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International

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Luxury Fashion and Transfer Pricing: IP Owners, Distributors, Supply Chain and Digitalization at the Beginning of a New Era

High profitability, worldwide physical presence and strong leverage on intangibles make the luxury fashion businesses ideal targets for transfer pricing scrutiny. The industry dynamics are rapidly transforming, with digital revolution and younger customer base being the main factors. New transfer pricing issues are already adding to the existing ones: progressive lack of comparables due to expansion along the supply chain, double taxation remedies still costly and slow, increasing interest in APAs as the only viable solution to secure transfer pricing risk.

1. Business Landscape

Until recently, businesses which are now obviously included in the luxury sector were seen as part of the industry of the goods or services they produced and sold: fashion, automotive, jewellery and so on.

Yet Comité Colbert – the association of the major French luxury businesses – was founded as early as 1954.[1] Starting from the 1990s, similar associations of high-end businesses operating in different "traditional" sectors were formed in Italy and other European countries.[2] The seven organizations now compose the European Cultural and Creative Industries Alliance (ECCIA), including over 600 brands and cultural institutions in Europe.

In 2012 the European Commission, in a communication to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions[3] observed that "fashion and high-end industries … rely on a strong cultural and creative input", stating that the sector includes "high-end fashion, jewellery and watches, accessories, leather goods, perfumes and cosmetics, furniture and household appliances, cars, boats, as well as gastronomy, hotels and leisure".

In 2022, the luxury industry is universally recognized as an industry with its own features, regardless of the range of products and/or services provided by each business operating in the luxury segment. Within luxury, "personal luxury goods" (including high-end fashion) is the second largest industry after automotive[4] and the most resilient one in the last 15 years.

In such a timeframe, luxury fashion has been fast-growing, has recovered quickly after crisis moments and has seen extensive business transformation – an ongoing process that has been accelerated by the COVID-19 pandemic.

After the 2008/09 economic crisis caused by the credit crunch, the 2010s have registered steady growth in the sector, mainly through the expansion to new markets, especially in the fastest growing economies (first of all China, but also India, Brazil, Russia, Taiwan and others). The expansion happened not only through geographically broader distribution, but also through a constant increase of the number and presence of directly operated points of sale (DOS) by all luxury fashion brands. On the one side, this trend allowed the *maisons* to increase their profitability, and on the other side it enabled better, broader and more consistent brand awareness worldwide: luxury fashion extensively leveraged on brand power, together with continuous design innovation.

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1. M. Chevalier & G. Mazzalovo, *Luxury Brand Management*, p. 86 (4th ed., Wiley 2021):

   We are so used to the idea of luxury brands that we tend to forget that this is a relatively new concept. For many years, businesses that we now include in the luxury sector were considered completely separate and were represented by different federations: the Federation of Ready to Wear, the Federation of Leather Goods, the Federation of Perfumes and Cosmetics, and so on. On the face of it, in the manufacturing and sales processes, a bottle of champagne and a lady's dress have very little in common. The champagne is produced through an automated system using very modern machinery. It is then sold in wine stores, but also in supermarkets and hypermarkets. However, a lady's dress is often made by hand and in very limited numbers, and sold in exclusive luxury stores around the world. The French were probably the first to understand the fact that a bottle of champagne and a sophisticated dress do have something in common, and this is why in 1954 they created the Comité Colbert, an association to promote the concept of luxury.
2. Fondazione Altagamma in Italy (1992), Walpole in United Kingdom (founded in 1990 as The Churchill Group, renamed as Walpole in 1992 and focused on luxury since 2005), Círculo Fortuny in Spain (2011), Meisterkreis in Germany (2011), Gustaf III Kommitté in Sweden (2018) and Laurel in Portugal (2021).
3. *See Promoting cultural and creative sectors for growth and jobs in the EU*, COM(2012) 537 final.
4. Luxury fashion is estimated to have reached EUR 288 billion in 2021 and luxury automotive EUR 551 billion, out of a total of EUR 1.140 billion for the whole luxury sector. *See* Bain & Co. – Altagamma, *Luxury Goods Worldwide Market Study*, 20th ed. (Fall 2021), available at www.altagamma.it/studi-e-ricerche/ (accessed 28 Nov. 2022).

