

THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2019

MODULE 3.03 – TRANSFER PRICING OPTION

ADVANCED INTERNATIONAL TAXATION (THEMATIC)

TIME ALLOWED – 3¼ HOURS

This exam paper has **three** parts: **Part A**, **Part B** and **Part C**.

You need to answer **five** questions in total.

You must answer:

- **Both** questions in **Part A** (25 marks each)
- **One** question from **Part B** (20 marks)
- **Two** questions from **Part C** (15 marks each)

Further instructions

- All workings should be made to the nearest month and in appropriate monetary currency, unless otherwise stated.
- Start each answer on a new page and clearly indicate which question you are answering. If you are using the on-screen method to complete your exam, you must provide appropriate line breaks between each question, and clearly indicate the start of each new question using the formatting tools available.
- Marks are specifically allocated for clarity of presentation of your answers.
- The time you spend answering questions should correspond broadly to the number of marks available for that question. You should therefore aim to spend approximately half of your time answering Part A, and the other half answering questions in Parts B and C.
- The first 15 minutes of the exam is reading time. You will be allowed to annotate the question paper during this time; however, you will **not** be permitted to start writing or typing your answer. The Presiding Officer will inform you when you can start answering the questions.
- **Although references and short quotes from the OECD Transfer Pricing Guidelines can be included in your answer, you will not benefit from any extra marks by copying from the OECD Transfer Pricing Guidelines directly.**

PART A

You are required to answer BOTH questions from this Part.

1. Cradle Group is listed on the New York Stock Exchange. It operates as a multinational group through wholly owned subsidiary companies located in several jurisdictions. The principal operations of the group encompass the design, manufacture and distribution of information technology-related products.

The group owns intellectual property (IP) for the products which it sells. The IP encompasses licences, patents and trademarks relating to the group’s brand names, technology and manufacturing processes. The group is a market leader for particular IT products, which sell at a premium price point compared to rival products. The group has expended significant funds in research and development and building its brand over more than twenty years, and this is the principal reason why the group’s products are well known and market leading.

The group sells its products through its own retailers; to wholesalers in markets where it does not have a retail presence; and through the internet.

Certain functions are centralised within particular group companies. Such functions include research and development, brand development, procurement, logistics, transportation and other services.

The group’s management has summarised the key functions carried out by the most significant group companies as follows:

<u>Jurisdiction</u>	<u>Key functions/assets</u>
Alexus	Operates retail outlets with sales being to independent customers in Alexis. Sells to independent wholesalers in Alexis. Legal ownership of worldwide IP rights. Provides managerial and technical services to associated enterprises.
Bablas	Operates retail outlets with sales being to independent customers in Bablas.
Colobus	Conducts contract research and development for associated enterprises.
Dharma	Conducts sales to all associated group entities. Conducts contract manufacturing. Procures inputs for manufacturing process. Arranges transportation of finished manufactured products.

Continued

1. Continuation

The following table details key financial information for the group’s operating entities in the 2018 calendar year. The information is also representative of the 2014 to 2017 calendar years.

<u>Jurisdiction</u>	<u>Tax rate</u>	<u>Net profit to sales margin</u>	<u>Net profit as % of total assets</u>	<u>Sales to independent customers</u>	<u>Number of employees</u>
Alexus	30%	-2%	-5%	\$150 million	2,000
Bablas	25%	1%	1%	\$60 million	1,000
Colobus	20%	88%	150%	\$0	2
Dharma	15%	46%	78%	\$0	25

You have been approached by the group’s board of directors, to provide transfer pricing advice in relation to the arrangements described. Your advice should be accompanied by appropriate references to the July 2017 OECD Transfer Pricing Guidelines.

You are required to:

- 1) **Identify all of the cross-border transactions between associated group enterprises.** (5)
- 2) **Provide your opinion on the most appropriate transfer pricing methodology for each transaction identified in your response to 1), with reasons in support of your answer.** (15)
- 3) **Identify the most significant transfer pricing risks within the group, with regard to the arm’s length principle.** (5)

Total (25)

2. The Spark group has recently expanded its operations into new jurisdictions. The group provides electronic engineering consulting services to large mining companies. The consulting services are highly technical in nature, and performed by highly qualified staff holding significant experience and postgraduate university qualifications. In addition to providing services, the group also sells large conveyor belts which are used to stockpile minerals mined at project sites.

The Spark group operates in three jurisdictions, using a main operating company in each as follows:

- Spark Corporation undertakes a range of business operations, including research and development for the manufacture of conveyor belts; manufacture of conveyor belts; providing technical training to its staff and staff of associated entities; providing consulting services to miners; and sale of conveyor belts to end customers and associated enterprises. Of its income, 50% is derived from consulting services and the sale of conveyor belts.
- Fastlight Ltd generates its income by providing services to Spark Corporation. These services comprise contract manufacturing of conveyor belts; administration; accounting; human resources; marketing; information technology; and finance/treasury functions.
- Nugget Ltd generates 90% of its income by selling conveyor belts to independent parties which sell these on to end customers. The remaining 10% of sales derives from engineering consulting services provided to mining customers.

You are required to answer each of the following questions:

- 1) What steps would you take, in practice, in order to produce a functional analysis of the Spark group?** (9)
- 2) Which operations of the three associated enterprises in the Spark group are most likely to give rise to transfer pricing issues?** (6)
- 3) Why is it important to undertake a comparability analysis for the related-party transactions within a controlled group such as the Spark group? Discuss any issues or other factors which may need to be considered in relation to comparability, with regard to the Spark group.** (10)

Total (25)

PART B

You are required to answer ONE question from this Part.

