

CENTRALIZED PROCUREMENT MODELS - TRANSFER PRICING PERSPECTIVE

1. Introduction

Centralized Procurement activities usually fall within risk parameters for transfer pricing assessment and are widely scrutinized by tax authorities



NITHYA SRINIVASAN
Founder & CEO
VSTN Consultancy
Private Limited



NITYA JOSEPH
Principal
VSTN Consultancy
Private Limited

globally. On one hand, payments made to procurement entities located in low-tax jurisdictions often attract attention and may be viewed adversely with concerns about lack of economic substance. On the other hand, tax authorities at the procurement service provider's location may recharacterize the services as high value adding services and allocate a higher remuneration.

In this article, we explore the concept of centralized procurement in the context of transfer pricing, the key aspects to be considered in determining an arm's length remuneration for the same, the various procurement structures generally adopted by multinational enterprises ('MNEs'), how the activities are

remunerated in accordance with the arm's length principle, global practices, as well as local and global jurisprudence covering this transaction.

2. What is centralized procurement?

MNEs often centralize certain business functions of the Group, for operational efficiencies. One such function which is routinely centralised is the procurement activity. Procurement is a critical component in the value chain of any business and it encompasses all activities relating to sourcing and acquiring goods or services (core or non-core) required for the business operations.

Centralized procurement refers to procurement activities undertaken by an entity for one or more entities in the Group. Procurement may be centralized for various reasons, including combining the purchasing power across the MNE, reducing the administrative costs for the MNE, standardizing buying terms and making use of specialised experience required in handling such activities. Centralized Procurement often leads to cost savings for the Group entities, which could be attributed to the

volume involved, efficient coordination of vendor and buyer requirements or reduction of administrative costs by aggregating purchase orders.

3. Transfer pricing considerations

The United Nations Practical Manual on Transfer Pricing for Developing Countries extensively discusses the transfer pricing aspects relating to centralized procurement. While evaluating an appropriate remuneration for these activities from a transfer pricing viewpoint, three important various factors need to be taken into consideration: 1) the level of functions performed by the service provider 2) the nature of products sourced, and 3) the risks assumed while rendering these services.

a) Level of functions performed

The value added through centralized procurement activities varies, depending on the nature of activities performed and therefore, it must be assessed on a case-to-case basis. Broadly procurement functions can be divided into two main categories.

Purchasing

This is a relatively simpler role where the procurement company acts as a facilitator or coordinator. In a purchasing function, all the specifications regarding the products and required terms are provided by the associated enterprises and it does not involve extensive work in evaluating the vendors or scheduling the delivery of products. The purchasing company acts on the basis of the instructions provided by the associated enterprises and predominantly performs an administrative function relating to raising purchase orders and managing accounts payable.

Sourcing

A sourcing function is complex and broader in terms of role. It is strategic and requires specialised expertise of the service provider. The activities involved would include collaborating with associated enterprises to determine specifications of products required, developing sourcing strategies, identifying vendors, understanding their capabilities, evaluating alternatives, scheduling delivery by working along with the vendors based on forecasts of goods required, performing quality control, managing vendor relationships.

Considering the higher level of contributions involved in a sourcing function, it would warrant a higher compensation.

b) Nature of products sourced

An important factor to consider when assessing the value contributed by procurement activities is the type of goods or services procured and their significance to the company's operations. The goods/services purchased can be broadly categorised as core spend and non-core spend.

Core spend, also known as direct spend, are items that are converted or resold in the course of the business of the recipient associated enterprises and which are essential for carrying out the core business of the Group. Examples include raw materials/semi-finished goods. **Non-core spend**, also known as indirect spend are goods and services that support the businesses of the recipient associated enterprises and are not themselves converted into a finished item or resold. Examples of the same could be office stationery, communication related expenses etc.

Non-core spend may not pose any significant risk for the service recipient since these items may be available from various sources and the prices would already be competitive. Hence the

role of the procurement company in this regard would be limited to coordinating and aggregating the purchases within the Group. On the other hand, core spend would be specific to the business of the company and if it is in niche area, there would be specifications involved and the items would be available only from a few sources. As a result, the availability and pricing of core items would be associated with significant risks for the service recipient. The activities relating to core spend would therefore require expertise and skill from the procurement team.

Considering the higher value added and risks involved in connection with core spend, procurement activities for these items should generally earn higher returns when compared to non-core spend.

c. Risks assumed

The procurement company should be compensated in line with the level of risk it assumes. While the company may contractually bear various risks, it is important to evaluate whether it can control the risk and has the financial capacity to

assume the risk. In case of a procurement company that buys and sells goods to the associated enterprises, inventory risk would be assumed. Hence the company needs to determine an appropriate purchasing strategy to minimise its inventory risk. However, if the goods are only procured and sold on a back-to-back basis where the procurement company only takes flash title, this risk is considerably reduced. Also, it needs to be evaluated which party is responsible for inventory management, determining purchase quantity etc. as that party would be the one controlling the inventory risk.