The 2020s started with the COVID-19 pandemic. 2020 brought the sector's growth to an abrupt halt, but the recovery was very fast in 2021. In 2022 fashion is expected to reach a new historical peak, beyond 2019 turnover and profitability.[5]

In terms of competitive landscape, in the 2010s big luxury conglomerates formed and/or consolidated. LVMH,[6] Richemont[7] and Kering[8] now dominate the sector, together with Chanel and Hermès, the only mono-brand companies comparable in size to the three bigger players.[9] A small group of companies controlling more than one brand constitutes the second tier: Capri Holdings,[10] Prada,[11] OTB,[12] Tod's.[13] The third tier is composed of single-brand companies (such as Burberry, Ferragamo, Zegna and others), presently struggling to keep the pace of the bigger players in innovation investments, omni-channel strategy and communication. Finally, new and emerging small brands are trying to gain market shares either on the more classical styles or in cutting edge innovative ones, leveraging the digital channel. In the next years some of them may succeed in growing enough to enter the third tier, or being acquired by a conglomerate.

The pandemic acted as an important accelerator of trends already present in the industry, but even before it luxury fashion was already in the midst of a transformation phase.

Such transformation is driven by many factors, the crucial one being the increasing share of new generations among the luxury customers. It is estimated that by 2025 over 60% of consumers will be millennials and from the Z-generation.[14] Of course, this implies the need for technological and digital evolution with customer engagement being the primary focus of technology adoption.

On the distribution side, the rigid separation between channels is fading, leaving the scene to a unique bubble where the consumer may freely navigate towards the brand and its offer without strict borders: consistency between digital and physical experience, omni-device access, pick up in store, remote sales, personalized assistance are some essential elements of the omnichannel diktat.

Sustainability is another crucial driver for transformation, together with environmental, social, and corporate governance and social responsibility. These drivers certainly are common to many – if not all – sectors at the moment, but in luxury fashion the pressure from increasingly aware consumers is particularly felt, with fashion being one of the most polluting industries in the world.[15] All brands are making significant investments and trying to make their business model more and more sustainable, circular, inclusive, transparent and responsible – and they are communicating it, of course.

The rush for sustainability, the omnichannel model and the pandemic outdated some delocalization choices. "The gradual increase in costs, including in the so-called "low cost" countries (including part of China and Eastern Europe), the recent interruptions and delays in supply chains in all sectors and, in the near future, also the claims for a greater transparency, sustainability and social responsibility"[16] are bringing the industry towards more centralized supply chain models.

The higher cost of doing business is another preeminent feature of the present business landscape – again, the issue is common to many if not all sectors, but has its own peculiarities in luxury fashion. Higher regulatory and compliance requirements, inflation caused by the pandemic and then the Ukraine war, calls for digitalization, product sustainability and supply chain traceability and the increase in energy costs: it is all leading to either reduced profitability or price increases. The industry chose to repeatedly increase prices in the last collections, but this is for sure a short-term strategy. Efficiencies in production and operating model must be achieved in the near future.

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5. C. D'Arpizio from Bain & Co. on the occasion of the presentation of the *Altagamma - Bain Monitor on the Worldwide Market for Personal Luxury Goods – Spring Update 2022* in June 2022, observed:

   > Despite significant macroeconomic challenges, including hyperinflation, slower growth of GDP and the Russian-Ukrainian conflict, the luxury personal goods market has once again proven resilient. Luxury goods brands began this year showing particularly strong growth, and playing a leading role in the sustainable and digital transformation taking place around the world.