3. Sweet Tooth Group is a multinational group of companies. The head company, ST Corp, is headquartered in Country C which levies a corporate tax rate of 30%. ST Corp's primary business operation is the manufacture and distribution of a wide range of confectionery products.

ST Corp has built a global brand for its products based on the perception of high quality, and conducts significant research and development activities relating predominantly to flavour extensions and the introduction of different variations to its products. The products are distributed globally, through related and unrelated parties. ST Corp has legal ownership of the intellectual property of the group including brand names and manufacturing knowhow. ST Corp also owns a large manufacturing plant based in Country C.

Following the appointment of a new CEO, Sweet Tooth Group plans a global restructuring of its operations with the goal of generating operational efficiencies and cost reductions. The restructuring will consist of the following key changes:

- Creation of a new regional manufacturing plant operated under Subsidiary X in Country D, in addition to the existing plant in Country C.
- Transfer of all intellectual property from ST Corp to Subsidiary Y in Country E. A related party payable was established for the consideration of the transfer, supported by an in-house valuation. Subsidiary Y will have a small team of staff assisting with the maintenance and protection of the intellectual property.
- Provision of a significant related party, interest-free loan from ST Corp to Subsidiary X in Country D. The purpose of the loan is to meet Subsidiary X's start-up costs.
- Transfer of the research and development function from ST Corp to Subsidiary X in Country D.
- Payment by Subsidiary X and ST Corp of a royalty totalling 8% of sales, for use of the intellectual property legally owned by Subsidiary Y in Country E.

The corporate tax rate in Country D is 15%, and in Country E is 5%.

Discuss the implications, from a transfer pricing perspective, of the business restructure proposed by Sweet Tooth Group. Your answer should consider changes in the functions, assets and risks of the entities concerned, along with characterisation in regard to the arm's length principle and the 2017 OECD Transfer Pricing Guidelines. (20)

4. The Tenor group is a multinational group of companies. Its parent company is incorporated and based in Velaris.

The Tenor group recently dispatched some of its senior managers from Velaris to Dunland to negotiate and conclude a major contract with a government funded company incorporated in Dunland. The contract related to the installation of a major telecommunications upgrade with a new high speed cable.

The installation programme has been divided into a number of smaller projects involving various related companies of the Tenor group in Dunland, each lasting between three and six months, with multiple sub-contracts agreed under the principal contract.

The Tenor group now sends specialist service technicians to Dunland, on a fly-in, fly-out basis, in order to manage the complexities of certain elements of the programme. It is not apparent whether the Tenor group has an established office in Dunland or relies solely on independent contractors for office space there.

The revenue authority of Dunland has commenced an audit and has expressed an initial view that Velaris has a permanent establishment in Dunland.

You are required to answer the following questions:

- 1) **Do you agree or disagree with the revenue authority's position? Your opinion should be supported with reference to relevant articles of the OECD Model Tax Convention.** (15)
- 2) **What methods could the Dunland revenue authority apply in attributing profits to the potential permanent establishment?** (5)

Total (20)

PART C

You are required to answer TWO questions from this Part.

5. You are a transfer pricing consultant and have been asked to provide advice to the global tax manager of a multinational group of companies operating in the extractives industry. The group performs a wide range of services, ranging from basic administrative functions to complex technical services along its value chain, encompassing manufacturing, marketing, sales, distribution, procurement, logistics, research and development and back office functions.

Advise the global tax manager on the transfer pricing analysis of the various intra-group services, including discussion of chargeability, direct and indirect services, and allocation keys that may be applied to services. You should reference the 2017 OECD Transfer Pricing Guidelines. (15)

6. You have been engaged, as a consultant, to provide advice to the head of tax at a multinational group of companies in relation to transfer pricing documentation.

You are required to answer the following questions:

- 1) **What are the benefits of preparing contemporaneous documentation of related-party pricing decisions, from a tax risk management perspective?** (7)
- 2) **Explain the requirements of the three-tiered approach to transfer pricing documentation.** (8)

Total (15)

7.

1. “The realisation of losses by an entity operating in an MNE group that is profitable as a whole is always related to transfer pricing issues.”

Is this statement true? Discuss this statement, providing evidence in support of your views. (10)

2. “Customs valuations are a very good indicator of arm's length pricing between associated enterprises in a MNE group.”

Is this statement true? Discuss this statement, justifying your position. (5)

Total (15)

8. You are an adviser to a multinational group which has business operations in jurisdictions which share double taxation agreements.

You are required to answer the following questions:

- 1) **What type of advance pricing arrangement should the group enter into? Provide reasons in support of your answer.** (5)
- 2) **What impact could Arbitration Article 25 have upon an advance pricing arrangement?** (5)
- 3) **Should tax administrations develop transfer pricing safe harbours for multinationals? Provide reasons in support of your view.** (5)

Total (15)

9. **You are required to answer the following questions:**
- 1) **Why may it be challenging for a multinational group to apply the arm's length principle in practice?** (8)
 - 2) **Why might a multinational group enter into a cost contribution arrangement, and how do the OECD Transfer Pricing Guidelines deal with such an arrangement?** (7)
- Total (15)