NovioTax

The attribution of Location Savings in a transfer pricing context

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When multinational companies ("MNEs") choose a location to set up activities, they have to consider many factors, including among others local market circumstances, level of production expenditure, available infrastructure and the political/tax climate. We continue to see a trend of relocations of low-risk, manufacturing activities to China, Brazil or India (i.e. the more prominent emerging markets, where labour / manufacturing costs are generally lower than in the Netherlands) as well as Germany, observing generally lower investments expenditure compared to The Netherlands.

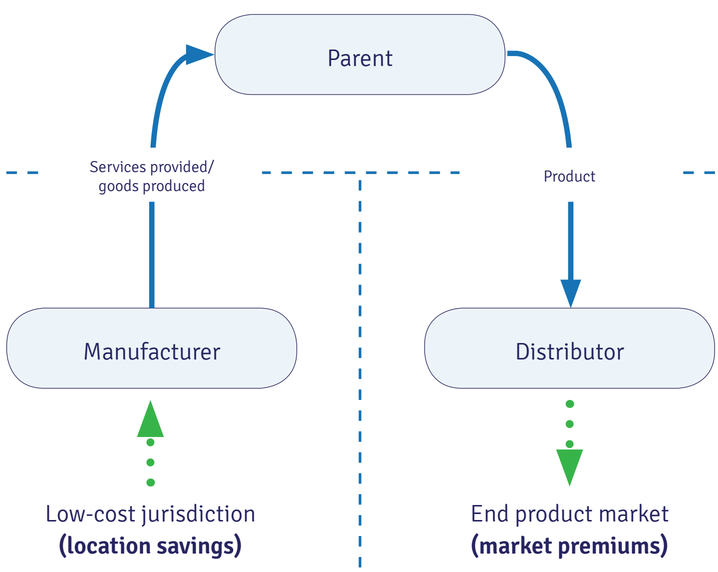
The issue of location savings, or location-specific advantages ("LSAs") is a key topic within the field of transfer pricing, and generally deals with the question where MNEs should allocate the additional profits (if any) resulting from LSAs. It is no surprise that the emerging countries (in particular China and India) are big advocates of the concept of LSAs, as additional profits attributable to LSAs means more taxation for the jurisdiction in which those business operations actually take place. However, it should be noted that LSAs are not only relevant in relation to emerging markets, as it is an issue that should be taken into account in a wider transfer pricing context, as illustrated above with example of Germany.

In this blog, we have chosen to elaborate on our experiences in respect to LSAs and the different ways to factor them into the transfer pricing analysis, such to increase the chance of acceptance of the various Tax Authorities involved, and likewise reduce partial double taxation as well as time and resource consuming MAP-procedures.

LSAs in a transfer pricing context

As noted in the introduction, LSAs are generally regarded as benefits that MNEs are able to receive from relocating part of their businesses to certain jurisdictions. The benefits observed should be regarded as net cost savings – these savings include wage costs, raw material costs, transportation costs, rent, training costs, subsidies, tax incentives, infrastructure costs, etc. Besides the commonly perceived low-cost of labour or real estate, LSAs can also be observed in locations with highly specialized skilled manpower and knowledge (such as the software industry).

Conceptually, we have also seen so-called market premiums which somewhat relate to LSA's, but unfortunately lack an international agreed understanding. Typically, the proximity to growing local/regional markets and a large customer base with increased spending capacity triggers market premiums. The straightforward example would be the Chinese preference for certain types of products and brands (i.e. German cars), leading to higher demand and therefore triggering a higher price (i.e. a market premium). Strictly, LSAs and market premiums should be distinguished from each other. Hence in the context of this blog we have chosen not to elaborate on market premiums.



