THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2017

PAPER 3.03 – TRANSFER PRICING OPTION

ADVANCED INTERNATIONAL TAXATION (THEMATIC)

TIME ALLOWED – 3¼ HOURS

This 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.
- Start each answer on a new page and clearly indicate which question you are answering. 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.
- Marks are specifically allocated for presentation.
- 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 Parts B and C.
- The first 15 minutes of the exam consists of reading time. You will be allowed to annotate the question paper during this time; however, you will **not** be permitted to start writing or typing your answer, or use a calculator. The Presiding Officer will inform you when you can start answering the questions.
- 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. Raptor plc was incorporated in 1977 and is a publicly listed company on the United Kingdom stock exchange. It is the ultimate holding entity of the Jacks Group, a multinational group with a number of subsidiaries located in several countries. The Jacks Group designs, manufactures and distributes branded cosmetics products.

   Raptor plc owns all patents, licences and trademarks (IP) relating to the group's product formulation, brand name and manufacturing expertise. The IP assists the Jacks Group in marketing the products, and to generate a price premium over its competitors. As the group operates in the fast-moving consumer goods market, advertising is crucial to its continued success. On average, the group targets a marketing spend of 15% of net sales.

   The Jacks Group sells its products through wholesalers, department stores and speciality stores in 25 countries. The group has centralised certain functions, including procurement, logistics, research and development, contract manufacturing, treasury and technical services.

   You have received the following publicly available information, showing the financial performance of the key members of the Jacks multinational group.

Entity	Net Sales (£m)	Net Profit Margin	Net Profit as % of Total Assets
Raptor plc	15	2%	1%
Isakate Pty Ltd	10	13%	15%
Conrad Pte Ltd	40	19%	20%
Lance Ltd	12	11%	11%
Royal, Inc.	20	-8%	-4%

The following additional information has been provided by the Jacks Group, in relation to the functions undertaken by key members of the worldwide group.

Entity	Description of entity activities
Raptor plc	Retail sales to third parties in the UK; group IP ownership; managerial service provision to all group entities; technical service provision to Conrad Pte Ltd.
Isakate Pty Ltd	Retail sales to third parties in Australia.
Conrad Pte Ltd	Sales to Jacks Group companies; research and development for Raptor plc; group procurement and logistics; product manufacture.
Lance Ltd	Product distribution to third party wholesalers in numerous countries.
Royal, Inc.	Retail sales to third parties in the United States.

You are required to answer the following questions relating to the Jacks Group, based on relevant chapters of the 2015 Final Reports of the OECD Base Erosion and Profit Shifting Project and the 2010 OECD Transfer Pricing Guidelines.

1) Identify the international related party transactions within the group. (5)

2) With regard to the arm's length principle, what transfer pricing risks should the UK tax authority consider? (5)

Continued

1. Continuation

3) For each international related party transaction undertaken by the following entities, which transfer pricing methodology is the most appropriate? You should provide reasons in support of each answer.

a) Raptor PLC (6)
b) Isakate Pty Ltd (3)
c) Conrad Pte Ltd (6)

Total (25)

2. Snare Group is a multinational group which operates beer breweries in a number of countries. The group has centralised its managerial and reporting lines, according to the following geographical regions: North America; Europe; Asia; the South Pacific; Africa; and the Middle East. The parent company (SnareCo) is located in the United States and legally owns all brand names, trademarks and copyrights utilised by the group.

Snare Group's management wants to ensure that the group's products taste exactly the same in all countries. Therefore, all of the group's significant brewing ingredients (including barley, hops and yeast) for all of its breweries are purchased by SnareCo from a single supplier, Blueharvest, an unrelated conglomerate based in the US. Because of the large order size, SnareCo generates a substantial volume discount which would not be available to individual breweries purchasing smaller volumes. SnareCo has ten employees, who place regular orders with Blueharvest based on each demand projections provided by each brewery. SnareCo staff also arrange the insurance and transportation of the ingredients from Blueharvest's premises. SnareCo takes flash title of the ingredients, before a third party transports them overseas to the subsidiaries.

You are advising Snare Europe, resident in Germany, in relation to their tax affairs. You are informed by the company that the current transfer pricing policy of Snare Group requires each subsidiary operating a brewery to target a 2% earnings before interest and tax (EBIT) margin. The 2% margin target was determined by pricing the purchase of ingredients from SnareCo. Snare Europe operates a brewery and does not record any related party transactions other than the purchase of ingredients from SnareCo.

You have been notified that a local market exists for the same goods purchased by SnareCo (including barley, hops and yeast). The goods purchased from SnareCo comprise 60% of Snare Europe's cost of goods sold. Snare Europe undertakes manufacturing and owns the assets utilised in the brewing process, including plant, equipment, land and buildings. The brewing process is largely automated, with twenty staff employed to assist with the process. Snare Europe employs thirty staff in order to undertake marketing and distribution functions in the local market.

