THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2023

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.
- 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.

1. National Group is a multinational company whose shares are publicly traded on a stock exchange. National Group's head office and ultimate parent, ZeusCo, is located and domiciled in the jurisdiction of Zeus, where it also lodges the group's audited, consolidated financial statements. National Group operates through wholly owned subsidiaries, domiciled in several jurisdictions in which it undertakes business.

National Group's key business operations comprise the design, manufacture and distribution of branded, luxury leather handbags. National Group sells its products in around ten jurisdictions, with the most significant entities in the group detailed below.

ZeusCo owns National Group's intangible assets, including trademarks, copyright, designs, know-how, patents and manufacturing processes. ZeusCo develops, maintains and protects these intangible assets, which are critical to the group, and has entered into legal arrangements to license the intangible property with its associates domiciled in other jurisdictions. ZeusCo undertakes certain functions on behalf of the group, including research and development, treasury, logistics, strategic management and administration.

In addition to selling its products to retailers in Zeus, and to its subsidiary entities in its capacity as a wholesaler or distributor, ZeusCo also sells its handbags to independent retailers in other jurisdictions where the group does not have a physical presence. These jurisdictions are Poseidon and Hestia, where the retailers who purchase the goods market and sell to the end customers, typically wealthy individuals. ZeusCo seeks to target a gross profit margin of 50% and a net profit margin of 20% (after considering direct and indirect expenses such as logistics, manufacturing and employee costs).

National Group has a wholly owned subsidiary, AresCo, domiciled in the jurisdiction of Ares. This entity makes sales to retailers in Ares and nearby jurisdictions. AresCo purchases all products from the parent company and its employees tailor the marketing in order to maximize sales. It leases a warehouse to store the goods and utilises an independent transport company to deliver bulk orders to customers. AresCo also leases a small office space with the required fixtures and fittings, enabling its employees to undertake marketing, maintain relationships with its customers and forecast product orders.

National Group also has a wholly owned subsidiary, HeraCo, domiciled in the jurisdiction of Hera. HeraCo undertakes contract manufacturing of luxury wallets for the group. It is able to purchase higher quality tangible goods, such as premium leather, from independent parties at a cheaper price, for use in the manufacturing process. HeraCo is also able to purchase electricity at a cheaper price than the group entities in other jurisdictions, resulting in cost savings for the group. It has the right to manufacture, utilising National Group's manufacturing and other know-how. HeraCo does not make any product sales as it manufactures goods based on orders from ZeusCo under the legal contract between the entities.

The following key financial information from National Group's country-by-country report has been summarised, for the financial year ending 31 December 2022:

Entity	Net Sales ($)	Net Profit Margin	Total Assets ($)	Employees
ZeusCo	100,000	35%	250,000,000	1,000
AresCo	20,000,000	25%	15,000,000	10
HeraCo	5,000,000	5%	100,000,000	180

Additional information:

ZeusCo generated handbag sales of $35 million to retailers domiciled in Poseidon and Hestia.

You are required to:

1) **Accurately delineate the transactions between the associated enterprises within the National Group.** (10)

2) **Select and apply the most appropriate transfer pricing method(s), to ensure an arm's length outcome for each of the delineated transactions identified between the associated enterprises. Provide justification for the method(s) selected.** (10)

3) **In consideration of the arm's length principle, advise on the single most material risk or issue based on the facts available.** (5)

Total (25)

2. Rascal is a multinational group of companies, whose main business is the manufacture and sale of soft drinks and sodas. Rascal undertakes manufacturing operations in its largest markets around the world. Each company in the group is domiciled in a different jurisdiction, and all are regarded as associates or related parties.

Rascal has centralised managerial and reporting lines, broadly aligned with geographical regions, encompassing North America, South America, Europe, Asia, Oceania, Africa and the Middle East. The ultimate parent company, IP Co, legally owns all intangible assets for the group, including trademarks, copyright, designs, know-how, patents and manufacturing processes. As Rascal ensures a consistent quality product in all markets across the world, the key ‘recipe’, brand name, design and marketing materials are consistent globally. IP grants the legal right to a number of related ‘Man Co’ manufacturing companies to licence the intangible assets in their territory. A royalty is paid by each Man Co to IP Co as compensation for granting the licence, under the arm’s length principle. IP Co also provides financing and treasury functions, including the loaning of funds, to each Man Co as it requires a substantial investment for land, buildings and equipment in order to undertake the manufacturing process.

A procurement company, Procure Co, sources the majority of key ingredients for the manufacturing process such as bulk liquid sugar, preservatives, cardboard, plastic bottles and aluminium cans. This results in substantial cost savings for the group, as Procure Co is able to negotiate discounts by purchasing for all Man Cos in substantial volumes. Procure Co employs twenty staff and rents a small office with computer and telephone equipment. It purchases from independent parties around the world and arranges insurance and transportation from third parties to the warehouse of each Man Co. Procure Co retains title to the goods until they are delivered to these warehouses. Procure Co sells the goods in its local currency, which in most cases differs from that of the Man Co in question.

