

Day 4, Session 2

Administrative Approaches to Minimising Transfer Pricing Disputes - Workshop



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

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Agenda

- I. Case study I: Manufacturing
- II. Case study II: Financial Services
- III. Case study III: Construction



Section I

Case Study I *Manufacturing*

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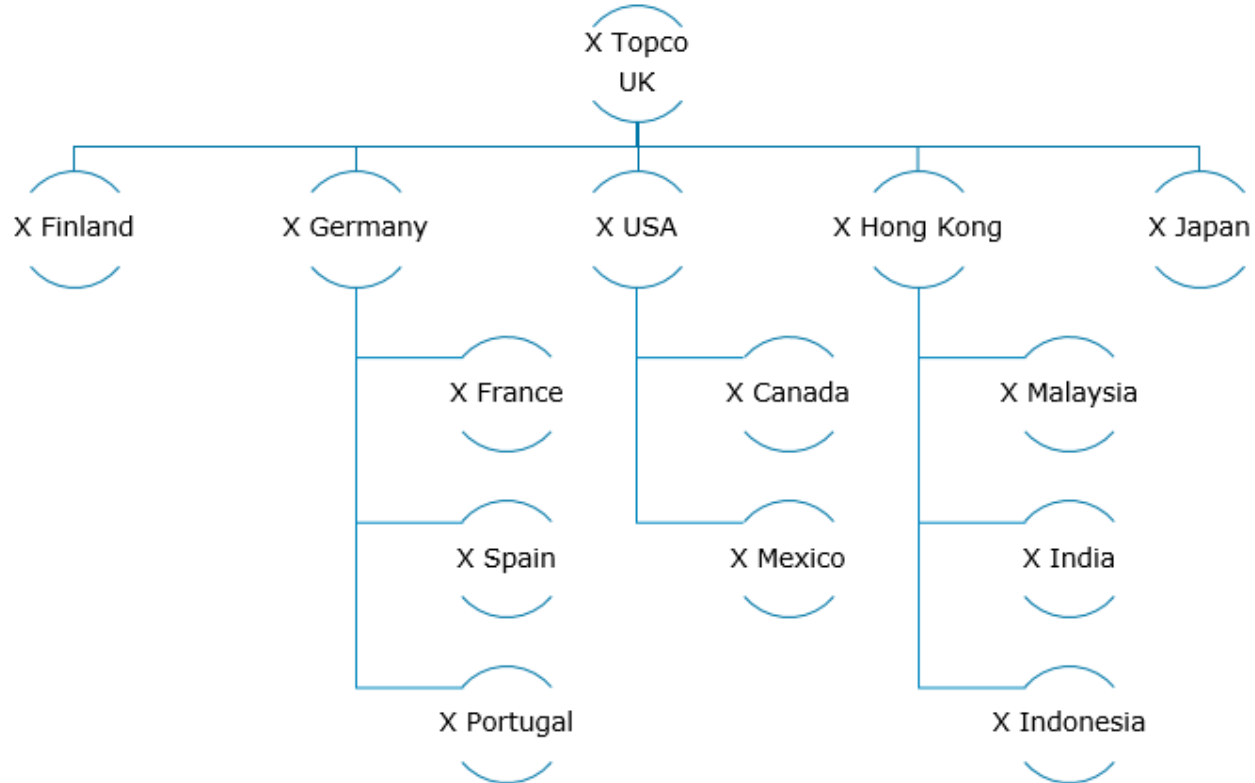
Background and Facts of the Case

- X Group is a UK headed technology group. X TopCo is the UK Parent of the group.
- The group's main business consists of developing, manufacturing, distributing, and retailing mobile phones under the 'X' brand name.
- X TopCo has five subsidiaries: X Finland, X Germany, X USA, X Hong Kong, and X Japan.
- X Finland is where the R&D for the group is carried out – generating the patents and intellectual property installed on the handsets. X Finland employs IT engineers and designers, but also engages some third-party designers in Italy.
 - Owing to a favourable R&D tax incentive in Italy, X Group is considering setting up a new subsidiary in Italy which can become the R&D hub of the group, replacing X Finland.
- X Finland also manufactures the phones for the group and only sells finished mobiles to X TopCo.

Background and Facts of the Case

- The phones X TopCo purchases from X Finland are stored in a warehouse in the UK that is rented out by X Finland.
- X TopCo then sells mobile phones to its four (excluding Finland) direct subsidiaries as well as third party wholesalers.
- X Germany, X USA, and X Hong Kong, are the regional master distributors for the European, North American, and Asian markets (other than Japan), respectively.
- X Japan is the distributor in Japan, only.
- X India provides IT support services to all subsidiaries in the X Group. X India has previously had a unilateral APA with the Indian Tax Administration that prescribed that X India should be remunerated with a cost+30%.
- X France has had difficulty growing the 'X' brand as French consumers prefer 'French' products. This has resulted in X France being loss-making.

