



THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2013

PAPER IIIF – TRANSFER PRICING OPTION

PRINCIPLES OF CORPORATE AND INTERNATIONAL TAXATION

TIME ALLOWED – 3½ 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.
- 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 common to Questions 1, 2 and 3

Watch Guardian Corporation (WG) is the ultimate holding company of a multinational group with three wholly owned subsidiaries located in Europe (WGE), Asia (WGA) and Latin America (WGL). WG is a publicly held company headquartered in North America and is listed on several stock exchanges. WG has a consolidated annual turnover of USD 980 million, with a Gross Profit of 45% of turnover, an Earnings before Interest and Tax (EBIT) of 20% of turnover, and a Net Profit before Tax of 10% of turnover. WG has been operational since 1998 and has 2,200 employees across the four related party entities.

WG produces a wifi-enabled smartwatch, featuring a multi-point touch screen and boasting an android intelligent operating system. The watch includes a special unique health care feature that monitors vital health signs and alerts the wearer of potential health issues, for example high blood pressure. The watch is water resistant and has a lifetime guarantee.

What makes this watch truly unique is that it is connected to WGE's emergency healthcare services. If the watch detects an emergency situation or the wearer presses the distress signal, WGE will dispatch an emergency health rescue service (such as an ambulance or rescue air crew). In addition, the watch extracts a monthly blood sample (through an undetectable needle embedded in the watch) and sends a health report to the wearer's inbox. At the same time the report is also sent to WGE's global medical team, who will contact the wearer of the watch should any anomalies be detected.

The watch retails at a premium price of USD 15,000 per watch, which includes a three year emergency healthcare services package. The cost of any follow-up health care is charged on a usage basis. After the three year initial period the services are rolled over into an annual healthcare package, with an annual fee for the client of USD 3,000.

WG:

- Is the owner of all intangible assets including trademarks and manufacturing know-how;
- Develops the overall corporate marketing strategy; and
- Enters into the sales and services agreement with the clients worldwide.

WGA:

- Manufactures and distributes the watches worldwide on behalf of WG. WG sources all the materials, controls the quality and guarantees to buy all the production.

WGL:

- Undertakes research and development (R&D), both in ground-breaking watch technology and in the delivery of premium healthcare services on behalf of WG;
- Provides various intercompany services to the group entities; and
- Provides loans and treasury functions to the group.

WGE:

- Provides emergency healthcare services to the owners of the watch.

1. **You are required to:**

- 1) Explain the major components of a functional analysis, and why such an analysis is used in a transfer pricing study. (8)
- 2) Describe the steps that you would take to gather the information required to prepare a functional analysis. (5)
- 3) Prepare a functional analysis for the WG group. (12)

Total (25)

2. **You are required to:**

- 1) Explain how each of the following methods works in practice:
 - (a) CUP
 - (b) Resale price method
 - (c) Cost plus method
 - (d) TNMM or CPM
 - (e) Profit Spilt Method – using Residual analysis
 - (f) Profit Spilt Method – using Contribution analysis

You must provide an example to illustrate the practical application of each method. (12)
- 2) Under what circumstances can a taxpayer use “other methods”? Give one example of how an “other method” can be used to determine the arm’s length price/profit. (3)
- 3) Which method, or combination of methods, would you select as the most appropriate to determine whether WGA (who manufactures and distributes the watches worldwide on behalf of WG) is transacting in accordance with the arm’s length principle (ALP)?

List the steps to be undertaken to apply this method, and draw a conclusion on the expected arm’s length range, mark-up or profit element for WGA whilst providing arguments to support your conclusion. (10)

Total (25)

3.

1) "WGL provides various intercompany services to the group entities". WG's strategy is to provide intra-group services from a centralised entity (WGL) because they consider this approach to be beneficial to the group as a whole.

You are required to:

- (a) **Identify three intra-group services that can be charged out (with or without a mark-up), and explain the reasoning in favour of charging out each service.**
- (b) **Identify three types of intra-group service that will generally be excluded from being charged out, and explain the reasons why each service would not be charged out.**
- (c) **Identify two benefits of adopting a centralised group service entity.**

(15)

2) WGL charges out intra-group services on both a direct and an indirect charge method.

Explain what is meant by the terms 'direct' and 'indirect' charge in the context of intra-group services. Under what circumstances would you advise WGL to use an indirect approach? (5)

3) **Give two separate examples of intra-group services that are charged out on an indirect charge method, and demonstrate the use of a different allocation key in each example.** (5)

Total (25)

Part II

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

4.

- 1) You are advising a large Multinational Enterprise and you have been asked to explain the term 'safe harbour provisions' in the context of transfer pricing. Explain the term and give three practical examples of a safe harbour. (8)
- 2) Why would a tax administration implement safe harbour rules? List some benefits and potential problems, to both tax administration and taxpayers, which can be associated with safe harbours. (7)
- 3) Explain the term 'economic double taxation' and give an example of how it could occur in a transfer pricing case. (5)
- 4) List the remedies available to a Multinational Enterprise seeking relief from economic double taxation. (5)

Total (25)

5.

- 1) Prepare the global transfer pricing documentation framework for a Multinational Enterprise with separate entities located in USA (the parent), Europe (provides intra-group services) and Asia (undertakes manufacturing and distribution functions for the group). (15)
- 2) Identify the two types of penalties which could arise in terms of transfer pricing. (4)
- 3) Describe the purpose of making an adjustment (or adjustments) as part of the comparability analysis, and identify two types of adjustments which could be made as part of this process. (6)

Total (25)

6.

Business restructuring is one of the major areas of concerns for governments, advisory firms, development agencies, civil society and Multinational Enterprises (MNEs).

You are required to:

- 1) Explain what the term 'business restructuring' means, in the context of transfer pricing. (5)
- 2) Discuss the most important transfer pricing issues in relation to business restructuring from the perspective of both a tax administration and an MNE. (20)

Total (25)