



## Day 2, Session 2

# Workshop: Practical Application of the Transfer Pricing Methods (First Part)

### Case Study: MedTech Austria G.m.b.H.

**MedTech Austria G.m.b.H.**, an Austrian producer of Medical Equipment, manufactures and sells different kinds of medical appliances. Manufacturing takes place at the parent company's factory in Austria. MedTech Austria controls the entire production process and all relevant IP needed in the production process. Since many years the group is heavily investing in a new product line which shall boost the turnover of the group. Besides, development of the corporate strategy and other headquarter functions are based in Austria. Customers of MedTech Austria are its subsidiaries in France, Italy, and Spain but also some unrelated distributors of medical appliances.

**MedTech FR, MedTech IT, and MedTech ES** are subsidiaries located in France, Italy, and Spain, respectively, which serve as distributors of MedTech Austria's products in their local market. Due to the complexity of the products the subsidiaries employ a well educated sales team which has a strong academic background, i.e. doctors and scientists with university degrees. They also provide professional advice as well as other pre- and after-sales services to their customers. Apart from the products purchased from its parent company, they also resell similar products though not complementary products from three unrelated suppliers.

**MedTech CN** is a subsidiary of MedTech Austria 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 for medical appliances, 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.

Last week, MedTech Austria was confronted with a tax audit which, as it turned out, put a particular focus on the group's transfer pricing. From the viewpoint of the tax auditor, the ongoing losses of the Austrian parent company and the high margins abroad provides clear evidence that the group's transfer prices are not arm's length.

Regarding the three related distributors in France, Italy and Spain, MedTech Austria could provide evidence that it actually charges higher prices to its subsidiaries than to its unrelated customers. However, the tax auditor questioned the comparability of the transactions due to differences in market levels and markets. MedTech Austria referred to a comparison of gross margins that its subsidiaries earned from the resale of products sourced from MedTech Austria as compared to the margins earned through the resale of products purchased from unrelated suppliers. Lastly, the tax advisor of MedTec Austria put forward a Pan-European benchmarking study suggesting 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.

Regarding the Chinese license manufacturer, MedTech Austria's tax advisor prepared benchmarking studies both for the license rate (royalty benchmark) and for the manufacturing activity of semi-finished products performed by the parent company. However, the tax auditors especially raised doubts about the comparability of the benchmarked license agreements. According to the auditors, the excessive profits of MedTech CN clearly prove that the current license rate are not in line with the arm's length principle.

Below you find excerpts from the unconsolidated P&Ls of the group entities for the period 2019-2022:

<b>MedTech Austria</b>	<b>2019</b>	<b>2020</b>	<b>2021</b>	<b>2022</b>	<b>Average</b>
Sales	126,500	129,000	145,321	152,369	138,298
COGS	89,532	93,652	98,632	106,532	97,087
Gross Profit	36,968	35,348	46,689	45,837	41,211
<i>in %</i>	29.2%	27.4%	32.1%	30.1%	29.8%
SG&A	10,320	12,531	14,652	15,632	13,284
Depreciation	2,321	2,653	2,463	2,895	2,583
Research Expenses	25,653	26,986	28,965	30,263	27,967
EBIT	-1,326	-6,822	609	-2,953	-2,623
<i>in %</i>	-1.0%	-5.3%	0.4%	-1.9%	-1.9%

<b>Subsidiaries MedTech</b>	<b>2019</b>	<b>2020</b>	<b>2021</b>	<b>2022</b>	<b>Average</b>
<b><u>France</u></b>					
Sales	26,300	27,600	28,200	30,500	28,150
COGS	18,200	19,500	19,502	19,800	19,251
Gross Profit	8,100	8,100	8,698	10,700	8,900
<i>in %</i>	30.8%	29.3%	30.8%	35.1%	31.6%
SG&A	5,600	5,700	5,750	6,231	5,820
EBIT	2,500	2,400	2,948	4,469	3,079
<i>in %</i>	9.5%	8.7%	10.5%	14.7%	10.9%

<b>Italy</b>					
Sales	18,200	18,500	19,600	19,400	18,925
COGS	12,100	12,650	13,250	13,500	12,875
Gross Profit	6,100	5,850	6,350	5,900	6,050
<i>in %</i>	33.5%	31.6%	32.4%	30.4%	32.0%
SG&A	4,100	4,120	4,160	4,290	4,168
EBIT	2,000	1,730	2,190	1,610	1,883
<i>in %</i>	11.0%	9.4%	11.2%	8.3%	9.9%
<b>Spain</b>					
Sales	38,320	42,510	45,300	46,981	43,278
COGS	26,540	28,641	30,657	31,250	29,272
Gross Profit	11,780	13,869	14,643	15,731	14,006
<i>in %</i>	30.7%	32.6%	32.3%	33.5%	32.4%
SG&A	7,895	8,978	9,125	10,960	9,240
EBIT	3,885	4,891	5,518	4,771	4,766
<i>in %</i>	10.1%	11.5%	12.2%	10.2%	11.0%
<b>China</b>					
Sales	23,200	38,621	45,632	63,254	42,677
COGS	18,654	28,965	31,230	42,653	30,376
Gross Profit	4,546	9,656	14,402	20,601	12,301
<i>in %</i>	19.6%	25.0%	31.6%	32.6%	28.8%
SG&A	3,956	5,123	8,235	8,345	6,415
EBIT	590	4,533	6,167	12,256	5,887
<i>in %</i>	2.5%	11.7%	13.5%	19.4%	13.8%

Moreover, the following table shows gross profits of the Italian subsidiary split into those earned through resale of internally sourced and externally sourced products. Italy serves as an example, the figures for the other related distributors (France and Spain) are similar:

	2019	2019	2020	2020	2021	2021	2022	2022	Aver- age	Aver- age
	Int.	Ext.	Int.	Ext.	Int.	Ext.	Int.	Ext	Int.	Ext.
<b>Italy</b>										
Sales	14,100	4,100	14,400	4,100	15,400	4,200	15,500	3,900	14,850	4,075
COGS	9,400	2,700	9,800	2,850	10,400	2,850	10,800	2,700	10,100	2,775
Gross Profit	4,700	1,400	4,600	1,250	5,000	1,350	4,700	1,200	4,750	1,300
in %	33.3%	34.2%	31.9%	30.5%	32.5%	32.1%	30.3%	30.8%	32.0%	31.9%

Lastly, you are provided with the interquartile range of the before mentioned benchmarking studies:

<b>Pan-European Distribution</b>					
PLI	Minimum	Lower Quartile	Median	Upper Quartile	Maximum
ROS	-1.0%	4.0%	8.6%	11.8%	15.3%

<b>Royalty Benchmark</b>					
PLI	Minimum	Lower Quartile	Median	Upper Quartile	Maximum
License rate	0.5%	3.0%	4.0%	7.0%	11.3%

<b>Manufacturing of semi-finished products</b>					
PLI	Minimum	Lower Quartile	Median	Upper Quartile	Maximum
FCMU	-0.5%	2.0%	4.4%	6.5%	9.1%

### **Your tasks:**

There are meetings scheduled between the CFO and tax advisor of the company and Austrian's specialized transfer pricing audit division. Due to the complexity of the case the Austrian tax authorities have set up two meetings. One meeting only deals with the distribution margins and the second meeting will deal with the license manufacturer in China. Due to the controversial nature, the tax authorities and the company have agreed to meet at a neutral place, the Vienna University of Economics and Business.

Please prepare for the meeting assuming that you are a) the company representative/tax advisor or b) the tax authorities.