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Germany

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Transfer Pricing Considerations for Procurement and Sourcing Entities

This article deals with the arm's length determination of transfer prices for intercompany sourcing activities. In particular, it challenges the view that intercompany sourcing activities represent merely routine services that should be entitled to a low cost-based remuneration without considering any markup on the procurement cost. On the contrary, sourcing activities are usually part of the key value chain of MNE groups meaning that the inclusion of the purchasing cost for raw materials or goods in the cost base is appropriate in the context of the application of the cost-plus method in accordance with the OECD Transfer Pricing Guidelines.

1. Introduction

Transfer prices for intercompany procurement and sourcing activities in an MNE group are currently heavily scrutinized in German tax audits. The German tax authorities regularly take the position, in particular, in outbound cases that a central sourcing company renders only low-value routine services to the other group companies. Consequently, a sourcing entity should be entitled to a small cost-based remuneration. Such a remuneration should cover, in particular, only the cost for personnel and office equipment incurred by the sourcing company.

This article critically examines the approach preferred by the German tax authorities. The transfer pricing issues at stake are illustrated by the following example case:

Asia-Ltd., based in Hongkong, takes the role of a central sourcing company for raw materials within the MNE group Electronic Industries. Asia-Ltd. purchases raw materials (components) in its own name and for its own account from suppliers based in Asia and sells them on to production companies of the MNE group based in Germany and other European countries. The raw materials are delivered directly from the suppliers to the respective production company. The production companies are manufacturing and distributing electronic devices at the European markets.

The employees of Asia-Ltd. perform the following functions:

- purchasing of raw materials (acquisition and selection of suppliers; development of purchasing strategies, negotiation of purchasing conditions with suppliers based on the instructions of the purchasing companies, visits of fairs and potential suppliers, negotiation of purchasing conditions with suppliers, order and payment processing);
- pre-financing of purchasing (30 days between payment to the supplier and receipt of funds from production companies);
- price risk management through hedging;
- quality management;
- handling of complaints and warranty issues; and
- organization of consignment stocks.

Asia-Ltd. employs in total 15 FTE, including a local managing director and personnel in the fields of sourcing, quality management and order processing.

Transfer prices are determined on a cost-plus basis where the cost base is equal to the purchasing cost for raw materials. The cost base is subsequently increased by a markup of 8%. Asia-Ltd. earns an average profit before taxes (EBT) of EUR 10 million.

The German tax audit takes the view that the profit per employee is "much too high". Instead, Asia-Ltd. should be entitled to a low cost-based remuneration covering costs incurred for employees (EUR 2 million) and office equipment (EUR 0.5 million) and increased by a markup of 5%.

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2. Classification of the Asia-Ltd. as an Intermediary Trader

If a supplying company does not produce raw materials or goods itself but resells purchased raw materials or goods, the basic form of classification is as a purchasing agent, as a commission agent or as a full-fledged trader.^[1]

The purchasing agent corresponds to a representative within the meaning of section 164 of the German Civil Code (*Bürgerliches Gesetzbuch*, BGB) or a commercial agent within the meaning of section 84 of the German Commercial Code (*Handelsgesetzbuch*, HGB). The commercial agent brokers commercial transactions for another person or concludes them on his behalf. Unlike the commercial agent, however, the purchasing agent does not sell the principal's goods on the sales market but buys goods on behalf of and for the account of the principal on the procurement market. Usually, in addition to purchasing goods in the name and for the account of others, the purchasing agent takes on functions such as establishing contacts with suppliers, analysing the competition and developing new procurement markets.^[2] For transfer pricing purposes, the purchasing agent is regularly treated as a routine service provider.^[3]

This is to be distinguished from the commission agent who buys or sells goods for the account of another (the principal) in his own name. The purchasing commission agent therefore buys the goods on the procurement market in his own name but for the account of the principal.^[4]

