



Transfer Pricing Compliance for Distributors

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Distribution is the backbone of commerce, but the similarities among distributors pretty much end there. There are almost as many forms of distribution as there are goods and services to buy and sell, with each transaction having unique products, markets, storage, security, logistical, and legal requirements.

When it comes to transfer pricing compliance, these differences are highly material. That's because when related entities conduct business together, determining who creates value, who owns what, and who carries what risk becomes pivotal. These factors strike at the heart of the complexity and risk in transfer pricing, shining a sharp compliance spotlight on documentation, particularly the functional analysis and the chosen transfer pricing methodology—both frequently challenged by tax authorities.

In this white paper, we untangle the complexities of transfer pricing compliance for distributors and highlight the additional benefits for companies who get it right.

How the Distributor Model Works in Transfer Pricing

Consider a basic example: a railcar full of products. The manufacturer creates the product, loads it onto skids, and places it in a railcar or shipping container. Upon arrival, the shipment is unloaded, put on a truck, and driven to a warehouse. There, it's stored until an order comes in. A picker then decides if the full skid is sent out or if it needs to be broken down for order fulfillment and delivered to the final destination.

That is the most elementary description of what a distributor does. But even in this simple example, when you drill down into the specifics—what's being shipped and under what conditions—things get complicated quickly. Is the product perishable? Is it a controlled substance? A rare metal? What happens if something breaks or is stolen in transit? How do these factors affect transfer pricing?

That's where a **functional analysis**—or a “FAR analysis” (for functions, assets, and risks)—accompanied by a clear and credible narrative, becomes crucial. The FAR analysis unpacks and dissects the building blocks of value creation, detailing who performs which functions, owns what assets, and bears what risks. It is the cornerstone of transfer pricing compliance, forming the foundation for identifying comparables, selecting appropriate transfer pricing methods, attributing profits, and determining arm's length prices.

No matter your distribution model, if you invest the time and effort necessary to conduct a thorough functional analysis, the rest of your transfer pricing report is likely to fall neatly into place.

TWO KINDS OF DISTRIBUTORS

With the FAR analysis in hand, the next step is to characterize the business in a way that's meaningful to tax authorities. This characterization is crucial because it binds your comparability analysis to the price or return shown in your documentation. For transfer pricing purposes, distributors can be broadly categorized into two groups: limited-risk distributors and full-fledged distributors.

LIMITED-RISK DISTRIBUTORS (LRDS)

Limited-risk distributors generally buy goods from related parties and resell them to customers, focusing on basic distribution functions like receiving, storing, and shipping products. They operate under the close control and supervision of the parent company, which mitigates risks such as inventory, bad debt, and market volatility through **intercompany agreements**. This setup ensures that LRDs earn a modest, stable margin without developing significant marketing intangibles.

Example: A subsidiary of a global clothing brand imports garments from the parent company, follows established pricing and marketing guidelines, and handles the logistics of receiving, storing, and shipping products to retail stores. The subsidiary doesn't engage in significant local advertising or strategic decision-making, as the parent company manages most of the risks. Consequently, the LRD earns a routine return.

FULL-FLEDGED DISTRIBUTORS (FFDS)

Full-fledged distributors manage the entire distribution and sales process, from purchasing goods from related-party and independent suppliers to selling them to end customers. They exercise significant control over their operations, including inventory management, customer-relationship management, and strategic marketing plans, which often create local brand value and other marketing intangibles. Due to their broader functions and risks—such as supply-chain, inventory, credit, compliance risks, cyber threats, and market volatility—FFDs are expected to earn higher returns.

Example: A pharmaceutical distributor is responsible for importing, storing, and distributing medications within a region. The company conducts market research, sets prices, manages relationships with healthcare providers, adheres to local health regulations like HIPAA, and develops marketing initiatives to promote new drugs. This comprehensive role leads to higher but more volatile profits due to the significant risks and broader functions involved.

DOCUMENTATION REQUIREMENTS FOR LIMITED-RISK VS. FULL-FLEDGED DISTRIBUTORS

When it comes to documenting your transfer pricing, more information is better. You want to ask—and answer—every possible question before the tax authority has a chance to.

Both LRDs and FFDs must prepare comprehensive documentation to justify that their transfer prices meet the arm's length standard, with the FAR analysis serving as the foundation of the documentation package. That said, the level of detail and complexity in the disclosure will differ due to their distinct operational roles and risk profiles.



Limited-Risk Distributors

Documentation for LRDs should focus on their limited functions and risk profile. It should include:

- Detailed descriptions of their activities.
- Strategic decisions made by the parent company, supported by the functional analysis.
- Intercompany agreements outlining roles and risk allocation.
- If losses occur, detailed documentation to justify that these are due to extraordinary circumstances, not transfer pricing policies. (More on that below.)

Full-Fledged Distributors

Documentation for FFDs should be comprehensive, reflecting their extensive functions and higher risk profile. It should include:

- A detailed analysis of activities, risk management, and strategic decisions.
- Economic analysis, comparability analysis, and documentation of complex transactions.
- Detailed financial data on pricing strategies, gross margins, and profit splits, supported by benchmarking studies and the functional analysis.
- Contextual information clarifying each entity's role in controlled transactions, spelled out in intercompany agreements.

