THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2022

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.

Machine Incorporated (Machine Group) is a multinational group which commenced operating in 1950. It is listed on the New York Stock Exchange. Machine Group's business operations include the design, manufacture, distribution and sale of electric tools and equipment for use by professionals in the construction industry. Machine Group's products are well known in the market and there is no need to discount products as the products are in high demand, with a reputation for lasting longer than those of Machine Group's competitors.

Machine Group's extensive product range includes drills, grinders, sanders, saws and related products. The products utilise the latest technology, with improvements to products typically made every two to three years.

The below information has been extracted from Machine's Group's Country-by-Country documentation, in relation to the income year ending 31 December 2021.

Country of Residence of Machine Group Entities – Summary of primary operations and other key information

Country Alpha (Parent company)

- Hosts regular Board of Director meetings to establish strategic direction, approve key decisions and funding decisions
- Legal ownership of key intangibles including patents, trademarks, trade names and brand names
- Know-how and trade secrets relating to manufacturing and research and development
- Ownership of head office building, office furniture, computer equipment and motor vehicles
- Undertakes research and development
- Sources funds through a combination of banks and issuance of corporate bonds
- Loans funds to subsidiaries
- Undertakes activities on behalf of subsidiaries including management, administration support, in-formation technology services, accounting, marketing assistance and demand forecasting
- Independent retailers are provided with marketing material and training to educate sales staff
- Technical helpline for tradespeople to ask questions and to handle faults with products
- 2,100 employees
- Assets of $10.5 billion
- Revenue of $5 billion through sales to independent retailers in Alpha and other major markets around the world
- Net operating profit margin of 5%
- Corporate income tax rate is 20%
- Paid income tax of $50 million

Country Beta (Subsidiary)

- Undertakes sales and marketing activities in Country Beta and neighbouring countries
- Has been established for commercial reasons to service customers in Country Beta and neighbouring countries, due to linguistic and cultural barriers and the significant distance from Alpha
- Rents an office building from an independent party
- 100 employees
- Assets of $20 million, consisting predominantly of motor vehicles, computer equipment and office furniture
- Sales income of $1 billion
- Net operating margin of 10%
- Corporate income tax rate is 15%
- Paid income tax of 15 million
- For transfer pricing purposes, remunerated based on 10% of sales

Country Gamma (Subsidiary)

- Legal agreement with Alpha to contract manufacture products on behalf of Alpha
- Sources products for manufacture from independent parties
- Utilises key intangibles from Alpha, including manufacturing know-how
- Undertakes logistical services relating to the manufacture of products, and uses independent transport companies to transport finished goods to associated entities
- Advised by Alpha quantities of products to manufacture

- Do not make sales to any associated entities or independent customers
- 450 employees performing manufacturing activities
- Assets of $500 million, primarily building and plant and equipment for manufacture
- Revenue of $1 billion
- Net operating margin of 4%
- Corporate income tax rate is 10%
- The transfer pricing policy is that Gamma earns its income based on a profit split arrangement with Alpha

Country Delta (Subsidiary)

- Sells goods to customers, utilising a website hosted by Delta
- Only sells to customers in countries which the Country Alpha and Country Beta entities do not sell to
- Most customers are individual tradespeople as Machine Group does not sell to retailers in these countries
- The website is managed and updated by Alpha
- Rents a serviced office space from an independent party
- Three employees, who process online orders and arrange for transport to customers directly from Country Gamma
- Assets of $250,000, comprising IT and office equipment
- Sales income of $700 million
- Operating margin of 50%
- Corporate tax rate is 5%
- Acquires finished goods at cost price from Gamma

1. As Machine Group's tax adviser, you have been asked to prepare transfer pricing documentation.

   You are required to provide the following information and guidance:

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

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

   3) In relation to the application of the arm's length principle, outline any concerns which the tax administration of Country Alpha is likely to raise in relation to Machine Group. Do you support the tax administration making an audit adjustment, relying only on the information available from Machine Group's Country-by-Country reports? (5)

   Total (25)

2. **You are required to:**

   1) Advise on the information that Machine Group should include in its Country-by-Country report. (5)

   2) Perform a functional analysis for Machine Group. (12)

   3) Explain how you characterise each entity in the Machine Group for transfer pricing purposes, with reasons in support of your conclusion. (8)

   Total (25)

PART B

You are required to answer ONE question from this Part.