The functions performed by a purchasing company organized as a purchasing commission agent generally correspond to those of the purchasing agent. In addition, however, the purchasing agent often takes over the handling of complaints and warranty issues, liability management and purchasing controlling.^[5]

The full-fledged trader buys and sells goods in his own name and for his own account, so that he does not act legally or economically for another company. In these cases, the full-fledged trader is comparable to a wholesaler or an intermediary sales company in the procurement sector.^[6] In addition to the usual functions for the purchasing agent and the purchasing commission agent, the full-fledged trader assumes more extensive functions, such as supplier selection, negotiation of contract conditions, quality assurance, supply chain management and logistics functions. Moreover, the full-fledged trader regularly bears price and market risks. This makes the full-fledged trader functionally comparable to a "full-fledged distributor".^[7]

The OECD also considers the decisive criterion for defining a full-fledged trader or intermediary trader to be that they acquire raw materials or goods in their own name and for their own account. In this context, the OECD qualifies a so-called low-risk distributor as an intermediary trader (a form of full-fledged trader with weaker functions and limited risks) as long as there is at least a transitory acquisition of the goods.^[8] It is irrelevant that the low-risk distributor's risk profile is very limited and that it acts exclusively for related parties.^[9] In any case, purchasing in one's own name and for one's own account does not constitute a low-value-added service. This is because, according to the OECD, such low-value-added services are only of a supportive nature and are not part of the core business of the MNE group, i.e. they do not establish profit-making activities and do not contribute to the economically significant activities of the MNE group. As a result, the OECD explicitly clarifies that purchasing activities are part of the MNE group's core business and should not be considered as low-value-added intra-group services.^[10]

Against this background, a purchasing company structured as an intermediary or full-fledged trader does not provide pure services with low added value, in which the procurement of ownership is only brokered. Rather, the purchasing company is functionally comparable to a distribution company (depending on the function and risk profile in the form of a low-risk distributor or a full-fledged distributor). Both acquire raw materials or goods which they resell. The purchasing company acquires raw materials or goods from the procurement market, which it resells to the affiliated company; the distribution company buys the goods from the affiliated company and sells them on the sales market. While the sales company usually implements marketing measures and has to build up a customer base, the purchasing company is dependent on building up a supplier base and negotiating favourable purchase conditions. Unlike the sales company, the purchasing company regularly assumes additional functions such as quality assurance of the purchased goods and processing of warranty cases and complaints. If a purchasing company purchases goods on the procurement market in its own name and for its own account, it acts as a proprietary or intermediary trader with a corresponding turnover-based remuneration claim.^[11]

