Institute for Austrian and International Tax Law Vienna
WU Transfer Pricing Center

WIRTSCHAFTS UNIVERSITÄT WIEN VIENNA UNIVERSITY OF ECONOMICS AND BUSINESS

## Day 2, Session 4

# Workshop: Transactional Profit Methods

## Case Study – Telecommunication Company

### Facts

Company A in Austria is one of many subsidiaries of Company B, headquartered in Germany. Company A is divided into two divisions –Consumer Division (B2C market) and the Enterprise Division (B2B market). The B2B segment generates an average revenue of 7.7 trillion euros across a three-year period FYE 2016-2018, before intra-group eliminations.

Since FYE 2017, Company A and all other subsidiaries switched from a (routine) service provider under a central entrepreneur model to a highly integrated services provider to third party customers. Company B, the central entrepreneur, incurred historical losses before the changes in business model.

Owing to changes, Group AB initiated a Telecom Services Agreement (TSA) involving all the subsidiaries for a globally integrated, seamless provision of telecom services across various countries for third party B2B customers. Each legal entity was designated to have capabilities to deliver customer services independently with key risk-taking functions.

To deliver integrated network solutions to its customers, all subsidiaries own tangible network assets located at various points of presence around the world and at client premises, such as switches, routers and transmission equipment. Company A also owns the leasing agreements based on which the transmissions capacities are leased from third party capacity providers. The overall business failure risks are borne jointly by the group of affiliates.

Under the pre-conversion scenario, Company A adopts the TNMM as the most appropriate method, with Company A as tested party, with a standard remuneration of 8% (*appropriate PLI*). Comparable companies performing telecom business support services were identified.

Under the post-conversion scenario, Company A adopts the Residual Profit Split Method (RPSM) as the most appropriate TP method considering its globally integrated activities.

| | Pre-conversion | | Post-conversion | |
|---|---|---|---|---|
| **Function** | **Co A (AU)** | **Co B (GER)** | **Co A (AU)** | **Co B (GER)** |
| Trade IP | No | Yes | +DEMPE? | Yes |
| Marketing IP | No | Yes | +DEMPE? | Yes |
| Sales and marketing | Limited | Yes | Yes | Yes |
| Field operations | Limited | Yes | Yes | Yes |
| Network Infrastructure | Limited | Yes | Yes | Yes |
| Performance risk | Limited | Yes | Yes | Yes |
| Market risk | No | Yes | Yes | Yes |
| Technology risk | No | Yes | Yes | Yes |
| FAR | Low-value services | Entrepreneur | High-value service | Entrepreneur |
| TP Method | TNMM | | PSM | |

The (contractually) agreed steps in applying the RPSM as per the TSA contract was described in the legal contract, as follows:

- **Step A** – Aggregated Profits: Company B (HQ) calculates an aggregate of operating margins of all parties to the TSA
- **Step B** – Reduction of Routine Profits: Standardised 8 % "uplift" would be applied to each party and with the employee costs as the base, and the individual "uplifts" are aggregated at the level of Company B.
- **Step C** – Allocation of Residual Profits:
    - (C 1) Aggregate Allocable Amount = Amt. Step A – Amt. Step B; The resulting Allocable Amount is further divided into three

"functional parts" - Network Operations (1/3rd), Sales and Marketing Operations (1/3rd), and Field Operations – (1/3rd).

- (C 2) Functional Parts = Amounts derived under the three separate "functional part" is apportioned among the parties to the TSA based on their respective *contributions* to each functional part.

- Contribution value is determined based on the following cost drivers:

  - Network infrastructure – Network staff cost + Network investment amortisation

  - Sales and marketing – Sales and marketing staff cost

  - Field operations – Field operations staff cost

**Step D** – Operating Margin Entitlement:

- Routine Return (Uplift) + (Allocable Amt. X Operating Margin%)

  *Where Operating Margin% for each party = C1 ÷ C2 (see Step C)*

- TSA consists of approx. 90 legal entities with approx. 4000 possible unique bilateral transactions between the various group companies.

- Profit agreed under TSA contract is based on budgeted profits and not actual profits

- AB Group was faced with various tax audits worldwide pursuant to its TP model and choice of TP method. While PSM was accepted by tax authorities in U.K. and India, TNMM has been identified as the most appropriate method in Australia and France.

- Billing Model - Invoicing of the services can take place either centralized or decentralized according to the customers' choice

- Company A experienced losses since the change in business model and corresponding TP method from TNMM to PSM

## Questions:

Austrian Tax Auditors initiate transfer pricing audit on Company A for FY 2016-18.

1. Considering your role as a tax auditor assessing the facts, please answer the following with regard to the two separate scenarios – pre and post conversion:

   a. What could be the initial risk factors/triggers for the tax administration to challenge Company A on its facts/legal merits?

   b. Are the transactions accurately delineated and recognised under both pre- and post-conversion scenarios?

2. Selection of the most appropriate TP method:

   **a. Pre-conversion**

   - TNMM adopted by Company A is the most appropriate method?
   - What could be the criteria and rationale for selection of TNMM?
   - Comment on the selection of tested party, and selection of PLI

   **b. Post-conversion**

   - Is PSM the most appropriate TP method or could TNMM be more appropriate? - Criteria and rationale

3. Application of the most appropriate TP method

   **a. Post-conversion**

   - Is the aggregation of profits and use of 8% "uplift" appropriate?
   - If PSM were to be accepted, discuss the specific problems in the design of the mechanism as per the TPA contract:
     - Is the weighting of 1/3rd for the three functional parts in Step C1 appropriate?
     - "Contributions" under step C2 determined appropriately?

- Does AB Group's methodology and Company A's implementation resemble revenue sharing model/ formulary apportionment (FA)? What is the difference between FA and PSM?

- If TNMM were to be the most appropriate method for the post-conversion scenario, discuss criteria and rationale

Extending the facts discussed, Company A wishes to provide additional analysis to substantiate its TP position, following intense scrutiny by Austrian tax auditors. As a representative of Company A (tax advisor/in-house) comment on the steps that could be taken:

4. What are the steps that could be taken to refine the application of PSM in the above case?

   - What is the role of value chain analysis and process mapping in the above situation? Discuss with regard to specific criteria such as DEMPE functions and RACI Model for contribution analysis.

   - What are the risks deviations between budgeted PSM (*ex-ante*) and actual PSM outcome *(ex-post)*? How to mitigate them?

5. Does the fact that PSM was accepted in few other countries automatically help the case of Company A in Austria?