

Day 2, Session 1

Selection and Application of Transfer Pricing Methods 1 Traditional Methods



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Advanced Transfer Pricing Course (General Topics), April 15-19, 2024

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Agenda

- I. Overview of transfer pricing methods
- II. Selection of methods
- III. Comparable Uncontrolled Price Method (CUP)
- IV. Resale Price Method (R-)
- V. Cost Plus Method (C+)
- VI. Appendix – Function and risk analysis
- VII. Appendix – Benchmarking



Section I

Overview of Transfer Pricing Methods

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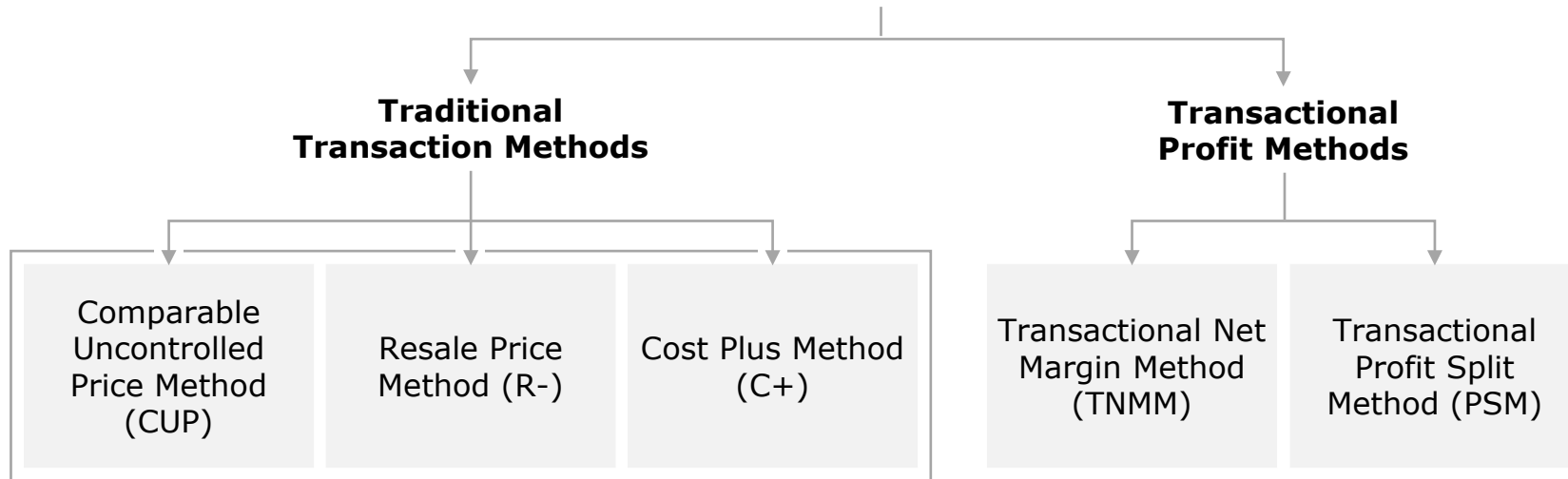


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Overview of Transfer Pricing Methods

TRANSFER PRICING METHODS



Discussed in this session



Section II

Selection of Methods



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Selection of Methods (1/4)

PRIORITY OF METHODS

OECD

No hierarchy of transfer pricing methods, application of the most appropriate method



USA

“Best method rule”

Most countries require taxpayers to document only one method.



Selection of Methods (2/4)



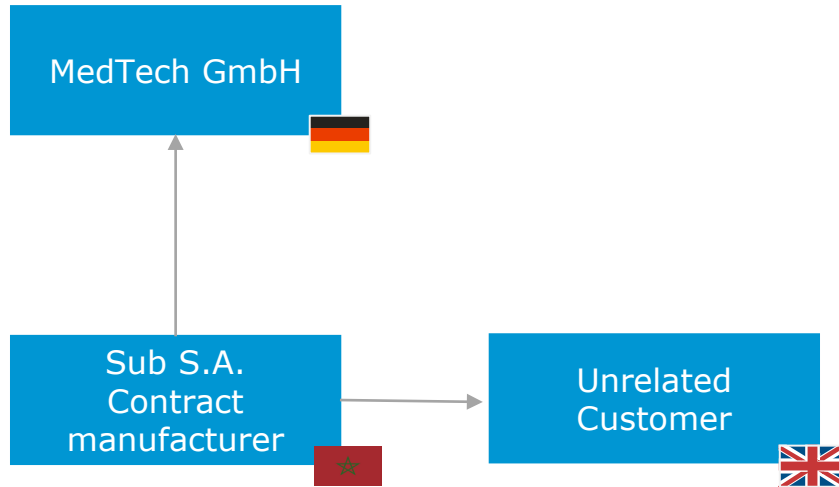
- The selection of a transfer pricing method always aims at finding the **most appropriate method** for a particular case.
- The selection process should take account ...
 - the respective **strengths and weaknesses** of the OECD recognized **methods**;
 - the appropriateness of the method considered in view of the nature of the controlled transaction (**functional analysis**)
 - the **availability of reliable information** (in particular on uncontrolled comparables) needed to apply the selected method and/or other methods
 - and the **degree of comparability** between controlled and uncontrolled transactions, including the reliability of comparability adjustments that may be needed to eliminate material differences between them ([Sec. 2.2 OECD Guidelines](#))

Selection of Methods (3/4)



- “Most appropriate” serves as the main selection criterion but ...
 - where [...] a traditional transaction method and a transactional profit method can be applied in an equally reliable manner, the **traditional transaction method is preferable** to the transactional profit method.
 - where [...] the comparable uncontrolled price method (CUP) and another transfer pricing method can be applied in an equally reliable manner, the **CUP method is to be preferred**. ([Sec. 2.3 OECD Guidelines](#))

Choice of TP method



- MedTech is producing a niche product of medical consumables
- Since the product can be highly customized to customer requirements production requires highly manual work. A clean room production was set up in Marocco in 1998.
- Sub has established itself as being able fulfill highest quality requirements while producing at very low costs.
- 60% of products are supplied to German parent according to its specifications and using the parents logo, however, sub is engaged in testing and final approval as it has most technical experience. It earns a margin of **C+25%**
- In 2008 sub gained a large UK customer, so that 40% of goods are supplied to the unrelated customer. Sub earns **C+35%** margin.
- The tax authorities dismisses the third party transaction and requires the contract manufacturer to earn a margin which is in line with TNMM benchmarks, i.e. **C +5%**.

TNMM vs. internal (transational) C+



Selection of Methods (4/4)

USE OF MORE THAN ONE METHOD



“The arm’s length principle **does not** require the application of **more than one method**. [...] For difficult cases, where no one approach is conclusive, a flexible approach would allow the evidence of various methods to be used in conjunction.”

(Sec. 2.12 OECD Guidelines)



“Data from these ranges could be useful for purposes of more accurately defining the arm’s length range, for example when the ranges overlap, or for reconsidering the accuracy of the methods used when the ranges do not overlap.”

(Sec. 3.58 OECD Guidelines)



“No general rule may be stated with respect to the use of ranges derived from the application of multiple methods because the conclusions to be drawn from their use will depend on the relative reliability of the methods employed to determine the ranges and the quality of the information used in applying the different methods.”

(Sec. 3.58 OECD Guidelines)

Section III

Comparable Uncontrolled Price Method (CUP)



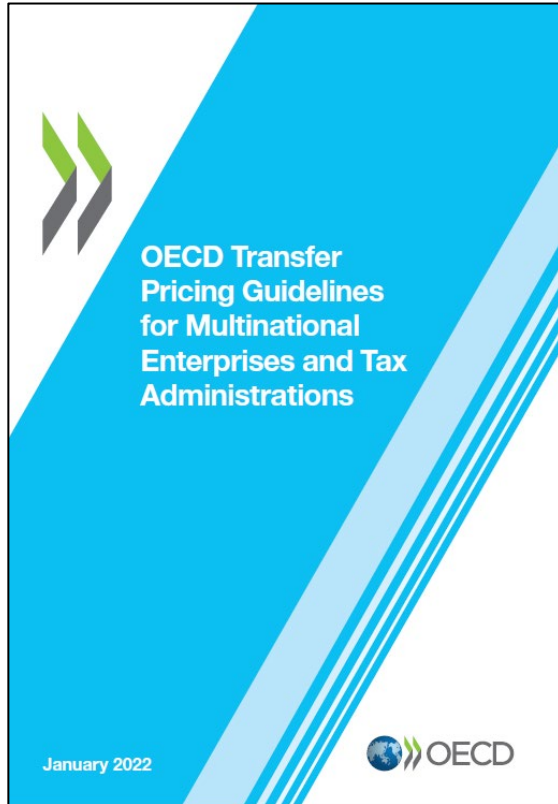
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Comparable Uncontrolled Price Method (CUP) (1/5)



