THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

December 2020

MODULE 3.03 – TRANSFER PRICING OPTION

SUGGESTED SOLUTIONS

PART A

Question 1

Part 1

The associated transactions of the E-Scoot group (international related party dealings):

Related party purchases

E-Scoot Sub 1 (Country B) purchases three product types from E-Scoot Ltd (Country A).

E-Scoot Sub 2 (Country C) purchases three product types from E-Scoot Ltd (Country A).

Related party sales

E-Scoot Ltd (Country A) sells three product types to E-Scoot Sub 1 (Country B).

E-Scoot Ltd (Country A) sells three product types to E-Scoot Sub 2 (Country C).

Research and development

E-Scoot Sub 3 (Country D) performs research and development services for E-Scoot Ltd (Country A).

Intragroup services

E-Scoot Sub 3 (Country D) performs intra-group administrative services for E-Scoot Ltd (Country A).

Part 2

A functional analysis should identify the economically significant activities and responsibilities undertaken, assets used or contributed, and risks assumed by the parties to the transactions. Each entity should be characterised following identification of the functions, assets and risks of the entities (OECD Transfer Pricing Guidelines 2017, Chapter 1, D.1.2). Industry knowledge is another important element in understanding the business and global value chain.

Consideration should also be given to Section D.1. – Identifying the commercial or financial relations (CFRs). Some key points from paragraphs 1.33 to 1.41 include:

- Identify the CFRs between the associated enterprises and the conditions and economically relevant circumstances attaching to those relations in order that the relevant circumstances attaching to those relations in order that the controlled transaction is accurately delineated; and to compare those conditions with those of comparable transactions between independent enterprises.

- Requires understanding of the relevant industry.

- Consider options realistically available.

With reference to Section D.1.1 – The contractual terms of the transaction, contractual terms of the associated transactions would need to be examined and compared to the substance of the arrangement.

Functional interviews should be conducted with a broad range of personnel of the associated enterprises as part of a functional analysis, this includes personnel at not only the strategic but operational levels across various business divisions.

A review of relevant transfer pricing documentation should be conducted as part of a functional analysis (refer to the OECD Transfer Pricing Guidelines, Chapter V: Documentation), including taxpayer prepare transfer pricing documentation to demonstrate the arm's length nature of the associated transactions and the three-tiers of documentation available: master file, local file and country-by-country reports.

<u>E-Scoot Ltd</u>

Functions:

- Manufacturing
- Inventory management
- Demand planning
- Procurement (raw materials)
- Sales/marketing
- Distribution
- Strategy development
- Supplier selection

Assets:

- Intellectual property
- Plant & equipment
- Warehouses
- Staff

Risks:

- Market risk
- Manufacturing risk
- Financing risk
- Credit risk
- Inventory risk
- Capital investment risk
- Warranty risk

Characterisation: Fully-fledged manufacturer.

<u>E-Scoot Sub 1</u>

Functions:

- Sales/marketing
- Procurement
- Demand planning

Assets:

- Warehouse
- Staff

Risks:

- Market risk
- Warranty risk

Characterisation: Limited risk distributor with additional marketing intensity/local market strategy.

E-Scoot Sub 2

Functions:

- Sales/marketing
- Procurement
- Demand planning

Assets:

- Warehouse
- Staff

Risks:

- Market risk

Characterisation: Limited risk distributor.

E-Scoot Sub 3

Functions:

- Research and development
- Administrative services

Assets:

- Staff
- Office
- Plant and equipment

Risks:

- Research and development risk

Characterisation: Service / research and development provider.

Part 3

Reference is made to the OECD Transfer Pricing Guidelines (2017), Chapter II: Transfer Pricing Methods.

Part II of Chapter II of the OECD Transfer Pricing Guidelines (2017) lists the traditional transaction methods.

Comparable uncontrolled price method

The CUP method compares the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances.

Most direct and reliable way to apply the arm's length principle.

Requires the same or very similar functionality products.

Useful for commodities and financial transactions.

A CUP method could potentially be applied comparing:

- The prices paid between the sale of electric scooters by E-Scoot Ltd (Country A) to E-Scoot Sub 1 (Country B) and the sale of electric scooters by E-Scoot Ltd (Country A) to Scooter Blazer (Country B); and

- The prices paid between the sale of electric scooters by E-Scoot Ltd (Country A) to E-Scoot Sub 2 (Country C) and the sale of electric scooters by E-Scoot Ltd (Country A) to Scooter Blazer (Country B).

The second potential CUP may have a comparability issue with regard to the products being sold in a different market (Country B and C in terms of the related and independent transactions); potentially different economic circumstances.

Another potential comparability issue relates to the characteristics of the property (scooter differences when comparing the prices of the products).

Para 1.36 of the OECD Transfer Pricing Guidelines (2017) outlines the comparability factors as:

1. Contractual terms.

2. Functions, assets and risks.

3. Characteristics of property or services.

4. Economic circumstances.

5. Business strategies.

Regard need to be given to all of the comparability factors in applying a CUP analysis.

<u>Resale price method</u>

The resale price method begins with the price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise. This price (the resale price) is then reduced by an appropriate gross margin on this price (the resale price margin) representing the amount out of which the reseller would seek to cover its selling and other operating expenses and, in the light of the functions performed (taking into account assets used and risks assumed), make an appropriate profit. What is left after subtracting the gross margin can be regarded, after adjustment for other costs associated with the purchase of the product, as an arm’s length price for the original transfer of property between independent enterprises.

Most useful where it is applied to marketing operations.

The resale price margin of the reseller in the controlled transaction may be determined by reference to the resale price margin that the same reseller earns on items purchased and sold in comparable uncontrolled transactions (internal comparable).

The resale price method could potentially be applied as a final product is being purchased by an associated entity and on-sold to independent parties. This is the case for E-Scoot Ltd selling a final product to its associated entities (E-Scoot Sub 1 and 2) who are also selling to independent parties; as well as E-Scoot selling a final product to Scooter Blazer, who on-sells to independent parties.

The resale price margin of the reseller in the controlled transaction may be determined by reference to the resale price margin that the same reseller earns on items purchased and sold in comparable uncontrolled transactions (para 2.28 OECD TP Guidelines, 2007).

Again, the comparability factors would need to considered in the potential application of this method. The functions assets and risks in particular are important with this method (refer to para 2.32 of the OECD TP Guidelines, 2007). The existence of a warranty with E-Scoot Sub1 may cause comparability issues, however reliable adjustments may be made. In addition, the differences in business strategies need to be considered (e.g. E-Scoot Sub 1 with a locally tailored marketing strategy).

