THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2015

PAPER 3.03 – TRANSFER PRICING OPTION

ADVANCED INTERNATIONAL TAXATION (THEMATIC)

Suggested solutions

Question 1

Part 1

The five key areas could include a range of topics, for example:

- The scope of the legislation i.e. which taxpayers (size, industry etc.) and types of transactions will be within the scope of the legislation and whether there are any monetary thresholds or simplification measures and/ safe harbours.
- Definition of terminology such as the ALP, Associated Enterprises (related parties), methods, etc.
- Burden of proof linked to documentation and coupled with a penalty regime.

Part 2

The student should address the considerations/impact on the implementation of the selected areas.

The main purpose of this question is for the student to demonstrate they understand how a transfer pricing regime operates in practice. The answer must focus on the five key areas selected in Part 1; marks are not awarded to any part of the answer that is not clearly referenced to these areas.

Briefly describe the policy/ administrative consideration, just a few sentence is sufficient.

The main marks were allocated to the explanation of how these areas impact on the implementation of Utopia's transfer pricing regime. Because this is an open ended question marks were allocated to answers that demonstrate the student's knowledge. Policy and administrative considerations could include a whole range of issues for example:

Burden placed on taxpayer to provide documentation to be balanced with the information required by the tax administration and the cost to the taxpayer in providing the documentation.

Court and the legal system should have the capacity to deal with transfer pricing.

Internal capacity to deal with transfer pricing linked to training.

If for example comparability was one of the key areas identified in Part 1 then some policy issues would be to what extent are internal, external, domestic, foreign and secret comparables are relied upon and the impact such a policy decision would have on both the tax administration and taxpayer include the ease by which comparables can be sourced and the cost and time to undertake to produce a comparability analysis. The student could have also crossed linked the problem of the lack of available comparables to other transfer pricing issues, e.g. safe harbours.

<u>Question 2</u>

<u>Part 1</u>

Reasons could include losses, specific transactions e.g. management fees, targeted audit activity in the mining sector, dealings with low tax jurisdictions, poor or unexplained/unusually profits, excessive capital write-off/depreciation, services fees paid (either excessive or not readily explained), etc.

<u>Part 2</u>

Any format covering the main area would suffice, for example the following is based on the ATO, but other formats are acceptable:

1. Parties to the Unilateral APA
2. Period and income tax years covered by the Unilateral APA
3. Transactions and Agreements covered by the Unilateral APA
4. Agreed Transfer Pricing Methodology and selection of tested party (if applicable)
5. Compensating Adjustments
6. Catch-Up Clause for the Compensating Adjustments
7. Basis of Financial Statements
8. Critical Assumptions
9. Implementation
10. Annual Reports
11. Record Retention
12. Omissions, False or Misleading Statements 12. Signatures and date

The student should elaborate on each area, for example:

Implementation

Global Mining Company agrees to notify the Utopian Tax Authority (UTA) when it becomes aware that a breach of a critical assumption has occurred. A breach of critical assumptions will result in a review of the terms of the APA. Subject to agreement between the parties, this may lead to the suspension, renegotiation, cancellation or modification of the APA.

Omissions, False or Misleading Statements

The UTA may review, revise or cancel the APA where Global Mining Company makes a statement that is false or misleading or deliberately omits from a statement any matter or thing without which the statement is false or misleading in either the APA application or any submission, report, information, or documentation regarding or supporting the APA application.

Question 3

Marks were awarded to observations and recommendations as they relate to the case. There was flexibility in the possible answers and as long as there was a sound base for the reasoning points were awarded accordingly. One approach is listed below:

Identify the controlled transaction/s

The 200 crates purchased by Vanilla Ltd from Plain, Inc.

Select the tested party

The least complex party to the transaction: Vanilla Ltd.

Select the most appropriate method to the circumstance of the case

Resale Price Method is the most appropriate for distributors and in this case it is the only method that can be applied based on the available information i.e. we have gross profit for the sale of robots from a third party .

All other methods would require further information/assumptions.