   See https://altagamma.it/media/source/PRESS%20RELEASE_%20Altagamma%20Consensus%20e%20Monitor%20Update%202022_def%20ENG%5B6%5D.pdf (accessed 28 Nov. 2022).
6. LVMH Group, based in France, is the largest luxury conglomerate (EUR 64.2 billion revenue in 2021), with a portfolio of dozens of luxury brands in various sectors: wine and spirits, jewellery and watches, *hotêllerie*, perfumes and fashion. The main fashion brands are: Louis Vuitton, Dior, Fendi, Bulgari, Loro Piana, Céline, Emilio Pucci, Givenchy, Kenzo, Marc Jacobs, Loewe, Berluti and Off-White. The group is also present in high-end fashion distribution, owning DFS Group (leader in travel retail distribution in Asia) and the Parisian department stores Le Bon Marché and La Samaritaine.
7. Richemont Group is the second largest conglomerate (EUR 19.2 billion revenue in 2021-2022). More focused on jewellery and watches, Richemont is present in the leather accessories segment through brands such as Montblanc, Cartier, Delvaux, Serapian Milano, and in fashion through Chloé, Azzedine Alaïa and Dunhill. It also acquired the online high-end fashion distributor Yoox – Net-à-porter, presently co-owned by the other online high-end fashion distributor Farfecth.
8. Kering Group, also based in France, is the third largest conglomerate (EUR 17.6 billion revenue in 2021), including various jewellery and watches and fashion brands. Among the latter: Gucci, Yves Saint Laurent, Bottega Veneta, Balenciaga, Brioni and Alexander McQueen.
9. Chanel (USD 15.6 billion revenue in 2021) is a total-look brand, historically leader in perfumes and cosmetics as well. Hermès Group (EUR 9.0 billion revenue in 2021) expanded over the years along the supply chain, buying producers of raw materials, semi-finished and finished goods and building factories. It owns shoe brand John Lobb and various brands of home textiles and tableware.
10. Capri Holdings (USD 5.7 billion revenue in 2021-2022) owns Versace, Jimmy Choo and Michael Kors.
11. Prada Group (EUR 3.4 billion revenue in 2021) includes Prada, Miu Miu, Church's and Car Shoe.
12. OTB Group (EUR 1.5 billion turnover in 2021) owns Diesel, Maison Margiela, Marni, Viktor&Rolf, DSquared2 and Jil Sander.
13. Tod's Group (EUR 0.9 billion turnover in 2021) includes Tod's, Fay, Roger Vivier and Hogan.
14. Boston Consulting Group X Altagamma, *True Luxury Global Consumer Insights* (June 2021), available at https://altagamma.it/media/source/PRESS_True%20Luxury%20Global%20Consumer%20Insight.pdf (accessed 28 Nov. 2022).
15. Fashion is considered by many the second most polluting industry after oil and gas, but this has been questioned by many studies. Recently, the World Economic Forum classified it as the third most polluting industry: *see* World Economic Forum, in collaboration with Boston Consulting Group, *Net-Zero Challenge: The supply chain opportunity*, available at www3.weforum.org/docs/WEF_Net_Zero_Challenge_The_Supply_Chain_Opportunity_2021.pdf (accessed 28 Nov. 2022). For an extensive summary of the main studies published in recent years on the topic, *see* A. Wicker, *Fashion Is Not the 2nd Most Polluting Industry After Oil. But What Is It?*, Ecocult (Jan. 2022), available at https://ecocult.com/now-know-fashion-5th-polluting-industry-equal-livestock/ (accessed 28 Nov. 2022).
16. *See* F. Scucciati, *The 10 challenges for today's Fashion and Luxury industry* (The European House – Ambrosetti, Feb. 2022), available at https://www.ambrosetti.eu/en/news/the-10-challenges-for-todays-fashion-and-luxury-industry/ (accessed 28 Nov. 2022).

Still, the whole luxury fashion industry is strongly based on IP rights, which stay at the core of the industry's value chain. The power of the brand is stronger than ever and continuous innovation in design is the pivot for staying relevant. Then, it is "just" a matter of customer engagement, the right communication and selective distribution.

2. Macro Trends Short- to Mid-Term

Sustainability, cost efficiency and quality control are pushing brands to expand along the supply chain through industrial verticalization and insourcing, by acquiring tanneries, leather cutting facilities, shoes and bags factories, jewellery makers and all kind of high-end manufacturers, especially in Italy.[17] More mergers and acquisitions in the supply chain are expected to happen in the next decade.

On the governance side, big conglomerates keep buying other brands and it is likely that new conglomerates will form in the coming years.[18] Another factor pushing the industry towards greater concentration and transparency is the increasing presence of private equity funds, attracted by the high profitability of the sector: it is *common lieu* that any luxury business achieves a two-digit EBIT margin at group level even in the worst years.

Such two phenomena are leading – as in many other industries – to an increased share of the global turnover being implemented through infra-group transactions: the transfer pricing perimeter for the industry is destined to constantly increase.

Additionally, the luxury fashion businesses are increasing the number and dimension of central functions and shared services among subsidiaries (some core, some ancillary): again, this will lead to increasing volumes of infra-group transactions in the coming years.

The need for central functions comes from many factors. The luxury fashion consumer is global and moves in a global environment, hence brand communication, customer engagement, retail management, merchandising strategy and product creation must be more and more uniform and centralized.

