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United States and Global Contemplation of Location Savings in Transfer Pricing

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ABSTRACT: When average costs start falling as output increases, then economies of scale occur. Economies of scale apply to various organizational and business situations and various levels, such as production, plant, or an entire enterprise[1]. "Location savings" is an economy of scale principle and is the net savings in costs derived by a multinational enterprise (MNE) group that relocates some of its activities to where labor or real estate expenditures are lower than in the original location [2].Transfer pricing refers to the rules and methods for pricing transactions within and between enterprises under common ownership or control [3]. This article examines the typical global, including United States consideration of location savings in transfer pricing.

KEYWORDS: Transfer pricing, Economics

I. INTRODUCCTION TO ECONOMIES OF SCALE

Economies of scale is a microeconomics concept. Enterprises obtain the cost advantages due to their scale of operation (typically measured by the amount of output produced), with cost per unit of output decreasing, which causes scale to increase.Economies of scale refer to the cost advantage experienced by a firm when it increases its output level.The advantage arises due to the inverse relationship between the per-unit fixed cost and the quantity produced. The greater the quantity of output produced, the lower the per-unit fixed cost. Economies of scale also result in a fall in average variable costs (average non-fixed costs) with increased output. Operational efficiencies and synergies bring this about due to an increase in production scale [4].

II. LOCATION SAVINGS

At present, location savings arise because markets are only partially integrated. Since globalization is an ongoing, dynamic process, it is possible to achieve savings (and ultimately profits) by relying on factor inputs provided by relatively inexpensive markets.

What is the appropriate way to handle "location savings" under arm's length transfer pricing? Specifically, when an affiliate realizes cost savings specific to its local market, to what extent should its compensation under an arm's length standard reflect such savings?Should the affiliate earn some premium to reflect the cost savings it is contributing to the overall enterprise? [5]

When comparable uncontrolled enterprises operate in different geographical markets, location savings adjustments are needed to measure significant differences in wages and adopted technology measured by incremental capital/output ratios. Transfer pricing rules have no established method of making reliable adjustments to account for differences in geographic markets. The relevant tax authorities provide only limited guidance, but they are ad hoc and not guided by economic learning. See the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, United Nations Practical Manual on Transfer Pricing for Developing Countries (2017), and U.S. Treasury Section 1.482 Regulations below. Additional guidance provided by case law has been unsatisfactory [6].

III. U.S. TREASURY SECTION 1.482 REGULATIONS [7]

The U.S. transfer pricing regulations provide limited guidance regarding location savings. As per the U.S. transfer pricing regulations, adjustments for significant differences in costs attributable to the geographic markets must be based on the impact such differences would have on the controlled transaction price, given the relative competitive positions



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of buyers and sellers in each market. Under an arm's length condition, the seller's relative bargaining power/position (low-cost location), the buyer (high-cost location), and competition would be the critical determinants in arriving at a price for an uncontrolled transaction.

Extract from U.S. transfer pricing regulations - 26 CFR 1.482-1(d)(4)(ii)(C) - Location Savings -

If an uncontrolled taxpayer operates in a different geographic market than the controlled taxpayer, adjustments may be necessary to account for significant differences in costs attributable to the geographicmarkets. These adjustments must be based on the effect such differences would have on the consideration charged orpaid in the controlled transaction given the relative competitive positions of buyers and sellers in each market. Thus, forexample, the fact that the total costs of operating in a controlled manufacturer's geographic market are less than the totalcosts of operating in other markets ordinarily justifies higher profits to the manufacturer only if the cost differenceswould increase the profits of comparable uncontrolled manufacturers operating at arm's length, given the competitive positions of buyers and sellers in that market.