Identify the potential comparable/s

Comparable Uncontrolled Transaction ~Basic Ltd (an unrelated company) buys and sells a sufficiently similar product into the same market. FAR are comparable.

Apply the most appropriate method to the circumstance of the case and make a determination of the arm's length remuneration (profit or price)

Using the RPM determine the gross profit for Basic Ltd (1,000,000 less 780,000 = gross profit of 220,000 or a gross profit percentage of 22%.

22% is a good approximation of what a cardboard box distributor would be expected to return in Utopia.

Plain, Inc. sold 200 crates to Vanilla Ltd at a price of $5,000 per crate and Vanilla Ltd sold the crates to unrelated (third party) customers for $6,500 per crates. Sales $1,300,000 less GOGS $1,000,000 equals a gross profit of $300,000 per robot or GP 23% comparing the gross profit of the controlled transaction to the uncontrolled transactions the gross profit made from both companies is very similar. Note that apart from the transport cost all other terms and conditions are comparable between Basic and Vanilla.

Conclude with a statement as to whether or not there is a need to adjust Vanilla Ltd transfer pricing and if so, calculate the amount of the adjustment, showing all calculations.

The student could argue for or against an adjustment and as long as the answer is reasoned well it will be sufficient for a pass).

Question 4

Part 1

Tax treaties place limits on countries taxing powers, Article 9 in particular limits adjustments by tax authorities to associated party dealings by reference to the ALP.
Tax treaties containing this article, without domestic law, are typically considered not to provide a legal basis for a transfer pricing adjustment (primary adjustment).

Article 9 does not provide a comprehensive definition of “associated party” but rather refers to participation in capital, management or control – the rest is, in effect, left to domestic law. As a result definitions vary considerably between countries.

Part 2

Article 9(2) provides a clear basis for a corresponding adjustment in order to provide relief to economic double taxation.

Although the wording implies that an adjustment “shall” be made, the commentary makes it clear that this is only the case where the other country’s authority agrees with the primary adjustment in principle and amount. Not all countries include paragraph 2 in their treaties, and some take the position that where it is not in the treaty the taxpayer does not have access to MAP (Article 25).

Provide one country example of a reservation in the OECD Model to Article 9(2).

Paragraph 3 of the UN Model places limitations on the applicability of paragraph 2 in cases of fraud, etc.

Part 3

Article 25 provides for the MAP, which provides a mechanism for taxpayers to seek relief from double taxation through a procedure that takes place between the two treaty partner countries’ “competent authorities”.

This may apply to transfer prices cases, where one country has made a primary adjustment and the taxpayer is seeking a corresponding adjustment and can also provide a basis for bilateral APAs.

Without a binding arbitration provision (such as Article 25(5)) although states should endeavor to eliminate double taxation, there is no requirement that they actually reach an agreement.

Not all treaties contain binding arbitration provisions. The arbitration provision in the OECD model is binding and is at the request of the taxpayer, in the UN Model (2010) there are two alternatives, one without arbitration (A) and one with (B).

The UN Model’s arbitration is at the request of one of the competent authorities (not the taxpayer, as in OECD Model).

Part 4

The OECD TPG are guidelines and not, on their own, a binding source of law. As per preface, their primary role is to govern the MAP process and application of Article 9. However, in some countries they have been given a legal significance (through reference in the law) examples include UK, Australia, Norway, Ireland and others. In other countries they are of high practical significance, and are often referred to in administrative guidance, by the courts, or are simply referred to by taxpayers and or tax authorities as a source of reference in practice.

Question 5

Part 1

No specific process of number of steps – but in general:

Step 1

Determine what services have actually been rendered and what components/subcategories of service it comprises of (commercial benefit test, taking account of shareholder activities, duplicative activities, passive association). Information – functional analysis.

Step 2

Examine the costs of the related party associated with providing the service (consider costs that can be directly allocated, those that are payments to related parties, allocation of overheads, possible pass through costs). Information – break down of costs.

Step 3

Determine appropriate allocation key or keys (depending of the subcategories of service and information available). Information relevant to allocation key – employee numbers, number of computers, etc. (depending on services).

