Impact of BEPS Project on Centralized Operating Models

The central operating models adopted by MNEs for marketing & distribution and for procurement of commodity products may be challenged by the tax authorities in light of the BEPS Final Report. The author considers plausible transfer pricing challenges, and offers solutions that may mitigate transfer pricing risk for MNEs having central operating models.

1. Introduction

Multinational enterprises (MNEs) focused on commodity products are increasingly setting up centralized operating models for the marketing and sale of group products or for the procurement of products for the members of the MNE group. Typical operating models adopted by MNEs involve greenfield establishment or brownfield use of an associated enterprise which acts either as an agent or principal or as service provider in relation to the marketing and sale of commodity products on behalf of the MNE or for the procurement of commodity products for members of the MNE group.

This article considers typical central operating models adopted by MNEs for marketing and sales and for procurement of commodity products; plausible challenges and transfer pricing issues that MNEs may face in respect of such central operating models in light of Final Reports from the OECD Base Erosion and Profit Shifting (BEPS) project; and suggested measures or solutions that can be adopted by MNEs to mitigate transfer pricing risk.

2. Centralized Marketing Hubs

2.1. Background

MNEs focused on commodity products typically set up a marketing entity within the group which acts as the central entity for marketing and selling the products of the group members to third-party customers. Such an entity in an MNE group that functions as the central marketing and sales entity, is commonly referred to as a centralized marketing hub or offshore marketing hub. Typically, such hubs perform activities related to, for example, customer identification; establishing and maintaining customer relationships and distribution channels; and negotiating prices for members of the MNE group. Depending on the intensity of functions performed, risk assumed and assets employed by central marketing hubs, these hubs are typically compensated by way of a gross profit margin (through discount on the price of the commodities purchased by the marketing hub from other members of the MNE group) or by way of service fees.

2.2. Transfer pricing issues

In order to understand the typical transfer pricing issues that may be faced by MNEs in respect of central marketing hubs, it is essential to consider the modus operandi of MNE operations prior to and following establishment of the centralized marketing hub structure. This can be illustrated as shown in Figure 1.
Under the structure prior to establishment of the marketing hub:

- the principal entity headquartered in Country A and focused on commodities, distributes products outside Country A; and
- the principal entity in Country A supplies directly to third-party customers outside Country A.

Under the structure following establishment of the marketing hub:

- the principal entity in Country A sets up a central marketing hub in Country B to coordinate its global operations;
- the principal entity supplies products to the offshore marketing hub (a member of the MNE group); and
- the marketing hub undertakes marketing, sales and distribution functions and resells commodity products to third-party customers outside Country A.

The structure following establishment of the marketing hub can pose transfer pricing issues for MNEs, particularly in light of BEPS Actions 8-10. The Actions 8-10 Final Report requires that transfer pricing outcomes be in line with value creation. The Report recommends that the actual business transactions undertaken between associated enterprises and the transfer price thereof reflect the economic reality. The Report also emphasizes the need for tax authorities to be able to disregard transactions between associated enterprises in circumstances when the transactions are commercially irrational.

Thus, in the BEPS era, one can expect that the tax authorities may question MNEs setting up or currently having an offshore central marketing hub that lacks economic substance or where there is no commercial rationale for interposing such a hub. The issue can be grave if the central marketing hub is set up in a low-tax jurisdiction. The primary contention of the tax authorities would be that, by interposing the marketing hub in a low-tax jurisdiction, the MNE is shifting some part of the profits of the entire value chain to that low-tax jurisdiction. In fact, the Australian Taxation Office (ATO) has already issued a Practical Compliance Guidance (“PCG”) 2017/1 on its compliance approach for centralized operating models involving procurement, marketing, sales and distribution functions (PCG 2017/1). The purpose of the PCG 2017/1 is to set out the framework for hub risk assessment, enable taxpayers to understand the ATO’s compliance approach having regard to risk profile of the hub, provide framework relating to type of analysis and evidence ATO would require when testing outcomes of the hub as well as suggest ways to mitigate transfer pricing risk in relation to hub.

