THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 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.

Beagle Group is a multinational group whose business operations encompass the manufacture and sale of dog food. It has been operating for more than fifty years and is owned by a family of wealthy individuals. Beagle Group is one of the market leaders in the countries in which it makes sales and has a strong brand, allowing it to sell its products for a higher price than its main competitors.

You have been provided with the following notes, from Beagle Group's Country by Country documentation, in relation to the income year ending 31 December 2020.

Company A (Parent company), based in Country A

- Board of Directors holds meetings to discuss the group's strategic direction and approve key decisions.
- Holds legal ownership of group intellectual property, including brand names, trademarks, patents, manufacturing technology and knowhow.
- Owns its office building, office furniture and motor vehicles.
- Undertakes sales and marketing activities in Country B.
- Loans funds obtained from banks to provide interest free financing to subsidiaries.
- Provides management, administrative, information technology, accounting, taxation, marketing assistance and technical assistance to subsidiaries.
- Sources approximately 40% of Beagle group's products from independent contract manufacturers.
- Sells to customers in Country A.
- Has 800 employees.
- Records income of $700 million and an operating profit margin of 2%.
- Country A's corporate income tax rate is 30%.

Company B, based in Country B

- Undertakes sales and marketing activities in Country B.
- Rents an office space and owns motor vehicles.
- Has 100 employees.
- Records sales income of $200 million and an operating margin of 15%.
- Country B's corporate income tax rate is 15%.

Company C, based in Country C

- Undertakes sales and marketing activities in Country C.
- Contract manufactures products under a legal agreement on behalf of Company A.
- Procures inputs for the manufacturing process.
- Transports completed products to Company A, Company B and Company D in their respective countries.
- Undertakes group research and development, under instruction from Company A.
- Rents office space for employees from an independent party.
- Rents premises to manufacture from an independent party.
- Has 50 employees undertaking sales and marketing activities, and 250 employees undertaking manufacturing activities.
- Records sales income of $90 million and an operating margin of 10%.
- Country C's corporate income tax rate is 20%.

Company D, based in Country D

- Sells products online to customers in approximately 30 countries (but not in Countries A, B or C).
- Rents a small premises.
- Five employees process the online orders and arrange for transport to customers.
- Records sales income of $250 million and an operating margin of 30%.
- Country D's corporate income tax rate is 10%.

1. **As Beagle Group's tax adviser, you have been advised to prepare transfer pricing documentation. You are required to provide the following information and guidance:**

   1) Accurately delineate the transactions between the associated Beagle Group enterprises. (10)

   2) For each transaction you have identified, advise on the most appropriate transfer pricing methodology to apply, together with your reasons. (10)

   3) In relation to the application of the arm's length principle, outline any concerns which the tax administration of Country A is likely to raise in relation to Beagle Group. (5)

   Total (25)

2. **You are required to:**

   1) Perform a functional analysis for Beagle Group, including the practical approaches involved in undertaking a functional analysis. (15)

   2) Explain how you would characterise each Beagle Group entity, including reasons in support of your characterisation. (5)

   3) Explain why it is necessary to undertake a comparability analysis. (5)

   Total (25)

PART B

You are required to answer ONE question from this Part.

3. The HeartHealth group is a multinational group of healthcare companies, which manufactures and distributes products to help patients with cardiovascular conditions.

The group's management have presented you with the following notes, relating to the current operations of the HeartHealth group:

HH Headco (based in Country A)

- Undertakes manufacturing operations for the group.
- Purchases inputs for the manufacturing process from third parties.
- Manufactures a range of products, most of which are highly specialised medical devices.
- Sells end products to associates, HH Sub 1 and HH Sub 2, in Countries A and B respectively.
- Invests in and conducts research and development.
- Owns all intellectual property, predominantly patents for the products developed, manufactured and sold.
- The corporate income tax rate in Country A is 30%.

HH Sub 1 (associated entity, based in Country A)

- Purchases finished products from HH Headco and sells them to third parties, predominantly hospitals.
- A supply agreement is in place with HH Headco; HH Headco is responsible for the warranty risk.
- Provides after sales services and training to clients in hospitals.
- Receives training for product use from sales representatives employed by HH Headco.

HH Sub 2 (associated entity, based in Country B)

- Purchases finished products from HH Headco and sells them to third parties, predominantly hospitals.
- A supply agreement is in place with HH Headco; HH Sub 2 is responsible for the warranty risk.
- Provides after sales services and training to clients in hospitals.
- Receives training for product use for sales representatives from HH Headco.

The HeartHealth group operates in a number of markets, and over time has seen a substantial increase in demand for its range of products. As a result, the group tax manager recently engaged a management consultancy firm to provide options for a potential reorganisation.

