

Day 1, Session 3

Accurate Delineation and Recognition of the Actual Transaction



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Advanced Transfer Pricing Course (General Topics), April 15-19, 2024

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Agenda

- I. Identification of the commercial or financial relations
- II. Recognition of the accurately delineated transaction
- III. Comparability analysis



Section I

Identification of the commercial or financial relations



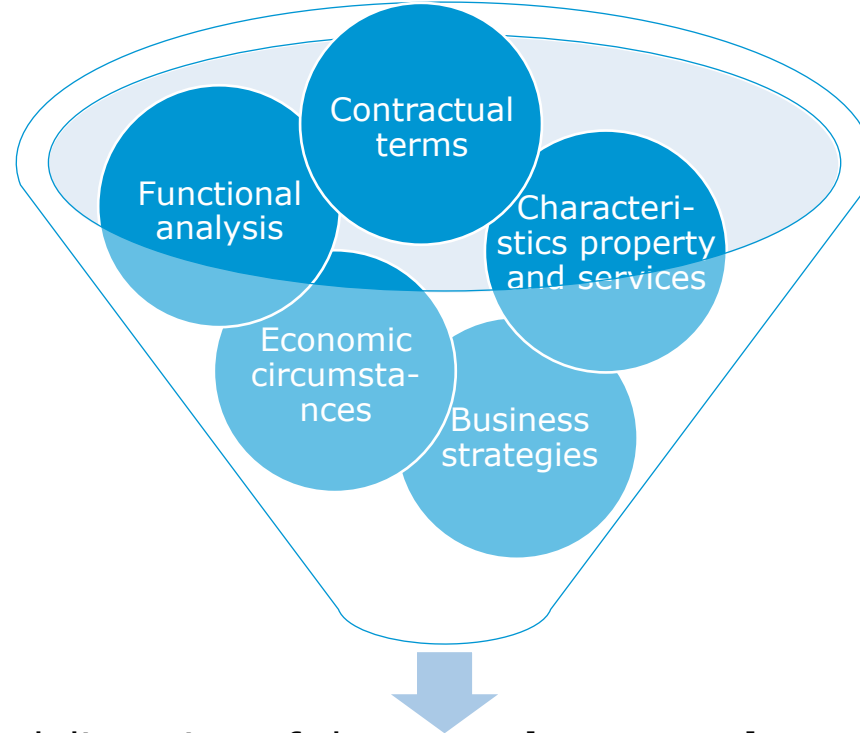
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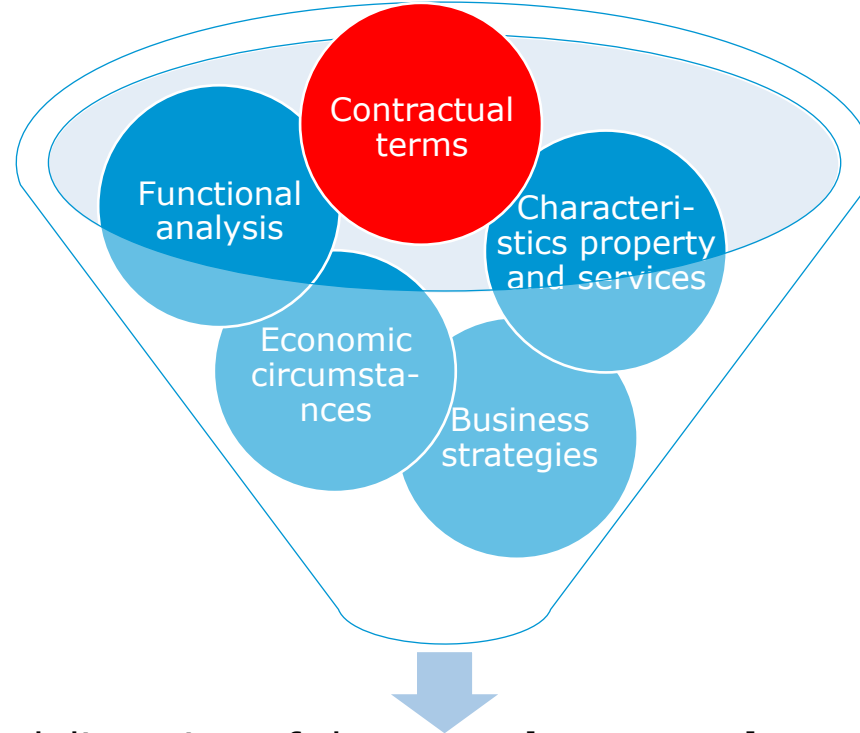


Identification of the commercial or financial relations



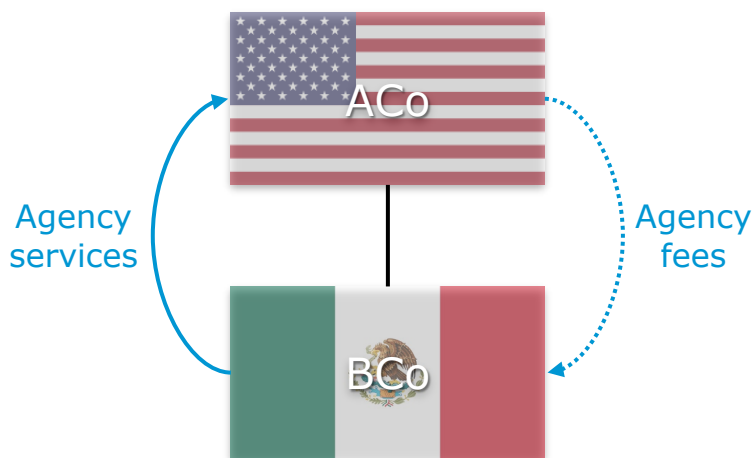
Accurate delineation of the **actual transaction** undertaken
(by means of the above **economically relevant characteristics** or **comparability factors**)

