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Nurturing Relationships



# Synergies and Procurement: Chapter B.6 -UN TP Manual

CA Jugal Gala

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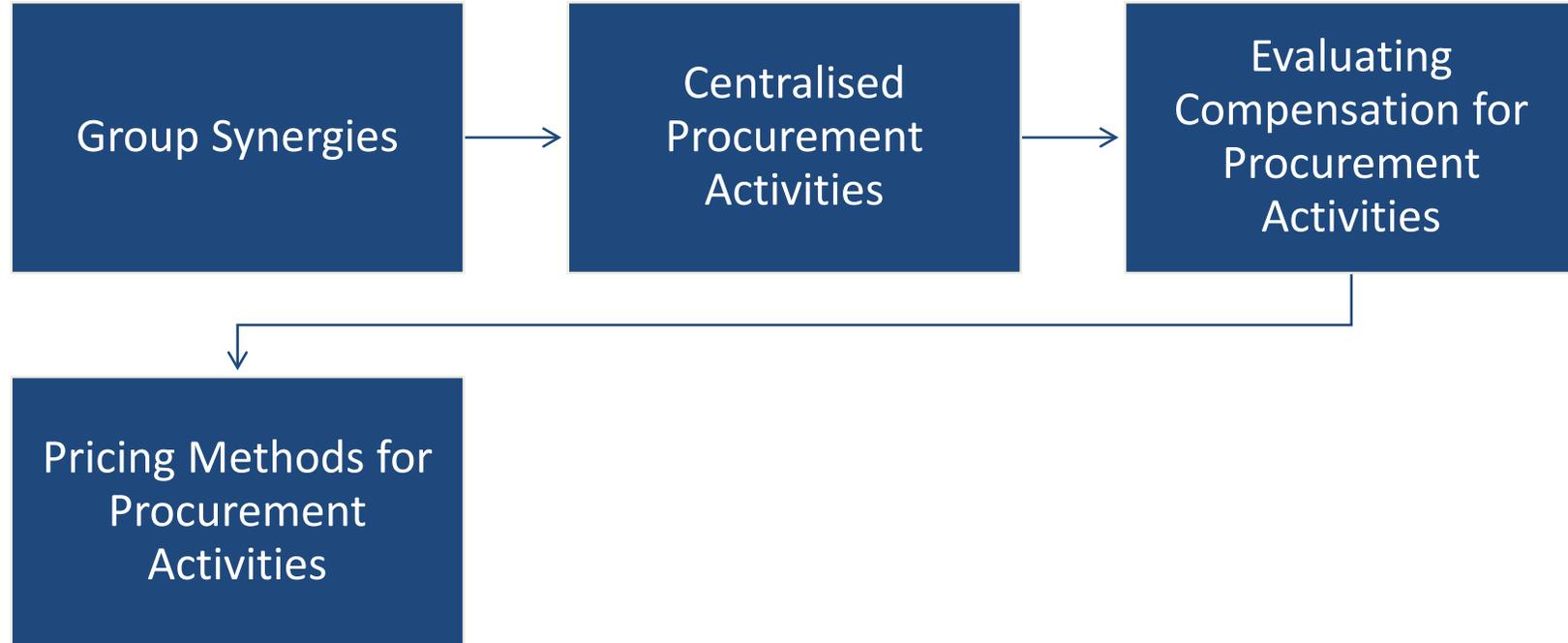
# Research Credits

Subash R

# Legends used in the Presentation

AE	Associated Enterprise
CPC	Centralised Procurement Company
CPM	Cost Plus Method
CUP	Comparable Uncontrolled Price
MNE	Multi National Enterprise
TNMM	Transactional Net Margin Method

# Presentation Schema



# GROUP SYNERGIES

# Group Synergies

Due to the existence of an MNE group, the AEs comprising such groups may benefit from **interactions or synergies among group members** which are **not generally available to independent enterprises**. Such synergies are called group synergies.

Globalization has made it possible for an MNE **to achieve high levels of integration** and the ability to have **control centralized in one location**.

