THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 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.

Start each answer on a new page. If 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. As proposed in its Action Plan on Base Erosion and Profit Shifting (BEPS), the OECD has developed the following six-step analytical framework for the analysis of risks in its revision to Chapter 1, Section D of the OECD Transfer Pricing Guidelines:

    1. Identify economically significant risks with specificity.

    2. Contractual assumption of risk.

    3. Functional analysis in relation to risk.

    4. Interpreting steps 1-3 in relation to (i) whether the associated enterprises follow the contractual terms; and (ii) whether the party assuming risk, as analysed under (i), exercises control over the risk and has financial capacity to assume the risk.

    5. Allocation of risk.

    6. Pricing of the transaction, taking account of risk allocation.

    Company X and Company Y are part of the same multinational enterprise group, which manufactures sophisticated smartphones.

    Company X is located in Silicon Valley, in California, and is responsible for developing new products. It hires Company Y, located in Shanghai, China, to perform part of its research. Company X assumes development risk under the contract with Company Y, and this is identified as an economically significant risk. Company X controls the development risk by exercising its capability and authority in making relevant decisions about whether, and how, to take on the development risk.

    Company X's Chief Scientist also assesses the progress of product development and whether its ongoing objectives are being met, and decides whether continuing investment in projects are warranted in the light of that assessment. Company X has a high degree of capitalisation, and also acts as the group's global treasury entity, with the capacity to assume any risk should the research fail.

    Company Y assumes day-to-day responsibility for carrying out research under the master plan and direction of Company X. Its research team reports back to the Chief Scientist at Company X, at predetermined milestones. Company Y has no capability to evaluate development risk, and does not make decisions on Company X's research activities. Its risk is mainly in whether it performs the research activities competently. Company Y's risk is distinct from the development risk assumed by Company X under the contract, and which is controlled by Company X based on the evidence of the functional analysis.

    1) Apply the OECD's six-step analytical framework to the situation involving Company X and Company Y, described above. (20)

    2) Would your answer to 1) differ if the Chief Scientist relocates from Company X to Company Y? If so, explain how, and why, your answer would differ. (5)

Total (25)

2. Beautyco manufactures and sells beauty products, including face creams, body creams, and bath and shower products, occupying a niche position in its market. Beautyco's products are manufactured solely from natural ingredients sourced in Italy. The vast majority of research and development (R&D) activities relating to Beautyco's product range is carried out in-house at the company's global headquarters (HQ Co) in Sicily. Most of Beautyco's manufacturing is also conducted in in Italy.

Beautyco also operates a large production facility in Mexico (M Co) with no R&D, for its aloe vera products. This company is a contract manufacturer for HQ Co. Beautyco also has a small production facility in France (F Co) for its lavender products. F Co was acquired from a third party, performs some R&D, and works almost independently from HQ Co. A separate sales company exists in France (F Sales Co), which sells all of Beautyco's product lines. Other sales subsidiaries exist elsewhere in Europe and Asia.

Beautyco has grown both organically and through acquisitions. In countries where the company has expanded organically, it primarily has limited risk distributors. In countries where Beautyco has expanded through acquisitions, most of the distributors are standalone companies which assume several risks, including all marketing risks. Each sales subsidiary sells all types of products.

In addition to its beauty products, Beautyco also has a line of home products, but the company's directors have realised that revenues from this product line are not growing as fast as those from the beauty products; consequently, Beautyco has decided to sell the home product line to a third party, Homeco, based in Germany. Homeco has agreed to pay €100 million for Beautyco's home product line. The sale of this business primarily includes marketing assets (such as customer relationships, workforce in place (sales people), product rights and product names). The deal does not include the sale of any manufacturing assets or rights, with the exception of F Co (which is to be included in the sale as it conducts manufacturing and R&D work relating to lavender products, most of which are within the home product line).

Following the sale of the home product line, Beautyco will no longer manufacture in France and will buy from Homeco those lavender products which it needs for its beauty product lines.

