THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

December 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.
- 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.

The Stolhurst Group is a multinational group of companies that operates in the high-end domestic appliance and equipment industry. The group's products are designed, manufactured and distributed under a well-established brand name, commanding a premium price in the markets in which they are sold.

Key facts relating to associated enterprises of the Stolhurst Group are as follows:

Stolhurst Parentco

- Parent company for the group, resident in Country G with a corporate tax rate of 35%.
- Has legal ownership of all intellectual property.
- Conducts significant research and development activities, and incurs the associated expenditure, that lead to product innovations and improvements as well as new product development.
- Board meetings for the Stolhurst Group are held monthly in Country G and attended by key strategic decision makers.
- Undertakes manufacturing of products and parts utilising a large manufacturing facility located in Country G.
- Sells finished goods and replacement parts to Stolhurst Sub 1 and Stolhurst Sub 2.
- Sells finished goods and replacement parts to Independent Co 1 and Independent Co 2, which are resident in Country Y and Country Z respectively.
- Receives royalties from Stolhurst Sub 1, Stolhurst Sub 2, Independent Co 1 and Independent Co 2 for the use of intellectual property (brand name), as stipulated in a licensing agreement between the associated enterprises.
- Pays interest to Stolhurst Sub 3 in connection with an inter-company loan for working capital requirements.
- Has entered into a cash pooling arrangement with Stolhurst Sub 3.
- Pays a management fee to Stolhurst Sub 4 for the provision of administrative support and marketing services.

Stolhurst Sub 1

- Resident in Country H with a corporate tax rate of 15%.
- Purchases finished goods and replacement parts from Stolhurst Parentco.
- Pays royalties of 8% of sales to Stolhurst Parentco for the use of intellectual property (brand name). Sells finished goods and replacement parts to customers in Country H to generate income.
- Owns retail stores in Country H.
- Pays a management fee to Stolhurst Sub 4 for the provision of administrative support and marketing services.
- Has consistently been achieving a net profit margin of 1.5%.

Stolhurst Sub 2

- Resident in Country I with a corporate tax rate of 20%.
- Purchases finished goods and replacement parts from Stolhurst Parentco.
- Pays royalties of 10% of sales to Stolhurst Parentco for the use of intellectual property (brand name).
- Sells finished goods and replacement parts to customers in Country I to generate income.
- Owns retail stores in Country I.
- Pays a management fee to Stolhurst Sub 4 for the provision of administrative support and marketing services.
- Has consistently been achieving a net profit margin of 1.5%, and recorded a marginal loss position in the most recent financial year.

Stolhurst Sub 3

- Resident in Country J with a corporate tax rate of 5%.
- Engages in investment management functions.
- Has an inter-company loan agreement with Stolhurst Parentco and receives interest payments in connection with this agreement.
- Involved in a cash pooling arrangement with Stolhurst Parentco.

Stolhurst Sub 4

- Resident in Country K with a corporate tax rate of 10%.
- Provides administrative support and marketing services to Stolhurst Parentco, Stolhurst Sub 1 and Stolhurst Sub 2, in exchange for a management fee charged at cost plus 25%.

1. **You are required to:**

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

   2) Perform a functional analysis of the Stolhurst Group, and characterise each entity. (15)

Total (25)

2. **As a transfer pricing adviser for the Stolhurst Group, you are required to:**

   1) Explain how you would select and apply the most appropriate transfer pricing methods, to ensure an arm's length outcome for the various delineated transactions identified between the associated enterprises of the Stolhurst Group.

   You should provide both the strengths and weaknesses of each method considered, and discuss any potential comparability issues involved. (15)

   2) Identify those transfer pricing issues which you would raise to the Group Tax Manager from a transfer pricing risk management perspective, with regard to the arm's length principle. (10)

Total (25)

PART B

You are required to answer ONE question from this Part.

3. Charlie Corp. is a market leader in its industry, having been successful in substantially growing its sales and profits in recent years.

The parent company (Parent Co) is located in Country A and has thus far been the only entity in the business. Parent Co undertakes all functions, owns all assets and bears all risks for the group. For example, it has undertaken research and development activities and legally owns the valuable intellectual property (including trade names, patents, technical know-how and designs). Parent Co manufactures the products which are sold to independent distributors, who in turn sell to end consumers.