Modern information and communications systems also provide **increased horizontal communications across geographic and functional business lines**.

Also, management teams of an MNE can be based in different locations, leading the MNE from several locations.

But **Group Synergy does not constitute an intangible because it is not capable of being owned or controlled by an enterprise**

# Benefits and Burdens of Group Synergy

Group synergies are often favourable to the group as a whole and therefore may heighten the aggregate profits earned by group members compared to independent enterprises.

## Examples

economies of scale

elimination of costly duplication of effort

integrated systems

purchasing or borrowing power

streamlined management

However they also encompass the following difficulties

Difficulty in **allocating income/ costs of MNEs** between jurisdictions for tax purposes

**Lack of competitive edge** in performing functions in-house

Creation of **bureaucratic barriers** due to large size and scope of operations

Forcing **inefficient system of working** as a matter of group-wide standards established by MNE group

# Guidance on Intra-Group Services

An AE should not be considered to receive an intra-group service or be required to make any payment when it obtains **benefits attributable solely to being part of a larger MNE group**.

**The benefits of association with an MNE group are not a chargeable service** for the members of the MNE group.

The key feature of this kind of incidental benefit is that it is **passive and cannot be attributed to a deliberate concerted action** taken by another member of the MNE group

On the other hand, a deliberate concerted action involves one associated enterprise performing functions, using assets, or assuming risks for the benefit of one or more other associated enterprises, such that arm's length compensation is required.

Existence of group synergy, the nature and source of the synergistic benefit or burden, and whether the synergistic benefit or burden arises through deliberate concerted group actions can only be determined through **a thorough functional and comparability analysis**.

# Deliberate Concerted Action and Benefits of Passive Association

It is important to note the difference between benefits arising from a deliberate concerted action and from passive association. Lets take 2 illustrations-

## Illustration 1

### Scenario 1

Central purchasing manager at the parent company negotiates a group-wide discount with a supplier on the condition of achieving minimum group-wide purchasing levels, and group members then purchase from that supplier and obtain the discount.

### Scenario 2

Supplier unilaterally offers one member of a group a favourable price in the hope of attracting business from other group members

**In scenario 1**, the favourable price is a synergistic effect that may be a comparability factor relating to the economic circumstances of the group member. Therefore, it is a deliberate concerted action and the same should be appropriately rewarded.

**In scenario 2**, no deliberate concerted group action would have occurred, as a group member was unilaterally approached by a supplier with the hope of encompassing supply-deals with all group members.

*Thus, if the synergistic effect has been **deliberately created by the CPC for the group as a whole**, then we can say there is a deliberate concerted action.*

## Illustration 2- Lower Interest Costs

### Scenario 1

Company B, belonging to an MNE group may benefit from credit terms from third-party lenders because third-party lenders may conclude that Company B is less likely to present credit risk as the MNE Group is likely to support Company B and prevent default

