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Transfer pricing – Important considerations for minority shareholders

We have, in practice, encountered many situations where transfer pricing rules apply to local entities which are majority owned by a foreign shareholder, but with a minority local shareholder or shareholders. This scenario happens regularly in South Africa, significantly due to our BEE rules, but is by no means unique to South Africa. There are often local ownership requirements which apply in order for multinational enterprises (MNEs) to obtain, in new territories, such rights such as mining rights, broadcasting licenses, banking licenses etc. In some cases, the local shareholder may be the government of the relevant country (or a legal entity owner by the government). In other cases, it may be a local resident or residents.

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In practice the existence of transfer pricing rules can serve to protect the interests of local minorities since they are designed to ensure an arm's length return for the local entity (LocalCo) from intra-group transactions. Therefore, the local shareholder may well be reassured that they are not being prejudiced by intra-group pricing arrangements since these need to be shown to be arm's length.

However, the interaction between local ownership and transfer pricing rules can be complex. Situations which we have encountered in practice include the following:

- The MNE's overriding transfer pricing policy is such that local distributors are set up as limited risk distributors (LRDs). In other words, the local entity has limited profit (and loss) potential. This is a significant underlying dynamic in determining the value at which a local shareholder may invest into LocalCo.
- Due to an updated benchmark search, after a number of years, the target profit margin for LocalCo is revised upwards or downwards. This will correspondingly affect the return of the local shareholder and may mean that the local shareholder ends up receiving more (or less) than the extent of the profits anticipated when they made the original investment into LocalCo.
- The arrangements negotiated as part of setting up LocalCo result in it earning profits which are higher than those regarded as arm's length in terms of the MNEs global transfer pricing policy. Notwithstanding being required to effectively give away more than an arm's length level of profits from the local entity, the MNE decides to proceed with setting up LocalCo because of the wider commercial interests of the group.
- A significant long-term intra-group arrangement (for example, a franchise fee) is agreed as part of the process of setting up the local entity. Due to economic factors, the arm's length amount to be retained

by the MNE outside the country (for example, the franchise fee) subsequently becomes lower than the amount agreed when setting up LocalCo. The MNE is unwilling to adjust the franchise fee downward since this would result in the local shareholder effectively earning higher profits that those which were envisaged when the local shareholder originally invested in LocalCo.

- LocalCo requires additional shareholder funding. It cannot afford an additional interest cost. Therefore, it is proposed to the local shareholder that the funding be provided by way of an injection of additional share capital. However, the local shareholder is unable (or unwilling) to inject the additional share capital required in line with its existing shareholding. The MNE, on the other hand, cannot subscribe for additional shares in LocalCo because this would result in it acquiring too great a shareholding, thereby diluting LocalCo's shareholding. Therefore, the MNE decides that, in order to stabilise the operations of LocalCo, it has no choice but to provide the funding by way of an interest free loan.

Therefore, transfer pricing rules can impact on local ownership structures (and vice versa) in many different ways. Therefore, this aspect needs to be carefully considered. The precise action to be taken depends on the specific facts, but a few overriding guidelines are as follows:

- Local shareholders, at the time of making an investment into a LocalCo, need to be aware of the existence of underlying transfer pricing policies within the MNE and how these may potentially impact on the returns which they earn.
- The effect of transfer pricing policies can be an issue of crucial significance to the relationship between the MNE and the local shareholder. It is crucial that awareness of the transfer pricing policies be created at the time when the upfront negotiations with the local shareholder are conducted. This is because the subsequent discovery by the local shareholder that, for example, its profit potential from the investment in LocalCo is limited and can result in disillusionment and a loss of trust in the integrity of the MNE.
- On the other hand, as already noted, transfer pricing rules may be reassuring for minority shareholders since they assist in discouraging adverse pricing practices within an MNE. Therefore, a local minority shareholder may regard transfer pricing rules as protecting its interests.
- The possibility of subsequent revisions of the TP policy (in line with the ongoing evolution of the MNEs global transfer pricing policy) also need to be discussed and considered. This means that the consequences of such revisions can be provided for in the agreements concluded between the shareholders.

An important final point is that the existence of local ownership rules – and the impact of these on transfer prices – needs to be disclosed and analysed in the transfer pricing documentation of the MNE. This is obviously of particular importance where the local ownership arrangement has the effect of requiring a deviation from the normal transfer pricing practices of the group.

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