

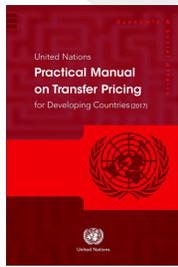

**UN-ATAF Workshop on Transfer Pricing  
Administrative Aspects and Recent Developments**  
 Ezulwini, Swaziland  
 4-8 December 2017


**AFRICAN TAX  
ADMINISTRATION FORUM**

**INTANGIBLES  
and SERVICES:**

**CASE EXAMPLE**

**Wednesday, 6 December 2017  
4.00pm – 4.30pm**



## Retail Group

The purpose of this example is to present common types of issues that can arise in a transfer pricing case involving a related group of companies engaged in a global retail business.

Each participant should consider the facts of the case and be prepared to discuss the questions that are posed

2

## Relevant Facts

- Retailco is the parent company of a multinational group. It is organized in Country A. It has conducted a successful clothing and household goods retailing business in Country A for the past 8 years. It achieves net operating margins of approximately 8 percent of sales, the highest in the Country A clothing retail industry.
- Retailco has developed a unique business model and sophisticated computer systems that support that model. It purchases supplier overstock goods at discounted prices. These are then distributed through wholly owned retail outlets. Retail outlets have little say in what goods they stock. Central management pushes purchased overstocked goods into the retail outlets as quickly as they are received from suppliers according to proprietary algorithms.

3

## Relevant Facts

- Two elements are key to the success achieved by Retailco:
  - The company's willingness to purchase overstocked goods at fixed prices from suppliers on cash terms and to guarantee that Retailco will not return unsold goods to suppliers provided the goods were delivered in good condition. This allows Retailco's buyers to close deals quickly and suppliers to know they have a guaranteed market for their products and that the suppliers do not need to provide any financing to their customers
  - Retailco follows a strict policy of marking prices in its stores down at five day intervals according to strictly applied proprietary pricing algorithms. Products that have not been sold are continuously marked down according to proprietary algorithms. Products marked down five times are given to charitable organizations. This approach means that Retailco stores continuously have fresh brand name merchandise and continuously have low and decreasing prices which creates a "treasure hunt" mentality for customers.

4

### Relevant Facts

- Because a constantly changing mix of goods is available at Retailco stores, Retailco does little or no product advertising. Its overall advertising costs are quite low and all advertising focuses on the Retailco “treasure hunt” model and Retailco brand promotion.

5

### Relevant Facts

- In 2015, Retailco determines that it will expand its business to country B. It acquires a very small existing off price retailer known as Bargainco in Country B. Bargainco has five retail outlets in a single metropolitan area and at the time it is acquired is near bankruptcy.
- Retailco sends several dozen employees to Country B for six months to implement the conversion of the Bargainco stores to the Retailco business model. Retailco computer programs, purchase algorithms and pricing algorithms are all adopted by Bargainco. Bargainco expands the number of retail outlets it maintains in Country B to 50 outlets in eight metropolitan areas by the end of 2016.

6

### Relevant Facts

- Bargainco continues to use the Bargainco name on all of its stores. It does not adopt the Retailco brandname or trademarks. However, its newspaper advertising always describes the store’s name as “Bargainco, a Retailco company.”
- Bargainco maintains its own buying staff, its own warehouses, its own advertising relationships, and its own employee base. Following the original six month conversion, some members of Bargainco senior management will have previously worked at Retailco in Country A, but some members of the Bargainco senior management team will have been recruited from other Country B retailers.

7

### Relevant Facts

- While Bargainco buyers negotiate the purchase of approximately 70 percent of the goods Bargainco sells. Some but not all suppliers of Bargainco are also Retailco suppliers.
- Retailco gives Bargainco the right to “piggyback” on Retailco purchases as well. Thus, when Retailco buys goods, Bargainco, at its option, can obtain up to 15 percent of the goods purchased by Retailco at Retailco’s cost. Such piggyback purchases amount to 30 percent of Bargainco’s purchases of goods.
- All Bargainco computer systems are run on Retailco computers located at a data center Retailco’s head offices in Country A. Bargainco pays 10 percent of the cost of maintaining Retailco’s data center.

8

### Relevant Facts

- In 2015 and 2016 Retailco does not charge Bargainco for any services or intangibles other than Bargainco's payment of 10 percent of Retailco's data processing costs.
- Bargainco's profitability gradually improves in 2015 and 2016. At the end of 2016, Bargainco is earning operating profits equal to 5 percent of its sales whereas at the time of the acquisition it had been losing money each month and had been near bankruptcy.

9

### Relevant Facts

- In 2017, Retailco begins to charge Bargainco a fee equal to 2 percent of Bargainco's annual sales. The fee is described in an agreement signed by Retailco and Bargainco as a payment for Retailco intangible property including business models, computer programs, algorithms and systems, and as a fee for services provided to Bargainco by Retailco.

10

### Questions

- Did Retailco provide Bargainco with valuable intangibles for which payments should be made?
- If so, what intangibles were provided?
- Did Retailco provide Bargainco with valuable services for which payments should be made?
- If so, what services were provided?
- Was it appropriate for Bargainco not to make any payment for intangibles and services, other than the computer systems fee, in 2015 and 2016?
- Was it appropriate for Retailco to charge Bargainco a fee of 2 percent of sales beginning in 2017?

11

### Questions

- What transfer pricing methods can be utilized to determine the right amount of the fee for intangibles and services?
- If you are the Country A tax authority, what position do you take when auditing Retailco?
- If you are the Country B tax authority, what position do you take when auditing Bargainco?
- What additional information would you like to have to resolve the case?

12