The parties to the Asset Purchase Agreement are HQ Co and Homeco's German headquarters. The full €100 million sale price will therefore be paid by Homeco to HQ Co.

Using arguments from relevant chapters of the 2015 Final Reports of the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project, and the 2010 Guidelines, you are required to answer the following questions:

1) **How would you allocate the sale price of €100 million between HQ Co and its various subsidiaries? Please explain your reasoning and justification using concepts from the OECD Guidelines.** (10)

2) **If HQ Co decides not to allocate any amounts from the sale price to its subsidiaries, what transfer pricing risks might result? How could these risks be managed?** (10)

3) **Describe and explain the transfer pricing policy implications, for HQ Co, of the sale of its home product line to Homeco.** (5)

Total (25)

PART B

You are required to answer ONE question from this Part.

3. The government of County P, a low-income country in which excessive charges for intragroup management services and head office expenses constitute one of the major BEPS challenges, has come to seek your advice as a transfer pricing expert. Country P is in the process of assessing the BEPS recommendations and deciding which parts to adopt.

The final report on BEPS Actions 9-10 (aligning transfer pricing outcomes with value creation) introduces an elective, simplified approach for low value-adding services which:

- specifies a broad category of common intra-group services which command a very limited profit mark-up on costs;
- applies a consistent allocation key for all recipients for those intra-group services; and
- provides greater transparency through specific reporting requirements, including documentation showing the determination of the specific cost pool.

The text of the recommendation is as follows:

> "The approach aims to guarantee payor countries that the system through which the costs are allocated leads to an equal treatment for all associated enterprises that are operating in similar circumstances. Moreover, the approach aims to guarantee that no overpricing takes place due to general agreement on the categories of costs included in the cost base and general agreement on the moderate mark-up of 5% that should be charged. Finally, the transparency of the approach makes clear to payor countries whether intermediary companies, that may have no or low functionality and may aim to inflate the intra-group service charges, have been interposed.
>
> The BEPS guidance provides that, because of the construction of the elective, simplified approach, the benefits test by the payor country is simplified and moderated. If the elective, simplified approach is applied, the assumption that businesses are only willing to incur costs if there is a business reason to do so and the assurance that the approach leads to an equal treatment of these costs for MNE group members in similar circumstances, replaces the detailed testing of the benefits received that is customary for other intra-group service charges. This approach allows tax administrations to free up resources for identifying and examining transfer pricing cases where the risk of encountering BEPS issues is more substantial."

In your advice to Country P, you are required to answer the following questions regarding the recommendation:

1) **How does this simplified approach differ from the general approach in the OECD Transfer Pricing Guidelines, in relation to cost recharges for services?** (5)

2) **Is the above approach consistent with the arm's length principle? Provide and explain two arguments in support of your answer.** (5)

3) **What are the potential benefits and disadvantage to Country P in adopting the simplified approach?** (5)

Continued

3. Continuation

4) Will your answer to 3) be different if Country P subscribes to the concept of location savings as put forth by China and India in the UN Transfer Pricing Manual? Briefly explain your reasoning. (5)

Total (20)

4. It is often held that the concept of 'incidental benefits' or 'implicit support', as explained in the OECD Transfer Pricing Guidelines (chapter 7), is difficult to apply in practice.

1) For what reason(s) did this concept come to play a role in the *GE Capital* case in Canada [2010 FCA 344]? You should provide a brief outline of the case in your explanation. (10)

2) How is the concept of incidental benefits approached in the OECD Transfer Pricing Guidelines, in the context of group synergies and central purchasing situations? (10)

Total (20)

PART C

You are required to answer TWO questions from this Part.

5. Titan Automobiles (Titan) and Deutsche Maschinell Gefertigt (DMG) are two car companies with Indian and German parent companies respectively. Titan is a family-owned car maker, part of the famous Telangana Industries group. DMG was founded 100 years ago, and is listed on the Frankfurt stock exchange. It is active in the design, manufacturing and distribution of cars in Germany and around the world. Among DMG's competitive advantages are its precision engineering techniques, and its marketing campaigns are widely admired with a unified design language, helping to ensure that customers remain interested in DMG's cars. Titan began its operations by assembling imported 'copies' of foreign car models under production licence, before eventually developing and introducing its own car model, the Micron A.

