TP Courtroom Around the World | 2020

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Foreword

We are pleased to present Nexdigm (SKP)'s annual publication 'TP Courtroom' for 2020. This is our second edition that analyzes the findings of key judicial rulings of the global Transfer Pricing landscape for the year 2020.

While we focus on court judgments, we also clearly recognize that the quarantine induced by COVID-19 has created damaging repercussions in court activities. In the efforts to slow the spread of COVID-19, the functioning of the justice system has been massively impacted across all countries. Most of the judicial cases are or will be, inevitably deferred, if not paralyzed. The worldwide extent of the COVID-19 crisis has confronted us again in our history, with humanity's eternal fragility.

That being said, the year 2020, despite the unprecedented challenges, saw some interesting court judgments on critical issues, including the importance of identifying 'Control over risk' in Transfer Pricing (TP) analysis, intangible issues arising in business restructuring, the importance of adopting consistent TP analysis approach Year over Year (Y-o-Y), etc. This edition of TP Courtroom scrutinizes the key arguments in prominent judgments published during 2020, like Coca-Cola, Puma, Apple, Glencore, etc.

One common theme that one could observe from the judgments covered in this edition is that the tax world is getting 'BEPSed.' The enormous amount of work done by the Organisation for Economic Co-operation and Development (OECD) on its landmark Base Erosion and Profit Shifting (BEPS) project has equipped the tax authorities with more tools to detect tax leakage due to transfer pricing arrangements deployed by MNEs.

We hope that the key takeaways of every case in this edition assist the MNEs in laying a framework for robust defense strategies in the event of an audit by tax authorities. This booklet can also serve and support the MNEs while they revalidate/formulate their key transfer pricing strategies. As global entities like OECD become a standard, it is prudent for MNEs to evaluate their tax positions and adopt sound practices to avoid coming under the radar of tax authorities.

Maulik Doshi
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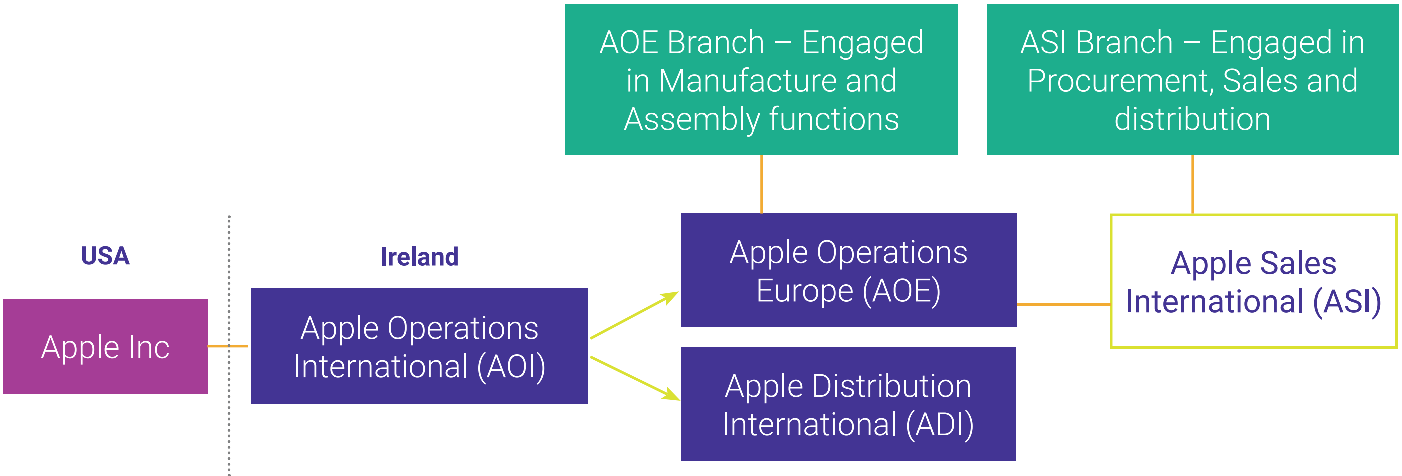
Apple | Ireland | General court provides relief to 'Apple', confirming that there is no 'State Aid'/selective advantage in the advance tax ruling



Advance tax rulings are a common feature of mature tax jurisdictions. Companies enter into such agreement with tax authorities to get clarity and consistency regarding the application of tax law, fixing on the tax liability and ensuring smooth compliances.

This case pertains to an advance tax ruling entered between Apple group entities in Ireland and Ireland tax authorities in effect for the tax period 1991 to 2014. Ireland is one of the Member states in the EU region.

The EU Commission (The Commission), in its final decision in 2016, adjudicated the advance rulings granted by Ireland in 1991 and 2007 as unfair, offering 'selective advantage' and digressing from principles of Arm's Length Price ('ALP') as prescribed by OECD transfer pricing guidelines. It stated that the attribution of profits to the Irish branches of two Irish incorporated, non-resident companies constituted unlawful State aid, thus ordering an immediate recovery of the aid.

What is selective advantage/State aid?

State aid is defined as an advantage in any form whatsoever conferred on a selective basis to business undertakings by national public authorities (Ireland in the instant case).

The Ireland tax authorities and Apple group (vide its affected group entities - Apple Operations Europe AOE and Apple Sales International - ASI) appealed to the General Court against the decision pronounced by the Commission.

Facts

- The Apple Group is engaged in designing, manufacturing and marketing, mobile communication and media devices, personal computers and portable digital music players, and sells software, other services, networking solutions and third-party digital content and applications.
- It markets its products and services worldwide through retail stores, online stores and direct sales force, as well as through third-party cellular network carriers, wholesalers, retailers and resellers. The relevant group structure and entities are illustrated as above:
- Among the Apple Group companies incorporated in Ireland, a distinction can be made between companies incorporated in Ireland that are Ireland tax residents and companies incorporated in Ireland but are not tax residents. The ASI and AOE were managed and controlled from outside Ireland but carried out the trading activity in Ireland through their respective branches. The ASI and AOE, although incorporated in Ireland, are considered as non-resident entities whereas their respective Irish branches are considered as residents in Ireland for tax purposes.
- Under the Cost-sharing agreement (CSA) between Apple Inc., ASI and AOE, both parties agreed to combine their R&D efforts and to share the costs and rights relating to the 'Development Programme.' The right to use Apple's intangible property to manufacture and sell Apple products is shared amongst parties in the agreement. Apple Inc. holds the right to manufacture and sell Apple products in the Americas. The ASI and AOE hold right to manufacture and sell Apple products in markets outside of the Americas. The legal title to all intangible property is held solely in the name of Apple Inc. The ASI and AOE have beneficial ownership in their territory of intangible property developed as a result of R&D conducted under the CSA.
- In the advance tax ruling effective 1991, a profit allocation formula largely based on operating costs/manufacturing process turnover was agreed for Irish branches of AOE and ASI. The Commission opened a formal investigation concerning the chargeable profits allocated to Irish branches of ASI and AOE on the ground that these could constitute state aid for the Treaty on the Functioning of the European Union (TFEU).

- The Commission, in its decision, established that these arrangements conferred an advantage to Ireland branches as it departed from a transfer pricing agreement based on arm's length principle in an open market scenario. **The Commission concluded and ruled in favor of AOE and ASI constituting an aid within the meaning of Treaty, thereby directing Ireland tax authorities to recover this aid from the AOE and ASI along with interest on below premise:**

  a. Profits derived from the IP licences held by the ASI and AOE not allocated to Irish branches

  b. Inappropriate choice of methods for allocating profits to ASI and AOE's Irish branches

  c. Incorrect application of arm's length principle and the OECD TP Guidelines.

Issue: Whether advance tax ruling entered between Apple group entities in Ireland and Ireland tax authorities in effect for the tax period 1991 to 2014 are unfair and offering 'selective advantage'?

Key Contentions of Commission

- Regarding activities of the Apple entities:
  - Head offices of the ASI and AOE did not have any employees. It could not perform any functions concerning product quality control, R&D facilities management and business risk.
  - The ASI's branch performs functions crucial for developing and maintaining the Apple brand in the local market and ensuring customer loyalty to that brand.
  - The ASI's branch incurred local marketing costs directly with marketing service providers.
  - ASI's branch was responsible for gathering and analyzing regional data to estimate demand forecast for Apple-branded products.
  - The AOE's branch developed specific processes and manufacturing expertise and ensured quality assurance and quality control functions to preserve the value of Apple brand.
  - Costs covered by the CSA agreement are allocated as an IP return, meaning that the AOE's branch was involved in the development or management and control of IP
- In view of the above, in its primary line of reasoning the commission contended that –
  - The, profits resulting from the allocation of economic ownership of Apple Group's IP licenses should be allocated to branches of ASI and AOE
  - The arm's length principle should be applied in determining allocable profits following the authorized OECD approach
  - As the head offices of ASI and AOE were unable to control or manage the Apple Group's IP licences, these head offices should not have been allocated, in an arm's length context, profits derived from the use of those licenses. Accordingly, those profits should have been allocated to ASI and AOE's branches (Exclusion approach).