Omnichannel strategy (which is, total integration between the physical and digital distribution channels, so-called "phygital") and new customers are demanding a wide range of after sale services. Personalized assistance, delivery and pickup, repair, remote returns, and customization are a must-have for all brands. Consequently, stock management, logistics, IT infrastructure, service hubs and retail training are playing a crucial role in delivering such services in a timely and effective way.

Digital transformation has been a cross-industry mantra in these last years. In luxury fashion the problem can be conceptually split into three parts: the creative part, the customer engagement and retail transformation part and the production area part.

3D design and prototyping have been used and developed in the recent years. The industry has been able to attract talent and innovate, enhancing cost efficiency in the creation and product development process.

Digitization of physical retail appears to be slower than expected, but the new functionalities available through augmented reality and biometrics are one of the key drivers for the future of e-commerce (and the whole of retail). Digital presence is the more and more focused on content and engagement, through communication of the brand values and digitalization of the luxury experience. Crypto currencies are already accepted for retail payments by various brands. Metaverse and non-fungible tokens now seem to open a new distribution channel.

On the industrial side the sector is still struggling to make the transformation happen. IT integration with external producers, forecasting and resource/stock planning using artificial intelligence, blockchain certifications of the supply chain and process digitalization through co-working IT tools are just some of the key challenges for the next years.[19] The only new technology widely adopted is radio-frequency identification, used both for counterfeit and logistics purposes. Brands belonging to the largest groups are 2.1 times faster than competitors in experimenting and adopting the new technologies.[20]

To summarize, in the next four to five years the whole industry is going to transform its way of doing business, trying to capture innovation trends from other sectors, understand the changing taste and needs of its consumers and ultimately maximise growth and profitability in a sustainable way.

3. Typical Operating Models in the Industry Sector Considered

3.1. Stars, hubs and conglomerates

A business in the luxury fashion industry typically operates according to one of the following models:

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17. A peculiar feature of Italy is the presence of various specialized manufacturing districts, composed mainly by family-owned small to medium-sized enterprises, such as the Tuscan leather district, the silk district in the Como area (Lombardy), the sneakers district in the surroundings of Lecce (Apulia), the jewellery districts of Arezzo (Tuscany) and Valenza (Piedmont), and so on.
18. Every now and then the idea of an Italian luxury conglomerate is spoken of, but until now only French brands were able to pursue a consolidation strategy. The latest talk about the Italian alternative to the big French Groups came from Renzo Rosso, founder and majority shareholder of OTB: *see* https://www.businessoffashion.com/articles/luxury/diesel-comeback-reignites-otbs-ambitions-to-build-italian-fashion-empire/ (accessed 28 Nov. 2022).
19. *See* F. Scucciati, *The 10 challenges for today's Fashion and Luxury industry* (The European House – Ambrosetti, Feb. 2022).
20. For the status of technology innovation in the industry, *see* Comité Colbert – Bain & Co., *Luxe et technologie. Les dèbuts d'une nouvelle ère* (Sept. 2022), available at www.comitecolbert.com/app/uploads/2022/09/comite-colbert-x-bain-rapport-luxe-et-technologie-2022.pdf (accessed 28 Nov. 2022).

- "Stellar" mono brand group model. Here staff functions, central core functions, IP rights, creative department, R&D, production and first level distribution (hence, logistics) are concentrated in one legal entity, which is the ultimate parent company as well. This model may encompass regional distribution hubs and/or headquarters, such as Hong Kong or Singapore for Asia-Pacific, the United States for the Americas and so on.
- Hub-based model. Under this model certain key functions are separated and distributed along the supply chain, e.g. Luxembourg or Dutch IP owner, UK design centre, Italian or Eastern European R&D centre, Swiss or Italian logistic hub, Italian, French or Chinese manufacturer, French or Italian formation hub, and so on.
- Big conglomerates. Born through acquisitions of single brands, for some years their headquarter functions have been limited to top management, finance and M&A, leaving each brand independent and allowed to maintain its original group structure. Lately, certain key functions are centralized for all or some brands in the portfolio, such as logistics, after sales services, e-commerce and digital, manufacturers (specialized in certain product categories), and so on. In this way, groups are achieving economies of scale, verticalizing the production of certain merchandise categories and empowering digital and after sale services innovation on a larger investment scale.

