THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

December 2020

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 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.

1. E-Scoot Ltd is the head entity of a multinational group of companies in Country A. The core business of E-Scoot Ltd is the manufacturing and distribution of electric scooters. E-Scoot Ltd owns intellectual property (IP) for the products it manufactures and sells.

E-Scoot Ltd has three related parties, which are wholly owned subsidiaries as detailed below:

- E-Scoot Sub 1, resident in Country B, purchases final product electric scooters from E-Scoot Ltd for sale to independent parties in Country B. Three versions of the electric scooter are purchased and sold, the main product differences being the engine capacity and top speed. E-Scoot Sub 1 has designed and implemented a locally tailored marketing strategy for Country B to increase brand awareness and boost sales, and offers a three-year warranty on all products sold.

- E-Scoot Sub 2, resident in Country C, purchases final product electric scooters from E-Scoot Ltd for sale to independent parties in Country C. The same three versions of electric scooter are purchased and sold. E-Scoot Sub 2 relies upon a marketing strategy designed by E-Scoot Ltd with no local market adaptation, and does not offer a warranty on two of the three scooters sold. E-Scoot Sub 2 also contracts an independent party in Country C to customise one of the electric scooters for increased performance, before selling to independent parties in Country C.

- E-Scoot Sub 3, resident in Country D, performs research and development services for E-Scoot Ltd, as well as intra-group administrative services.

Scooter Blazer is an independent party, resident in Country B, which purchases final product electric scooters from E-Scoot Ltd for sale to independent parties in Country B.

You are required to:

1) Accurately describe the associated transactions of the E-Scoot group. (5)

2) Perform a functional analysis for the E-Scoot group, characterising each of the group entities. (10)

3) Discuss the potential selection and application of each transfer pricing method, as well as any comparability issues. (10)

Total (25)

2. You have been engaged as a transfer pricing consultant by the global tax manager of a multinational group of companies, the Light Speed group, and received the following facts from your initial briefing.

Light Speed Ltd (LS), resident in Country A, is the head company operating in the mining industry. Its functions include:

- exploration activities through open-cut and underground mining;
- operation of smelting and refining; and
- agreements in place to sell commodities X and Y, extracted in Country A, to both associates and independent parties.

LS Sub 1, resident in Country B, is a related party of LS that purchases commodities X and Y from LS for sale to independent parties.

Corvex, resident in Country C, is an independent party that purchases commodities X and Y from LS for sale to independent parties.

LS Sub 2, resident in Country D, is a related party of LS that has recently been established to perform marketing and sales activities on behalf of LS and has a staff of 30. A loan agreement has been put in place, in which LS Sub 2 borrows a principal of $100 million for working capital purposes over a nine-year period at an interest rate of 8.5% with significant early termination fees. In addition, LS has transferred intellectual property (consisting of tradenames) to LS Sub 2.

You are required to:

1) **Perform a functional analysis of the Light Speed group. What practical considerations and processes should be followed?** (8)

2) **Discuss the potential transfer pricing methods which could be applied, including the advantages and disadvantages of each method, to ensure an arm's length outcome for the Light Speed group.** (8)

3) **Advise the Light Speed group on any comparability issues which should be raised.** (5)

4) **Outline any further transfer pricing issues which should be considered by the Light Speed group.** (4)

Total (25)

PART B

You are required to answer ONE question from this Part.

3. The Virtual group (Virtual) carries out its business operations through a number of wholly owned subsidiaries operating in a range of countries. Virtual operates as a manufacturer and distributor of mobile telephones to customers in several industries. Virtual's global value chain covers a number of functions, including:

- Marketing and sales;
- Procurement;
- Logistics;
- Treasury, financing and accounting;
- Administration;
- Research and development;
- Human resources; and
- Information technology.

The head office of Virtual owns all of the group's valuable intellectual property.

In each country in which Virtual has a subsidiary, the subsidiary sells to independent wholesalers or through its own retail stores.

Virtual has a documented policy which mandates that the head office will charge each subsidiary for services.

