# Centralised Procurement Strategies: Transfer Pricing Considerations

**Neil Casey** *Director, Transfer Pricing, KPMG*

## Introduction

Increasingly, multinational enterprises (MNEs) across all industries are focusing on driving through procurement savings by centralising the management of certain procurement activities. Business operating models that use a centralised purchasing and sourcing approach have become more prevalent over the past 10 years, and centralised procurement is playing a bigger part in the overall commercial strategy to drive value within an organisation.

## Procurement Fee Structures

Centralisation of procurement may involve outsourcing procurement activities to a third party or setting up an in-house central procurement organisation. Where procurement is outsourced, broadly, third-party providers apply four different fee structures:

- full-time equivalent (FTE) (i.e. own personnel cost plus a mark-up),

- managed spend fee (a return or commission based on spend under management, i.e. total purchases),
- gain share (a fee that is charged as a percentage of the value generated/cost reduction achieved) and
- hybrid (a fee with components of gain share and managed spend fee).

An FTE fee is generally applied only where there is little or no correlation between the activities of the procurement outsourcers and the value generated in terms of procurement spend savings, which is typically the case where the procurement function is outsourced to achieve headcount savings. The other fee structures, based either on spend under management or savings generated, are commonly applied in third-party arrangements.

## Transfer Pricing: Application to Centralised Procurement Models

Under transfer pricing principles that apply to transactions between related parties, a procurement company must earn an arm's-length price in return for the functions it performs, the risks it assumes, and the assets (intangible and tangible) used to deliver the procurement service. Essentially, the consideration paid should be commensurate with what would be expected had the transaction taken place between two independent third parties under similar commercial terms.

There can be quite a degree of interpretation and judgement in arriving at an appropriate arm's-length transfer price for the transaction(s) under review, which can lead to disputes between taxpayers and tax authorities. In practice, in the case of procurement activities, the core issue underlying such disputes is often the extent to which the activity of the procurement centre is considered to be a key factor in contributing to the performance and profitability of the business as a whole.

## Measuring the Contribution of a Procurement Activity

The typical starting point in measuring the contribution made by the procurement function is to measure the savings generated by the centralised procurement organisation in terms of either cost avoidance or cost reduction. The return earned can vary from a routine return (usually based on a mark-up on the entity's operating expenses) or a gross commission on total spend under management, to a gain share or profit-split payment.

Procurement centres using their own strategic know-how that contributes to the overall supply chain might set transfer pricing policies using benchmarks set by reference to gross commissions realised by third-party procurement companies, e.g. a 5% commission on total spend under management (i.e. total purchases). This is usually supported by gathering evidence from third-party transactions (using the comparable uncontrolled price (CUP) method). An alternative transfer pricing method, such as a mark-up on operating expenses (using the transaction net margin method (TNMM)), can lead to a very different result.

The use of different transfer pricing methods and their outcomes are best illustrated in an example.

***Example***

*A procurement entity has operating expenses of €20m and total spend under management (i.e. total amount of goods or services procured as a buying agent) of €750m. Using a 5% gross commission return, the procurement company is entitled to a payment of €37.5m for its services (i.e. 5% of €750m). This leaves the procurement entity with a profit of €17.5m after deducting its operating costs of €20m.*

*Alternatively, if it received a mark-up of 20% on its operating expenses, it would receive a payment of €4m (i.e. a 20% mark-up on its costs of €20m).*

*These two results, which are derived from reasonably common industry-standard pricing approaches, are starkly different – a difference that could lead to significantly different tax results for the MNE where the profits of the fee payer and the service provider are taxed at different tax rates.*

An appropriate transfer pricing assessment of the functional profile of the procurement entity is an important exercise informing the decision to adopt one pricing method over another. There are, of course, a multitude of other important aspects to take account of in assessing the appropriate transfer pricing approach to follow, including the availability of appropriate and reliable arm's-length price comparables, of industry-specific pricing standards, and the attitude to or acceptance by local tax authorities of certain transfer pricing methods.

## Transfer Pricing Disputes

Transfer pricing principles and guidance can appear straight-forward, but often the complexity arises when it comes to applying them in practice. This is particularly the case for procurement activities if the procurement centre is a key component of the overall supply chain and is responsible for driving strategic and operational decision-making on the group's overall procurement process.

Although a pricing approach based on gross commissions and gain shares may be supportable as arm's length, these methods are coming under increased scrutiny – particularly when the procurement entity is in a low-tax-rate jurisdiction.

Furthermore, the transfer pricing guidance that emerged from the October 2015 final reports on Actions 8–10 of the OECD's Action Plan on Base Erosion and Profit Shifting ("the BEPS Plan") focused on developing guidance that leads to transfer pricing outcomes that are aligned with value creation. In broad terms this means that, in setting transfer pricing policies, there is more focus on people based substance and important economic activities when assessing an appropriate profit allocation to an entity. In practice, tax authorities internationally are already applying the guidance in the BEPS Plan report in their conduct of transfer pricing audits and in advanced pricing agreement (APA) processes.

This guidance also addresses MNE group synergies and states that the benefits of such synergies should generally be shared by group members in proportion to their contribution to the creation of the synergy. This applies where important group synergies arise from deliberate or concerted group actions that provide material advantages or burdens not typical of comparable independent companies. Some helpful examples around centralised purchasing and synergies are also included in this new guidance that seeks to expand on the existing principles for applying the arm's-length principle (set out in Chapter 1 of the 2010 OECD Transfer Pricing Guidelines).

Across the globe, we are therefore seeing an increasing number of transfer pricing disputes in this area – a trend that we believe is likely to continue over the next number of years.

## Safeguards

There are a number of safeguards that MNEs should ensure are in place to support their transfer pricing policies for related-party transactions involving centralised procurement centres:

1. *Establish and articulate an appropriate and robust commercial description of that centralised procurement business to demonstrate the contribution it is making to the overall value chain and the profitability of the business as a whole. This may be in the form of a thorough value-chain analysis, for example, but in any event should be industry specific and emphasise or address any variances relative to competitors.*

2. *Ensure that the appropriate substance is in place around strategic and operational decision-making. This is not purely a headcount matter, and due consideration must be given to the nature of the roles and the relevant experience and expertise of those individuals, relative to the procurement function.*

3. *Validate that appropriate risks are assumed and controlled by the procurement entity and that there is contractual support in place evidencing this point.*

4. *Identify the benefits and value that the procurement centre is contributing to the overall profitability of the business. This involves quantifying and tracking these benefits using appropriate metrics.*

5. *Prepare robust transfer pricing documentation that adequately addresses the key aspects that support the pricing adopted. Unfortunately, all too often, the documentation process is seen as a follow-up procedural or compliance matter once the rationale supporting the pricing has been discussed and agreed. Common pitfalls when documenting the basis for adopting a transfer pricing method include:*

   - *a lack of corroborative support in the economic analysis, e.g. a secondary pricing method,*
   - *general industry analysis providing little support specific to the transaction or taxpayer entity under review and*
   - *the overuse of standardised language or document "padding out".*

## Conclusion

Transfer pricing documentation affords MNEs the opportunity to explain (on their terms) the transfer pricing policies adopted and the supporting rationale. Done well, this should not be underestimated as a very effective defence mechanism supporting the approach adopted.

The challenge with transfer pricing guidance is that it is just that, guidance. There is no "bright line" to be satisfied that will provide an absolute level of comfort or certainty to your business that your transfer pricing approach to centralised procurement activities can withstand a challenge.

The extent to which your transfer pricing policy can be said to be robust and capable of a strong defence is, to quite a degree, dependent on the quality of the process undertaken to support that position.