Man Cos are located in each geographical region. In addition to the ingredients provided by Procure Co, each Man Co directly purchases certain goods, such as carbon dioxide, from an independent party in their jurisdiction. The Man Cos also utilise substantial volumes of water, which undergoes a complex and lengthy filtration process to remove any impurities. Each Man Co legally owns the required land and buildings, and possesses substantial equipment to undertake the manufacturing of soft drinks. They utilise independent parties to transport the finished product via train and road to various ‘Distribution Co’ distribution companies. Each Man Co sells the finished soft drinks in the currency of the Distribution Co.

Each Distribution Co is responsible for selling the packaged soft drinks to customers in its jurisdiction. All customers are either major retailers, or other distributors who will sell on to small retailers. Each Distribution Co employs a substantial number of staff, responsible for maintaining relationships with key customers, promoting the product in their territory, forecasting demand and placing orders with the Man Co. The Distribution Cos utilise offices that are fitted with the necessary equipment, such as computers, desks, meeting rooms and telephones. They also maintain a fleet of motor vehicles, which are used by Distribution Co employees to visit retailers and ensure that the product is appropriately merchandised with advertising material. Each Distribution Co is also responsible for determining wholesale prices in its market, and has discretion to provide discounts to customers if they purchase certain volumes throughout the year. The Distribution Cos use independent logistics companies to transport the product from their warehouses, which they lease from independent parties, to customers’ warehouses.

As the international tax adviser to the group, you have been informed that Rascal seeks a transfer pricing policy which will achieve the following:

- each Man Co returning earnings before interest and taxes (EBIT) of 3% of sales; and
- each Distribution Co returning EBIT of 3% of sales.

You are required to:

1) **Perform a functional analysis of the group, and characterise each entity.** (10)

2) **Provide a memo on the relevance of a comparability analysis, based on the facts provided.** (10)

3) **Advise on whether you have any concerns regarding the approach which Rascal is applying in relation to intangible property.** (5)

Total (25)

PART B

You are required to answer ONE question from this Part.

3. Marine Power (MP Group) is a multinational group of companies with its core business in marine engines. The following details are provided in relation to the structure and operations of MP Group:

MP Headco is the ultimate parent company of MP Group, domiciled in Barracudia where the headline corporate income tax rate is 30%. It has legal ownership of all MP Group intellectual property, including brand names, trademarks, patents, designs and manufacturing processes. MP Headco procures parts from independent companies and undertakes the manufacture of a range of marine engines varying in design, size, power and other specifications.

MP Headco also undertakes research and development (R&D) activities to develop different marine engines, and employees involved in these R&D activities possess mechanical engineering degrees and significant industry experience. MP-branded engines are regarded as a premium product in the markets in which they are sold, in terms of quality and reliability. MP Headco owns a fleet of different marine equipment, including boats and jet skis, that it utilises in the course of its R&D activities. It distributes to companies in a range of jurisdictions, including wholly owned subsidiaries (MP Sub 1 and MP Sub 2) as well as independent companies that distribute to end customers, including in the same jurisdictions as MP Sub 1 and MP Sub 2. MP Headco has been consistently achieving earnings before interest and taxes (EBIT) of approximately 20% of sales.

MP Sub 1 is a wholly owned subsidiary of MP Headco, domiciled in Haddockia, where the corporate income tax rate is 25%. It purchases finished marine engines from MP Headco and distributes both to independent retailers in Haddockia and to end customers through retail outlets that it owns and operates in Haddockia. MP Sub 1 also undertakes marketing activities to promote the sale of products in Haddockia. It pays a royalty to MP Headco, amounting to 5% of sales, for the use of intellectual property. MP Sub 1 achieves EBIT of approximately 8% of sales.

MP Group's chief financial officer has recently received advice from a transfer pricing and international tax consultant on maximising the group's after-tax profitability. The following facts are provided, following the receipt and implementation of this advice:

- MP Sub 2 has been created and domiciled in Mackerela, where the corporate income tax rate is 10%. All legal ownership of intellectual property has been transferred to MP Sub 2.
- MP Sub 2 provides administrative and technical services including assistance in R&D activities undertaken by MP Headco.
- MP Sub 2 receives a royalty payment from MP Sub 1, amounting to 10% of sales, for the use of intellectual property. MP Headco no longer receives a royalty.
- MP Sub 2 enters into a cost contribution arrangement with MP Headco. As part of this arrangement, MP Sub 2 pays cost plus 5% to MP Headco for conducting R&D activities.
- MP Sub 3 has been created and domiciled in Codland, where the corporate income tax rate is 25%.
- MP Sub 3 has entered into a contract manufacturing arrangement with MP Headco in which MP Sub 3 manufactures marine engines on behalf of MP Headco for a remuneration of cost plus 8%. MP Sub 3 ships the finished goods directly to the wholly owned subsidies and independent companies on behalf of MP Headco.
- MP Group's profitability (EBIT) in the tax year following these changes is as follows:
    - MP Headco: 7% of sales
    - MP Sub 1: 5% of sales
    - MP Sub 2: 15% of sales
    - MP Sub 3: 5% of sales

