Workshop Solutions: Practical Application of Transfer Pricing Risk Management and Compliance

Dr. Sven Bremer, Head of Group Transfer Pricing

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Case Study 1 – M-Group

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Potential Issues

1) Substance of license agreements: German tax auditors may argue that the purported license manufacturers based on the functions performed are actually only contract manufacturers (especially since M-AG negotiates customer contracts); this is not changed by the recharge of the relevant costs. Therefore, they may limit the remuneration of the manufacturers to a typical cost plus mark-up (such as cost plus 5%). Side note: the negative OPM in France is not an issue from a German perspective; however, if the French tax authorities share the view that M France SAS should be considered a contract manufacturer instead of a license manufacturer then they would probably argue that M France SAS should not make losses as a limited risk entity.
2) Alternatively: German tax auditors may argue that the royalty applied to the Chinese license manufacture is significantly too low, since the profit in China is too high; From a tax auditor point of view, taxpayers, under the arm's length principle, should be required to reflect differences in profitability in the license rates.

Qualification of the manufacturers as license manufacturers even though they do not negotiate customer contracts:
Is the manufacturer responsible for performing other non-routine functions and /or bears and controls other non-routine risks?

Functions	Risks

• Production
• Who is responsible for improvements in efficiency?
• Management of complex processes in terms of
    • Just in time (JIT)
    • Just in Sequence (JIS)
• Procurement?
	• Volume risks
	• Guarantee / liability risks
	• Foreign exchange risk
	• Procurement risks / risk of price changes in procured risk
	
	→ Losses are often the result of risks

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Can tax authorities change the qualification of the manufacturer as made by the taxpayer and implemented in the existing contracts?

Sec. 1.142 f. OECD TP Guidelines
1.142 […] The transaction as accurately delineated may be disregarded, and if appropriate, replaced by an alternative transaction, where the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner in comparable circumstances, thereby preventing determination of a price that would be acceptable to both of the parties taking into account their respective perspectives and the options realistically available to each of them at the time of entering into the transaction. […] 1.143 The key question in the analysis is whether the actual transaction possesses the commercial rationality of arrangements that would be agreed between unrelated parties under comparable economic circumstances, not whether the same transaction can be observed between independent parties. […]

Argumentation to defend uniform royalty rate in tax audit

1) CUP
   - Royalty rate is determined based on market rates.
   - CUP analysis shows that royalty rates in a range between 1-4% are at arm's length.
2) Cost plus method
   - Validation via cost plus method based on historical R&D investment of M-AG.
3) Knoppe-Formula (generally not accepted anymore)
   - Rule of thumb: 25%–33% of the pre-royalty profit.

Taxpayer is free to choose between TP methods available
- If tax auditor rejects the method selected by the taxpayer, he bears the burden of proof.
- Different royalty rate of one exactly the same intangible at arm's length?

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Case Study 2 – Toys4Kids
Part 1

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Task 1

- Demonstration that lower margin of distributing subsidiary is not the result of high intercompany transfer prices paid by the distributor for products purchased from the French headquarter.
- Demonstration of results being inside the IQR with normal level of expenses. Determine and quantify the impact of extraordinary expenses.

Task 2

- Extraordinary expenses that the distributing company had to incur.
- One-time costs (e.g. marketing expenses for product positioning, introductions in the market)

Task 3

Impact of extraordinary expenses on the results of the distributing company needs to be quantified.

The proper way of preparing a quantitative justification will depend on the availability of data to perform the analysis. The more information available, the more solid the justification will be, thus, the less risk that the British tax authority will perform a TP adjustment.

According to the income statements of T4K plc., the SG&A expenses for FY2023 amounted to 18T€.

In order to calculate the extraordinary (not regular yearly expenses) portion of the marketing expenses, the first step is to determine the segmentation between the amount of marketing expenses allocated to regular products and the amount allocated to new products.

Marketing expenses for regular products	4T€
Marketing expenses for new product	4T€
Total marketing expenses	8T€

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Once the segmentation is done, the second step is to determine:

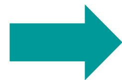
- which portion of the (marketing) expenses for new products was incurred in order to introduce these new products into the market (expense which will not be incurred again once the product has been positioned in the market) and
- which portion was incurred as ordinary (marketing) expenses for new products (expenses that will continue to be incurred once the product is positioned in the market)

Only the one-time costs will be considered as an extraordinary expense.

Extraordinary marketing expenses for new products	3T€
Ordinary marketing expenses for new products	1T€
Total marketing expenses for new products	4T€

Once the portion corresponding to extraordinary expenses has been determined, it shall be removed from the calculation of T4K plc's operating margin and re-tested against the arm's length IQR.

Income Statement T4K plc	Recalc.
Revenue	100T€
COGS	-80T€
SG&A	-15T€
Operating Profit	5T€
OM	5.0%



The recalculated Operating Margin of T4K plc is within the arm's length range which demonstrated that the reason for the FY2023 original margin being outside of the IQ range is not related to transfer pricing but to an extraordinary business event.