You are required to provide the following guidance to Virtual, citing appropriate references and sources in support of your answers:

1) Explain the main issues to be considered by Virtual, in relation to intra-group services. (7)

2) Based on the information provided, identify the services for which the head office should not charge its subsidiaries. (5)

3) Explain how Virtual should determine an arm's length charge for the services provided. (8)

Total (20)

4. The BathCo group (BathCo) is a worldwide leader in the manufacture of bathtubs.

BathCo's head office is located in Plutonia, the country where its shares are listed on the stock exchange. The head office is the sole legal owner of the group's valuable intellectual property portfolio, including trade names, patents and know how.

The key functions of BathCo's Plutonian head office include:

- Manufacture of all products for the group;
- Research and development (R&D);
- Developing key group marketing material;
- Providing certain services to associated entities, including administration;
- Human resources;
- Treasury and accounting; and
- Information technology

The largest market for the sale of products is the country of Neptunia, where the associated enterprise acts as a wholesale distributor of the product to independent retailers. BathCo has a policy of targeting a 3% operating margin in Neptunia.

BathCo's directors are considering making a number of changes to the structure of the group's worldwide business operations, including the following steps:

1) Establishing a new subsidiary in the country of Martia, to undertake R&D and manufacture products for sale to associated enterprises, including the Netpunian entity.

2) The new subsidiary will be provided with all material which it needs to undertake business from the head office.

3) The new subsidiary will be loaned funds in order to build a new manufacturing facility in Martia. The loan will be interest free for a period of five years.

4) The Plutonian head office will be required to borrow the funds, which will then be provided to Martia.

5) The manufacturing facility in Plutonia will shut down, with 100 staff losing their jobs and significant termination payments being made.

6) The Plutonian head office will continue to undertake all of its current key functions, with the exception of R&D.

7) The directors and key management staff of BathCo will remain in Plutonia.

Based on forecast budgets prepared by BathCo's senior management, the average operating margins for the group entities are as follows:

- Plutonia – 5%
- Neptunia – 3%
- Martia – 20%

As a transfer pricing expert, you have been requested to provide the following advice to BathCo's directors, citing appropriate references in support of your answers:

1) Identify the key transfer pricing issues and risks to the BathCo group if the proposed changes are to take place. (16)

2) Describe the entity characterisation of the Neptunian associated enterprise, from a functional analysis perspective. (4)

Total (20)

PART C

You are required to answer TWO questions from this Part.

5. You have been presented with the following transfer pricing cases:

- Chevron Australia Holdings Pty Ltd v Commissioner of Taxation [2017 FCAFC 62];
- GE Capital [2010 FCA 344]; and
- DSG [2009 UKFTT 31 (TC)]

For one of these cases, you are required to explain the following:

1) the applicable facts of the case;

2) the issue which was contested;

3) the decision made by the highest court deciding the case; and

4) any broader implications which have arisen from the decision. (15)

6.

1) Explain the importance of the 'arm's length principle' in transfer pricing. (5)

2) Explain the 'global formulary apportionment' approach. (5)

3) Would you expect an associated enterprise to make ongoing losses if it was classified as a low risk distributor for transfer pricing purposes? (5)

Total (15)

7. You are the global tax manager of a multinational group which enters into transactions with associated enterprises in several jurisdictions. Most of the head office entity's material transactions are with associated enterprises in two jurisdictions:

- Apollo (which has a tax treaty with the group headquarters' country); and
- Zeus (which does not have a tax treaty with the group headquarters' country).

You are required to answer the following questions, including appropriate references:

1) What types of advance pricing arrangement should the multinational group enter into with its associated enterprises, and why? (5)

2) Explain the reasons why tax administrations may consider undertaking a simultaneous tax examination with a focus on the transfer pricing policy of the multinational group. (5)

3) What options are available to the multinational group under the tax treaty, if a tax examination or audit by the Apollo tax administration leads to a transfer pricing adjustment and future double taxation? Your answer should refer to relevant OECD developments in recent years. (5)

Total (15)

8. You are the international tax adviser for a multinational group which provides consultancy services to clients around the world.

You are required to provide a written response on the following matters:

1) Explain the concept of a 'permanent establishment', including its importance for transfer pricing purposes. (10)

2) Explain the reasons why tax administrations publish transfer pricing safe harbours, and the potential relevance to the multinational group. (5)

Total (15)

9. **You are required to advise on each of the following matters:**

   1) Explain the concept of a 'cost contribution arrangement', including application of the arm's length principle to entry, withdrawal and termination. (10)

   2) Discuss the importance of country-by-country reporting for tax administrations. (5)

Total (15)