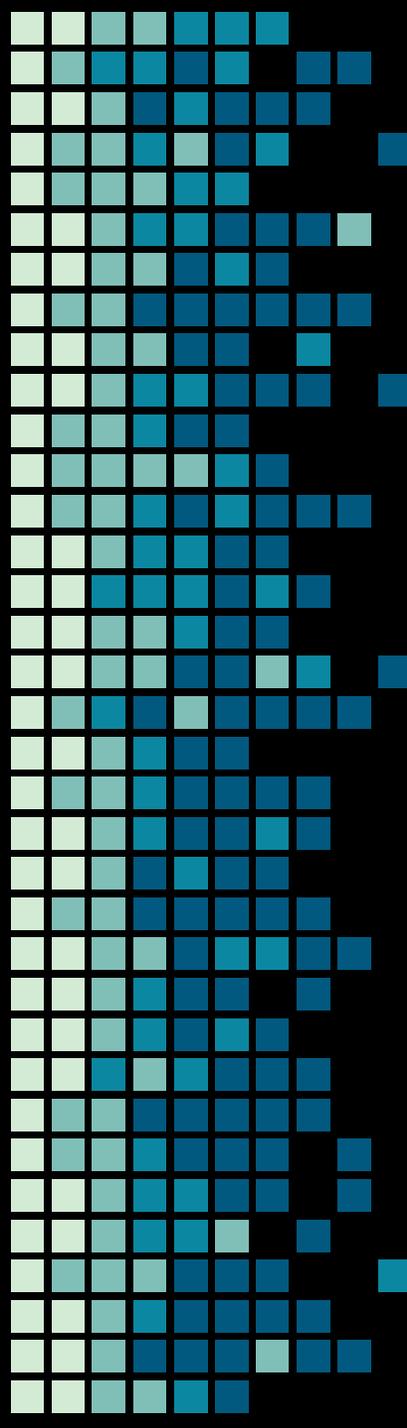
### Scenario 2

The parent company of MNE Group, Company A, provides a formal guarantee to the third-party lenders as an inducement to offer enhanced terms to Company B

In scenario 1, Company B receives a passive, **incidental benefit** that cannot be attributed to a deliberate concerted action of any member of the MNE Group. Instead the **implicit support is a synergistic effect** that may be a comparability factor relating to the economic circumstances of B.

In scenario 2, Company A would be party to a deliberate concerted action in which it **performs functions, uses assets, and assumes risks for the benefit of Company B**, such that arm's length compensation is required.

*In other words, if the benefit accrues to the group as a result of economic circumstances of individual group members then they are merely benefits of passive association.*



# ADDITIONAL GUIDANCE - CENTRALISED PROCUREMENT ACTIVITIES

# Introduction

**Centralised Procurement Activity** typically involves **connecting a parent or group company with vendors**. It generally involves, vendor identification, price negotiation, liaising with vendors, and inventory holding.

Procurement is seen as a potentially mobile activity that could be located outside key markets and used to reduce the level of taxable income in the jurisdictions where goods are processed or sold

Most MNE groups operate some form of centralised procurement, but the precise nature of the activities and their contribution to value can vary widely.

Developing countries sometimes encounter aggressive arrangements involving the insertion by an MNE group of procurement activities that seem to lack economic substance

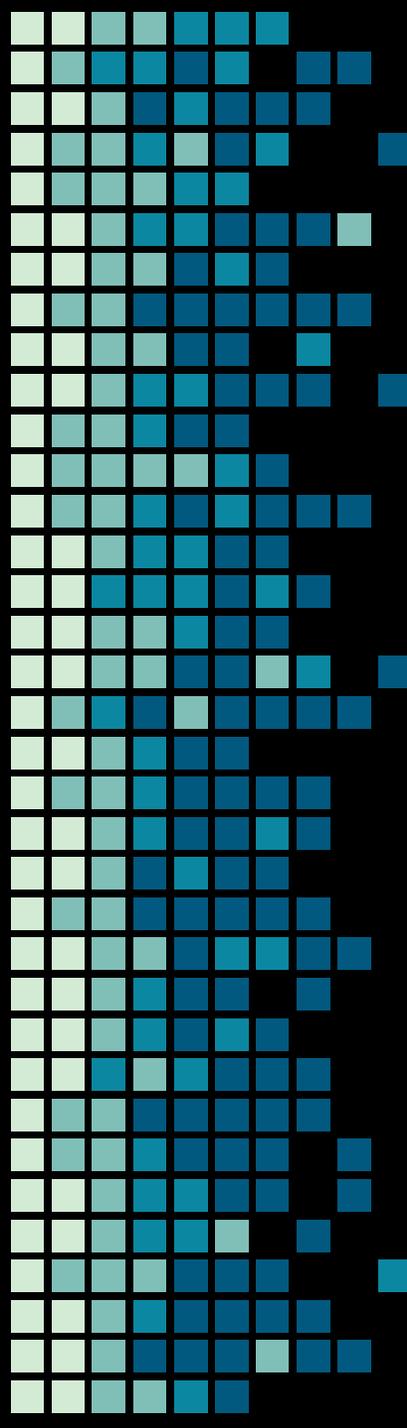
Incorrectly evaluating procurement activities can have detrimental tax consequences for both the jurisdiction in which the activity generates income and also the jurisdiction being charged a fee.