The ATO PCG 2017/1 uses six colour zones to rank the risk of central marketing hubs of Australian MNEs, ranging from the white (already reviewed by ATO), green zone (low risk) to the red zone (very high risk). The zone in which the Australian taxpayer’s offshore marketing hub falls, determines the strictness of the ATO audit of the taxpayer. The PCG 2017/1 is applicable from 1 January 2017 and applies to new and existing hub arrangements. At this stage PCG 2017/1 is applicable only to marketing hubs. It is possible that other countries may also prescribe rules for central operating models in line with the ATO approach.

In cases where audit enquiries to an MNE lead to the conclusion that there is no commercial rationale for interposing a central marketing hub or if there is lack of economic substance in the offshore central marketing hub of the MNE, the tax authorities may – depending on the facts of the particular case – make a transfer pricing adjustment by adopting one of the following approaches:

- where the central marketing hub undertakes buy-sell activities, increase the price of the product exported to the offshore central marketing hub. This would mean a reduction of the gross margin of the hub. It is also possible that tax authorities may re-characterize the arrangement from buy-sell to cost plus model, considering the functionality of central marketing hub;
- where the central marketing hub undertakes only marketing activity and is compensated on a cost-plus basis, reduce the cost-plus markup of the central marketing hub; or
- in extreme cases, disregard the entire offshore central marketing hub structure by applying domestic general anti-tax avoidance rules.

2.3. Plausible solutions

MNEs exporting commodity products through an offshore central marketing hub should prepare and maintain robust transfer pricing documentation to be well equipped for transfer pricing audits and to address enquiries from the tax authorities. The transfer pricing documentation should be supported by empirical evidence that substantiates the documentation. Typically, the following are seen as solutions or suggested measures that could be adopted by taxpayers.

2.3.1. Document the commercial rationale for interposing the hub

It is imperative that MNEs appropriately document the commercial rationale for interposing a marketing hub in their transfer pricing documentation. For example the commercial rationale may include:

- proximity to customers/key market. Trading through the offshore marketing hub may enable the MNE to be close to existing and potential customers;
- funding efficiencies. Some jurisdictions offer more competitive pricing as well as flexible options for opening a line of credit as compared to the jurisdiction in which the MNE is headquartered;
- ease of doing business. This could include a developed transportation network with key trading partners, developed ports and logistics infrastructure; and developed technical expertise; and

1. OECD, Aligning Transfer Pricing Outcomes with Value Creation – Actions 8-10 Final Reports; OECD/G20 Base Erosion and Profit Shifting Project (OECD 3 Oct. 2015), International Organizations’ Documentation IBFD.
2. PCG 2017/1: ATO compliance approach to transfer pricing issues related to centralized operating models involving procurement, marketing, sales and distribution functions AT.
The documentation of the commercial rationale must be coupled with evidence that demonstrates value creation by the offshore central marketing hub in the entire value chain. Such evidence could include an increase in sales volume or price, or any other benefit to the MNE that is directly attributable to the activities of the hub.

2.3.2. Document functional profile of the hub: Economic substance test

The functions performed, assets employed and risk assumed by the offshore central marketing hub and the taxpayer should be appropriately documented. Specifically, the following should be captured as part of functional profile of the offshore marketing hub, as they demonstrate economic substance and value creation by the hub.

Functions of the hub. The functions performed by the hub should be documented and relevant evidence should be maintained which substantiates that key decision making is undertaken by the offshore marketing hub. In addition, where functions have been transferred from the taxpayer to a central marketing hub in another jurisdiction, evidence should be maintained which demonstrates that those functions are no longer physically performed by the taxpayer. This can be demonstrated with senior level personnel or key decision makers responsible for marketing and distribution, which were earlier on the taxpayer’s payroll and are now moved to the payroll of the hub and also are physically shifted to the country in which the hub is resident.