Of course, certain features of each model can be mixed in the operating structure of each business.

3.2. The shift to retail

The entire sector has been inexorably shifting from wholesale to retail distribution in the last three decades. Regardless of the model, all businesses operate DOS through local limited-risk distributors (LRD) under exclusive retail distribution licence for a single market.

Retail allows direct control over brand positioning, customer experience, after sale services, visual merchandising, operational excellence and merchandising intelligence.

In recent years, central functions were developed and empowered to guide and support retail operations, enhancing consistent brand image and communication. Typically, a central function sets up strategy and goals, action plans, projects and field marketing initiatives and gives guidelines and drives the global budget, while local functions in LRD execute plans and guidelines provided by central functions.

The big conglomerates are striking deals with all the main malls around the world, securing prime locations for a certain number of their brands, sometimes getting discount on rent rates. Consequently, brands from the second and third tier are struggling to get the better locations and are sometimes paying a higher rent – lower traffic and higher costs negatively impact their profitability compared to brands belonging to conglomerates.

3.3. Licences

Presently it is common for *maisons* to license out their brands for the production and distribution of non-core products, such as glasses, watches, perfumes, skin care and make-up, hotel amenities, and accessories. Essilor Luxottica dominates the eyewear market, being the largest licensee of luxury brands.[21]

In the past it was not uncommon to have a licensed casual, sport or jeans line, but the phenomenon progressively disappeared during the 2000s. For example, in 2010 Dolce e Gabbana discontinued their successful D&G casual line to re-position their brand higher in the luxury pyramid.

In recent years some major brands have internalized the production of certain non-core lines. In 2015 Kering created the Kering Eyewear division, internalizing the production and distribution of glasses for the major brands of the group, starting from Gucci. On the other side, in 2021 Ferragamo discontinued the internal production of perfumes and hotel amenities, licensing it to a third party. Chanel has its own history as a pioneer, creating perfumes and cosmetics since 1924.

3.4. Producers and industrial districts

Many brands were born as outstanding producers of one single merchandising category: Louis Vuitton and Prada were luggage manufacturers, Hermès produced horse-riding leather goods and accessories, Ferragamo and Tod's were leading shoemakers and so on. All brands progressively became total look designers and producers, using external high-end manufacturers to complete their product offer.

All players in the industry have this mix of internal and external production, and even if they are expanding along the supply chain, they leverage on manufacturing districts to secure variety and excellence in product.

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21. The main luxury brands licensed to Essilor Luxottica are: Burberry, Bulgari, Chanel, Dolce e Gabbana, Ferrari Automobiles, Giorgio Armani, Miu Miu, Prada, Ralph Lauren, Tiffany & Co. and Versace. Revenue in 2021 amounted to EUR 17.9 billion.

4. Transfer Pricing Considerations

Luxury fashion businesses are highly profitable, present all over the world and their business model mostly relies on intangible-generated added value, hence they represent fertile terrain for transfer pricing based challenges from tax authorities all over the world.[22] End markets are pushing for profit split methods through the enlargement of the concept and relevance of marketing intangibles. Despite the BEPS guidance on the matter, the post-BEPS era still needs to address some of the issues that BEPS intended to solve.

4.1. The land of intangibles

Trademarks and logos take the lion's share among the intellectual property rights in the industry: brand is king – it has always been, and it is today more than ever. Iconic details and logos embedded in products (such as the LV monogram of Louis Vuitton, the GG of Gucci, the crossed CC of Chanel, Bottega Veneta's twined leather and so on) are usually registered as trademarks as well. As a consequence, DEMPE testing should be the starting point of any FAR analysis.

Each collection implies the development and registration of thousands of new designs and models, created through a complex designing and prototyping process, which constitutes the core of the R&D activity in the industry, including extensive research of new materials.

Patents have played an important part in the past, with many brands coming from a history of product excellence and innovation. As an example, Salvatore Ferragamo registered many patents in the first decades of the 20th century while inventing the modern women's shoe. In more recent years patents have become residual in luxury fashion's landscape, but it is likely that the innovation towards sustainability and a circular economy will see a new era of patents for raw materials and processes: patents will be relevant again. Manufacturers, then, may hold patents in the near future, provided they have an R&D centre able to invent and register patents. If not, they will need a licence to use patented innovative materials and processes from third parties.

Know-how is legally protected in a few legal systems and is tricky to register; most of the time it can be used as comparability factor.