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In all cases

- Settlement: First option for the French HQ would be to accept TP adjustment by the French tax authority. Thus, the case will be closed (advantage would be to have certainty). This is the easiest solution resulting in low defense costs and potential reduction of penalties. Nevertheless, this option will most likely result in double taxation and is, therefore, only feasible for small amounts. From a practical point of view sometimes tax authorities are more willing to reduce their adjustments in case no further measures (MAP/litigation) are pursued.
- Unilateral measures: No settlement but the French HQ would file an appeal or litigate. Depending on the jurisdiction, this could prove very time-consuming and would result in high controversy costs. Since the dispute is based on local law only, there is no guaranteed resolution for double taxation. This option is only feasible for certain cases.

US: A double taxation treaty between US and France including an arbitration clause (Article 26) exists. Therefore, the French entity in coordination with the US subsidiary can apply for a MAP. In accordance with the outcome of the MAP a bilateral APA can be applied for in order to agree on a future price setting for a defined period of years with both competent authorities.

Within EU: For cases involving European countries, the French entity can apply for MAP/APA according to the EU Arbitration Convention or according to DTTs.

Uruguay: There currently is no DTT between Uruguay and France, therefore, only unilateral APA or unilateral settlement.

Extra question (for debate): What are the challenges of these measures, in practice, for all actors involved (i.e., taxpayers and tax administrations)?

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Case Study 3 – Widget Group

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Task 1

As the entrepreneur, WidgetCo is entitled to the group's residual profits. It must also ensure that limited-risk entities in the group receive a consistent arm's length remuneration. As the IP licensor, it is important to ensure that the 3% royalty charged to LiMa is arm's length and defendable under audit. For example:

- a development, enhancement, maintenance, protection, and exploitation (DEMPE) analysis should be undertaken to value the IP and to track historical and future development costs and the benefit to licensees to determine an arm's length royalty rate;
- the royalty rate can be supported using comparable uncontrolled transaction (CUT) or comparable uncontrolled price (CUP) analysis (preferred) or other valuation-based methods;
- the characterization, tax deductibility and withholding tax treatment of the royalty payment in country B should be ascertained; and
- the licensing agreement should clearly outline the scope of the license, the royalty rate and the conduct of both the licensor and licensee, specifically the functions performed, and the risks borne, respectively.

For central functions, only beneficial services can be charged out. For instance:

- all direct, indirect, pass-through and stewardship costs should be identified. Duplicative services, if any, should also be identified, and costs for such services should be excluded;
- a benefit test should be performed to ensure service recipients are allocated costs which are commensurate with benefits received;
- indirect costs should be allocated using appropriate allocation keys;
- WidgetCo should earn an adequate arm's length remuneration (mark-up) for the provision of such services;
- low value-adding services (LVAS) should be identified (chapter 7, section D of the OECD Guidelines) and non-LVAS should be marked-up appropriately; and
- WidgetCo should document its cost allocation methodology for audit defense purposes.

The group should generally remain compliant with its global transfer pricing obligations (e.g. documentation: Local File, Master File, and CbCR, if applicable).

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Task 2 a)
WidgetCo's external debt provides an external comparable uncontrolled price (CUP) which can be used as a basis to price the intra-group loan to LiMa.

Task 2 b)
From the perspective of the borrower, LiMa in this case, several important factors need to be considered for pricing the intra-group loan. These include:

- calculating a standalone credit rating – this can be done using industry-specific credit rating methodologies published by agencies such as Moody's, Fitch or S&P;
- appropriately notching the credit rating depending on the level of implicit support and/or passive association;
- depending on the fact pattern and data availability, an arm's length interest rate can be calculated using a CUP (i.e. other comparable loans, bonds and other yield curves or other methods).
- where necessary, comparable data should be adjusted to match the terms of the intra-group loan (e.g. tenor, origination, maturity, sovereign risk, etc.);
- a debt serviceability analysis may be performed vs. industry comparables; and
- all of the above steps should be properly documented in a report for audit defense purposes.

Task 2 c)
LiMa pays a royalty of 3% to WidgetCo for access to technology, process, know-how and the right to manufacture and sell widgets. In doing so, it could bear certain risks as they relate to raw materials, inventory and procurement as well as other market and operational risks. LiMa should earn an arm's length return for its license manufacturing activities (typically a net cost-plus). However, it is possible for a license manufacturer to bear a non-operating loss post payment of royalties and interest. The local transfer pricing documentation for LiMa should include wording to support/justify the loss position.

Task 2 d)
Tax authorities in Country B could challenge the royalty payment to WidgetCo and disallow a deduction for tax purposes. As noted above, the analysis to support the arm's length nature of the royalty should therefore be robust.

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WU Transfer Pricing Center

Contact

Dr. Sven Bremer

Siemens AG
Werner-von-Siemens-Straße 1
80333 Munich
Germany

T +49 (89) 780526142
sven.bremer@siemens.com
www.siemens.com

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