Risks assumed by the hub. The economically significant risks in the value chain should be appropriately identified and documented. The taxpayer should follow the detailed six-step process set forth in the Actions 8-10 Final Report for analysing risk in transaction between a taxpayer and the offshore central marketing hub. In summary the six-step process is as follows:

- Step 1: identify economically significant risks;
- Step 2: identify which party to the controlled transaction contractually assumes the risk;
- Step 3: perform a functional analysis in relation to risk by analysing which enterprise(s) (i) exercise(s) control over functions and risk mitigation functions, (ii) bear(s) advantageous or disadvantageous consequences of risk outcomes and (iii) has/has the financial capacity to assume the risk;
- Step 4: interpret information gathered in Steps 1 to 3 by analysing whether the contractual assumption of risk is consistent with the conduct of the parties;
- Step 5: if Step 4 reveals that the associated enterprise assuming the risk based on Steps 1 to 4 does not exercise control over the risk or does not have the financial capacity to assume the risk, the risk is to be allocated to the enterprise exercising control and having the financial capacity to assume the risk; and
- Step 6: price the transactions taking into account the consequences of the allocation of risk in Step 5.

The economically significant risks documented in the transfer pricing report should be substantiated with evidence which demonstrates that the offshore central marketing hub exercises control over the risk allocated to it and has the financial capacity to assume such risks. Where the marketing and distribution functions are transferred from the taxpayer to the offshore central marketing hub, specific documents and evidence should be maintained which demonstrate the effective transfer of risks to the offshore central marketing hub. For instance where commodity markets increase or decrease substantially, the financial outcome of those movements should align with allocation of risks. Thus, where risk of such fluctuation is contractually borne by the offshore central marketing hub, the actual conduct should also demonstrate that the financial outcome of such fluctuation is borne by the offshore central marketing hub.

2.3.3. Aligning pricing arrangement and policy with value creation

The pricing arrangement of the taxpayer with the offshore central marketing hub should be aligned with the functional profile and economic substance of the hub (i.e. value creation by the hub). Depending on the facts of the particular case, compensation for the offshore central marketing hub may include:

- where the offshore marketing hub does not take title to the commodities, compensation should be based on a cost-plus arm’s length markup, capturing only the operating costs related to the marketing function; and
- where the offshore marketing hub takes title to the commodities, compensation should be based on the arm’s length gross profit margin to be retained by the offshore central hub, taking into consideration the functional profile and economic substance of the hub.

2.3.4. Advance pricing agreement

In order to obtain certainty regarding a centralized marketing hub structure and pricing arrangements with the hub, MNEs can explore entering into a bilateral advance pricing agreement.

3. Centralized Procurement Hubs

3.1. General

Similar to centralized marketing hubs, centralized procurement structures are also becoming a common feature in the value chain of MNEs. Centralized procurement hubs act as a one-stop-shop to meet sourcing requirements of the MNE group in a particular region or across the globe. Such hubs provide several advantages to MNEs, such as economies of scale; stronger bargaining power as the goods are procured in larger quantities to meet requirement of the entire group; and a dedicated procurement team for vendor identification and vendor assess-
ment – thereby ensuring standard quality of commodity products for all the members of the MNE group. However, such structures are not always interposed merely for business reasons. Indeed, MNEs may use structures in a tax efficient manner to reduce the effective tax rate of the group. To elaborate on this point, the discussion below analyses the tax implication under Structure 1 (prior to establishment of the centralized procurement hub) and Structure 2 (following the establishment of the centralized procurement hub).

### 3.1.1. Structure 1: Prior to setting up the centralized procurement hub

In Structure 1 (see Figure 2), the taxpayer is a full fledged/entrepreneur distributor purchasing goods directly from a third-party vendor and distributing the same to third-party customers in Country A (it may also distribute outside Country A). As a full fledged/entrepreneur distributor, the taxpayer identifies vendors; conducts vendor due diligence; checks the quality of products sourced; negotiates price with vendors and customers; and develops and maintains customer relationships and the distribution network. Here, the entire distribution profit belongs to the taxpayer (in the above example, USD 50) which is subject to the tax rate (in the above example, 30%) applicable in Country A. Thus, the overall tax cost for the taxpayer is USD 15.

### 3.1.2. Structure 2: Interposing a centralized procurement hub

Under Structure 2 (see Figure 3):

- the functional profile of the taxpayer in Country A is stripped, as it undertakes only marketing and distribution function (the procurement function is shifted to the central hub in Country B);
- the central procurement hub in Country B purchases products from a third-party vendor for USD 150 and resells to the taxpayer in Country A for USD 200; and
- the tax rate in Country B is 10% and in Country A is 30%. The overall tax burden of the MNE group under this structure is USD 9, with an effective tax rate of 18%.