Identification of the commercial or financial relations



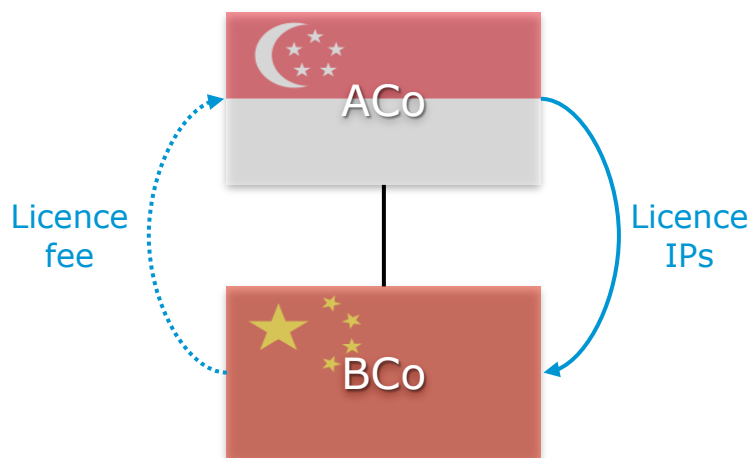
Accurate delineation of the **actual transaction** undertaken
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Example 1



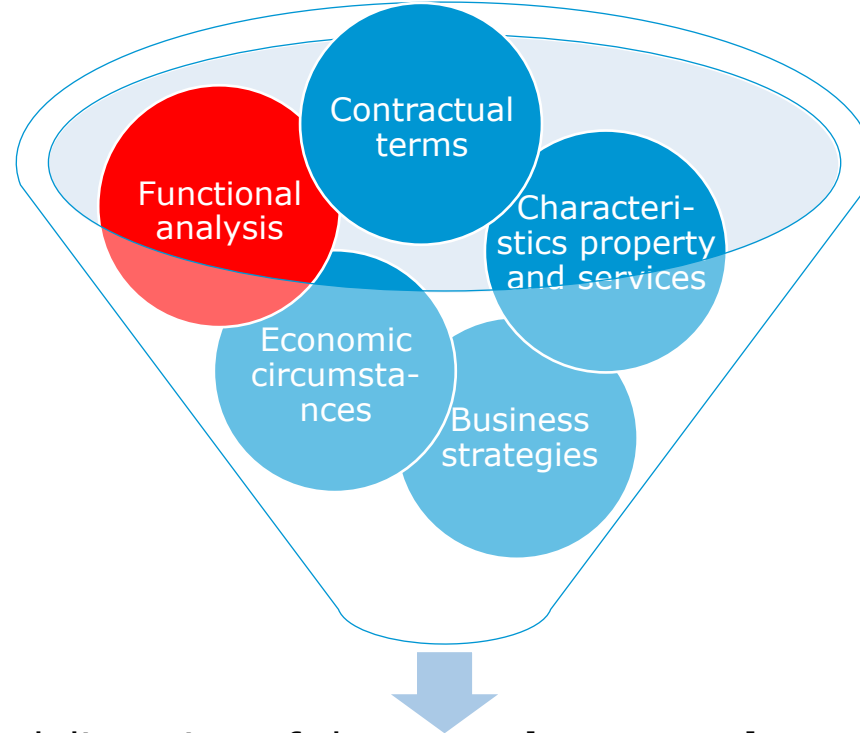
- ACo is the parent company of an MNE group situated in the United States. BCo, situated in Mexico, is a wholly-owned subsidiary of ACo and acts as an agent for ACo's branded products in the Mexican market. The agency contract between ACo and BCo is silent about any marketing and advertising activities in Mexico that the parties should perform.
- Analysis of other economically relevant characteristics and in particular the functions performed, determines that BCo launched an intensive media campaign in Mexico in order to develop brand awareness. This campaign represents a significant investment for BCo.

Example 2



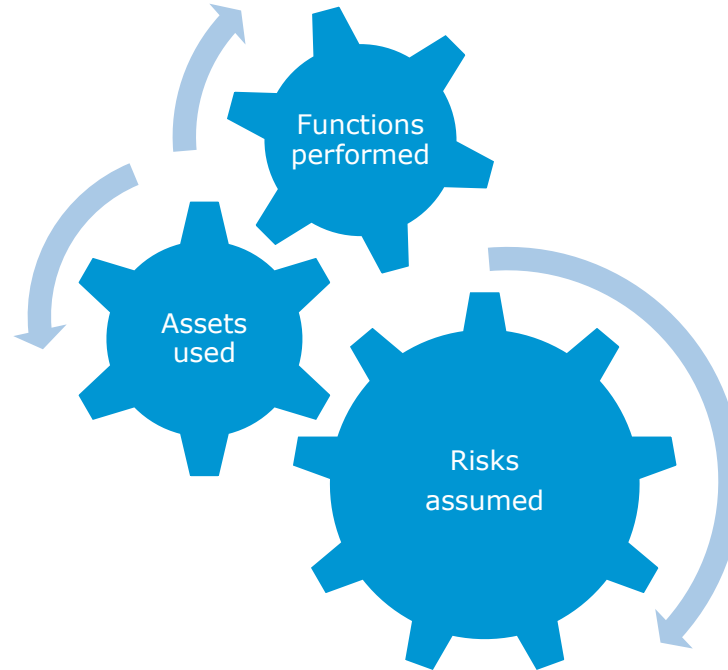
- BCo (resident in China) is a wholly-owned subsidiary of ACo (resident in Singapore). The parties have entered into a written contract pursuant to which ACo licenses intellectual property to BCo for use in BCo's business; BCo agrees to compensate ACo for the licence with a royalty.
- Evidence provided by other economically relevant characteristics, and in particular the functions performed, establishes that ACo performs negotiations with third party customers to achieve sales for BCo, provides regular technical services support to BCo so that BCo can deliver contracted sales to its customers, and regularly provides staff to enable BCo to fulfil customer contracts. A majority of customers insist on including ACo as joint contracting party along with BCo, although fee income under the contract is payable to BCo. The analysis of the commercial or financial relations indicates that BCo is not capable of providing the contracted services to customers without significant support from ACo, and is not developing its own capability.