4.2. One brand, many channels

The industry is characterized by a multitude of distribution channels. Retail includes directly owned mono-brand stores and outlets, branded corners or shop-in-shops, and licensed departments/concessions. The e-commerce channel is composed of brand.com, concessions, marketplaces, and multi-brand clients' platforms. The wholesale channel includes multi-brand retailers (department stores), mono-brand stores operated by third parties, and travel retail (mainly airports and downtown duty free).

The first transfer pricing issue here is how to properly remunerate each player along the distribution chain, based on risks assumed, functions performed and economics of the channel (assets owned are usually absent or residual). Internal comparables may differ from the tested parties in some ways, and comparability adjustments shall be needed. For example, travel retail relies more on carry-over items (i.e. products sold through more than one season), hence the inventory risk is lower than in DOS. Multi-brand retailers leverage on the variety of their offer and can better seize the momentum of one brand or product type, balancing risk in an efficient way.

How to recognize the existence of marketing intangibles and how to remunerate them is maybe the trickiest issue. The BEPS Final Report on Actions 8-10 has undoubtedly brought useful clarifications, but the new economies loudly advance different points of view and are keen to be more aggressive when it comes to the existence and remuneration of marketing intangibles.[23]

We may say that local limited-risk distributors are increasingly limited in their power to set up specific market strategy, to assume risks and to drive performance. Central functions increasingly guide their operations through group strategies, policies and training. On the other hand, the hit of the pandemic on luxury retail has shown us that market risk is riskier than we thought. Still, most principals made contributions to LRD to stop/limit their losses: a "pain-sharing" approach seems the most appropriate one for the industry in the years 2020 and 2021.[24]

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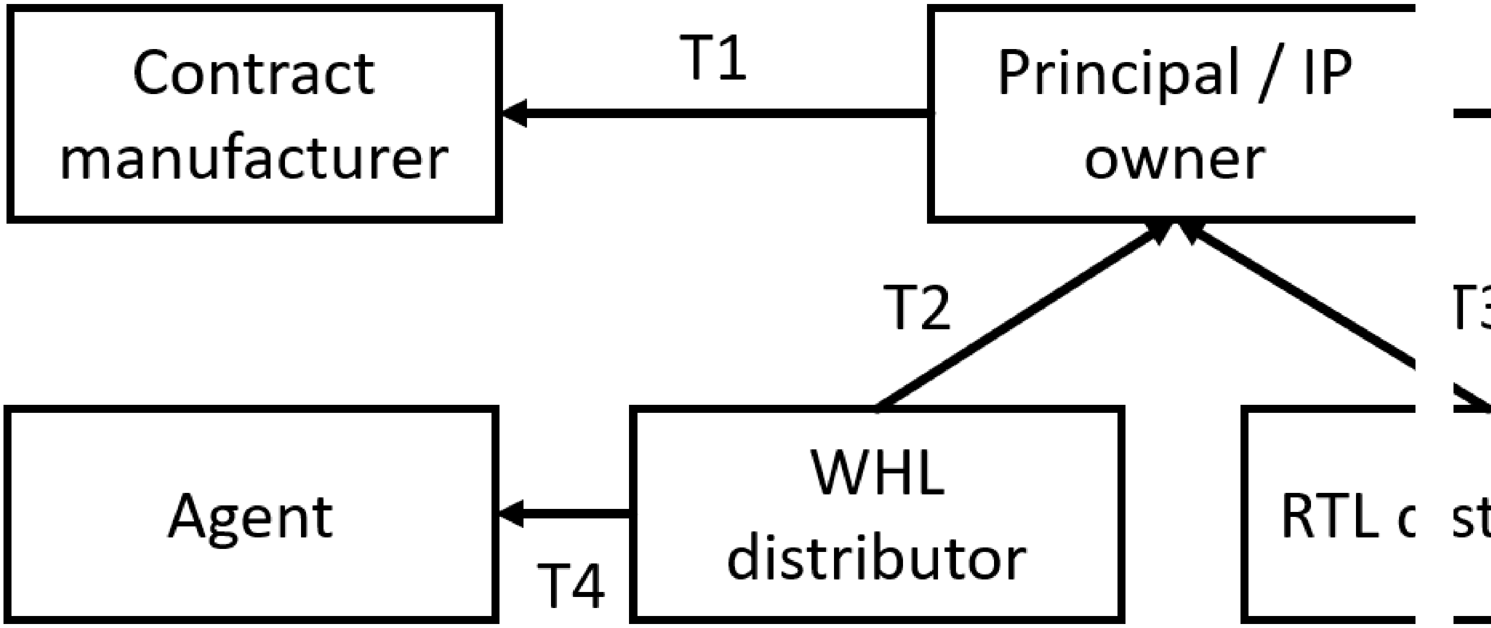
22. *See* M. Levey, *The Bare Truth About Luxury Business & Tax*, Luxury Society (2015):
    > Transfer pricing is a fertile issue for Luxury & Fashion companies due to the inherent subjective nature of the area and the vast potential revenue that may be placed in issue. […] taxing authorities are seeking the same revenues within a supply chain ...
23. *See* United Nations, *Practical Manual on Transfer Pricing for Developing Countries* (2021), Part D – Country practices, available at www.un.org/development/desa/financing/sites/www.un.org.development.desa.financing/files/2021-10/Transfer%20Pricing%20with%20new%20cover.pdf (accessed 28 Nov. 2022).
24. Despite that OECD Guidance on the impact of the pandemic basically resulted in a case-by-case approach recommendation, the pain-sharing approach appears to be consistent with the considerations included in the guidance. The first APAs covering the pandemic years, signed in the last months, have either used adjusted indicators or comparable searches including 2020. *See* OECD, *Guidance on the transfer pricing implications of the COVID-19 pandemic* (Dec. 2022), available at https://www.oecd.org/coronavirus/policy-responses/guidance-on-the-transfer-pricing-implications-of-the-covid-19-pandemic-731a59b0/ (accessed 28 Nov. 2022).

