THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

December 2021

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 will **not** receive marks for any additional answers.

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.
- As you are using the online 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.
- There is no separate reading time, so you can start typing your answers as soon as the exam begins. However, we recommend that you set aside some time to thoroughly read each question and plan each of your answers.
- **Although references and short quotes from the OECD Transfer Pricing Guidelines can be included in your answer, you will not receive any marks for copying directly from the OECD Transfer Pricing Guidelines.**

PART A

You are required to answer BOTH questions from this Part.

The following facts apply to both Question 1 and 2.

Gaming Paradise Group (the GP Group) is a multinational group of companies in the videogame and digital media industry. Information relating to associated and independent entities within the GP Group is outlined below.

GP Headco

- Headquartered company for the group, resident in Country A with a corporate tax rate of 30%.
- Conducts research and development (R&D) activities, to develop and commercialise mobile phone apps, video games and virtual reality devices.
- Party to contract manufacturing agreements with GP Sub 1, GP Sub 2 and Independent Co 1, whereby GP Sub 1, GP Sub 2 and Independent Co 1 each perform contract manufacturing on behalf of GP Headco.
- Sales are received globally from independent customers, both for physical products and for the use of online apps.
- Pays royalties to GP Sub 2 for the use of intellectual property.
- GP Headco has borrowed from an independent financial institution in Country A.
- GP Headco has entered into a cash pooling arrangement with GP Sub 1 and GP Sub 2.
- Board meetings are held monthly and attended by the directors of GP Headco.

GP Sub 1

- Resident in Country B, with a corporate tax rate of 10%.
- Contract manufactures on behalf of GP Headco.
- Sells physical products both to GP Headco and to third party customers globally.
- Pays royalties to GP Sub 2 for the use of intellectual property.
- Involved in a cash pooling arrangement with GP Headco and GP Sub 2.

GP Sub 2

- Resident in Country C, with a corporate tax rate of 5%.
- Contract manufactures on behalf of GP Headco.
- Holds ownership of intellectual property relating to software coding and brand names.
- Receives royalties from GP Headco, GP Sub 1 and Independent Co 1 for the use of intellectual property.
- Involved in a cash pooling arrangement with GP Headco and GP Sub 2.

Independent Co 1

- Resident in Country C, with a corporate tax rate of 5%.
- Contract manufactures on behalf of GP Headco.
- Sells physical products both to GP Headco and to independent customers globally.
- Pays royalties to GP Sub 2 for the use of intellectual property.

1. **You are required to:**

   1) Delineate the transactions of the associated enterprises of the GP Group. (5)

   2) Perform a functional analysis of the GP Group, characterising each entity. (8)

   3) Explain how you would select and apply transfer pricing methodologies to achieve an arm's length outcome, applicable to the GP Group. As part of your response, you should discuss any comparability issues. (12)

Total (25)

2. The tax administration of Country A has commenced a transfer pricing audit on the GP Group. As a result of information requests issued by the tax administration, the following facts have been established:

   - GP Headco's contract manufacturing agreements with GP Sub 1 and GP Sub 2 have been cancelled, but the contract manufacturing agreement with Independent Co 1 remains in place.
   - GP Sub 1 and GP Sub 2 are now characterised as fully fledged manufacturers.
   - GP Headco has entered into a related party financing arrangement with GP Sub 1 and GP Sub 2, whereby significant funds are lent to facilitate the operations of both manufacturing operations.
   - Following the development and commercialisation of a new videogame app by the R&D staff of GP Headco, sales staff in GP Sub 1 and GP Sub 2 are now negotiating and concluding contracts in Countries B and C, respectively, to secure sales to independent customers.
   - The intellectual property for the new videogame app, registered in Country A by GP Headco, has been legally transferred to GP Sub 2.

   You are required to provide the GP Group with advice on the following questions:

   1) What are the potential transfer pricing risks that may be raised by the tax administration of Country A as a result of the transfer pricing audit? Your answer should include consideration of the *OECD Transfer Pricing Guidelines 2017*. (15)

   2) What are the potential permanent establishment risks that may be raised by the tax administration of Country A as a result of the transfer pricing audit? You are also required to give consideration to Article 5 (and Commentaries) of the *OECD Model Tax Convention on Income and Capital 2017*. (10)

Total (25)

PART B

You are required to answer ONE question from this Part.

3. Norfolk Group (Norfolk) is a multinational group of companies undertaking the manufacture and distribution of premium carbonated beverages in countries around the world. Norfolk is headquartered in Country H and owns all intellectual property, manufactures product for sale to subsidiaries, develops marketing and associated sales material for utilisation by subsidiaries, and provides a range of administrative and technical assistance to subsidiaries.

Norfolk's headquartered parent company employs 1,000 staff and earns double digit operating margins. Norfolk's subsidiaries generally operate as low risk marketing distributors as they sell product to independent retailers. The subsidiaries earn operating margins ranging between 1% and 2%.