Group Structure



Background and Facts of the Case

- X Group has two routes to market:
 - Retail sales through stores in each jurisdiction the group has a presence.
 - Wholesale sales (e.g., to third party department stores, multi brand retailers, or franchised stores). Where this happens, the local X entity would best decide the mix of retail:wholesale sales and would liaise with potential wholesalers in their market.
- Independent franchisees operate some X Group retail stores and pay a franchise fee of 5% of sales.
- X Group has Transfer Pricing documentation, but it was produced ten years ago.
- There are formal agreements for the franchise fees paid by third parties, but the provision of IT services isn't formally agreed between entities.



Questions?

The CEO of X Group has asked for your expert help to:

- a. Provide a high-level overview of potential tax risks that could arise from the transactions described (wider than just Transfer Pricing).
- b. List the material Transfer Pricing transactions described along with methodologies you would consider most appropriate for each material transaction and what type of comparability factors you deem important in this case.
- c. Advise on what steps the group need to take to evidence their Transfer Pricing filings.
- d. Advise on what transactions you would suggest could benefit from a dispute prevention mechanism such as an APA. Would these APAs be unilateral/bilateral/multilateral? And what countries should participate?
- e. Suggest what an APA agreement may actually look like. I.e., what would be some of the expected headings in the legal APA agreement?



Section II

Case Study II *Financial Services*



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Case study – Financial Services

- French bank (a subsidiary of German bank group) has a London permanent establishment (“PE”). Both French Head Office (“HO”) and the UK PE have a number of full-time staff (UK-37, France-12)
- Decisions on whether to take up opportunities brought in by the bankers employed in London and Paris, and therefore decisions on whether to actually make loans, are made by the Executive Committee (“EC”) which meets in Paris. The EC is composed of the CFO and the COO in Paris, and the CEO who lives and works in the UK but travels to Paris for 1-2 days a week. The EC meets regularly.
- The (very experienced) CRO sits in London, and, together with his three-person team, is actively involved in compiling a risk analysis on each of the prospective loans. He dials into the EC meetings and answers questions etc. on the risk analysis when the prospective loan opportunities are being discussed, but he is not empowered to make decisions on whether the loans should be made, due to French regulatory requirements.
- The CEO was physically present in Paris for 85% of the EC meetings. For 5%, he was on holiday, and for the remaining 10%, he dialled in to the discussion from London. When he dialled in, he did not express a view on whether business should be accepted or not because someone had told him that doing so might be problematic. However, he did normally raise questions on the deals proposed.



Case study – Financial Services (cont.)

- a) Business opportunities for the bank are in large measure generated by 3 senior staff in London.
- b) One of the very senior Frankfurt bankers in German bank has considerable interaction with the EC and often discusses individual proposals to make sure they are within the group-wide risk limits.
- c) The groups are interested in an APA.
 - i. In which countries are KERT functions being carried on? To what country or countries should the loan assets therefore be attributed?
 - ii. How would your answer change if (1) you later found out that the CEO had always dialed in to the EC meeting (and expressed his views on concluding the loans under discussion) when on holiday in his holiday home in Spain?
- d) Assume a treaty is in place between the UK, France and Germany. What type of APA(s) would you explore?
- e) What if Paris was a PE as well?
 - i. And what if there wasn't a Germany-France treaty?



Section III

Case Study III *Construction*



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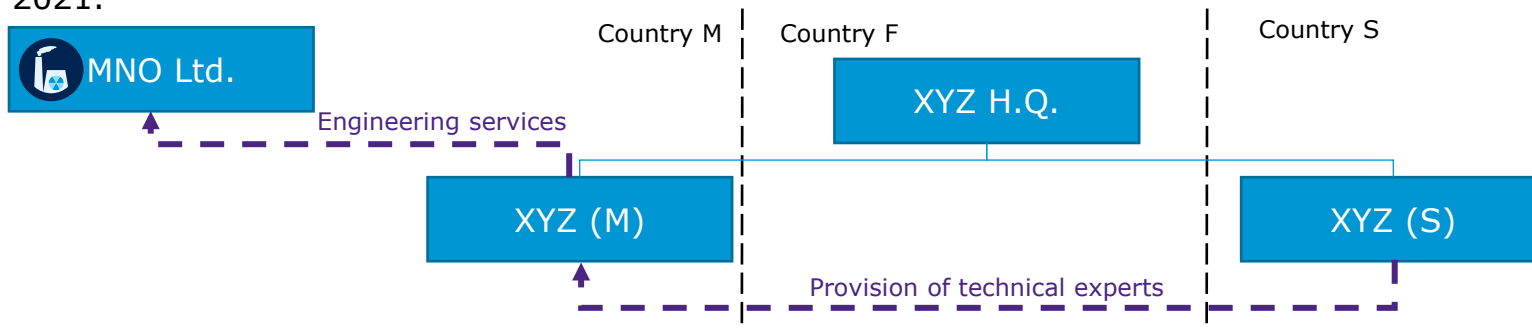
Case study – Construction