# Monitoring Procurement Activities

In practice, the MNE group may monitor and measure in various ways the performance of procurement activities for commercial purposes in order to assess its own effectiveness, and those measures may be instructive in a transfer pricing analysis.

Depending on the commercial objectives of the MNE group, monitoring and measurement of centralised procurement activities may focus on

- quality,
- speed,
- standardising the range of items,
- finding alternative sources of supply,
- working capital management through vendor credit terms and inventory levels,
- order processing costs,
- production disruption,
- integrating other divisions or newly acquired businesses,
- meeting external and internal standards (for examples, ethical trading, traceability, safety), and
- specific improvement projects to which the procurement function contributes.



# EVALUATING COMPENSATION FOR PROCUREMENT ACTIVITIES

# Factors to be Evaluated for Compensation

Any evaluation of the compensation for centralised procurement activities in an MNE group should be based on a thorough understanding of the accurately delineated transaction i.e. the actual transactions that add value to the group which may differ from the actual contract terms.

## Three Important Factors to be Evaluated

Role and expertise of a procurement services provider;

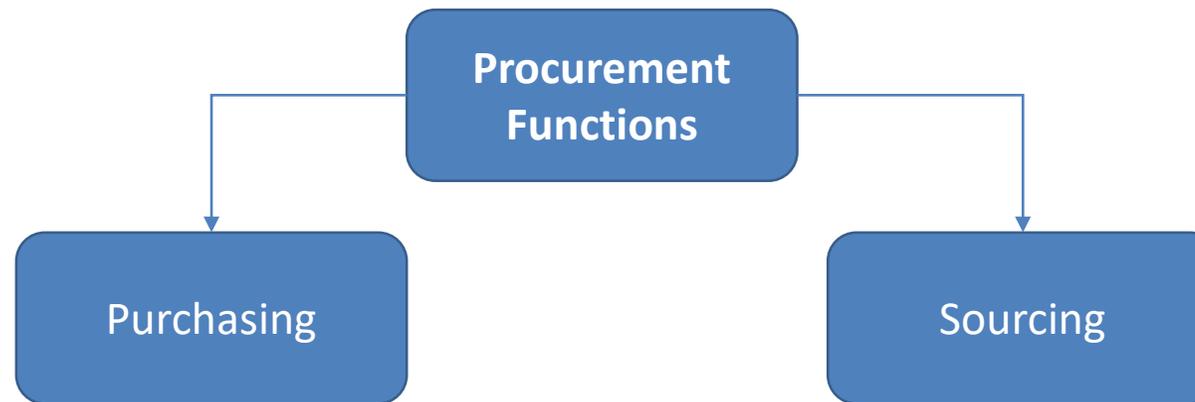
Nature of the items procured and the commercial risks associated with those items

Risks that a service provider assumes.

# Role and Expertise of Procurement Service Provider

Procurement activities cover a range of functions and the particular functions actually performed in a particular case need to be specifically identified and their commercial objectives and contribution assessed.

In performing such an analysis, it can be helpful to consider two categories of functions relating to procurement: **purchasing and sourcing**.



Purchasing and sourcing would generally be more valuable to the recipient enterprises than a purchasing only service, and would be expected to command a higher amount of compensation than that for purchasing alone.

# Nature of Items Procured and Commercial Risks Associated

## Accurate Delineation of Procurement

**Core Spend**, involves items that are converted or resold in the course of the business of the recipient associated enterprises.  
Core spend activity **demands a higher compensation than non-core spend.**

**Examples:** Lithium for a battery manufacturer, certain ingredients for a food manufacturer, energy for a smelter etc.

In accurately delineating the transaction, it is to be tested **whether goods or services may represent a significant contribution to business performance** and associated with significant risks.

The function of the CPC in case of core spend may require **specialised expertise and may involve mitigation of critical business risks for the recipient AEs.**

**Non-Core Spend** sometimes referred to as indirect spend, covers goods and services that support the businesses of the recipient associated enterprises and are not themselves converted into a finished item or resold.