The Company may also assume price risk or volume risk, if it undertakes to provide goods at a certain price or of a certain volume to the associated enterprises. This risk would be minimised by negotiating similar terms with vendors

4. Procurement structures

Procurement entities are generally structured in either of the following ways

- **Purchasing or sourcing entities** – These are service providers that render procurement related services to associated

enterprises, but the contract for purchase of goods/services is entered into directly between the associated enterprises and vendors. In this case, the procurement company does not take title to the goods.

- **Buy-sell companies** - These companies purchase the goods/services on behalf of the associated enterprises. Often, procurement companies only take flash title of goods, and delivery is directly made by the vendors to the associated enterprises.

5. Compensation structures and TP methods

Some of the commonly used compensation models for procurement activities are described below:

- **Cost plus model**- Under this model, all costs incurred in rendering the services are charged to the service recipient along with a mark-up. While applying this model, the suitability of a direct charge or indirect charge method would need to be evaluated. The Direct charge method can be used when the specific services and costs relating to a service recipient can be directly identified. Indirect charge method is more commonly

used when services are rendered to multiple recipients, wherein cost allocation and apportionment methods are used as a basis for calculating an arm's length charge. Under this method, selection of reasonable allocation keys for costs allocation is a key point. While using the indirect charge method, it is important that similar services (eg: whether sourcing or purchasing) are identified and categorised together for the purpose of allocating the relevant costs.

The cost-plus methodology would be more suitable in connection with purchasing activities or for sourcing activities involving non-core spend. The Transactional Net Margin Method ('TNMM') would be an appropriate transfer pricing method in this case and a search for comparable companies undertaking such functions would need to be performed from public databases.

- **Commission based model** – In this model, the procurement company is remunerated based on a percentage on managed spend (i.e. the portion of a company's total spend that is managed by the procurement company)/total value of goods/services acquired. This remuneration structure typically translates to a

higher compensation as against a cost-plus model and is therefore more suitable for sourcing activities, where greater value addition is involved. The Comparable Uncontrolled Price ('CUP') method would be ideal in this case and comparable commission rates would need to be identified from public domain. In practice, availability of commission rates for procurement activity may be limited, hence one could consider evaluating service agreements akin to sourcing as an alternative, if similar functions are performed.

- **Gain share** – This structure takes into account the cost reduction achieved by the procurement company while procuring goods and services and shares the savings between the procurement company and associated enterprises receiving the services. A Profit Split Method ('PSM') may be evaluated depending on the facts and circumstances.

The correct compensation structure should be carefully determined based on the functions performed and risks assumed by the procurement companies, as remuneration can vary significantly under different models. For example, a cost-plus model may result in a markup of 5–10% on costs incurred, whereas a

commission-based model could yield remuneration of 1–3% on total managed spend, which, depending on the spend volume, might translate into substantially higher earnings.

In addition to the above pricing models, a return on value added costs (Berry ratio) could be evaluated in the case of buy-sell entities, only taking flash title of goods.

6. Discussion in OECD guidelines

The OECD guidelines have discussed procurement activities in a few areas.

While mentioning about low value adding intra group services, in Para no.7.47 of the Guidelines, it is stated that “purchasing activities relating to raw materials or other materials that are used in the manufacturing or production process” would not qualify for the simplified approach relating to low value-adding intra-group services. Hence entities carrying out procurement activities for core components cannot opt for the simplified approach, since this activity relates to the core business of the Group.

Additionally, the CbC report requires reporting of companies engaged in procurement activity. As per the OECD Country-by-Country Reporting: Handbook on Effective Tax Risk Assessment (2017), one of the potential tax indicators that could be derived from a CbC report is where a group has procurement entities located in jurisdictions outside its key manufacturing locations. While it is acknowledged that there can be good business reasons for the use of centralised procurement entities, there is also a risk that this can be used to reduce the level of taxable income in the jurisdictions where manufacturing occurs. Tax authorities are advised to understand the business reasons for use of a procurement entity before deciding that there is a transfer pricing risk.

7. Global practices

Netherlands

The Dutch TP decree has a section which discusses intra-group procurement. According to it, the remuneration for procurement-related activities can range from a routine remuneration (based on the operational costs incurred, or compensation related to the

purchase value) for activities of a routine nature to a transactional profit split-type remuneration if the activities can be considered a core function of the group. If, by centralising the purchasing activities, the group manages to realise higher discounts than before as a result of the increased purchase volume, the extra benefit should ideally not be allocated to the centralised purchasing office. Such a benefit must be allocated to the members of the group that enable the purchasing office to realise the extra discounts by their joint purchase volumes. Only where the extra discounts are realised by the specific knowledge and skills of the purchasing office, allocation of part of this to the purchasing office will be at arm's length. This concept has arisen out of the decision of the Supreme Court (judgment dated 23 April 2004, no. 39 542), which has been described subsequently.