Example:Couture, a U.S. apparel design corporation, contracts with Sewco, its wholly-owned Country Y subsidiary,to manufacture its clothes. Costs of operating in Country Y are significantly lower than the operating costs in the U.S.Although clothes with the Couture label sell for a premium price, the actual production of the clothes does notrequire significant specialized knowledge that actual or potential competitors could not acquire to Sewco at a reasonable cost. Thus, Sewco's functions could be performed by several actual or potential competitors to Sewco ingeographic markets that are similar to Country Y. Thus, the fact that production is less costly in Country Y will not, inand of itself, justify additional profits derived from lower operating costs in Similar geographic markets capable of performing thesame functions at the same low costs indicate that at arm's length such profits would not be retained by Sewco.

The U.S. Services Regulations include a "cost safe harbor," allowing certain services to be charged at cost without a mark-up. In the case of "low margin covered services," a taxpayer must establish an interquartile range of arm's length mark-up on total services costs and evaluate whether the median mark-up is less than or equal to 7 percent.

IV. TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATION, 2010 (OECD GUIDELINES) [2]

Depending on what independent parties would have agreed under independent circumstances based on their functions, assets, and risks, respective bargaining power's location savings should be attributed to the parties. A business strategy aimed at deriving location savings is put forward as a business reason for restructuring. Business strategies would take into account aspects of an enterprise, such as innovation and new product development, market penetration schemes, degree of diversification, risk aversion, assessment of political changes, the input of existing and planned labor laws, duration of arrangements, whether the nature of the relationship between the parties to the controlled transaction would be consistent with the taxpayer bearing the costs of the business strategy and other factors bearing upon the daily conduct of business. It must be examined in determining the comparability of controlled and uncontrolled transactions for transfer pricing purposes. The most important consideration is whether the strategy in question could plausibly be expected to prove profitable within the foreseeable future and that a party operating at arm's length would have been prepared to sacrifice profitability for a similar period under such economic circumstances and competitive conditions.

V. UNITED NATIONS PRACTICAL MANUAL ON TRANSFER PRICING FOR DEVELOPING COUNTRIES (2017) [8]

Location savings are cost savings or benefits such as cheaper production or service costs resulting from locating a manufacturing or other operation in a low-cost jurisdiction. In addition to location savings, the relocation of a business gives some other *location-specific advantages (LSAs)*, including a highly specialized skilled workforce and knowledge; proximity to a growing local/regional market; a large customer base with increased spending. *Location rents* are the incremental profits of a multinational group from LSAs in a particular location.



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The process to arrive at the appropriate arm's length price typically involves location savings and location rents. Characteristically, the possibility to derive location savings may vary from one jurisdiction to another, depending on labor costs, raw material costs, transportation costs, rent, training costs, subsidies, incentives including tax exemptions, and infrastructure costs. Location savings' computational formula:

Cost Savings -	Dis-savings	=	Net Location Savings	+/-	Other Location Specific Benefits	=	Location Specific Advantages	=>	Location Rent
Cheap Labor	High Transportation Costs								Incremental Profit

VI. Non-U.S.CONSIDERATION OF LOCATION SAVINGS IN TRANSFER PRICING

China

Location savings are critical questions that Chinese tax authorities have raised in many audit cases. They contend that with the efficiency of the MNEs infrastructure and labor force, the related Chinese manufacturing entity should receive higher compensation, translated into higher prices for its products, to reflect the "location savings" when MNE conducts manufacturing/processing in China. Also, questions posed are how to quantify the location savings, which should be entitled to the benefits associated with it, and the extent to which this should be recognized in China.

The globalization of trade and economies has given rise to concepts such as "location savings," and more generally, LSAs. As a developing country and emerging market economy, China has comparative advantages due to its large market size, cheap land and labor, and effective market demand. The State Taxation Administration of China (SAT) has emphasized concepts such as location savings. The Chinese SAT can prioritize accepting the application from a taxpayer if it falls into thiscategory: location-specific factors, including location savings, have been given adequate consideration, and the proposed transfer pricing method and the calculation method are appropriate.In dealings with Chinese taxpayers, the Chinese tax administration has adopted a four-step approach on the issue of LSAs:

- a. identify if an LSA exists;
- b. determine whether the LSA generates additional profit;
- c. quantify and measure the additional profits arising from the LSA; and
- d. determine the transfer pricing method to allocate the profits arising from the LSA.

