Chartered Institute of Taxation
Excellence in Taxation

THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

December 2016

PAPER 3.03 – TRANSFER PRICING OPTION

ADVANCED INTERNATIONAL TAXATION (THEMATIC)

TIME ALLOWED – 3¼ HOURS

You should answer **FIVE** out of the nine questions: **BOTH** questions from Part A; **ONE** question from Part B; and **TWO** questions from Part C.

Part A questions are worth 25 marks each. Part B questions are worth 20 marks. Part C questions are worth 15 marks each.

You should aim to spend approximately half of your exam time answering Part A, and the remaining half answering Parts B and C. The amount of time you spend answering each question should correspond broadly to the number of marks available for that question.

As you are using the on-screen 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.

All workings should be made to the nearest month and appropriate monetary currency, unless the question requires otherwise.

Marks are specifically allocated for presentation.

Although references and short quotes from the OECD Transfer Pricing Guidelines can be included in your answer, you will not benefit from any extra marks by copying from the OECD Transfer Pricing Guidelines directly.

PART A

You are required to answer BOTH questions from this Part.

1.

1) You have been presented with the following three scenarios:

   a) CarCo manufactures toy cars, which are sold to subsidiaries in Europe and Asia. The subsidiaries then package the goods and distribute them to retail outlets.

   b) TVCo manufactures a cutting-edge component for television sets. The component units are then sold to a sister company in Taiwan, which manufactures and assembles the televisions. The completed televisions are, in turn, sold to a German distribution company, related to the Taiwan sister company and TVCo, for sale to third party retailers.

   c) UK Mining Co is a diamond mining company. It sells diamonds in unprocessed form to an associated jewellery manufacturer based in the Netherlands. The Dutch company then sells the jewellery onto the world market.

   You are required to determine, in each of these scenarios, whether or not the resale minus method is considered the most appropriate method for determining inter-company pricing, and explain why. (6)

2) A company, BoatCo, sells toy boats to its distribution subsidiary in Germany. It also makes the following sales of the same product:

   a) Sales to retailers in the UK;

   b) Sales on the same terms to related companies in Japan;

   c) Sales to distribution companies in Germany, but on different terms (i.e. longer settlement terms, and the exchange rate risk is borne by the Germany, not UK); and

   d) Sales to ToysFR, the largest toy shop in France.

   Which of these sales is most likely to be considered a valid comparable for the application of the Comparable Uncontrolled Price method, and why? (8)

3) You have been presented with the following three scenarios:

   a) UKBrakes is a contract manufacturing subsidiary of a US multinational. It manufactures brakes and conducts research and development under a contract with its US parent company, for installation in motor vehicles.

   b) UKHoldco has a subsidiary in Sweden, which has been established for many years. UKHoldco performs management services for the Swedish subsidiary, including information technology and human resources administration.

   c) UKMaker is a manufacturing subsidiary of US, Inc. It purchases the same finished goods from US, Inc. as from an independent party. UKMaker does not add any substantial value to the products, which it sells on to independent parties.

Continued

1. Continuation

You are required to explain whether or not the cost plus methodology would be considered the most appropriate method in each of the three scenarios, and why? (6)

4) SlovakCo is the headquarters of a multinational group that manufactures and sells electrical appliances. SlovakCo distributes the products in Slovakia. In other countries, the products are distributed by related companies. The group's consolidated sales amount to €428 million. GeorgiaCo, a 100% owned subsidiary of SlovakCo, purchases products from related parties and distributes those products in Georgia. GeorgiaCo also provides after-sales service to its customers.

SlovakCo provides a variety of administrative services to its related party distributors, including:

- planning and co-ordination services for effective and efficient marketing;
- legal services on local regulations; and
- accounting services to provide financial records for the group based on a single accounting standard, facilitating a consolidated statement. The accounting services rendered to the group's distributors conform to the accounting requirements of Slovakia.

Under intra-group service agreements, group companies (including GeorgiaCo) are required to pay 3% of their sales for services provided by SlovakCo.

Does this arrangement represents an arm's length outcome, and why? (5)

Total (25)

2.

