



Chartered
Institute of
Taxation
Excellence in Taxation

THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

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PAPER IIIF – TRANSFER PRICING OPTION

PRINCIPLES OF CORPORATE AND INTERNATIONAL TAXATION

SUGGESTED SOLUTIONS

QUESTION 1

Question 1

Functional analysis (FA) is one of the five OECD comparability factors that should be considered when determining the Arm's Length Principle to set a transfer price/profit/return for controlled transactions. In preparing a FA there is a requirement to identify:

- Functions performed
- Risks assumed
- Assets employed

Further explanation of FAR should be included and then the major components should be listed with a brief description. The link of the FA back to the overall transfer pricing study should be explained including the relationship to the value/supply chain, classification of the entities, selection of the tested party, comparability, selection of the method and financial indicators/PLIs, etc.

Question 2

Students expected to explain the following steps involved in performing functional analysis in more detail:

- i. Fact finding process;
- ii. Analysis of functions, assets and risks; and
- iii. Industry and Economic analysis.

The purpose of this analysis is to identify the role of each participant in a related party transaction i.e. functions performed, risks borne and resources (including intangible assets) used.

The relative compensation earned should generally correspond to their relative contribution made by the parties involved in a transaction.

A comprehensive answer will also discuss various factors such as the:

- importance of weighting the FAR;
- significance of the supply chain;
- necessity to conduct interviews of key personnel;
- interaction of the FA with the business and industry analysis;
- relationship of FA in selecting the tested party (Paragraph 3.18 OECD TPG) and the most appropriate transfer pricing method;
- typical process in conducting a comparability analysis;
- typical process in conducting a comparability analysis;
- FA and documentation requirements; and
- FA in the business restructuring context

Additional information:

- Organisational structure of the group;
- Nature of the business/industry and market conditions;
- Company's transfer pricing policy;

- Legal rights and obligations of the taxpayer in performing its functions;
- Business strategies including market penetration, hedging arrangements, forward contracts, put and call options, swaps; and
- Cost contribution arrangements or Inter- group service agreement.

Question 3

Required to analyse the functions performed, taking into account assets used and risks assumed by the associated enterprises WG, WGA, WGS and WGT. The functional analysis includes reference to the industry specifics, the contractual terms of the transaction, the economics circumstances and the business strategies. The functional analysis helps to identify if the operations are complex justifying a higher level of profit or more limited and consequently generating a lower profit.

Students are required to identify and compare the controlled transactions (i.e. the economically significant activities and responsibilities undertaken, assets used and risks assumed by the parties to the transactions) based on the facts in the case study. It is permissible to make reasonable assumptions to support the analysis but these should be clearly listed.

After identifying the controlled transactions, prepare the FAR for example in a table format. A brief discussion about the merits of conducting an analysis at different levels, e.g. product, divisional or company would merit additional points.

Functional analysis (this list is not exhaustive):

Functions

- **WG**
Develops the overall corporate marketing including advertising.
Provides intercompany services to the group entities?
Manages customer services including after sales service
Management: develop and monitors worldwide strategy
Other, e.g. Purchasing
Financing, Legal, etc.?
Manage customer relationships and after Sales Service
- **WGA**
Manufacturing
Design, develops (R&D), manufactures and distributes unique watches worldwide
Marketing and Distribution (including transportation)
Corporate marketing strategy is modified for local needs
Other?
- **WGS**
R&D
Provides intercompany services to group entities
Intercompany financing/Treasury activities
- **WGT**
Healthcare services
R&D
Technical assistance to the group

Assets

- **WG**
Intangible assets (Trademarks, Patents, trade names, product know how, etc.)
- **WGA**
Plant and equipment
Technology embedded within manufacturing process

Warehousing

- WGS
Sophisticated technology embedded into manufacturing process
Use of Valuable intangibles
Plant and equipment
- WGT
Intangible assets

Risks

- WG
Products risks including reputational risks, i.e. faulty products and inventory risks
Market risks
Credit and collection risks
Warranty risks
- WGA
Inventory risks
Manufacturing risks
Technology obsolescence
Warranty risks
- WGS
Financial risks on the loans, forex movements, interest rates volatility, credit risks
Investment risks in R&D
- WGT
Warranty
Product risks?
Technology risks

Functions

While one party may provide a large number of functions relative to that of the other party to the transaction, it is the economic significance of those functions in terms of their frequency, nature, and value to the respective parties to the transactions that is important.