Following a swift implementation of the recommendations provided to the HeartHealth group, two additional associated entities have been established:

HH Sub 3 (based in Country C)

- Established as a regional hub for supply chain efficiencies.
- Performs contract manufacturing on behalf of HH Headco, and the supply agreements with HH Sub 1 and HH Sub 2 are transferred from HH Headco to HH Sub 3.
- Employees from HH Headco have been transferred to HH Sub 3 to create a new research and development operation, along with additional staff, all of whom are highly skilled medical device specialists. This includes new product development for an advanced ECG monitor.
- The corporate income tax rate in Country C is 15%.

HH Sub 4 (based in Country D)

- Owns the group's intellectual property, which has been transferred from HH Headco.
- A number of key, senior staff employed by HH Headco have relocated to Country D to make strategic decisions on behalf of HH Sub 4.
- All associated entities now pay a royalty for the use of intellectual property to HH Sub 4.
- As a tax incentive, a special corporate income tax rate of 5% has been provided in Country D.

Continued

3. Continuation

You are required to:

1) Outline the functions, assets and risks for the entities within the HeartHealth group, as well as their characterisation before and after the group's restructuring. (8)

2) Discuss the potential transfer pricing methods that may be applied to the transactions, and any comparability issues which may arise. (7)

3) Outline the transfer pricing issues that may be raised by the relevant tax administration if the HeartHealth group is subject to a transfer pricing audit. (5)

Total (20)

4. The Nightingale group is a newly established multinational group of companies.

The parent company within the group, NG Headco, is resident in Country X. It has signed a contract with Roxo Ltd, an independent party resident in Country Z, for the construction of a sewage treatment facility. NG Headco's key decision makers were involved in the negotiation and execution of the contract, which was signed in Country Z.

Staff employed by NG Headco are seconded from Country X to perform functions underpinning the operations of the contract in Country Z, including:

- Interactions with suppliers;
- Procurement;
- Construction;
- Storage of equipment; and
- Project management.

Each of the functions performed by employees in Country X is undertaken by a different entity registered in Country Z, under a separate contract with NG Headco.

Employees in Country Z negotiate and conclude separate contracts with third parties, as part of smaller projects which are typically between two and three months in duration. Employees are able to return to Country X for short periods between projects.

As a tax inspector employed by Country Z's tax administration, you are required to answer the following questions:

1) What are the potential permanent establishment issues that exist for the Nightingale group with regard to Article 5 (and Commentaries) of the OECD Model Tax Convention on Income and Capital 2017? (15)

2) What considerations would you raise, in relation to the attribution of profit or loss to any potential permanent establishment? (5)

Total (20)

PART C

You are required to answer TWO questions from this Part.

5. **You are required to provide a written response to the following questions:**

   1) **What options are available to a multinational group of companies that is subject to double taxation as a result of a transfer pricing adjustment?** (5)

   2) **What issues may arise from corresponding and secondary transfer pricing adjustments by a tax administration?** (5)

   3) **What is the importance of the OECD Base Erosion and Profit Shifting (BEPS) Action 14, in relation to transfer pricing disputes?** (5)

   Total (15)

6. **You have been requested to provide transfer pricing advice on the following matters:**

   1) **Define 'safe harbours', and outline the advantages and risks of their use.** (5)

   2) **Explain the concept and operation of 'simultaneous tax examination', including your recommendations on their use.** (5)

   3) **When would intra-group services be classified as 'low value adding', and what are the implications of this?** (5)

   Total (15)

7. The following cases have been cited as examples of important decisions in the practice of transfer pricing:

   - *Cameco Corporation [2020 FCA 112];*
   - *GSK Canada [2010 FCA 201]; and*
   - *SNF (Australia) Pty Ltd [Full Federal Court Decision, 2011 FCAFC 74]*

   For one of these cases, you are required to summarise the facts and issues, and provide your critique of the decision and its implications for transfer pricing. (15)

8. The chief financial officer of the Starr multinational group has asked you to prepare a report regarding the OECD's Base Erosion and Profit Shifting (BEPS) Project.

   You are required to provide a report, including:

   1) **The original objectives of the BEPS Project.** (8)

   2) **The current status of the BEPS Project, including outstanding issues.** (4)

   3) **Your consideration on which one of the outstanding BEPS issues will be the most challenging to resolve, along with the reasons why you consider it to be the most challenging.** (3)

   Total (15)

9. **You are required to:**

   1) **Explain why tax administrations may find Country by Country documentation useful.** (5)

   2) **Give your recommendation as to whether or not a multinational group should enter into an Advance Pricing Arrangement. What are the benefits and costs?** (5)

   3) **Explain the concept of a cost contribution arrangement for transfer pricing purposes.** (5)

   Total (15)