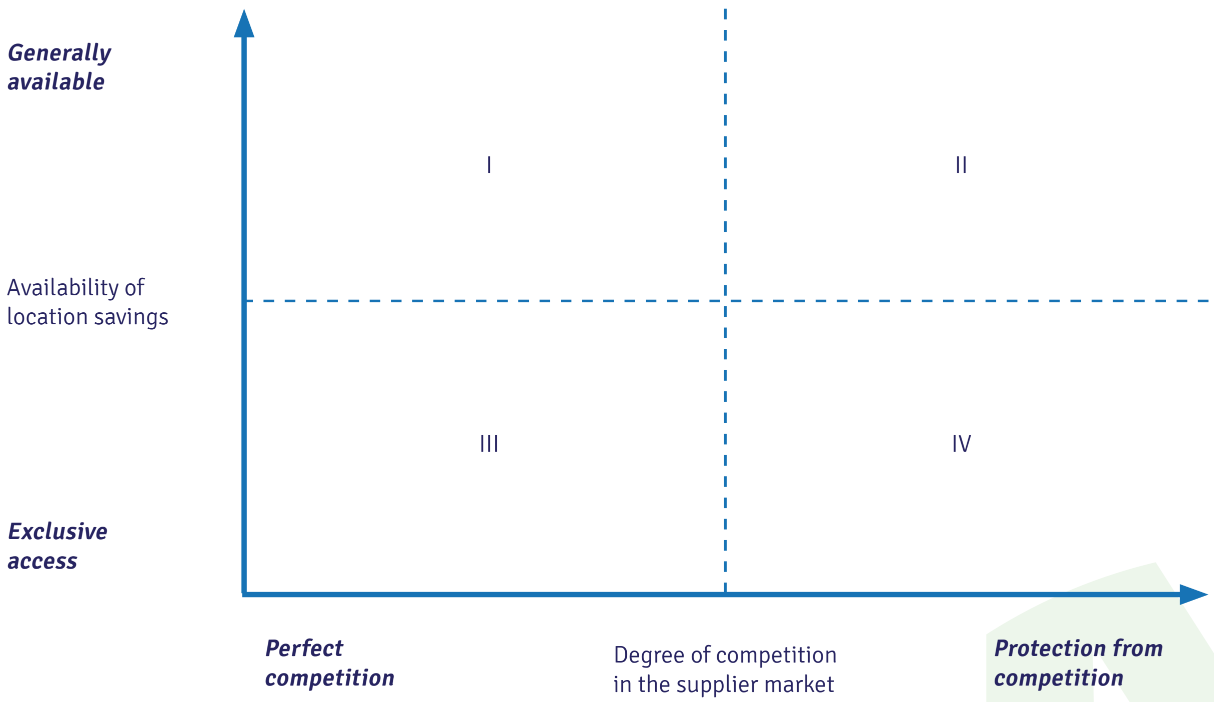
The fact that purchased goods and services from low-cost jurisdictions are relatively low, does not necessarily mean that the selling price of the goods or services have to be low as well. We have seen cases whereby the parent company achieved a strong competitive position and subsequently enabled the group to secure higher sale prices (observing its pricing power). At the same time, the labour resources in the jurisdiction of the group manufacturer) were however not generally available. In these cases, the so-called LSAs, in our opinion should not completely accrue to the parent company. Ultimately this may lead to a higher mark-up in the internal price charged between the group manufacturer and the parent company.

From a transfer pricing point of view, LSAs are regarded as a comparability factor that has influence on the transfer price or profitability of internal transactions. Where significant LSAs are derived as a result of a business relocation, it should be assessed to what extent LSAs should be shared among the parties observing the possible costs involved in the relocation. Normally clients, but also to a certain extent Tax Authorities, tend to take the position that some kind of exit taxation should be considered. This is however not necessarily the case. In order to properly allocate profits between affiliated companies in the context of LSAs, we generally perform, depending on the specific situation at hand, the following analysis, which is in line with the OECD Guidelines:

§.1 Identifying and quantifying the amount of locational advantages or disadvantages by assessing the amount of any increase or decrease in revenues, costs or profits;
§.2 determining the degree to which the locational advantages or disadvantages are passed on to independent consumers or suppliers, and;
§.3 if not wholly passed on to customers or suppliers, the manner in which independent enterprises operating under similar circumstances would allocate any retained net LSAs.