Cost plus method

The cost plus method begins with the costs incurred by the supplier of property (or services) in a controlled transaction for property transferred or services provided to an associated purchaser. An appropriate cost plus mark-up is then added to this cost, to make an appropriate profit in light of the functions performed and the market conditions. What is arrived at after adding the cost plus mark up to the above costs may be regarded as an arm's length price of the original controlled transaction.

Useful for semi-finished goods and provision of services.

The cost plus method would be potentially applicable to reimburse E-Scoot Sub 3 for the intra-group services it performs on behalf its associated entity (E-Scoot Ltd) as well as the research and development services being performed.

Consideration would need to be given to Chapter VII: Special Considerations for Intra-Group Services (OECD TP Guidelines, 2007), i.e. has a service in fact been rendered, is there low or higher value added service being performed, establish the cost base and establish an appropriate margin to mark-up on.

An appropriate set of comparable companies performing similar or the same services could be established utilising the comparability analysis guidelines in Chapter III of the OECD TP Guidelines, 2007.

Transactional profit methods

Transactional net margin method (TNMM)

The TNMM examines the net profit relative to an appropriate base (e.g. costs, sales, assets) that a taxpayer realises from a controlled transaction.

Less affected by transactional differences than a CUP.

Net profit indicators more tolerant to some functional differences between the controlled and uncontrolled transactions than gross profit margins.

A TNMM may be applied using E-Scoot Sub 1, 2 and 3 in separate analyses. They would be the tested party and compared against companies (applying the comparability analysis framework in Chapter III of the OECD TP Guidelines and the comparability factors). A appropriate PLI may then be applied, e.g. EBIT/Sales (profitability) with distribution/marketing/sales functions.

Transactional profit split method

Identifies the profits to be split for the associated enterprises from the controlled transactions in which the associated enterprises are engaged (the combined profits / losses). It then splits those combine profits between the associated enterprises on an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm's length.

Useful for highly integrated operations for which a one-sided method would not be appropriate.

Most appropriate where both parties to a transaction make unique valuable contributions (e.g. contribute unique intangibles) and wish to share their respective contributions.

Contribution analysis and residual analyses can be conducted.

A profit split would most likely not be applied in this situation given the associated enterprises do not own or develop intellectual property (intangibles), rather have a distribution, marketing or sales function. This would have to be tested, particularly the substance of E-Scoot Sub 3's research and development functions (contract R&D?) and the form versus substance.

Question 2

Part 1

A functional analysis should identify the economically significant activities and responsibilities undertaken, assets used or contributed, and risks assumed by the parties to the transactions.

Each entity should be characterised following identification of the functions, assets and risks of the entities (OECD Transfer Pricing Guidelines 2017, Chapter 1, D.1.2).

Consideration should also be given to Section D.1. – Identifying the commercial or financial relations (CFRs). Some key points from paragraphs 1.33 to 1.41 include:

- Identify the CFRs between the associated enterprises and the conditions and economically relevant circumstances attaching to those relations in order that the relevant circumstances attaching to those relations in order that the controlled transaction is accurately delineated; and to compare those conditions with those of comparable transactions between independent enterprises.

- Requires understanding of the relevant industry.

- Consider options realistically available.

With reference to Section D.1.1 – The contractual terms of the transaction, contractual terms of the associated transactions would need to be examined and compared to the substance of the arrangement.

Functional interviews should be conducted with a broad range of personnel of the associated enterprises as part of a functional analysis, this includes personnel at not only the strategic but operational levels across various business divisions. Interviews can be conducted with not only local personnel, but personnel offshore working for associated enterprises. Industry knowledge is another important element in understanding the business and global value chain.

A review of relevant transfer pricing documentation should be conducted as part of a functional analysis (refer to the OECD Transfer Pricing Guidelines, Chapter V: Documentation), including taxpayer prepare transfer pricing documentation to demonstrate the arm's length nature of the associated transactions and the three-tiers of documentation available: master file, local file and country-by-country reports. Functional interviews are an excellent opportunity to test the substance of the arrangement relative to the contractual arrangements and transfer pricing documentation presented to support the international related party dealings.

Light Speed Ltd (LS)

Functions:

- Exploration activities (mining – open cut and underground); the full extent of these activities would need to understood (through TP documentation and functional interviews). In addition, industry knowledge is critical for the mining industry given the complexity of it.
- Smelting and refining.
- Sales/marketing of commodities.
- Inventory management
- Demand planning
- Procurement (raw materials)
- Sales/marketing
- Distribution
- Strategy development
- Supplier selection

Assets:

- Intellectual property
- Plant & equipment (mining) – this would be significant
- Warehouses
- Staff

Risks:

- Market risk
- Manufacturing/mining risk
- Financing risk
- Credit risk
- Inventory risk
- Capital investment risk

Characterisation: Fully-fledged mining company (upstream through to downstream operations).

<u>LS Sub 1</u>

Functions:

- Sales/marketing
- Procurement
- Demand planning

Assets:

- Warehouse?
- Sales office
- Staff

Risks:

- Market risk
- Product risk depending on terms of contacts (when title passes, shipping, etc.)

Characterisation: Sales/marketing hub.

<u>LS Sub 2</u>

Functions:

- Sales/marketing
- Procurement
- Demand planning

Assets:

- Warehouse?
- Sales office
- Staff

Risks:

- Market risk
- Product risk depending on terms of contacts (when title passes, shipping, etc.)

Characterisation: Sales/marketing hub.

Delineating the associated dealings:

- Sales of commodities from LS (Country A) to LS Sub 1 (Country B) / purchase of commodities by LS Sub1 (Country B) from LS (Country A);
- Sales of commodities from LS (Country A) to LS Sub 2 (Country D) / purchase of commodities by LS Sub2 (Country D) from LS (Country A);
- Loan between LS and LS Sub 2 (LS Sub 2 borrows from LS); and
- Transfer of intellectual property between LS and LS Sub 2.

<u>Parts 2 and 3</u>

Reference is made to the OECD Transfer Pricing Guidelines (2017), Chapter II: Transfer Pricing Methods.

Part II of Chapter II of the OECD Transfer Pricing Guidelines (2017) lists the traditional transaction methods.

<u>Comparable uncontrolled price method</u>

The CUP method compares the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances.

Most direct and reliable way to apply the arm’s length principle.

Requires the same or very similar functionality products.

Useful for commodities and financial transactions.

An uncontrolled transaction is comparable to controlled transaction for the purposes of a CUP if a) None of the differences (if any) between the transactions being compared or between the enterprises undertaking those transactions could materially affect the price in the open market; or b) reasonably accurate adjustments can be made to eliminate the material effects of such differences. Where is possible to locate comparable uncontrolled transactions, the CUP method is the most direct and reliable way to apply the arm’s length principle.