Which Transfer Pricing Method Is Most Effective—and Why?

The choice of transfer pricing method aligns closely with the functional profiles, risk levels, and transactional nature of both LRDs and FFDs. Most distributors default to the Comparable Profits Method (CPM) / Transactional Net Margin Method (TNMM) due to the difficulty in obtaining reliable information for the other methods.

But circumstances, as always, can differ. Here's a deeper dive into the pros and cons of each potentially applicable method:

For Limited-Risk Distributors

CPM/TNMM:

- **Why:** CPM/TNMM examines the net profit margin relative to an appropriate base (e.g., sales, costs) and compares it to the net margins of comparable independent entities. This can be an effective method for LRDs because net profitability is easier to benchmark for entities with limited functions and risks, and consistent, low-risk returns.
- **Caveats:** Identifying truly comparable companies with similar limited-risk profiles can be challenging. Variations in functions, risks, and market conditions can affect the reliability of the comparables.

The Resale Price Method (RPM):

- **Why:** The RPM calculates the transfer price by starting with the resale price to an independent party and subtracting a gross margin that covers the distributor's functions and risks. It suits LRDs because it focuses on gross margins, which align well with their limited functions and risks, ensuring they earn an arm's length gross margin.
- **Caveats.** RPM requires comparable resale price margins for reliable arm's length pricing. Inconsistent economic circumstances or accounting methods among comparables can undermine its reliability.

For Full-Fledged Distributors

CPM/TNMM:

- **Why:** As with LRDs, the CPM/TNMM examines the net profit margin but is applied to entities with more complex functions and higher risks. For FFDs, this method is effective because it allows for a comprehensive analysis of profitability, considering their extensive marketing, sales, and distribution activities.
- **Caveats:** FFDs can experience significant variability in profits due to market conditions, strategic decisions, and risk-taking. The CPM/TNMM must account for this variability and consider any developed valuable marketing intangibles to ensure appropriate profit allocation.

RPM:

- **Why:** While more commonly used for LRDs, the RPM can also be effective for FFDs if reliable comparable data is available. It can reflect the full range of functions and risks undertaken by the FFD when the gross margins of comparable independent distributors are available.
- **Caveats:** The RPM is less commonly applied due to the broader range of functions and risks they assume. The method may not fully capture the value added by the FFD, and the variability in gross margins due to extensive marketing and sales activities can lead to potential mismatches in profitability.

Profit Split Method (PSM)

- **Why:** The PSM allocates combined profits from controlled transactions based on the relative value of each party's contributions, functions, and risks. It can be particularly effective for FFDs involved in complex, integrated operations where both parties contribute significantly to value creation. Also, FFDs often develop significant marketing intangibles and bear substantial risks. The PSM can appropriately reflect the economic contributions of both the distributor and the parent company, ensuring an arm's length allocation of profits.
- **Caveats:** The PSM is complex to implement and requires a thorough understanding of the value chain and each entity's contributions, which can increase compliance costs and the risk of errors. Also, PSM requires subjective judgments about the relative value of contributions by different entities, which can lead to disputes with tax authorities when it comes to profit allocations.

Should Limited-Risk Distributors Ever Assume Losses?

The simple answer is that an LRD should always be profitable. The more nuanced answer is that it depends on the situation.

By definition, LRDs are designed to operate with limited risks. Their controlled environment, characterized by stable, routine functions and minimal risk exposure, typically justifies a steady, modest profit. Hence the expectation that an LRD should consistently be profitable. However, exceptional circumstances sometimes require exceptional measures. The COVID-19 pandemic vividly demonstrated how LRDs could face financial losses beyond their control. Reduced consumer demand, supply chain disruptions, increased operational costs, and workforce disruptions were common. Insisting on profitability under such conditions could lead to unsustainable cash burn, potentially compromising the parent company's overall financial health.

Recognizing this, the OECD and many tax authorities have provided **guidance** on making comparability adjustments to justify any deviations from expected stable returns. The onus is on the taxpayer to demonstrate that the losses are not due to transfer pricing manipulation but rather to uncontrollable market realities. This requires robust and transparent documentation, including:

- A detailed analysis of the market conditions.
- A clear demonstration of how these conditions have impacted the LRD's performance.
- Evidence that similar independent entities have also experienced losses.
- Explanations of any measures taken by the parent company to mitigate these impacts.



COUNTING THE BENEFITS

Ensuring compliance with transfer pricing regulations isn't just about avoiding penalties; it's about maintaining the integrity of your global operations.

But it's also about seizing strategic opportunities for sustainable growth. Regardless of your distributor model, the documentation supporting your functional analysis is like an X-ray, revealing the inner complexities of your business. This detailed process offers valuable insights that can optimize your internal processes, highlighting opportunities for operational improvements, cost efficiencies, and strategic adjustments—and potentially boost your profitability.

What's more, by delivering a comprehensive functional analysis, you help tax authorities understand your business and justify your transfer pricing approach. This proactive stance prevents misunderstandings and disputes, fostering a cooperative relationship with tax authorities. Never a bad thing to have in such a complex, high-risk compliance area.