Chartered Institute of Taxation
Excellence in Taxation

THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2015

PAPER 3.03 – TRANSFER PRICING OPTION

ADVANCED INTERNATIONAL TAXATION (THEMATIC)

TIME ALLOWED – 3¼ HOURS

- You should answer **FOUR** out of six questions including **AT LEAST ONE** from each Part.
- Each question carries equal marks.
- Start each answer on a new sheet of paper. 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 good 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 I

You are required to answer AT LEAST ONE question from this Part.

Background information relevant to Question 1, 2 and 3

Utopia is a prosperous, technologically advanced country that has a strong currency, experiencing long-term high levels of Gross Domestic Product, while maintaining both unemployment and interest rates below 3%. Since 2010, there has been an influx of Multinational Enterprises eager to tap into Utopia's rich natural resources, abundance of fresh produce, incentives, extensive transport network, and highly educated and skilled workforce. Utopia's tourism, logging, mining and fishing industries are some of the most lucrative in the world. The population has just peaked at 15 million and there are over 2,000 Multinational Enterprises currently operating in the country.

Although Utopia is not part of the EU, its government has decided to issue the following guidelines based on the EU Joint Transfer Pricing Forum's documents:

- Code of conduct on transfer pricing documentation for associate enterprises;
- Guidelines for Advance Pricing Agreements; and
- Guidelines on low-value-adding intra-group services.

1. **Before Utopia issues these guidelines, you have been engaged to provide advice to the Utopian government on drafting its transfer pricing legislation. You are required to:**

   1) **List five key transfer pricing areas that Utopia should consider.** (5)

   2) **Explain the policy and administrative considerations for each area listed in Part 1, and how each key area will impact on the effective and efficient implementation of Utopia's transfer pricing regime. Your answer must focus on the five key areas which you selected in Part 1; marks will not be awarded to any part of the answer that is not clearly referenced to these areas.** (20)

Total (25)

2. Several years have passed since Utopia issued its transfer pricing legislation and guidelines. The Utopian government has successfully concluded several transfer pricing audits, resulting in the collection of significant additional taxes and the imposition of penalties for non-compliance. In addition, Utopia has recently entered into twelve Double Tax Agreements (based on the UN Model) with its major trading partners. You now act as a transfer pricing advisor to several Multinational Enterprises operating in Utopia. One of your clients, Global Mining Company, Inc., is concerned about its exposure to a transfer pricing audit and is seeking to enter into an Advance Pricing Agreement (APA) in order to minimise the risk of being selected for a transfer pricing audit.

   You are required to:

   1) **Briefly explain the circumstances which would expose Global Mining Company, Inc. to a transfer pricing audit.** (5)

   2) **Outline the components which would be contained in a draft unilateral APA between Global Mining Company, Inc. and the Tax Authority of Utopia, concerning the sale of minerals to a foreign related party engaged in trading and marketing activities. Reasonable assumptions can be made in answering the question.** (20)

Total (25)

3. Several more years have passed and you have acquired a reputation as Utopia's leading transfer pricing expert. You are approached by Miss Doubtful, the Chief Financial Officer of Vanilla Ltd, located in Utopia. She is very nervous about all the media attention surrounding the OECD's Base Erosion and Profit Shifting (BEPS) project and engages you to prepare the company's comparability analysis for the year ending 31 December 2014.

Vanilla Ltd is a distributor of cardboard boxes in Utopia, and purchases all of its boxes from its parent company Plain, Inc., located in Paradise. Plain, Inc. manufactures and sells cardboard boxes worldwide.

Miss Doubtful provides you with the following information for the year ending 31 December 2014:

- Plain, Inc. sold 200 crates of cardboard boxes to Vanilla Ltd at a price of US$5,000 per crate.

- Vanilla Ltd sold the crates to unrelated (third party) customers for US$6,500 per crate.

- Plain, Inc. pays the transportation costs to ship the cardboard boxes to Utopia.

- Plain, Inc. made an overall operating profit margin of 15%.

- An independent company, Basic Ltd, also distributes cardboard boxes in Utopia.

- Basic Ltd buys all of its boxes from an unrelated local company.

- Basic Ltd's annual turnover was US$1 million and its Cost of Goods Sold totaled US$780,000.

- Vanilla Ltd returns an operating profit margin of 10%.

- Basic Ltd and Vanilla Ltd have no other business lines.

- The terms and conditions (excluding the transportation costs paid by Plain, Inc.) relating to the purchase and sale of cardboard boxes by Vanilla Ltd and Basic Ltd are comparable.

- Vanilla Ltd and Basic Ltd both have similar functions, assets and risks.

- The cardboard boxes sold by Vanilla Ltd and Basic Ltd, although not identical, are sufficiently comparable to apply the OECD transfer pricing methods.

- The gross profit margins for all the companies listed on Utopia's stock exchange are within the range of 10% to 60%.

- The operating profit margins for all the companies listed on Utopia's stock exchange are within the range of 1% to 20%.

- Utopia's Bureau of Statistics issued the 2014 yearly average for all distributors of paper related products (including cardboard boxes) and the average gross profit margin and average operating profit margin were 20% and 10%, respectively.

- The tax administration of Paradise has issued a 'safe harbour' rule for cardboard box distributors and the gross profit margin and operation profit margin are 30% and 10%, respectively.

Continued

3. Continuation

Based on information above, you are required to prepare the 2014 comparability analysis for Vanilla Ltd, following the typical nine step process described in the OECD Transfer Pricing Guidelines (paragraph 3.4).

The answer must focus on the nine steps as they relate to Vanilla Ltd; marks will not be awarded for repeating the information already contained in the OECD Transfer Pricing Guidelines.

