In the current economic environment, many transfer pricing optimization strategies have come under heavy attack from both tax authorities and the general public. Strategies such as the migration of intangible property have historically been popular for large multinational corporations, but they are now being scrutinized heavily and can often result in disagreements between taxpayers and tax authorities (disagreements that have been well publicized). There are, however, a number of less controversial options available to taxpayers to optimize their transfer pricing in a tax-efficient manner. Often, corporations have arbitrage opportunities within their existing structure that are not being fully utilized, simply because basic transfer pricing methodologies are being applied when there are more sophisticated methodologies that remain regulatory compliant.

In addition to these missed opportunities, the centralization of certain business functions, as well as the accompanying shifting of functions and risks, is often considered as part of an operational optimization plan. If the transfer pricing planning associated with such a project is done correctly, it can also drive tax benefits. When implementing any kind of supply chain restructuring, the savings generated can often be protected from much of the tax burden that would normally result. This tax reduction will increase the after-tax return on investment for the project. Typical functional centralization projects involve implementing a shared service center for back-office operations, creating an IT support center or establishing a financing company. Over the course of the last five years, a major trend in supply chain planning has been the centralization of the procurement function.

This article focuses on the potential benefits associated with establishing a tax-efficient procurement company and the associated transfer pricing considerations. While there are many technical tax considerations associated with establishing a procurement company, this article focuses solely on the transfer pricing aspects of such a project.

Multinational businesses have extensively applied the use of tax-effective procurement companies to deliver efficiencies in the sourcing of goods and materials to achieve financial benefit. Businesses are often resistant to significant operational change across the entire supply chain, as it can prove to be costly and time-consuming. Procurement, on the other hand, generally offers an opportunity to achieve supply chain savings without a large movement of people or assets. Additionally, the people that must be relocated as part of the centralization are generally not customer facing, which leads to less disruption to the sales process. Corporations are sometimes dissuaded from this centralization if procurement spend (the amount of money spent on procured goods) is not substantial. The example below illustrates the potential tax savings from establishing a centralized procurement function in a tax-efficient jurisdiction.

**Operational Considerations**

There are a number of reasons that large multinationals consider supply chain planning involving the centralization of key business functions. Equally, for a domestic business expanding internationally, whether organically or through acquisition, the use of shared functions can help to maximize operating efficiency and speed. Typical drivers for such strategies include:
Eliminating operational redundancies across multiple business units or multiple geographical areas;
Consolidating volumes of purchased raw materials and using this as a lever to drive down price and negotiate better commercial terms;
Bringing dispersed procurement team members (i.e., Asia-Pacific sourcing teams) together to create a single team with a common global perspective; and
Identifying and capitalizing upon opportunities to optimize the international supply chain and reduce total supply chain cost.

The Steps Involved
Numerous steps are involved in establishing a centralized procurement company. They can be summarized by the following four major themes:

- Identify and isolate the procurement activities within the business organization, including determining the functions, assets and risks associated with this process, as well as the different types of procurement spend. (See illustration below.)
- Determine the optimal procurement model for the centralized procurement company: service provider, buy-sell or a hybrid.
- Operationally centralize the performance of strategic procurement activities, as well as the management of key functions and risks, in one location.
- Arrange for the local operating companies that make use of the procurement function to either buy goods from or pay a fee (often a percentage of the cost of the goods procured) to the centralized procurement company in return for the performance of strategic activities and management of key risks.

By centralizing the procurement company in a tax-efficient jurisdiction (i.e., Singapore or Hong Kong for Asian procurement), multinational organizations can significantly increase commercial benefits. Placing the procurement company in a tax-efficient jurisdiction effectively allows cost savings and other commercial benefits that are achieved as a result of establishing a central procurement company to be taxed at an optimal rate.

Transfer Pricing Considerations
The transfer pricing structure put in place as part of this supply chain planning project is critical to sustaining the benefits. This structure must be:

- Commercially justified — for example, the company may already possess senior procurement expertise in a particular jurisdiction, such as Singapore or Hong Kong for Asia-Pacific sourcing;
- Compliant — the transfer pricing must meet tax requirements in all major jurisdictions making use of the centralized procurement function, as well as the jurisdiction that the procurement company resides in;
- Non-aggressive — there should be a reasonable charge commensurate with third-party competitors and based on an analysis of arm’s length comparable transactions; and
- Supported by robust analysis — the economic significance of the relevant functions and risks must be thoroughly analyzed and documented.

From a transfer pricing technical standpoint, one of the keys to driving profits into a centralized procurement company lies in how third-party service providers often price for such services. It is commonplace to put in place intercompany service arrangements that involve remuneration derived from the cost (generally with a markup or other profit element) associated with providing the service. Third-party arrangements in the procurement field, however, often involve remuneration based on the cost of the goods procured.

To leave cost savings and other commercial benefits in the centralized procurement company, a taxpayer must identify strategic functions and ensure the assets and risks associated with providing those functions are borne by the procurement company. The level of income left in the procurement company must be commensurate with the functions and risks and, ultimately, supported by what third parties earn engaging in similar activities in the free market.

Example
Consider a multinational corporation that spends US$100 million annually on procured goods. Currently, the majority of the functions and risks associated with the procurement activities are spread across multiple jurisdictions with high effective tax rates. As part of a strategic supply chain initiative, the company’s management team decides to centralize the procurement function in Singapore. Virtually all of the company’s goods and materials are sourced from Asia, and management believes this will create operational efficiencies leading to cost reductions.
After robust analysis of the functions and risks associated with the centralized procurement function, as well as a thorough examination of third-party comparable transactions, it is determined that 4.00 percent of the cost of the goods procured is a supportable and arm’s length fee for such a service. Therefore, the revenue earned by the procurement company in Singapore amounts to approximately US$4 million per year. The Singapore company has approximately US$1 million per year in annual operating costs, leaving it with US$3 million in operating profits. If the blended tax rate differential between Singapore and the jurisdictions where the functions previously resided is 25 percent, this leads to annual tax savings of US$750,000. These tax savings are incremental to the operational cost savings derived from the supply chain planning initiative, and they increase the return on investment for the project.

**Alvarez & Marsal Taxand Says:**
Centralizing procurement does not necessarily require a significant change to the business operating model and often does not involve a significant disruption to the supply chain. If done carefully, the creation of a centralized procurement company in a tax-efficient jurisdiction can be well supported under scrutiny from tax authorities. Centralizing procurement can provide multinational businesses with supply chain savings, tax efficiencies and other economic benefits. Through effective planning, this can be achieved while bypassing many of the anticipated cost and time issues that arise.

Feedback:
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