Charlie Corp. has recently engaged a well-known international tax consultant to undertake a value chain transformation. The following key changes have been proposed:

- Incorporate a new subsidiary (Sub B) in Country B.
- Transfer legal ownership of all intellectual property from Parent Co to Sub B.
- A payment of £20 million will be made by Sub B to Parent Co for intellectual property.
- Parent Co will continue to undertake research and development, with a legal agreement in place for Sub B to remunerate Parent Co on the basis of costs incurred plus a 7.5% mark-up (cost plus basis).
- Parent Co will retain key managerial, administrative and technical staff and provide these services to Sub B, with remuneration on a cost plus 7.5% basis.
- Sub B will undertake manufacturing of all products for the group.
- Sub B will undertake procurement, logistics and distribution functions for the group, previously undertaken by Parent Co.
- Parent Co will discontinue manufacturing, following the sale of the property, plant and equipment and provision of redundancy payments to staff.
- It is expected that Parent Co will realise losses of approximately £50 million from the discontinuation of manufacturing operations.
- The corporate tax rate in Country A is 30%, while the corporate tax rate in Country B is 15%.

You are required to:

1) **Describe the changes in the characterisation for each of the entities in relation to functions, assets and risks for Charlie Corp. as a result of the proposed business restructure.** (10)

2) **Discuss any potential transfer pricing risks and issues relating to the business restructure for Charlie Corp.** (10)

Total (20)

4. The Flexible Group is a multinational group which is headquartered in Megalop.

The group recently directed a number of its senior managers, resident in Megalop, to travel overseas to Gigalot in order to negotiate and execute a material contract with an entity which is incorporated and only has operations in Gigalot. The contract relates to the design, engineering and construction of a new airport runway in Gigalot.

The Flexible Group does not currently have a subsidiary incorporated or resident in Gigalot. As the contract of works is for a period of approximately three years, Flexible Group plans to direct employees who normally reside in Megalop and possess specialist skills to adhere to the scope of works for the contract. These employees will travel to Gigalot for consecutive periods of between two and three months over a three-year period. Employees of Flexible Group will build temporary buildings at the site location so that they can oversee the work.

The revenue from the contract will be “booked” by the Flexible Group in Megalop. Megalop and Gigalot have previously entered into a double tax agreement.

You are required to:

1) Advise on what basis Flexible Group may be deemed to have a permanent establishment (PE) in Gigalot. (15)

2) Advise on the methodology by which profits would likely be attributed to the potential PE. (5)

Total (20)

PART C

You are required to answer TWO questions from this Part.

5. **As the in-house international tax adviser for a multinational group, you are required to prepare a memo addressing each of the following:**

   1) **The benefits of the group adhering to a transfer pricing safe harbour;** (5)

   2) **The reasons why the group should prepare contemporaneous transfer pricing documentation on a yearly basis; and** (5)

   3) **The importance of the arm's length principle.** (5)

   Total (15)

6. Borderline plc is a multinational group, with operations in a number of large countries. The group is considering establishing a new entity in a country which maintains a policy of not entering into tax treaties.

   As the international tax adviser to Borderline plc, you are required to advise on the implications of undertaking business in a country which does not have tax treaties, in relation to:

   1) **Avoiding double taxation and preventing disputes; and** (8)

   2) **Country-by-country reporting.** (7)

   Total (15)

7. "Pillar One of the OECD/G20's Base Erosion and Profit Shifting project will likely result in significant changes to current transfer pricing arrangements."

   In relation to this statement, you are required to explain:

   1) **How you anticipate that Pillar One may impact on transfer pricing arrangements; and** (10)

   2) **The relevance of permanent establishments in transfer pricing.** (5)

   Total (15)

8. You are engaged as a transfer pricing adviser for a multinational group of companies.

   You are required to provide a critical analysis in relation to the following:

   1) **Advance Pricing Agreements (APA); and** (8)

   2) **Cost Contribution Arrangements (CCAs).** (7)

   Total (15)

9. **What would you consider to be the riskiest intra-group financing arrangements, from a transfer pricing perspective? What issues should be considered from a transfer pricing risk management perspective? You may cite any relevant case law in your answer.** (15)