<u>Question 3</u>

To ensure that the arm's length principle is met, transactions between controlled parties should be comparable to transactions between uncontrolled parties in comparable conditions. Therefore, in assessing whether this principle has been met, a comparability analysis should be undertaken.

The OECD Transfer pricing guidelines (TPG) sets out a typical process for undertaking a comparability analysis, which includes 9 steps, the relevant steps are dealt with in turn below.

The comparability analysis for Vanilla Ltd is as follows:

Years covered:

As instructed by Miss Doubtful, a comparability analysis for year ending 31 December 2014 is required. The question is whether to take in prior years dealings to ensure that average trend is reviewed, and extraordinary items affecting purely 2014 is somewhat alleviated.

Broad Analysis of Vanilla's circumstances:

Vanilla Ltd is tax resident in Utopia, a country rich in natural resources and high GDP (assume from previous question still applies).

It is in the business of distributing cardboard boxes in Utopia (under a distribution agreement between Plain Ltd, an associated company. It does not take any risks in relation to transportation of the cardboard boxes into Utopia.

Utopia is broadly a market whereby barriers to entry, particularly for distribution of boxes, are low.

Industry of selling cardboard boxes requires little or no marketing activities. It is a high volume, low cost business.

There are no other material regulatory or other barriers of entry to note regarding distribution of cardboard boxes relevant to Vanilla to note.

Identification of controlled transactions

Controlled transactions are transactions between related parties.

The controlled transaction to be reviewed is the purchase of cardboard boxes from Vanilla's Ltd parent company, Plain Ltd (Plain). Per the facts, there are no further controlled transactions under review for this analysis.

Per this transaction, Plain sells the cardboard boxes (in finished form) to Vanilla. Vanilla pays for the transportation costs up to storage of Plain's warehouses located in Utopia. Vanilla therefore assumes the risk in relation to transportation and is responsible for clearing of customs and other related import requirements.

Plain distributes to third parties located in Utopia only. It does little or no marketing activities given the nature of the industry. As mentioned above, it does not bear any risks of transportation up to delivery to their warehouse. It owns inventory at the warehouse.

(Need to review the contract agreement between Vanilla and Plain to determine who bears risk of inventory write offs, etc.)

Based on the above information, Vanilla is the simpler party as there is more available and reliable information to test the transaction. Per the facts, it acts as a distributor (limited risk status needs to be further reviewed).

The key driver to Vanilla is sales to the third parties in Utopia.

Review of any existing internal comparables

Internal comparables are transactions between related party and third party. It generally offers stronger comparables as the terms between related party and third party can be tested further for comparability (e.g. terms of contractual agreement).

Potential comparables for review further is the sale by Plain of cardboard boxes to third party in Utopia, Basic Ltd. Plain sells to Basic a create for $6,500, whereas it sells to Vanilla a crate for $5,000. Prima facie, there is a comparable which should be reviewed and analysed further. There are five factors that should be reviewed for comparability, including:

- Characteristics of the goods
  Per the facts, the cardboard boxes sold by Vanilla to Basic, are sufficiently comparable to apply.

- functional analysis
  Both Vanilla and Basic both act as distributors in Utopia. There are no significant differences in the functions, asset or risk profile between the two and therefore they are sufficiently comparable (as stated in the facts).

- Contractual terms
  Given that Basic also distributes in Utopia, it would be safe to assume (but should be verified by reviewing the contract) that Vanilla does not have an exclusive contract.

The main difference in terms is that Plain pays the transportation costs to ship the cardboard boxes to Utopia. We assume that Basic needs to cover their own transportation costs.

Economic circumstances and business strategies

Again, they are sufficiently comparable given that they operate in the same market.

Based on this information, there is a potential CUP. That being said, for a transaction to be comparable, there should be no material differences affecting the price, and if there are differences, reliable adjustments cannot be done to eliminate such differences.
Therefore, the main difference is the transactions, is that Vanilla pays for transportation costs for transactions between Vanilla and Plain whereas it does not pay for it to sales to basic.

There is a $1500/ per crate difference between the price charged between the two entities. To the extent that transportation costs is the difference, then the price charged to Vanilla should be at arm's length.

However, Basic makes an gross operating margin of 32%. Vanilla makes an operating profit of only 10%. Therefore, this implies that either Vanilla incurs significant operating expenses or that the prices charged for the cardboard boxes is not at arm's length.

Price Vanilla	
Income	10000
COGS	5000
Gross	5000
Expenses	4000
Operating profit	1000

Add transportation costs (assume 1000)

Income	10000
COGS	5000
Transportation	1000
Gross	4000
Expenses	4000
Operating	1000

Gross profit is still 40%, whereas Basic is 32%. Adjust price by 8% upwards.