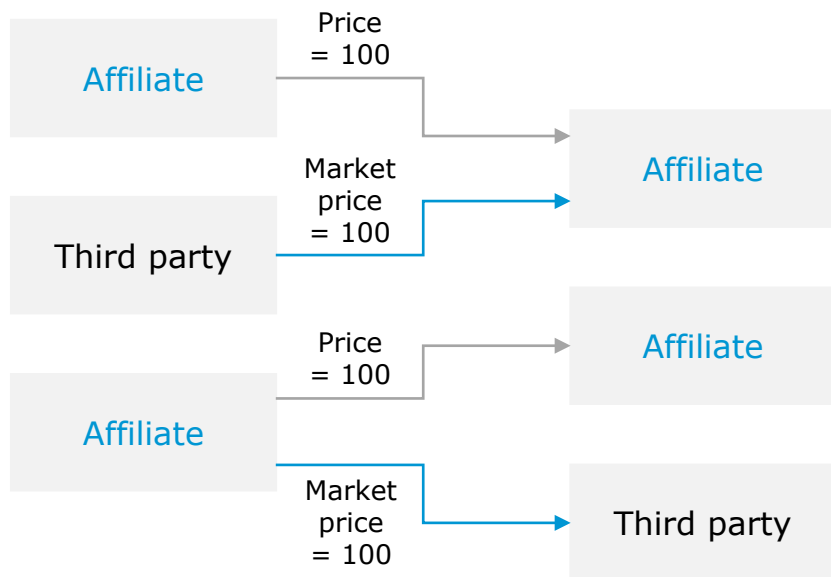
The CUP method compares the price charged for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances. (Sec. 2.14 OECD Guidelines)



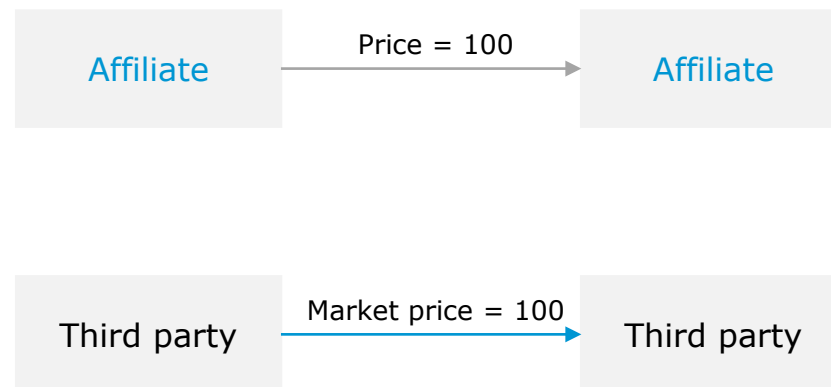
- **INTERNAL CUP**
Transaction between tested party and third party
- **EXTERNAL CUP**
Transaction between two third parties without any involvement of tested party

Comparable Uncontrolled Price Method (CUP) (2/5)

INTERNAL CUP



EXTERNAL CUP



→ I/C Transaction
→ CUP



Discussion point



Have you used CUP
method in practice



Comparable Uncontrolled Price Method (CUP) (3/5)

APPLICATION OF CUP

Importance of comparability analysis:

"[...] an uncontrolled transaction is comparable to a controlled transaction (*i.e.* it is a comparable uncontrolled transaction) for purposes of the CUP method if one of two conditions is met

a.

none of the differences (if any) between the transactions being compared or between the enterprises undertaking those transactions could materially affect the price in the open market; or,

b.

reasonably accurate adjustments can be made to eliminate the material effects of such differences."

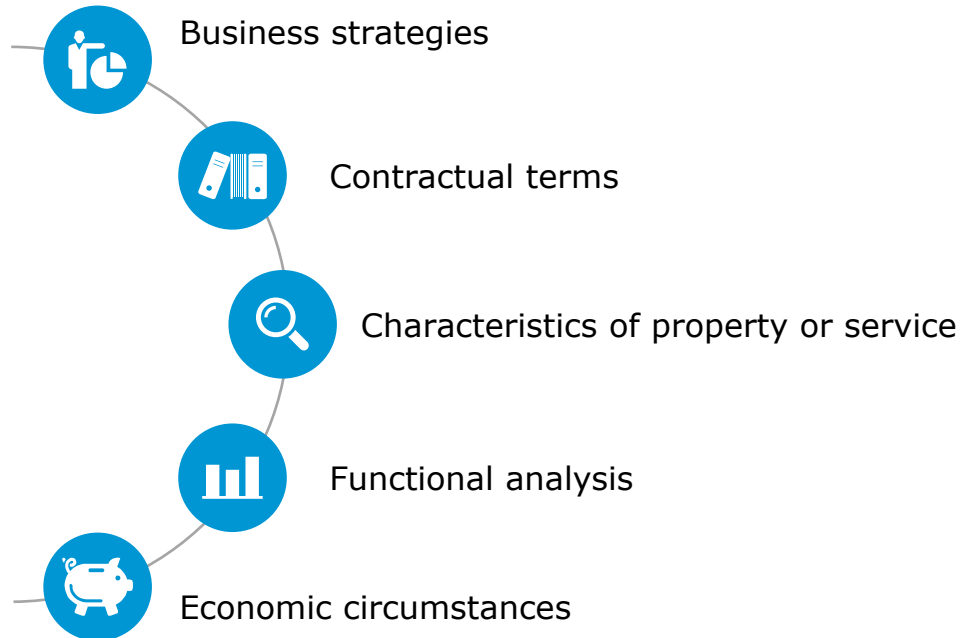
(Sec. 2.15 OECD Guidelines)

Often impossible to identify reliable comparables!



Comparable Uncontrolled Price Method (CUP) (4/5)

FACTORS THAT HAVE TO BE ACCOUNTED FOR TO ENSURE COMPARABILITY (Sec. 1.3 et seq. OECD Guidelines)



Comparable Uncontrolled Price Method (CUP) (5/5)

Most countries allow CUPs to be adjusted if differences between the CUP and the related party transaction can be valued and have a reasonably small effect on the price. Examples of adjustments that are commonly allowed include differences in:

- the terms of the contract (for example, credit terms)
- the volume of sales, and
- the timing of the transaction.

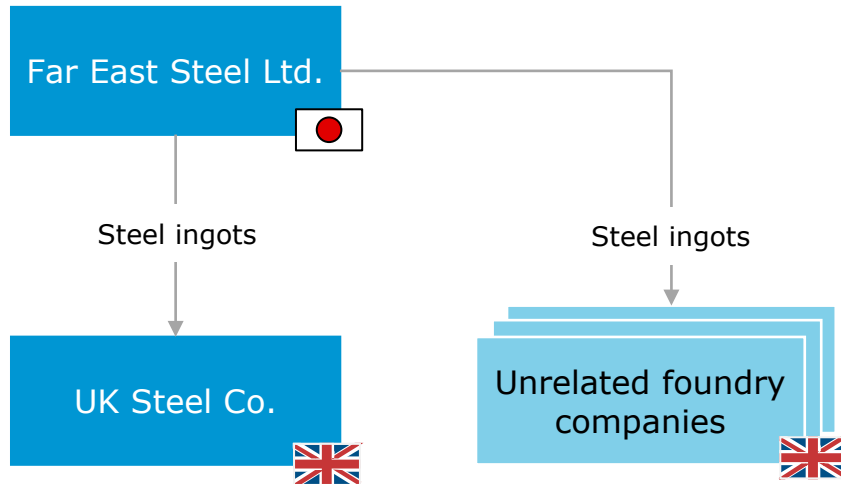
Differences in respect of which adjustments are difficult or impossible to make include the:

- quality of the products
- geographic markets
- level of the market, and
- amount and type of intangible property involved in the sale.

CUP Method can often be applied:
Raw material/homogeneous goods, Publicly traded Goods, license fees, interest rates



CUP case study – steel (1/2)



- Far East Steel Ltd (FES), a Japanese company, manufactures steel ingots in the Far East and ships them to UK Steel Co., a related foundry company, and unrelated foundry businesses in the UK.
- The ingots that FES ships to UK Steel Co. and its unrelated customers are identical in every respect.
- The terms and conditions of the sales are also identical, except that the related party customers are given **payment terms** of 90 days as opposed to only 45 days for unrelated party customers and that the **transaction volume** to UK Steel Co. is 10 times as high compared to the unrelated parties.

Does it seem appropriate to use CUP in this case?

If yes, do you have to make any adjustments to ensure comparability?



CUP case study – steel (2/2)

CUP applicable?



Adjustments needed?