Thus by interposing a central procurement hub, the value chain is divided between the procurement entity (in Country B) and distribution entity (i.e. the taxpayer in Country A). The profit attributable to the procurement function resides with the central hub in Country B, while the profit related to the distribution functions performed by the taxpayer in Country A resides in Country A. If the central procurement hub is set up in a low-tax jurisdiction, the overall tax cost and effective tax rate of the MNE group can be reduced.

### 3.2. Transfer pricing issue

The Actions 8-10 Final Report requires that the transfer pricing outcomes be in line with value creation. According to the Report, the actual business transactions undertaken between associated enterprises and the agreed transfer price must reflect the economic reality. The Report also emphasizes the need for tax authorities to be able to disregard transactions between associated enterprises in circumstances when the transactions are commercially irrational. Thus, it is possible that more audit enquiries may be initiated by the tax authorities to analyse the commercial rationale for interposing a central procurement hub and to evaluate whether the hub has the requisite commercial and economic substance. In cases where audit enquiries to the MNE lead to the conclusion that there is no commercial rationale for interposing a central procurement hub or if there is a lack of commercial and economic substance in the offshore central procurement hub of the MNE, the tax
authorities may – depending on the facts of the particular case – make a transfer pricing adjustment by adopting one of the following approaches:

- where the central procurement hub undertakes buy-sell activities, the tax authorities may reduce the purchase price of the product imported by the taxpayer from the offshore central procurement hub. This would result in an increase in the gross margin of the taxpayer;
- where the central marketing hub is performing only procurement services and is compensated on a cost-plus basis, the tax authorities may reduce the cost-plus markup of central procurement hub;
- in extreme circumstances, the tax authorities may disregard the entire offshore central procurement hub structure if taxpayer fails to prove a commercial rationale for interposing the hub and/or where the hub lacks economic substance; or
- the tax authorities may expect a potential exit charge on account of the stripping of the functional profile of the taxpayer from full fledged/entrepreneur distributor (under Structure 1) to a stripped distributor not undertaking procurement functions (under Structure 2).

### 3.3. Plausible solutions

The plausible solutions discussed in section 2.3. (relating to central marketing hubs) are equally relevant for central procurement hubs. Briefly, MNEs setting up a central procurement hub should prepare and maintain robust transfer pricing documentation that clearly (i) sets forth the commercial rationale for interposing the hub and (ii) documents the economic substance in the hub.

Typically, the commercial rationale for interposing a central procurement hub could include economies of scale, better barging power with vendors, a specialized and dedicated vendor assessment team and quality checks (thereby ensuring standard quality of products procured for the entire MNE group). The documentation of the commercial rationale should be coupled with evidence which substantiate the value addition to the MNE group by interposing the hub. The evidence may include competitive prices for products procured by the central hub, better commercial terms (such as extended credit facility) as well as better quality.

In addition to documenting the commercial rationale, the economic substance should also be appropriately documented. This would entail documenting the function, asset and risk profile of the taxpayer and the central procurement hub. It should be ensured that the key personnel and decision makers responsible for procurement activi-
4. Conclusion

While one cannot prognosticate the future of central hubs, in light of the Actions 8-10 Final Report and the recent ATO PCG 2017/1 relating to centralized operating models, it is possible that tax authorities may conduct detailed audit enquires. Accordingly, it is essential for MNEs to evaluate their central hub structures in light of guidance provided in the Actions 8-10 Final Report and take corrective measures in order to avoid any untoward audit outcomes.

ties are located in the country of the central procurement hub and are also on the payroll of the hub. In addition, the risk related to procurement activities (such as fluctuations in the price of the products) are, in form and substance, borne by the hub.

Documentation should also capture the pricing arrangement or policy for transacting with the hub. The pricing arrangement or policy should also be aligned with the value creation by the hub. In order to obtain certainty on the pricing arrangement, the taxpayer may also consider entering into a bilateral advance pricing agreement.