A CUP method is particularly reliable where an independent enterprise sells the same product as is sold between two associated enterprises. However, it does require a high degree of comparability.

A CUP method could potentially be applied comparing:

- The prices paid between the sale of commodities by LS (Country A) to LS Sub 1 (Country B) and the sale of commodities by LS (Country A) to Corvex (Country C);
- The prices paid between the sale of commodities by LS (Country A) to LS Sub 2 (Country C) and the sale of electric scooters by E-Scoot Ltd (Country A) to Scooter Blazer (Country D); and
- The interest rate charged to LS Sub 2 on the loan and purpose/commerciality of the arrangement and benchmarking for what an independent party would charge, having regards to the contractual terms of the arrangement.

There may be a comparability issue with regard to the types of products being sold – different quality/grades of commodities being compared, volume traded (adjustment could potentially be made) and different markets (economic conditions). The contractual terms would also need to be examined closely for comparability.

Para 1.36 of the OECD Transfer Pricing Guidelines (2017) outlines the comparability factors as:

1. Contractual terms.

2. Functions, assets and risks.

3. Characteristics of property or services.

4. Economic circumstances.

5. Business strategies.

Regard need to be given to all of the comparability factors in applying a CUP analysis.

Resale price method

The resale price method begins with the price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise. This price (the resale price) is then reduced by an appropriate gross margin on this price (the resale price margin) representing the amount out of which the reseller would seek to cover its selling and other operating expenses and, in the light of the functions performed (taking into account assets used and risks assumed), make an appropriate profit. What is left after subtracting the gross margin can be regarded, after adjustment for other costs associated with the purchase of the product, as an arm's length price for the original transfer of property between independent enterprises.

Most useful where it is applied to marketing operations.

The resale price margin of the reseller in the controlled transaction may be determined by reference to the resale price margin that the same reseller earns on items purchased and sold in comparable uncontrolled transactions (internal comparable).

Resale price method is difficult to apply in terms of gaining gross margin data and also requires no alteration to the product resold.

The resale price method could potentially be applied as a final product is being purchased by an associated entity and on-sold to independent parties. This is the case for LS selling a final product (commodities) to its associated entities (LS Sub 1 and 2) who are also selling to independent parties; as well as E-Scoot selling a final product to Scooter Blazer, who on-sells to independent parties.

The resale price margin of the reseller in the controlled transaction may be determined by reference to the resale price margin that the same reseller earns on items purchased and sold in comparable uncontrolled transactions (para 2.28 OECD TP Guidelines, 2007).

Again, the comparability factors would need to considered in the potential application of this method. The functions assets and risks in particular are important with this method (refer to para 2.32 of the OECD TP Guidelines, 2007). When looking at the comparability factors, there may be a comparability issue with regard to the types of products being sold – different quality/grades of commodities being compared, volume traded (adjustment could potentially be made) and different markets (economic conditions). The contractual terms would also need to be examined closely for comparability.

A different form of resale margin may also be considered, for example, a margin (or percentage) taken from the LME price.

Cost plus method

The cost plus method begins with the costs incurred by the supplier of property (or services) in a controlled transaction for property transferred or services provided to an associated purchaser. An appropriate cost plus mark-up is then added to this cost, to make an appropriate profit in light of the functions performed and the market conditions. What is arrived at after adding the cost plus mark up to the above costs may be regarded as an arm's length price of the original controlled transaction.

Useful for semi-finished goods and provision of services.

The cost plus method would be potentially applicable to reimburse LS Sub 1 and LS Sub 2 for marketing and sales functions performed.

Consideration would need to be given to Chapter VII: Special Considerations for Intra-Group Services (OECD TP Guidelines, 2007), i.e. has a service in fact been rendered, is there low or higher value added service being performed, establish the cost base and establish an appropriate margin to mark-up on. A mark-up on the costs of the salaries of the personnel performing the sales/marketing functions may be appropriate.

An appropriate set of comparable companies performing similar or the same services could be established utilising the comparability analysis guidelines in Chapter III of the OECD TP Guidelines, 2007.

<u>Transactional profit methods</u>

<u>Transactional net margin method (TNMM)</u>

The TNMM examines the net profit relative to an appropriate base (e.g. costs, sales, assets) that a taxpayer realises from a controlled transaction.

Less affected by transactional differences than a CUP.

Net profit indicators more tolerant to some functional differences between the controlled and uncontrolled transactions than gross profit margins.

A strength in includes that the net profit indicators are less affected by transactional differences than is the case with price, as used by the CUP method. Also, net profit indicators may be more tolerant to some functional differences between the controlled and uncontrolled transactions than gross profit margins.

As with any one-sided method, it is necessary to examine a financial indicator for only one the associated enterprises (the tested party) which is a benefit when one of the entities to the transaction are complex and has many interrelated activities or lack of information.

Weaknesses include being influenced by some factors that would either not have an effect, or have a less substantial or dire t effect, on price or gross margins between independent parties.

Also requires information on uncontrolled transactions that may not be available at the time of the controlled transactions as well as may not having enough specific information on profits attributable to controlled transactions including operating expenses.

Net profit indicators may also be affected by forces operating in the industry.

A TNMM may be applied using LS Sub 1, 2 and 3 in separate analyses. They would be the tested party and compared against companies (applying the comparability analysis framework in Chapter III of the OECD TP Guidelines and the comparability factors). A appropriate PLI may then be applied, e.g. EBIT/Sales (profitability) with distribution/marketing/sales functions. A return on sales (of the commodities) may be considered.

<u>Transactional profit split method</u>

Identifies the profits to be split for the associated enterprises from the controlled transactions in which the associated enterprises are engaged (the combined profits / losses). It then splits those combine profits between the associated enterprises on an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm's length.

Contribution analysis and residual analyses can be conducted.

A main strength is that it can offer a solution for highly integrated operations for which a one-sided method would not be appropriate.

Also, when both parties may be found to make valuable contributions to the transaction and therefore a two-sided method is more appropriate. If this is not the case, then it would not be appropriate. Less likely that either party to the controlled transaction will be left with an extreme or improbable profit result.

A weakness is in the application in terms of accessing information for offshore affiliates and to identify the operating expenses to allocate.

A profit split would most likely not be applied in this situation given the associated enterprises do not own or develop intellectual property (intangibles); owned by LS, rather have a distribution/marketing/sales function. Having said that, this would have to be tested, particularly the substance of LS Sub 2's intellectual property function (creation?) post transfer of IP, and the form versus substance. This will be discussed in part 4 below.