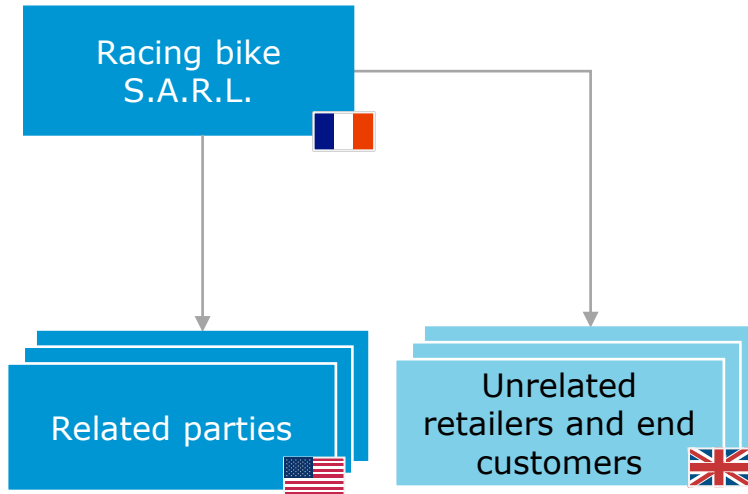


POSSIBLE SOLUTION

- Based on prevailing interest rates, it is determined that the difference in payment terms is worth 0.5% of the ingot price.
- Adjusting the unrelated party price for this difference, it is established that the inter-company price should reflect the unrelated party price plus 0.5%.
- The transaction volume might not have an impact on the price in case of commodities/publicly traded goods.



CUP case study – Use of data analytics (1/5)



Major risks: TP adjustment and double taxation

Facts

- Distribution company / HQ France
- Customers: retailers, end customers and related parties
- High EBIT margin achieved by the related parties.
- French tax audit challenges the transfer price setting in France.

Key challenges

- CUP method is the best theoretical TP method, as it compares directly the prices of comparable transactions.
- Comprehensive amount of data to be analyzed
- Provision of data analytics solution that support the arm's length nature of taxpayer's transfer pricing
 - Flexibility by combining variables to provide combined distributions / interquartile ranges
 - Flexibility regarding all internal CUP possibilities (e.g. gross margins, net margins, prices, etc.)

CUP case study – Use of data analytics (2/5)

Solution

- Analysis of available data, e.g. successive analysis of all transaction data (monthly/quarterly/yearly/multiple-year)
- Visualization of the results / risk areas
- Perform fast and easy analysis
- Use available (big) data in order to:
 - make judgments about varying degrees of comparability of uncontrolled prices and controlled prices;
 - explain the causes of tax risks

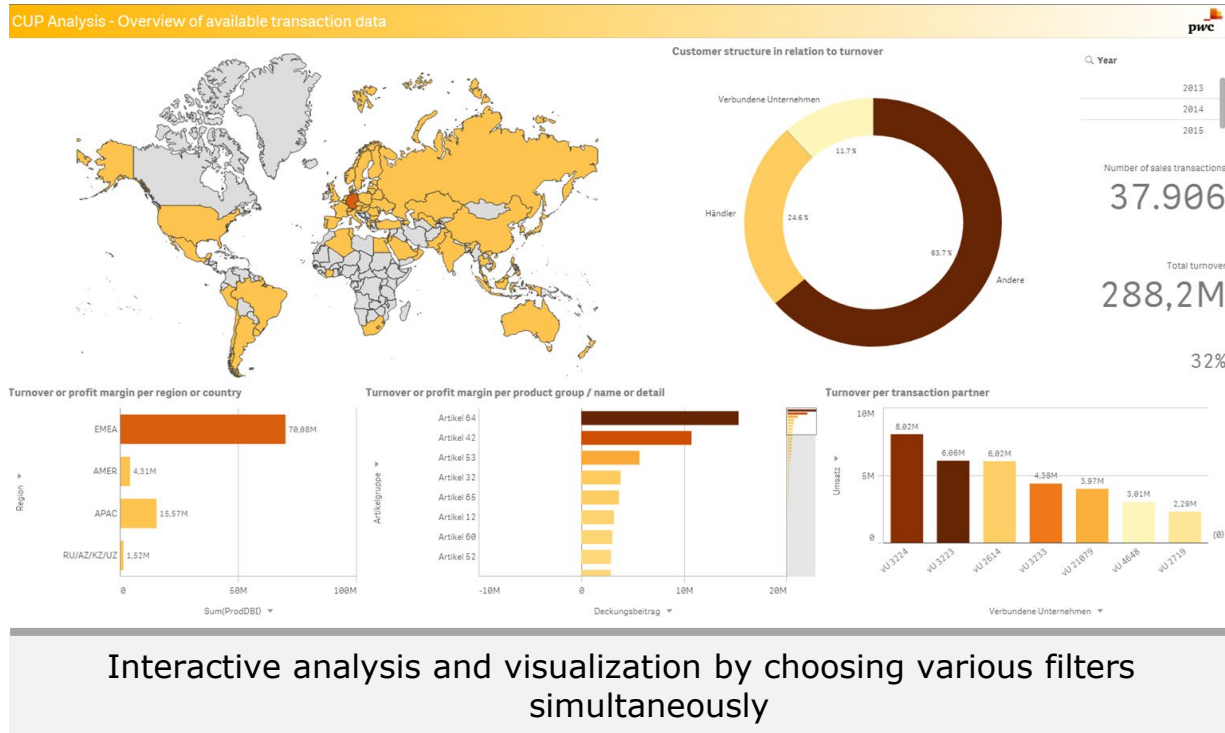


Data analysis and visualization through software



CUP case study – Use of data analytics (3/5)

CUP Analysis - Overview

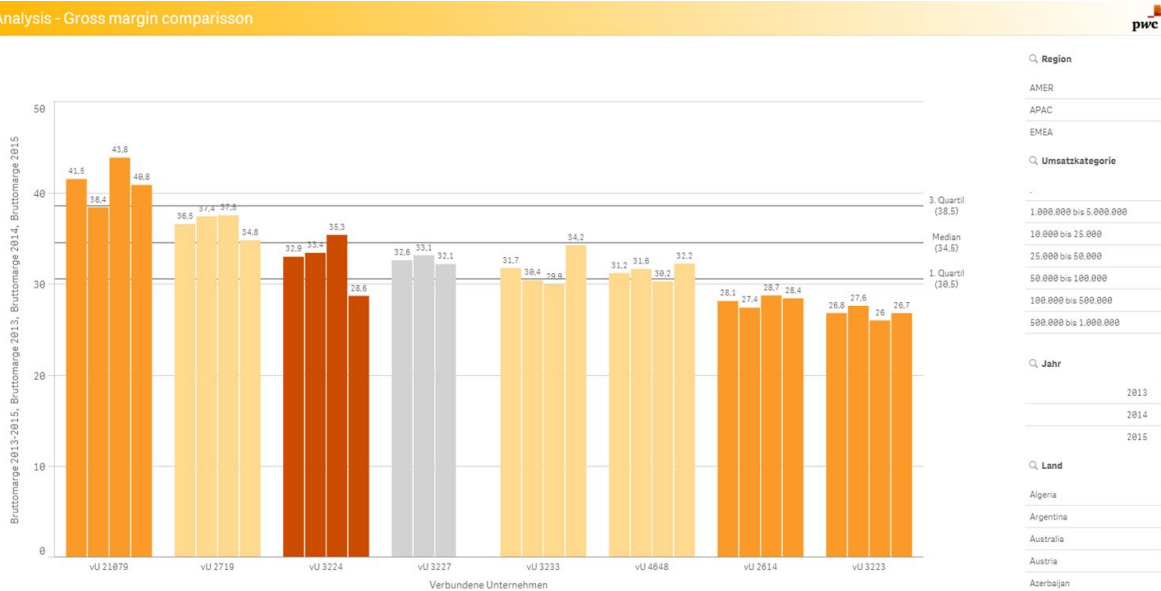


- Overview of countries where turnover was generated
- Customer structure in relation turnover
- Number of sales transactions performed
- Turnover or profit margin shown per region or country
- Turnover or profit margin shown per product group / product name or product detail
- Turnover per transaction partner

CUP case study – Use of data analytics (4/5)

CUP Analysis - Gross margin of related parties vs. interquartile range of unrelated parties

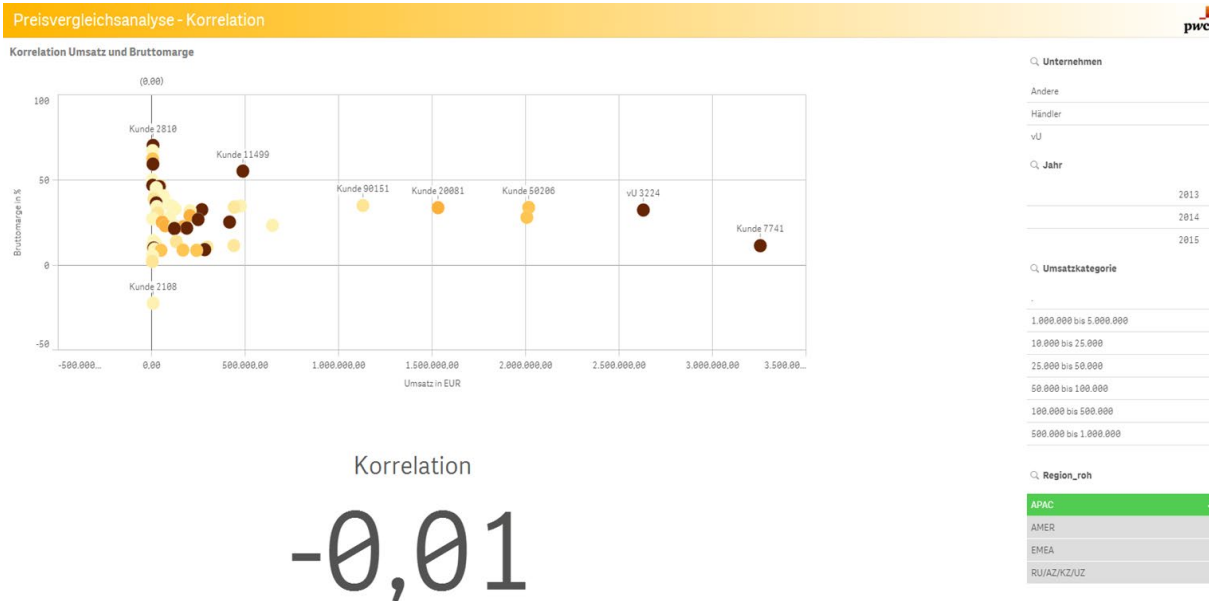
CUP Analysis - Gross margin comparison



- Additional analysis and visualization of the TP risk in case the gross (or net) margins earned in transactions with related parties lie outside the interquartile range as defined by transaction with unrelated parties.

