benefit and an arm's length guarantee fee was nil. The taxpayer had argued that the 1% guarantee fee did not exceed arm's length pricing and that implicit support from GECUS should be ignored since it stemmed from the non-arm's length relationship.

The Tax Court agreed with the Crown on implicit support and applied a "yield approach," comparing the interest rate GECC would have paid with and without GECUS's guarantee. The Tax Court found that GECC's credit rating (with implicit support but without the guarantee) was at most BBB-/BB+ and the 1% guarantee fee satisfied the arm's length test.

The FCA approved of both the Tax Court's yield approach and its conclusion that the guarantee fee did not exceed an arm's length price. Although not essential to its conclusion, the FCA addressed the legal question of the relevance of implicit support and concluded that implicit support had to be taken into account. The FCA commented that determining arm's length pricing "involves taking into account all the circumstances which bear on the price whether they arise from the relationship or otherwise." This is consistent with the recent FCA decision in Glaxo.

Accordingly, circumstances that are themselves inherently non-arm's length in nature are to be considered in assessing whether pricing is arm's length. The relevant inquiry is: What would an arm's length guarantor charge to guarantee the obligations of a comparable subsidiary of a comparable AAA-rated US parent company? Looking simply at what an arm's length guarantor would charge to guarantee the obligations of a comparable subsidiary in isolation, without regard to the parent, fails to recognize all of the relevant economic circumstances.

So, the taxpayer in GE Capital Canada has again won on the merits and lost on the implicit support issue. This case forms a key part of the developing Canadian jurisprudence in the transfer pricing area and provides guidance to the many taxpayers who are grappling with transfer pricing compliance and dispute resolution.

Question 8

Transfer pricing issues involved with the intra-group financing should include discussions around:

- Commercial rationale and purpose for funding arrangements including the loans, cash pooling and factoring.
- Alternative funding arrangements that could have been entered into.
- Arm's length interest rates.
- Pricing of the related party loans.
- Credit ratings for the parent and subsidiaries.
- Guarantee fees and implicit support.
- Potential CUPs with third party loans.
- Credit margins.
- Interaction of transfer pricing and thin capitalisation.
- Potential anti-avoidance.
- Impact of funding arrangements on the profitability of the entities relative to characterisation.

Question 9.

BEPS Action 7 – Preventing the artificial avoidance of PE status - the final report on Action 7, Preventing the Artificial Avoidance of Permanent Establishment Status, proposes changes to the PE definition in Article 5 of the OECD Model Tax Convention to prevent the use of the following arrangements and strategies that are considered to enable a foreign enterprise to operate in another country without creating a PE:

Commissionaire arrangements and similar strategies

The use of specific preparatory or auxiliary activity exemptions, including the artificial fragmentation of so-called “cohesive” business activities into several smaller operations such that each part is able to benefit from the use of such specific activity exemptions.

The final report also proposes the use of the PPT rule that will be included in the OECD Model Tax Convention under Action 6 to deal with strategies involving the splitting-up of contracts between closely related enterprises in the context of construction contracts, and an alternative provision in the Commentary consisting of an automatic rule requiring the aggregation of time spent by closely related enterprises at the same building site or construction or installation project to calculate the 12 month threshold.

The final report, compared to the revised discussion draft, BEPS Action 7: Preventing Artificial Avoidance of PE Status, issued in May 2015, contains no major changes in terms of the position taken by the OECD on the perceived BEPS abuses arising from the artificial avoidance of PE status. However, the final report reflects some refinements to the proposed amendments to Article 5(5) as well as Article 5(6).

Currently, Article 5(5) requires a person (other than an independent agent) acting on behalf of a foreign enterprise to have the “authority to conclude contracts in the name of the enterprise” in order to create a PE.

The final Action 7 report would refer to persons (other than an independent agent) that habitually conclude contracts or “habitually play the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise,”8 while the discussion draft referred to “persons that habitually concluded contracts or negotiated the material elements of contracts.”

Changes also were made to the proposed wording to tighten the definition of independent agent in Article 5(6) by replacing the concept of “connected parties” with “closely related enterprises;” the final report now includes for this purpose cases where a person possesses directly or indirectly more than 50% of the beneficial interest in the other or, if a company, more than 50% of the aggregate vote and value of the company’s shares or the beneficial equity interests.