4.3. Transactions and how to manage them

The typical infra-group transactions in the luxury fashion sector can be schematized as shown in the Figure (where the arrows indicate payment flows).

Figure – Infra-group transactions in the luxury fashion sector



T1 = Production of finished goods

T2 = Sale of finished goods to a wholesale distributor

T3 = Sale of finished goods to a retail distributor

T4 = Agency activity in the interest of a distributor

T5 = Licence of trademark (general or for specific product categories)

T6 = Rendering of service (core or ancillary)

Apart from the right transfer pricing method to be applied, it is important that the infra-group agreements regulating such transactions conform to the arm's length behaviour, i.e. the contractual regulations should align to agreements of the same kind entered into between third independent parties. Of course, this applies even more so when internal comparables are available.

T1 – Production of finished goods

It is very common to find all kind of external and internal comparables for this transaction, since production is often externalized in the industry. This is even more true for Italian brands, still widely leveraging on the variety, efficiency and flexibility of the Italian manufacturing districts. Hence, the transaction can be easily priced according to the CUP, cost-plus or RPM methods.

Brands often purchase raw materials and externalize only the *façon*. It is not uncommon that the largest external manufacturers have raw material warehouses and product facilities exclusively dedicated to one brand. Quality control by the brands is always very strict, and sometimes a certain minimum threshold of defectiveness (1% or so) is accepted without penalty applied.

T2 – Sale of finished goods to a wholesale distributor

Distribution agreements are usually limited to a geographic area and/or a distribution channel (travel retail/domestic retail).

Internal comparables usually show an average gross margin guaranteed for each product order. The difference between a “light” distributor (e.g. having no warehouse) and an agent can be difficult to establish from an economic standpoint, despite the legal arrangements. In such a case, the gross margin achieved should be similar.

Provisions on the right of return are key in determining the kind of inventory risk borne by the distributor; in case of differences between related and unrelated parties, comparability adjustments are needed.

The parties usually agree to share advertising, marketing and promotion expenses (AMP): the distributor is obliged to invest a certain percentage on the turnover, under strict control and direction by the brand, which in its turn contributes to such expenses in a certain percentage (20 to 50% is the most common range). Such AMP contributions are key in the DEMPE analysis, constituting ultimately the cost borne by the brand owner for enhancing the brand awareness even where the marketing and communication activities are not directly performed. The same applies to AMP contributions in other transactions.

At the end of the contractual term, the distributor may be obliged to pass to the principal the list of customers, sometimes for consideration. Such a clause should be included in infra-group arrangements as well. Also, whenever distribution rights are transferred from a subsidiary to another one, the latter should pay a lump-sum amount to the former distributor for the customer list, the assignment of the commercial agreements in place and generally out of goodwill, possibly applying a discounted cash-flow method in determining the transfer price.

