THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

December 2024

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 in appropriate monetary currency, unless otherwise stated. Any monetary calculations should be made to the nearest whole unit of currency. Any necessary time apportionments in your calculations should be made to the nearest whole month.
- You must provide appropriate line breaks between each question, and clearly indicate the start of each new question using the formatting tools available.
- Marks may be 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.

1. United Resorts Group is a multinational group of companies that owns and operates resorts in jurisdictions predominantly within and around the Indian Ocean.

United Resorts LLC is the ultimate parent entity of the group and a tax resident of Country A, where the headline corporate tax rate is 30%. United Resorts LLC has legal ownership of the group trademark.

United Resorts Group has recently opened a new resort on Crystal Waters Island, incorporated as Crystal Waters United Ltd (CWU), wholly owned by United Resorts LLC and resident in Crystal Waters Island. CWU is a luxury five-star resort and currently has occupancy rates of approximately 80%. Crystal Waters Island is a country with a headline corporate tax rate of 25%.

United Resorts LLC provided significant financing to CWU to construct the resort, in the form of a loan with an interest rate of 11.5% and requiring monthly repayments over a 20-year term. CWU pays United Resorts LLC a royalty of 4.5% of gross sales for the use of the group trademark.

A management agreement is in place between CWU and an associated enterprise within the group, United Management Pty Ltd (UMP), resident in Country B. The agreement stipulates that UMP provides various services to CWU, including accounting, legal, human resources, procurement, stock control, reservations, marketing and promotion services. UMP is also responsible for strategic management, including ensuring that CWU operates in a manner consistent with all other resorts operating under the United Resorts trademark. CWU remunerates UMP to the value of 2.5% of gross revenue and 10% of operating profit.

United Resorts LLC has the following arrangements in place with another associated enterprise, White Sands Management Co Ltd (WSM):

- royalty payments of 2.5%;
- loans provided to finance the construction of the hotel and working capital, at an interest rate of 9%; and
- the same terms and conditions as the management agreement with CWU.

WSM operates in Country C, where the headline corporate tax rate is 10%.

You are required to:

1) **Accurately delineate the transactions within the United Resorts Group.** (5)

2) **Discuss which transfer pricing methods you may consider selecting and applying, including any potential comparability issues.** (10)

3) **Identify, giving your reasons, any issues that may exist from a transfer pricing risk management perspective.** (10)

Total (25)

2. FastConnect HeadCo Ltd is the ultimate parent entity of the FastConnect telecommunications group, based in Country A with a headline corporate tax rate of 12.5%. The FastConnect group comprises a number of subsidiaries, all of which provide internet and mobile services in their respective markets.

FastConnect HeadCo Ltd is the legal owner of all intellectual property for the FastConnect group, including the brand name. It provides a range of services to all subsidiaries within the group, including technical services (deploying staff in each jurisdiction), accounting, human resources, procurement, supply chain management and legal services. FastConnect HeadCo Ltd charges each subsidiary a license fee for the provision of these services, based on a percentage of the subsidiary's revenues.

FastConnect Sub 1 Ltd is a tax resident of Country B, where the headline corporate tax rate is 25%. It provides centralised connection services to FastConnect Sub 2 Ltd. An interconnection agreement is in place between the two subsidiaries, which remunerates FastConnect Sub 1 Ltd with a percentage of sales revenues from customers.

FastConnect Sub 2 Ltd is a tax resident of Country C, where the headline corporate tax rate is 15%. It provides technical network services to FastConnect Sub 1 Ltd, for which it is remunerated at a cost reimbursement plus a margin of 20%.

FastConnect Sub 3 Ltd is a tax resident of Country D, where the headline corporate tax rate is 10%. It is responsible for project managing the development and implementation of a new digital platform that will provide innovative services for customers. A cost contribution arrangement is in place between all subsidiaries of the FastConnect group and FastConnect HeadCo Ltd, in relation to this project.

You are required to:

1) Perform a functional analysis of the FastConnect group, and characterise each entity within it.

(15)

2) Discuss any transfer pricing issues that the FastConnect group may need to consider when preparing transfer pricing documentation, including intellectual property and digital services.

(10)

Total (25)

PART B

You are required to answer ONE question from this Part.

3. The Starr group is incorporated and has its headquarters in the jurisdiction of Swickland.

The Starr group specialises in the manufacture and sale of large-scale computer servers for customers, predominantly large corporations and governments. The group has an annual turnover of approximately €1 billion, and recorded a net operating margin of 15% in the most recent fiscal year.

The Starr group operates a simplified model whereby it partners with unrelated companies in each market in which it sells computer servers to customers. Each unrelated company installs the servers and receives payment directly through the customer. The Starr group receives a commission of 2% of its invoice price for installation of Starr servers. The Starr group does not have any incorporated entities outside Swickland.

In July five Starr group employees, who are residents of Swickland, travelled to the jurisdiction of Neptunia to negotiate the sale of the most advanced computer servers for the Neptunian government. The employees met over three days with staff from the Neptunian government's IT department, to present on the technical specifications of the equipment. Employees of Starr group were subsequently asked to return two months later to negotiate a contract for the purchase of the order, which took place over one week. This resulted in the Starr group supplying €100 million of computer servers. An unrelated company, Retro Ltd, installed the servers and invoiced the Neptunian government €15 million for the installation. The Starr group received a payment of €300,000 from Retro Ltd.