Key Contentions of the taxpayer/Ireland authority

- Commission did not have the jurisdiction to analyze the advantage and selectivity conditions for non-resident companies (i.e. ASI and AOE) who were governed by separate charging provisions.
- Commission erred in adopting the approach to examine non-resident company's profits in entirety and extent to which profits cannot be allocated to other parts of that company, are allocated by default to Irish branches.
- The principles of arm's length pricing cannot be applied under normal provisions of the Irish Tax. Ireland did not have transfer pricing regulations in place during the covered period. The taxpayer argued that the existence of an advantage by way of reduction in tax burden to taxpayers can be established only when compared with 'normal' taxation. The Commission erred in placing reliance on the OECD Model Tax convention for allocation of profit.
- Regarding activities of Apple entities:
  - Activities and functions performed by Irish branches of ASI and AOE represent only a tiny part of their economic activity and profits.
  - Irish branches neither perform management nor strategic decision-making related activities towards the development or marketing of the IP.
  - All strategic decisions, including product design and development, were taken in accordance with commercial strategy determined in the USA and were implemented outside Ireland.

Decision of General Court (the Court)

- The General Court observed that contested tax ruling was issued to allow ASI and AOE to determine their chargeable profits in Ireland for the purpose of tax. The objective of general Irish corporation tax regime is to tax profits of companies carrying on activities in Ireland, be they resident or non-resident. **Therefore, the provisions concerning chargeable profits of non-resident companies cannot distinguish it from the ordinary rules. Accordingly, the jurisdiction question was answered in favor of the Commission.**
- Regarding activities of the Apple entities in Ireland, the General Court upheld that –
  - The Commission failed to demonstrate that functions were actually performed by branches.
  - If the Commission argues that ASI cannot perform functions outside its branch due to lack of staff, it will have to consider the same in case of ASI's branch, which had no staff till 2012.
  - CSA doesn't indicate that ASI's branch performed activities in relation to development and maintenance of Apple brand.
  - Payment of marketing cost to third parties doesn't make branch responsible for designing marketing strategy.
  - These activities are clearly support roles and cannot be regarded as key functions to determine that Apple Group's IP licences should be allocated to the Irish branches

Also, the court ruled that while Commission did not err in relying on authorized OECD approach for determining the arm's length price, Commission erred in application of such rules.

In its subsidiary line of reasoning, the Commission contended that profit allocation methods which resembled Transaction Net Margin Method (TNMM) as adopted by the taxpayer had below inconsistencies:

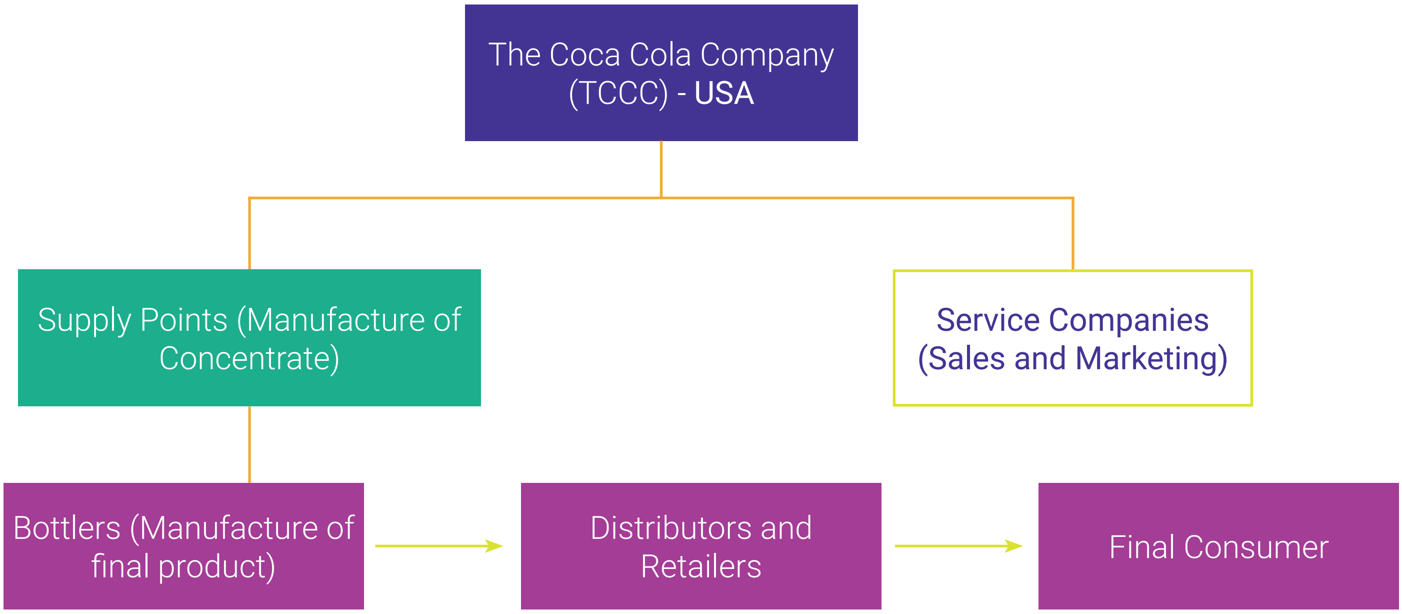
- Choice of branches as tested party is a methodical error in the instant case
- Choice PLI
- Comparable companies selected by the taxpayer for benchmarking

General Court ruled that the above contentions of the Commission are not justified without providing any evidence as to the actual performance functions by these branches. Thus, the Commission was not correct in questioning reliability of comparability studies without proving the fact that tax rulings led to a reduction in tax liability.

Key Takeaways

- For all taxpayers, the key take-away from this judgment is to re-evaluate their operating structures and intra-group arrangements with respect to intangible related returns. In the modern scenario, with the implementation of three-tiered documentation - Country by Country Reporting (CbCR), Group master File and Local Files, tax related transparency has increased multi-fold and any misalignment between economic substance and tax incidence will likely get questioned aggressively.
- Lastly, it would not be out of context to mention that all the work that is currently happening in the area of currently happening would have a very significant impact on such operating structures that give rise to double non-taxation. A 'consensus' as well as 'conscious'-based solution is the only way to deal with such situation!

Coca Cola | United States of America | US tax court ruled royalty tax dispute ruled in favor of the Internal Revenue Service (IRS)



The Coca-Cola Co. (TCCC or the company), headquartered in Atlanta, Georgia, is the ultimate head of the beverage giant, which is also the legal owner of major Intellectual Property (IP) (trademarks, know-how, etc.) of the Group. It licensed these IPs to Supply Points to produce concentrates used by the Bottlers to manufacture the final product. The service companies were responsible for advertising and marketing.

For the years 2007-09, the Supply Points remunerated TCCC for the use of IP by adopting the methodology agreed during the prior year, i.e., in 1996 at a closing agreement with the IRS, which covered the tax years 1987-1995. As per the agreement, the TCCC and Supply Points will adopt the '10-50-50' approach (Supply points to retain 10% of their gross profit, and then evenly split the remaining 90% of profit between the Supply Points and TCCC). However, the agreement did not contain a roll-forward provision or apply to the years 2007-2009. The Tax Court agreed with the IRS, that since there was no formal agreement to extend the terms of the closing agreement, the IRS was not bound by its terms. The IRS proposed a TP adjustment by increasing the aggregate taxable income of TCCC against the royalty payment received. It rejected the 10-50-50 formulary apportionment method and employed the Comparable Uncontrolled Price (CUP) as the MAM with 'Bottlers' as the tested party and PLI as Return on Operating Asset.

Issue: Whether the royalty payment pricing using 10-50-50 methodology is at arm's length?

Key contentions of the taxpayer

The IRS acted arbitrarily by abandoning the 10-50-50 method having consented to use the method during the prior audit cycle.

The taxpayer's principal contention is that the Supply Points owned immensely valuable off-book assets in the form of 'marketing intangibles'. According to the taxpayer, what kept TCCC's products fresh in the consumers' minds, were the billions of dollars spent annually on television advertisements, social media, and other channels of consumer marketing. The taxpayer accordingly urges that the Court should look beyond TCCC's legal ownership of these assets and focus instead on supposed 'marketing intangibles' generated by the expenditure of advertising dollars.

The taxpayer submitted transfer pricing reports from three experts admitting that TCCC owned the trademarks, secret formulas, etc., and concluding that the supply points, at arm's length, would be entitled to receive the vast bulk of the income that the Company derives from foreign markets. The three reports provide as follows:

a. Use of Comparable Uncontrolled Transaction (CUT) method (similar to CUP) from 'master franchising transactions' that companies like McDonald's and Domino's Pizza execute with regional franchisees abroad;
b. Use of Residual Profit Split Method to be considered where residual profit would be split between Supply Points and TCCC based on the marketing expenditure incurred by each of the parties;
c. Use of unspecified method where royalty payable to TCCC by the supply points should be calculated using an 'asset management model'.