Assets

Type of tangible assets used and the nature of the assets used, such as the age, market value, location, property right protections available should be considered. A party that developed the intangibles should be able to obtain benefit from the intangibles either through a sale or licensing of the intangibles or through an increase in prices of products or services with imbedded intangibles.

Risks

Allocation of risks would influence the conditions of transactions between the associated enterprises and usually, in the open market, the assumption of increased risk would also be compensated by an increase in the expected return, although the actual return may or may not increase depending on the degree to which the risks are actually realised. Allocation of risk should be consistent with the economic substance of the transaction, the parties' conduct should generally be taken as the best evidence concerning the true allocation of risk.

QUESTION 2

Question 1

Each method should be briefly defined followed by a practical example.

Comparable Uncontrolled Price

Compares the price for property/services/IP transferred in a controlled transaction to the price charged in a comparable (similar circumstances) uncontrolled (by an independent entity) transaction.

Example: can be either an internal or external CUP and a range of examples are acceptable such as price for a commodity, interest rate, royalty rate, tangible product, etc.

Resale Price Method

Based on the price at which a product that has been purchased from an associated enterprise and is resold to an independent party. Taking the final selling price to an independent party and working backward the resale price is reduced by the gross margin that would have been earned had the AE been an independent entity (margin is calculated based on independent comparable data). What is left after subtracting the gross margin can be regarded as an arm's length price of the original transfer of property between the associated enterprises.

Example: can be from any industry/situation (but most likely will applied to retail/distribution entities) answer should show that it applied at the gross level and works back to the ALP for the purchase from the AE.

Cost Plus Method

Using a defined cost base (incurred by the supplier of property or services in a controlled transaction) an appropriate cost plus mark-up is added to this cost base, which allows for an appropriate profit to be made in light of the functions performed (taking into account assets used and risks assumed) 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.

Example: can be from any industry/situation (but most likely will applied to contract manufacture, contract R&D or services) answer should discuss the selection of the cost base and the use of comparable to establish the mark up %.

Transactional Profit Methods

Practical application – example.

Transactional net margin method (TNMM) or Comparable Profit Method (CPM)

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

Example: can be taken from a range of industries and type of companies (e.g. manufacturing, distribution, service, etc.). Student would describe how comparability analysis is used to find what a comparable uncontrolled entity in similar circumstance would earn at the net profit (EBIT) level. The relevance of the PLI and the range should be discussed – in the example the student should demonstrate that they understand how to work back for the net margin level (can be transactional or aggregated) to compute the value of the related party dealing.

Profit Split Method – using Contribution Analysis

A transactional profit method that identifies the combined profit to be split for the associated enterprises from a controlled transaction and then splits those profits between the associated enterprises based upon 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.

Example: should include two entities either that have intangibles and/or the other methods cannot be applied – need to identify the profit to be split – split is determined with reference to comparables (if available) or another approach based on a sound economic rationale.

Important to note the relative value of each controlled taxpayer's contribution (based on FAR) to that combined operating profit or loss.

Profit Split Method – using Residual Analysis

An analysis used in the profit split method which divides the combined profit from the controlled transactions under examination in two stages. First stage, each participant is allocated sufficient profit to provide it with a basic return appropriate for the type of transactions in which it is engaged. Ordinarily this basic return would be determined by reference to the market returns achieved for similar types of transactions by independent enterprises. The basic return would generally not account for the return that would be generated by any unique and valuable assets possessed by the participants. Second stage, any residual profit (or loss) remaining after the first stage division would be allocated among the parties based on an analysis of the facts and circumstances that might indicate how this residual would have been divided between independent enterprises.

Example: would involve complex business activities where both entities have intangible property – industry examples could include pharmaceutical industry, sophisticated high tech equipment. Important to note the relative value of each controlled taxpayer's contribution (based on FAR) to that combined operating profit or loss.

Question 2

Other Methods – Application

MNE groups retain the freedom to apply “other methods” to establish prices/profits provided the outcome satisfies the arm's length principle. Other Methods can be applied where it can be demonstrated that it is the most appropriate method to the facts and circumstances of the case or it provides a better solution.

