IOTA

Intra-European Organisation of Tax Administrations

IOTA Case Study Workshop

"Transfer Pricing Challenges in Advance Pricing Agreements"

Proposed Solutions

3 - 5 December 2024

Budapest, Hungary

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CASE STUDY 1- SPAIN

Case Submitter:

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Question 1 (relating to the case):

1. Would you categorize the functions carried out by Company A related to the Online Sales in Country A, as a provision of services?

Proposed Solution:

We had a prefilling with the company and we made a proposal to give them a different treatment for this transaction.
Our understanding is that, in this sector, both retail and online sales channels are the same. We asked the company to separate the online sales made in Country A from the remaining online sales, and they were willing to do so.
Therefore, we proposed to include the online sales with the retail sales, eliminating the distinction between them whatever the sale channel was, retail or online. At the end of the day, when you buy something on the website, if you need to change it you go to the store and maybe you buy something new in return.
So, given the specific profile of the sector, we considered that company A had the same functional profile in online sales.
Finally, they accepted the change, thus threatening the same way the retail and online channels. With this approach, company A is acting as a limited risk distributor both for retail and online sale channels, and the business platform fee they proposed to apply, would be calculated including both retail and online sales.
Once we have the same treatment for all the sales, we began to discuss about the proper way to remunerate the transactions, as we were not comfortable with the Business Platform Fee.

Questions 2 & 3 (relating to the case):

1. Given that the functional characterization made by the Group is correct, do you think the remuneration for company A is accurate?
2. Do you think that the related-party transactions proposed by the company are well-defined?

Proposed Solutions:

We thought the functional characterization was correct. Company A meets the features of a limited risk distributor, so a remuneration based on the TNMM could be accurate.
For us, the problem was the related-party transaction design.
The main operation between company A and the HQ is the sale of tangible products (clothing) without adding a margin to the cost incurred by the second.
The Group was willing to maintain the open-market price to remunerate the covered transaction, as the addition of a margin could cause them problems with the Customs Office goods valuation.
On the other hand, the HQ was using a platform to give support to all the subsidiaries with the business of selling the relevant products.
We could consider it a Service Provision, but the Group argued that the Platform differed from any usual service that you could quantify with a cost plus.
Both, sales of tangible fashion products and the platform are much related.
They were taking the residual profit to the HQ by drawing a new transaction. We agree with the proposed remuneration for Company A, as it is well characterized as LRD, but we think that the correct way to remunerate Company A in this case, is not by creating a new transaction with the mentioned fee, but by making the adjustment trough the existing transaction: the intercompany sale of fashion tangible products.
As for the alleged potential problem that could arise with the customs offices, this might be a possibility between countries which are not part of the European Union, but in our case, both countries were in the EU.
So we proposed to the company to apply the TNMM to the sales of tangible products, including both online and retail, using the same benchmarking they proposed. In conclusion, Company A will receive a remuneration based on sales by the application of a TNMM within the range of 1,67%-4,87%.

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CASE STUDY 2 - LITHUANIA

Case Submitter:

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Questions (relating to the case):

1. Are the specified circumstances sufficient to apply the profit split method? If not, what other evidence is missing? What other transfer pricing method could be applied to these transactions?

2. Would your tax administration accept to examine such a request and what could be your decision (approve, disapprove the request, approve with reservations / additional critical assumptions or other options)?

Proposed Solution

After reviewing the taxpayer's request and evaluating the materials submitted, the Lithuanian tax administrator decided to disapprove the transfer pricing principles for the future controlled transaction outlined in the request.

Such a decision was taken because:

- The unique and valuable asset (license to conduct business) indicated by the UAB "A" does not meet the description of unique and valuable assets defined in the OECD TP Guidelines. According to the Lithuanian tax administrator, registration is necessary to conduct business, and it is more of a legal requirement that any company wishing to engage in similar activities must comply with. By having such a right, the Group does not create any exceptional asset in this case (the value aspect may be arguable, but under the aforementioned condition, the asset must have both characteristics, i.e., uniqueness and value). Based on the provided information, it appears that UAB "A" grants other Group companies the right to use the registration held by UAB "A" (i.e., UAB "A" business activity), but it is unclear what UAB "A receives from the other Group companies in return. The business creation chain provided is also based solely on explanations or the UAB "A" opinion regarding the significance of certain value drivers (such as strategic management, IT (software), customer relationships, brand, and business registration), but lacks justification for their significance (what was relied upon in determining the weight of each, i.e., very important, medium importance, or low importance). This is important because these weights are later used in calculations (for profit allocation among the Group companies).