3. You have been allocated a transfer pricing audit to lead, as a tax administration official.

The following details of the Surfco Ltd multinational group were obtained through a risk review that was conducted prior to audit:

<u>Surfco Ltd (group head company)</u>

- Tax resident in Country A, with a tax rate of 30%
- Designs, manufactures and sells brand name clothes
- The legal owner of all intangible assets within the group
- Managed and controlled with board meetings conducted in Country A
- Possesses an established, mature brand name in the market
- Undertakes marketing, procurement and services functions centralised in Country A
- Sells products to both associated enterprises and independent parties in Country A

<u>Surfco Sub1</u>

- Tax resident in Country B, with a headline corporate tax rate of 10%
- Purchases products from Surfco Ltd and on-sells to independent parties via retail stores owned by Surfco Sub1 in Country B, as well as online to customers globally
- Incurs substantial marketing expenditure in Country B
- A royalty of 5% of sales is embedded into the purchase price of goods for the brand name owned by Surfco Ltd

<u>Independent Co</u>

- Tax resident in Country B, with a headline corporate tax rate of 10%
- Purchases products from Surfco Ltd and on-sells to independent parties via retail stores owned by Independent Co in Country B as well as online to customers globally
- Incurs substantial marketing expenditure in Country B
- A royalty of 2% of sales is embedded into the purchase price of goods for the brand name owned by Surfco Ltd

The following information was subsequently gathered during the course of the audit:

1) All intellectual property held by Surfco Ltd has been transferred to Surfco Sub1, and a separate royalty of 8% of sales is now charged by Surfco Sub1 to Surfco Ltd and Independent Co.

2) A financing arrangement has been established, whereby Surfco Ltd provides Surfco Sub1 with an interest-free loan to fund the purchase by Surfco Sub1 of the intellectual property transferred.

3) Surfco Ltd's manufacturing operations have ceased and an associated entity, Surfco Sub2, has been incorporated in Country C where the corporate tax rate is 20%. It is understood that Surfco Sub2 has been provided with a tax exemption, reducing its corporate tax rate to 5%.

4) Surfco Ltd, Surfco Sub1 and Independent Co now purchase all goods from Surfco Sub2.

5) Surfco Ltd continues to undertake a significant marketing function.

You are required to provide a risk assessment, from a transfer pricing perspective, for the Surfco Ltd group. You should consider any implications in terms of business restructuring, changes to functions, assets, risks and characterisation, with regard to the arm's length principle. (20)

4. The Apollo Group is a multinational group of companies that specialises in property development. Apollo Ltd is the head company, tax resident in Valla. Apollo Ltd's directors and senior marketing staff recently identified an opportunity to construct a luxury resort in another country, Occorian, and negotiated and concluded a commercial deal with an independent party resident in Occorian.

Staff employed by Apollo Ltd have travelled to Occorian to undertake construction of the resort. The staff are engaged on a 'fly in fly out' basis, meaning that they work in Occorian for a maximum of one month during a set period. A project manager and team of engineers employed by Apollo Ltd have been seconded to Occorian to oversee the project.

Several associated enterprises of Apollo Ltd have been established in Occorian to perform functions essential to the project, including procurement, logistics, storage, finance and accounting. Separate contracts have been entered into, between the associated enterprises and independent companies.

Apollo Ltd oversees marketing and software engineering functions in Valla on behalf of an independent company, as part of a campaign to advertise the new resort to potential customers in Occorian. The campaign involves online platforms including a website registered in Occorian and various social media platforms.

You are required to identify the permanent establishment issues that could potentially be raised by a tax administration, following a review of the Apollo Group. You should consider Article 5 of the OECD Model Tax Convention on Income and on Capital 2017, together with the Commentaries, and attribution of income or losses. (20)

PART C

You are required to answer TWO questions from this Part.

5. You have been approached to provide tax advice in relation to cost contribution arrangements (CCAs) for a multinational group of companies. Initial discussions indicate that the value chain in the arrangements includes intellectual property development between associated enterprises in the group.

   You are required to provide an overview of CCAs, their advantages and disadvantages, and how they may be implemented and documented. (15)

6.
   1) **Discuss the value that transfer pricing documentation may contribute to risk assessment, risk management and audits, from both a tax administration and taxpayer perspective.** (8)

   2) **Explain your understanding of one of the following types of audit, including the associated benefits and costs:**

      - **Simultaneous audit;**
      - **Joint audit; or**
      - **Multilateral audit.** (7)

   Total (15)

7. Intragroup financing transactions can be considered high-risk from a transfer pricing perspective.

   You are required to discuss this statement in consideration of the application of the arm's length principle, and cite any relevant case law in support of your conclusions. (15)

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

   1) **To what extent do you expect the OECD/G20's proposed two-pillar solution to Base Erosion and Profit Shifting (BEPS) to effectively address the tax challenges arising from the digitalisation of the economy? Your answer should include consideration of how the Pillar One proposals may impact upon transfer pricing.** (10)

   2) **In what circumstances should a multinational group charge for intragroup services? You should include appropriate explanation and references in support of your answer.** (5)

   Total (15)

9. You have been engaged as the international tax adviser to a multinational group.

   Following the completion of a transfer pricing audit, the tax administration of the country in which the group's parent entity is tax resident has made a material transfer pricing audit adjustment. This adjustment has resulted in an increase in the amount of royalty income received from three subsidiaries to reflect an arm's length price for the supply of intellectual property.

   The multinational group does not fully agree with the adjustments made by the tax administration.

   You are required to advise the group on the following matters:

   1) **What option(s) may be available to the multinational, in resolving the dispute with the tax administration following the audit? Your answer should include any conditions or requirements which apply to the option(s) you suggest.** (8)

   2) **Advise on how the group can minimise the risk of tax administrations undertaking future transfer pricing audits and adjustments in relation to its activities.** (7)

   Total (15)