Key contentions of the tax authorities

- The tax authorities contested that such formulary method did not reflect the arm's length price and the IRS was not obliged to follow the terms of such method for future years.
- Supply Points enjoyed levels of profitability unjustified by the economic functions they performed. They engaged almost exclusively in manufacturing, and the taxpayer experts agreed that this was a routine activity that could be a benchmark to the activities of contract manufacturers. IRS employed a CPM that benchmarked the supply points' profits against the profits earned by independent Coca-Cola bottlers.
- The bottlers owned and controlled genuine intangible assets in the form of retail distribution networks, sales forces, and customer lists--each deriving from the bottlers' relationships with tens of thousands of wholesale and retail customers. The supply points held no comparable assets.
- The CUT method will not be able to accurately capture the value of Licensing the company's unique brand. Likewise, the IRS rejected the Residual Profit Split Method (RPSM) stating that its unreliable as one party, i.e., TCCC, owned valuable intangible assets and the other party, i.e., Supply Points, owned virtually none.

Key Takeaways

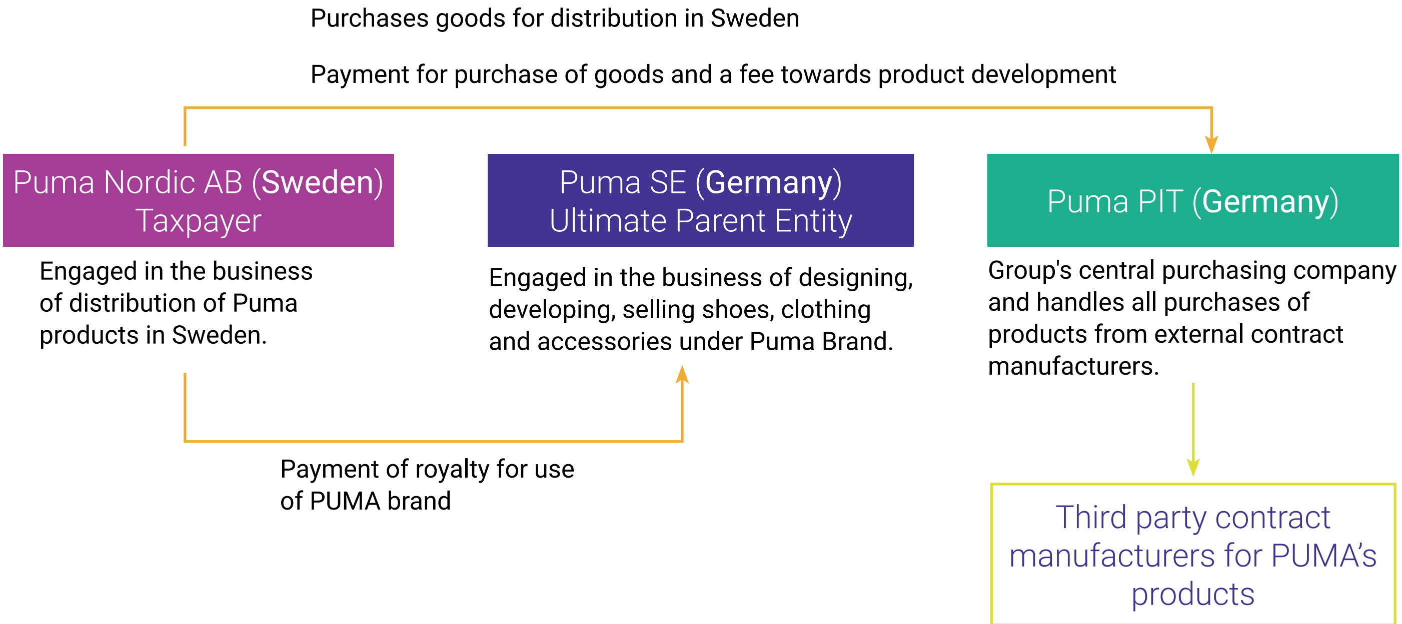
- Firstly, this judgment highlights the need to re-examine the terms of inter-co agreements, especially to those who have prepared the inter-co agreement using a standard template without giving any regard to the actual conduct.
- One of the important observations is TCCC's claim that since Supply Points were incurring marketing expenses, it automatically means a contribution to off-book intangibles/marketing-related intangibles. In analyzing the entire arrangement, the Court rightly concluded that a mere incurrence of costs does not lead to a contribution to intangibles creation and entitlement to residual profits. This observation is again a wake-up call to the taxpayers to conduct and document a robust functional analysis during the transfer pricing study.

US Tax Court Judgment

- The IRS did not abuse its discretion by reallocating income to the taxpayer by employing a Comparable Profits Method (CPM) that used the Supply Points as the tested parties and the bottlers as the uncontrolled comparables.
- The Court agreed with IRS and stated that there is no evidence in the agreement that depicted that IRS shared the desire or agreed to implement the formulary method in future years. Further, such agreement was silent on the application of TP methodology to be implemented for future years.
- The Court held that Supply Points played no role in arranging the consumer marketing and had no voice in selecting or evaluating the services for which they were financially responsible. The agreement between TCCC and Supply Points explicitly stated that Supply Point had no ownership interest or rights in TCCC's IP. Furthermore, based on the analysis, the Court observed that in substance, all strategic decisions around consumer marketing were undertaken by the TCCC alone, with negligible inputs from Supply Points. Accordingly, the Court held that just bearing the financial expense cannot lead to constituting that Supply Point was in substance the economic owner of intangibles.
- The Court concluded CPM as the Most Appropriate Method (MAM) and stated that CPM is preferably used where only one entity contributes to meaningful intangible property and such intangibles are hard to value as CPM avoids the direct valuation of such intangibles. The Court also upheld considering Bottler as a comparable, stating that they operate in the same industry, faced similar economic risks, had similar (but favorable) contractual and economic relationship with TCCC, etc. Accordingly, the Court upheld the TP adjustment made by IRS for under-compensation of royalty payment to TCCC by Supply Point.

Puma Nordic AB | Sweden | Swedish Tax Agency applies OECD principle to conclude 'Control over risk'

The risk related to brand and product was with the Associated Enterprise (AE) while the taxpayer merely functions as a marketing and reselling entity.



Overview of Puma Group

- Puma Group (Puma) has been designing, developing, selling marketed shoes, clothing and accessories under the Puma brand, dealing majorly in **performance** and **sport-inspired lifestyle** products in categories such as football, running, training, golf and motorsport.
- Puma's production is done by **external manufacturers** in **Asia,** whereas the Puma Group's main focus is on **marketing, designing and developing products**.
- Puma advertises globally as well as locally via magazines, television, cinema and outdoor advertising.

Background of Puma Nordic AB (taxpayer) and transactions under review

- Puma Nordic AB is an indirect **wholly owned subsidiary** of Puma SE and states that it is more than a 'routine' **distribution company** performing the main functions of marketing and selling PUMA branded products in its **local market** and bearing corresponding risks.
- Puma Nordic AB purchases the PUMA branded products from its affiliated sourcing company in Germany, i.e., Puma International Trading GmbH (PIT), for resale in its local market (Sweden).
- Furthermore, Puma Nordic AB obtains a license from Puma SE for the use of the brand 'PUMA' and related marketing material, which is prepared by Puma SE. The license covers the costs of creation and maintenance of its marketing strategy on the part of Puma SE. Further, as per the license agreement, Puma Nordic AB also invests in local marketing and bears the expenses in relation to the same.

Pricing Policy and Outcome

- Puma Nordic AB pays a cost-based fee for the products to PIT along with a commission, and further also pays a product development fee to PIT. Puma Nordic AB pays a royalty for use of the PUMA brand and the use of marketing content to Puma SE.
- The applied pricing model by Puma Group resulted in **continuous losses** for Puma Nordic AB.

Issue: Whether Puma Nordic AB can be considered as a low risk distributor for products distributed in Sweden, although it contractually assumes the 2 most significant risks of brand and product development, relating to Puma SE's business operations?

Key contentions of the Swedish Tax Agency (STA)

- The primary functions, as set out in the value chain analysis, were analyzed by the STA in order to understand the contribution of each entity of the Puma Group, whereby it inferred that Puma SE takes strategic decisions regarding product design, development and brand, provides marketing content to distribution entities. Further, Puma SE is the legal owner of all Intellectual Property rights relating to Puma products and the brand. On the other hand, PIT is the central procurement entity of the Puma Group which outsources to external manufacturers, and Puma Nordic AB is the local sales, marketing and distribution entity, using the marketing material provided by Puma SE while having its own customer lists and bearing expenses of local marketing.

