Manufacturer, Distributor or Service Provider – A Practical Perspective for Arm's Length Price Considerations for all

8 May 2024

Agenda

Manufacturer, Distributor and Service Provider – Transfer Pricing (TP) context

Manufacturers - Different business models and typical Arm’s Length Price (ALP) issues/challenges

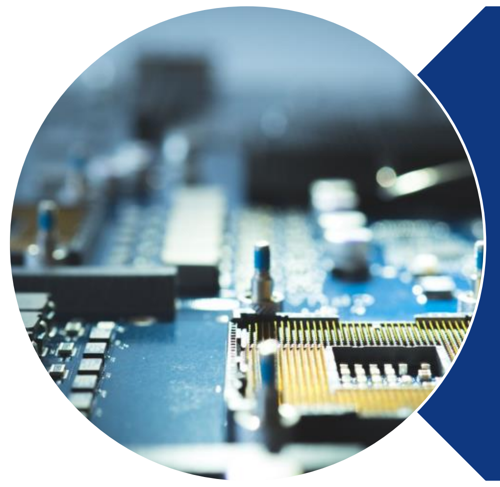
Distributors - Different business models and typical ALP issues/challenges

Service Providers - Different business models and typical ALP issues/challenges

Key judicial rulings

Q&A

Manufacturer, Distributor and Service Provider – TP context



Manufacturer – Typically, it would mean a group entity that would be manufacturing certain products/goods using own or licensed process/technology for making an onward sale to a sales entity in the same Group, or to a third party.

Distributor - Typically, it would mean a group entity that would buy/purchase certain products/goods from either a group manufacturer or master distributor and resell them to third party customers **or** purchases made from both group entities and third parties for resale purposes.

Service Provider - Typically, it would mean a group entity providing services for the benefit of another group entity wherein the services provider would be incurring certain costs and seeking a remuneration on such costs from the services recipient.

Typical cost structures

Singapore Co. direct manufacturing costs - SGD 2,000
Singapore Co. indirect manufacturing costs - SGD 3,000
Singapore Co. total manufacturing costs – SGD 5,000

Singapore Co. sales revenue to third parties - SGD 8,000
Singapore Co. purchases from group manufacturer - SGD 2,000
Singapore Co. operating expenses – SGD 3,000

Singapore Co. direct costs - SGD 1,000
Singapore Co. indirect costs - SGD 2,000
Singapore Co. total costs – SGD 3,000

Manufacturers - Different business models (1/2)

Toll Manufacturer

- Least risky business model
- Principal or full-fledged manufacturer retains ownership of the raw materials, work-in-process and finished goods during the entire manufacturing process
- Toll manufacturer is not responsible for functions such as production scheduling, procurement of raw material, quality control, logistics and no title to inventory
- Primarily performs only processing services in accordance with the principal's prescribed guidelines and directions
- Does not bear any key risks such as market risk, price risk etc
- Compensated vide a fee that is typically calculated as a mark-up on total processing costs

Contract Manufacturer

- Limited risk business model
- Responsible for the procurement and ownership of raw materials and/or semi-finished goods. Has its own plant and machinery
- Primarily manufactures products/goods in accordance with the principal's prescribed guidelines and directions and quality specifications
- Mainly bears the risks associated with ownership of tangible assets and limited inventory carrying cost
- The principal or full-fledged manufacturer bears demand and final customer pricing risk
- Compensated vide a fee that is typically calculated as a mark-up on total manufacturing costs

Licensed Manufacturer

- Moderate risk business model
- Produces goods under a license agreement, using manufacturing intangibles owned by the principal for which the licensed manufacturer pays a royalty to the principal, on the sales made to customers
- Purchases/procures and takes ownership of raw materials and semi-finished products
- It also owns the plant and equipment required for manufacturing which is however, carried out as per the terms of the license agreement
- Holds inventories of raw materials and finished products and bears risks associated with holding inventories and sale of products
- Principal bears all the risks related to the manufacturing intangibles and its own market and price risk

Full-Fledged Manufacturer/Entrepreneur

- Full risk business model
- Responsible for all key activities such as production planning/scheduling, procurement, supply chain management, quality control, capacity utilization planning and third-party sales to customers
- Generally, earns fixed returns on routine functions/activities and all residual profits or losses for non-routine functions/contributions
- Exposed to substantial risks such as R&D risk, product liability risk, capacity utilization risk, market risk, price risk etc

Manufacturers - Typical ALP issues/challenges (2/2)

Toll Manufacturer

- Lack of "appropriate" comparable companies in some industries and geographic regions, especially when the tested party is a toll manufacturer
- Loss makers are scrutinized in detail during TP audit
- Selection of appropriate comparable companies along with the search strategy
- Proper functional characterizations especially between toll and contract manufacturer
- Comparability adjustments like capacity utilization are not easily accepted by the tax authorities
- Selection of appropriate cost base for mark-up purposes especially treatment of extraordinary items

Contract Manufacturer

- Lack of "appropriate" comparable companies
- Heightened scrutiny of loss makers during TP audit
- Selection of appropriate comparable companies along with the search strategy
- Aggregation of transactions especially those involving manufacturing, distribution and services via-a-vis transaction-by-transaction analysis
- Issues related to business restructuring i.e. conversion from one business model to other
- Selection of appropriate cost base for mark-up purposes especially treatment of extraordinary items

Licensed Manufacturer

Full-Fledged Manufacturer/Entrepreneur

- Accurate delineation of the transaction in the context of DEMPE functions
- Selection of the most appropriate method for determining ALP
- Selection of appropriate royalty agreements with similar terms and intangible involved
- Differing views of tax authorities on royalty rates
- Issues related to business restructuring i.e. conversion from one business model to other
- Transactions with an entity lacking economic substance

