Day 1, Session 4

Accurate Delineation and Recognition of the Actual Transaction - Workshop

WIRTSCHAFTS UNIVERSITÄT WIEN VIENNA UNIVERSITY OF ECONOMICS AND BUSINESS

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Agenda

I. Case 1: Business restructuring
II. Case 2: Digital gaming

Section I

Case 1. Business restructuring

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Alpha Group: Description of the Case

Pre-restructuring

- The Alpha Group is active in the manufacturing and distribution of equipment and spare parts for running data centers
- The Parent Company, IT Alpha, sells both equipment and spare parts to its UK affiliate and UK customers, which according to the TP file is remunerated on a Cost Plus 3% for low-value adding mktg activities

Post- restructuring

- As of FY 200x+1, the UK entity will take full responsibility in dealing with UK customers, while the TP policy will change at group level, with the UK affiliate now remunerated on a Cost Plus 13%
- The distribution agreement does not consider any break-up fee in the event of termination or renegotiation of contracts

Alpha Group pre/post restructuring
Description of the Case

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Current transactions	Future transactions
IT-Alpha → UK-Alpha	IT-Alpha → UK-Alpha
▪ Sales of Equipment	▪ Sales of Equipment
▪ TP Policy: Cost Plus 3%	▪ TP Policy: Cost Plus 13%
IT-Alpha → Customers UK	UK_Alpha → Customers UK
▪ Sale of Spare Parts and Updates	▪ Sale of Spare Parts and Updates

Business restructuring consequences

- Is this a business restructuring?
- Has IT transferred something of value?
- UK has to pay any indemnification to the IT company?
- Quantification?
- TP policy after restructuring?

Quantification – methods

- Valutation techniques: Discounted Cash Flow

$$DCF = \frac{CF_1}{(1+r)^1} + \frac{CF_2}{(1+r)^2} + \ldots + \frac{CF_n}{(1+r)^n}$$

CF = Cash Flow

r = discount rate (WACC)

- Assumptions: financial projections, growth rate, WACC, **terminal value**.
- Net financial impact = additional income from new TP policy – EBIT moved

DCF - Calculation Model

Indemnification (3yrs+Terminal Value)					
€ '000		**2016**	**2017**	**2018**	**TV**
Operating profit moved to UK on Spare		6.000	6.200	6.300	
Other Operating profit moved to UK		1.168	1.191	1.215	
Operating profit moved to UK		***7.168***	***7.391***	***7.515***	
Additional operating from new TP Equipment		***5.800***	***6.000***	***6.400***	
Additional operating from services		***34***	***34***	***34***	
Net financial impact		***-1.334***	***-1.357***	***-1.081***	***-1.086***
					-14.485
WACC	8%				
Discounted net balance		-1.235	-1.163	-858	-11.499
Period		1	2	3	3
Stable growth (TBD)	0,50%				
Total Discounted Net Financial Impact	-14.756				
Tax (rate=31.4%)	4.633				

Remuneration of post-restructuring

- The application of arm’s length principle to business restructuring should not be different from the application to other controlled transactions
- It is not possible to base TP adjustment on before and after restructuring scenarios
- Accurate delineation of the new transactions