You are required to:

1) **Perform a transfer pricing analysis of MP Group, outlining the impact on the functional analysis and comparability as a result of the business restructuring. You should give regard to the conditions both pre- and post-restructuring.** (14)

2) **Identify and discuss any transfer pricing risks in relation to the arrangements within MP Group.** (6)

Total (20)

4. Ocean Dream Ltd (Ocean Dream) is a company domiciled in Fisherman’s Cove. Ocean Dream’s two directors, through regular travel to Relax Isle, have negotiated a contract with the government of Relax Isle to develop and implement an electronic border protection system for its customs agency.

Ocean Dream has established a number of separately registered companies domiciled in Fisherman’s Cove. The staff of these separately registered companies, all of which are wholly owned subsidiaries of Ocean Dream, perform a number of different activities as part of the project for the electronic border system in Relax Isle. The staff perform the work in Relax Isle on a ‘fly-in fly-out’ basis, to the extent that no staff member is physically present in Relax Isle for more than 30 days. Their activities include:

- Product and technical services (including services undertaken by biometrics engineers);
- Research and development (R&D) activities;
- Operations and liaising with government staff (undertaken by operations and project managers);
- Legal and compliance services;
- Border management services; and
- Support functions.

Ocean Dream leases a small office on a monthly basis, from which its staff operate whilst in Relax Isle. All strategic and key decision-making is conducted in Fisherman’s Cove by the directors.

Intellectual property created through the R&D activities conducted by the staff in Relax Isle is legally registered in Fisherman’s Cove.

The directors of Ocean Dream co-own a boat that is registered in Fisherman’s Cove. Given the relatively small distance between Fisherman’s Cove and Relax Isle, the boat is used to transport the staff between the jurisdictions. When not being utilised for this purpose, the boat is chartered to tourists in Relax Isle. The income received from tourists is booked by Ocean Dream in Fisherman’s Cove and the captain of the charters is remunerated. Customers book the charters via an online platform.

Ocean Dream has registered neither a company nor a branch in Relax Isle.

You are required to:

1) Discuss, with reference to the OECD Model Tax Convention on Income and on Capital (2017), whether the tax administration in Relax Isle would raise any issues, from a transfer pricing perspective, in relation to a permanent establishment. (11)

2) Assess how any potential profit or loss would be attributed to Ocean Dream by the tax administration of Relax Isle. You should refer to any relevant OECD guidance. (6)

3) Discuss any transfer pricing issues, specific to intellectual property, in consideration of the OECD BEPS Action Items and the development, enhancement, maintenance, protection and exploitation (DEPME) of intangibles. (3)

Total (20)

PART C

You are required to answer TWO questions from this Part.

5. **You are required to:**

   1) **Explain how you would manage transfer pricing risk in relation to intra-group financial transactions. You may support your answer with reference to relevant transfer pricing litigation cases.** (10)

   2) **Discuss key aspects of the interaction between thin capitalisation rules and transfer pricing.** (5)

Total (15)

6. **You are required to:**

   1) **Identify and explain the key issues for companies to consider when reviewing their transfer pricing policies, in relation to intra-group services.** (8)

   2) **Discuss the models that are available to develop and exploit intangibles, in a transfer pricing context.** (7)

Total (15)

7. **You are required to answer the following questions:**

   1) **Tax transparency has impacted upon transfer pricing for both taxpayers and tax administrations in recent years. What would you consider to be the advantages and disadvantages, for both taxpayers and tax administrations, of the changes to transfer pricing documentation requirements?** (8)

   2) **E-commerce has been increasingly scrutinised in a transfer pricing context since the release of OECD BEPS Action 1 (Tax Challenges Arising from Digitalisation). What do you regard as the key issues, from a transfer pricing risk perspective, for tax administrations in relation to digital platforms, and why?** (7)

Total (15)

8. **You are required to:**

   1) **Identify and summarise, in your own words, the key articles of a tax treaty that may be relevant for transfer pricing purposes.** (10)

   2) **Explain the challenges presented to tax administrations by the concept of intangible property, in relation to the application of the arm's length principle.** (5)

Total (15)

9. **You are required to consider the following:**

   1) **Explain how arbitration may apply in relation to transfer pricing matters. You should articulate the circumstances in which arbitration might apply.** (7)

   2) **Recent OECD developments are expected to have a significant impact on the international tax landscape, including tax incentives offered by governments to multinationals in their jurisdictions. Discuss how recent OECD initiatives could have implications for these tax incentives.** (8)

Total (15)