Other Methods – Example

e.g. NPV for the valuation of sale of an intangible asset.

Question 3

Select Cost Plus Method or TNMM or a hybrid or combination or any other methods as long as the student supports their decision

List the relevant OECD “typical process” steps or a tailored approach which covers the same elements:

Step 1: Determination of years to be covered.

Step 2: Broad-based analysis of the taxpayer's circumstances.

Step 3: Understanding the controlled transaction(s) under examination, based in particular on a functional analysis, in order to choose the tested party (where needed), the most appropriate transfer pricing method to the circumstances of the case, the financial indicator that will be tested (in the case of a transactional profit method), and to identify the significant comparability factors that should be taken into account.

Step 4: Review of existing internal comparables, if any.

Step 5: Determination of available sources of information on external comparables where such external comparables are needed and taking into account their relative reliability.

Step 6: Selection of the most appropriate transfer pricing method (already completed) and, depending on the method, definition of the relevant financial indicator (e.g. definition of the relevant net profit indicator in case of a transactional net margin method).

Step 7: Identification of potential comparables: defining the key characteristics to be met by any uncontrolled transaction in order to be regarded as potentially comparable, based on the relevant factors identified in Step 3 and in accordance with the comparability factors

Step 8: Determination of and making comparability adjustments where appropriate.

Step 9: Interpretation and use of data collected, determination of the arm's length remuneration.

Draw a conclusion, e.g. cost plus 10% on the manufacturing activity (student could opt to classify WGS as a toll or contract manufacturer who also undertakes the distribution functions) and a TNMM with a PLI, e.g. EBIT/Sales of 3% for the distribution activities - the number is not crucial as long as the student draws a logic conclusion and include relevant elements, e.g. depends on the industry, importance of the cost base. Points are awarded for explaining that a bona fide contract manufacturer or toll manufacturer would bear minimal risk and would expect a positive return for the contract manufacturing function. But that WGS is more than a CM because it also distributes and this add functions, assets and risks to the WGS entity and they should be remunerated or compensated accordingly

Contract Manufacturer

Generally owns plant & machinery and employs a skilled labour force and goods are made for the principal. The CM has no or low risks associated with holding/selling the manufactured goods (provided it meets a specified quality, and quantity, the principal guarantees to buy all the goods manufactured); the CM could buy the raw materials and most likely will hold title to the goods until bought by the principal.

Toll Manufacturer

Generally the principal retains title to the goods and buys the raw materials or sub-assembled goods, although the physical flow of goods will be directly to the manufacturer himself. The principal bears all the inventory and selling risk.

QUESTION 3

Question 1a

List and explain three intra-group services that can be charged out:

- Administrative services (planning, accounting, auditing, budgetary control, legal, IT)
- Financial services (cash flows, recaps, loans)
- Assistance in production, buying, distribution & marketing
- Staff services (recruitment, training)
- R&D
- IP administration

MNE group arrange for a wide scope of services to be available to its members, in particular administrative, technical, financial and commercial services. Such services may include management, coordination and control functions for the whole group. The cost of providing such services may be borne initially by the parent, by a specially designated group member ("a group service centre"), or by another group member.

Intra-group services often include those that are typically available externally from independent enterprises (such as legal and accounting services), in addition to those performed internally (e.g. by an enterprise for itself, such as central auditing, financing advice, or training of personnel). The charge for intra-group services should be that which would have been made and accepted between independent enterprises in comparable circumstances.

Question 1b

Identify three types of service that will be generally excluded from being charged out:

- Duplicative activities. If services performed by a group member or by a third party are duplicated, this is not normally a provision of services unless:
 - Temporary duplication;
 - Duplication is to reduce risk of making a wrong business decision, e.g. obtaining a second opinion.
- Activities giving rise to incidental benefits: a group member may obtain an economic benefit as a result of a transaction aimed to achieve something else, e.g. a group structural reorganization. This would not normally be an intra-group service, as the activities producing the benefit would not be activities for which an independent enterprise would pay
- Benefits only because of membership of a large group: Benefits obtained solely due to being part of a large group should not constitute a service (as opposed to benefits attributable to specific activity). Example: a higher credit rating because of affiliation is not an intra-group service. But: if higher credit rating is due to a guarantee issued by another group company, an intra-group service is provided
- Service availability 'on call': Is the availability of services itself a separate service that justifies an arm's length charge in addition to charges for services actually rendered? per the OECD: Yes, if reasonable to expect independent enterprises to incur similar charges: Examples: retainer fees to law firms or service contracts for priority IT services in case of network breakdown. "Sanity check" should be performed before accepting charge. Charge not acceptable if:
 - Potential need for service is remote;
 - Advantage of having services on-call is negligible;
 - The services on-call can be obtained readily and promptly from other sources with no need for stand-by arrangements.
- Shareholder activities: Shareholder activities are activities performed by a parent company solely because of its ownership interest. Shareholder activities do not justify a charge to recipient companies. Examples:
 - Activities relating to the legal structure of the parent company (shareholder meetings);
 - Reporting for the parent company;
 - Fundraising for acquisition of parent company's participations.

Question 1c

Identify two advantages:

- advantages from economies of scale
- development of centres of excellence
- centralized business strategies
- the control of entire group services

Question 2

Direct

A direct charge is generally preferred to an indirect allocation and is required to be made where a service can be charged (both in terms of identifying the service and allocated a cost/mark-up for that service) i.e. when a MNE has the ability to demonstrate a separate basis for the charge (e.g. by recording the work done and costs expended in fulfilling its third party contracts). For example the cost of providing computers, training, legal advice, etc. for a specific entity. A direct approach is normally required where services are also rendered to third parties. Intra-group services are not different, in principle, to other intra-group transactions, so the standard Arm's Length Principle applies. WGL should apply the charge that would have been made and accepted between independent parties for similar services under similar circumstances.

Indirect

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

Under what circumstances would you use advise WGL to use an indirect basis?

When the calculation of a direct charge may be too difficult due to administrative burden or complicated processes. An indirect charge or allocation is relevant where 1) The value of services rendered cannot be quantified – e.g. sales promotion activities performed centrally affecting sales for many affiliates or 2) Separate recording of costs related to each beneficiary would involve an administrative burden that would be “disproportionately heavy”. Indirect charges normally apply to the vast majority of charges made by MNEs.

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

Question 3

Two separate examples to demonstrate the use of a different allocation key in each example. Any sound example will be accepted (the purpose of this question is for the student to demonstrate practical application – the focus is not on the numbers but the application of the concept) such as:

Example: A group service centre provides legal services to three group companies. Total costs of services provided amount to 200. An allocation key based on turnover is used to determine the charges to the group companies. Based turnover COA (400), COB (500), COC (100) the allocation would be 80, 100 and 20 respectively.

Example: A group service centre provides legal services to three group companies. Total costs of services provided amount to 200. An allocation key based on the number of entities is used to determine the charges to the group companies. Based entity COA, COB and COC the allocation would be 67 for each entity.

Example WGL provides training to AEs – cost could be allocated on the staff that attended the training course

Example WGL provides IT services, Helpdesk. On-call service – charge out, e.g. number of computers.

QUESTION 4

Question 1

Safe harbour rules are, whereby if a taxpayer's reported profits within a range or percentage or under a certain amount, or the like, that amount can be relied on by a taxpayer as an alternative to a more complex and burdensome rule, such as applying the transfer price methodologies.

A safe harbour cannot normally be used to the disadvantage of a taxpayer. There are some risks to safe harbours, such as that may favour low profit margin transactions that do not develop the economy in the long term, they may over time no longer reflect business realities, and may unreasonably either favour or dis-favour certain taxpayers.

The intention of safe harbour rules is to increase taxpayer certainty and reduce taxpayer compliance costs, but also to reduce the administration's costs of collection, as well as allowing the administration to concentrate scarce audit and other resources on the cases where more is likely to be at stake in terms of non compliance and revenue.

One example of a "safe harbour" is a rule that a taxpayer is deemed to have an appropriate transfer price when the average export sales price is at least 90% of the average domestic sales in the domestic market during the same period and under similar payment terms.

Another example is a list of parameters that, if followed, will assure sale and leaseback treatment to certain transactions under which partial or total relief from transfer pricing obligations is granted.