Step 4

Determine appropriate markup by reference to comparables (or safe harbours if provided for under domestic law)

Step 5

Determine arm's length service charge.

Part 2

Safe harbour is typically a legal or administrative rule that allows a taxpayer to avoid doing a comparability study when determining the arm's length charge for certain types of services and provides protection from a transfer pricing adjustment if complied with/applied by taxpayer.

Application will typically be limited to routine services, and it will be required that a full cost plus method (TNMM on cost basis) is applied, with the allocation of costs and benefit of the services, etc. clearly documented. In such cases the markup, or range of markups considered as a 'safe harbours' will be acceptable to the tax authority – these are often in the range of 5-10%).

Examples include Australia, Singapore, New Zealand, Hungary, and the US (but allows for no markup under SCM) plus others, and more recently OECD proposed this in services discussion draft delivered as part of BEPS (range of 2-5%).

Part 3

No specific process or answer, but expect a reasoned and structured analysis covering:

- Analysis of services per functional analysis highlighting any issues, i.e. consolidation of accounts (shareholder service) and to whom (which group members) services are provided (invoicing only for distributors?)
- Analysis of costs information, carving out % for shareholder service (consolidation) and discussion concerning the installation of special software (direct charge, pass through).
- Determination of appropriate allocation keys based on information provided, with explained reasoning (highlighting considerations such as # staff v FTE etc.), including which parties should be charged and which should not.
- Calculation of a possible charge to D1 (costs allocated for each sub service + markup)
- Specification of any additional information that would be needed (for example, around staff training, etc., or for application of different allocation keys).

Question 6

Part 1

Sale of a financial asset (the loan asset) from X Co to Finance Co.

Interest payment by Y Co to X Co (pre transfer) and Interest payment by Y Co to Finance Co (post transfer).

Part 2

Initial assessment of interest payment Y Co to X Co 2013-2015:

- Determine base rate (risk free rate for USD) for 5 year period.
- Determine Credit rating of Y Co at time of loan.
- Examine loan specifics - seniority, security, terms and conditions.
- Determine risk premium /spread specific to borrower and loan specifics.
- Consider options available to X Co.

Interest payment Y Co to Finance Co (2015-17).

Loan balance transfer (sale of financial asset).

The asset is the right to receive 9% p.a. interest for next 2.5 years and the USD20m in 2.5 years' time, which is subject to a 5% fee for early repayment.

Consideration (payment for transfer of financial asset) should be consistent with the arm's length principle– this may be higher or lower than the face value depending on markets and on any changes in riskiness of Y Co.

This will require an analysis of the credit worthiness of Y Co at time of transfer and of current market interest rates for 2.5 year USD loans.

Once a new discount rate is determined, a discounted cash flow can be used to calculate the premium or discount that may be applicable to the USD 20m.

Examples: loan contract, loan transfer agreement, financial statements (balance sheets and profit and loss) for entities at relevant times, including forecasts for purposes of determining creditworthiness, financial markets data (government bond rates or similar for risk free rate) and risk premium for similar credit worthiness (comparables from market).

Part 3

Need to consider if there is a benefit to the recipient (appears yes - as formal guarantee and purpose was to reduce cost of finance – holdings has a much higher credit rating than financial services co and results in bonds being AA not BBB).

It does not appear that this is shareholder service (i.e. purpose was to get cheaper finance and it does not seem guarantee is a condition of being able to raise finance – but more facts would be needed).

In determining price for guarantee fee there is a contentious issue about what is the level of the benefit (due to possible implicit guarantee/ notching up of stand-alone credit rating) – should the fee account for the entire move from BBB to AA+/AAA or should we assume that bonds would have been higher than BBB in first instance due to implicit guarantee of holdings.

Methods may involve looking at benefit (saving to financial services co) or to look at cost (to holdings co) in order to price the guarantee.

Part 4

Involved issue of guarantee fee and if it should be payable from Canada to US entity. Issues were around passive association (if being member of group lifted credit rating in itself)/implicit guarantee, determination of guarantee fee (methods, etc.)