# Transfer Pricing Business Models

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National Association of Certified Valuators and Analysts

## Aligning Business Models and Business Practices

**A key factor in establishing a reasonable transfer price is establishing the business model used by sales and distribution organizations. In this article, the authors describe the three primary models and their relevance establishing and defending a transfer price.**

Once the initial transfer pricing interviews (i.e., functional analysis interviews) have been conducted and the necessary data has been gathered, it is then time to describe the client's business model. This means distinguishing the functions performed, the assets employed, and the risks assumed by the entities involved in intercompany transactions so that it conforms to one of the several business models defined by the tax authorities. Some of the common business models used by sales and distribution organizations today are:

1. Commission agent
2. Limited risk distributor
3. Full-fledged distributor (marketer/distributor)

An entity's profitability is typically related to the functions, risks, and intangible assets associated with its activities. Therefore, it is important to define the business model selected, as it will drive the type and amount of compensation that can be determined under arm's length principles and will define which country will enjoy the largest portion of the profits. The key characteristics of these three popular business models are as follows.

**Commission Agent (CA)**

In general, a commission agent (CA) receives a commission on the sale of products to customers contacted on behalf of the manufacturer or distributor.

A CA generally operates as a sales representative, who does not purchase products for resale, but receives a commission on the sale of products to customers. The CA contacts on behalf of a manufacturing or distribution entity. A CA is responsible for typical sales functions, such as: (i) identifying potential customers; (ii) calling on

active and potential customers; (iii) introducing new products; (iv) taking customer orders; (v) maintaining customer relations; and (vi) providing limited technical assistance. The CA undertakes fewer operational functions than a distributor/marketer and limited-scope distributor, and is typically not involved in any strategic or marketing activities.

Functions performed by the CA include:

- Canvassing potential clients
- Introducing new products and taking customer orders
- Maintaining customer relations (but providing only limited technical assistance)

Terms and contracts are agreed to outside of the local country with little input from the CA.

Also, the CA does not take title to goods, and usually, CA incurs no market risks, or risks related to either marketing or technology intangibles.

Local revenue is usually not recorded on the books of the CA, only sales expenses, thus, revenue is limited to the sales commission.

In such an arrangement, the Principal located outside the country should be careful to avoid being characterized as “doing business” (having a permanent establishment [PE]) in the U.S. Although it is possible that the Principal may have “Nexus” for state and local purposes, and have the obligation to collect sales tax in one or multiple jurisdictions—even where no PE exists.

For a CA, the commission received is usually determined based on a cost plus algorithm and provides a very modest return, due to the fact that few functions are performed and little risk is incurred.

**Limited Risk Distributor (LRD)**

In general, a limited risk distributor (LRD) is a buy/sell organization that performs all sales and distribution functions and has limited risk profile.

The limited-scope distributor undertakes many of the same activities as a marketer/distributor; however, the primary distinction between the two entities is the degree of involvement in strategic marketing decisions. In many industries, a limited-scope distributor has little or no strategic marketing responsibility, but may undertake the day-to-day risks delegated by the manufacturer whose products the limited-scope distributor purchases and resells. Because the distributor does not undertake responsibility for these functions, it also avoids the associated risks, including some market risk, and typically does not develop the associated marketing intangibles.

Local revenue is recorded on the books of the LRD as well as the cost of goods sold. In some cases, the intellectual property (IP) is bundled in the product price paid to the Principal, who is the IP owner. In other cases, especially for a more mature company, there is a separate service fee for the use of intangibles. This fee or royalty is charged in addition to the purchase price of the product/offering.

For an LRD, the resale price method, or the comparable profits method (CPM), can be utilized to determine the amount of the payment to be received. Various algorithms can be used to determine a targeted distribution return, such as a return on sales (ROS) or the Berry Ratio (i.e., the ratio of gross profits to operating expenses).

**Full-Fledged Distributor (FFD)**

In general, a full-fledged distributor (FFD) undertakes all of the sales and distribution functions as well as the typical risk incurred in performing this function. It buys, holds, and sells product/offerings, as appropriate.

Additionally, the FFD (marketer/distributor) holds some strategic and operational marketing responsibility. These marketing functions include: (i) conducting market research, such as building sales forecasts and consumer

profiles; (ii) developing advertising materials or campaigns or hiring independent advertising professionals; and (iii) developing strategic marketing plans. Because the FFD undertakes both operational and entrepreneurial functions relating to the marketing, distribution, and sales activities, the marketer/distributor bears the risks associated with these activities, such as credit, inventory shrinkage, and market risk. It also develops the associated marketing intangibles, including: (i) customer relationships; (ii) recognition of a trademark/trade name; (iii) a third-party dealer network; and/or (iv) expertise in either technical or customer assistance.

As with the LRD, local revenue is recorded on the books of the FFD, and in addition to the purchase price of the goods/offering, there is a separate charge/royalty for the Principal's IP.

For an FFD, the payment received for its services is usually determined based on the CPM.

Once the business model (commission agent, limited risk distributor, or full-fledged distributor) for transfer pricing has been defined, the next step is to determine the "best method" to achieve an arm's length transfer price. At this point, the payment to be made to related parties must be comparable to the remuneration realized by unrelated parties under comparable circumstances.

For this exercise, economists and global databases are utilized to identify a range of potential prices, which related parties would use to create cross charges to be included in the local books and records of each of the related parties. It is not unusual for much of the income, in an entity's tax return, to be generated by the transfer pricing exercise.

After the suitable prices have been determined, it is necessary to establish intercompany legal documents to memorialize the transfer pricing policy and method. To avoid future tax exposure or tax disagreements with governments, companies need to align their business model and business practices with their legal agreements and produce the documentation required by the relevant taxing authorities.

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