**Examples:** stationery, office equipment, telephone services, vans, media space

The goods and services are likely to be available from a range of suppliers, and so the pricing is already competitive.

The function of the CPC in case of non-core spend is largely that of a **co-ordinator and aggregator**, with the main commercial benefits being the combining of purchasing power across MNE group and efficiencies in reducing administrative costs for the MNE group.

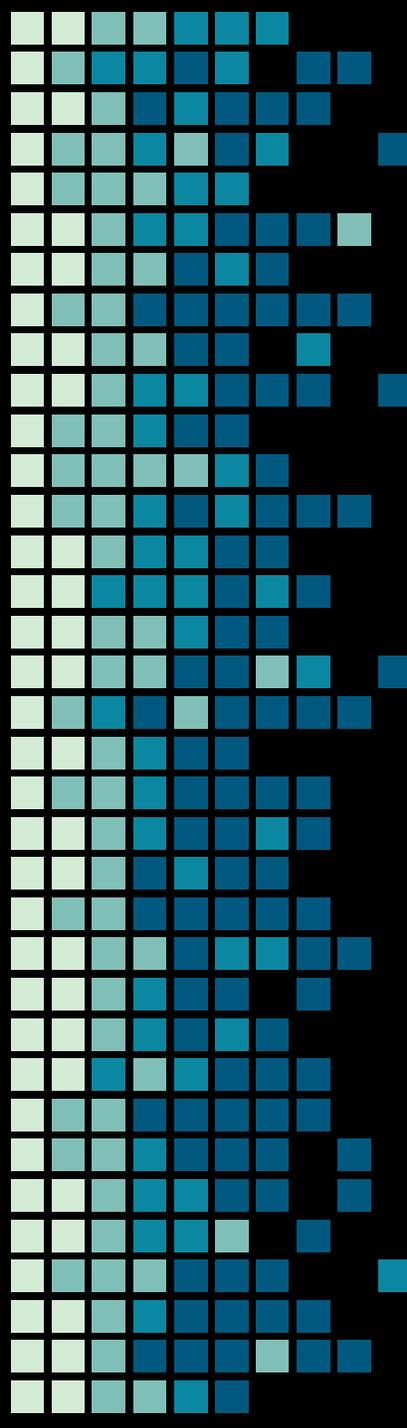
# Risks Assumed by Service Provider

## Inventory Risk

- It can be asserted that a CPC assumes risk associated with holding inventory.
- Where inventory is determined to be owned by the CPC, evaluation of the risk is required. Risk may be in the form of
  - Changes in the value of inventory owing to **market price changes or obsolescence**
  - Additional costs because of **overstocking**

## Other Risks

- Other risks include **Price risk** - by undertaking to guarantee a certain range of prices or **Volume risk** by undertaking to supply a certain volume.
- However, such risks may be reduced or eliminated if the terms agreed with the vendors in practice pass price or volume risk back to the vendors.
- Before determining compensation, attention should be paid to whether CPC has the expertise to evaluate the risk, make decisions in relation to the risk, and has the financial capacity to bear the risk.



# PRICING METHODS FOR PROCUREMENT ACTIVITIES

# Pricing Methods

In general, where the centralised procurement activity provides services to multiple associated enterprises in the MNE group, and the services to each associated enterprise can be separately analysed and quantified, then a direct charge approach may be reliably applied.

Care should be taken in applying an indirect allocation of the fee to ensure that all the associated enterprises receive the same kind of service

For example, it may be that the procurement activity provides a purchasing service for some associated enterprises but a purchasing and sourcing service for others;

or

It may be that the procurement activity relates to non-core spend for some associated enterprises but to core spend for others

In such instances, there may be different levels of fee required depending on the category of services.

As in any transfer pricing analysis, the appropriateness of the method depends crucially on the facts and circumstances of the controlled transaction and the reliability with which the method can be applied.