The LSA matrix

The matter in which LSAs are passed on to independent consumers or suppliers mostly depend on the availability of LSAs in the manufacturing jurisdiction and the degree of competition in the parent market. The LSA matrix provides for a framework to identify whether an MNE is able to obtain LSAs and can be used as a starting point for a transfer pricing analysis. The LSA matrix categorizes four quadrants based on two factors: the availability of LSAs in the low-cost jurisdiction and the degree of competition in the local market. We refer to the figure below. We particularly note that the analysis of the allocation of LSAs should also take into account an assessment of the parent company and the distributors / manufacturers relative bargaining powers. For instance, has the parent company many options available other than to use the service provider / distributor in country X? Likewise the distributor / manufacturer may have unique resources (skilled personnel).



Hereafter, we will describe the four quadrants in more detail.

Quadrant I

Quadrant I is a situation where LSAs are generally accessible and the end product market is highly competitive. Observing the fact that competitors would also move their manufacturing facilities to low-cost jurisdictions, any first-mover would be forced due to competitive pressures to cut price at some stage. Ultimately in these situations the benefits of LSAs may shift to consumers through lowered selling prices.

It should be noted however that in some cases the parent company can, for some period of time, continue to sell its products at the original price despite the significantly reduced labour costs, if competitors have yet to move to low-cost jurisdictions. After a certain period of time, competitors will also move to low-cost jurisdiction forcing the parent company to decrease its prices. Hence, LSAs will be passed on to consumers.

In a perfectly competitive market where local resources are generally available (i.e. the manufacturers do not have any market power), it would ultimately be the question what the incentive of a relocation would be. In the long-run, any benefits would diminish to zero. This would also be one of the arguments in a potential exit discussion with Tax Authorities. In addition, it would be relevant (among other elements) to understand whether the particular client is a first mover.

Quadrant II

Quadrant II is a situation where LSAs are generally accessible and the parent company has a strong market position. The manufacturer achieves low costs and the parent company is able to maintain a high price (based on its market positions). In this scenario the LSAs are secured by the parent company as a result of its market power, therefore the benefits of LSAs should also be allocated to the parent company.

For example, one of our clients designs, manufactures and sells high-quality tyres. The brand name is famous and represents a highly valuable intangible. Based on IP protection (i.e. the Netherlands parent office has retained the rights on the brand name), the market position of the Dutch parent company is strong, and it is able to maintain a relative high price. The manufacturing process however is basic and resources (i.e. cheap labour) are generally available in India. The tyres are being manufactured by the affiliate in India under a contract manufacturing arrangement. The contract manufacturing arrangement does not involve the use of any significant intangible owned by or licensed to the Indian company.

In our opinion the benefits of LSAs should be allocated to the Dutch parent company. In addition, it is likely that the Netherlands parent office has the option (realistically) available to use either the affiliate in India or a third-party manufacturer. To a certain extent, the competition in India (the affiliate and its competitors) have squeezed out Indian earnings via the strong competition. In such a situation, a contract manufacturer, treated at arm’s length, would generally be attributed very little, if any, part of the LSAs. Not doing so would put the associated manufacturer in a situation different from the situation of an independent manufacturer and would be contrary to the arm’s length principle.

Quadrant III

Quadrant III is a situation where the manufacturer has exclusive access to the LSAs in the low-cost jurisdiction while the end product market is highly competitive. In this scenario the parent company cannot influence the selling price of goods / services (observing the strong competition). The manufacturing costs are however low since the parent company has exclusive access to LSAs opposite to competitors. Reasonably speaking, the benefits of LSAs should be allocated for the larger part to the manufacturer.

Let’s assume the scenario in which a manufacturing subsidiary in country X (low-cost jurisdiction) is able to provide necessary software services with a superior quality standard, and that the parent company in the Netherlands has obtained exclusive access to the services of the particular subsidiary. Unfortunately however, the Netherlands parent company has difficulties withstanding market pressure because the technical know-how it has developed has not been properly secured. Furthermore, the Netherlands parent company does not have the option of engaging qualified engineers in other countries (i.e. labour costs would be too high, insufficient skilled engineers et al). Considering this, the parent company has secured exclusive access of the services of its subsidiary in country X. To a certain extent, the exclusivity established also acts as a barrier for competitors, which have difficulty obtaining a workforce with the same degree of know-how and expertise. In this case, the value of the services conducted by the subsidiary in country X should take into account the larger part of the benefits of the LSAs. Hence, the LSAs are secured by the exclusive access of the manufacturer.