- It was insufficiently justified why a one-sided method was not chosen, and why it is not possible to determine arm's length remuneration for UAB “A” based on individual functions, even though this applies to part of the activities.
- No justification was provided that in this sector the weight of functions in the value chain is assessed in this way and that unrelated parties would allocate residual profit in the same proportions.

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CASE STUDY 3 - FINLAND

Case Submitter:

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Questions (relating to the case):

1. What is your first reaction to the 0,05% interest rate of the Covered Transaction 1? Have you seen similar interest rates?
2. What is your first reaction to the contract manufacturing compensation of the Covered Transaction 2? Have you seen a similar level of compensation for contract manufacturing?
3. B Corporation sells the products to markets, but there is no further information on distribution activities. Would you send a lengthy questionnaire to the taxpayer where you would ask for more information about distribution, or would you consider that you are able to discuss the APA without distribution information?
4. In what way would you approach the case? Would you evaluate the case on a transaction-by-transaction basis, or would you combine the evaluation of both transactions?
5. What would be your position to sign the APA?

Proposed solution

Finnish Competent Authority (CA) would consider Chapter I of the OECD Transfer Pricing Guidelines (OECD TPG) as relevant guidance to evaluate the APA request. Especially paragraphs from 1.60 to 1.69 of the OECD TPG are useful in determining whether the transactions could be at arm's length. In order to accurately delineate the actual transactions, Finnish CA would go through the steps outlined in paragraph 1.60 of the OECD TPG.

Based on the functional analysis presented in the APA request, it seems to be that B corporation is performing control functions and risk mitigation functions as well as encountering upside and downside consequences of risk outcomes. B Corporation has also the financial capacity to assume the risks.

B Corporation has control over economically significant risks as defined in paragraph 1.65 of the OECD TPG. B Corporation has the capability to make decisions to take on, lay off, or decline a risk-bearing opportunity, together with the actual performance of that decision-making function. B Corporation has also the capability to make decisions on whether and how to respond to the risk associated with the opportunity, together with the actual performance of that decision-making function. B Corporation has made the investment decision on a new greenfield factory using its know-how in building a factory with state-of-the-art technology and optimal layouts for the manufacturing process. B Corporation manages the overall supply chain and has also among other functions the capability to operate in the global markets to sell the manufactured products. On the other hand, BX as a newly established entity does not have any capability to make investment decisions or operate the factory without guidance. Besides, BX doesn't have any financial capacity to assume the risks involved with the investment.

Consequently, B Corporation should bear the downside consequences, if the factory investment fails, but at the same time should be entitled to receive the upside benefits. For this reason, BX should be compensated only for its routine manufacturing services, as it controls the risk that it fails to deliver its services to the principal. The Net Cost Plus 3,5% compensation could be considered at arm's length.

Determining the arm's length compensation for the loan transaction is not as straightforward. B Corporation is nevertheless responsible for the investment, so B Corporation should bear the investment risk as well as the cost of funding. It's clear that BX doesn't have access to funding to take the investment risk. It could be argued that BX is unable to service a 455-million-euro loan on conditions that independent parties would have agreed to. The conditions could include for example around five per cent or even higher interest rates, which BX would be unable to service. The solution could be that the advance of funds from B Corporation could be entirely considered as a contribution to equity or the amount of the debt could be significantly lower to match BX's servicing ability. Another solution could be to combine the evaluation of the transactions as in effect the taxpayer is proposing in the APA request.

Finnish CA would prefer the latter approach. In combining the evaluation of the transactions Finnish CA would not accept the 0,05% interest rate as arm's length as such but would accept the transactions as arm's length in viewing the transactions in their totality. Finnish CA could agree on taxpayers' conclusion that the overall transaction (intra-group loan and the contract manufacturing operations) is at arm's length.

The case highlights the advantages of the APA procedure because in cases like this CA's can seek pragmatic solutions for potentially difficult transfer pricing issues. The outcome could be completely different, if for example without a bilateral APA, a tax audit would tackle the loan interest rate as an isolated transaction.