CUP case study – Use of data analytics (5/5)

CUP Analysis - Additional insights based on the data available



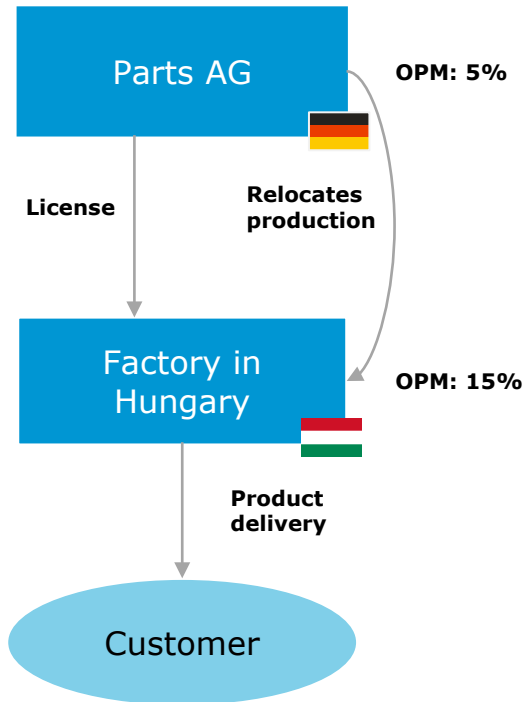
- Performing correlation analysis (e.g. what is the correlation between customers' turnover/revenue and contribution margin?)
- Possibility to analyze whether the gross margin correlates with the customer size and if not analyze the reasons, e.g. high / inefficient pricing in specific regions or for specific products etc.

Polling Question

Have you used data analytics for TP purposes and for which purpose?

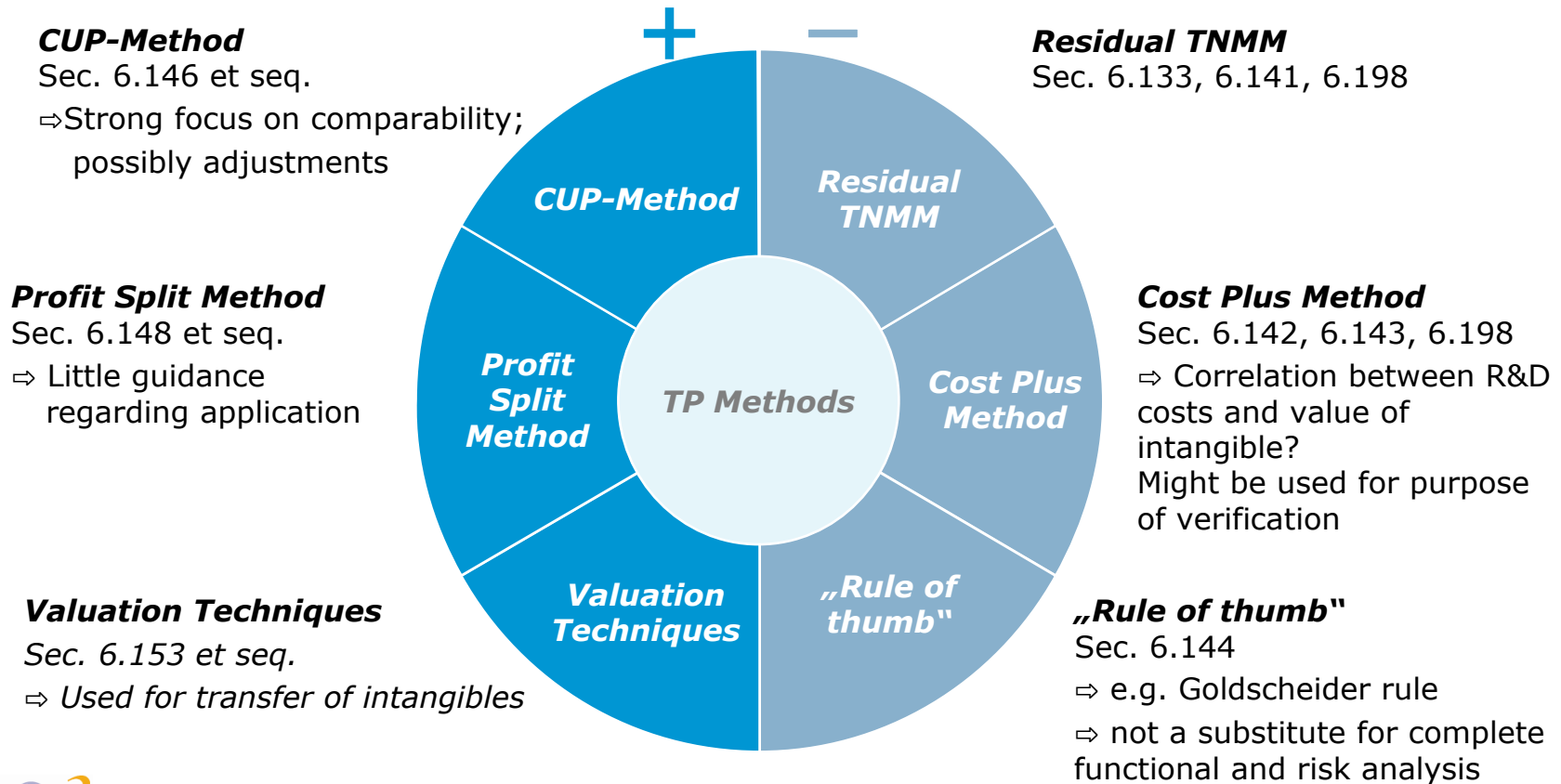
- Transactional data for arm`s length analysis
- Visualisation of CBCR data
- Analysis of transaction streams
- Analysis of margins
- Others
- Have not used it yet

Approach to Documentation on License Models – Case Study



- The German automotive supplier Parts AG relocates the production of car seats to its new factory in Hungary, which generates annual sales of EUR 100 million.
- So far Parts AG has realized a profit margin of 5% regarding the relevant projects. In Hungary, a profit margin of 15% (before license) is expected. The machines are relocated at a market price of EUR 15 million.
- The production is relocated due to contractual commitments towards OEM, which operates a local production near its factory in Hungary.
- The long-term average of the R&D costs in the group come to around 4%.

License Fees – Preferred methods according to OECD Guidelines



License Fees – CUP Method (1/2)

Internal comparables are rarely available (e.g. licenses granted to third parties)

External comparable transactions can be determined via databases

Approach: Search for third-party license agreements in publicly accessible databases, e.g.:

- RoyaltySource
- RoyaltyStat
- Lexis Nexis
- Internet
- FindLaw for Corporate Counsel
- Consusgroup Contract Intelligence Database etc

License Fees – CUP Method (2/2)

Sec. 6.146 OECD Guidelines 2022:

"Where reliable comparable uncontrolled transactions can be identified, the CUP method can be applied to determine the arm's length conditions for a transfer of intangibles or rights in intangibles. [...] It should be recognized that the identification of reliable comparables in many cases involving intangibles may be difficult or impossible."

Experience of tax audit:

- Profit potential is to be compensated additionally
- Third-party agreements do not involve:
 - Client agreements
 - Application-related development
- Third parties would not license their key intangible assets ("crown jewels")
- Third-party agreements are not comparable

Appropriate license fee about 2 - 5%



License Fees – Cost-Plus Method

- Example: Parts AG's R&D expenses are 4%
- **Appropriate license fee about 4 – 5%**
- Sec. 6.142 OECD Guidelines 2022: "The use of transfer pricing methods that seek to estimate the value of intangibles based on the cost of intangible development is generally discouraged. [...]"

Sec. 6.143 OECD Guidelines 2022: "However, in some limited circumstances, transfer pricing methods based on the estimated cost of reproducing or replacing the intangible may be utilized. Such approaches may sometimes have valid application with regard to the development of intangibles used for internal business operations (e.g. internal software systems), particularly where the intangibles in question are not unique and valuable intangibles. [...]"