   Since 2007, DMG has sold its products in India under a limited risk distribution agreement with Titan. Titan purchases and sells DMG cars in India, working with a DMG marketing office in India. The marketing office employs 50 staff, who follow DMG HQ's marketing philosophy. Under the agreement, DMG is required to buy back any inventory which remains unsold by Titan.

   In 2009, DMG acquired 35% of the shares in Titan to form a joint venture with the Telangana Industries group. The limited risk distribution agreement above remained unchanged.

   In 2010, confident that the success enjoyed thus far by the partnership would continue, Titan created a new subsidiary in Germany, Titan Deutschland (TD), to distribute Titan's Micron A to German car dealers. These cars are made in Titan's factories in India, utilising some state-of-the-art technology patented by DMG and licenced to Titan for a fee of 2% of annual revenues generated from exploiting the technology.

   In 2013, DMG's 35% holding in Titan was increased to 51%. Again the limited risk distribution agreement remaining unchanged. However the licensing agreement was withdrawn. Instead, DMG allowed Titan unlimited use of its patents, free of charge, since it is now part of the global DMG corporate 'family'. In addition, DMG moved certain production lines to Titan in India as manufacturing and labour costs are significantly lower in India than in Germany. The cars made by the assembly lines in India are now distributed by both DMG and TD in Germany. To support this expansion of activities, DMG extended a working capital loan of $100 million to Titan. DMG also charges Titan head-office management fees for finance, marketing and other central costs, since Titan is now consolidated into the DMG group and receives the standard finance, HR and other support from DMG head office.

   You are required to:

   1) **Identify three different related party transactions, one in each of the three periods 2007-2010, 2010-2013, and 2013 onwards.** (6)

   2) **Formulate a functional analysis of the three group entities (Titan, DMG and TD) at the end of 2013, on the basis of the information available to you.** (9)

   Total (15)

6. **Describe five different profit level indicators (PLIs) which can be used as part of the Transactional Net Margin Method. For each PLI, you should include an example illustrating how the PLI is used, or the type of transactions for which it is used.** (15)

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

1) **What is meant by 'compensating adjustments', according to the OECD Transfer Pricing Guidelines?** (5)

2) **What problems might be posed by compensating adjustments, in the context of customs? How would your answer differ if the country under consideration has foreign exchange controls? You should refer to applicable sections of the OECD Transfer Pricing Guidelines.** (5)

3) **Are there any practical solutions which might address the problems identified in 2) above? You should refer to applicable sections of the OECD Transfer Pricing Guidelines.** (5)

Total (15)

8. You are managing a large audit, involving a transfer pricing adjustment within a multinational enterprise group. The adjustment affects several years' activity, for a related party transaction between Subsidiary A and Subsidiary B, which are situated in the nations of Antabria and Bolmaris respectively.

You are required to answer the following questions, which have been raised by the group's Chief Finance Officer:

1) **How does a Mutual Agreement Procedure (MAP) differ from an Advanced Pricing Agreement (APA)?** (3)

2) **What condition would need to be met by the double taxation agreement between Antabria and Bolmaris, before Subsidiary A and/or B can apply for a MAP or APA?** (4)

3) **What are the principal benefits and potential problems, to both tax administration and taxpayers, which may be associated with a MAP? You should aim to describe four benefits or problems.** (8)

Total (15)

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

1) **Briefly explain, in your own words and with illustrative examples, the five comparability factors in Chapter 1 of the OECD Transfer Pricing Guidelines.** (8)

2) **How would you apply the five comparability factors when trying to apply the internal Comparable Uncontrolled Price (CUP) method? You should provide an example from a relevant legal case.** (7)

Total (15)