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Transfer Pricing

Transfer Pricing Alert

Alert 3 of the 'Transfer Pricing Alert' series

Multinational company (MNC) groups typically tend to operate in several jurisdictions with a view to make their products and services available to their customers based in several locations. Often, the overall act of delivering its products or services to its end customers is spread across a number of legal entities located in different countries to ensure delivery of products or services to customers in the most efficient manner.

The rationale for spreading the operations across multiple locations are linked to business reasons and could, inter-alia, include:

- sourcing of raw materials available in a particular region
- reduced cost of production
- availability of skilled work force
- efficient delivery of products in customer location
- Intellectual Property (IP) protection laws etc.

On this account often, a group's supply chain is designed based on business needs and commercial rationale. However, the profitability of a business does eventually get impacted by how that supply chain is structured to minimise trade and tax expenses. To this effect, MNC groups use the differential tax rates available in different countries to structure the inter-company pricing within their supply chains to optimise their tax costs.

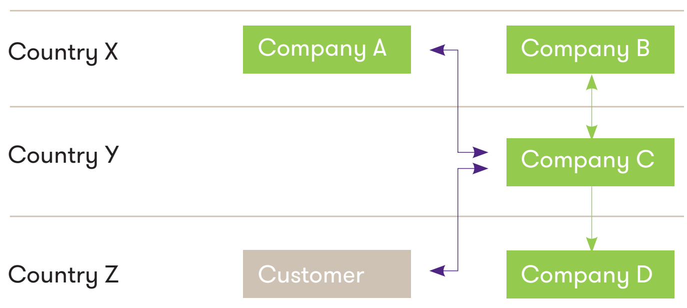
Tax implications

Whilst MNCs try to align their pricing arrangements to optimise their tax costs, they are impacted by significant changes in the international tax environment across the world. Greater transparency and equity within the taxation system around the world are being brought about by the formulation of Base Erosion Profit Shifting (BEPS).

With the essential focus of the BEPS action plans on aligning profits from related party transactions with commercial realities and economic substance, one can expect the Governments in various countries to challenge and disregard aggressive pricing models adopted, designed to achieve an optimised effective tax rate. The three-tier transfer pricing documentation system adopted by various countries, especially the country by country report and the master file, would enable the identification of such aggressive pricing arrangements amongst the various legal entities of an MNC group.

Rajesh Narasimhan, Partner - Taxation

Structure



Operations

Company A - contract R&D for company C

- Conduct Research and Development (R&D)
- Team of 50 scientists including head of group R&D
- Conduct end to end R&D towards groups IP legally owned by company C

Company B - contract manufacturer to company C

- Manufacture group's products on an end to end basis
- Takes all decisions regarding manufacture of group's products
- Drop ships products to customer of company C

Company C - entrepreneur

- Principal entity within the group
- Legal owner of IP
- Invoicing sales to customers

Company D - marketing for company C

- Marketing products to customers in its country
- Solicitation includes negotiation with customers

Pricing

Company	Tax rate	Pricing arrangement
A	25%	Cost plus 20%
B	25%	Cost plus 10%
C	5%	Residual profits / losses
D	20%	Cost plus 7%

Potential challenges

The inter-company pricing arrangement within the supply chain of the group are therefore designed to ensure that all super profits emanating from the sale of products to customers reside within company C. However, it is seen here that company C's people functions comprise mainly of invoicing to customers. However, on closer observation, this structure could be challenged in various countries due to lack of substance within company C. Some of the challenges that could arise in various countries are given below.

Country X

The contract R&D characterisation of company A could be challenged as the head and brains vis-à-vis the research and development activities are based in company A. All major R&D decisions, right from origination of research to its implementation is taken by company A. It is likely that the tax authorities of country X could re-characterise company A as the economic owner of the group IP and attribute royalty income from sale of goods to company A.

The tax authority might challenge this cost plus 10 per cent pricing arrangement for remunerating company B from its sales of goods to company C, under a contract manufacturing arrangement in country X. Since majority of the manufacturing related activities are performed by company B in its own capacity the related risks could also be attributed to company B. Consequentially, company B could be re-characterised as a full-fledged manufacturer entitled to commercial profits after compensation for the distribution activities and for the license of IP.

Country Z

The cost plus based marketing fee earned by company D could be challenged due the intensity of the functions performed by company D. The tax authorities may try and deem a commission income in the hands of company D. Further, the tax authorities in country Z may deem a permanent establishment (PE) of the group in country Z with a further attribution of profits to such PE.

Conclusion

As can be observed from the above illustration, optimisation of the supply chain and designing the inter-company pricing arrangements within the supply chain to optimise benefits and reduce overall costs (including tax costs) would always remain a focal point of MNC businesses. However, it is imperative to understand that the pricing arrangements should be designed keeping in mind the substance embedded within respective entities as against artificial allocation of functions and risks.

A faulty design on pricing arrangements within the supply chain may lead to the group's intended cash flow getting adversely affected due to economic double taxation of income, as well as stretch the group's resources and budgets on account of protracted transfer litigation across multiple jurisdictions.

For a detailed assessment or assistance in addressing / resolving inter-company transfer pricing within your organization, please contact the Marketing, Communications and Business Development team on 395 2313, or Rajesh Narasimhan on rajesh.narasimhan@bw.gt.com.

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