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CASE STUDY 4 - FRANCE

Case Submitter:

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Questions (relating to the case):

1. Proper use of benchmarking studies, and the correct range to choose
2. Dealing with some routine remuneration that will impact an RPSM, with potentially some side effects, up to sharing losses.
3. The correct remuneration of each entity holding IP and/or value creation, while also performing some routine functions.
4. The taxpayer came again with the idea of adding more transactions, regarding some restructurings.
5. Z group has filed a similar BAPA with FR and another country, but this time with a different TP methodology proposed.

Proposed solution

1) Importance of mutual understanding between the CA's

2) Rejection of amendments meaning major changes in the APA

3) Correct use of a Split factor in an RPSM method: non-routine costs that should or not be included in the calculation of a split factor.

4) For routine remunerations: a narrower arm's length range is to be retained

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CASE STUDY 5 - GERMANY

Case Submitter:

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Questions (relating to the case):

1. Is the Tested Party "one" legal entity or different divisions?
2. How to handle Upfront Costs from change of production?
3. Performing a Term Test or a single-year test? If Term Test: How long is a "Term"?
4. Which years should a benchmark analysis include?
5. How to deal with Local Tax Audit adjustments during the negotiation/APA period?

Proposed solution

Preliminary Note: Since the case has not yet been finally closed, there is no solution to share. The considerations of the German Competent Authority are therefore provided below.

Considerations of the German APA-Team

1. Whole of Entity or Segmented Approach?

The whole of entity - OECD

The OECD also assumes that the central element of a transfer pricing analysis should be the individual transaction. However, it is quite common that several transactions should be tested together. The OECD cites as an example long-term contracts for the delivery of goods and services or the contracting out of production know-how in connection with the delivery of important components to a manufacturing company.[1] This is to be assumed here for transactions 2 and 3. Funny Cars AG provides Funny Cars SA with both the production know-how and

[1] OECD TPG Tz. 3.9

important components so that Funny Cars SA can sell the X-series vehicles produced, respectively the Y-series from 2022, to Funny Cars AG. These two types of transactions can be summarized and tested as contract production. A separate summary must also be made for transaction type 1 - the purchase of vehicles for sale on the local market.

The portfolio approach, which also takes into account other relationships in different transactions such as goods and service transactions in the after-sales area or in related product groups, also fails.[2] This approach should not be used for different business transactions with different economic logic.[3] It is therefore not appropriate to test a company as a whole if the company carries out a large number of different intra-group transactions that cannot be compared as a whole with the transactions between independent companies.[4]

Whole of entity - Case

From an economic perspective, a fundamental distinction must be made between the two categories "NSC" and "Plant". The activity areas of Funny Cars SA mainly consist of two different, separable units, which each have to be considered separately also from a transfer pricing methodology perspective. The German tax auditor does not share the "whole of entity" approach presented by the company. From an economic perspective, these functions are fundamentally separate from each other, like independent business models. On instructions from Funny Cars AG, the production plant produces the X-Series respective since 2022 the Y-Series. The NSC imports and distributes imported vehicles from Funny Cars AG. There isn't such a strongly integrated business model that is economically or actually inseparable. Both the production plant and the distribution company respectively can act on their own behalf on the market.

The legal corporate structure of a single legal entity has been chosen based on specific local legal provisions, in order to benefit from the discounts and credits granted by the incentive program created by the Country B government. This does not lead to a mandatory consideration of the "Whole of Entity" approach. An arm's length principle-compliant allocation of the incentives to the respective division is possible.

2. Following comments regarding Upfront Cost of the Production Change:

Between February 2021 and March 2022, the plant was renovated to accommodate the production of the new Model Y. For transfer pricing purposes the restructuring costs were not directly reimburse in 2021 and 2022 by Funny Cars AG, but remunerated later as part of the vehicle production of the new Modell 2022 onwards. The restructuring costs therefore only have a transfer price-increasing effect as of the year 2022 onwards.

From an economical and a transfer pricing perspective, this procedure is arm's length principle-compliant. An unrelated third-party manufacturer would also have had to rely on advance payment for the production of a new product, if they had generated a sufficient profit from the overall business throughout the period. This conduct is common in the automotive industry. For instance, unrelated third-party suppliers also do not ordinarily receive subsidies or separate compensations from the Original Equipment Manufacturer (OEM) for the development of a new product on behalf of the OEM, if the subsequent serial delivery was agreed with the OEM. In such cases as well, the development costs of the supplier are covered by the part price of the OEM and therefore "subsequently" receive a profit component.

