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Related-party sales units rarely perform routine functions: How we explain excess or weak profitability of related parties

by Dr. Markus Brem

Cross-border transfer pricing requires the so-called function and risk analysis – one of the key elements of a transfer pricing documentation process of related-party taxpayers. For example, the OECD, in its deliverables on the Base Erosion and Profit Shifting (BEPS) project towards national law makers and tax authorities, proposes the integration of a function and risk analysis into the overall documentation package and the arm's length assessment model.

Many transfer pricing experts consider the function and risk analysis as a more or less complex exercise of describing verbally, or in table format, the functions a related-party unit performs, the risk items it assumes, and assets it deploys. That is the descriptive part recommended by the OECD-BEPS project and numerous jurisdictions. Among experts, often the notion exists that the more functions performed by the taxpayer unit the higher the profitability can be expected.

However, even though the descriptive presentation is considered necessary, it is not the core of that component of an arm's length analysis. We doubt that it is sufficient to assess the profit allocation of a given related party using such function and risk analysis model. In particular, with regard to the risk assumption, we rather suggest to understand the contracts of the related parties involved in order to conclude whether a given profit allocation and the underlying transfer prices are at arm's length. Compare the graph for a simplified reseller model.

Contracts determine the function and risk allocation

For example, consider company R being a sales unit of a multinational group. Suppose company R, performing as a reseller, only gets supplies from Company M, the group's manufacturer which is also the headquarters unit. For simplicity, Company M shall perform all other functions of the group, which are, in particular, functions like R&D, sales to its local customers, key account management, etc.

The nature of the reseller, i.e. the Company R, is to purchase the products and to resell such products. It invoices its customers, and it pays the related-party supplier by settling the inbound invoices. Any dedicated add-on Sales Agreement might also exist between company R and M, in addition to the order-invoice contract (on the basis of the law of obligations).

In our fact pattern, we assume that no such arrangement, however, does specify anything like the number of pieces sold, the monetary volume sold per year, the customer served, and the like. Also, no compensation or sanction is granted by M, if R does not perform in line with the budget figures. In addition, also no such arrangement between R and others parties shall exist (e.g. intra-group services, any supplier contract, shareholder, statutory provisions).

Referring to our daily transfer pricing cases, about four-fifths of our multinational client cases represent such default fact pattern on the reselling side of the value chain.

Profit volatility is the result of risk assumption

Can Company R be of a routine nature regarding its functions performed and risks assumed? A clear **No** is the answer, although many transfer pricing experts would label such fact pattern at R with "routine". Straightforwardly, the profit of R, and its profitability like the operating margin will be volatile. Despite, worldwide in about 90% of all arm's length tests the operating margin is used to assess the arm's length nature of the transfer pricing fact pattern, and the test is called "transactional net margin method".

As long as there is no contractual arrangement between R and any other party, R will have to bear the full scope of risks of a reseller. That is, among others, the full load of bad debt risk, volume risk, market price risk, labour risk, possibly stock risk, and to a minor level the risks related to inbound supplies. Product warranty risk and capacity risk of the manufacturer shall be with Company M.

As a consequence of that default example, the profit of Company R, and likely also its profitability such as the operating margin expressed as percentage value, will turn out as planned if the sales figures turn out to be in line with the budget figures; it will be high if the business is even more successful than expected ("planned") and it will be small or even negative if R fails to meet its own expectations. It is decisive for understanding the volatility of Company R's profitability that neither Company M nor any other contracting partner has assumed the risks of the reseller. Again, four out of five of our cases apply to that situation.

As a consequence, an excess profitability of a related party should be explained by the assumption of risk, and the successful management of such risk. Vice versa, if a related



party shows negative operating margins, such results might be caused by the damages of the events which are integral to the risk assumed.

We believe that the same statement applies to any of the functions of the group of related-party companies. As long as no other contracting party assumes risk integral to such function, the risk remains with that function and at this legal entity unit performing that function.

The function and risk analysis must not be restricted to the descriptive analysis of functions performed and risk borne. Rather, it is essential to elaborate whether such risk is contractually shifted to other legal entities, or not. If no such contract exists, that risk remains at the function, and the profitability will be volatile over time, subject to the business development and external factors.

An inspiration for this view could be also a look at third parties in market economies. Not shifting risk to others will result in small profits, losses or even bankruptcy if costs at the function become higher than expected, or output is smaller than expected, or warranty coverage is claimed. On the other hand, excess profits will be observed if performance is higher than expected in budget figures. Data exactly tell this story.

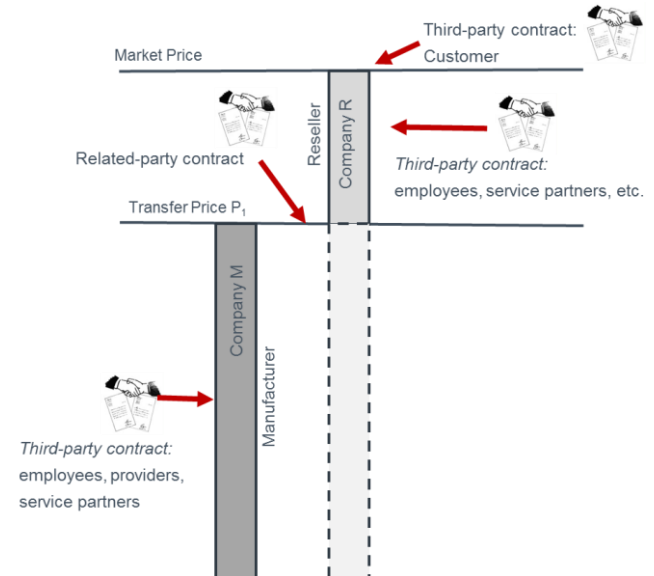
Conclusion

Functions are routine in only a few multinational groups. A good example for that is a service provider which is remunerated on an "actual cost-plus" basis, i.e. de facto costs are compensated as accrued and, in addition, even a markup is granted. Such unit earns the markup which might correspond to the expected profitability of that unit.

However, in most cases of related-party functions and defined risk settings, the entity performing the given function rarely is exempted by the contract in place from significant risk inherent in that function. To our observation, this statement even holds for functions such as sales agents, contract manufacturers, contract R&D units, and the like. Although typically labelled so, they are rarely routine, given the contractual setting. Whenever there is no such contract which, if it were existent, would shift such risk to any other party, such risk stays local with the entity. The entity better should be deemed a "local entrepreneur" allocating the volatilities such function and risk type is comprised with. Company R, in our example, would be such local entrepreneur.

We believe that this logic is key to explain volatilities on absolute profits and relative profitability (e.g. operating margins) of related-party units of multinational groups.

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Graph: A simplified contractual structure of a reseller model in multinational groups.