Therefore, a comparability adjustment adding the transportation costs from the operating expenses of Plain should be completed to compare whether the prices are comparable once this is added. It is likely that, given the facts, the price charged is still too low and price should be adjusted upwards to be comparable with the CUP. The methodology should be well documented, along with reasoning supporting the comparability adjustment and reasons supporting the CUP.

Given that operating expenses is an unknown, then TNMM method may also be used. As sales is a driver ,then operating profit can be the financial indicator.

Question 4

Part 1

Article 9(1) of the OECD Model Double Tax Convention (DTC) is typically referred to as the authoritative statement of the arm's length principle. It forms the basis of bi-lateral tax treaties involving OECD member countries and increasingly, non member countries.

Article 9(1) provides a mechanism for tax authorities to adjust profits upwards to the extent that conditions applied between two associated enterprises differ from those which would have applied between independent enterprises and include in their taxable base profits that would have accrued had the arm's length principle been observed and applied.

Practical limitation of this provision include:

- Arm's length principle is onerous to apply
- It can lead to double taxation, and in some cases, double non- taxation
- Implications with wider domestic rules may not be consistent with Article 9(1), such as safe
- harbour rules

Part 2

Article 9(2) of the OECD Model Double Tax provides a mechanism for corresponding adjustment to be made to ensure double taxation is eliminated. It is known as the relieving provision.

For example, company A in country A sells to related party Company B in country B goods for 100. Country B's tax authority maintains that the price paid of 100 is not t arm 's length and applies arm's length price of 80, based on a CUP. It therefore invokes article 9(1) to increase profits by 20. By virtue of Article 9(2), Country B should allow for a corresponding adjustment to the sale price down from 100 to 80 (and thereby decrease profits by 20).

However, it should be noted that the shortfall of Article 9(2) is that the other State is only required to provide a corresponding adjustment only to the extent that the arm's length principle was not observed. Therefore, if the other state does not agree that the price was not at arm's length, then double taxation may still arise.

The OECD Model Double Tax treaty is just that - a model. Each state will need to enter into treaties with other states separately, which may or may not follow the OECD Model. OECD Model does represent consensus of member countries and should be followed, to the extent possible, particularly where double taxation is likely to result otherwise.

Article 9(2) is important as it enables the elimination of double taxation which is a barrier to international trade.

The UN Model has similar provision to Article 9, albeit includes an additional clause precluding the operation of paragraph two to the extent that "juridical, administration or other legal proceedings have resulted in a final ruling that by actions giving rise to an adjustment of profits in paragraph 1, one of the enterprises concerned is liable to fraud in relation to fraud, gross negligence or wilful default". Therefore, where the upward adjustment is a result of fraud, negligence or wilful default, then a corresponding adjustment is not provided and double taxation is likely to result. The UN members are generally less developed countries and therefore the provisions included in the model offer more protections.

Part 3

Article 25 sets out a means through which tax administrations consult to resolve disputes regarding the application of double tax conventions. The procedure as set out in Article 25 can be used to eliminate double taxation that could arise from a transfer pricing adjustment.

There are three different area where MAP is used, including where transactions are not in accordance with the provisions of the convention.

Practical considerations include:

- Best endeavours - the article states the competent authority is only required to use their best endeavours to final a solution. However, this may not always lead to an agreement, which was the case in the Glaxo Case relating to Zantac between HMRC and IRS.

- Changes to the model treaty take some time to be adopted into double tax treaties between nations. For example, Art 25(5) relating to the arbitration procedures where agreement is not reached within 2 years. Some double tax treaties have amended their treaties to include this change, (such as US and Germany), but it is a long process requiring a high level of negotiation between parties.

- Tax authorities do not have the resources to support all MAP applications made to them. With any organisation, tax authorities have limited resource and can only devote a limited number of people to MAP procedures. It is for this reason, MAP has sometimes been criticised as being slow and long.

Part 4

The OECD guidelines is a consensus of member states relating to transfer pricing. It therefore has no authority to bind member states to such guidelines. Each country will has the sovereign to develop their own tax rules and therefore it is up to their accord to enact or include whole or part of the TPG into their domestic legislation.

Nevertheless, some states adopt the transfer pricing guidelines directly into their domestic legislation, such as the UK.

Other countries such as India have stated that their tax model broadly follows the OECD TPG, only to the extent that it does interfere with their local legislation. In an international setting, not all countries follow the TPG and it leads to double taxation, uncertainty, etc.

