International Tax and Transfer Pricing

Interview preparation summary · AU track

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INT.TI.1.a · Taxing rights and relief

Explain how corporate residence and permanent establishment decide where a company's profits are taxed, and say how profits are attributed to a permanent establishment.

A company is taxed on its worldwide profits in the country where it is resident, and usually only on local-source profits elsewhere. Residence tests differ. Many countries tax a company that is incorporated there; many also look at where central management and control sits, meaning where the board really takes its key decisions. The UK, for example, treats a company incorporated in the UK as resident and can also treat a foreign-incorporated company as resident if it is managed and controlled here. A company can therefore be resident in two places, and a tax treaty then has a tie-breaker, often settled by agreement between the two authorities. Outside its home country, a company is normally taxed only if it has a permanent establishment: a fixed place of business such as an office or factory, or a dependent agent who habitually concludes contracts in its name. Preparatory or auxiliary activity, such as pure storage, is traditionally excluded, though recent treaty changes narrowed that. Profits are attributed to the permanent establishment as if it were a separate enterprise, using the functions it performs, the assets it uses and the risks it assumes. Candidates often say a PE needs an office. Say instead that people who sign contracts can be enough.

WORKED EXAMPLE: A CONTRACT-SIGNING EMPLOYEE ABROAD

Halden Instruments is an invented manufacturer resident in country A. It has no office in country B, but one employee based at home in B regularly negotiates and signs contracts with B customers in the company's name, generating sales of 8.0m a year. Independent distributors of similar goods earn an operating margin of 6.0% on sales. The tax rate in B is 25%. These figures are illustrative. Decide whether Halden has a permanent establishment in B and estimate the profit and tax at stake.

Answer: Halden very probably has a permanent establishment in B because the employee habitually concludes contracts. About 0.48m of profit is attributable to it and about 0.12m of B tax arises, relieved in A.

> **Interview tip:** Say where the company is resident, then test for a PE, then attribute profit, then relief. Name the contract-signing employee as the usual trap, and say you would check the actual treaty wording.

INT.TI.1.b · Taxing rights and relief

Compare the credit and exemption methods of double taxation relief, and work out the credit when foreign tax is above or below the home tax on the same income.

When two countries tax the same profit, the home country gives relief. Under the exemption method it leaves the foreign income out of its own tax, so the group bears only the foreign tax. Under the credit method it taxes the income but gives a credit for the foreign tax paid. The credit is limited to the home tax on that income. If foreign tax is higher than home tax, the credit is capped and the excess is unrelieved, so the total is the higher foreign rate. If foreign tax is lower, the credit covers only part of the home tax and the company pays the top-up, so the total equals the home rate. Credit therefore pulls the total tax up to the higher of the two rates; exemption leaves the foreign rate in place, which is why low-tax countries matter more under exemption. Many countries use exemption for dividends and foreign branches and credit for other income, and the UK mostly exempts dividends but credits other foreign income. Relief is also available unilaterally under domestic law where there is no treaty. Check the current rules for the country in question.

WORKED EXAMPLE: CREDIT AND EXEMPTION SIDE BY SIDE

A home company earns 100 of foreign income. The home tax rate is 25%. Work out the total tax under credit and under exemption in two cases: foreign tax of 30% and foreign tax of 15%. Figures are illustrative.

Answer: Credit: total tax 30 in the high-tax case (5 of credit unusable) and 25 in the low-tax case. Exemption: 30 and 15. The methods differ when the foreign rate is below the home rate.

> **Interview tip:** Give the rule in one line: credit tops the total up to the higher rate, exemption keeps the foreign rate. Then say the credit is capped at the home tax on that income.

INT.TI.1.c · Taxing rights and relief

Explain how tax treaties reduce withholding tax on dividends, interest and royalties, what a company must show to claim the treaty rate, and how controlled foreign company rules work in outline.

Many countries collect tax at source by withholding a percentage of dividends, interest and royalties paid abroad. A tax treaty caps that rate, often at a low rate for dividends to a parent with a substantial holding and at a modest rate for interest and royalties. Treaties only limit tax: if domestic law already charges less, the lower rate applies. To claim the treaty rate the recipient usually must be resident in the treaty country and be the beneficial owner of the income, and many treaties now deny benefit where obtaining it was a main purpose of an arrangement, which targets shell companies set up to access a treaty. Withholding tax is then credited at home or, where income is exempt, becomes a cost. Controlled foreign company rules tax a parent currently on certain profits of a low-taxed foreign subsidiary, so profits cannot simply be parked there. Typical features: a control test, a low-tax test, a focus on mobile or artificial income and exemptions where there is real activity. Candidates often forget that the treaty rate is a ceiling, not a rate that is always charged. Check current rates in the treaty.

WORKED EXAMPLE: WITHHOLDING TAX WITH AND WITHOUT A TREATY

Sellara Ltd, an invented subsidiary in country S, pays its parent in country P a dividend of 1,000 and a royalty of 400. S withholds 20% on dividends and 25% on royalties under domestic law. The S-P treaty sets 5% for dividends to a parent with a substantial holding and 10% for royalties. Sellara earned profits of 1,200 and paid 96 of tax; P taxes at 25% and treats a subsidiary taxed below three quarters of that rate as low-taxed for its CFC rules. Figures are illustrative.

Answer: Treaty withholding is 90 against 300 under domestic law (dividend 50, royalty 40). Sellara's 8.0% rate is below the 18.75% line, so the parent still has to run the CFC tests.

> **Interview tip:** Say that the treaty rate is a ceiling and that benefit needs residence and beneficial ownership. Treat CFC as a separate question about low-taxed profits.