T3 – Sale of finished goods to a retail distributor

Retail distributors can operate mono-brand stores and shops-in-shop. The distribution rights are always exclusive and limited to a country/region. When the rights are granted to third parties, they are often referred to as “franchisees”. In distribution agreements with third parties, the licensor is usually obliged to pay two kinds of contributions: (i) CapEx contributions for the layout of newly opened or renovated mono-brand stores; and (ii) AMP contributions. On its part, the distributor guarantees the AMP investment to be at least a certain percentage on the turnover (5% to 9% is pretty common, depending on the maturity and strategic importance of the market). TNMM is extensively used in APAs covering LRD all over the world.

T4 – Agency activity in the interest of a distributor

The contractual scheme is less and less common between third parties and brands, due to the increasing need for the latter to control brand positioning and selective distribution worldwide. Yet, it can be useful in infra-group relationships, leveraging on proximity to certain wholesale markets by certain managers or divisions.

Agency agreements with third parties usually include: (i) an additional/premium agency fee in case of overperformance; (ii) strict rules excluding the agent from entering into any agreement with customers; (iii) non-competition clauses or limitations to the number and positioning of brands the agent can represent; and (iv) end-of-term indemnification according to national legislations. Commission should be based on CUP. When no comparable agents are available, light distributors can be used as comparables, with adequate adjustments.

T5 – Licence of trademark (general or for specific product categories)

The general licence of trademark as a phenomenon has mostly disappeared. In the past, common cases were: (i) the licence granted by the owner of a once successful trademark, or of a niche brand, to a third party intending to relaunch or expand the brand; or (ii) the infra-group licence of the trademark to the principal by a low-tax jurisdiction entity, mostly for tax planning purposes. The latter structure has been jeopardized and hence outdated by the BEPS Project and the introduction of the DEMPE test. Due to the lack of exact comparables, CUP may be difficult to apply, unless extensive comparability adjustments are made. Profit split may be the solution, where of course intangibles are owned on both sides of the transaction.

Instead, it is still very common practice – as illustrated in section 2. – to license for specific non-core product categories such as eyewear, perfumes, cosmetics, watches, accessories.

Licence agreements with third parties usually show: (i) minimum guaranteed royalties per year; (ii) design guidelines by the brand; (iii) brand approval of the merchandising set-up of each collection; (iv) AMP contributions paid by the licensee for collection campaigns paid for the brand and including licensed products; (v) selective distribution and AMP investment obligations for the licensee; and (vi) strict rules attributing to the brand the right to exercise control and direction over the marketing and communication strategy.

In case of such licences to internal divisions producing non-core products, CUP would be easily applicable.

T6 – Rendering of service (core or ancillary)

The author extensively mentioned in the first part of this article the business trends in the industry leading to an increased number of services rendered infra-group. The crucial point here in applying the OECD Guidelines lies in the distinction between low value-adding services and core ones: in certain cases, the business transformation makes the analysis more uncertain. For example, designing, building and maintaining an e-commerce platform integrated with retail operations and logistics (enabling omnichannel), consistent with the brand image and able to enhance customer engagement strategies, may be seen as an IT service (yet a sophisticated one) to be simply charged back according to mere cost sharing, or deemed as a value-adding activity to be remunerated.

5. Summary/Outlook

Luxury is nowadays recognized as an industry and, within the industry, luxury fashion is the second largest sector. High profitability, worldwide physical presence and strong leverage on intangibles make the businesses of this industry ideal targets for transfer pricing scrutiny.

The industry dynamics are rapidly transforming and are at the dawn of a new era: the change is driven by the digital revolution and the younger consumers rapidly gaining shares of the market.

A cultural shift for the whole sector is on its way, and the capability of each player to adapt its business model and make investments in the right direction will be crucial to winning competition and profiting from the non-stop growth of luxury fashion.

New transfer pricing issues are already adding to the existing ones. Expansion along the supply chain by all major players is leading to the progressive lack of comparables, which will make transactional profit methods the more and more appropriate. Double taxation remedies are still costly and slow: APAs may be the only solution for businesses to effectively manage their transfer pricing and secure tax risk worldwide. The post-BEPS era still needs to address some of the issues that BEPS intended to solve, finding viable and more rapid remedies to double taxation and controversies.

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