Australia

The Australian Taxation Office ('ATO') has laid down specific guidelines (Practical Compliance Guidelines) in relation to the TP compliance approach for centralized non-core procurement activities carried out by procurement 'hubs' to address issues relating to tax avoidance using offshore hubs. The ATO uses a

hub risk framework, consisting of six risk zones, ranging from low risk to very high risk depending on the profits earned by the hub and other factors such as tax impact. This is used to self-assess a hub's compliance's risk. Based on the risk rating identified for the hub, the compliance approach would vary. The higher the risk rating, the higher the priority for review and higher is the level of analysis and supporting evidence required.

Non-core procurement hub arrangements (offshore procurement hubs that supply 'indirect' or 'non-core' goods or services to an Australian entity) are assessed as low risk and in the green zone where the hub profit is less than or equal to a 25% mark-up of hub costs. If the hub is rated as being in the green zone, the company can opt to minimise the transfer pricing documentation and compliance costs in relation to the hub. If the arrangement is outside of the green zone, there would be increased disclosure requirements including provision of additional data in relation to the hub on a yearly basis.

The ATO also provides guidance to assist with the transfer pricing analysis if the risk rating is outside the green zone,

which would help companies understand the enquiries and potential concerns that may arise from the ATO if the hub is subject to review.

8. Local jurisprudence

An important judgement concerning procurement activities in the Indian context was that of GAP International Sourcing (India) (P.) Ltd. ([2012] 25 taxmann.com 414 (Delhi)), where several key aspects were discussed.

Gap India was engaged in facilitating sourcing of apparel merchandise from India for its Group, with a pricing policy of cost plus 15%. The TPO, looking at the company's functional profile and other factors, rejected the said Arm's Length Price ('ALP') and held that commission at the rate of 5 per cent on FOB value of goods sourced by AE through Indian vendors was the appropriate PLI for determining ALP, which was also accepted by DRP. The ITAT held that:

- The assessee was only a low-risk procurement support service provider and no major business risks was borne by assessee.

-
- Assessee's role, functions/activities etc. were limited to scrupulously following prescribed handbook/instructions and assessee had no authority to deviate from set policies of its parent group
 - In case of non-risk bearing procurement facilitating functions which were preordained by contract and handbook/instructions, appropriate PLI would be net profit/total cost and not certain percentage of FOB value of goods sourced by AE.
 - The arm's length principle requires benchmarking to be done with comparables in the jurisdiction of tested party and location savings, if any, would be reflected in the profitability earned by comparables. No separate/additional allocation is called for on account of location savings.
 - Tribunal accepted the remuneration model of assessee (i.e., Cost Plus mark-up) but the mark-up was revised to 32 per cent on cost.

For another assessment year, the said issue had reached the High Court as well as Supreme Court where the Revenue appeals were dismissed.

This judgement emphasises the significance of the functional profile of the procurement company in determining the arm's length remuneration.

9. Global jurisprudence

The Dutch Supreme Court in its judgment dated 23 April 2004, no. 39 542 had adjudicated on allocation of profits resulting from centralizing procurement functions within a Group. A Belgian entity had been appointed by the Group to centralise the purchasing of raw materials. Its role involved negotiating the discounts on the basis of the estimated joint raw material requirements of the Group companies. The Group companies would conclude and actually sign the agreements with suppliers. For its services, the Belgian entity was remunerated with a part of the additional discount, which resulted from the stronger negotiation position obtained by centralising the demand for raw materials.

The tax authorities took the position that the profit claimed by a centralized purchasing office was not aligned with the functions performed and the risks assumed by the office.

According to the tax authorities, profits derived from the realized discounts should be distributed to the members of the group (including a Dutch member) in proportion to their contribution of purchasing volume. The Supreme Court ruled in favor of the tax authorities. It was held that profits in excess of the operating costs of the centralized purchase office with a markup of 5%, should at arm's length be distributed to the members of the group in proportion to their contribution of purchasing volume.

10. Key takeaways

A proactive approach that compensates procurement activities in accordance with the arm's length principle, supported by strong documentation, is crucial for effectively justifying these transactions before tax authorities. Key documentation to maintain includes:

- Detailed Functions, Assets and Risks ('FAR') profile, outlining the activities undertaken by the procurement company
- Description of nature of products sourced and their importance to the business

-
- The commercial rationale for appointing a procurement service company
 - Intercompany agreements specifying the roles, responsibilities, and risks of the procurement company and associated enterprises. Moreover, the conduct of the entities should correspond with the contracts
 - A robust benchmarking analysis to support the transfer pricing position.

From an Indian perspective, one may also need to evaluate the impact of Deemed International Transaction provisions, considering pricing and other terms are negotiated between the procurement company and third party vendors on behalf of the Associated Enterprise.

(The authors are part of VSTN Consultancy Private Limited, Transfer Pricing boutique firm and can be reached at snithya@vstnconsultancy.com and nityajoseph@vstnconsultancy.com)