1) ParentCo Y is a bicycle manufacturer, and is based in Country C. Its 100% owned subsidiary company, SubCo X, is based in Country D where it is the exclusive distributor of the Type S, a high-specification bicycle manufactured by ParentCo Y. This is the only bicycle model distributed by SubCo X.

You work for the tax authority of Country D. You have received the following information on SubCo X and ParentCo Y.

SubCo X

	Sales (£)	Gross Profit Margin (£)	Net Profit Margin (£)
2006	500,000	22.0%	2.0%
2007	710,000	21.1%	1.7%
2008	730,000	17.8%	-2.1%
2009	560,000	21.4%	1.8%
2010	650,000	21.5%	1.5%
2011	800,000	17.5%	-2.5%
Average	658,000	20.0%	0.1%

ParentCo Y

	Sales (£)	Gross Profit (£)	Gross Profit Margin (£)
2009	20,000,000	6,000,000	30.0%
2010	23,000,000	6,500,000	28.3%
2011	28,000,000	8,500,000	30.4%

You pursue a comparability search and find unrelated distributors, Company A and Company B, in Country D. Company A and Company B also purchase and distribute bicycles manufactured by ParentCo Y to independent parties in Country D. The distribution conducted by Company A and Company B relates solely to the Type T, a middle-grade popular-use bicycle produced by from ParentCo Y.

You obtain the following publicly available financial information regarding the sales of Company A and Company B.

	Company A		Company B	
	Gross Profit Margin	Net Profit Margin	Gross Profit Margin	Net Profit Margin
2006	27.1%	3.4%	25.0%	3.3%
2007	26.0%	3.0%	23.5%	2.9%
2008	26.9%	3.8%	25.7%	3.4%
2009	27.5%	3.8%	25.9%	3.3%
2010	26.7%	3.3%	25.8%	3.2%
2011	27.8%	3.7%	25.0%	3.3%
Average	27.0%	3.5%	25.2%	3.3%

The two bicycle models are priced as follows:

(GBP)	Type S	Type T
Wholesale price	565	445 (to Company A), 455 (to Company B)
Resale price	720	610

You are required to respond to the following questions:

a) How would you undertake a functional analysis for SubCo X, including practical approaches? How would you characterise SubCo X? (8)

b) With regard to the arm's length principle, what is the transfer pricing risk for the tax authority of Country D? (2)

Continued

2. Continuation

2) Cycling is a popular sport in Country D, and both the Type S and Type T bicycles are targeted at regular cyclists. This differentiates them from the general bicycle market aimed at consumers who use bicycles less frequently. However, there are significant differences in the specifications of the two products. The Type S has an alloy frame of lighter weight and stronger material than the Type T, and also has a very sophisticated gearing system. As a result, the retail price of the Type S is higher than that of the Type T. It should be noted that prices are also influenced by other elements, such as foreign exchange rate fluctuations.

SubCo X has developed a production plan, based on sales targets and projections for the Type S in the Country D market, and ordered the bicycles from ParentCo Y in accordance with the planned numbers. SubCo X is not authorised to return unsold Type S stocks under the terms of its agreement with ParentCo Y (no "sale or return").

Company A and B purchase Type T bicycles under single contracts that they have negotiated based on their own sales projections, targets and market situation. Under the contracts, each has the right to return unsold Type T stocks to ParentCo Y. Accordingly, SubCo X bears inventory risk but Company A and B do not.

SubCo X recorded a loss in 2011, which has been attributed to the realisation of an inventory loss caused by the introduction of a new version of the Type S, which led to the scrapping of unsold stocks of the old model. SubCo X argues that this is a normal business result, and that it is quite common for a marketing strategy to go wrong. Both sales policy and the manufacturing plan were under SubCo X's control. Indeed, one of the conditions of SubCo X being granted the exclusive right to resell the Type S was that the distributor was to assume inventory risk. You question whether this exclusive right has much in the way of value, given that the Type T is broadly distributed.

SubCo X and Company A each provide a product warranty service to their customers, covering repairs to the bicycle for two years after the sale. Company B does not provide any warranty service, and thereby incurs fewer expenses.