Phase 1– Analysis of the Circumstances

XYZ is a multinational group of companies (the “Group”) that provides specialist **consultancy, design** and **project-management services** for large-scale engineering projects. The group’s ultimate parent company and head office is located in Country F.

In 2017, the Group was engaged to provide a **full range of engineering services** with respect to the construction of an oil refinery in Country M. The refinery was being constructed by **MNO Ltd.**, an unrelated petroleum company operating in Country M.

Also in 2017, the Group set up a **local subsidiary company, XYZ (M) in Country M** whose function was to **oversee and manage the provision of engineering services to MNO Ltd.** during the construction of the refinery. It was expected that the project would last four years, with completion in 2021.



Case study – Construction

Phase 2–Delineation of the Controlled Transaction

- XYZ (M) **dealt directly with MNO Ltd.** to provide these services under a contract. Under the terms of the contact, fees for the services are paid directly to XYZ (M), which **has the responsibility for the satisfactory completion** of the contract.
- XYZ (M) employs approximately **15 employees** located in Country M, based in its offices near the site of the construction project.
- XYZ (M) **engages a number of technical experts**, engineers, and managers employed by a sister company XYZ (S) located in Country S. **The costs of these personnel are recharged to XYZ (S) at a rate of their pay, plus a mark-up of 40 percent.**
- Throughout the period of the contract, XYZ (M)'s revenue consisted of the fees charged to MNO Ltd., and its costs consisted of its local costs, plus the fees paid to XYZ (S) for the provision of specialist personnel.
- During the course of the project there were a number of **delays** and, as a result, the contract with MNO Ltd. was **renegotiated in 2019**. The financial accounts of XYZ (M) show **significant losses** for all years from 2017 to 2020.

Questions: 1

- What risks do you see that a tax authority might look to further explore?
- If you were XYZ, what could you do to minimise/prevent dispute?



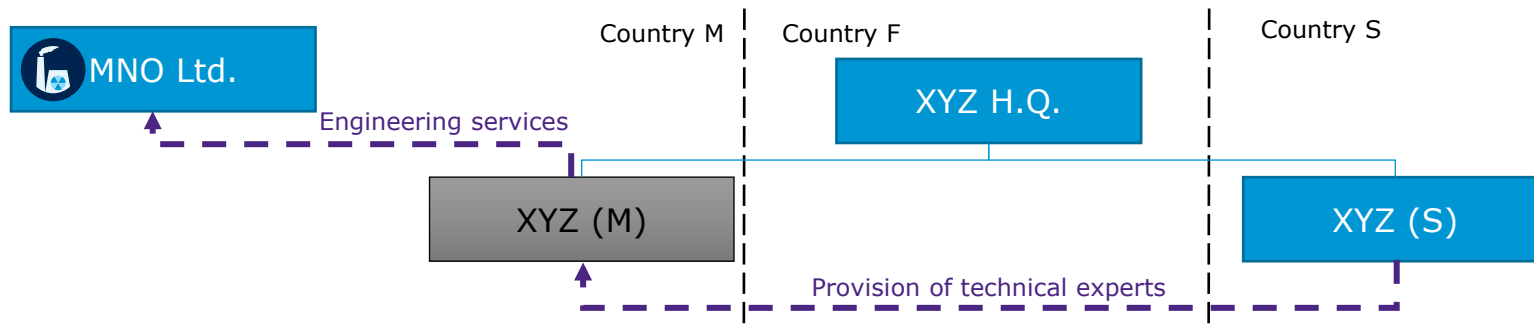
Case study – Construction

Phase 3– Tax Audit (1/3)

Country M's tax authority decided to **audit the tax position of XYZ (M)**, including the transfer pricing in respect of the costs of provision of personnel by XYZ (S). The tax authority conducted a detailed analysis in order to fully delineate the transaction.

The analysis concluded that the **key issues that drive the commercial success or failure of the contract** with MNO Ltd. are:

- the **terms and pricing of the initial, and revised, contract with MNO Ltd.**, and
- the **control of the Group's costs** through the management of the engagement of specialist personnel, and the management of their deployment in the project.