<u>Part 4</u>

The most significant additional transfer pricing issue in this case is that of a restructure; that is, the transfer of intellectual property from LS to LS Sub 2.

Reference is made to the OECD Transfer Pricing Guidelines (2017), Chapter IX: Transfer Pricing Aspects of Business Restructures and some key points are as follows.

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?
- Is the transfer of intellectual property at arm's length from LS to LS Sub 2?
- Valuation issue in relation to the arm's length compensation for transfer of intellectual property.
- Buy-out payments?
- Arm's length nature of any potential royalties paid by LS to LS Sub 2.
- Loss of profit making potential.
- 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?
- 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.

In addition to the above potential transfer pricing issues/considerations, implications in relation to the OECD Transfer Pricing Guidelines, Chapter VI: Special Considerations for Intangibles, noting some key points:

- Arm's-length pricing should be based on accurately delineated transactions.

- Analysis of the contractual relations together with evidence of the actual conduct of the parties, including control over risks.

- Where economically relevant characteristics of a transaction are inconsistent with contractual terms, the actual transactions should in general be identified based on the actual conduct of the parties.

- The legal form of the transaction relative to the economic reality of the transaction.

- As part of the business structure and functional analysis of the LS Group, the transfer of intellectual of property must be examined. In this regard, the legal and economic ownership requires consideration for the transaction between LS and LS Sub 2 within the group. This has implications for a potential royalty being paid also and the beneficial owner of the intellectual property.

- Ownership of intangibles and transaction involving the development, enhancement, maintenance, protection and exploitation of intangibles.

- An examination of operating profit allocation to the entities within the LS group to the economic activities generating them.

The substance of the financing arrangement also needs to be examined in terms of the commerciality of the overall arrangement. For example, need to understand why LS Sub 2 would require significant working capital relative to its characterisation and function of marketing/sales.

The 'marketing hub' arrangement put in place, particularly in relation to LS Sub 2 being established with transfer of IP involved requires a detailed interrogation into the substance of the arrangement in the context of the LS Group. The existence of only 30 employees in LS Sub 2 as an IP holder relative to the Head company, LS needs to be rationalised from a transfer pricing perspective having regard to the comments above and guidance on business restructurings and intellectual property.

PART B

Question 3

Part 1

Chapter VII of the July 2017 OECD TPG provides guidance in relation to intra-group services. Key points that candidates should discuss include:

- Based on the facts provided, Virtual owns all of the groups valuable intellectual property and performs a number of key services for members of the group.
- There is a need to consider if services are actually provided by Virtual for other members of the MNE group.
- If services are provided, there is a requirement to establish the arm's length price for the services.
- Based on the facts, it is assumed that there are no cost contribution arrangements in place.
- There may be instances where enterprises acquire services from an independent enterprise or from an associated enterprise. If so, this is an indication that there is valuable in an associate paying for the services.
- There are likely to be commercial reasons as to why an MNE group may centralise services due to being more cost effective or administratively easier for an associated entity to provide services.
- Paragraph 7.3 highlights that intra-group arrangements for providing services can be liked to arrangements for transferring goods or intangibles. Due to the possible linkages, it may be necessary to consider Chapter III where there may be a mixed transfer of services and property.
- There is a requirement to consider the facts and circumstances and the arrangements within the Virtual group.
- Based on the facts provided, it is apparent that Virtual groups parent provides a range of services to subsidiaries as it has a centralised business model.
- Subsidiaries will be considered associates in this case as they are wholly owned.

Determining whether intra-group services have been rendered (B.1):

- Consistent with paragraphs 76-78, there is a need to consider whether each of the services provided have economic or commercial value.
- This includes whether an independent enterprise in comparable circumstances would have been willing to pay for the activity. If an independent enterprise could have been willing to pay for the service or perform the activity for itself, the activity or service should be considered under the arm's length principle.
- There is a need to have regard to the facts and circumstances which have not been provided in sufficient detail to make an informed decision, therefore some candidates may make appropriate assumptions.
- In relation to centralised services (B.1.5) as in the case of Virtual group, services may be made available to group members. The examples referenced in paragraph 7.14 are similar to those provided in the facts. These services will generally be considered intra-

group services s they are the type that independent enterprises will be willing to pay for or would have to engage a third party to undertake.

<u>Part 2</u>

Based on the facts of Virtual, further information would need to be sought including the possibility of conducting functional interviews and requesting additional clarification.

The services must actually be provided by Virtual to the subsidiaries in order to be charged.

Shareholder activities (B1.2) may be provided to associates even though group members do not need the activity. Such activities are usually performed because of its ownership interest in another group member. Such activity would not be considered an intra-group services and would not justify a charge to other group members. Examples of shareholder activities are outlined at paragraph 7.10 which candidates are expected to discuss.

B.1.3 addresses duplication. In general, intra-group services should not be charged to group members where the same activity is being undertaken by the entity itself or by a third party.

B.1.4 covers instances where an intra-group service is performed by a group member for the benefit of another group member but incidentally provides benefits to other group members. The TPG provide examples including for example, reorganisation and terminating a division. In such cases, economic benefits may arise for other group members not directly involved in the potential decision.

In relation to Research & Development undertaken by Virtual, it is unlikely that these costs should be charged to subsidiaries on the basis that Virtual retains ownership of valuable intellectual property.

<u>Part 3</u>

As it has been determined that the majority of the services have actually been provided to associated enterprises of Virtual, consideration needs to be given to the amount of the charge and if this is in accordance with the arm's length principle. Refer to B.2.1.

In some instances, the arrangements for charging of intra-group services can be readily identified. Such cases where the group uses direct-charge method are covered in B2.2.1 and may be where services similar to those rendered to associated enterprises are also rendered to independent enterprises. The MNE should have the ability to demonstrate the separate basis of the charge such as recording work done or fee basis. The direct charge may be difficult to apply in practice.

Another approach is to allocate and apportion as explained by B2.2.2 as an indirect-charge method. However, regard must be given to the value of the services to the recipients and the extent to which comparable services are provided between independent enterprises. For example, an allocation key may be developed.

The method to be used to determine arm's length transfer pricing for intra-group services should be determined according to Chapters I, II and III of the TPG. In most cases, this will lead to the CUP or a cost based method (including cost plus or cost based TNMM).

Section D covers low value services which are of a supportive nature, are not considered to be part of the MNE's core business, do not require the use of unique and valuable intangibles and do not involve the assumption or control of significant risk by the service provider. Paragraph 7.47 sets out activities which do not qualify for the simplified approach. Further, paragraph 7.45 provides examples which are likely to meet the definition of a low value service including a number which are of the type undertaken by Virtual.