- Further, the STA followed the six-step model laid down in the 2017 OECD TP Guidelines, in order to identify economically significant risks, which were found to be:
  a. Build a strong international brand (brand risk); and
  b. Design and develop new products (product risk).
- On comparison of the contractual assumption of risks and the actual conduct of the parties, and finding disparity in the two, the STA found that although the brand and product risk were contractually attributed to Puma Nordic AB, but it is actually Puma SE who has the decision-making capacity and control over these risks. In reality, only the normal risks related to market demand were borne by Puma Nordic AB.
- The STA, therefore, concluded that Puma Nordic AB should be considered as a Low-Risk Distributor (LRD) performing routine functions and assuming routine risks as that of an LRD.
- Furthermore, the STA stated that, for an LRD model, any independent LRD would not have accepted the current pricing model of the Puma Group, which resulted in losses for several years to the LRD. Thus, Puma Nordic AB, exposed to low-risks, should not be incurring losses for so many years, as per the arm's length principle. Therefore, the STA concluded that the intra-group pricing is not in accordance with the arm's length standard.

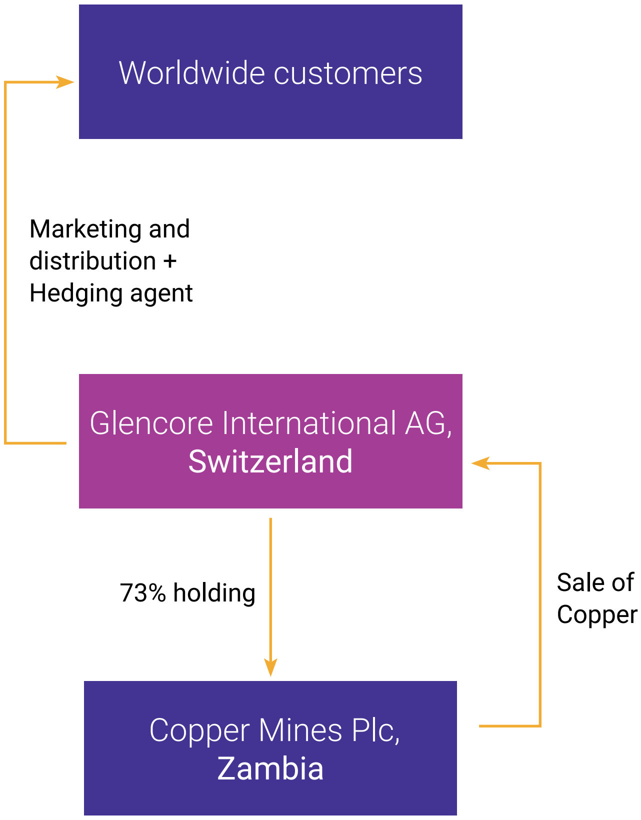
Key Takeaways

- Distributors should re-evaluate whether the Inter-corporate Agreements and the Group's transfer pricing policy is in compliance with the risk control framework as per the OECD TP Guidelines 2017.
- The OECD TP Guidelines 2017 highlights the importance of understanding how the value is generated in the group as a whole based on actual conduct of the AEs, interdependencies of the functions performed by the AE with the rest of the group and the contribution made by each AE to that value creation rather than a sole focus on contractual terms and legal form of transactions.
- The six step approach suggested by the OECD guidelines to identify the risk owner are useful reference:
  1. Identify economically significant risks
  2. Determine how risks are contractually assumed
  3. Determine which enterprise has capacity to assume risk (through functional analysis)
  4. Determine if the contractual assumption of risk is consistent with actual conduct (reference to 3 above)
  5. Basis the findings of (4) above allocate the risk to party actually assuming the risk by conduct
  6. The transfer price should factor the impact of (5) above
- Hence, it would be advisable to monitor the actual conduct of the entities to a transaction and align the contractual arrangements to the same. Misalignment can lead to major repercussions, including rejection of the taxpayer's contracts and analysis based on the same, and possibility of re-characterization of the entities preceding the economic analysis.

1. Facts of the case

- Mopani Copper Mines Plc. hereafter referred to as 'appellant', is engaged in large-scale copper mining activities in Zambia.
- The appellant had sold copper to its AE and the sale price was based on the price quoted on London Metal Exchange (LME) as Copper A Grade for a period.

The intra-group arrangements are explained below:



- The tax authority raised concerns on the related party transactions of the appellant and several rounds of meetings/discussions took place between them. During the course of hearing, the appellant was allegedly asked to seek an independent consultant's opinion to examine the related party transactions (including hedging arrangement) and whether it complies with the arm's length standard. The independent consultant issued its report and opined that the appellant's related party transactions complied with the OECD principles and pricing terms are more favorable as compared to the independent market scenario.
- Notwithstanding the response from the appellant, the tax authority had undertaken their own analysis and thereby, an addition was made on 50% of sales volume.

2. Appeal against the decision to the Revenue Appeals Tribunal (Tribunal)

- The tax authorities were not obligated to accept the Independent consultant's report and it was not binding to them as it was not requested formally.
- Basis the audit conducted by tax authorities, the sales price charged to related parties was lower compared to the sales price charged to the unrelated third parties. This is a sufficient basis upon which tax authorities invoked its power under Section 95 of the Zambia Income Tax Act (deals with Tax avoidance) (The Act).
- Hedging agreement between the appellant and related party was of no benefit since:
  - It was not produced before Tribunal
  - It was not demonstrated that the period of hedging was not open-ended
  - The appellant has entered into a Development Agreement with the Government of the Republic of Zambia for hedging activity, and it had dispute resolution provisions which the appellant could have invoked
  - Tax authority was not privy to the hedging agreement
- In view of the above, Tribunal dismissed the appeal of the appellant.

Key contentions of appellant

- The appellant is of the view that the tax authority's decision to adjust the price to 50% of sales volumes was unjust and without basis or justification and therefore, filed an appeal before the Tribunal on the following grounds:
  - Actual sales figures were ignored and the tax authority considered sales figures basis their own estimation to determine tax liability;
  - Independent Transfer Pricing Report from the consultant was not considered;
  - Imposing an ad-hoc price adjustment of 50% of the revenue was unjust.

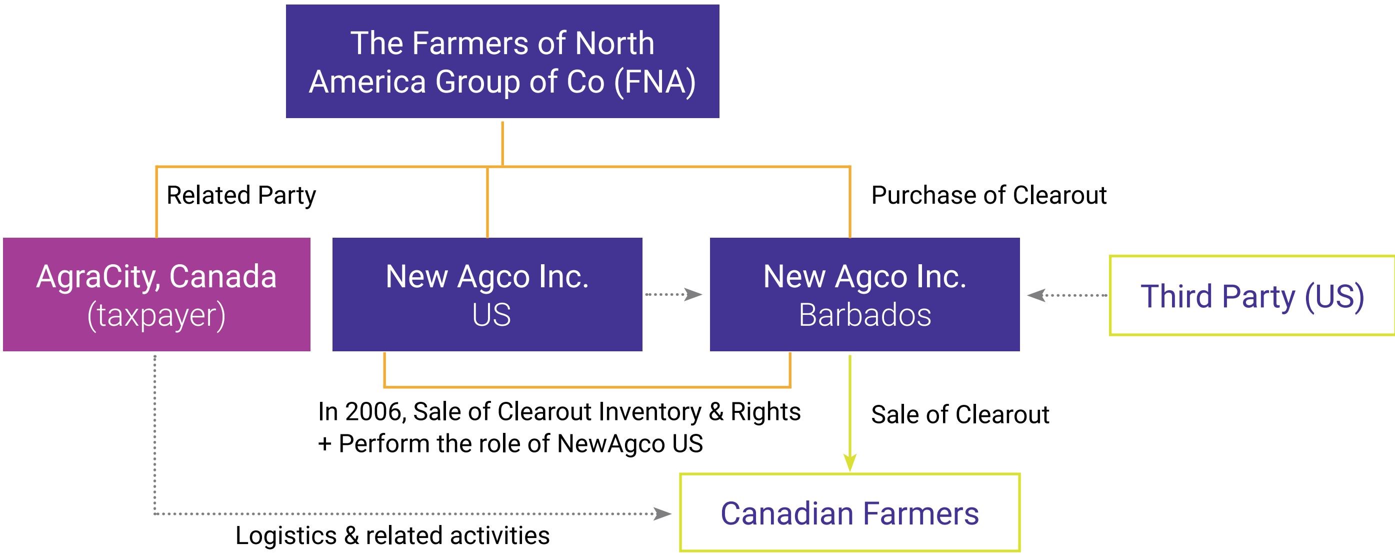
Judgment of the Supreme Court

- The Supreme Court opines that the consultant's report was addressed to the related party and it clearly mentioned the write-up as to how and why the report was prepared. Conspicuously, it did not suggest/refer the name of the appellant as engaging/commissioning party in the report.
- The Income-tax Act reposes the power and right to tax authorities to take prescribed measures basis their reasonable belief.
- The tax authorities explained the sufficient rationale for their belief to invoke tax avoidance provisions in the instant case.
- It was not an undisputed fact that the tax authorities shared the information with the appellant basis which they reasonably believed the tax avoidance in related party transactions.
- Since the appellant did not produce the hedging agreement before the lower tax authorities, the same cannot be considered.

In view of the above reasons, the SC dismissed the appeal of the appellant and upheld tax avoidance provisions.