Case study – Construction

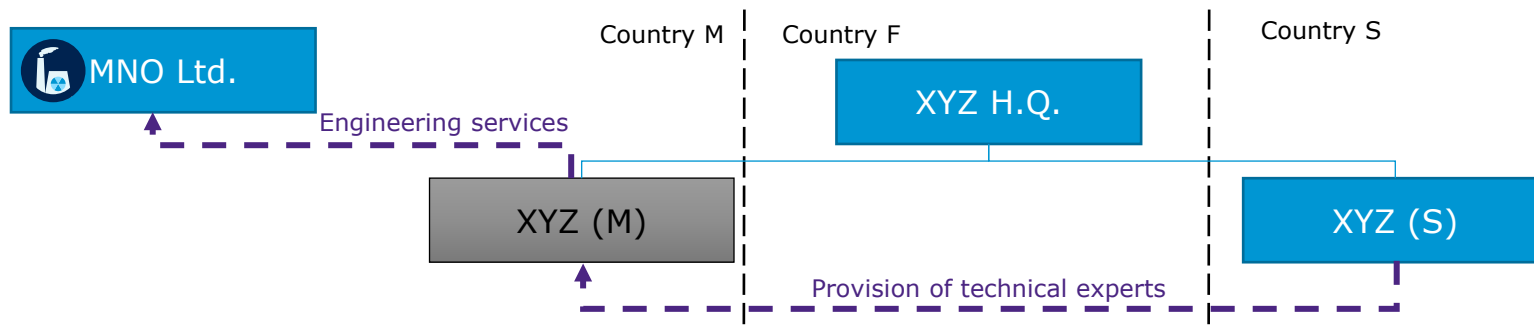
Phase 3– Tax Audit (2/3)

Who negotiated the **terms and pricing of the initial, and revised, contract with MNO**?

- the contract with MNO Ltd. was negotiated by personnel from the Country F head office, although signed by the Managing Director of XYZ (M). The renegotiation of the contract was led by personnel from the Country F head office, although employees of XYZ (M) were present at the renegotiation.

Who controlled the Group's **costs**?

- The analysis also revealed that the management of the deployment of specialist experts (engineers, consultants etc.) was undertaken by project managers engaged by XYZ (S).



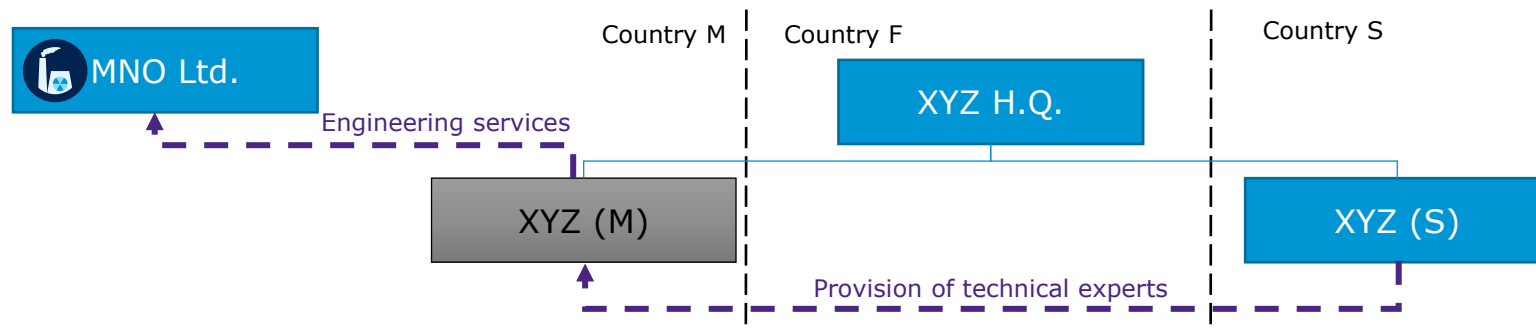
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Phase 3– Tax Audit (3/3)

It was concluded that **the employees of XYZ (M) were not suitably qualified to manage the project, did not have the authority to manage the project, and did not in fact do so.**

It was further considered that **the real role of XYZ (M) was to provide local logistics** (including office and IT support and provision of utilities) to the engineering personnel.

The audit also found that XYZ (S) had sufficient financial capacity to assume the risks related to the ongoing control of group costs associated with the project.

