KPMG

Centralised procurement strategies - transfer pricing considerations

Neil Casey, Director, KPMG's transfer pricing team reviews the strategies of many companies to achieve procurement savings and explores transfer pricing principles associated with centralised procurement strategies

Background

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 are playing a bigger part in the overall commercial strategy to drive value within an organisation.

Procurement fee structures

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

1. Full Time Equivalent ("FTE") (i.e. own personnel cost plus a mark-up);
2. Managed Spend Fee (a return or commission based on spend under management i.e. total purchases);
3. Gain share (i.e. a fee that is charged as a percentage of the value generated/cost reduction achieved); and
4. Hybrid (i.e. a fee with components of gain share and managed spend fee).

An FTE fee is generally only applied in cases where there is 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 controls, as well as 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 subjectivity applied in the process that is followed to arrive at what is considered 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 overall 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 either in terms of 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. The use of different transfer pricing methods and their outcomes is best illustrated through the use of an example.

Example

Procurement centres that use their own strategic know-how that contributes to the overall supply chain might set transfer pricing policies which use 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 using available evidence from third party transactions (using the Comparable Uncontrolled Price method, "CUP").

Using 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.

Take an example of a procurement entity which has operating expenses of €20million and total spend under management (i.e. total amount of goods procured as buying agent) of €750million. Using a 5% gross commission return, the procurement company is entitled to a payment of €37.5million for its services (i.e. 5% of €750million). This leaves the entity with a profit of €17.5million after deducting its costs of €20million. Alternatively, if it received a mark-up of 20% on its operating expenses, it would receive a payment of €4million (i.e. a 20% mark-up on its costs of €20million).

These two results, which are derived from reasonably common industry standard pricing approaches, are starkly different – a difference which could lead to significantly different tax results for the MNE where the profits of the fee payor 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 in order to inform 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, such as, the availability of appropriate arm's length price comparables, consideration of industry specific pricing standards, the attitude to or acceptance by local tax authorities of certain transfer pricing methods, etc.

Transfer pricing disputes

Transfer pricing guidance and principles can appear straightforward but are often complex to apply in practice. In the circumstances of procurement activities, this is particularly the case 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 located in a low tax rate jurisdiction.

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

Across the globe, KPMG's network of transfer pricing specialists is finding that clients are encountering more transfer pricing disputes – a trend which we foresee is likely to increase over the next number of years.

What safeguards can be put in place if your business is developing transfer pricing policies for procurement activities?

There are a number of safeguards that MNE's 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 profitability of the business as a whole. This description 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 but rather 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 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. Examples of common pitfalls when documenting the basis for adoption of a transfer pricing method include:

   - a lack of corroborative support in the economic analysis
   - 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".

Transfer pricing documentation affords MNE's the opportunity to explain (on their terms) the transfer pricing policies adopted and 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 degree to which your transfer pricing policy can be said to be robust and capable of a strong defence is to quite a degree dependant on the quality of the process undertaken to support that position.

To answer questions your business may have on transfer pricing matters, please feel free to contact Neil Casey or your usual KPMG team contact.

Contact

Neil Casey
Director
Transfer Pricing
CHEC Tax

t: +353 1 700 4244
m: +353 87 050 4244
e: neil.casey@kpmg.ie

kpmg.ie