The chief financial officer of Norfolk has engaged an international tax adviser to develop a transfer pricing optimisation plan. The following has been proposed:

- A subsidiary in Country R (Sub R) will acquire Norfolk's intellectual property (including but not limited to know-how, trademarks and copyrights), and will commence undertaking manufacturing activities for the group.
- A nominal amount will be paid by Sub R to the parent company for intellectual property.
- As the parent company has substantial cash balances in the bank, it will loan $2 billion to Sub R at a five-year interest rate of 0.5%.
- The funds will be utilised by Sub R to construct the manufacturing premises, and acquire plant and equipment.
- The parent company will continue to employ 1,000 staff, and will continue to undertake research and development activities and provide administrative and technical services to all subsidiaries.
- Sub R will manufacture all product for the group and sell carbonated beverages to all group entities.
- All subsidiaries with the exception of Sub R will continue to operate as low risk marketing distributors and target an operating margin of between 1% and 2%.
- The parent company will also target an operating margin of between 1% and 2%.
- Sub R will target a substantial, double-digit operating margin.
- The corporate tax rate in Country R is 10%, and substantial concessions will be provided by its government to attract Norfolk's manufacturing operations.

In relation to the facts provided, you are required to:

1) Identify the key transfer pricing issues and risks with the transfer pricing optimisation proposal.
(15)

2) Advise, from the perspective of the tax administration of Country H, on how you would seek to treat the arrangement, with appropriate reference to the *OECD Transfer Pricing Guidelines 2017*.
(5)

Total (20)

4. Furniture Corp. is a multinational group of companies whose core business is the distribution of household furniture. The global value chain of Furniture Corp. includes the following key functions:

- Research and development;
- Procurement or outsourcing of manufacturing to third parties;
- Manufacturing;
- Logistics;
- Marketing;
- After sales servicing via a call centre;
- Human resources;
- Finance (incorporating accounts receivable, tax and treasury); and
- Information Technology.

Furniture Corp. has a documented tax policy, under which the head office and regional offices charge for services provided to subsidiaries as all group entities have access to such services, despite not necessarily requesting or making use of the services available.

In relation to the facts provided, you are required to:

1) Identify potential chargeable services within the group. (7)

2) Identify the services that should not be chargeable between members of the group. (7)

3) Provide examples of appropriate allocation keys which could be applied to intra-group services between members of the group. (6)

Total (20)

PART C

You are required to answer TWO questions from this Part.

5. **You are required to prepare a note to your global tax manager, addressing the following items:**

   1) Where countries have adopted arbitration, explain the general impact which this has had on Mutual Agreement Procedures. (5)

   2) Provide a summary of the current status of the OECD/G20 BEPS Action Item 1: Addressing the Tax Challenges of the Digital Economy. (5)

   3) Summarise, in your own words, the key differences between Article 5 (Permanent Establishments) and Article 7 (Business Profits) of the *OECD Model Tax Convention*. (5)

   Total (15)

6. **You are required to provide written advice on the following matters to your government's finance department:**

   1) Explain why an Advance Pricing Agreement programme should be implemented. (7)

   2) Give your recommendation on whether Country-by-Country Reporting should be adopted, including reasons. You should identify any practical considerations if your recommendation is that it should be adopted. (8)

   Total (15)

7. **You are required to:**

   1) Explain whether or not you support tax administrations using 'secret comparables' as the primary basis for making transfer pricing adjustments, given the gradual decline in independent businesses that operate in some countries. (5)

   2) Explain whether or not you support the inclusion of loss-making comparables when undertaking a comparability analysis in periods affected by the COVID-19 pandemic. (5)

   3) Consider and explain whether customs valuations can be relied upon when applying the arm's length principle. (5)

   Total (15)

8.

   1) "Transfer pricing documentation is a critical component of risk assessment and risk management for both tax administrations and multinational enterprises."

   Critically evaluate this statement. (7)

   2) **In what circumstances would you consider a cost contribution arrangement (CCA) to be advantageous, with regard to the arm's length principle? Explain your understanding of a CCA and any situations in which a CCA may not be appropriate. Provide examples to support your arguments.** (8)

   Total (15)

9. **You are required to provide the following transfer pricing advice to your global tax manager, in relation to intra-group financing:**

1) Explain your understanding of Global Formulary Apportionment. Do you consider this concept to be relevant in the current transfer pricing environment? Provide support for your statements and opinion. (5)

2) How do thin capitalisation rules impact upon transfer pricing? (5)

3) What would you consider to be the most important principles concerning intra-group financing transfer pricing risk? Your answer should refer to the *Chevron Australia Holdings Pty Ltd* case [2017 FCAFC 62]. (5)

Total (15)