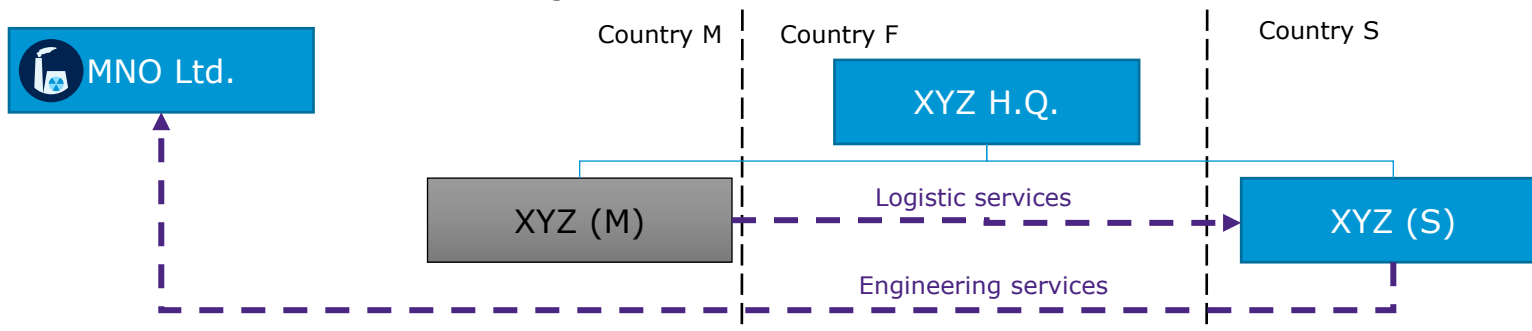


Case study – Construction

Phase 4 – Delineating the Actual Transaction (1/2)

The application of the Country M transfer pricing rules (in line with international principles) requires that in delineating the actual transaction the assumption of risks must be supported by the exercise of control and the existence of financial capacity to assume such risks.

Although **XYZ (M)** was contractually allocated the entrepreneurial risks, it **did not exercise control** over them. **Instead, a combination of XYZ (H.Q.) and XYZ (S) controlled these risks.** Since XYZ (H.Q.) and XYZ (S) also had the relevant financial capacity to assume these risks, they were allocated for the purposes of delineating the transaction to XYZ (H.Q.) and XYZ (S). **XYZ (M) was merely providing low-risk services.** This accurately delineated transaction is then used to determine and apply the most appropriate transfer pricing method, and to search for independent comparables with which to benchmark an arm's length result.



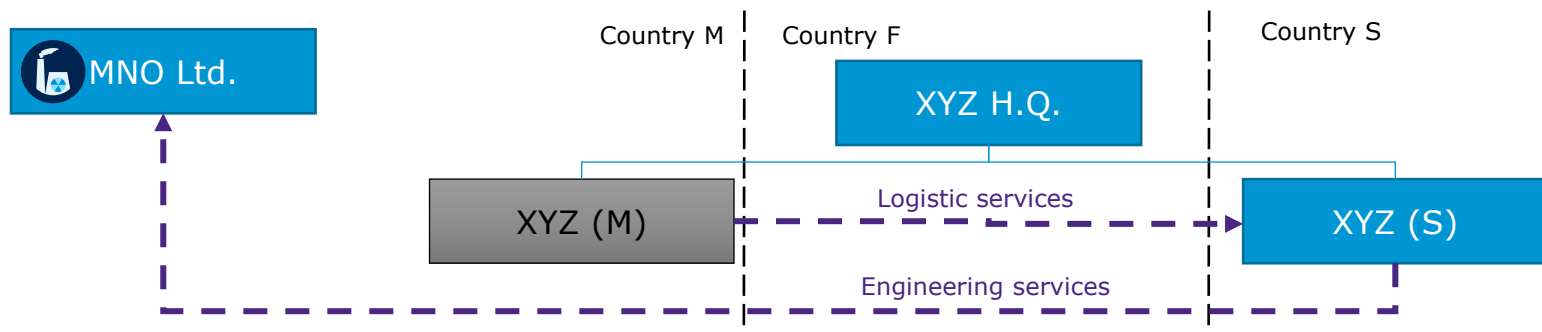
Case study – Construction

Phase 4 – Delineating the Actual Transaction (2/2)

As a result, the tax administration took the view that a method based on a **mark-up on cost is most appropriate**, with **XYZ (M) as the tested party**.

A benchmarking study was undertaken to find suitable comparables. The effect of the application of this method was **to recognise a profit in XYZ (M) for tax purposes throughout the period of the contract**.

The adjustment in Country M is a **reduction in the deductible fee paid by XYZ (M) to XYZ (S)**.



Questions: 2

- If you were XYZ, what would you do now?
- (Segway into the next session!)



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