1. See Borstell, in Kessler/Kröner/Köhler, *Konzernsteuerrecht* sec. 8, marginal no. 690 (3rd ed. 2018).
2. See Von Hoyningen-Huene, in MüKo, HGB, sec. 89b, marginal no. 11 (5th ed. 2021); on the terminology, see also OLG Hamburg of 10 Nov. 1966 - 6 U 89/66, MDR 1967, 310 "Einkaufs-Vertreter"; Baumhoff/Liebchen, in Mössner, *Steuerrecht international tätiger Unternehmen*, marginal no. 4.358 (5th ed. 2018); Ditz/Greinert, in Flick/Wassermeyer/Baumhoff et al., sec. 1 AStG, marginal no. 1452; Elbert/von Jesche, in Vögele/Borstell/Bernhardt, *Verrechnungspreise*, ch. N, marginal no. 598 (5th ed. 2020).
3. See Becker/Loose, Ubg 2010, 786 f.; Borstell, in Kessler/Kröner/Köhler, *Konzernsteuerrecht*, sec. 8, marginal no. 690 (3rd ed. 2018).
4. Sec. 383 (1) HGB; see also OECD/G20, *Preventing the Artificial Avoidance of Permanent Establishment Status – Action 7: 2015 Final Report*, para. 5 (OECD 2015), Primary Sources IBFD; Becker/Loose, Ubg 2010, 786; Häuser, in MüKo, HGB, sec. 392, marginal no. 45 (5th ed. 2021).
5. See Becker/Loose, Ubg 2010, 787; Ditz/Greinert, in Flick/Wassermeyer/Baumhoff et al., sec. 1 AStG, marginal no. 1454.
6. See Becker/Loose, Ubg 2010, 786; Löwisch, in Ebenroth/Boujong/Joost/Strohn, HGB, sec. 84, marginal no. 168 (4th ed. 2020); on the distinction, see Borstell/Hülster, in Vögele/Borstell/Bernhardt, *Verrechnungspreise*, ch. M, marginal no. 180 (5th ed. 2020); Puls, in Flick/Wassermeyer/Baumhoff et al., sec. 1 AStG, marginal no. 585.
7. See Ditz/Greinert, in Flick/Wassermeyer/Baumhoff et al., sec. 1 AStG, marginal no. 1456.
8. See OECD/G20, *Preventing the Artificial Avoidance of Permanent Establishment Status – Action 7: 2015 Final Report*, para. 32.12 (OECD 2015), Primary Sources IBFD; see also Becker/Loose, Ubg 2010, 786 f.
9. See Baumhoff/Liebchen, in Mössner, *Steuerrecht international tätiger Unternehmen*, marginal no. 4.356 (5th ed. 2018); Elbert/von Jesche, in Vögele/Borstell/Bernhardt, *Verrechnungspreise*, ch. N, marginal no. 607 et seq. (5th ed. 2020).
10. See *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* paras. 1.188, 1.189, 7.47 (OECD 2022), Primary Sources IBFD [hereinafter *OECD Guidelines* (2022)]; referring to this, Federal Ministry of Finance of 14 July 2021 - IV B 5 - S 1341/19/10017 :001, sec. 3.77 [hereinafter VWG 2021].
11. See Macho/Steiner, TPI 2017, 150, 156: "share in residual profit"; Becker/Loose, Ubg 2010, 786 f. "margin between purchase and sales price".

In the example case, the sourcing company (Asia-Ltd.) purchases raw materials from suppliers in its own name and for its own account and sells them to the production companies. The sourcing company thus fulfils the requirements of a trader in the sense of an intermediary trader.^[12]

If the functional and risk profile of the sourcing company in the example case is compared with the functional and risk profile of a low-risk distributor, the following picture emerges:

Low-risk distributor ^[1]	Sourcing company
Functions	
Purchase goods in their own name and for their own account from related companies and sell them to customers	Purchase raw materials in their own name and for their own account from suppliers and sell them to affiliated companies
Acquisition of new customers	Acquisition of new suppliers
Visits of trade fairs and suppliers	Visits of trade fairs and suppliers
Negotiating price conditions with customers	Negotiation of purchasing conditions with suppliers
–	Development of purchasing strategies
–	Price risk management through hedging
–	Pre-financing of purchasing
–	Quality management
–	Handling of complaints and warranty issues
Order processing	Order processing
Warehouse planning or goods distribution	Organization of consignment stocks
Risks	
Occupancy risk	Occupancy risk
–	Pre-financing risk in relation to purchasing
–	Risk of failed purchasing strategies
–	Investment risk
–	Development risk (in relation to strategic co-operations and purchasing platform)
Use of intangible assets	
Use of a customer base (provided free of charge by the producer)	Use of a supplier base
Sales know-how	Purchasing know-how
–	Quality assurance know-how
–	Self-developed purchasing platform

As a result, the functional and risk profile of the sourcing company in the example case does not only go beyond the activities of a routine service provider; rather, the sourcing company assumes functions that go beyond the functional and risk profile of a low-risk distributor. The sourcing company performs comparable purchasing functions, bears comparable risks and uses comparable assets as a distributor whose functional profile is between a low-risk distributor and a full-fledged distributor. Thus, the sourcing company is to be classified as an intermediary trader for transfer pricing purposes.