Key Takeaways

- In the instant case, TP report was submitted by the taxpayer only during the course of scrutiny, which accorded the tax authority an opportunity to undertake independent audit of arm's length principle. Therefore, the ruling re-emphasizes the principle of a robust and contemporaneous TP documentation
- It is important to understand the importance of hedging arrangement in price determination and its corresponding impact on transfer pricing.



AgraCity Ltd (AgraCity), Canada, the taxpayer is a part of the Farmers of North America Group of companies (the FNA Group). In 2005, the FNA established New Agco Inc. (NewAgco US) to act as a distributor of a glyphosate-based herbicide (ClearOut), wherein it purchased the product from a third-party US supplier and sold it directly to Canadian FNA members.

New Agco US entered into a Services Agreement with the taxpayer to attend to the logistical and related activities of NewAgco US' sales and deliveries to the Canadian buyers. Under the service agreement, the taxpayer was paid an amount per liter of ClearOut sold to perform these services.

In March 2006, NewAgco Inc. (NewAgco Barbados) was incorporated to take on the role NewAgco US had until then carried on. NewAgco US orders from FNA members in the fall of 2005 for spring 2006, and its ClearOut inventory and rights, were transferred to NewAgco Barbados.

NewAgco Barbados also entered into an exclusive supply agreement with the US third-party supplier of ClearOut, and a services agreement with the taxpayer for 'promotion, invoicing, collection of receivables, payment of supplier invoices, bookkeeping services, logistics etc.' The taxpayer was paid approximately USD 2 million of service fees for the years in question. NewAgco Barbados otherwise recognized all of the profits associated with the purchase and sale of ClearOut from the supplier to the FNA members.

Issue: The Canada Revenue Agency (CRA) believed that the service agreement between the taxpayer and NewAgco Barbados represented a sham, and reallocated all of the profit of NewAgco Barbados to the taxpayer

The tax authorities are of the position that transactions (i) were a sham (ii) to apply paragraphs 247(2)(b) and (d) to re-characterize the transactions and (iii) to apply transfer pricing adjustment by application of paragraphs 247(2)(a) and (c). The same is detailed out below:

1. Whether transaction is a Sham?

Arguments of the tax authorities: The Services Agreement is a sham to camouflage the operations of the taxpayer as those of NewAgco Barbados that gave the illusion that NewAgco Barbados was selling ClearOut to Canadian farmers "when the evidence shows that the activities were those of taxpayer". The tax authorities provided reasons to support the same such as:

- The Services Agreement purports to be a logistics service agreement when in fact, the taxpayer performed all of the functions relating to the sale.
- Services Agreement was disregarded because the services went beyond the enumerated activities and included all aspects of carrying on the ClearOut business, which included selling and sourcing the ClearOut, and negotiating with suppliers.
- The confused books and records of the taxpayer and NewAgco Barbados.

2. Re-characterization

The tax authorities did not make any factual assumptions to support their position that the arm's length parties would not have entered into transactions other than those made to support the sham or transfer pricing adjustments under paragraphs 247(2)(a) and (c) of the ITA.

3. Transfer Pricing Adjustment

The tax authorities report sets out that the value created by the parties to the transactions did not align with what was credited to the taxpayer and NewAgco Barbados. Their expert opinion was that 100% of the net sales profits realized from the ClearOut sales by NewAgco Barbados to the FNA members should have been the taxpayer's and none of those profits would have been NewAgco's had they been dealing at an arm's length.

Tax Court's Decision

The Court placed reliance on the recent judgment in the Cameco Corporation v. The Queen (Cameco) and Palletta v The Queen and concluded that the evidence presented did not establish the existence of any sham transactions nor any deceptive window dressing. The transactions that occurred and were documented were the transactions the parties intended, agreed to, and that the parties reported to others, including the CRA. Some of the key reasons are as follows:

- The basic structure involving a non-Canadian company to source and sell ClearOut was done for bona fide non-tax reasons with no reason or intention to deceive anyone.
- It was NewAgco Barbados that purchased the ClearOut and the third-party supplier and others within AgraCity were fully aware of this and the fact that company personnel was acting on behalf of NewAgco Barbados in negotiating the purchases and exclusive supply contract.
- The accounting records reflected the structure of the transactions, and the cash moved into and out of NewAgco Barbados bank accounts.
- AgraCity collected the amount from the customers and remitted the amounts to NewAgco Barbados, and the amounts were recorded as revenue by NewAgco Barbados.

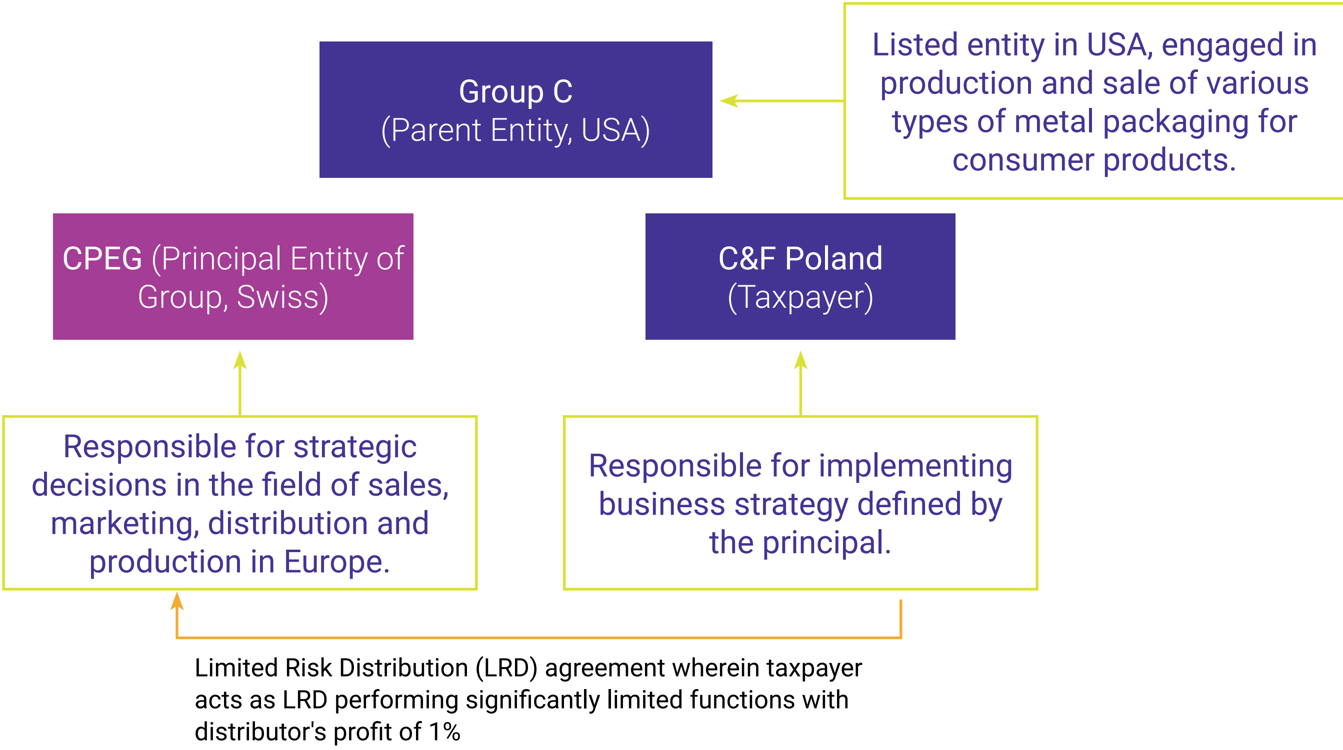
Based on the above evidence presented, the Court concluded that there is no existence of any sham transactions nor any deceptive window dressing.

The tax authorities's expert witness testimony and report did not include anything specific to support or prove that the transactions would not have been entered into between the arm's length parties. Due to the lack of supporting evidence, the Court dismissed this re-characterization argument.

The Court noted that the tax authorities failed to produce satisfactory evidence to prove on a balance of probabilities that its relevant assumptions, or its further allegations or positions, were correct. Consequentially, the Court ruled that AgraCity succeeded in the appeal.

Key Takeaways

- The judgment of the tax court brings out an important point that to re-characterize a transaction, the tax authorities will need to provide some evidence to support its assertion that the transaction would not be entered into between arm's length parties. The request of requirements made should be reasonable, i.e., a rational connection between the requested documents and information and the on-going tax audit or procedure should be there.
- A transaction should not be subject to re-characterization if it is commercially rational. If it is commercially rational, the transfer pricing analysis must focus on the actual transaction and the terms, rights and obligations regarding that transaction.



TNMM was selected as the MAM to benchmark related party transactions of the taxpayer with its related parties. Companies in the European market engaged in a similar business of distribution were taken as comparables having a range of 0.9% to 3.4%. Thus, a margin of 1% earned by the taxpayer was considered at arm's length.