Identification of the commercial or financial relations



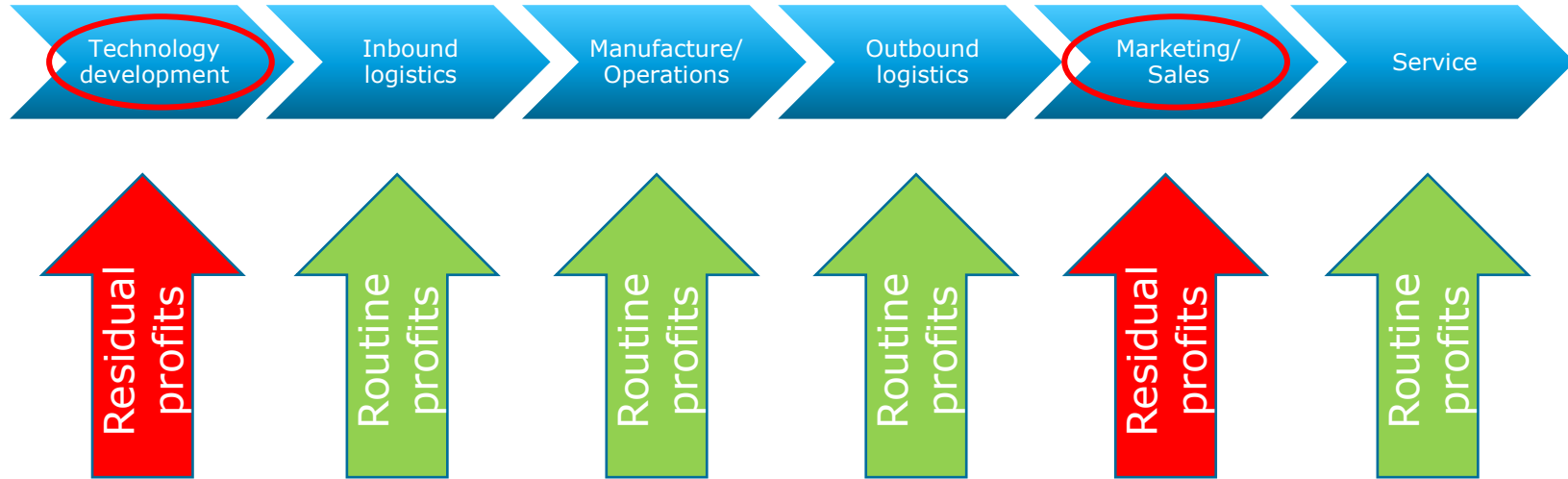
Accurate delineation of the **actual transaction** undertaken
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Functional analysis

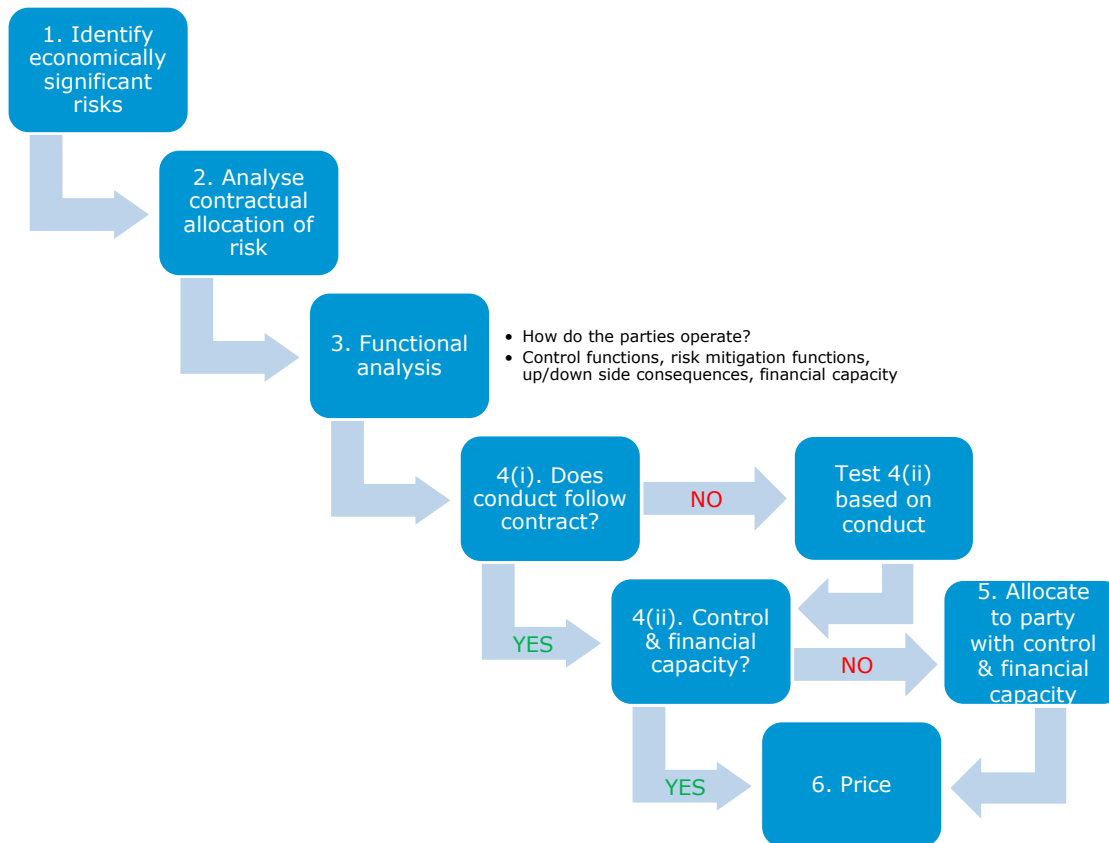


including how those functions relate to the wider generation of value by the MNE group to which the parties belong, the circumstances surrounding the transaction, and industry practices

