



Center-led: The Goldilocks of operating models

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Key points

- A center-led model strikes a balance between centralization and decentralization by enabling the business to appropriately locate decision-making roles throughout a global organization with periodic adjustments.
- The model may be applied by function or business unit and can evolve to respond to market needs and strategic goals.
- It provides balance between operational flexibility and tax certainty.
- Transfer pricing policies should align with the model to accommodate operational flexibility while maintaining financial control.
- Strong corporate governance will improve the success of the model.

Introduction

Operating models can be trendy, evolving as companies try to keep up with market dynamics and disruptive forces. These models may also require changes in organizational structures to align with the broader business transformation. The pendulum swings between centralized and decentralized decision-making. While it can be attractive to follow the global trends, the smartest organizations define an operating model that embodies the best fit and then flexes over time as the business grows and changes.

Centralization offers globally consistent policies and quick decision-making but may overlook local nuances and increase the risk of bureaucracy. In contrast, decentralization can enhance local customer responsiveness and boost employee morale but may lead to inefficient processes, duplication, artificial internal barriers, inconsistent global policies (e.g., quality, pricing) and difficulties with negotiating volume discounts.

Extreme centralization or decentralization are typically not the best decision-making frameworks. Business leaders generally prefer flexibility to adapt to changing needs. Transfer pricing policies typically favor stable business models over fluctuating practices because stability provides predictability, reliability and simplicity.

Business leaders may favor a model that permits periodic adjustments to the organization's "who, where, and how" of decision-making while ensuring corporate governance, financial control, tax certainty, and manageable intercompany pricing policies and procedures.

This model is too centralized! This one is too decentralized! The center-led model is just right!

A center-led model co-locates certain strategic management (potentially for a function or business unit) and enables business leaders to control key strategic decisions and oversight in the organization. It also permits various levels of autonomy throughout the organization as appropriate. The leaders at "the center" of the organization have the flexibility to change the decision-making autonomy at the regional hubs and local entities (e.g., factories, distributors and sales companies) periodically as facts, circumstances and business strategy require.

From a tax perspective, decision-making, including decisions about business strategy and risks, is a key factor considered when analyzing profit allocation between related entities.¹ In general, more decision authority tends to draw more profit allocation. In the open market, the assumption of increased risk would result in an increase in the expected return, although the actual return may or may not increase depending on the degree to which the risks are realized. Accordingly, as decision-making and risk control may periodically shift throughout the organization in a center-led model, intercompany pricing policies and methodologies should be designed to accommodate that dynamic.

To illustrate the basic concept of a center-led model, Diagram 1 reflects three potential levels in a global organization where decisions are made. In the example, key strategic decisions are made at the principal company level (centrally), certain decisions (e.g., localization, specific choice of approved vendors) are made at the regional hubs level, and factories are empowered to make local day-to-day decisions.

Diagram 1

As business needs evolve, the degree of autonomy at each organizational level may need to increase or decrease accordingly. For example, unique market conditions (e.g., regulatory restrictions, culturally sensitive customer demands, high competition, low brand recognition) may support more local control over product portfolio management and pricing. A few years later, when the brand is established, product preferences are better known, and competition equalizes, perhaps product portfolio management and pricing can be managed more regionally or even globally.

The basic paradigm

Global strategy

Principal

Regional oversight

Regional hubs

Local execution

Factories or distributors

¹ OECD Guidelines, Ch. I at paragraph 1.51

In procurement, a company may exercise strong centralized control over key categories of raw materials to ensure quality, cost-effectiveness, continuity of supply for a new product line while at the same time reducing supplier risk. Over time, the procurement organization may establish reliable alternative suppliers for specific categories. It may also find that sourcing certain materials from the same region or country is more beneficial due to regulatory requirements, material costs, or local content rules. Consequently, while it may be wise to maintain centralized control over key categories of raw materials, it could be more efficient to empower regional hubs or, in some cases, the factories themselves to manage the procurement of certain localized materials.

In both examples, the initial decision framework needed to evolve over time to align with how business leaders responded to changing market conditions. Initially, corporate governance, such as delegations of authority and reporting lines, and intercompany pricing models were established to reflect specific scenarios and economic contributions at each organizational level. As the management model evolved, corporate governance and intercompany pricing should be adjusted to align with the new strategy and conditions.

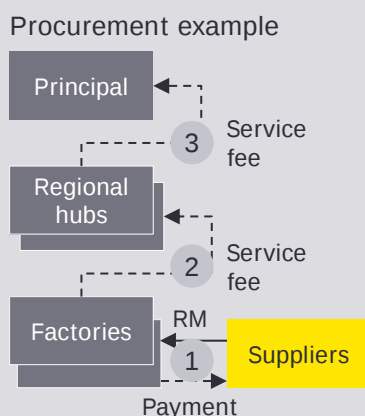
Changing the authority or autonomy of various leaders throughout the organization may be within the control of the company, subject to good corporate governance, and may not require government approval. On the other hand, allocating profit between entities differently from one year to the next to align with the operational change may draw the attention of tax authorities.