Issue: Rejection of benchmarking performed by taxpayer disregarding differences in functional profile of taxpayer and comparable companies

Key Contentions of the Tax Authority

- First-level tax authorities rejected comparables selected by the taxpayer and selected packaging distributors in Poland as comparable companies having a range of 2.06% to 8.20%.
- The tax authorities contended that comparables selected by the taxpayer were functionally different, having different product mix and markets.
- They argued that the taxpayer should have selected companies only in Poland since the market in Poland looked relatively better for such products relative to the EU countries selected by the taxpayer.
- An additional approach was also adopted to selected companies of comparable sizes earning average profits of 2.34%, thus proposing a transfer pricing adjustment. The tax authority concluded 2.10% as the arm's length price assuming additional risks borne by the taxpayer.

Key Contentions of the taxpayer

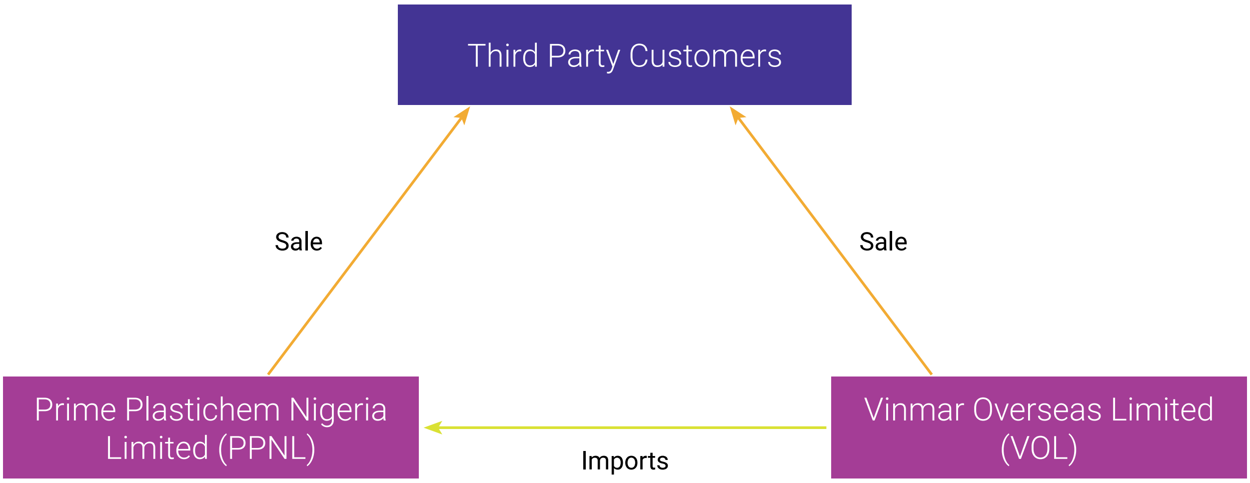
- The tax authority did not provide any arguments or detailed calculations to support the rejection of companies selected as comparables by the taxpayer. They merely concluded that the local nature of the company's operations indicated that comparability analysis should include Polish companies only.
- The tax authority did not consider the international nature of its activities. Also, while the covered period was 2013, tax authorities considered a period of 2009 to 2011 to determine the arm's length range. The taxpayer relied on the OECD guidelines for comparability analysis and to consider data from the same period as a controlled transaction, which was available at the time of assessment.
- It also argued that if the taxpayer is operating in the European market, then why couldn't the EU comparables be accepted.
- The taxpayer argued that the tax authorities did not consider the impact of costs and risks related to the conclusion of agreement borne by other group companies on the taxpayer's financial results. If such costs/risks were borne by the taxpayer (as borne by third party comparable companies), its margins would have been higher than 1%.

Decision of Provisional Administrative Court (the Court)

- Tax authorities did not thoroughly verify facts of the case. Furthermore, a detailed search analysis for new benchmarking proposed and rejecting taxpayer's comparables was not provided.
- While computing the taxpayer's margins, the tax authorities failed to take into account, the economic adjustments in taxpayer's favor for contractually agreed operating conditions in the nature of certainty of deliveries, no liability for defects, certainty of remuneration, just in time delivery and other business risk items. Such conditions would have a material impact on the economic conditions existing in a transaction between the unrelated parties.
- Here, the authorities failed to prove that the terms of cooperation between the parties to a transaction were different from the terms that would exist in an independent scenario, failing in assessing if transaction was economically rational for the taxpayer, due to a direct or indirect advantage.
- The matter was thus remanded back to the tax authority for re-assessment to freshly assess the case.

Key Takeaways

- One must consider the impact of relationships on establishing the conditions that exist between independent entities while benchmarking related party transactions. It is necessary to establish whether a specific transaction is in line with market conditions or the same is merely on account of decision made within the group.
- It is observed from this ruling that Polish transfer pricing law also emphasizes the importance of functional analysis and that search process should be adequately documented. Furthermore, the revenue authorities cannot reject the taxpayer's benchmarking analysis when the taxpayer has prepared a robust TP documentation.



The company is engaged in importing plastics and petrochemicals from VOL for resale to Nigerian customers. In FY 2013, VOL had entered into transactions with independent third parties in Nigeria for similar products (which the company has imported). However, VOL had not entered into similar third-party transactions in FY 2014. Accordingly, based on the data available, the company has benchmarked the import transaction using Comparable Uncontrolled Price (CUP) Method for FY 2013 by using the price charged by VOL to Nigerian third party for similar products, as the arm's length price (ALP). However, for FY 2014, the company adopted Transactional Net Margin Method (TNMM) using Operating Profit Margin (OPM), i.e., EBIT/Operating Revenue, as Profit Level Indicator (PLI) to benchmark the import transaction, since CUP data was not available for comparison.

Issue: Whether selection of MAM and PLI by the taxpayer is appropriate.

Key contentions of the the Federal Inland Revenue Service (FIRS)

- PPNL failed to provide reliable information for the selection of CUP as MAM for FY 2013.
- Change in methodology from FY 2013 to FY 2014 for the same transaction was contrary to the consistency principle, which is also advocated by the OECDTP Guidelines, 2017.
- As PPNL applied TNMM in FY 2014, the same should be applied in 2013
- PPNL admitted that CUP has been applied in error in FY 2013.
- Use of Gross Profit Margin (GPM) as PLI was based on the functional characteristics of the controlled transaction. As GPM only considers elements related to the controlled transactions, the comparability is enhanced. Such an approach is in line with OECD TP guidelines.

Key contentions of the taxpayer

- PPNL has provided all relevant documentation and information with regards to the application of CUP as MAM for FY 2013
- As reliable internal data was not available for FY 2014 for selecting CUP as MAM for FY 2014, accordingly, TNMM has been considered as MAM
- Usage of GPM by tax authorities for the application of TNMM is neither elucidated in OECD TP guidelines nor United Nation Practice Manual on TP, 2017 (UN TP Manual)

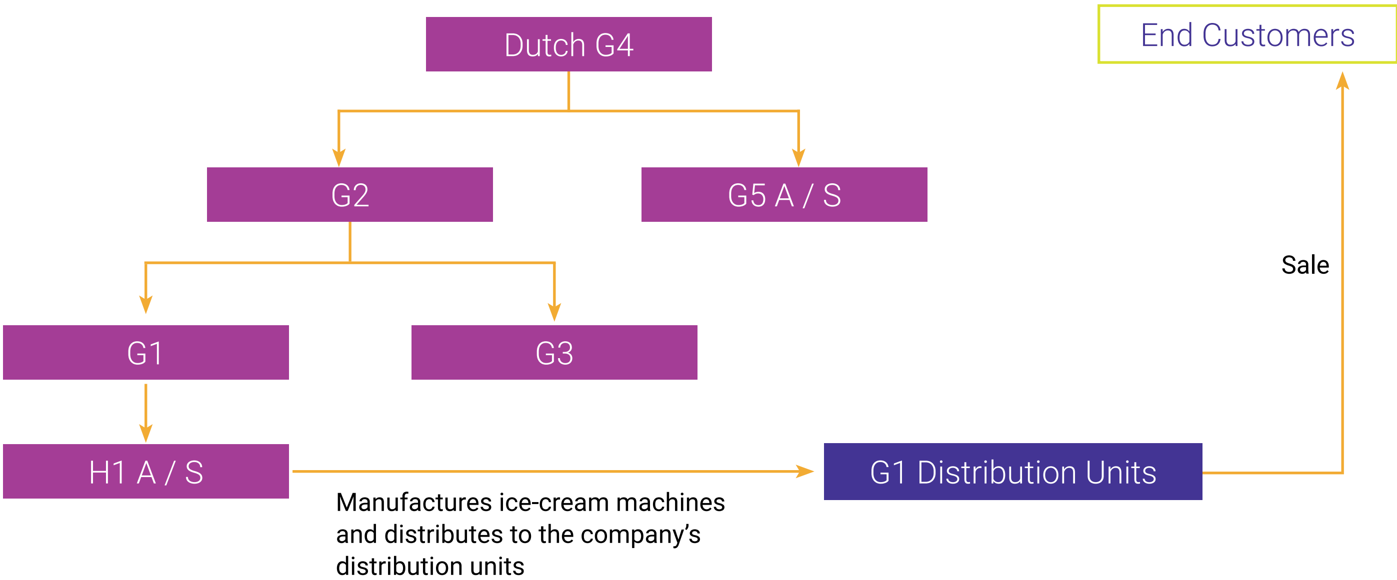
Judgment

- Nigerian Tax Appeal Tribunal accepted FIRS argument and relied on the OECD TP Guidelines to state that "Consistency in the application of benchmarking method from year to year is also very important and fundamental". Availability of reliable information was a necessary condition for selection of MAM, holds that Revenue's rejection of the CUP method was in accordance with TP Regulations and in consonance with the provisions canvassed by the OECD in its TP guidelines.
- Tribunal accepts Revenue's adoption of GPM noting that it uses direct trading elements (sales revenue and its cost of importing products up to the Nigerian Ports) thereby eliminating factors that may introduce distortions arising from different incomes and cost profiles of the comparable entities, takes support from the OECD Guidelines.