SubCo X has been required to advertise the Type S intensively, in order to raise consumer awareness of ParentCo Y's products in the Country D market. Company A and B have not undertaken any advertising, and have relied on the efforts of SubCo X to improve ParentCo Y's brand recognition among customers in Company D. Accordingly, SubCo X appears to have contributed to an increase in the value of ParentCo Y's brand. ParentCo Y has retained the legal right to its brand name, and SubCo X, Company A and Company B have no legal interest in the brand other than its value in driving sales of the bicycles.

You are required to respond to the following questions:

a) On the basis of the information above, as well as your responses to (1), what transfer pricing method(s) may be considered most appropriate to these circumstances? How would your chosen method(s) be applied, and what are the advantages and the disadvantages of your chosen method(s)? (10)

b) How would you adjust for the functional differences, in order to improve reliability when applying your chosen method(s)? What further information is necessary for the adjustment? (5)

Total (25)

PART B

You are required to answer ONE question from this Part.

3. You work for the Treasury Department in the Republic of Estria, a small, lower-income country which is in the process of introducing transfer pricing legislation. You have been presented with a copy of the draft transfer pricing legislation by the Estria Inland Revenue Department (EIRD). The draft transfer pricing legislation reads as follows:

   Part 3: Transfer Pricing

   3.1 When does this Part apply?

   This Part applies in respect of any enterprise that is a resident of the Republic of Estria where that enterprise ("the primary enterprise") conducts business with a related enterprise that is not so resident, and as a result of the relationship between the two enterprises the prices at which business is conducted are not commensurate with what would ordinarily be expected from business transactions between unrelated parties.

   3.2 Definitions

   "Conducts business" means the purchase and sale of goods.

   "Related enterprise" means:

   i) An enterprise in respect of which the primary enterprise purchases or sells goods.
   ii) An enterprise which conducts business with the primary enterprise and that business accounts for more than 50% of the sales or purchases of the first-mentioned enterprise.

   3.3 Adjustment

   If this Part applies, the prices charged can be adjusted by the EIRD so as to make those prices commensurate with what would ordinarily be expected from business transactions between unrelated parties.

   3.4 Documentation

   A taxpayer to whom this Part applies is required to lodge comprehensive transfer pricing documentation annually with his/her or its annual tax return.

   3.5 Penalties

   Where a taxpayer fails to comply with 3.4 above, the taxpayer will not be able to utilise any documentation that has not been provided in accordance with that section in any future judicial or quasi-judicial proceedings. Where a price adjustment is made as a result the application of this Part, the EIRD may impose penalties up to 4 % of the total tax shortfall arising.

   You are required to:

   1) Identify and explain four potential weaknesses of the draft legislation, and suggest in each case how you might remedy the position. (13)

   2) Advise the Treasury Department on three other requirements that could be put in place to ensure effective and efficient implementation of the transfer pricing regime, in addition to the primary legislation detailed above. (7)

Total (20)

4. You have been approached by the Chief Financial Officer (CFO) of a large Australian public company which has recently expanded overseas into Southeast Asia, with subsidiaries or branches in Hong Kong, Indonesia, Singapore and Vietnam.

The CFO has detailed knowledge of the transfer pricing legislation as it currently exists in Australia, has performed a thorough examination of the pricing of transactions between related parties within the global organisation, and seeks to provide some certainty going forward.

After an extensive review of all possible transfer pricing arm's length testing methods, the company has decided to test its pricing on benchmark comparison using the transaction net margin method with an EBIT/sales profit level indicator. In doing so, it compared five other competitor companies which operate in the same industry and found that its own TNM (EBIT/sales of 4%) was identical to one competitor, slightly higher than two (EBIT/sales of 3.6% and 3.7%) and substantially lower than the other two competitors (EBIT/sales of 8% and 8.3%).

The CFO seeks your guidance in relation to the following issues which have been raised by the board of directors:

1) Should the organisation enter into a comprehensive Cost Contribution Agreement? To what extent would this limit any risk going forward?