- Not a recognized method under US Regulations



License Fees – 25% Rule

Hungary factory earns 15% before license fee

➤ **Appropriate license fee of 3.75 – 5%**

- In Germany the so called Knoppe formula is sometimes used by taxpayer/tax authority as an indicator -> third parties would use it to determine license fee.
- According to Knoppe formula, 25 - 33% of the profits before license payment must be paid as license fee to the licensor (Cf. Knoppe. Helmut: Die Besteuerung der Lizenz und Know-How-Verträge. 2nd edition, Cologne 1972. p. 97-102).
- Empirical evidence e.g.: Goldscheider. Robert et al.. 2002. Use of the 25 Percent Rule in Valuing IP. Journal of the Licensing Executives Society. Volume XXXVI. No. 4. p. 123-133.
- Generally not recognized by OECD:
“[...] Accordingly, a rule of thumb cannot be used to evidence that a price or apportionment of income is arm’s length, including in particular an apportionment of income between a licensor and a licensee of intangibles.” (Sec. 6.144 OECD Guidelines 2022)

License Fees – Residual TNMM

- Example: According to a benchmark survey, an external producer without intangible assets realizes arm's length margins of 3 – 8%
- Hungary factory earns 15% before license fee
- **Appropriate license fee of 7 – 12%**
- Sec. 6.133 OECD Guidelines 2022: “[...] in matters involving the transfer of intangibles or rights in intangibles it is important not to simply assume that all residual profit, after a limited return to those providing functions, should necessarily be allocated to the owner of intangibles. [...]” ⇒ **functional analysis is needed.**
- US-Regs: 1-482-4(a) US-Regs: Factual Preference of Residual CPM



License Fees – Results

| | | |
|------------------|------------|---|
| CUP Method | 2 - 5 % |  |
| Cost Plus Method | 4 - 5 % | |
| Knoppe Formula | 3.75 - 5 % | |
| Residual TNMM | 7 - 12 % | |

License Fee?



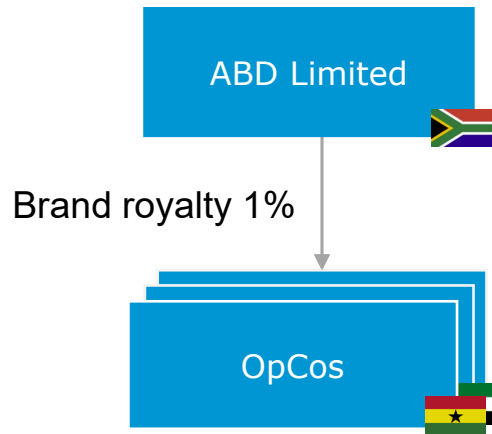
Polling Question

Which method would most probably be used in your country for license transactions?

1. CUP
2. Profit split
3. Valuation techniques
4. Residual TNMM
5. Cost plus (for IP owner)
6. Rules of thumb
7. Others



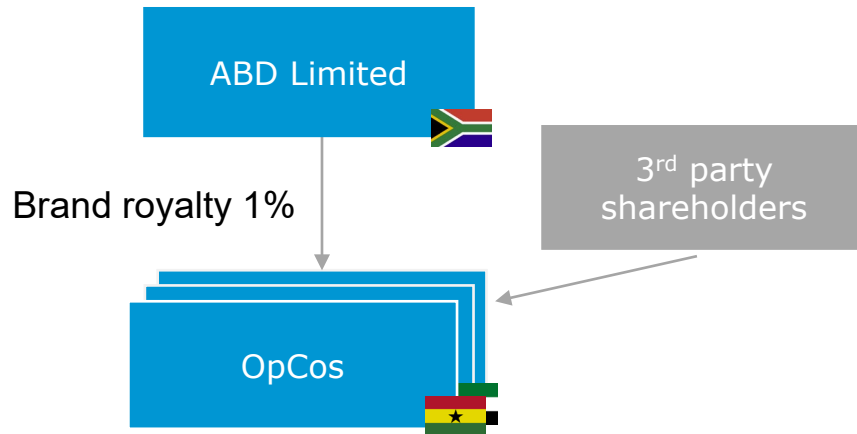
Application of CUP method



South African Tax Court, IT 14302
dated 14.2.24

- ABD Limited is a South African Telecom Group
- ABD charges 1% royalty for brand usage to its subsidiaries which are mobile phone operators
- Support of taxpayer:
 - Profit Split, Role of brand index, royalties vary between 0.7% and 1.3%, depending on financial performance, market share and brand health in each territory.
 - “Cyprus CUP” – License agreement with former subsidiary confirming 1%
- SARS: “WTP Method” (Profit Split):
 1. Step: determine profit attributable to brand value based on customer interviews
 2. Step: relative marketing spending (50:50)
 3. Step: determine a % of net sales (varying between 0.7% to 9.2%, avg. 2,7%)
- Tax Court dismissed SARS adjustment and refers to Cyprus CUP

Consideration of minority shareholders



- Further argument of taxpayer:
 - Tax rates have been higher abroad
 - Conflict of interest due to 3rd party shareholder

Do you agree with the argument that (minority) shareholders establish a natural conflict of interest and provides proof of arm's length behavior?

- Tax court agreed with the argument of low risk of tax evasion, no further discussion
- Many civil law legislation protect minorities and require arm's length principle
- Note 2.167 OECD guidelines suggest joint ventures as a reference point for profit splits
- German Federal Tax Court dated March 6, 2003
- China: Sec. 4.6.3.7 of UN TP Manual agrees with conflict of interest in case of JVs.

Section IV

Resale Price Method (R-)



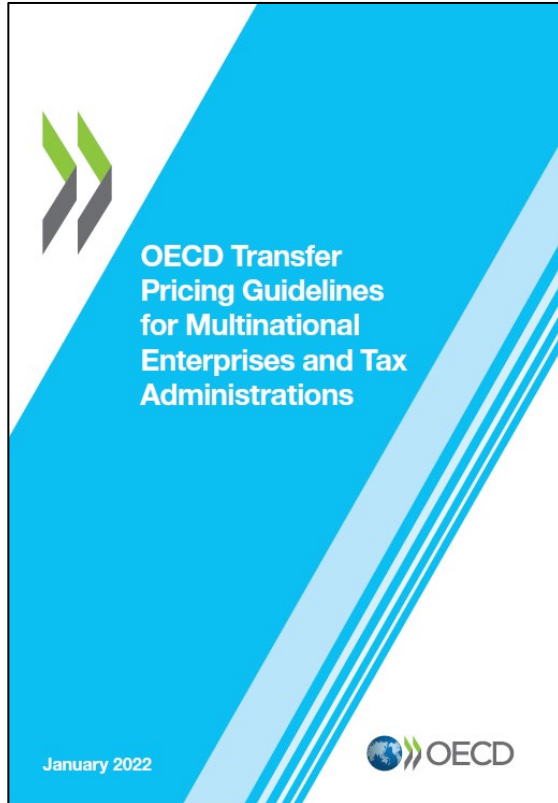
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Resale Price Method (R-) (1/4)

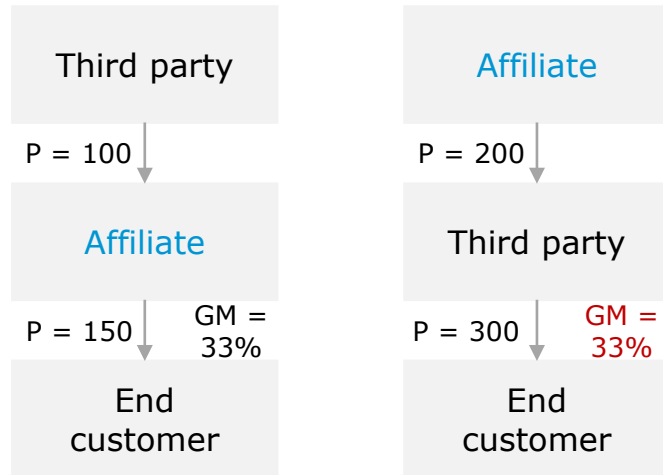


“The resale price method begins with the price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise. This price (the resale price) is then reduced by an **appropriate gross margin** on this price (the “resale price margin”) representing the amount out of which the reseller would seek to cover its selling and other operating expenses and, in the light of the functions performed (taking into account assets used and risks assumed), make an appropriate profit. What is left after subtracting the gross margin can be regarded, after adjustment for other costs associated with the purchase of the product (e.g. customs duties), as an arm’s length price for the original transfer of property between the associated enterprises.”

