THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2025

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.

The following facts apply to both Questions 1 and 2.

Sapupo Group is listed on the Newvania Stock Exchange, with its financial accounts published regularly. It operates as a multinational group, through wholly owned subsidiary companies located in several key jurisdictions. Sapupo Group's main operations encompass the development, design, manufacture, distribution, marketing and sale of mobile phones and related products.

Sapupo Group is the owner of the intellectual property (IP) for all physical products which it sells. it does not sell or market any physical goods of independent parties. The IP includes licences, patents and trademarks relating to the group's brand names, technology and manufacturing know-how processes.

Sapupo Group also sells third party online applications which can be downloaded on its mobile phones. Sapupo Group sources the online apps from independent parties, who are developers or owners of the apps. In the 2024 fiscal year, 20% of Sapupo Group's total sales came from the sale of online apps.

Sapupo Group is a global market leader in the mobile phone market, being in the largest three by sales in each continent. As its products are continually improved through ongoing research and development (R&D), with new releases incorporating the latest technology and features, its products sell at a premium compared to its competitors, and are rarely discounted significantly below their regular retail price. Sapupo Group has also invested heavily in building its brand through marketing and advertising, both globally and in the markets in which its products are sold.

Sapupo Group operates a limited number of its own retail stores, where it is able to showcase its products and sell directly to customers. However, 95% of sales to customers are made by unrelated retailers.

Like many large multinational groups, Sapupo Group centralises certain functions including R&D, brand development, procurement, logistics, human resources, marketing, information technology, legal, finance and tax. In the 2024 fiscal year, Sapupo Group disclosed US$20 billion of sales and a net operating margin of 22% in its audited, consolidated financial statements.

Sapupo Group's board of directors, head office and key senior management, which set the strategic direction of the group, are all located in Newvania.

Its country-by-country report for key group companies relating to the 2024 fiscal year includes the following:

<u>NewvaniaCo</u>

- Parent entity of Sapupo Group and based in Newvania, a mature market with a developed economy, whose population has one of the world's largest disposable incomes.
- Legal owner of all Sapupo Group IP.
- 15,000 employees, with an average salary of $165,000 per year.
- Undertakes the majority of R&D for the group.
- Provides marketing, human resources, information technology, finance, legal services and tax services to all associated enterprises.
- Owns a premium office building with assets to undertake business, including computers, office furniture, and computer servers that provide hosting services for associated enterprises.
- Operates 50 retail outlets throughout Newvania, deriving a net operating margin of 30%.
- Utilises an independent party to warehouse inventory, which also arranges transportation of finished goods to retail stores and to independent distributors.
- A significant number of employees undertake sales and marketing activities, Newvania being one of the largest markets.
- Makes sales to independent distributors, deriving a net operating margin of 15%.

- Sources funds from third parties to meet the group's overall financing needs.
- Generates annual revenues of $6 billion, with a net operating margin of 18%.

The corporate tax rate in Newvania is 20%.

OldvaniaCo

- Wholly owned subsidiary based in Oldvania, a mature market with a developed economy and reasonably high disposable income.
- 9,000 employees, with average salary of $105,000 (conversion undertaken from the local currency).
- Sales are in made in the local currency.
- Undertakes some local marketing activities tailored to the Oldvania market, given the different culture and language to Newvania.
- Operates 35 retail outlets, which are all leased from independent parties and derive a net operating margin of 30%.
- Purchases finished products manufactured by PalmariaCo in US$ (i.e. in a different currency to the local currency).
- Three months' worth of stock is stored at a central warehouse owned by OldvaniaCo, which is transported by a third party to its retail stores and independent distributors in Oldvania.
- Borrowed $100 million over a five-year term from NewvaniaCo, at 9% fixed interest rate, to fund working capital.
- Makes sales to independent distributors, deriving a net operating margin of 7%.

The corporate tax rate in Oldvania is 25%.

PalmariaCo
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- Wholly owned subsidiary based in Palmaria, an emerging economy with a substantial and fast-growing population.
- 50,000 employees, with average salary of $20,000 (conversion undertaken from the local currency).
- Legally contracted by NewvaniaCo to manufacture finished goods for Sapupo Group (with NewvaniaCo providing guidance regarding the types and quantities of products to manufacture).
- All IP is supplied by NewvaniaCo to undertake manufacturing of product.
- Operates a large manufacturing and distribution warehouse with substantial plant and equipment.
- Sources some components for manufacturing from independent parties located in Palmaria.
- Borrowed $400 million over a 10-year term from NewvaniaCo, based on an interest rate at 3% in excess of NewvaniaCo's cost of funds (i.e. the current variable rate paid by PalmariaCo is 7%).
- The loaned funds were utilised to purchase land, construct a building and purchase plant and equipment to manufacture.
- Operates 20 retail outlets, deriving a net profit margin of 20%.
- Undertake sales, marketing and distribution in Palmaria to unrelated parties.
- The net operating margin achieved from manufacturing is 3%.