You are required to answer the following questions:

1) Advise on the application of a functional analysis to Snare Europe's operations, including practical approaches. (8)

2) For transfer pricing purposes, how would you characterise the operations of Snare Europe? (3)

3) In undertaking a comparability analysis in relation to the purchase of ingredients from a third party, what factors should be considered? (10)

4) Do you consider the transfer pricing policy relating to Snare Europe to be appropriate? You should provide reasons in support of your answer. (4)

Total (25)

PART B

You are required to answer ONE question from this Part.

3. The Dewar Corporation (Dewar Corp) is a multinational group of companies. The parent company (ParentCo) is headquartered in Country A and is an electronics manufacturer and distributor with intellectual property (IP) ownership, research and development, sales and marketing functions.

   Dewar Corp has recently implemented a global business restructure. The key changes can be summarised as follows:

   - Two new subsidiaries will be established, SubB located in Country B and SubC located in Country C.
   - Legal ownership of all group IP (including trademarks, patents, and expertise) will be transferred from ParentCo to SubB. ParentCo will continue to conduct research and development and be compensated for these tasks by SubB on a cost plus 5% basis, under a new agreement.
   - ParentCo will pay an annual management fee to SubB.
   - SubB will become a centralised hub for the group's procurement, sales, distribution and logistics functions, which were previously performed by ParentCo.
   - SubC will become the manufacturing site for the group (operating as a toll manufacturer). ParentCo's manufacturing site will be shut down and long term supply agreements with existing distribution centres will be terminated.
   - SubC will enter into an agreement with SubB, whereby SubB will compensate SubC with a fully absorbed cost plus 30%.

   The applicable corporate tax rates are 30% in Country A, and 10% in Country B. Country C does not apply any corporate tax.

   You are required to:

   1) **Describe the changes in characterisation for each of the Dewar Corp entities, in terms of functions, assets and risks before and after the group's restructure.** (10)

   2) **Discuss the potential transfer pricing issues and risks, in relation to Dewar Corp's restructure.** (10)

   Total (20)

4. Lucky Corp is a multinational group of companies which provides engineering, procurement and construction management services as its core business. The group's global value chain spans a number of functions including manufacturing, distribution, marketing and sales, research and development, procurement, logistics, financing, administration, after sales service, and human resource management.

Lucky Corp has an intra-group services policy which stipulates that a central entity (Lucky, Inc.) provides the services for related entities within the group on the basis that such an arrangement is beneficial to the group as a whole.

You are required to:

1) **Identify potential chargeable group services, and explain the rationale for the charge.** (5)

2) **Identify potential non-chargeable services, and explain the rationale for each service's non-chargeable status.** (5)

3) **Explain direct and indirect charging, and provide examples in the context of intra-group services within Lucky Corp.** (5)

4) **Provide examples of how allocation keys could be applied to direct and indirect intra-group services within Lucky Corp.** (5)

Total (20)

PART C

You are required to answer TWO questions from this Part.

5. **You are required to answer the following questions, which have been raised by the Board of Directors of a multinational group. In each case, you should use an example to illustrate your answer.**

   1) **Describe the types of Advanced Pricing Arrangement (APA) that can be entered into.** (5)

   2) **Explain why you would enter into a request for Mutual Agreement Procedure (MAP).** (5)

   3) **Advise the board of the mechanism via which tax authorities may engage in relation to MAP.** (5)

   Total (15)

6. Action 13 of the OECD/G20 BEPS 2015 Final Reports focused on transfer pricing documentation and country-by-country reporting. According to one expert,

   > "Country-by-Country reporting will be a game changer in the context of transfer pricing".

   1) **Discuss the above statement in regards to both multinationals and tax administrations.** (12)

   2) **You are required to identify the implications of country-by-country reporting for tax authorities which do not possess a tax treaty network.** (3)

   Total (15)

7. The following cases have been cited as examples of important decisions in the practice of transfer pricing:

   - Chevron Australia Holdings Pty Ltd v Commissioner of Taxation [2015 FCA 1092] – Federal Court decision, Judgment Date: 23 October 2015; Robertson, J (not the decision following the appeal to the Full Federal Court).
   - GSK Canada [2010 FCA 201]
   - DSG [2009 UKFTT 31 (TC)]
   - GE Capital [2010 FCA 344)

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

   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)

8. Wizard Ltd is a multinational mining group which operates significant intra-group financing transactions, including related and third party loans, cash pooling and factoring.

   The group has recently injected additional debt into its entities in several jurisdictions through related party financing arrangements, resulting in some entities entering into low profitability or even loss positions and breaching thin capitalisation safe harbours.

   You are required to discuss the transfer pricing issues for Wizard Ltd, in terms of the intra-group financial transactions in operation. (15)

9. **Discuss the proposed changes contained within Action 7 of the OECD/G20 BEPS 2015 Final Reports (Preventing the Artificial Avoidance of Permanent Establishment Status).** (15)