(Sec. 2.27 OECD Guidelines)

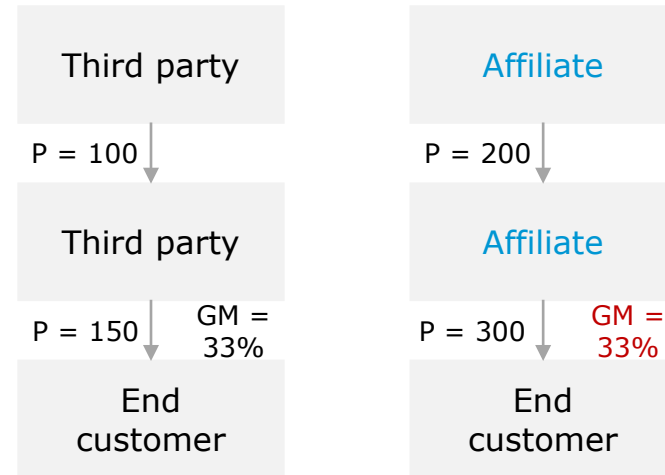
Resale Price Method (R-) (2/4)

INTERNAL R-



33% = "uncontrolled margin"

EXTERNAL R-



33% = "controlled margin"

Resale Price Method (R-) (3/4)



- Comparability between the controlled and the uncontrolled transaction is again of crucial importance.
- However, compared to the application of the CUP Method, similarity of products is less important
- That is “[...] because minor product differences are less likely to have as material an effect on profit margins as they do on price.”
([Sec. 2.29 OECD Guidelines](#))
- However, the R- Method heavily depends on comparability of functions performed (taking into account assets used and risks assumed).

Resale Price Method (R-) (4/4)

OTHER IMPORTANT ISSUES TO CONSIDER IN APPLYING R-



Relevant external data (gross margins) are often not available



Accounting treatment of gross margin



Differences in functions and risk often difficult to quantify

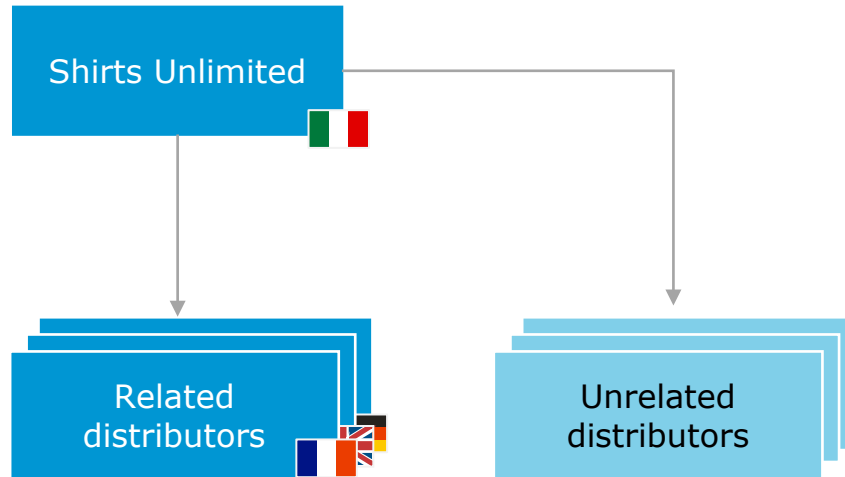


An appropriate resale price margin is easiest to determine where the reseller does not add substantially to the value of the product (e.g. marketing operations)



Exclusive selling rights will effect a reseller's gross margin

R- case study – shirts (1/2)



- Shirts Unlimited (SU), an Italian company, manufactures and sells sports shirts. Manufacturing takes place at the parent company's factory in Italy.
- Subsidiaries in Germany, France and the UK serve as distributors in their respective markets.
- Through a search of comparable distributors of sports shirts, it is determined that independent distributors earn gross margins of 25%.
- There is one major difference between the related party distributors and the independent distributors – the independent distributors also design the shirts, whereas the related party distributors do not.

Does it seem appropriate to use R – in this case and, if yes, do you have to make any adjustments to ensure comparability?

R- case study – shirts (2/2)

R- applicable?

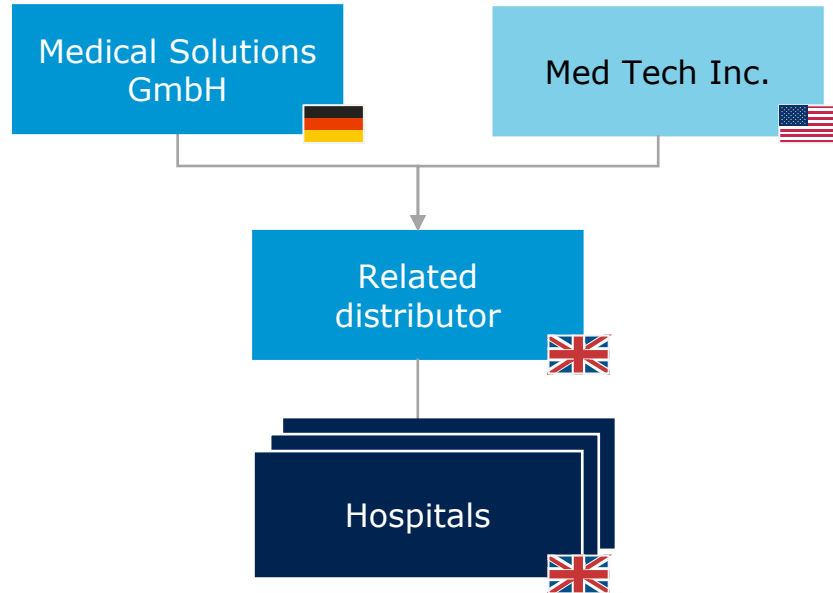


Adjustments needed?

EXPLANATION

- As a functional difference exists between related and unrelated distributors, it is usually not possible to establish comparability
- Rather, in most cases you will not even find external data on gross margins in the first place.

R- case study – medical equipment (1/2)



- Medical Solutions GmbH, a German producer of Medical Equipment, manufactures and sells different kinds of medical appliances. Manufacturing takes place at the parent company's factory in Germany.
- A subsidiary in the UK serves as a distributor.
- At the same time, the UK based related distributor purchases slightly different but not complementary medical appliances from an unrelated US based producer called Med Tech Inc.
- Both the products purchased from Medical Solutions GmbH and the ones purchased from Med Tech Inc. are resold to hospitals in the UK at a gross margin of some 40%.

Does it seem appropriate to use R- in this case?

R- case study – medical equipment (2/2)

R- applicable?



EXPLANATION

- Given the comparability in terms of functions and markets R- seems to be applicable.
- As long as differences in product characteristics are not material, they should not have an impact on the applicability of R- (as opposed to CUP method). The OECD states: “Under the resale price method and cost plus method, some differences in the characteristics of property or services are less likely to have a material effect on the gross profit margin or mark-up on costs ([Sec. 1.128 OECD Guidelines](#)).”
- As Gross Margins are rarely publicly available, R- can usually only be applied if internal comparables exist.



Section V

Cost Plus Method (C+)



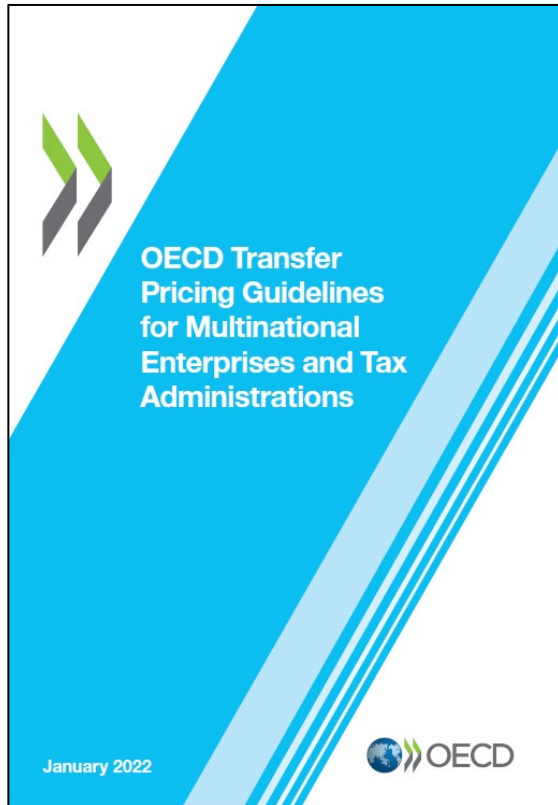
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Cost Plus Method (C+) (1/4)

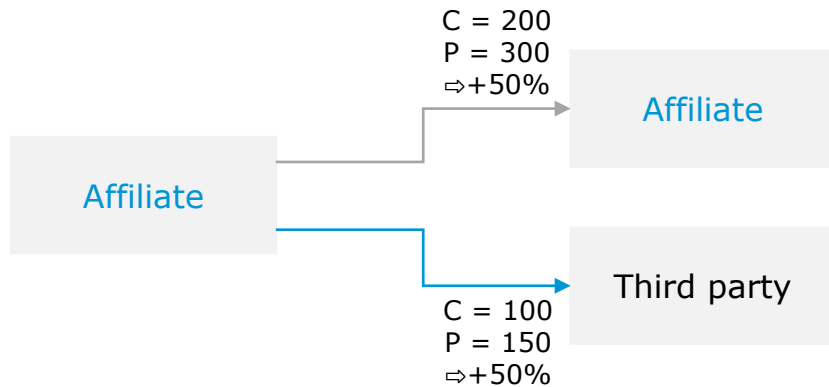


“The cost plus method begins with the costs incurred by the supplier of property (or services) in a controlled transaction for property transferred or services provided to an associated purchaser. An appropriate cost plus mark up is then added to this cost, to make an appropriate profit in light of the functions performed and the market conditions. What is arrived at after adding the cost plus mark up to the above costs may be regarded as an arm's length price of the original controlled transaction.”