The corporate tax rate in Palmaria is 15.5%.

<u>ArchipeliaCo</u>

- Wholly owned subsidiary based in Archipelia, an emerging economy with a small population which has been actively seeking to attract new business.
- 100 employees, with average salary of $55,000 (conversion undertaken from the local currency).
- Does not sell mobile phones in Archipelia.
- Leases a small office premises with computers and office equipment for its employees.
- Sources online apps for Sapupo Group's customers to purchase and download on its mobile phones.
- Developers and owners of the apps are unrelated to Sapupo Group, and based in locations around the world.
- Staff often travel to Newvania to meet with head office employees and discuss new development opportunities.
- Meetings with online app staff are usually held at the Newvania head office or through virtual meetings.
- All revenues from the sale of apps are included in ArchipeliaCo's financial accounts.
- ArchipeliaCo's directors sign contracts with app developers, with NewvaniaCo providing the final approval on whether to agree to make new apps available and execute agreements.
- Derives a 50% gross margin from sales of apps and a 42% net margin (i.e. app sales are generally shared 50/50 with the third party app developers).

The corporate tax rate in Archipelia is 5%.

1. **As Sapupo Group's recently appointed transfer pricing adviser, you have been asked to prepare transfer pricing documentation. You are required to:**

   1) Accurately delineate the transactions between the associated enterprises within Sapupo Group. (8)

   2) Perform a functional analysis for Sapupo Group, based on the information available. (8)

   3) Advise on what additional information you would need to obtain, to finalise your functional analysis. Identify how you would source the information, from a practical perspective. (3)

   4) For each transaction identified in your response to 1), identify the most appropriate transfer pricing methodology, with arguments in support of your selection and with regard to the available facts. (6)

   Total (25)

2. **You are required to prepare additional transfer pricing documentation for Sapupo Group, addressing the following matters:**

   1) How would you characterise each Sapupo Group entity? You should provide arguments in support of your characterisations. (8)

   2) In applying the arm's length principle, advise on the extent to which each associated enterprise should achieve the same economic outcome from a transfer pricing policy perspective, such as targeting the same operating margin. (6)

   3) What is the relevance of undertaking a comparability analysis in relation to ArchipeliaCo? (6)

   4) In applying the arm's length principle, based on the information available, outline any potential material tax concerns which the tax administration of Newvania may identify. (5)

   In responding, you should use appropriate references to support your answer. Where you have made any assumptions, you should identify these.

   Total (25)

PART B

You are required to answer ONE question from this Part.

3. AI Connect Pty Ltd (AI Connect), tax resident in Fastria, is a company specialising in the implementation of artificial intelligence software into computer networks for various corporations. The intellectual property (IP) attached to the software is legally registered in Fastria.

The chief executive officer (CEO), chief operating officer (COO) and senior software engineer (SSE) of AI Connect recently met with Accounting Solutions Ltd (AS), a large accounting firm, to propose the implementation of the software for AS. AS is an independent enterprise based in Greshia, not associated with AI Connect.

The managing partner of AS subsequently advised the CEO of AI Connect of AS's decision to enter into a contract for the implementation of the software. The CEO, COO and SSE returned physically to Greshia to meet with AS's managing partner and successfully negotiate and execute the contract.

The software implementation was conducted as a project over a 12-month period in Greshia. AI Connect sent the following staff to Greshia to assist with the project implementation:

- The SSE;
- One local liaison officer;
- One marketing and communications manager;
- Three operations managers;
- One delivery lead;
- One systems operations manager;
- Six software engineers;
- 20 customer service agents; and
- One project manager, who would report weekly to the CEO and COO.

Given the complex nature of the systems operated by AS, the software implementation was not as streamlined as initially planned and required manipulation of the software code by the software engineers, to successfully integrate into AS's systems. This final code development for the project in Greshia was then registered separately as IP in Fastria.

AI Connect has not registered a company, branch or permanent establishment in Greshia.

You are a tax auditor for the Greshia tax administration, and have commenced an audit in relation to this project.

You are required to answer the following questions:

1) **What transfer pricing risks would you identify in relation to this project? You should provide arguments in support of your responses.** (15)

2) **How would you treat the allocation of any income derived from the project?** (5)

Total (20)

4. Nutrition Corp. is the ultimate parent entity of a multinational group of enterprises, recognised for its range of natural health, beauty and nutritional products. Nutrition Corp. is tax resident in Country X, where the headline corporate tax rate is 30%.

