

Limited risk distributors: What's in a label?

An idea worth considering | July 20, 2010

If one hangs around the transfer pricing water cooler long enough, one is certain to encounter the term 'limited risk distributor' or LRD. A typical LRD structure purports to strip out, or at least minimize, business risk for the distributor in a multinational enterprise's (MNE's) supply chain. The LRD receives a relatively modest level of remuneration for performing distribution functions on behalf of the MNE, and compensation is usually "cost plus" or a Berry ratio (GM/OE) or something similar. In plain English, the LRD is reimbursed for its costs, plus a markup on those costs; therefore, the LRD's taxable income simply equals the markup.

Example

USACo is a U.S. manufacturer that makes and sells widgets. USACo desires to sell the widgets in Country X. So USACo

establishes FCo, a distributor in Country X, and draws up the requisite intercompany agreements to establish FCo as a limited risk distributor. As such, USACo compensates FCo for its distribution activities at cost plus five percent, meaning that USACo will reimburse FCo for all of FCo's costs, plus five percent of those costs. USACo views FCo as a service provider, i.e., FCo provides (and USACo pays for) the service of distributing USACo's products to retailers in Country X. USACo determines the five percent markup from the median range of the adjusted results of a group of uncontrolled, third-party distributors, adjusted for FCo's assumption of less business risks than the uncontrolled distributors.

In general, the USACo-FCo intercompany transactions must achieve arm's-length results under applicable transfer pricing provisions. This means the remuneration FCo receives for its distribution activities (and that USACo pays to FCo for those activities) must be comparable to the remuneration comparable parties would receive (and pay) under comparable circumstances. The circumstances in our example consist of limiting FCo's business risks (e.g., the intercompany contract could provide that FCo will not bear inventory, credit or currency risks). Thus, it would follow that deriving the appropriate level of



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arm's-length "comparable" compensation turns on the ability to determine and analyze the results of reasonably comparable third-party distributors.

If an MNE is going to utilize an LRD structure, it should be able to establish a range of arm's-length compensation that uncontrolled LRDs earn. But do LRDs exist in the real world? Opening up the yellow pages to L generally yields no results. Similarly, a Google search turns up 286,000 hits, but most relate to transfer pricing concepts, rather than actual companies. The simple fact is: In the real world, it is difficult, if not impossible, to limit or eliminate business risks. As most business owners know, it is hard to contain costs, let alone receive full reimbursement for those costs from customers, plus a markup above and beyond those costs (i.e., to earn a profit no matter what).

Recently, some IRS officials and other taxing jurisdictions have grumbled about simply applying an LRD label to an arrangement for transfer pricing purposes. The tax authorities assert that more robust analyses must be performed in order to compute the arm's-length results from distribution operations. They often point to the need to develop full-blown, robust analyses to determine the appropriate remuneration in light of the purported risk limitations that exist in the intercompany contract. In fact, one view (not necessarily originating from or confined to government sources) says that LRD structures are creatures of transfer pricing — existing only in the special, controlled confines of the intercompany MNE setting. Within an MNE, contracts can be drawn up; therefore, risks can be assigned or assumed simply because the MNE can

and does control both sides of the transaction. The basic critique is the LRD is merely a label by which the MNE guarantees or assigns the distributor a profit, no matter what — notwithstanding that at arm's length, companies can (and do) lose money. The arguments often go further, because the higher/lower the costs the LRD incurs, the higher/lower the LRD's income, by virtue of multiplying the markup against the higher/lower cost base.

So, here's a thought worth considering:

If you have an MNE arrangement involving one or more LRDs, contact Grant Thornton. We have a cadre of transfer pricing professionals available to assist you in analyzing LRD structures and arrangements. We can help you proactively address any and all questions regarding the who, what, why of LRDs.

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