An argument to limit the allocation of the net LSAs to the manufacturing entity would be if other countries have options realistically available with a similar unique workforce. This would limit the exclusivity of the LSAs in country X, thus creating a stronger bargaining position for the Dutch parent company. If, for instance, the Indian Tax Authorities would take the position to wholly allocate the net LSAs to the manufacturing entity in country X, the aforementioned would be an important argument to limit the allocation of the benefits of LSAs.

This reasoning however may also change if we consider for instance that the Netherlands parent company needs to make available valuable process technology to start-up / support the manufacturing process in India and in doing so relocates a number of key process engineers and / or fixed assets. In this approach, from a transfer point of view, we would typically expect intercompany transactions relating to the purchase of raw materials/components/goods and payment of royalties for the use of technology and trademark or brand (i.e. marketing intangibles). In addition, from a transfer pricing point of view, in this particular case a functional analysis could also identify a (taxable) transfer of technology / know-how.

Quadrant IV

Quadrant IV is a situation where the manufacturer has exclusive access to the LSAs in the low-cost jurisdiction and the parent company has a strong market position. Subsequently, the manufacturer achieves low costs and the parent company is able to maintain the price level. In this case, the benefit of the LSAs (1) are secured by the parent company as a result of its market power, but (2) also by the manufacturers exclusive access to the LSAs. Hence, the benefits will be shared by the manufacturer and the parent company based on their respective bargaining power.

This can be best illustrated with the example used in Quadrant II (high-quality tyres with valuable intangible in the Netherlands). We assume that the Indian manufacturer has a unique workforce that is only able to provide the Netherlands parent office with the required tyre quality standard. The Netherlands parent office in this case does not have many other options available other than to use the Indian affiliate company. By utilizing the highly specialized skilled manpower available the manufacturer secures exclusive access to the LSAs. The strong market position of the Netherlands parent company however enables it likewise to secure a high price level. Hence, in these cases questions arise in respect of the amount of LSAs, and the extent to which LSAs are allocated between countries.

It should be carefully examined if options are realistically available in other low-cost jurisdictions with a similar unique workforce. This would create a stronger bargaining position for the parent company or vice versa the manufacturing company if no other options are identified from the perspective of the parent company.

Takeaways

- The concept of LSAs plays an important role in the allocation of profits in relation to emerging markets and generally triggers discussions with local Tax Authorities.

- The matter in which LSAs are passed on to independent consumers or suppliers mostly depend on the availability of LSAs in the manufacturing jurisdiction and the degree of competition in the parent market. These positions need to be assessed in determining the applicable transfer price.

- The analysis of the allocation of benefits of LSAs should (also) factor in the relative bargaining powers of the parent company and the distributors. For instance, has the parent company many alternative options available to it other than to use the service provider / distributor in country X?

- The profit split method may or even should be relevant in the context of LSAs. A one-sided approach may not properly account for all of the intrinsic features (bargaining power, market position and exclusive access to resources et al) in which LSAs are recognized.

As a general note we would like to state that we expect an increase in transfer pricing disputes that may involve LSAs observing (1) the increased transparency and cross-border information exchange in the context of the implementations of the OECDs' Base Erosion and Profit Shifting project and (2) the fact that China and India are big advocates of the concept of LSAs. Conceptually however due to a gradual increase in cost-base LSAs may become less relevant at some stage.

ABOUT NOVIOTAX

NovioTax is a Dutch research-oriented tax consultancy firm with offices in Amsterdam and Nijmegen. Our employees are members of the Dutch Association of Tax Advisers (NOB) and the International Fiscal Association (IFA), have many years of experience and some are much sought-after guest speakers on tax policy and other topics that fall within their field of expertise. We typically serve midsized and large MNE clients, coordinate discussions with the DTA and closely cooperate with international law and tax law firms.

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