Distributors - Different business models (1/2)

Commission Agent

- Least risky business model
- Generally, the related party functions as an agent instead of a buy-sell entity or a distributor
- The agent primarily identifies potential customers, explains them about the products, takes orders on behalf of its principal (either a manufacturer/distributor) and receives a commission for the same
- Does not undertake any significant advertising or marketing activities
- Typically, would also not be signing or executing contracts on behalf of the principal
- On the other hand, the principal entity bears the overall contractual risks, market risks and other key risks

Limited Risk Distributor

- Limited risk business model
- Typically, performs sales and distribution related functions in the overall value chain
- Primarily engaged in routine functions such as purchasing products from either the group manufacturer or master distributor for the onward sale to customers, limited inventory holding and limited marketing/advertising and after-sales support activities, in accordance with the parent's directions and under its control
- Does not participate significantly in strategic decision-making functions or preparation of sales and marketing plans
- Typically, is remunerated via an assured margin on sales
- All significant and complex functions and risks are primarily undertaken and borne by the entrepreneur

Full-Fledged Distributor

- Full risk business model
- Generally, this entity executes all sales and distribution functions
- Responsible for planning and developing sales and marketing budgets, managing the inventory and logistics, undertaking extensive sales and marketing related activities, and other sales support services
- Bears substantial risks like price risk, credit risk, market risk etc
- Exposed to market volatility in terms of returns

Distributors - Typical ALP issues/challenges (2/2)

Commission Agent

- Accurate delineation of the transaction is necessary with emphasis on robust FAR analysis
- Appropriate remuneration methodology needs to be carefully worked out and should be aligned with the FAR analysis
- Selection of appropriate comparable companies along with the search strategy
- Loss-making cases are generally picked up for scrutiny during TP audit
- Potential permanent establishment implications

Limited Risk Distributor

- Lack of “appropriate” comparable companies in some industries and geographic regions
- Proper functional characterization
- Selection of appropriate comparable companies along with the search strategy
- Selection of appropriate profit level indicator
- Treatment of extraordinary items while computing the margin on sales
- Business restructuring related issues
- Loss-making cases are generally picked up for scrutiny during TP audit
- GST/VAT adjustments and corresponding TP impact on the business model

Full-Fledged Distributor

- Accurate FAR analysis is required
- Business restructuring related issues
- Analysis on the allocation of risks amongst such entities in the Group is particularly important
- GST/VAT adjustments and corresponding TP impact on the business model

Service Providers - Different business models (1/2)

Shared service center (SSC)

- Specially created business unit rendering specific or several activities such as accounting support services, information technology support services, human resource support services etc
- The unit generally has its own staff and is responsible for managing the cost and quality of services
- Activities rendered by the SSC are generally routine/simple in nature
- Typically, SSC are compensated for the costs and risks associated with the services provided by either a cost-plus mark-up-based methodology to a specific related party (direct method) or cost allocations to different related parties based on usage (indirect method)

Contract service provider

- Generally, these are entities rendering certain services to related parties and third parties as well
- Type of services include marketing support, technical support, customer support, software support, procurement support etc
- The services are typically rendered under the control and supervision of the overseas related party (could be one party or multiple)
- Such entities are generally remunerated vide a total cost-plus pre-agreed mark-up-based methodology and are insulated from most of the business risks like price risk, market risk etc
- All the contractual risks and other key risks such as market risk, price risk etc are borne by the overseas related party

Complex service provider

- These service providers render a wide range of services including activities related to core business processes like strategic management, sales & marketing, finance etc
- They also provide many support services akin to a contract service provider to support the core operations of the Group
- Generally, they would be risk-bearing entities with a high-remuneration volatility i.e. a steady mark-up for routine operations and residual returns for non-routine activities

Service Providers – Typical ALP issues/challenges (2/2)

Shared service center (SSC)

- Nature of services need to be carefully elaborated
- Proper functional characterization of the entity
- Selection of appropriate comparable companies along with the search strategy
- Selection of appropriate remuneration methodology and approach (like selection of cost allocation keys)
- Compliance with "Benefit-Test" rule

Contract service provider **Complex service provider**

- Nature of services need to be carefully elaborated
- Proper functional characterization
- Selection of appropriate comparable companies along with the search strategy
- Treatment of various cost heads and extraordinary items while computing the total cost base
- Loss-making cases are generally picked up for scrutiny during TP audit
- Comparability adjustments to be conducted judiciously
- GST/VAT adjustments and corresponding TP impact on the business model
- Compliance with "Benefit-Test" rule

Key judicial rulings

a. **ECCO** – Shoe manufacturing case – The High Court of Western Denmark

b. **Kellogg India Private Limited** – Licensed manufacturing case – The Income Tax Appellate Tribunal, India

c. **Coca-Cola Co.** – Selection of method for manufacturing operations – US Tax Court

d. **ST Dupont** – Pricing policy for manufacturing operations - Administrative Court of Appeal of Paris

e. **Olympus Medical Systems India Pvt. Ltd.** – Losses for distribution operations - The Income Tax Appellate Tribunal, India

f. **Terex Italia s.r.l.** - Remuneration of the distributor – Italy Supreme Court

g. **TRMSB (Part of the Thomson Reuters Group)** – Distribution operations - Special Commissioner of Income Tax, Malaysia

h. **Eli Lilly ČR** - Pricing policy for distribution - Supreme Administrative Court, Czech Republic

i. **McDonald’s** - Royalty payments - French tax authorities

j. **Intralot S.A.** – Intra-group services - Supreme Administrative Court, Greece

Q&A

THANK YOU