The adoption of safe harbour regimes in one country may require that the other countries' tax administrations examine the transfer pricing policy of all companies associated with enterprises that have elected a safe harbour in order to identify all cases of potential inconsistency with the arm's length principle. Failure to do so could amount to a transfer of tax revenue from those countries to the country providing the safe harbour. Consequently, any administrative simplicity gained by the tax administration of the safe harbour country would be obtained at the expense of other countries, which, in order to protect their own tax base, would have to determine systematically whether the prices or results permitted under the safe harbour are consistent with what would be obtained by the application of their own transfer pricing rules. The administrative burden saved by the country offering the safe harbour would therefore be shifted to the foreign jurisdictions.

Double taxation possibilities would exist not only where a single country adopts a safe harbour.

Adoption of a safe harbour by more than one country would not avoid double taxation if each taxing jurisdiction were to adopt conflicting approaches and methods. The parameters of two countries' safe harbours for specific industry segments are likely to deviate since both countries would want to safeguard their revenues. In theory, international coordination could achieve the degree of harmonization among national systems that would be required to prevent double taxation. However, in practice, it is most unlikely that two jurisdictions could harmonize conflicting safe harbours that would eliminate double taxation.

Advance pricing arrangements and safe harbours Internationally, safe harbour and Advance Pricing Arrangement (APA) are emerging as the two most efficient ways of reducing litigation in the area of transfer pricing, which is developing as the most important taxation subject among the chief executives and tax authorities.

APA is the alternative approach, which is gradually gaining greater acceptability. The basic difference between the two is that while safe harbour is general in nature, APAs are taxpayer-specific.

An APA is as an arrangement between a tax authority and a taxpayer that determines, in advance of intragroup transactions, an appropriate transfer pricing methodology for a fixed period of time. An APA is unilateral if one tax jurisdiction is involved, and bilateral when two

tax jurisdictions are involved. The latter provides the certainty of the arrangement being accepted by both the tax jurisdictions, thereby removing any chance of double taxation.

Question 2

The answer below is more detailed than expected; however it covers points expected from students.

Advantages of Safe Harbours

1) Compliance relief

Application of the arm's length principle may require collection and analysis of data that may be difficult to obtain and/or evaluate. In certain cases, such complexity may be disproportionate to the size of the corporation or its level of controlled transactions.

Safe harbours could significantly ease compliance by exempting taxpayers from such provisions. Designed as a comfort mechanism, they allow greater flexibility especially in the areas where there are no matching or comparable arm's length prices. Under a safe harbour, taxpayers would know in advance the range of prices or profit rates within which the corporation must fall in order to qualify for the safe harbour. Meeting such conditions would merely require the application of a simplified method, predominantly a measure of profitability, which would spare the taxpayer the search for comparables, thus saving time and resources which would otherwise be devoted to determining transfer prices.

2) Certainty

Another advantage provided by a safe harbour would be the certainty that the taxpayer's transfer prices will be accepted by the tax administration. Qualifying taxpayers would have the assurance that they would not be subject to an audit or reassessment in connection with their transfer prices. The tax administration would accept without any further scrutiny any price or result exceeding a minimum threshold or falling within a predetermined range. For that purpose, taxpayers could be provided with relevant parameters which would provide a transfer price or a result deemed appropriate to the tax administration. This could be, for example, a series of sector-specific mark-ups or profit indicators.

3) Administrative simplicity

A safe harbour would result in a degree of administrative simplicity for the tax administration. Once the eligibility of certain taxpayers to the safe harbour has been established, those taxpayers would require minimal examination with respect to transfer prices or results of controlled transactions. Tax administrations could then allocate more resources to the examination of other transactions and taxpayers.

Problems presented by use of safe harbours

The availability of safe harbours for a given category of taxpayers would have a number of adverse consequences which must carefully be weighed by tax administrations against the expected benefits. These concerns stem from the facts that:

- 1) The implementation of a safe harbour in a given country would not only affect tax calculations within that jurisdiction, but would also impinge on the tax calculations of associated enterprises in other jurisdictions, and
- 2) It is difficult to establish satisfactory criteria for defining safe harbours, and accordingly they can potentially produce prices or results that may not be consistent with the arm's length principle.