Consistent with section 2.4 (paragraph 7.61), the arm's length charge for low value-adding intra-group services shall apply a profit mark-up to all costs in the pool with the exception of pass through costs (refer to paragraphs 2.99 and 7.34). The mark-up should be 5% of the relevant costs, determined consistent with section D.2.2. No benchmarking is required to be undertaken in support of the 5% markup.

Section D.3 addresses the documentation requirements for MNE's electing to apply the simplified methodology to low-value intra-group services.

Question 4

Part 1

BathCo should apply the arm's length principle in relation to transactions between group members which are considered associates.

Chapter II of the 2017 OECD Transfer Pricing Guidelines stipulate that the suitable transfer pricing methodology should be chosen based on the specific facts and circumstances. As limited factual information is provided, candidates are not expected to provide a detailed analysis regarding the method.

Consistent with Chapter III of the OECD Guidelines, a comparability analysis should be performed.

BathCo should prepare and retain appropriate transfer pricing documentation based on the domestic requirements of Plutonia and other jurisdictions it conducts business operations.

Depending on the materiality of sales of BathCo, there may be a requirement to prepare country-by-country documentation (including master file and local files). Refer to Chapter V of OECD Guidelines

To minimise their risk and to increase certainty regarding treatment by tax administrations, BathCo may consider entering into an advanced pricing arrangement (APA) with the tax administrations it jurisdictions in which it has operations.

Plutonia

Intellectual property:

- The entity that operates in this jurisdiction owns valuable intellectual property, including trade names, patents and know how.

Business Restructure:

- BathCo is considering undertaking a business restructure with the termination of manufacturing and research and development in Plutonia and incurring significant redundancy costs.
- Consideration needs to be given as to whether Plutonia is compensated by Martia.
- Chapter IX addresses the transfer pricing aspects of a business restructure.
- There is a requirement to understand the reasons for the restructure and the expected benefits, including other options available.
- Martia may be classified as a contract manufacturer for Plutonia as we understand that the materials for manufacture are provided.
- It is assumed that Plutonia retains the valuable intellectual property.
- Refer to Chapter VI regarding the identification and transactions involving the use of intangibles.

- Based on the information provided, the forecast 20% operating margin of Martia may not be arm's length if the functions it undertakes are manufacturing and contract research and development on behalf of Plutonia.

- Plutonia is forecast to make an operating margin of 5%, but it continues to retain key assets including intellectual property and be the entrepreneur for the group with key management and undertaking key functions or activities for the group. The margin may not be arm's length and the entity may not be rewarded appropriately for the intellectual property that associated enterprises within the group utilises based on the higher profit margin of Plutonia.

- Based on the operating margins provided, Plutonia may be at risk of compliance activity including audit or examination by the tax administration due to the 5% operating margin when an associated entity earns a substantially higher margin without owning any valuable assets or undertaking key functions and possibly risks.

Services:

- Plutonia continues to undertake a significant number of key functions and services for the group, excluding Research & Development which will be undertaken by Martia.

- If associated enterprises are provided with services, consideration should be given to whether they receive a benefit and if so, determine an arm's length price.

- The method to be used to determine arm's length transfer pricing for intra-group services should be determined according to Chapters I, II and III of the TPG.

- Section D of Chapter VII covers low value services which are of a supportive nature, are not part of the MNE's core business, do not require the use of unique and valuable intangibles and do not involve the assumption or control of significant risk by the service provider.

- The mark-up should be 5% of the relevant costs, determined consistent with section D.2.2. No benchmarking is required to be undertaken in support of the 5% markup.

Finance:

- The facts advise that Plutonia borrows funds (assumed from an independent party at market rates) and loan to Martia interest free.

- Parties dealing at arm's length would not usually provide a loan for a five-year period with no interest payable.

- An arm's length amount of interest should be applied to the balance of the loan. If Plutonia borrows these funds from an independent party, this may be a reference point for an interest rate.

<u>Neptunia</u>

This entity targets an operating margin of 3%.

Depending on the facts and circumstances, a margin of 3% may not be arm's length for the functions, assets and risks.

Consideration should be given to whether the jurisdiction has safe harbours which can be applied in support of the 3% operating margin (refer to E. Of Chapter IV on administrative approaches).

Part 2

Plutonia

It should be noted that the commercial and financial relations should be identified between associated enterprises and the conditions and economically functional circumstances considered. Refer to Chapter 1, D.1

A functional analysis should also be undertaken in order to delineate the controlled transaction and determine comparability between controlled and uncontrolled transactions.

Based on the facts, likely to be an entrepreneur as owner of the groups intellectual property, undertaking key group management functions and overseeing manufacturing operations. Also likely to have a head office function with the provision high value functions and services and managing risk.

Neptunia

Wholesale distributor of products to independent parties.

Martia

Possibly a contract or toll manufacturer (limited risk) for an associated enterprise (Plutonia).

Service provider (limited risk) in regards to research and development possibly under the control of Plutonia.

PART C

Question 5

This example of a solution will focus on the Chevron Australia case.

The relevant borrower was Chevron Australia Holdings Pty Ltd – "CAHPL" (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:

1. the Borrower borrowed the AUD equivalent of US $2.5 billion;
2. interest would be paid at 1-month AUD LIBOR + 4.14% p.a.;
3. the loan was repayable in full after 5 years, but could be repaid earlier at the Borrower's option;
4. the loan was not subject to financial covenants; and
5. no guarantee or security was provided by the Borrower.

The Commissioner of Taxation disallowed deductions for interest paid under the Credit Facility Agreement in the 2004 to 2008 period. In doing so, the Commissioner relied, depending on the relevant income year, upon the transfer pricing provisions in Division 13 of the Tax Act 1936 and in Division 815-A of the Tax Act 1997, 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 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.

The underlying issue in the Chevron case is how one should construct the hypothetical transaction between independent parties for the purposes of applying the transfer pricing provisions. The potential tax adjustments that may arise under the transfer pricing provisions will be affected by the features that are to be taken into account in constructing the hypothetical. In the Chevron case, one of the key issues was whether the features of the hypothetical transaction should include the provision of security or other covenants in favour of the lender.

As is clear from the decision of Justice Robertson, where the hypothetical loan between an independent borrower and lender is to include security provided in favour of the lender to secure repayment of the loan, then the inclusion of this feature can affect the conclusion as to the arm's length interest rate for the purposes of applying the transfer pricing rules.

As the statutory tests under Division 13 of the Tax Act 1936 and Division 815-A of the Tax Act 1997 are different, it is necessary to address the question of the hypothetical separately.