Key Takeaways

- This decision of the Nigerian Tribunal throws light on the emphasis of OCED's framework of selection of MAM and PLI.
- Change in TP method has always been prone to litigation due to lack of appropriate reasoning provided for such change in TP documentation.
- The Indian Tribunals in their judgments have been clear that there is no bar under the Indian Income Tax Act, 1961 or the Rules that restrict an Taxpayer to change method of determining the arm's length price, however, the selection of method should be based on the principles of MAM. However, the Tribunals have also clarified that change of method should be for bonafide reasons and not in an arbitrary manner just to circumvent adjustment made by the tax authorities. The facts and data should support the reasons for change.

Danish HC allows discretionary TP adjustment citing assesses's unsubstantiated deficit and defective TP documentation.



H1 A / S (the company) is a part of G1, which mainly deals with Packaging Solutions and Processing Solutions. G1 is part of G2 that is divided into three divisions, with G1 as the one and G3 as the other 2. The company is owned by the Dutch G4.

The company's main activity is the manufacturing of production plants for the production and packaging of all kinds of ice cream. The company distributes its production facilities (ice machines) to G1 distribution units (worldwide presence).

The company incurred a deficit at the Earnings Before Interest and Taxes (EBIT) level during income years 2005-2009.

Pursuant to the above, the tax authorities initiated a formal investigation and found that no information was provided to sufficiently demonstrate that the industry in which the taxpayer operated was more severely affected by the financial crisis in 2008 and 2009 than the comparables or that the taxpayer faced extraordinary circumstances during 2005 to 2009 justifying the low earnings.

Issue: Whether the company is able to justify its considerable deficit at EBIT level during income years 2005-2009. And whether the TP documentation prepared by the tax payer is sufficient comparability analysis.

Key contentions of the SKAT

- The taxpayer did not face any extra ordinary circumstances during the financial crisis for the year 2005-2009. Therefore, the tax-payer failed to justify its low earnings. SKAT increased the tax payer's taxable income DKK 353 million
- The tax authorities alleged that the gross margins earned by the company are not proportional to the functions and risks between H1 A / S and the sales companies:
- Gross margin of the company – 2.74%
- Gross margin of sales company – 12.1%
- Gross margin of the spare part company – 40-45%
- Deficiencies in TP documentation
- While preparing the TP documentation the tax payer did not provide information related to turnover details, related party transactions, comparability analysis to support that the sale of goods to the sales companies has happened at arm's length prices, justification for the choice of method and choice of tested party, etc.
- SKAT selected the tax-payer as the tested party and ran a comparability search and stated comparables selected by the tax authorities were comparable in terms of functions, assets and risks and the mere fact that some of them were from countries with lower wages than Denmark.

Key contentions of the taxpayer

- The company has adequately documented reasons for commercially justified losses. The company is a privately owned company and that such companies generally work with a longer time horizon than listed companies.
- The company has prepared and kept written documentation for the intra-group trade, and the company has therefore prepared a full TP documentation that lives up to the Tax Control Act.
- SKAT re-qualifies the company from being an Entrepreneur to order production and appointing the company to be the tested party instead of sales companies. This is despite the fact that the company is unquestionably the most complex party. The procedure is thus, fundamentally contrary to general TP principles, and it results in an arbitrary and incorrect discretionary increase of the company's income.
- SKAT's benchmark analysis itself relies on long-term transactions in a variety of different and non-comparable activities, including the production of accessories for nuclear power plants, patented capsule filling machines, etc. SKAT compares the company with companies producing in countries with incomparable production cost levels.

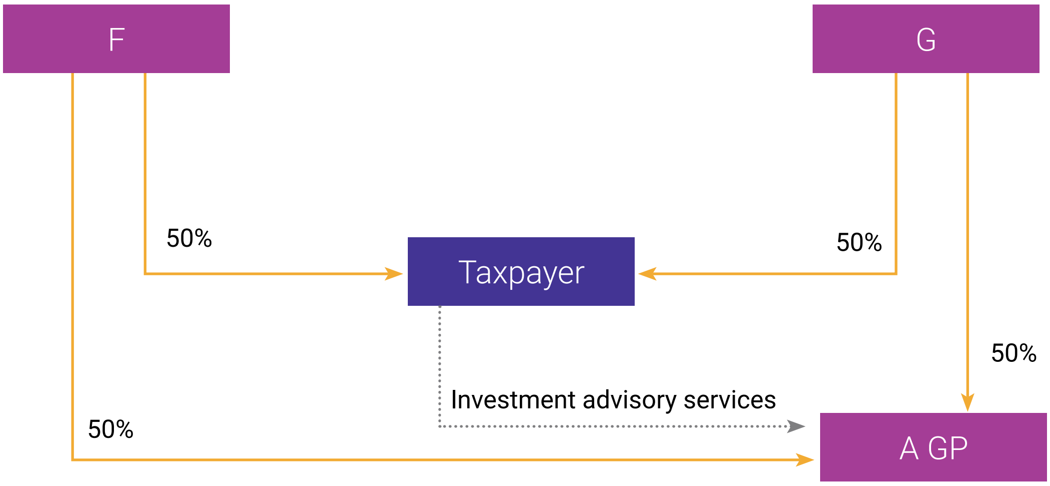
Judgment of the Danish High Court (HC)

- The Danish HC acquits the Ministry of Taxation, holds that tax authorities were entitled to make a discretionary increase (transfer pricing adjustment) in the taxable income of taxpayer.
- Further the court relies on precedent by SC (Microsoft judgment) wherein it was held that TP documentation incapable of providing the tax authorities with a sufficient basis for assessing compliance with the arm's length principle, must be equated with a lack of documentation.

Key Takeaways

- This ruling stresses on the aspect that continued loss could invite increased scrutiny by revenue authorities. However, maintaining appropriate documentation, subsuming detailed factual exposition is paramount in such cases.
- This also places emphasis on the importance of robust FAR (Function, Assets and Risk) analysis, rationale-based entity characterization, and appropriate and consistent documentation of the same. Also, industry overview should give a thorough picture of the industry level parameters, if any, impacting the taxpayer's business aspects.
- This decision of the Supreme Court throws light on the emphasis of the (OCED)'s framework of selection of the tested pary.

Zurich | Zurich Administrative Court (ZTA) attributes value-adding functions to Swiss investment advisor by holding that OECD Guidelines are non-binding



An AG, the Swiss taxpayer company, is mainly engaged in the evaluation and acquisition of potential investment objects and monitoring of investments. It renders exclusive investment advisory services to A GP (General Partner in a Fund – A LP). A LP is a limited company partnership under Kanalinsel H law, which serves as an investment vehicle for investors. It is a closed collective investment scheme, in which medium-sized companies in Switzerland and neighbouring German-speaking countries invested.

The taxpayer has entered into an 'Investment Advisory Agreement' with A GP. The taxpayer is remunerated with an advisory fee of 1.5% (Advisory Fee) of the committed capital.

During the audit process, the lower level tax authorities (based on functional analysis) concluded that all value-adding Functions (raising capital/searching for investors, portfolio management, exit decision) and Risks can be assigned to the taxpayer, while A GP only performs routine functions and have borne no risks.

Accordingly, the lower level tax authorities determined the arm's length remuneration to A GP as cost + 10% and proposed to allocate the rest of the profits to the taxpayer.

Issue: Whether the Swiss taxpayer company performed the value-adding functions with assumption of risk, and the AE had performed routine functions without bearing risks?

Key contentions of the Zurich Tax Authorities (ZTA)

- The ZTA were of the view that, based on the functional analysis of the actual conduct of the entities, it can be concluded that all of the value-adding functions (like capital raising/ investor search, portfolio management, exit decision etc.) and corresponding risks were attributable to the Swiss taxpayer, while the AE only carried out routine functions with no risks.
- During the audit process, the taxpayer contended that the benchmarking be concluded on the basis of 70:30 fee split however, the tax authorities rejected the said submission of the taxpayer on the premise of the above functional profile

Key contentions of Swiss taxpayer company

- The taxpayer contented to retroactively apply the 2017 OECD Commentary on the assignment and compensation of risks.
- It contended a profit-sharing method with a 70:30 fee split between itself and the AE. The taxpayer stated that the ZTA and the Lower Court acted in absolute contradiction on carrying out the assessment of transfer price in accordance with the arm's length comparison and hence, led to incorrect application of the guidelines on the pricing of the fee sharing ratio.