The issue can be examined from several perspectives.

- i. Under a safe harbour, taxpayers may not be required to follow a specific pricing method, or even have a pricing method for tax purposes. Where a safe harbour imposes a simplified transfer pricing method, it would be unlikely to correspond in all cases to the most appropriate method applicable to the facts and circumstances of the taxpayer under the regular transfer pricing provisions. For example, a safe harbour may impose a minimum profit percentage under a profit method when the taxpayer could have used the comparable uncontrolled price method or other transaction-based methods.
 - ii. Such an occurrence could be considered as inconsistent with the arm's length principle, which requires the use of a pricing method that is consistent with the conditions that independent parties engaged in comparable transactions under comparable conditions would have agreed upon in the open market. Some sectors where goods, commodities or services are standard and market prices are widely publicised such as, for example, the oil and mining industries and the financial services sector could conceivably apply a safe harbour with a higher degree of precision and, thus, a lesser departure from the arm's length principle. But even these industry segments produce a wide range of results which a safe harbour would be unlikely to be able to accommodate to the satisfaction of the tax administrations. And the existence of published market prices would presumably also facilitate the use of transaction-based methods, in which case there may be no need for a safe harbour.
 - iii. Even assuming that the pricing method imposed under a specific safe harbour is appropriate to the facts and circumstances of particular cases, the application of the safe harbour would nonetheless sacrifice accuracy in the reporting of transfer prices.

This is inherent in safe harbours, under which transfer prices are predominantly established by reference to a standard target as opposed to the individual facts and circumstances of the transaction, as under the arm's length principle. It follows that the prices or results that produce compliance with the standard target may not be arm's length prices or results.
 - iv. Safe harbours are likely to be arbitrary since they rarely fit exactly the varying facts and circumstances even of enterprises in the same trade or business. This arbitrariness could be minimized only with great difficulty by devoting a considerable amount of skilled labor to collecting, collating, and continuously revising a pool of information about prices and pricing developments. Obtaining relevant information for establishing and monitoring safe harbour parameters may therefore impose administrative burdens on tax administrations, because such information may not be readily available and may be accessible only through in-depth transfer pricing inquiries. Therefore, the extensive research necessary to set the safe harbour parameters accurately enough to satisfy the arm's length principle would jeopardize one of the purposes of a safe harbour, that of administrative simplicity.
- 3) Risk of double taxation and mutual agreement procedure difficulties From a practical point of view, the most important concern raised by a safe harbour is its international impact. Safe harbours could affect the pricing strategy of corporations.

Question 3

Double taxation is traditionally divided into two kinds, juridical double taxation and economic double taxation. Juridical double taxation may be described as the imposition of comparable taxes by two (or more) tax jurisdictions on the same taxpayer in respect of the same taxable income or capital. Economic double taxation may be described as the imposition of comparable taxes by two (or more) tax jurisdictions on different taxpayers in respect of the same taxable income.

An example of economic double taxation (preferably with diagrams) should be described to demonstrate the student has practical understanding of how economic double taxation arises in the context of transfer pricing.

Question 4

Remedies include:

Cross-border double taxation can be relieved through bi-lateral tax treaties, which can act to eliminate or reduce double taxation. Article 9 provides that where one tax authority makes arm's length adjustments, then the corresponding tax authority should make a "corresponding adjustment." A corresponding adjustment should sufficiently relieve double taxation.

Where there is a bi-lateral treaty and where a tax treaty may not apply (by exception, due to statutory time limits or otherwise), or where the competent tax authorities disagree on the adjustment(s) proposed (and hence the appropriate arm's length remuneration) alternative methods of relief can apply. Typically, this method is a Mutual Agreement Procedure (MAP) or for EU member states, the European Arbitration Convention can be sought. The MAP provision requires the competent tax authorities from each contracting country to come together, discuss the issues and seek to come to an agreement. The OECD Model Convention Article 25 distinguishes three types of mutual agreement: (1) "taxation not in accordance with the provision of the Convention" (2) "difficulties and doubts arising as to the interpretation or application of the Convention;" and (3) the elimination of double taxation in cases not otherwise provided for by the Convention. If agreement is reached then this procedure forms double taxation relief. Tax treaties with MAP provisions do not generally impose a binding obligation on the competent tax authorities to eliminate the double taxation arising; they also have no obligation to implement any agreements reached. Further, the formal requirements vary in degree and may result in an onerous, resource-consuming and time intensive process for both the taxpayer(s) and the tax authorities. MNEs report that this process is also fraught with uncertainty and the result is often beyond their control.