Division 13 focuses on the property acquired and consideration provided under the arrangement that is under investigation.

The question at issue was whether the consideration actually provided by CAHPL (i.e. the interest rate and nothing else) exceeded the arm's length consideration for that property. This task required one to assess what the consideration would be under a hypothetical transaction between independent parties dealing at arm's length.

On 21 April 2017, the Full Court of the Federal Court of Australia (full federal court) handed down its decision in Chevron Australia Holdings Pty Ltd v. Commissioner of Taxation [2017] FCAFC 62 dismissing the taxpayer's appeal from the lower court decision on 23 October 2015, addressing the arm's-length amount of the interest payable by Chevron Australia Holdings Pty Ltd (CAHPL) with its US subsidiary, ChevronTexaco Funding Corporation (CFC).

The full federal court unanimously upheld the ruling that the loan was not a genuine "arm's-length" transaction and the taxpayer had breached transfer pricing provisions of tax legislation. In dealing first with the Division 13 rule, Pagone J (with whom Allsop CJ agreed and whose reasons were adopted by Perram J) stated (at paras 124, 132, 133):

… The evidence found by his Honour was that the borrowing by CAHPL would not have been sustainable if obtained from an independent party. … As a standalone company, severed from the financial strength of its ultimate parent and corporate group, CAHPL could not secure a loan for an amount equivalent to $US2.5 billion at the rate obtained by its subsidiary with the backing of the ultimate parent.

The evidence...amply supported...the reasonable expectation of a borrowing by CAHPL being supported by security. …

An alternative submission made by CAHPL, however, does have some force. The alternative submission was that the hypothetical acquisition would need to assume that CAHPL had paid a fee to its parent for the provision of security on the hypothetical loan.

Turning to the Division 815 rule and, thus, Art. 9 of the Australia-U.S. Treaty, he stated (at para. 156):

His Honour was correct to assume...that what might be expected to operate between independent enterprises dealing wholly independently with each other was a loan by [sic] CAHPL with security provided by its parent at a lower interest rate.

In the (essentially) concurring reasons of Allsop CJ, he stated (at paras. 92-95):

92 The conditions operating between CAHPL and CFC if they were independent of each other would not include the direction by Chevron Treasury of the officers of both for the benefit of the group as a whole. The conditions between mutually independent CFC and CAHPL could, however, include CAHPL situated within the Chevron group and CAHPL being subject to the direction of Chevron for the benefit of the Chevron group.

93 In such circumstances, were CAHPL seeking to borrow for five years on an unsecured basis with no financial or operational covenants from an independent lender, in order to act rationally and commercially and conformably with the interests of the Chevron group to obtain external funding at the lowest possible cost consistently with any relevant operational considerations, it would do so with Chevron providing a parent company guarantee, if such were available.

94 In the light of the evidence as to Chevron's policy concerning external funding and its willingness to provide a guarantee to achieve that end the above is the natural and commercially

rational comparative analysis when one removes the controlled conditions operating between CAHPL and CFC and replaces them with the condition of mutual independence.

95 In the circumstances there would have been a borrowing cost conformable with Chevron's AA rating, which, on the evidence, would have been significantly below 9%.

The implications of this decision include the following:

- The Full Federal Court has now made it very clear that an Australian subsidiary of a multinational group is not to be treated as if it were an 'orphan' when undertaking transfer pricing arm's length calculations. In fact, some level of parental support may need to be assumed to exist depending on the facts/situation.

- If a borrower is part of a group that has a policy to borrow externally at the lowest cost and that has a policy that the parent will generally provide a third party guarantee for a subsidiary that is borrowing externally, then in the case of related party debt, the interest rate payable by an Australian subsidiary should probably be set at a level that assumes a parent company guarantee has been given.

- As a result, the appropriate interest rate on internal debt will likely be closer to the parent's global cost of funds for the relevant currency.

- It remains to be seen whether pretending that the debt was raised with the benefit of a guarantee given by the parent carries the further implication that the borrower can also pretend it paid a fee for the benefit of that fictitious guarantee.

Question 6

Part 1

Reference is made to the OECD Transfer Pricing Guidelines (2017) at section B – Statement of the arm's length principle (ALP).

Section B.1 has regard to Article 9 of the OECD Model Tax Convention as the authoritative statement of the ALP.

ALP has been adopted by OECD member countries and other countries mainly as it provides broad parity of tax treatment for members of MNE groups and independent enterprises, putting associated and independent enterprises on a more equal tax footing, and avoiding the creation of tax advantages or disadvantages as well as removing tax considerations from economic decisions; this promotes growth in international trade and investment.

Paragraph 1.9 – ALP works effectively in a vast majority of cases – examples are provided and reference is made in relation to dealing with more difficult cases including the use of transactional profit split method in Chapter II, Part III.

Paragraph 1.13 highlights the difficulty from a tax administration and taxpayer perspective in documenting the ALP but also notes the importance of finding a reasonable estimate of an arm's length outcome based on reliable information using judgement.

Reference is made to section B.2 – Maintaining ALP as the international consensus.

Paragraph 1.14 states that the view of OECD member countries continues to be that ALP should govern the evaluation of transfer prices among associated enterprises. Further, ALP is sound in theory since it provides the closest approximation of the working of the open market having regard to the economic realities of the taxpayer's particular facts and circumstances.

Paragraph 1.15 notes that an absence of the use of ALP would substantially increase the risk of double taxation. In addition, no legitimate or realistic alternative to ALP has emerged.

Part 2

Reference is made to the OECD Transfer Pricing Guidelines (2017) at Section C – A non-arm's-length approach: global formulary apportionment (GFA).

Paragraph 1.16 states that GFA is sometimes suggested as an alternative to ALP as a means of determining the proper level of profits across national taxing jurisdictions.

Paragraph 1.17 notes that GFA would allocate the global profits of an MNE group on a consolidated basis among the associated enterprises in different countries on the basis of a predetermined and mechanistic formula with three essential components:

1. Determining the unit to be taxed;
2. Accurately determining the global profits; and
3. Establishing the formula to be used to allocate the global profits of the unit (e.g. costs, assets, payroll and sales combination).

Paragraph 1.18 contrasts GFA with transactional profit methods.

Paragraph C.2 compares GFA with ALP.

Paragraph 1.19 notes that GFA advocates assert that it is more in keeping with economic reality and that the separate accounting method is inappropriate for highly integrated grounds having regard to contribution to the overall group profit.

Paragraph 1.20 notes that GFA advocates contend that it reduces compliance costs for taxpayers.