Question 5

Part 1

The OECD Transfer pricing guidelines contains a separate chapter on transfer pricing consideration for intra-group services (chapter 7).

The process of examining compliance to the arm's length principle for routine and administrative intergroup services is as follows:

Determine whether a intergroup service has been rendered

To answer this, the question that must be answered in the positive is whether the provision of administrative/routine services to related entity is an activity with economic and commercial value that enhances the commercial position of the recipient of the services. In other words, does the service provide a benefit to the recipient of the service? In answering this question, thought must be given to whether the recipient entity is likely to pay a third party for the services.

Special consideration should be given to:

- Shareholder activities which are activities undertaken to company with being parent but does not actually benefit the subsidiary (e.g. preparation of consolidated accounts). Shareholder activities should be distinguished from stewardship activities which are broader in nature (preparation of group policies, etc.)

- Duplicative activities - does the recipient complete the activities themselves such that they would not pay a third party for the repetition of the exercise/service. An exception to this is if it is temporary or during crisis period.

- Determine arm's length charge for the service provided. If it has been determined that an intra-group service has been rendered, then consideration needs to turn to what the charge should be.

Direct charging methodology is preferred by the OECD Transfer pricing guidelines.

To the extent direct charging is not possible, (e.g. the services are rendered to several intergroup companies and it would be overly onerous to determine split or activities are highly integrated), then indirect charge can be made on allocation basis.

The allocation key used should reflect the benefit received for the service. I.e. using a broad brush key is likely to be challenged by the tax authorities. Using headcount key for services provided to employees, such as human resources would likely to acceptable, or using a number of desktops for IT desktop support.

However, services should be reviewed from both sides, the service provider and the recipient. Therefore, the cost base should be appropriately considered in the circumstances.

Selecting the correct TP method

Given that these are routine services, then a CUP, cost plus or TNMM methodology is be most appropriate to use (RPM is used for reseller or manufacturers with intangible property, and profit split methods where intangibles are involved).

To the extent a CUP is not available, given that it is highly integrated services then the reasons should be clearly documented.

A cost plus approach should be reviewed and determined why this is not more appropriate to use - for example, certain costs are not known until year end (such as issue of shares to employees of service company), therefore Cost plus approach is not appropriate.

Transactional net margin method examines the net profit relative to a financial indicator. Given that cost is the driver of services, then cost based indicator (such as full cost mark up) is most appropriate.

Provided all the above steps are considered and reviewed, then payment of indirect basis (provided allocation key is appropriate) based on TNMM method may be appropriate. Further details are required to confirm this.

Part 2

Safe harbour provisions are statutory provisions that applies to a defined category of taxpayers or transactions and that relieves eligible taxpayers from certain obligations otherwise imposed by a country's general transfer pricing rules. A safe harbour substitutes simpler obligation for those under general pricing regimes.

In relation to services, safe harbour rules could allow taxpayers to establish transfer pricings in a specific way, e.g. charging on cost plus basis, mark up applied to be 5%.

Safe harbour rules could also exempt a defined category of taxpayers - such as taxpayers with turnover less than $50m do not have to fall within the transfer pricing rules.

Examples of this include:

- Regional – EU Joint transfer pricing forum - which supports a simplified method of documenting and charging for routine/low value services.
- International – OECD guidelines is international guidelines supporting safe harbour rules (which have been recently introduced after OECD recognised the benefit of states having safe harbour rules).
- Country – an example is Australia exempting taxpayers from application of Transfer pricing rules where they fall within a group of exempt taxpayers, e.g. turnover of AUD $10m (as an example only).

Part 3

Following the considerations set out in chapter 7 of the OECD transfer pricing guidelines, each service is reviewed separately in turn.

IT services

IT services supports sales to third parties and ongoing day to day operations of D1. It is therefore a service that benefits the D1 and D1 would pay a third party for.

In setting the arm's length charge, consideration needs to be given to the benefit actually received by D1.

It services total $300,000, of which $150,000 relate to payments to third party for one off installation.

Therefore, it is arguable that D1 did not benefit from special software for M Co, and it should be excluded from any charge to D1.

The balance of $150,000 should be allocated using either the number of computer terminals or number of computer users, as this is the most appropriate approximation to benefit received.

It should be confirmed with the IT department which key would represent benefit. Assuming it is the computer terminals, then charge to d1 would be 25% (i.e. 7/28).

Cost base is therefore 37,500, plus an appropriate mark up.

Accounting services

Similarly, D1 would benefit from accounting services.

Shareholder costs should be excluded from the cost base as it does not benefit D1, however.