3. Transfer Prices for Supplies by the Sourcing Company to the Production Companies

3.1. Inclusion of purchase cost in the cost base

In the example case, the prices for raw material supplies by the sourcing company to the production companies were determined using the cost-plus method. The cost basis for determining the price for deliveries by the sourcing company to the production companies is a cost price composed of the purchase costs incurred by the sourcing company after deduction of any volume discounts. Other costs such as employees' salaries (personnel expenses), rental expenses and miscellaneous costs are not taken into account. This means that all costs of the sourcing company, with the exception of the cost price for the purchase of raw materials, must be covered by the markup to be added to the cost base.

The application of the cost-plus method is, in the OECD's view, a valid transfer pricing method for the resale of raw materials from a purchasing company to related companies.^[13] Basically, the cost-plus method is an appropriate transfer pricing method to reflect

^{12.} See also *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* para. 9.158 (OECD 2010), Primary Sources IBFD [hereinafter *OECD Guidelines* (2010)], where the distinction between a mere purchasing agent or broker and a proprietary trader is determined by whether the purchasing company acquires ownership of the goods, i.e. whether the purchasing company acquires and resells the goods in its own name and for its own account.

¹ See on the functional and risk profile of a low-risk distributor Ditz, in Flick/Wassermeyer/Baumhoff et al., sec. 1 AStG, marginal no. 1654; Dolezel, in Vögele/Borstell/Bernhardt, *Verrechnungspreise* (5th ed. 2020), ch. X, marginal no. 326.

^{13.} See para. 9.157 *OECD Guidelines* (2010); Kroppen/Rasch, in Kroppen, *Verrechnungspreise bei Umstrukturierungen der Geschäftstätigkeit*, marginal no. 445.

the function and risk profile of a purchasing company. The core task of the sourcing company is the purchasing and sale of raw materials in its own name and for its own account to affiliated production companies. The contractual obligation of the sourcing company, therefore, consists in the procurement of ownership of the raw materials. In this respect, the purchasing function also requires sales-based remuneration based on individual cost prices of the raw materials.^[14]

Contrary to the common view of the German tax authorities, a sourcing company does not provide a routine service in which the procurement of ownership between the supplier and the respective production company is only brokered. Rather, the sourcing company in the example case sells raw materials to the production companies, which it owns. The fact that these are direct shipments (i.e. without physical delivery by the production company) does not change the assessment, because even an independent intermediary would try to minimize its own storage risk as much as possible.^[15]

The application of the cost-plus method on the basis of cost prices is also in line with the OECD Transfer Pricing Guidelines (OECD Guidelines). Section 9.157 of the OECD Guidelines (2010) already stated in the past that it is appropriate for a central purchasing company to purchase raw materials and supplies from third-party suppliers and resell them to the manufacturing companies at a cost-plus markup.

Nothing else applies according to section 1.188 of the OECD Guidelines (2022), according to which the arm's length price would have to compensate the purchasing company for the coordination of the centralized purchasing activities. If the price comparison method (CUP) is not applicable, the OECD suggests applying the cost-plus method in this case. The arm's length price is the cost price for the goods purchased by the purchasing company plus a profit markup. The purchasing advantages from the reduced purchase prices – such as the volume discounts granted by suppliers in the present case – are passed on to the producers in this way. In this respect, the OECD wants to explicitly apply the profit markup to the purchase price for raw materials. This takes into account the fact that the purchasing company acquires ownership of the products and thus also bears increased risks. The acquisition of ownership is associated with more risks than in the case of a mere brokerage.^[16]

Furthermore, in its paper Additional Guidance on the Attribution of Profits to a Permanent Establishment under BEPS Action 7 of 22 March 2018, the OECD clarified that a purchasing unit (i) is to be remunerated according to the cost-plus method and (ii) the purchase prices for the purchased goods are to be used as the cost basis. Example 4 (Procurement of goods (related intermediary)) on page 20 states in paragraph 74:

TradeCo pays BuyCo a commission equal to a percentage of the cost of purchases

In the OECD example, BuyCo acts as an agent and purchases goods on the procurement market on behalf of TradeCo. The sourcing company, on the other hand, trades in its own name and for its own account, so that the selling price to the production companies must be derived all the more from the purchasing cost.