Para 1.21 states that OECD member countries do not accept GFA as a realistic alternative to the ALP and paragraphs 1.22 to 1.31 list a number of reasons for this, including:

- Difficulty of implementation in a manner that protects against double taxation and ensures single taxation; time-consuming and extremely difficult.
- Disagreements in relation to each country wanting to include different factors in the formal having regard to activities in each jurisdiction.
- Present enormous political and administrative complexity; an unrealistic level of international cooperation for international taxation.
- Predetermined formulae are arbitrary and disregard market conditions, particular circumstances of the individual enterprises and management's own allocation of resources.
- Exchange rate movements complications.
- Compliance costs and data requirements.
- Difficulties in determining the sales of each member and in the valuation of assets.
- Cannot recognise practically, the import geographical differences, separate company efficiencies, and other specific factors within a group in relation to profit determination.
- Withholding taxes relevance by disregarding intra-group transactions.
- Potential non-inclusion transactions outside the group.

Section C.3, at paragraph 1.32 reiterates the position of OECD member countries in support of the ALP and rejection of GFA.

<u>Part 3</u>

Reference is made to the OECD Transfer Pricing Guidelines (2017) at Section D.3 – Losses.

Section 1.129 notes that the existence of consistent losses for an associated enterprise relative to a profitable position for the MNE group as a whole being a trigger for increased scrutiny of transfer pricing issues.

Section 1.130 suggests that the entity within the MNE group incurring losses could be selling loss making products and not receiving an appropriate service charge, having regard to the ALP.

Section 1.131 suggests the consideration of business strategies. For example, loss making as a result of a market penetration strategy. For example, a producer lowering prices of goods to increase sales and establish market position relative to competitors in the short run. This would not be expected to be continued for a prolonged period of time with the expectation of future/longer term profit generation.

Losses within entities of an MNE group, particularly for an entity that is characterised as a low risk distributor, would not be consistent with that of an independent enterprise of the same characterisation. The functions, assets and risks of that entity would therefore not be expected to produce less than a profitable position. An independent enterprise in a consistent loss position would cease to undertake business on such terms as it is not commercially realistic.

Question 7

Part 1

Although not specifically requested to be provided in the question, better candidates will address the definition and provide a general explanation of an advance pricing arrangement (APA), including the benefits.

An APA is defined in the OECD Guidelines as “an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g. method, comparables and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing of those transactions over a fixed period of time.” An APA may be unilateral involving one tax administration and a taxpayer or multilateral involving the agreement of two or more tax administrations.

An APA programme can assist taxpayers by eliminating uncertainty through enhancing the predictability of tax treatment in international transactions.

Part F of Chapter IV of the OECD guidelines cover APA’s. There are benefits and disadvantages (F.3 of OECD Guidelines) of entering into an APA and the different types of APA’s.

The types of APA’s outlined in Part F of Chapter IV of the OECD Guidelines are:

- Unilateral;
- Bilateral; and
- Multilateral

A bilateral or multilateral APA substantially reduce or eliminate the possibility of juridical or economic double or non-taxation since all the relevant countries participate. A unilateral APA does not provide certainty in the reduction of double taxation as tax administrations affected by the transactions covered by the APA may consider that the methodology adopted does not give a result consistent with the arm’s length principle (4.156 of OECD Guidelines).

Unilateral APA’s may present problems for tax administrations and taxpayers. A tax administration from the other side of the controlled transaction may disagree with the conclusion reached by the tax administration which agreed to the unilateral APA. Therefore, this may not lead to an increased level of certainly for the taxpayer.

Whether an MNE enters into an APA and the type of APA will depend on a number of practical considerations, for example:

- Whether the tax administrations have an APA programme;
- Whether jurisdictions in which the MNE operates have tax treaties with other countries
- Whether safe harbours apply in jurisdictions in which the MNE operates;
- The level of risk appetite of the MNE;
- The materiality and complexity of controlled transactions;
- The resources and funds available to the MNE;

- The likely position of other tax administrations in which the MNE operates (whether there has previously been transfer pricing adjustments or litigation); and
- Whether the MNE has previously had an APA.

In this case, it is only possible for the head office to enter into a unilateral APA with Zeus as there is no treaty between the jurisdictions. There is a requirement to have a treaty between jurisdictions to enter into a multilateral or bilateral APA. However, a unilateral APA can be entered into between one jurisdiction and one entity.

In relation to the transactions between the parent entity and Apollo, it is possible to enter into a bilateral or unilateral APA. Paragraph 4.173 confirms that where possible, an APA should be concluded on a bilateral or multilateral basis. A bilateral APA subjects MNEs to less risk of audit and penalties.

<u>Part 2</u>

The OECD Model Agreement defines a simultaneous tax examination as an “arrangement between two or more parties to examine simultaneously and independently, each on its owns territory, the tax affairs of (a) taxpayer(s) in which they have a common or related interest with a view to exchanging any relevant information which they so obtain”.

Paragraph 4.79 confirms that a simultaneous tax examination is a form of mutual assistance, used in a range of International issues such as transfer pricing. It enables two or more countries to cooperate in a tax investigation, review or audit.

Due to the sharing of appropriate information between tax administrations and the engagement between, they should result in a timelier resolution. They should reduce the instances of economic double taxation as an outcome between tax administrations is reached in the audit which results in minimising double taxation for the MNE group (between jurisdictions participating in the examination).

Article 26 of the OECD Model Tax Convention provides the legal basis for concluding such examinations and require the involvement of competent authorities of participating jurisdictions. If an examination is undertaken at an early stage, this may limit obstacles including time limitations for margin adjustments. The early exchange of foreseeably relevant information will aid this issue. Further, a case plan should be closely followed to ensure that timeframes are adhered to including frequent meetings with taxpayers to clarify factual information.

Tax administrations generally gain a better understanding and insight into the MNEs activities. They may also assist in determining taxpayer behaviour, practices and trends within an industry.

The process should help tax administrations establish pertinent facts faster and. This should assist in identifying potential risks or disputes at an earlier stage, minimising the potential for litigation.

Tax administrations participating may reach an agreement on the transfer pricing conditions of transactions between associated enterprises. This may result in adjustments betting made at an earlier stage, avoiding double taxation and drawn out processes. It should provide certainty at an earlier stage for the MNE.

The process may also benefit MNEs from saving of resources and time due to the co-ordination of examinations between several tax administrations.

Part 3

If the Apollo tax administration made transfer pricing adjustments to transactions between Apollo and the head office, the MNE is likely to be subject to double taxation.