The EU Arbitration Convention is a method of relief that can be applied for as an alternative or simultaneously with a MAP under a bi-lateral tax treaty. Unlike MAPs and other arbitration procedures provided for in tax treaties, the EU Arbitration Convention obliges the signing EU Member States to avoid double taxation and determines that arbitration procedures need to be finalized within a period of maximum two/three years.

Another option available to MNEs is to enter into bilateral APAs.

QUESTION 5

Question 1

Firstly, explain the potential related party transactions and the process of deciding when transfer pricing documentation will be required (this will depend on the risk assessment and the domestic transfer pricing documentation requirements). The student could use any available models to prepare the framework, e.g. OECD, PATA, European Union Master File Concept, US IRS documentation requirement, etc. but they should cover the following components:

- Executive summary;
- Scope and any guidance, etc. relied upon;
- Business overview;
- Description of transactions covered;
- Financial analysis;
- Industry analysis;
- Functional analysis (analyses);
- Selection of transfer pricing methodology(s);
- Application of transfer pricing methodology(s);

- Other relevant documents.

Documentation could be prepared on a separate entity basis on regional or global basis. The students should demonstrate practical implementation knowledge, for example the need to have a transfer pricing policy; balancing the compliance cost with risks/benefits; managing the groups transfer pricing documentation globally, regionally and/or locally, etc.

It is important that the student points out that documentation will be prepared to meet the domestic transfer pricing documentation requirement (even if there is a global transfer pricing policy) and that the documentation should be tailored to the domestic requirements, e.g. comparability analysis will most likely need to be prepared using local/regional comparables. The students who raise other interesting issues such as the lack of comparable; the need to find an answer, the relation between documentation and penalties, that transfer pricing documentation can be used for setting or testing the ALP, etc. will achieve a higher mark.

Question 2

Penalty for failure to keep transfer pricing documentation: will be specified in the domestic transfer pricing legislation, guidelines, etc.

Penalty on the primary transfer pricing adjustment (e.g. did not comply with the ALP or the economic substance of a transaction differs from its form); could be part of the general penalty provisions or there could be specific transfer pricing penalties

Question 3

Explain comparability adjustments are made to improve the quality and/or reliability of the comparability analysis and link to Article 9 of the MTC. Types of adjustments could include adjustments to eliminate accounting inconsistencies; economic adjustments; adjustment to the term and conditions of the contracts/agreements, e.g. for volume discounts, etc.

QUESTION 6

Question 1

Business restructurings in the context of transfer pricing is defined by Chapter IX of the TPG as the cross-border redeployment by a multinational enterprise of functions, assets and/or risks. A business restructuring may involve cross-borders transfers of valuable intangibles, although this is not always the case. It may also or alternatively involve the termination or substantial renegotiation of existing arrangements, for instance:

- conversion of a “full-fledged” distribution arrangement into a “limited-risk” distribution or commissionaire arrangement;
- conversion of a “full-fledged” manufacturer arrangement into a “contract” or “toll” manufacturer arrangement; and
- centralizing specialized operations, e.g. research and development and/or services.

Connect BR to the arm’s length principle by linking it back to Article 9 of the MTC.

Question 2

Addressing the issues raised in the OECD TPG the student should link these back to the question and discuss them from both the perspective of MNEs (the taxpayer) and the Tax Administration including; special considerations for risk; the arm’s length compensation for the restructuring itself ; remuneration of pre and post-restructuring; and the recognition of the actual transactions undertaken, etc.

The MNE will consider the rational (i.e. the business case; what is driving the BR; synergies and other advantages) behind the BR and other implications of the reorganization including non-tax issues.

A tax administration may take into account base erosion and profit shifting consequences and focus on transfers to low tax jurisdictions/tax havens and double non-taxation. Some TA also consider issues such as location savings and exit taxes but all TA should avoid the use of hindsight.