# Appropriateness of Pricing Methods

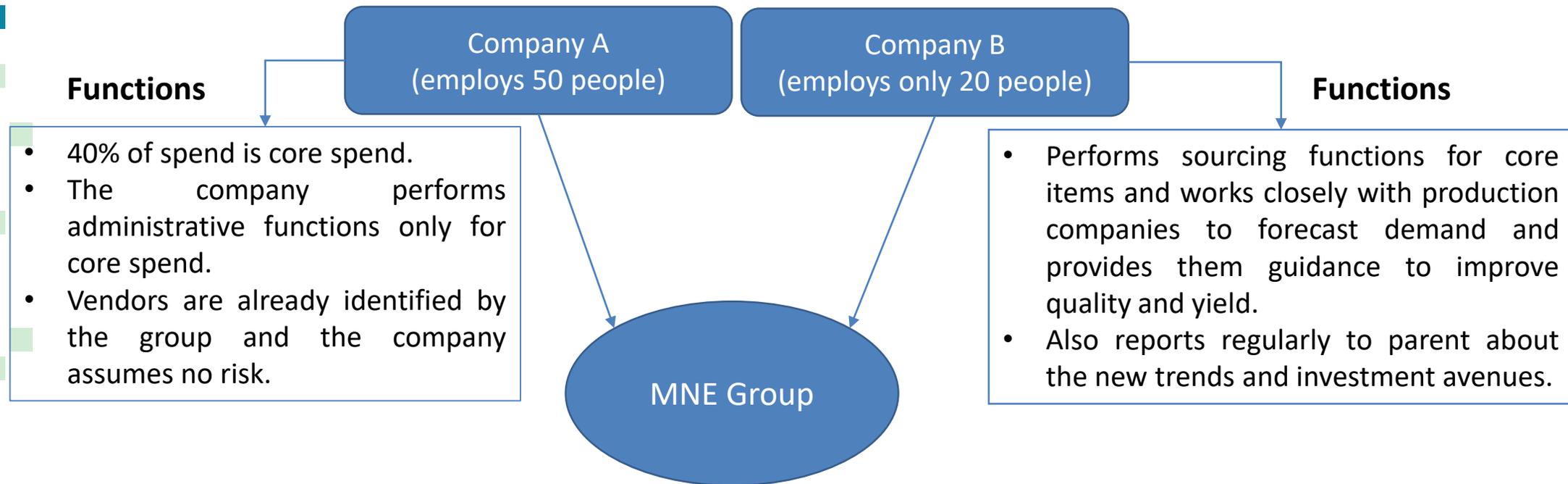
A CPM or TNMM is likely to be an appropriate method where the procurement activities are mainly purchasing rather than sourcing.

The CPM or TNMM can be applied in most cases, even in cases where the centralised procurement company provides expert services and employs know-how and proprietary tools.

CUP method is appropriate where the procurement activities involve **significant sourcing activities, relating to core goods and services**, including business-critical decisions, and involve some risk assumption or performance of risk control functions.

Where **commission rates in third-party arrangements are available**, a CUP Method can reliably be applied.

# Illustration- Appropriateness of Pricing Methods



- In the above illustration, Company A performs a useful function for the group, but it would not seem to be a highly valuable one that contributes significantly to business performance.
- Company B, though a smaller operator in terms of head count, concentrates on business-critical aspects that can directly affect group profitability.

# Illustration (Contd)

## Reliable method for Company A

Even though A spends 40% in core spend, the vendors for procurement are already identified by the group company.

In such a scenario, application of CUP would result in a higher compensation which cannot be justified by the limited activities performed by A.

Hence, CPM seems to be the most appropriate method based on the facts presented.