Your report should:

1) **include your observations and recommendations as they relate to the case;**

2) **identify the controlled transaction(s);**

3) **select the tested party;**

4) **select the method which is most appropriate to the circumstance of the case;**

5) **identify the potential comparable(s);**

6) **select the financial indicator, if relevant, that will be tested;**

7) **apply the most appropriate method to the circumstance of the case, and make a determination of the arm's length remuneration (profit or price); and**

8) **conclude with a statement regarding whether or not there is a need to adjust Vanilla Ltd's transfer pricing and if so, calculate the amount of the adjustment, showing all calculations.** (25)

Part II

You are required to answer AT LEAST ONE question from this Part.

4. **You are required to:**

1) **Explain the role of tax treaty articles based on Article 9(1) of the OECD Model, and discuss any practical limitations.** (3)

2) **Explain the role of Article 9(2) of the OECD Model, and discuss differences in country positions regarding the inclusion and importance of this paragraph in their tax treaties, and the significance of Article 9(3) of the UN Model.** (7)

3) **Explain the role of Article 25 with respect to transfer pricing, outlining any practical considerations and/or differences between the OECD Model, the UN Model, and Double Tax Agreements between states.** (8)

4) **Discuss the legal and practical significance of the OECD Transfer Pricing Guidelines, providing country examples.** (7)

Total (25)

5. **You are required to:**

1) **Explain, step by step, a practical process for examining consistency of a payment for routine administrative services with the arm's length principle (based on an indirect charge method, applying the Transactional Net Margin Method with costs as the basis for the financial indicator). You should refer to the sources and types of information required for each step.** (10)

2) **Explain what a 'safe harbour' for routine services is, providing an example and referencing examples of country specific, regional or international guidance.** (5)

3) Fox Coat Group is a multinational enterprise (MNE) engaged in the production and distribution of pet food.

The parent company, Fox Coat Holdings Ltd (FCH), is engaged in the distribution of pet food in its local market. FCH has three operational subsidiaries in other countries: M Co, which is the manufacturer of the pet food sold by the group; and D1 Co and D2 Co, which are distributors.

FCH, D1 and D2 only buy pet food from M Co, and M Co does not sell to any third parties. FCH provides administrative services to the subsidiaries, namely information technology (IT), accounting, and human resource (HR) services.

<u>Supplementary information</u>

Functional analysis demonstrates that:

- IT services comprise hardware and software procurement, installation, and helpdesk support services.

- Accounting services comprise the consolidation of financial accounts for Fox Coat Holdings Ltd's reporting requirements, and the processing of invoices for third party customers.

Continued

5. Continuation

- HR services comprise recruitment, performance management, and staff development.

The following costs were incurred in providing the services in 2014:

- IT services totaling US$300,000, including reasonable allocation of overheads. It is noted that, of this total, US$150,000 relates to payment to a third party for a one-off installation of special software for M Co's production facility machinery.

- Accounting services totaling US$200,000, including reasonable allocation of overheads. It is estimated that the staff spend 25% of their time working on the group consolidated reporting.

- HR services totaling US$200,000, including reasonable allocation of overheads.

Other information for 2014:

	FCH	M1	D1	D2
No. of computer terminals	10	5	7	6
No. of computer users	10	10	8	7
No. of employees	10	50	10	10
No. of full time equivalent employees	10	30	8	9
Turnover	US$10 million	US$20 million	US$25 million	US$30 million

You have been provided with a comparability study that proposes a mark up on costs for these types of services in the range of 3-7% for the 2014 year.

Based on the information provided above, you are required to determine a possible arm's length service charge for the services provided by FCH to D1 Co in 2014, providing explanations of each step in the process, the reasons for the decisions you make, and any assumptions you have made. Where you think additional information is needed, this should be clearly stated. (10)

Total (25)

6. FipWip Group is a large MNE group with a diversified business portfolio including consumer goods, financial leasing, and manufacturing, covering more than eighty countries. You have spoken to the global head of tax regarding the opportunity for transfer pricing work and, after several meetings, she has finally provided you with some specific issues about which she requires your advice.

Issue 1: Loan Balance Transfer

On 1 January 2013, X Co lent US$20 million to another FipWip Group member, Y Co. The term of the loan is five years, the interest rate is a fixed annual rate of 9%, and the principal is payable in full at the end of the loan period. The loan contract contains a penalty for early repayment, calculated as a one-off payment of 5% of the principal repaid. As part of the centralisation, it is planned to transfer the loan from X Co to FipWip Group's newly established finance company, Finance Co. In order to give effect to the transfer, Finance Co will make a payment of the US$20 million principal to X Co and, in return, will assume the rights under the loan agreement (i.e. Finance Co will replace X Co as the lender for the purposes of the loan agreement).

1) **Identify the related party transaction(s) and the parties to the transaction(s).** (2)

2) **Assuming there are no internal comparable uncontrolled transactions, please describe the transfer pricing analysis that will need to be undertaken in order to assess compliance with the arm's length principle in the related party transaction(s), including specification of any information and analysis that is required.** (14)

Issue 2: Financial Guarantee

In order to reduce financing costs, FipWip Holdings Ltd (which holds a AAA credit rating), the parent company of the FipWip Group, is planning to provide a formal guarantee in relation to tradable corporate bonds that FipWip Financial Services Ltd (whose standalone credit rating is classed as BBB) is planning to issue on the market. FipWip Holdings Ltd is advised by the investment bank handling the transaction that the bonds are likely to be rated as AA+, if not AAA.

3) **What issues require consideration when determining whether FipWip Financial Services Ltd should pay a guarantee fee to FipWip Holdings Ltd, and how should the guarantee fee (if any) be determined?** (6)

4) **Provide a brief description of an example of recent case law relating to this issue.** (3)

Total (25)