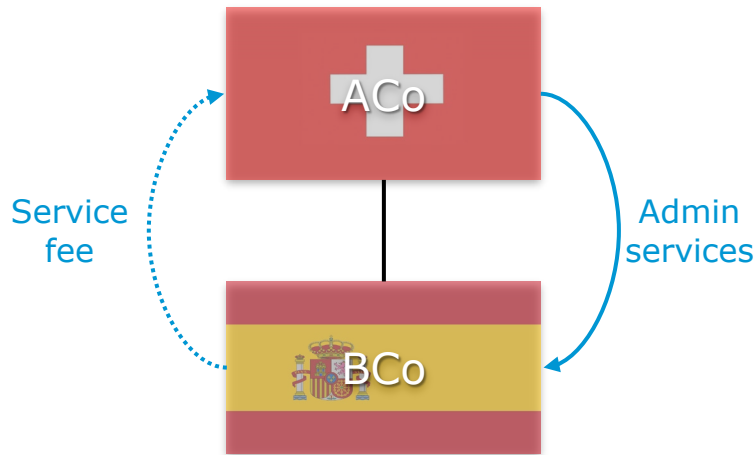
Global value chain analysis



Risk analysis

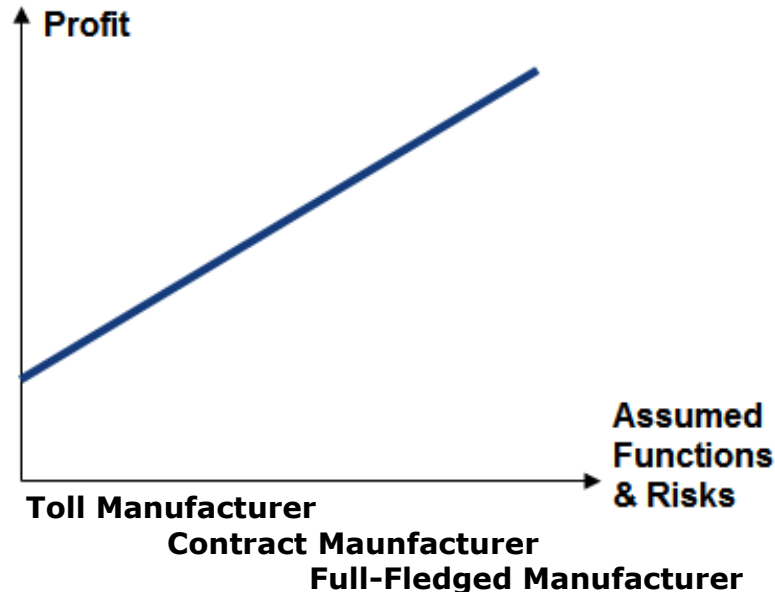


Risk analysis: example



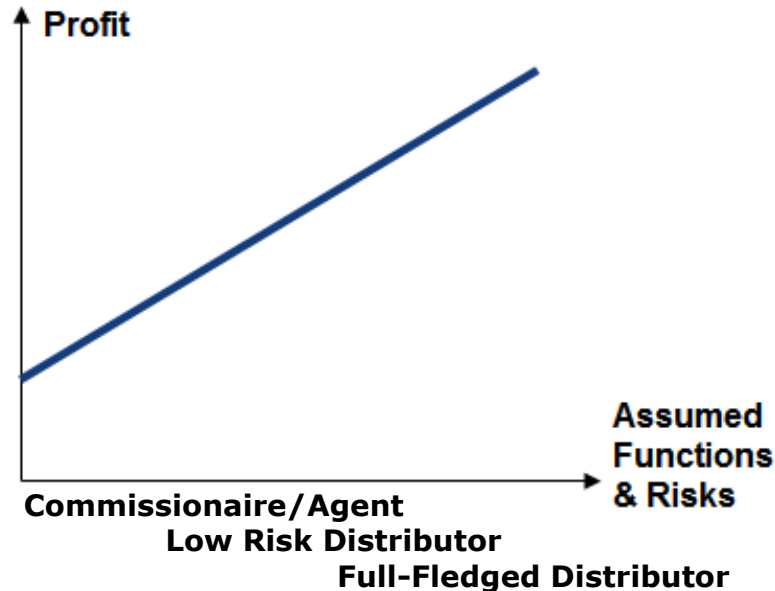
- ACo, located in Switzerland, is the parent company of BCo, located in Spain. ACo and BCo conclude an intra-group agreement whereby ACo should provide some administrative services to BCo. BCo should remunerate ACo for such services a fix fee of 100 CHF.
- The contractual allocation of the exchange risk on such transaction is on BCo. However, BCo does not have control over this risk and financial capacity to assume this risk.