Section II

Case 2. Digital gaming

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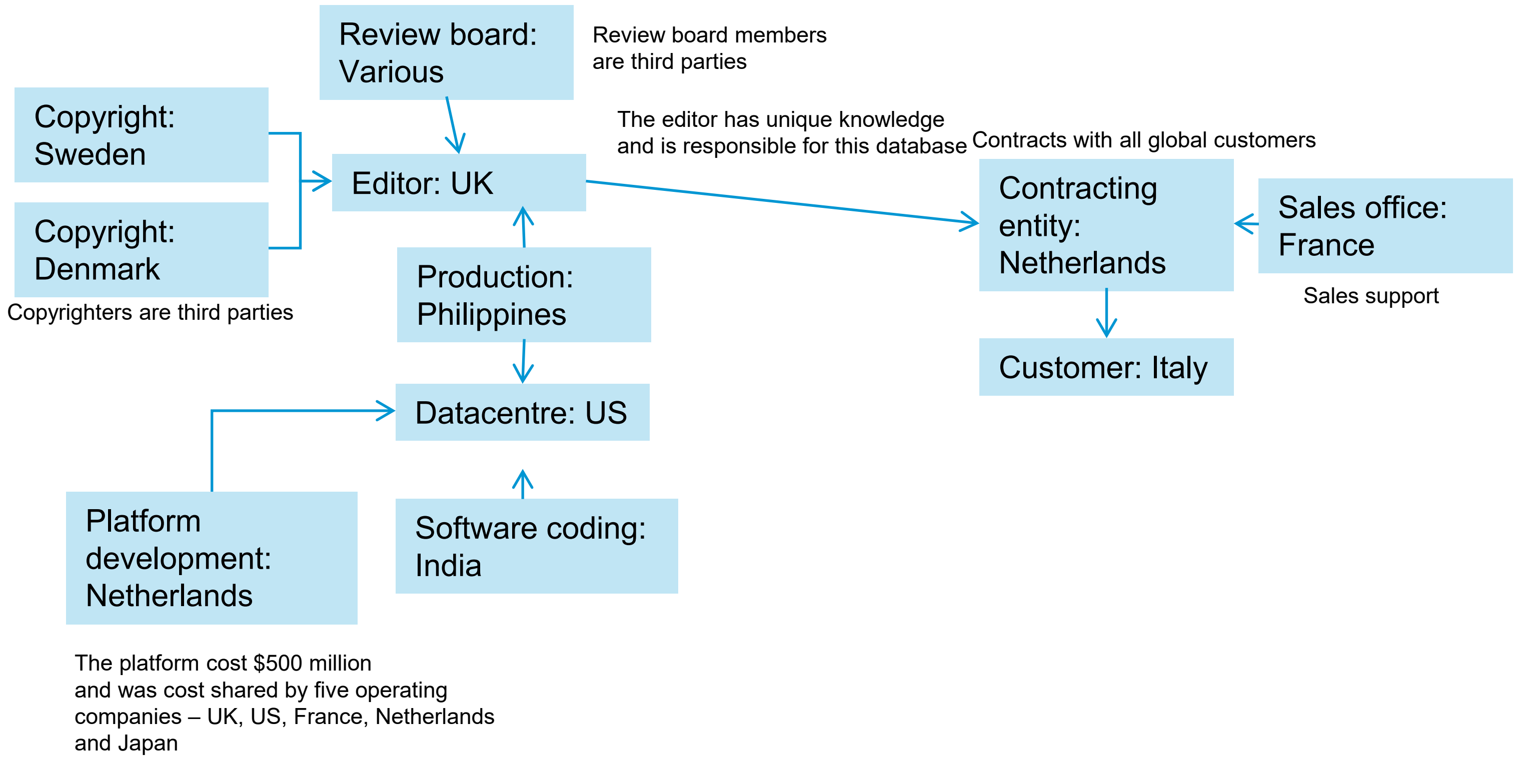
Case 2. Digital gaming



Description of the case

- The group produces videogames and developed and online database platform
- Various third-party authors provide data for the videogame creation
- The game editor is based in a UK operating company
- “Production” consists of processing the game and data so that it is searchable and appropriately stored in the various databases
- The datacentre contains servers – note that this is a routine function which could be located in many jurisdictions, and which is now a commodity service available from many third parties
- The platform (including the search algorithm) is unique and valuable
- The software coding is a routine service
- All sales contracts are entered into by the Netherlands entity which applies fairly standard terms
- The customer is an Italian organisation which then redistributes the program at wholesale level

Questions relevant for setting up a restructuring

- The Customers
  - Is it relevant where they are located
  - Where is the customer?
  - Who is the customer?
  - Where is the customer using the service?
  - How can we know?
- The Revenues
  - Where should the revenue (gross proceeds) be recognised? Is it relevant according to the current international tax framework?

Questions (C'd)

- The costs
  - How should the costs be allocated?
  - How should the costs of developing the technology be amortised?
  - If there is a digital PE, how should costs be allocated to it?
  - Do you think that the cost of the servers have a role
- The editor
  - If the editor moves e.g to the Netherlands, has there been a disposal of an intangible by the UK?

Potential answers

I. **On the customers**
- More than the relevance of their location it is important who is dealing with them from a negotiating standpoint (in our case, this is a B2B transaction and not B2C)
- To answer that question, we need to perform a value chain analysis and accurately understanding the weight of the distribution layer of the supply chain

II. **On the revenues and costs**
- Both they should follow-up the six-step approach of Section D2 of the TPG, Chapter I
- What about the possible impact of DSTs and Pillar I of the OECD Unified Approach?

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