Judgment of the Zurich Administrative Court (ZAC)

- The ZAC confirmed the view of the ZTA in respect of the characterization of taxpayer and its AE, emphasizing that the first step in a transfer pricing analysis is a functional analysis based on the actual conduct of the entities and not on the contractual arrangements, while the second step is the pricing of the transaction. It rejected the taxpayer's contention to retroactively apply 2017 OECD Commentary on the assignment and compensation of risks.
- Although the ZAC relied on the OECD TP Guidelines in stating the above, it also clarified that "*the OECD TP guidelines are not binding on the Courts but can only be used as an aid to interpretation*".
- The taxpayer trying to derive a claim based on one's own ideas results in failure.
- Also, the ZAC agreed with the ZTA's rejection of the taxpayer's fee split / profit sharing method and affirmed the fixing of the AE's profit share at 10% of the total costs and allocation of the remainder profits to the Swiss taxpayer.

Key Takeaways

- The ruling highlights the importance of aligning the actual conduct with the contractual terms between the transacting entities. This judgment might ring a bell amongst the most commonly followed operating structure by the investment companies. Another key takeaway from the said judgment is the necessity to have a robust documentation that supports the pricing policy adopted by the MNEs.

H1 DK | Denmark | Tribunal upholds transfer of intangibles during taxpayer’s conversion from distributor to the commission agent

Issue: Whether the interest on the loan provided by US Inc to the interested party and the interest on the loans subsequently provided by Luxco to BV 2 and BV 3 can be deducted from the interested party?

- The taxpayer is H1 ApS (called H1 DK) functions as one of the Group's European sales companies. H1 DK handles both direct and indirect sales of the Group's products. H1 DK also has a department that handles installation, training and other general services related to the sale of H2 Group's software products. H1 DK also performs R&D (research and development) activities on behalf of H3 Inc.
- With effect from 1 October 2010, the H2 Group carried out a restructuring, whereby all sales companies, including H1 DK, were transformed into commission agents on behalf of a newly established company.
- In connection with the reorganization, the Group established the company H4 in Country Y1. H4 was to function as the main company for the Group's activities in the EMEA. The purpose of the reorganization was to better adapt the Group's cost structure regarding the skills and resources required to more effectively pursue market opportunities and execute the Group's long-term growth strategy.
- Following are the contentions by the tax authority and the taxpayer regarding the above transaction:

Key contentions of Dutch Tax Authorities

- SKAT increased the company's taxable income in the income year 2010. It was SKAT's opinion that during the restructuring in 2010, intangible assets were transferred from H1 DK to the newly established company, H4. It is a direct consequence of this that intangible assets generated by H1 DK's activities on the Danish market belong to the Danish company.
- SKAT establishes that H1 DK at the time of the change in the business setup is the owner of acquired intangible assets in the form of know-how regarding the Danish market and the adaptation/implementation of the Group's products to Danish customers and not least over many years built customer relationships. And at the same time, it is important to establish that the intangible assets are valuable , which is documented by profit margins around the x% for H1 DK in the years prior to the restructuring.
- SKAT has considered itself entitled to make a discretionary assessment for the transfer of intangible assets. This is elaborated with the following:
  - SKAT believes that H1 DK, in connection with the restructuring in 2010, has divested the above-mentioned intangible assets and transferred these to H4 in Country Y1.
  - It is SKAT's opinion that H1 DK has accumulated intangible assets in the form of customer relationships and know-how under the royalty agreement.
  - Finally, in this connection, it should again be noted that H1 DK's activities are completely the same as before the restructuring. Simply, its profit margin for new customers drops to x% against the previous x%, and the earnings instead accrue to the newly formed companies.
  - As a result of the above, SKAT believes that there has been a transfer of intangible assets, and as the company has not prepared the TP documentation regarding the transfer, SKAT has considered itself entitled to make a discretionary assessment for the value of the transferred intangible assets.

Key contentions of the taxpayer

- The company's representative has made the following allegations:
  - A principal claim is filed that SKAT’s increase be deleted.
  - In the alternative, a claim is made that SKAT's increase be reduced to an amount determined by the National Tax Court.
  - More alternatively, a claim is made that the case be referred back to SKAT for reconsideration.
- The company has stated that H5's functions, assets and risks are not changed by the restructuring. The company writes that H1 DK neither before nor after the restructuring owns significant tangible or intangible assets. The specific functions that according to the company are moved are sales strategy and sales policy, marketing strategy , brand management, approval of contracts, pricing policy and discounts as well as strategic budgeting. These functions are not described in the company's performance analyses. The following risks are moved from H1 DK to H4: Market risk, operational risk, credit risk, currency exchange rate risk and inventory risk. The credit risk, the exchange rate risk and the stock risk are all described as minimal.

- The fact that SKAT has not lifted its burden of proof also appears from the fact that SKAT has not provided evidence that intangible assets have been transferred and, if so, which intangible assets were allegedly transferred to H4.
- As stated above, SKAT must identify the intellectual property rights that H1 DK according to SKAT was in possession of before the reorganization.
- SKAT's comparison of the two controlled transactions leads SKAT to the 'erroneous conclusion' that something of value must have been transferred from H1 DK to H4 in connection with the reorganization.
- The representative states that it follows from the Supreme Court's practice that the ownership of goodwill belongs to the company that actually controls and disposes of the clientele.

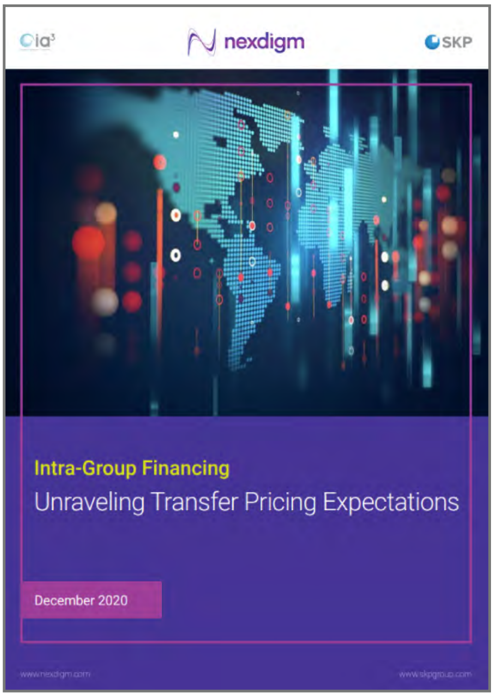
Judgment of the Dutch Court

- The National Tax Tribunal of Denmark upholds SKAT's decision that certain intangibles were transferred by the taxpayer pursuant to a business reorganization within the group and the valuation thereof. However, holds its view of insufficient TP documentation in respect of the transfer, as unjustified.
- Tribunal upheld that SKAT rightly concluded that the reorganization was not carried out on arm's length terms, and that during the restructuring, intangible assets are transferred in the form of customer relations and contract rights .However, directs reduction of expected life of the assets from infinite to 10 years.
- Tribunal rejects SKAT's opinion on insufficient TP documentation, the Tribunal holds that "The fact that the company has not described the transaction alleged by SKAT regarding the transfer of intangible assets cannot in itself lead to , that SKAT may make a discretionary adjustment."

Key Takeaways

- Internal re-organization is a common phenomenon amongst large mutlinational groups. More often than not, group restructurings are not only driven by the tax saving objective. There could be various other objectives, e.g., achieving operational efficiency, responding to market situation, etc.
- MNEs need to keep in mind the potential transfer pricing issues that may arise while carrying out the group restructuring (like the one in the instant case).
- There is a lot of literature made available by the OECD which discusses potential transfer pricing issues that may arise in a business restructuring arrangement. It can act as a useful guide while businesses evaluate the potential transfer pricing risks.

Intra-Group **Financing**
Unraveling Transfer Pricing Expectations



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About Nexdigm (SKP)

Nexdigm (SKP) is a multidisciplinary group that helps global organizations meet the needs of a dynamic business environment. Our focus on problem-solving, supported by our multifunctional expertise enables us to provide customized solutions for our clients.

Our cross-functional teams serve a wide range of industries, with a specific focus on healthcare, food processing, and banking and financial services. Over the last decade, we have built and leveraged capabilities across key global markets to provide transnational support to numerous clients.

We provide an array of solutions encompassing Consulting, Business Services, and Professional Services. Our solutions help businesses navigate challenges across all stages of their life-cycle. Through our direct operations in USA, India, and UAE, we serve a diverse range of clients, spanning multinationals, listed companies, privately owned companies, and family-owned businesses from over 50 countries.

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