Freshfields Bruckhaus Deringer

A practical group
goods prices policy

tax matters

worldwide

Setting a group goods prices policy is complicated by the stages at which goods can be sold between group members (eg raw materials, semi-finished products and finished goods) and the variety of terms on which they can be transferred (eg contract manufacturing, full risk manufacturing, limited risk distribution or full risk distribution). Companies can serve as procurement agents for related parties and/or distribute finished goods on their behalf.

While the goods may be essentially commodities for which arm's-length benchmarks should in theory be readily available, differences in contractual terms and schemes between related and third-party transactions are likely to require their own adjustments. These adjustments are often contested by tax administrations and are a source of substantial transfer pricing case law.

The requirement

In goods transfer pricing especially, the requirement on the taxpayer is primarily to select the method that can be applied most robustly, and where it can be applied as robustly as any other method, to apply the comparable uncontrolled price (CUP) method. As the CUP method requires a high degree of similarity of product, quality, finishing and volume, as well as of all the other comparability factors, it is in practice likely to be the most reliable method only for commodities, and even then some comparability adjustments may be required.

When the primary activity of the 'simpler' party (if there is one) is production, the cost-plus method may be the most robust; where the primary activity is distribution, the resale price method. In both cases these 'traditional transactional' methods can only be applied robustly when reliable adjustments can be made for, in particular, certain important functions, risks and assets of the 'tested' party.

These functions include, for example, a distributor performing an additional assembling/finishing or marketing/advertising function, for which a separate cost-plus or 'total cost-plus' (transactional net margin method (TNMM)) payment may be appropriate.

A manufacturer/producer may be responsible (to some level of complexity) for providing customer technical support or handling returns/repairs. Either party may be responsible for bearing the risks of bad debts or unsold goods (does the distributor buy for stock or to order; can it return unsold goods at the end of each season for a full refund?).

Linked to inventory risk is the issue of inventory ownership and also working capital financing – does the producer or the distributor maintain a large inventory of goods to offer an immediate supply to customers in return for a higher price or upfront payment to suppliers in return for a lower price, or do they offer extended credit to third party customers in return for a higher price? These arrangements may require recognition in the transfer pricing policy.

Apart from product and functional similarity, adjustments may be required to achieve comparability in terms of contractual terms, economic circumstances or business strategies. For example, the exclusive right to produce or sell a product in a territory would normally command a smaller gross margin percentage on the basis that the party would expect to achieve more sales and so an equal overall gross profit.

It may be that one of the related parties is in a much weaker or stronger bargaining position than a party in an otherwise comparable arm's-length transaction, for example because of its relative size or the extent to which the other party depends on it for its supplies or its custom; or a related party may be prepared to lower its prices to shift surplus stock or to use its excess production capacity. Finally, one of the related parties may be prepared to sell at unusually low prices to gain market share and perhaps achieve economies of scale.

A practical approach

It is possible to operate a simplified goods prices policy that will still follow the broad conventions and address the complexities described above, in the following ways.

- Define a set of types of related-party goods transactions and standard contractual terms on which they will take place – also define certain added value services that might be provided along with the scale of goods.
- Define regional or if necessary national groupings of companies for margin benchmarking purposes – on this basis establishing group goods prices and related added value services policies for the coming year.
- Ask the business units to complete an annual schedule (which will become part of the transfer pricing documentation) reporting the size of their transactions of each type with related parties in the previous financial year, and of any related added value services, and what profit margin was involved – to also note why margins deviated from the group policies.
- Explain these arguments in a goods transfer pricing policy document. This will provide for companies to request deviations from the standard margins, in which case a variation request form will be completed and authorised. Each company will sign to confirm their agreement for the group goods transfer pricing policy document, which will form another core element of the transfer pricing documentation.

Next steps

If this approach could be of interest, please contact your usual Freshfields tax partner or the head of the firm's international transfer pricing practice.

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