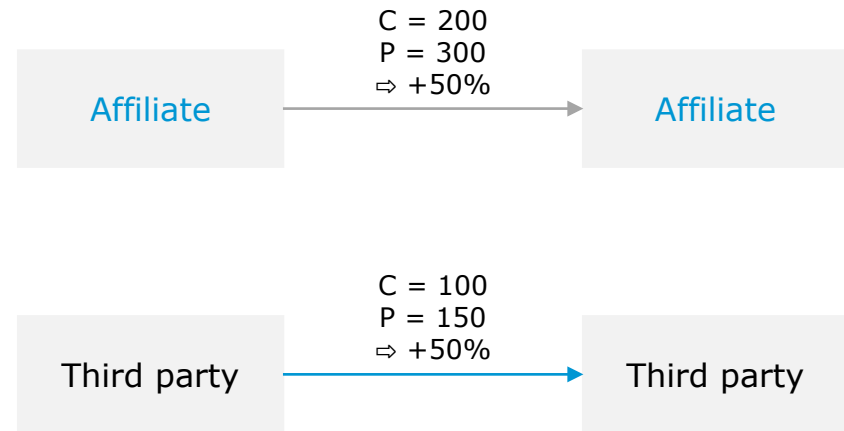
(Sec. 2.45 OECD Guidelines)

Cost Plus Method (C+) (2/4)

INTERNAL C+



EXTERNAL C+



- I/C Transaction
- Comparable Uncontrolled Transaction



Cost Plus Method (C+) (3/4)



It's important to determine which cost definition to be used

- Actual vs. Budgeted Standard costs
- Full costs or partial costs
- Accounting standards (e.g. IFRS, US-GAAP, local GAAP)

While acknowledging the diversity of accounting standards the OECD provides the following comments:

- Costs and expenses of an enterprise are generally divisible into three broad categories: direct costs of production (e.g. raw materials), indirect costs of production (e.g. repair department), and operating expenses of the enterprise as a whole (e.g. administrative expenses)
([Sec. 2.53 OECD Guidelines](#))
- The cost plus method will use mark ups computed after direct and indirect costs of production (Gross Profit/Production Costs), while a net profit method will use profits computed after operating expenses of the enterprise as well (EBIT/Full Costs).
([Sec. 2.54 OECD Guidelines](#))

Cost Plus Method (C+) (4/4)

FOUR MAJOR SOURCES OF INFORMATION TO DETERMINE ARM'S LENGTH MARK-UP

Financial data from
independent companies
(e.g. Amadeus)

Published industry
average data



OECD on low value
adding services
(Sec. 7.61 OECD-Guidelines)

EU-Joint Transfer
Pricing Forum
(„Report on Cost Contribution
Arrangements on Services not Creating
Intangible Property (IP)“
September 19, 2012)

C+ case study – glass (2/4)

C+ applicable?

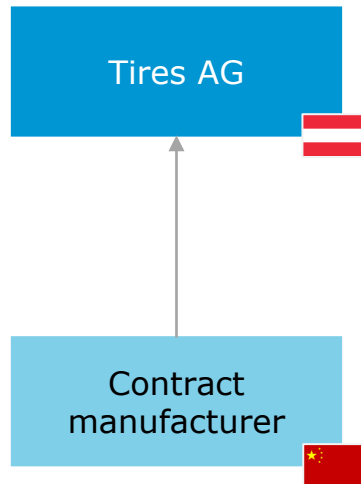


EXPLANATION

- Since the UK company uses no other contract manufacturer, a CUP does not exist from the UK standpoint.
- However, as the Irish affiliate is also performing manufacturing services for unrelated companies, comparable information will be available from these transactions.
- Specifically, the mark-up the Irish affiliate earns on services provided to unrelated companies can potentially be used to apply a cost plus method to the related party transaction (does not preclude the need for adjustments).



C+ case study – location specific advantages

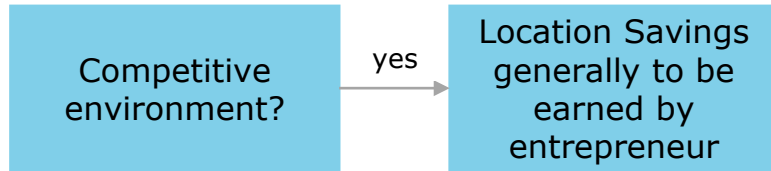


Who should benefit from location specific advantages?

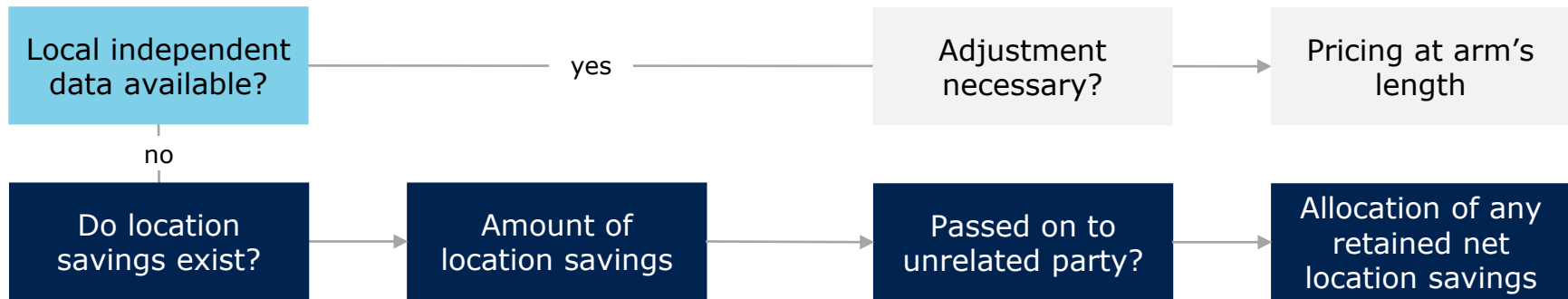
- Austrian Fiscal Authority assumes that location specific advantages are to be earned by the entrepreneur
- China claims that part of the benefits should be allocated to the contract manufacturer
- OECD: Split according to functions performed, risks assumed, and assets used
([Sec. 1.161 OECD Guidelines](#))

OECD view – location savings

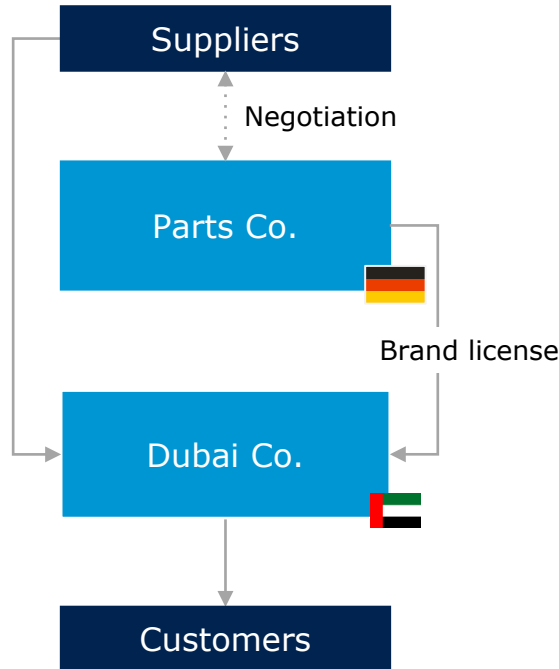
SEC. 9.128 OECD GUIDELINES



SEC. 1.161 ET SEQ. OECD GUIDELINES



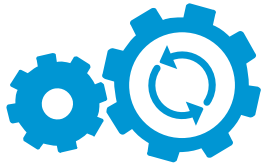
F&R case study – spare parts



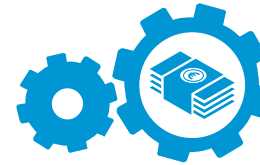
- Parts Co. sources low price car spare parts and develops supplier base. Products are then supplied by Suppliers to Distributors.
- Parts are sold via a network of national distributors. One of those national distributors, Dubai Co., employs 20 sales people, maintains a warehouse and has developed a customer base (network of independent whole sellers and retailers) in Africa.
- Products are sold using the brand “Professional Car Parts” which is owned by Parts Co. Dubai Co. pays a 2% royalty and C+ for procurement services of Parts Co.

Who in the value chain represents the entrepreneur, who is routine?