The cost-plus method adequately and appropriately reflects the functional characteristics of a purchasing company acting as an intermediary trader if – as in the present case – the cost price (purchasing cost for raw materials) is taken as the cost basis. The fact that the sourcing company has to finance its running costs from the *handling fee* also does justice to its characterization as an intermediary trader. Unlike a routine service provider, an intermediary trader is financed from the trading margin between the purchasing cost for the raw materials and the selling price.^[17]

The appropriateness of the cost basis is also supported by the fact that, according to general business principles, full costs are used when applying the cost-plus method.^[18] Full cost accounting is based on the assumption that a prudent and conscientious business manager will strive to cover the full costs of his delivery and, in addition, to make a profit (contribution margin approach).^[19]

In this respect, it is only logical that the sourcing company's remuneration is based on its expenses directly caused by the purchase (i.e. purchasing cost for raw materials).^[20]

3.2. No comparability of the purchasing activity with a low-value-added service activity

In the opinion of the German tax authorities and the OECD, intra-group low-value-added or limited-risk services are also to be remunerated according to the cost-plus method. However, in these cases only the operating expenses (consisting of personnel and material costs such as rent or leasing cost) are used as the cost basis.^[21] Low-value-added routine services are characterized by the fact that they:

- have a supportive character;

14. See sec. 433 para. 2 BGB, Weidenkaff, in Grünebert (previously Palandt), BGB, 81th ed., 2022, sec. 433, marginal no. 38: "Purchase price is the consideration for the transfer of the object of purchase".

15. See Macho/Steiner, TPI 2017, 150, 156; Möbus/Masorsky/Freudenberg, BB 2012, 933, 937.

16. See Rasch, in Kroppen/Rasch, *Handbuch Internationale Verrechnungspreise, Verrechnungspreisaspekte bei Umstrukturierungen der Geschäftstätigkeit*, marginal no. 122.

17. See Macho/Steiner, TPI 2017, 150, 156; Elbert/von Jesche, in Vögele/Borstell/Bernhardt, *Verrechnungspreise* (5th ed. 2020), ch. N, marginal no. 372; Möbus/Masorsky/Freudenberg, BB 2012, 933, 937; Becker/Loose, Ubg 2010, 786 f.

18. See OECD Guidelines (2022), para. 2.45; Baumhoff/Liebchen, in Mössner, *Steuerrecht international tätiger Unternehmen*, marginal no. 4.264 (5th ed. 2018).

19. See para. 2.49 OECD Guidelines (2022); Baumhoff/Liebchen, in Mössner, *Steuerrecht international tätiger Unternehmen*, marginal no. 4.264 (5th ed. 2018); Jacobs/Endres/Spengel, in Jacobs, *Internationale Unternehmensbesteuerung* (8th ed. 2016), 572.

20. See Ditz/Greinert, in Flick/Wassermeyer/Baumhoff et al, sec. 1 AStG, marginal no. 1456.

21. See sec. 3.74 VWG 2021; paras. 1.189 and 7.61 OECD Guidelines (2022).

- are not the part of the multinational group's main activity in its external relations with third parties;
- need neither unique nor valuable intangible assets for the provision; and
- for the service provider are neither associated with the assumption or control of significant risks nor result in the creation of significant risks.^[22]

According to the OECD, the activity of an agent or an intermediary trader can also be considered as such a routine activity.^[23] Nevertheless, in section 7.47 of the OECD Guidelines (2022), the OECD explicitly states that purchasing activities in relation to raw materials are not to be regarded as low-value-added, limited risk services:

The following activities are not eligible for the simplified approach described in this section:

- purchasing activities related to raw materials, consumables and supplies used in the manufacturing or production process ...