You should consider who would be a party to this agreement, and what sort of terms might appear in the agreement. (5)

2) Should the organisation enter into a comprehensive Advance Pricing Agreement? To what extent would this limit any risk going forward?

You should consider who would be a party to this agreement, and what sort of terms might appear in the agreement. (6)

3) How would the company go about supporting its pricing, based on the transactional net margin method (TNMM) through contemporaneous documentation? Explain, in detail, what the documentation should contain, and when it should be prepared. (9)

Total (20)

PART C

You are required to answer TWO questions from this Part.

5. ZCo is a well-known manufacturer, distributor and marketer of pharmaceutical products. It owns a valuable trade name, patents, intellectual property relating to its manufacturing and processes, valuable retail points, and valuable, long-term contracts with suppliers. It also employs an extensive marketing and sales division, and performs research and development activities.

ZCo has recently been acquired by a multinational group that operates under a global business model whereby:

- All the trade names and other valuable intangibles are owned by VCo in Valaris, a low tax jurisdiction.
- ZCo enters into a license agreement with VCo and pays a royalty as a percentage of its sales on a product basis.
- All key supplier contracts are held by WCo in Winteria, a low tax jurisdiction. WCo is responsible for the management of group-wide supplier contracts, and the global procurement and supply chain functions.
- All retail points are owned by XCo, a real estate company in Xyrea, a low tax jurisdiction.

Immediately after the acquisition, the Group decides to restructure ZCo by transferring its trade name to VCo, its valuable supplier contracts to WCo and its retail points to XCo, each in exchange for a lump sum payment. As a consequence of the transfer:

- ZCo is now operating as a low risk distributor for WCo.
- ZCo's post-restructuring profit potential is considerably less than it was prior to the restructuring, and its functional profile and characterisation has also changed.

Representatives from the multinational group explain that the commercial reason for the restructuring is to align the operating model of ZCo with the operating model of the rest of the group, and that this prospect was one key factor in the acquisition deal. In addition, the alignment of ZCo to the global business model will produce synergies and cost savings as well as providing ZCo with guaranteed profitability going forward; it is noted that ZCo had two years of losses due to a product quality issue.

The management of ZCo has had no choice other than to accept the restructuring, following the acquisition. It indicates that the transfer of its trade name, patents, intellectual property, contracts, retail points and physical assets was priced at arm's length, and that remuneration for its post-restructuring activities will also be priced at arm's length.

You are required to:

1) **Describe the changes in functions, assets and risks, as well as the transactions that have occurred as a result of the business restructure ('pre' and 'post' analysis), in the context of ZCo. How has ZCo's characterisation changed?** (7)

2) **Describe the factors that would need to be taken into account in analysing the consequences of the business restructure for ZCo, in the context of an arm's length outcome?** (8)

Total (15)

6. The following cases are often cited as examples of important case law in the practice of transfer pricing:

- GSK Canada [2010 FCA 201]
- DSG [2009 UKFTT 31(TC)]
- GE Capital [2010 FCA 344]
- SNF (Australia) Pty Ltd v Commissioner of Taxation [Full Federal Court Decision, 2011 FCAFC 74]

For any two of these cases, you are required to explain:

1) The facts which arose;

2) The issue that was in contest;

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

4) Any broader implications which have arisen from the decision.

(15)

7. **You are required to provide an overview of the OECD's Base Erosion and Profit Shifting (BEPS) Project, including the following:**

1) The goals and objectives of the BEPS Project;

2) The recommendations which have emerged; and

3) Your observations of practical implications and challenges for multinationals and tax authorities going forward.

(15)

8. "Transfer pricing is, at its core, an anti-avoidance weapon designed to stop tax cheats. It is the only weapon available and has succeeded in preventing the very worst cases of abuse".

Do you agree with this assessment? Explain your answer in detail. (15)

9. **You are required to explain how a parent company which operates in one jurisdiction may be subjected to a transfer pricing adjustment if it provides a guarantee to a bank in respect of a debt owed by its subsidiary to a third party.**

How might such an adjustment be argued against, and what evidence would be utilised by those seeking to resist such an adjustment?

You should use relevant case law, where possible, in support of your analysis. (15)