Therefore, cost base should be $200000 - $50,000 (or $150,000). accounting support is based on turnover (provides more support to high turnover business, and therefore D1 should receive a charge based of 25/85m*150k) with an appropriate mark up.

Finally HR services provides support to D1 and D1 therefore would pay third party.

The allocation should be based on headcount as this is the best approximation of benefit received. D1 has 8 full time employees and 20 other employees. information is needed whether support to contracting staff is provided, if not, then the full time equivalent key should be used of 8 employees over 57 total employees. Full cost base of $200,000 should be reasonable, but again, we need confirmation that this of what is included in the cost base.

Therefore, all three services should are services for the purposes of transfer pricing and an appropriate charge from FcH to d1 should be made, in line with above.

Question 6

Part 1

Related party transaction are transactions between associated enterprises (based on control provision in domestic legislation). On the facts, the related party transaction include:

- loan from X Co to Y Co
- loan from Finance Co to X Co, substituting X Co in loan agreement with Y Co.

Part 2

There is no separate chapter in the OECD transfer pricing guidelines which covers financing and loan transactions. The general application of the arm's length principle should be applied in the normal ways.

Therefore, in determining whether the finance transactions between X Co and Y Co as well as Finance Co and X co are at arm's length, consideration as to whether such transactions would occur on the same or comparable terms between unrelated parties.

The loan from X Co to Y Co.

There are two factors to consider, being:

- Whether the loan amount is arm's length
- Whether the interest rate applied is at arm's length

In assessing the interest rate, consideration of the following is required:
rate to remunerate X co for the use of the money must be provided. This is the base rate.

In setting the base rate, consideration of the following is needed:

- The currency is in USD. We do not know what currencies X Co or Y Co dominate in and therefore who, if any, bears any foreign exchange risk
- Fixed or floating - the loan has been set at fixed, which offers more certainty to the borrower and therefore is often provided with some premium]
- Date loan was made - and the economic conditions surrounding the time
- Term of the loan - 5 years

External data can be used in setting base rate (such a LIBOR, EURIBOR, etc.)

Remuneration for the risk undertaken by X Co must also be considered when setting the interest rate. This is reflected in the margin in addition to the base rate. It is more subjective and takes into account the circumstances of Y Co, including:

- Creditworthiness
- Debt ratio
- Interest cover
- Market conditions and other macro-economic conditions (e.g. industry, market, etc.)
- Other factors affecting the risk profile of Y co should also be considered.

As mentioned above, the margin used should reflect the risk undertaken by X Co is providing the loan to Y Co.

To determine this, external credit rating agencies can be used. However, this may be costly. Another option is asking a bank for rate. However, quotes are not usually accepted by tax authorities, particularly given that banks do not complete thorough checks for quoting purposes.

In addition to setting the interest rate, determination of whether or not Y Co could have received a $20m loan from a third party on its own accord needs to also be considered. Does Y co have the ability to support the loan?

Finally, the replacement of Finance Co of X co in the loan needs also to be considered. Would a straight swap or assignment of rights and responsibilities without remuneration normally occur in unrelated party transactions. Given that Company X is relieved of the risk of the loan, then it is unlikely that in a third party situation, Finance Co would not receive some/any benefit from assuming the position. This needs to be considered further.

<u>Part 3</u>

In determining whether a guarantee fee should be charged, consideration as to the benefit, if any has been provided to FipWip Financial Services Ltd, and if so, what would be a likely charge be between third party in similar or same conditions.

From the facts, FipWip Financial Services receives a better rating of AA+ with the guarantee as opposed from AAA without the guarantee. It is a formal guarantee and not merely a letter of comfort. therefore the provision of the guarantee enhances the commercial position of FipWip Financial Services by enabling them to issue between credit rated corporate bonds on the market (and thereby receive a better rate).

Once it is determined that a benefit was actually received, then guarantee fee charged should be arm's length. What would a third party charge for the provision of the guarantee? Additionally, what would a third party recipient likely pay for the better rating?

The interest rate differential is likely to be an appropriate basis for the charge, e.g. FipWip Financial Services could have receive rate of 5% without the guarantee, and receives 4% with the guarantee based on AA+ rating.

<u>Part 4</u>

General Electrics is a recent case relating to guarantee fees. GE Electrics Canada paid their parent company guarantee fee. The Canadian tax authorities attempted to argue that guarantee fee paid to its parent was not at arm's length as it was received as an incidental benefit only by being part of the group. The case goes onto further consideration of the actual benefit and how this should be calculated, but the key point there was an actual benefit received. The court held that GE Canada did receive a benefit from the guarantee, and it was not merely incidental. Therefore the fee should be made.