Types of manufactures



- **Contract manufacturer**
 - Assumes manufacturing functions on a contract basis
 - **Generally does take title to finished products and buys raw materials**
 - Owns no valuable IPs
 - Procurement decisions, logistics and planning are all conducted by the principal, the contract manufacturer generally is responsible for keeping up to date with current technology requirements, machinery and procedures in order to maintain competitive and to conduct quality control
- **Toll manufacturer**
 - Toll manufacturing and contract manufacturing do not differ greatly from a functional perspective
 - **A toll manufacturer does not buy raw materials and does not take title to the finished products manufactured**
 - A contract manufacturer has (slightly) more risks and responsibilities than a toll manufacturer
- **Full-fledged manufacturer**

Types of distributors



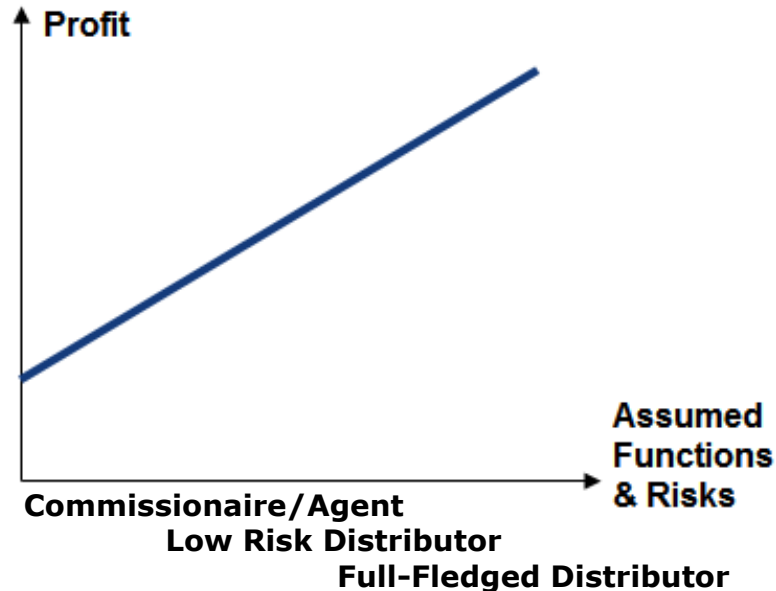
■ Agent

- Acts in the **name of the principal** (mediates sales)
- Does not obtain ownership in the products
- Acquires orders, but typically does not conclude, but
- If conclusion of contracts or playing the principal role (PE)

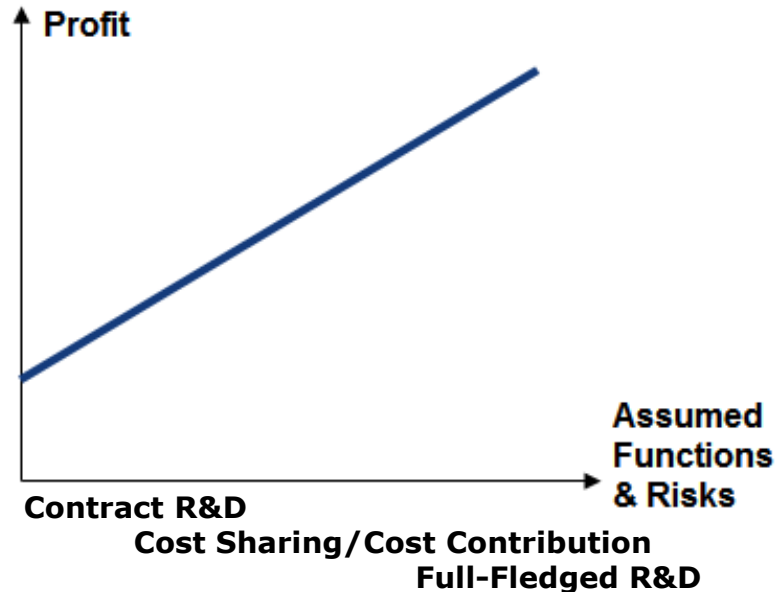
■ Commissionaire

- Acts in **his own name**, but for the account of the principal
- Does not obtain ownership in the products
- Concludes contracts (but in its own name)
- PE issue under BEPS Action 7 (playing the principal role)

Types of distributors (cont.)

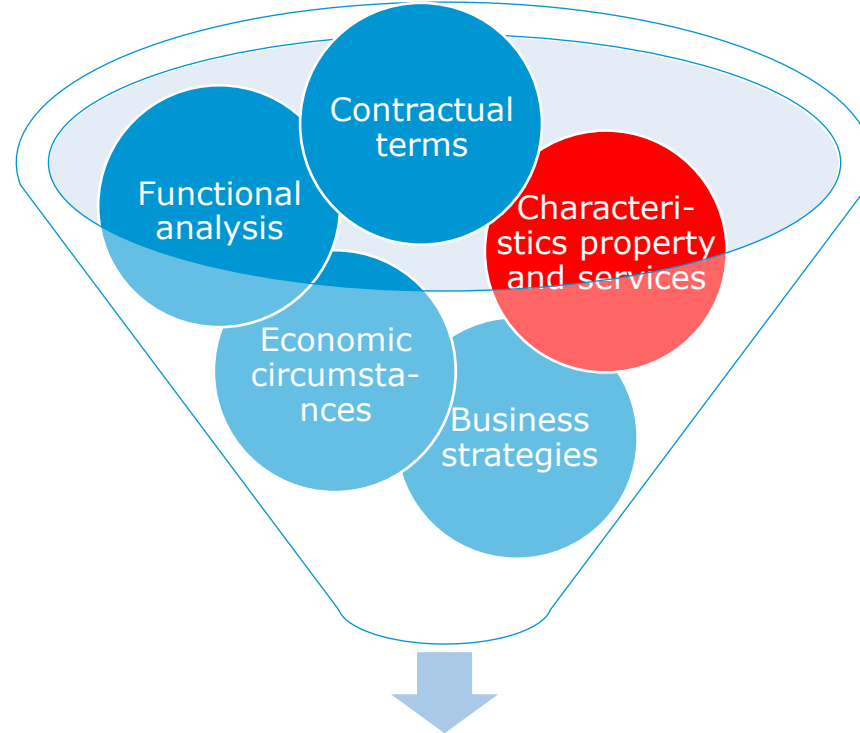


- **Limited risk distributor**
 - Acts in his own name
 - Concludes contracts and obtains ownership in the products (Buy-Sell)
 - Assumes limited risks - inventory risk, credit risk?
- **Full-fledged distributor**
 - Assumes entire distribution risk (e.g. market, pricing)
 - Other Risks: inventory, warranty, currency, credit etc.
 - Responsible for marketing activities
 - Obtains ownership in products