The reference in section 3.77 of the German Transfer Pricing Guidelines (*Verwaltungsgrundsätze, VWG "Verrechnungspreise"*), published on 14 July 2021 to section 7.47 of the OECD Guidelines (2022) shows that the German tax authorities share this view. The German tax authorities explicitly clarify that "sales, marketing and distribution" are not routine activities with low value added. Due to the comparability of the functions and risks of the sourcing company with a distribution company, nothing else can apply to the purchasing activity.

Furthermore, according to the OECD, even the weakest form of a purchasing entity, a purchasing office, is not supposed to perform an auxiliary activity (or mere service) if the employees working in the purchasing office have special purchasing knowledge, check the type and quality of the raw materials to be procured and conduct "supplier visits".^[24]

Moreover, the sourcing company's purchasing activity is not comparable to that of an agent or broker. This can be illustrated by comparing the sourcing company's purchasing activity with a typical agency activity:

Purchasing activity	Typical agency activity
Functions	
Purchase raw materials in their own name and for their own account from suppliers and sells them to affiliated companies (part of the core business of the MNE group)	Procurement of service providers in the areas of transport, logistics, human resources, maintenance of production facilities, insurance (services are only of a supportive nature)
Acquisition of new suppliers	Acquisition of new suppliers
Visits of trade fairs and potential suppliers	Visits of trade fairs and potential suppliers
Negotiation of purchasing conditions with suppliers	Support of production companies in negotiations with suppliers
Development of purchasing strategies	–
Price risk management through hedging	–
Pre-financing of purchasing	–
Quality management	–
Handling of complaints and warranty issues	–
Order processing	–
Organization of consignment stocks	–
Risks	
Occupancy risk	Occupancy risk
Pre-financing risk in relation to purchasing activities	–
Risk of failed purchasing strategies	–
Investment risk	–
Development risk (in relation to strategic co-operations and purchasing platform)	–
Use of intangible assets	
Use of a supplier base	–
Purchasing know-how	–
Quality assurance know-how	–
Self-developed purchasing platform	–

As a result, the sourcing company usually does not provide routine services with low value added – unlike in the context of agency activities.

22. See sec. 3.75 VWG 2021; para. 7.45 OECD Guidelines (2022).

23. See para. 7.34 OECD Guidelines (2022).

24. See para. 68 OECD Model Tax Convention on Income and on Capital: Commentary on Article 5 (21 Nov. 2017), Treaties & Models IBFD.

3.3. Arm's length transfer prices

The profit markup applied should be appropriate in view of the function and risk profile of the sourcing company, its particular contribution to value creation and the assets used. In particular, an independent intermediary trader would be remunerated by a correspondingly higher margin for the exercise of high-value-added purchasing functions such as supplier selection, negotiation of delivery conditions, development of a purchasing platform, coordination of purchasing activities in the MNE group and the assumption of risks such as capacity utilization risk, investment risk and pre-financing risk in relation to purchasing activities.

Further, the appropriateness of the markup can be derived from a comparison with the net return on sales (EBIT-margin) earned by third-party traders of similar goods and raw materials. If the markup of the sourcing company leads to an EBIT-margin within the range of EBIT-margins earned by third-party traders then it would fall within the arm's length range of markups. The comparison with EBIT-margins is necessary due to practical reasons. In many cases the factors need to determine the markup such as purchasing cost cannot be derived from the common benchmark data basis.

4. Conclusion

Based on its function and risk profile, a sourcing company can be classified as an intermediary trader that performs comparable purchasing functions, bears comparable risks and uses comparable assets as a distribution company whose function profile is between low-risk distributor and full-fledged distributor. Consequently, the inclusion of the purchasing cost for raw materials or goods in the cost base is appropriate in the context of the application of the cost-plus method in accordance with the OECD Guidelines.



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