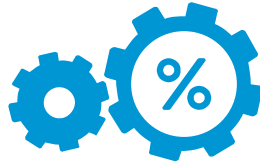
Summary



Traditional methods:
Are officially preferred



Mostly profit oriented
methods used in practise



CUP method often used
for interest royalties



Watch for comparability
differences

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Day 2, Session 2

Practical Application of the Transfer Pricing Methods (First Part)



Axel Eigelshoven

Transfer Pricing Partner

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Advanced Transfer Pricing Course (General Topics), April 15-19, 2024

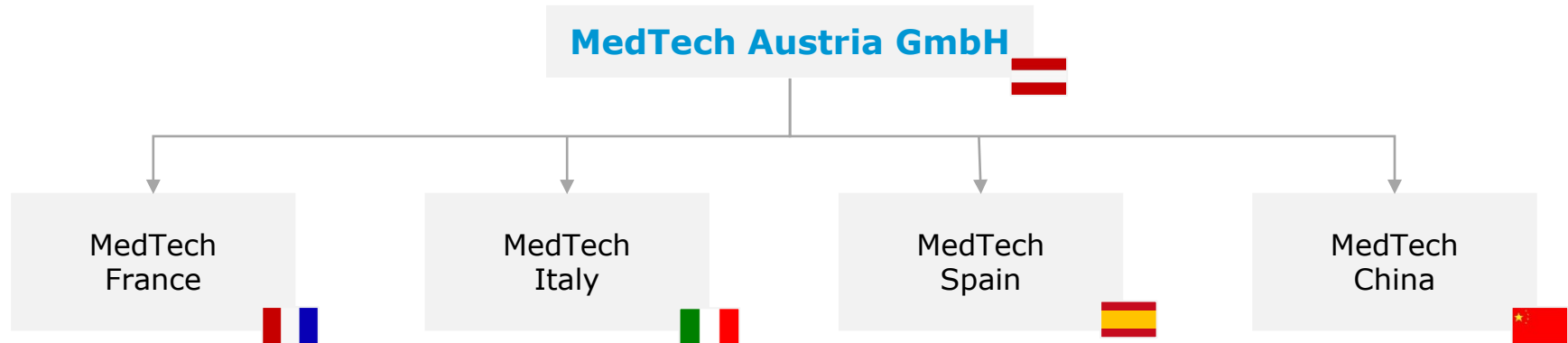
Institute for Austrian and International Tax Law . www.wu.ac.at/taxlaw



Case study – MedTech Austria GmbH (1/5)

MedTech Austria GmbH

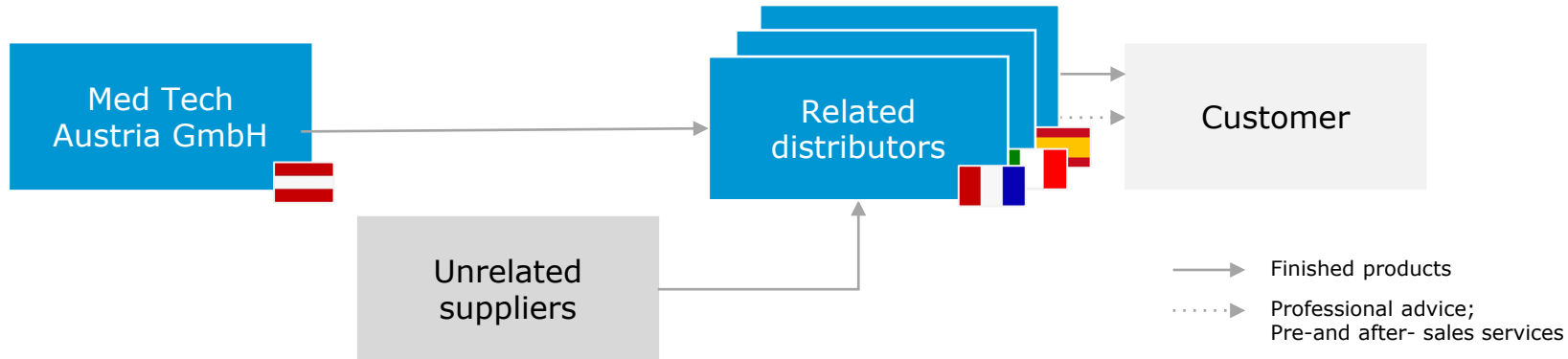
- Austrian producer of Medical Equipment
- Manufactures and sells different kinds of medical appliances
- Controls the entire production process and all relevant IP
- Develops corporate strategy and performs other HQ functions
- Customers are its subsidiaries in FR, IT, ES and CN as well as some unrelated distributors



Case study – MedTech Austria GmbH (2/5)

MedTech FR, IT, ES

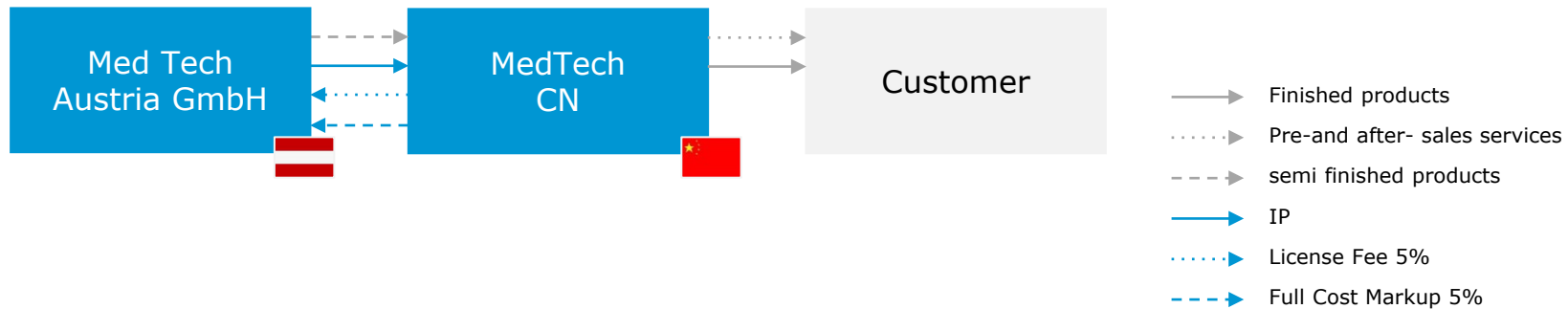
- Subsidiaries located in France, Italy and Spain, which serve as distributors of MedTech Austria's products in their local market.
- They have a very well educated sales team, which has a strong academic background (i.e. doctors and scientists with university degrees), due to the high complexity of the medical appliances.
- They provide professional advice as well as other pre- and after-sales services.
- Apart from the products purchased from its parent company, they also resell similar though not complementary products from three unrelated suppliers.



Case study – MedTech Austria GmbH (3/5)

MedTech CN

- Subsidiary located in China that manufactures and sells medical appliances for the local market.
- It makes use of MedTech Austria's production technology which is licensed from the parent company at a license rate of 5% of turnover.
- The company was established in 2018. Main success factors have been the growing Chinese market, the advanced technology of MedTech's products and the technical expertise of MedTech CN's salesforce.
- MedTech CN sources semi-finished products from MedTech Austria for which it compensates its parent company with full cost plus 5% mark-up.



Case study – MedTech Austria GmbH (4/5)

TAX AUDIT REGARDING FR, IT, ES

ARGUMENTS IN FAVOR OF CLIENT

- FR, IT and ES serve as value added distributors that employ very well educated sales team that justify higher margins.
- MedTech Austria could provide evidence that it actually charges higher prices to its subsidiaries than to its unrelated customers.
- MedTech Austria referred to a comparison of gross margins that its subsidiaries earned from the resale of products sourced from MedTech Austria compared to the margins earned through the resale of products purchased from unrelated suppliers that leads to similar results □ e.g. Italy with a gross profit of 33.3% of sales (Ext. 34.2%) 2019.
- Furthermore a Pan-European benchmarking study suggests that net margins earned by the subsidiaries are similar to the ones typically earned by independent companies operating in similar markets, performing similar functions and assuming similar risks.

ARGUMENTS IN FAVOR OF TAX AUTHORITY

- As entrepreneur, the Austrian parent develops new strategies, provides relevant IP and renders R&D services.
- R&D/sales ratio is significant (>20% of sales), significant profitability should be expected.
- The distribution entities perform more simple functions and should earn – on average – less than the more complex entrepreneur.
- The ongoing losses of the Austrian parent company and the high margins abroad provides evidence that the group's transfer prices are not arm's length.
- The comparison of the gross margins is based on significantly differing transaction volumes.
- In addition, there may be differences in quality, market level (e.g. purchases from importers vs. producers), geographical market.
- The benchmarking approach may not be applicable for non-routine entities.



Case study – MedTech Austria GmbH (5/5)

TAX AUDIT REGARDING CN

ARGUMENTS IN FAVOR OF CLIENT

- Serves as license manufacturer/non-routine entity
- Employs very well educated engineering and sales team
- MedTech prepared benchmarking studies both for the license rate (royalty benchmark) and for the manufacturing activity of semi-finished products performed by the parent company that show the arm's length character.
- High margins earned may also be justified with the strongly growing Chinese market and local market specifics.

ARGUMENTS IN FAVOR OF TAX AUTHORITY

- High profits in China (average EBIT margin close to 14%) is mainly based on advanced technology developed by MedTech Austria (s. previous slide regarding high R&D efforts).
- Since the Chinese entity was established in 2018, no strong market penetration/knowledge, customer base etc. may explain the high profits.
- The benchmarked license agreements are incomparable (intangibles not comparable).
- The excessive profits of MedTech CN compared to losses of MedTech Austria clearly prove that the current license rate are not in line with the arm's length principle.



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