INT.TI.2.a · Transfer pricing and the group

State the arm's length principle, name the main transfer pricing methods, and choose the best method for a given intercompany transaction.

Transfer pricing sets the prices for dealings between companies in the same group, such as sales of goods, services, loans and licences. The arm's length principle says those prices should match what independent parties would agree in comparable circumstances, so that profit is taxed where the economic activity takes place. The usual methods are: comparable uncontrolled price, which compares the price with that in a similar deal between independent parties; resale price, which starts from the price at which a distributor resells and deducts a margin typical for independent distributors; cost plus, which adds a markup typical of independent suppliers to the supplier's costs; transactional net margin, which compares the net profit margin of one party with margins of comparable independent companies; and profit split, which divides combined profit by the value each party adds, suited to integrated operations or unique intangibles that both sides contribute. The first three are traditional transaction methods; the last two are profit-based. The best method depends on the functions performed, assets used and risks taken, and on what reliable comparables exist. Candidates often name the methods without saying how to choose. Start from who does what.

WORKED EXAMPLE: CHOOSING A METHOD AND PRICING A DISTRIBUTOR

Corvane Tools, an invented group, makes finished goods and sells them to its related distributor Lurin, which resells to independent customers at 1,000 a unit without further processing. Independent distributors of similar goods earn a gross margin of 30% on resale. Lurin buys 20,000 units a year from Corvane at 780. Figures are illustrative. Pick the method and test the price.

Answer: Resale price method; the arm's length price is 700, not 780. Lurin's profit is understated by 1.6m a year, which invites an adjustment and a request for relief in Corvane's country.

> **Interview tip:** Name the method, then say why in terms of functions: a simple distributor points to resale price or a net margin test. Mention the corresponding adjustment.

INT.TI.2.b · Transfer pricing and the group

Test a tested party's profit with the transactional net margin method, adjust it to an arm's length range, and describe transfer pricing documentation and how intangibles and intercompany loans are priced in outline.

The transactional net margin method picks the simplest party in the transaction, the tested party, and measures its net operating margin, usually on sales or costs. That margin is compared with the margins of independent comparable companies, giving a range, often from the lower to the upper quartile. A result inside the range is accepted. A result outside it is typically adjusted to a point in the range, often the median. Documentation shows the authority and the group how prices were set: the master file describes the whole group, the local file describes the local entity and its related-party transactions, and a country-by-country report for large groups shows income, tax and staff by country. Missing or weak documentation can bring penalties and shift the burden of proof. For loans, arm's length interest depends on the borrower's credit standing, term, currency and security, not on the group's wishes. For intangibles, profit should follow who develops, enhances, maintains, protects and exploits the asset and who controls the risks, not simply who holds legal title. Check current local rules on thresholds and deadlines.

WORKED EXAMPLE: TESTING A DISTRIBUTOR AND A LOAN

Lurin, the invented distributor, had sales of 50.0m and operating profit of 1.0m. Independent comparable distributors have operating margins on sales with a lower quartile of 3.0%, a median of 4.2% and an upper quartile of 5.5%. The tax rate is 25%. Separately, Lurin borrows 10.0m from its parent at 9.0% when an independent lender would charge about 6.5%. Figures are illustrative.

Answer: Margin 2.0% is below the 3.0% to 5.5% range. Adjusting to the median adds 1.1m of profit and 0.275m of tax. The loan carries 0.25m of excess interest, worth 0.0625m of tax.

> **Interview tip:** Say which party you test and why, give the range, then the adjustment. Mention that documentation must show how the group set the price in the first place.

INT.TI.2.c · Transfer pricing and the group

Describe BEPS and the Pillar Two global minimum tax at a general level, compute a top-up tax, and explain how a multinational group plans and explains its tax.

Base erosion and profit shifting, or BEPS, describes strategies that use gaps and mismatches between countries' rules to move profit to low-tax places with little real activity. The OECD and G20 responded with a package of measures on transfer pricing, treaty abuse, interest deductions and disclosure. Pillar Two adds a global minimum tax, set at 15% in the model rules, for very large groups. For each country the group computes its effective tax rate on its profit. If that rate is below 15%, a top-up tax is due on the profit above a carve-out for real substance such as payroll and tangible assets. The rate gap times the excess profit gives the top-up. It is normally collected through the parent's country, or the low-tax country can collect it first with a domestic top-up tax. A multinational plans its tax by placing real functions where it can support them, using reliefs and incentives as legislated, keeping transfer pricing documentation, and managing risk with a clear policy. It explains its tax by reconciling the headline rate to the group effective rate and naming the drivers. Candidates should say that low tax alone is not the problem; lack of substance is. Check current rules, rates and scope.

WORKED EXAMPLE: TOP-UP TAX AND THE RATE BRIDGE

Zeta is a low-tax country where an invented group earns profit of 20.0m and pays covered taxes of 2.0m. The minimum rate is 15% and the substance-based carve-out is 4.0m. Separately the group reports profit before tax of 100.0m at a home rate of 25%, with lower overseas rates saving 3.0m, non-deductible costs adding 2.0m and prior-year items saving 1.0m. Figures are illustrative.

Answer: Zeta's top-up tax is 0.8m (effective rate 10.0%, gap 5.0%, excess profit 16.0m). The group's effective rate is 23.0% after the three bridge items.

Interview tip: Give the rate gap and the base, then multiply. For explaining tax, name the headline rate, the two or three biggest drivers, and say each rests on real activity.

Summary of the Charta interview-preparation topic. Companies and figures in the examples are invented. Draft content, not yet expert reviewed.