Intercompany pricing considerations

The center-led model establishes a structured flow of service fees and payments among the principal, regional hubs, and factories. For example, as illustrated in Diagram 2, factories earn routine manufacturing returns while paying service fees to regional hubs for procurement-related services. Regional hubs compensate the principal for strategic services. This fee structure ensures that each node in the procurement network is fairly compensated for its contributions.

Diagram 2

Charging out procurement services to factories requires a structured approach to comply with the arm's length principle, which ensures that transactions between related entities are conducted as if they were between unrelated parties, ensuring that the pricing reflects market conditions.



First, it's essential to clearly define the procurement services rendered, such as supplier selection, pricing and terms or contract negotiation, and logistics management. Understanding how these services benefit the receiving entities will help justify the pricing.

Once the services are defined, the next step is to determine the appropriate pricing method for the transaction. One common approach is using a mark up on the services costs,² where the total costs incurred in providing the procurement services, such as labor, overhead, and direct costs, are calculated, and an appropriate markup is added.

Alternatively, the comparable uncontrolled price (CUP) method uses market prices for similar services as a benchmark, such as commissions based on relevant procurement spend. While the CUP method can provide a useful framework for establishing intercompany pricing for procurement services, also analyzing alternative pricing structures that creates alignment between the contributions of each entity, value creation, and intercompany pricing provides for.

Regardless of the transfer pricing method selected, small changes to decision making in the operating model should not result in large deviations to the allocation of income between the levels of the organization. On the other hand, larger changes, such as the location of strategic procurement management, could require a refresh of the transfer pricing method selected and resulting allocation of income.

This approach could be applied using a transactional net margin method or cost-plus method, as defined in the OECD Guidelines.



Other considerations

Character of revenue: The transfer pricing framework in our example assumes that intercompany compensation is classified as a service fee. However, there is a risk that a tax authority may categorize these service fees as a royalty. The characterization of intercompany compensation can be supported by the terms of the intercompany agreement, but it is essential to carefully analyze the facts, circumstances, and substance of the arrangement because it could influence the deductibility and indirect tax treatment of the transaction.

Permanent establishment: Actions taken by executives and employees may establish a taxable presence for their employing entity in another country. For instance, regional hub executives who frequently negotiate and sign contracts for factories or regularly travel to these locations may create a taxable presence for the regional hub in the factory's country. Furthermore, traveling executives may trigger employer tax and social security compliance requirements, among others, for their employing entity. It is important to analyze local regulations, applicable income tax treaties, and the specific facts and circumstances to assess the risk. A customary practice is to develop clear guidelines outlining acceptable and unacceptable actions to help executives navigate these complexities.

Organizational design: From a people perspective, it is critical that workers understand and are receptive to the model's ways of working. Introducing change may be met with resistance, especially as local autonomy is reduced, power shifts and roles are modified. Articulating value and importance is key.

Throughout the transitional phase, clear change management and communication protocols should be deployed. A common practice is to form a cross-functional change management committee with representation from key business leadership, tax, legal, and human resources. Embedding a defined governance and approval framework, as well as clear roles and responsibilities (e.g., RACI), can facilitate operational success and guide the degree of local autonomy.

Clear reporting lines, with proper indication in the company's human resources information systems, will help maintain both governance procedures and ways of working protocols. However, cross-border reporting lines to the regional hubs and principal should be conscious of permanent establishment and other tax matters as noted above.

IT systems: Streamlined processes and technology solutions lead to greater efficiency in managing intercompany transactions. Automation in IT systems adds significant value to intercompany procurement charges by enhancing efficiency, accuracy, compliance, and data visibility. By leveraging automation, organizations can optimize their procurement processes and facilitate a more accurate way to track and monitor cost savings and ensure that intercompany charges are aligned with actual benefits received. Automation allows for seamless integration with other IT systems, including finance and accounting platforms. This integration ensures that intercompany charges are accurately reflected in financial records, facilitating better financial management and reporting.



Conclusion

- In today's dynamic environment, business leaders seek operational flexibility to shift decision-making roles throughout the organization and sometimes across different geographies. The center-led model offers this flexibility in global, regional, and local management and control, supporting operational needs while maintaining financial oversight and corporate governance. However, this operational flexibility can introduce several organizational and tax complexities that need to be managed. Therefore, transfer pricing policies and procedures must be carefully crafted to accommodate this business flexibility. The center-led model strikes the right balance, neither too centralized nor too decentralized, but "just right." Goldilocks would be pleased.

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