- **Contract R&D**
 - Company provides R&D services on behalf of another company (e.g. principal)
 - Contractor becomes owner of the developed IP and carries all important functions and bears all risks associated with R&D development process/outcomes (DEMPE)
- **Cost Sharing/Cost Contribution**
 - Several companies share the costs of particular R&D activities and become joint users of the developed IP
- **Full-fledged R&D**
 - Company carries R+D at own cost/risk (DEMPE) and has ownership rights in the developed IP
 - Typically licenses IP to manufacturing entities

Identification of the commercial or financial relations

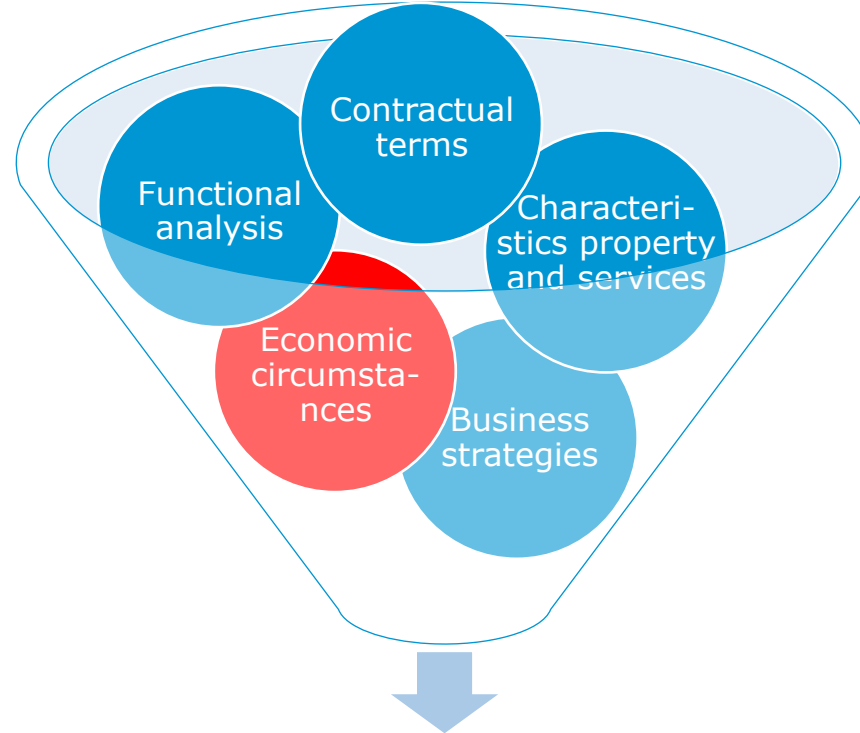


Accurate delineation of the **actual transaction** undertaken
(by means of the above **economically relevant characteristics** or **comparability factors**)

Characteristics of properties or services: Example

- Company P undertakes the sale of coffee beans that are imported from associated enterprise Q for sale to third parties. For the purpose of a comparability analysis, key characteristic properties of the transaction include evaluation of the following:
 - Whether the coffee beans are branded and comparable transactions included unbranded (potential) comparables
 - Delivery terms (CIF/FOB)
 - The effect of the differences in volume on price
 - Product differences such as changes to aroma, coffee grade, and extraction location
 - The technology involved in types of coffee bean processing
- In undertaking the comparability analysis, it is to be evaluated if reasonably accurate adjustments could be effected for the above differences.

Identification of the commercial or financial relations

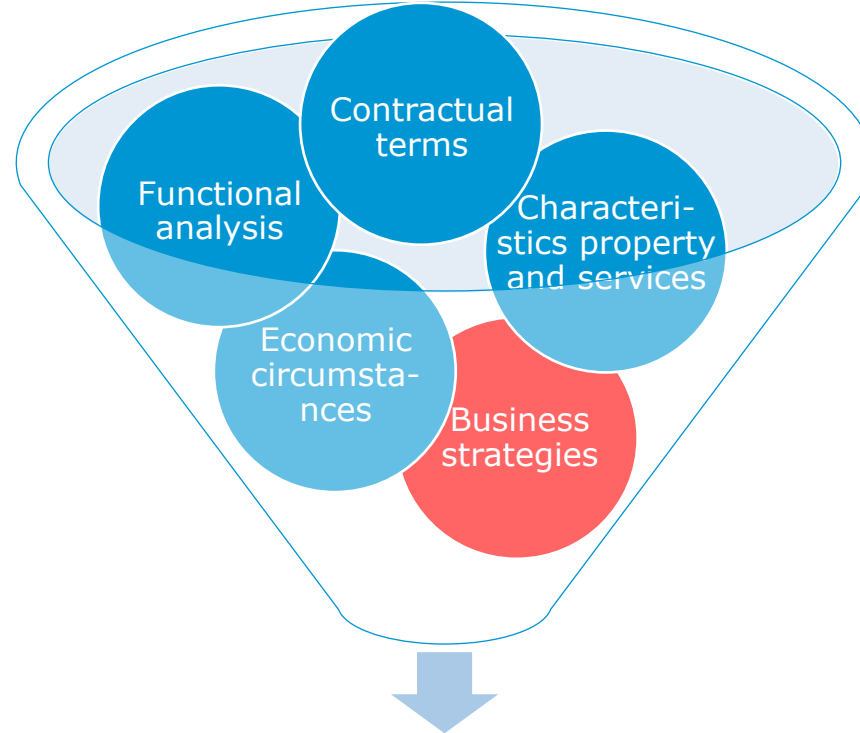


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Economic circumstances

- Geographic location and the size of the markets
- the extent of competition in the markets and the relative competitive positions of the buyers and sellers, the availability (and risk thereof) of substitute goods and services
- the levels of supply and demand in the market as a whole and in particular regions, if relevant
- consumer purchasing power
- the nature and extent of government regulation of the market;
- costs of production including the costs of land, labour, and capital transport costs; the level of the market (e.g., retail or wholesale) the date and time of the transactions