Even though the margin in 2021 and 2022 is outside the range, it is at arm's length. A third-party contract manufacturer would also have pre-financed the costs of the production change itself if

[2] OECD TPG Tz. 3.10
[3] OECD TPG Tz. 3.10
[4] OECD TPG Tz. 2.84

the costs were contractually guaranteed to be reimbursed via the part price during the contract term.

3. Following comments regarding the Single Year Test or Term Test:

According to OECD Transfer Pricing Guidelines (OECD TPG)[5], is important „to identify the commercial or financial relations between the associated enterprises and the conditions and economically relevant circumstances attaching to those relations in order that the controlled transaction is accurately delineated." After that all "conditions and economically relevant circumstances of the controlled transaction must then be compared with the conditions and economically relevant circumstances of comparable transactions between independent enterprises". Furthermore, the facts and circumstances underlying the controlled transaction must be fully understood and therefore the OECD also considers it necessary to examine data from both the year under review and previous years. The analysis of this information could reveal facts that influenced (or should have influenced) the determination of the transfer price.[6]

For the intra-group transaction between Funny Cars AG and Funny Cars SA, a proper delimitation of the actual business transactions and an analysis of the economically relevant characteristics must therefore be carried out. This includes both the terms of the business transaction and the economically relevant circumstances under which the business transaction takes place.[7]

A single year approach ignores the cyclical nature of the automotive industry and therefore leads to an unreliable comparison of the margins achieved by the peer companies with those of the tested party. The profitability of Funny Cars SA is generally not constant over a period of several years and can be affected by, for example, economic or product life cycles.[8] This effect is evident in the Corona pandemic, where companies that mainly depend on direct local customer contact have been hit harder than companies that were more independent of "lockdowns" due to online trading. To avoid distortions caused by these reasons and to provide consistent and robust results, the range should normally be calculated for a period of several years.

A comparison of a term test of the benchmark companies with an annual analysis of the tested party also contradicts the economic conditions of the individual years. For example, the supply chain problem in the wake of the global crises has led to considerable economic distortions, particularly in the automotive industry, which would not be considered or would only be taken into account inadequately by comparing a single year of the tested party with an average value of several years of the Benchmark-companies.[9]

Since a complete analysis of the "business transaction" shows that the supply and service relationships between Funny Cars AG and Funny Cars SA cannot be examined strictly on a yearly basis and that this does not make economic sense, a multi-year analysis on the part of Funny Cars SA is preferable. This is also supported by the fact that a multi-year analysis of the benchmark companies was carried out and thus a direct average comparison is more economically accurate.

According to the German APA team, the result should be tested using a term test.

Not yet clarified / In Question: Rolling Average or (Fixed) Term Test? Rolling Average 3-Years? Term Test -> How Long is a „Term" 3 Years, 4 Years, APA-Years, etc.?

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[5] OECD TPG Tz. 1.33 ff
[6] OECD TPG Tz. 3.76 ff
[7] OECD TPG Tz. 1.35
[8] OECD TPG Tz. 1.131
[9] OECD TPG Tz. 3.75 ff

4. Years included in the benchmark analysis?

According to OECD-TPG, a multi-year analysis can also be carried out to improve the quality of the benchmarking.[10] A (weighted) average for the benchmark analysis covering several years is also possible [11] and is in line with international practice.

Regarding the years covered by the benchmark analysis, the German CA is of the opinion that years that correspond to the APA period should be used as far as possible, as these years best reflect the economic circumstances. This means that for a term test for the years 2018-2020, a benchmark analysis for the years 2018-2020 should be used if possible. If this is not possible due to data sets not yet being available for the years included in the APA, the most recent data available should be used.

Whether a rolling average or a fixed term test should be used must be answered together with question 3.

5. Local Tax Audit Country B

In Germany, it is absolutely unusual to conduct an audit of transactions covered by an ongoing APA period.

Findings only under consideration of single years looks very much like „cherry picking“ and intensifies and hardens the ongoing APA-discussions between the CAs.

Single Year adjustments contradicts the economic realities (Life cycle, one-time economic impacts) and ignores extraordinary one-off effects.

[10] OECD TPG Tz. 3.75, 3.77, 3.78
[11] OECD TPG Tz. 3.79