Nutrition Corp. performs research and development (R&D), manufacturing, distribution, procurement, logistics, sales and marketing, and support services (including accounting, legal and human resources). It has associated enterprises in more than 40 countries, each of which distributes the products to independent customers in its respective country and also performs a sales and marketing function. The associated enterprises are reimbursed by Nutrition Corp. with a target operating margin of 5%. Nutrition Corp. holds legal ownership of all intellectual property (IP). It averages an annual operating margin of 35%.

A restructuring proposal has been presented to the board of directors of Nutrition Corp., with the goal of achieving cost and tax savings. Key points contained within the proposal include:

a) Establishment of Nutrition Sub A, tax resident in Country A, where the corporate tax headline rate is 15%. It would perform the manufacturing of the products for the group, and the manufacturing facility owned and operated by Nutrition Corp. would cease. All R&D activities for the group would be performed by Nutrition Sub A rather than Nutrition Corp.

b) Establishment of Nutrition Sub B, tax resident in Country B, where the corporate tax headline rate is 20%. It would become a service provider hub and perform all of the services currently undertaken by Nutrition Corp.

c) Establishment of Nutrition Sub C, tax resident in Country C, where the corporate tax headline rate is 10%. All legal ownership of IP would be transferred from Nutrition Corp. to Nutrition Sub C. Nutrition Sub C would have no employees, but would have two registered directors in Country C.

d) A royalty of 5% of sales would be paid by all of the associated enterprises (distributors) within the group to Nutrition Sub C.

e) All employees of Nutrition Corp. would be transferred to either Nutrition Sub A or Nutrition Sub B.

f) Nutrition Corp. would provide a loan to Nutrition Sub B at an interest rate of 12%. Nutrition Corp. maintains a distribution function.

A double tax agreement is in operation between Country X and Country B, that provides for a reduction in interest withholding tax from 15% to 5%.

As the group's transfer pricing adviser, you are required to provide a report to the board of directors of Nutrition Corp., articulating all transfer pricing implications and risks that may arise as a result of the restructuring of the group. (20)

PART C

You are required to answer TWO questions from this Part.

5. Intragroup financing can be a complex area to navigate for transfer pricing.

   You are required to consider what you regard as the most important issues for companies when examining financial arrangements with associated enterprises. You should provide relevant case law in support of your considerations. (15)

6.
   1) The global tax manager of a multinational group of companies has approached you, as a tax adviser, to provide transfer pricing advice in relation to a proposed services hub company that will be established for the provision of services to all associated enterprises within the group.

      You are required to identify and outline the fundamental transfer pricing issues that should be considered by the global tax manager, in relation to this proposal. (8)

   2) Safe harbours and tax incentives can be a contentious area of transfer pricing.

      You are required to provide your views on these areas, including advantages and disadvantages from the perspectives of both a tax authority and a taxpayer. (7)

   Total (15)

7. **You are required to provide your observations in relation to the evolution of transfer pricing with regard to intangible property, since the inception of the *OECD BEPS 2015 Final Reports, Actions 8–10: Aligning Transfer Pricing Outcomes with Value Creation*.** (15)

8. Surfland Ltd, a privately held company, is located in the jurisdiction of San Louie. Surfland Ltd purchases raw materials from an associated enterprise located in the jurisdiction of Cheetaland. Surfland Ltd then uses the raw materials in the manufacture of surfboards in two neighbouring jurisdictions, Tigerland and Lionland.

   Surfland Ltd has been carrying out its business for eight years, with year-on-year growth in sales. The tax manager of Surfland Ltd implemented a transfer pricing policy, whereby the associated enterprises of Cheetaland, Tigerland and Lionland were remunerated based on their audited financial accounts expenses, with an uplift of 5%. A transfer pricing analysis has not been undertaken to support the transfer pricing methodology.

   The board of directors of Surfland Ltd are considering listing their securities on a globally recognised stock exchange.

   You are required to answer the following questions, providing arguments as appropriate in favour of your responses:

   1) Should Surfland Ltd request an Advance Pricing Agreement (APA) with the revenue authorities in either or both of San Louie and Cheetaland? (3)

   2) What are the relative advantages and disadvantages of pursuing and obtaining an APA? (3)

   3) What are the main subject areas that you would expect to find in an APA? (3)

   4) Has the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project restricted any ability of Surfland Ltd to secure an effective APA? (3)

   5) What is the main consideration of whether a company should pursue a unilateral or bilateral APA? (3)

   Total (15)

9. Pillar One, Amount B has been one of the international tax priorities of the OECD for a number of years. You are the tax manager of a multinational group, headquartered in a jurisdiction that has publicly indicated that it plans to adopt the measure.

You are required to provide an update to the group's chief financial officer on the status of Pillar One, Amount B, including how it is proposed, how it will be applied, and how it may impact on future disputes between tax administrations and taxpayers. (15)