Identification of the commercial or financial relations



Accurate delineation of the **actual transaction** undertaken
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Business strategies

- Marketing and sales
- Technology/Digital/IT
- Outsourcing
- Human Resources
- Sustainability



Section II

Recognition of the accurately delineated transaction

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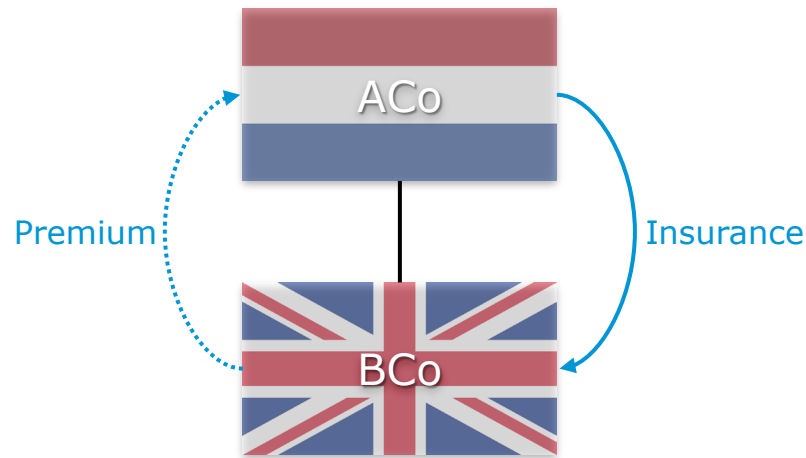
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Recognition of the accurately delineated transaction

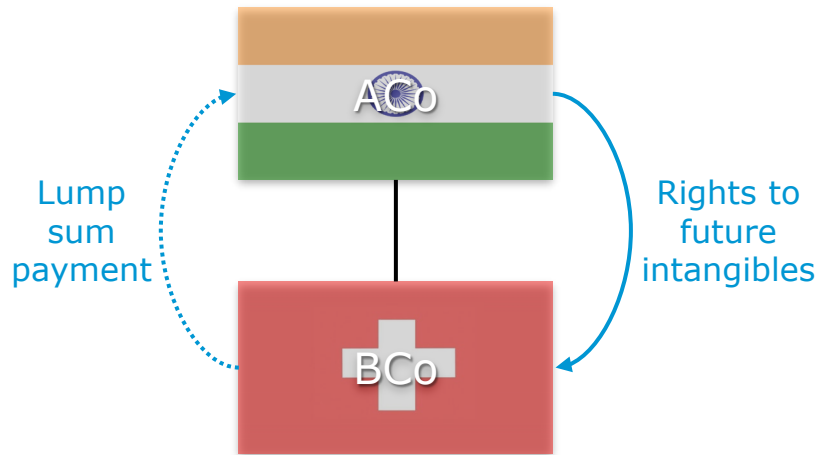
- The transaction may be disregarded (and if appropriate, replaced by an alternative transaction) where, exceptionally:
 - The arrangements viewed in their totality differ from those which would have been adopted by independent enterprises behaving in a **commercially rational manner** in comparable circumstances,
 - thereby **preventing determination of a mutually acceptable price**, taking into account their **options realistically available**.
- A relevant pointer: if the group would be worse off but for the tax benefit

Example 1



- BCo carries on a manufacturing business that involves holding substantial inventory and a significant investment in plant and machinery. It owns commercial property situated in an area prone to increasingly frequent flooding in recent years. Third-party insurers experience significant uncertainty over the exposure to large claims, with the result that there is no active market for the insurance of properties in the area.
- ACo, an associated enterprise, provides insurance to BCo, and an annual premium representing 80% of the value of the inventory, property and contents is paid by BCo.

Example 2



- BCo conducts research activities to develop intangibles that it uses to create new products that it can produce and sell.
- It agrees to transfer to an associated company, ACo, unlimited rights to all future intangibles which may arise from its future work over a period of twenty years for a lump sum payment.

Section III

Comparability Analysis

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Comparability analysis

1. Determination **years** to be covered

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

3. **Understanding the controlled transaction(s)**, based on functional analysis

4. Review of existing **internal comparables**, if any

5. Determination of available sources of information on **external comparables** where needed and reliable

6. **Selection of the most appropriate TP method** and, depending on the method, determination of the **relevant financial indicator**

7. Identification of **potential comparables**

8. Determination of and making **comparability adjustments** where appropriate

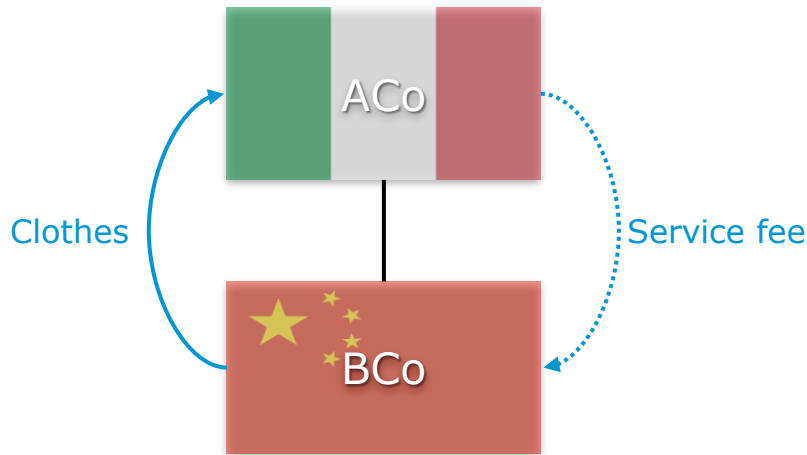
9. **Interpretation and use of data** collected, determination of the arm's length remuneration