The Starr group will make a net operating margin of 19% on the sale to the Neptunian government.

The Starr group does not have a subsidiary incorporated in Neptunia and does not anticipate making any additional sales in Neptunia in the remainder of the financial year.

You are engaged as an international tax adviser for the Starr Group.

With regard to the facts provided, advise the Starr Group on how the profits from the sale to the Neptunian government should be treated, including the allocation of any profits between the jurisdictions of Swickland and Neptunia. You should provide appropriate references in support of your advice. (20)

4. The Fluffy group is one of the largest and most famous multinational groups in the world, having been operating since 1912. Its brand is recognised in all jurisdictions in which it operates. The Fluffy group has its ultimate parent entity (UPE) located in the United States, and has incorporated subsidiaries in each country in which it sells its product. The UPE retains legal and economic ownership of the Fluffy brand name, which is applied to all products which it manufactures. The largest markets by sales value are the US, the United Kingdom, Germany, China, Japan, Brazil and India.

The Fluffy group manufactures and distributes ovens, dishwashers, fridges and similar products, as well as providing after sales services in markets in which its products are sold.

Subsidiaries undertake the manufacture of products in the US, Germany and Japan, under a model whereby each subsidiary has full responsibility for employing and training staff to manufacture the products, sourcing materials, forecasting demand and arranging transportation to associated enterprise distributors.

The distributors, which are also group subsidiaries, sell the manufactured products to unrelated retailers. The Fluffy group has a transfer pricing policy, whereby it seeks to achieve a transactional net margin of 4% of sales.

The chief financial officer (CFO) of the Fluffy group has contacted you with a proposal, the key aspects of which are as follows:

- The US, German and Japanese subsidiaries will discontinue manufacturing operations immediately.
- The US subsidiary will loan the Brazilian subsidiary $200 million to acquire land, buildings and equipment to manufacture all products for the Fluffy group. The US subsidiary will borrow the $200 million from a New York bank at an interest rate of 5% and will loan it to the Brazilian subsidiary at an interest rate of 4%.
- No changes will be made to distribution arrangements (i.e. the existing transfer pricing policy will apply to distributors).
- The existing manufacturers will sell the plant, equipment, land and buildings currently used to undertake manufacturing.
- Significant redundancy compensation packages will be offered to staff who currently undertake manufacturing.
- Technical staff will train new staff in Brazil on the manufacturing processes, and will prepare detailed documentation setting out the current manufacturing processes.
- As the current manufacturers have earned healthy profits over the years (margins averaging around 9%), they don't need to be compensated and will absorb the costs resulting from their cessation of manufacturing.
- The Brazilian subsidiary will undertake contract manufacturing for the US subsidiary, under its direction.
- The Brazilian subsidiary will earn a margin of cost plus 5%.
- Around $50 million of synergies are expected to be realised each year based on preliminary calculations, including material tax savings.

You are required to provide the following preliminary advice to the Fluffy group CFO:

1) **Identify the key transfer pricing issues relating to the proposal.** (15)

2) **Advise on any potential transfer pricing risks and obligations to which Fluffy Group may be subject, including from the US, German, Japanese and Brazilian tax administrations, should the proposal proceed in its current form.** (5)

Total (20)

PART C

You are required to answer TWO questions from this Part.

5. **You are required to:**

   1) **Identify and explain at least three strategies that multinational groups can adopt to minimise the risk of transfer pricing disputes.** (8)

   2) **Critically evaluate, explaining your reasoning, whether country-by-country reporting has been a success for tax administrations.** (7)

   Total (15)

6. **You are required to:**

   1) **Provide a specific example of a transfer pricing safe harbour which a tax administration has put in place. You should reference how the specific safe harbour which you have referenced applies in practice, giving your assessment of the efficacy or otherwise of the outcome.** (8)

   2) **Discuss the key challenges and considerations that multinational groups face, when setting transfer pricing policies and prices for transactions between associated enterprises. In your answer, you should address tax and non-tax considerations.** (7)

   Total (15)

7. **You are required to address the following matters:**

   1) **Discuss whether, in your view, the Pillar Two global minimum tax will be more of a game changer than Pillar One, providing supporting reasons.** (8)

   2) **It has been broadly speculated that the United States may not implement a global or domestic minimum tax. Assess the relevance of the US legislating for this measure, from the perspective of other implementing jurisdictions.** (7)

   Total (15)

8. You are an audit manager at a revenue administration, and have recently recruited a relatively inexperienced audit officer whom you plan to develop into a transfer pricing specialist.

   In mentoring the new staff member, you are required to advise on the following questions:

   1) **What factors should be taken into consideration in a transfer pricing risk assessment, and why?** (7)

   2) **What are the main practical considerations when preparing for and conducting a functional analysis, and why?** (8)

   Total (15)

9. The group tax manager of a multinational group of companies has sought your advice, in relation to a complex financing arrangement between a number of associated enterprises within the group.

   You are required to provide the following advice:

   1) **From a transfer pricing risk management perspective, what areas will need to be considered when preparing transfer pricing documentation in relation to the financing arrangement? Explain why these are important.** (10)

   2) **What are the most important tax risk management issues for a company with related party financing transactions to consider, in terms of the interaction between transfer pricing and thin capitalisation?** (5)

   Total (15)