The MNE can initiate a mutual agreement procedure (MAP) under Article 25 of the treaty if they are of the view that there has been "taxation not in accordance with the provisions of the Convention". The tax officials of the respective jurisdictions, called competent authorities will seek to resolve the matter which may have resulted from one tax administration undertaking an audit or investigation. However, there must be a treaty between the countries.

Members of the Inclusive Framework of BEPS agreed to implement the minimum standard in relation to resolution of treaty related disputes. This includes MAP cases being resolved in a timely manner and processes are implemented to promote the prevention and timely resolution of treaty related disputes.

A number of countries where they are unable to reach agreement under MAP have adopted mandatory binding arbitration.

Paragraph 5 of Article 25 of the OECD Model Tax Convention provides tax administrations who do not resolve a MAP within two years from the initiation of the case can request the case be resolved through arbitration. The decision of arbitration must be accepted by the tax administrations and reflected in the mutual agreement decision.

Question 8

Part 1

Article 5 of the OECD Model Convention with Respect to Taxes on Income and on Capital (Model Convention) defines Permanent Establishment (PE) as "a fixed place of business through which the business of an enterprise is wholly or partially carried on.

It specifically includes:

- A place of management;
- A branch;
- An office;
- A factory;
- A workshop;
- A mine, oil or gas well, quarry or other place of extraction of natural resources; and
- A building suite or a constructional or installation project if the period exceeds 12 months.

According to Article 7 of the Model Convention, business profits are only taxable if business is carried out through a PE in the other contracting state/jurisdiction. Under transfer pricing rules, profit must be attributed to the PE as if it were a separate and independent enterprise. Therefore, the arm's length principle should apply taking into account the functions performed, assets used and risks assumed.

The OECD's BEPS Action Item 7 published a report on "Preventing the Artificial Avoidance of Permanent Establishment Status". The report recommended changes to the definition of PE in Article 5 of the OECD Model Convention. The report also mandated the development of additional guidance on how the existing rules on attribution of profits under Article 7 would apply to a PE taking into account Actions 8-10. This sets out high level general principles to attribute profits and provides examples on the attribution of profits to certain types of permanent establishments.

Part 2

Chapter IV, Part E of the OECD Guidelines addresses safe harbours.

It is acknowledged that the arm's principle can be a resource intensive process. It imposes significant administration burden on multinational enterprises (MNEs) and tax administrations through complex rules and compliance burden.

Safe harbour rules have been adopted by some tax administrations and have been applied by small taxpayers and for less complex transactions. They can be beneficial for MNE's and tax administrations alike for low risk transfer pricing risks and when adopted on a multilateral or bilateral basis.

Safe harbours can also benefit tax administrations by not allocating scarce resources to low risk, small taxpayers or less complex transactions.

Candidates with more comprehensive responses should explain the benefits and concerns over safe harbours.

The main benefits of safe harbours are:

- Simplifying compliance and reducing compliance costs for eligible taxpayers.
- Providing certainty to eligible taxpayers that the price charged or paid on qualifying controlled transactions will be accepted by tax administrations will be accepted by the tax administration.
- Permit tax administrations to redirect their resources to more complex or higher risk transactions.

If the multinational is able to rely upon safe harbours in some jurisdictions, this may result in not having to prepare significant documentation (Chapter V of OECD Guidelines) including for example functional analysis, selection of the most appropriate transfer pricing method and comparability analysis. However, this will depend on the local documentation requirements. Therefore, the multinational may save significant resources and financial cost.

Question 9

Part 1

A contribution arrangement (CCA) is defined in Chapter VIII of the OECD Guidelines as a contractual arrangement among business enterprises to share the contributions and risks involved in the joint development, production or the obtaining of intangibles, trade assets or services with the understanding that such intangibles, tangible assets or services are expected to create benefits for the individual businesses of each of the participants.

A CCA does not necessarily require the participants of the arrangement to combine their operations in order to exploit the outcome from the CCA or to share the profits or revenue. However, participants exploit their interest in the outcomes of the CCA through their individual businesses. The transfer pricing issue focuses on the commercial or financial relations between the CCA participants and their contributions made.

A key feature of a CCA is the sharing of contributions. Consistent with the arm's length principle, at the time of entering into a CCA, each participant's proportionate share of the overall contribution to a CCA must be consistent with its proportionate share of the overall expected benefits under the arrangement. In order to consider this, the value of each participant's contribution to the arrangement should be considered.

Practically, a party may contribute pre-existing assets such as intellectual property or tangible assets. The value of the contribution should be consistent with the value that an independent party in comparable circumstances would attribute. Alternatively, performance of services may take the form of development activities including R&D and marketing activities.

A balancing payment may be required if one party's contribution is not consistent with the arm's length principle or is not equivalent to the respective proportionate contribution of the CCA parties.

Any change in the membership will necessitate a reassessment of the proportionate share of the participants' contributions and expected benefits. For example, if a new party is wishing to participate they may have to make a 'buy-in payment' determined with reference to the value of the interest they are acquiring in the CCA. Similarly, if a party exits a CCA and disposes their interest, they are likely to be entitled to compensation usually in the form of cash as a "buy-out payment". This may require an independent valuable to support the application of the arm's length principle.

Part 2

The OECD's BEPS Action 13 report addressed Transfer Pricing Documentation and Country-by-Country Reporting. It provided a template for MNEs to report annually for each jurisdiction they undertake business in the form of a Country-by-Country (CbC) Report.

Broadly, jurisdictions which implemented CbC require MNE groups to file their CbC Report in the jurisdiction of residence of the parent entity. This comprises a master file, local file and CbC Report.

The master file provides an overview of the MNE group business including for example global operations, transfer pricing policies and global allocation of income and economic activity. The file should provide a high level overview of the transfer pricing policies in a global economic, legal, financial and tax context. The document should include the groups organisational structure, a description of the MNE's business, the MNE's intangibles, MNE's inter-company financial activity and the financial and tax position, a list of important agreements, intangibles and transactions. This file should assist tax administrations in evaluating the presence of significant transfer pricing risk.

The local file provides more detailed information relating to intercompany transactions affecting the local jurisdiction. It should contain relevant transfer pricing documentation including functional analysis, selection of most appropriate method, comparability analysis and other documents in support of arm's length pricing.

The CbC report includes a summary of financial and other relevant information of aggregate tax jurisdiction wide relating to the global allocation of income, taxes paid and location of economic activities in jurisdictions in which the MNE operates. This information should be useful for a high level transfer pricing analysis and assessment of other BEPS related risks.

It should be noted that a tax administration should not undertake an examination or audit solely based on the information in CbC package of documentation. In summary, the documentation should assist tax administrations on a risk assessment basis and provide information which may not have been automatically filed with tax administrations.