Key issues

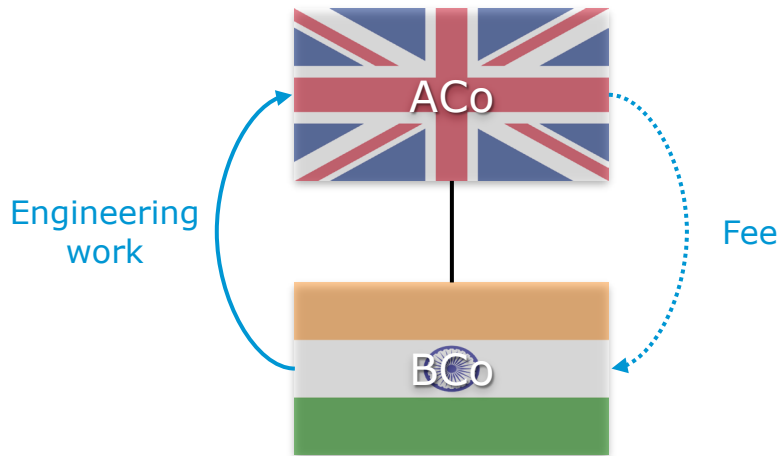
- Separate transactions vs. combine transactions
- Type of comparisons
 - Concrete vs Hypothetical transactions
 - Direct vs Indirect (i.e. adjustments needed) comparisons
 - Internal vs External comparisons
- Sources of data
 - Which database(s)?
 - Foreign sources?
 - Secret comparables?
 - Selection/rejection of comparables
- Adjustments
- Range of AL results (interquartile range?)
- Timing issues (date of the transaction, date of the review, multiple years?)
- Compliance issues

Location savings: Example 1



- ACo designs, manufactures and sells brand name clothes. The manufacturing process is basic and the brand name is famous and represents a highly valuable intangible.
- ACo is established in Italy where the labour costs are high and it decides to close down its manufacturing activities in Italy and to relocate them in an affiliate company (BCo) in China where labour costs are significantly lower. ACo retains the rights on the brand name and continues designing the clothes.
- Further to this restructuring, the clothes will be manufactured by BCo under a contract manufacturing arrangement. The arrangement does not involve the use of any significant intangible owned by or licensed to BCo or the assumption of any significant risks by BCo. Once manufactured by BCo, the clothes will be sold to ACo which will on-sell them to third party customers. This restructuring makes it possible for the group to derive significant location savings.

Location savings: Example 2



- ACo, resident in the UK, provides highly specialised and quality engineering services to independent clients. It charges a fee to its independent clients based on a fixed hourly rate that compares with the hourly rate charged by competitors for similar services in the same market. The wages for qualified engineers in the UK are high. The enterprise subsequently subcontracts a large part of its engineering work to a new subsidiary (BCo) in India. BCo hires equally qualified engineers to those in the UK for substantially lower wages, thus deriving significant location savings for the group. Clients continue to deal directly with ACo and are not necessarily aware of the sub-contracting arrangement.
- For some period of time, the well-known ACo can continue to charge its services at the original hourly rate despite the significantly reduced engineer costs. After a certain period of time, however, it is forced due to competitive pressures to decrease its hourly rate (at an amount that would not allow ACo to cover the wages for qualified engineers in the UK, but that would still yield a benefit if those services are provided by qualified engineers in India). Part of the location savings are passed on to its clients.
- There is a high demand for the type of engineering services that ACo sells. BCo is the only company operating in a lower-cost location that is able to provide such services with the required quality standard, and ACo is able to withstand competitive pricing pressures because the technical know-how it has established acts as a barrier to competition. Furthermore, ACo does not have the option of engaging qualified engineers in the UK to provide these services, as the cost of their wages would be too high compared to the hourly rate charged to clients.

Group synergies: Example

- A multinational group based in Country A, has manufacturing subsidiaries in Country B and Country C. Country B has a tax rate of 30% and Country C has a tax rate of 10%. The group also maintains a shared services centre in Country D. The manufacturing subsidiaries in Country B and Country C each have need of 5 000 widgets produced by an independent supplier as an input to their manufacturing processes. The Country D shared services company is consistently compensated for its aggregate activities by other group members, including the Country B and Country C manufacturing affiliates, on a cost plus basis, which is assumed to be arm's length compensation for the level and nature of services it provides.
- The independent supplier sells widgets for USD 10 apiece and follows a policy of providing a 5% price discount for bulk purchases of widgets in excess of 7 500 units. A purchasing employee in the Country D shared services centre approaches the independent supplier and confirms that if the Country B and Country C manufacturing affiliates simultaneously purchase 5 000 widgets each, a total group purchase of 10 000 widgets, the purchase discount will be available with respect to all of the group purchases. The independent supplier confirms that it will sell an aggregate of 10 000 widgets to the MNE group at a total price of USD 95 000, a discount of 5% from the price at which either of the two manufacturing affiliates could purchase independently from the supplier. The purchasing employee at the shared services centre then places orders for the required widgets and requests that the supplier invoice the Country B manufacturing affiliate for 5 000 widgets at a total price of USD 50 000 and invoice the Country C manufacturing affiliate for 5 000 widgets at a total price of USD 45 000. The supplier complies with this request as it will result in the supplier being paid the agreed price of USD 95 000 for the total of the 10 000 widgets supplied.



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