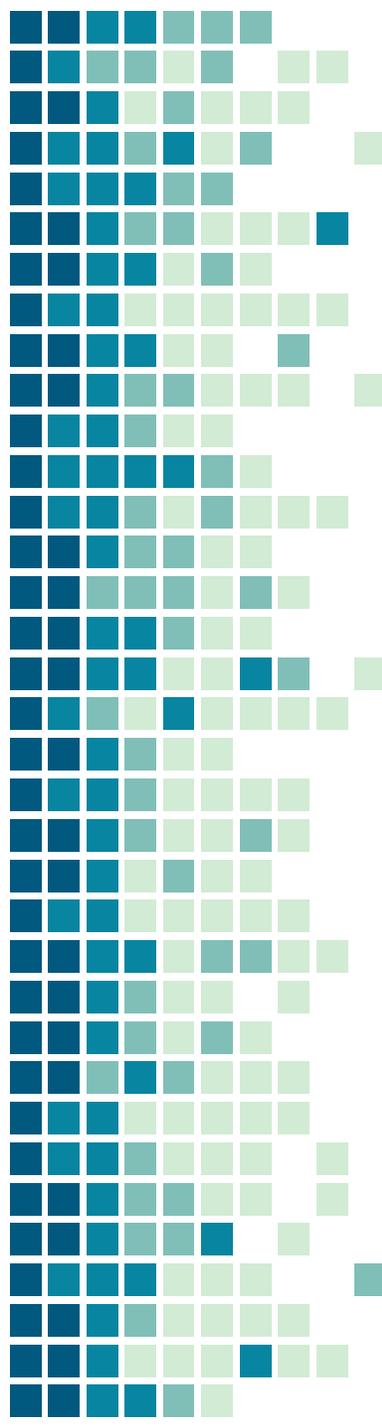
## Reliable method for Company B

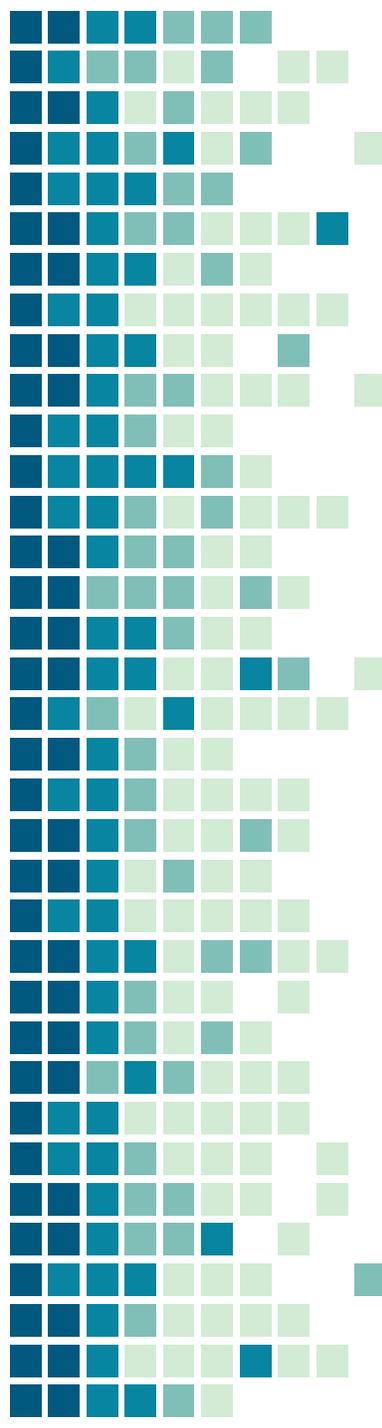
CPM cannot be adopted as it may not give effect to the full value created by the functions performed by B

Moreover accurately comparable companies which perform the exact same functions of B are difficult to identify.

Considering the above facts, a CUP Method can be reliably applied. Commission rates in third-party arrangements may be available, and the same can be taken as reliable benchmark.

# Conclusion

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- 1. The key to determine compensation for centralised procurement activities lies in the nature of items procured, risks assumed and the role and expertise of CPC
  - 2. One has to accurately delineate the transaction in order to identify the actual contribution of various parties to the transaction.
  - 3. The decision on appropriate pricing method would ultimately depend upon the actual role played by the CPC in the entire gamut of transactions.
  - 4. Most importantly, the benefits arising from synergy has to be carefully scrutinised to determine whether they arise on account of deliberate concerted action or merely from passive association.



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