Both industry analysis and quantitative analysis are critical in determining LSAs and their impact on transfer pricing [8].

Mexico

U.S. MNEs that utilize location savings in low-wage countries like Mexico may restructure for legitimate business purposes for meeting "commercially rational behavior test."OECD Guidelines further substantiate this "...that it considers that as long as functions, assets, and risks are transferred, it can be commercially rationale...for a multinational group to restructure to obtain tax savings". The conversion of a firm exhibiting characteristics of a manufacturing firm via the elimination of the requisite risks, functions, asset utilization, and risk of loss may be elected to restructure into either a contract manufacturing arrangement with a guaranteed cost-plus arrangement or a Maquiladora, which will result in most if not all cases a lower overall effective tax rate for its restructured Mexican operations.

India [9]

India's transfer pricing rules are based upon the OECD principle of preventing profit shifts by manipulating the prices charged (or paid) in international transactions, thereby eroding the country's tax base (CBDT Circular No. 14/2001). Earlier transfer pricing controversies involved location savings. Tax officers earlier argued that taxpayers should allocate location savings to the Indian operations. However, the courts have often ruled in favor of the taxpayers,



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stating that the large availability of comparable companies reduces the chance of location savings. The Indian government has accepted this position and confirmed it in the 2017 U.N. Transfer Pricing Manual.

VII. MAJOR INTERNATIONAL RULINGS [10]

The issue in the case of *Eli Lilly v. Commissioner* [856 F2d 855 (7th Cir 1988)] (U.S. Tax Court) was whether the taxpayer received an arm's length consideration for the transfer of intangibles. The taxpayer, a manufacturer of pharmaceuticals, established a U.S. subsidiary corporation in Puerto Rico (Lilly PR) to manufacture its Darvon line of products. The taxpayer did not recognize the exchange of its patent for proposyphene (used in Darvon) and other intangibles for stock in Lilly PR. The court held that the marketing return should be 100% and the marketing intangibles split should be 45%.

In the case of *Compaq Computer Corp. v. Commissioner (Tax Code Memorandum 1999-220) (U.S. Tax Court)*, Compaq US ("taxpayer") was in the business of manufacture and sale of printed circuit assemblies ("PCA"). Subsequently, it established a subsidiary in Singapore for the manufacture of PCAs. The subsidiary purchased materials from pre-approved third-party vendors and, after assembly, charged the taxpayer for completed PCA's. The issue under contention was whether and when locational advantage can be taxed. The court accepted the taxpayer's contention & the comparable uncontrolled price method used with necessary adjustments for product differences, payment terms. The court thus implicitly agreed that offshore affiliates could enjoy inherent locational advantages resulting in higher profits due to lower property costs and wages.

VIII. CONCLUSION

Some countries (usually developing countries) view that the economic benefit from moving operations to a low-cost jurisdiction, i.e., "location savings," should accrue to the country where such operations are conducted. Accordingly, the determination of location savings and their allocation between the group companies (and thus, between the two countries' tax authorities) has become a key transfer pricing issue in developing countries. Unfortunately, most international guidelines do not provide much guidance on location savings, though they sometimes do recognize geographic conditions and ownership of intangibles. The U.S. Section 482 regulations provide some limited guidance in recognizing that adjustments for significant differences in cost attributable to a geographic location must be based on the impact such differences would have on the controlled transaction price given the relative competitive positions of buyers and sellers in each market. The OECD Guidelines also consider location savings, emphasizing that the allocation of the savings depends on what would have been agreed by independent parties in similar circumstances [8]. In conclusion, MNEs must pay close attention to the transfer pricing of offshored manufacturing operations or services. MNEs must regularly review and document their business strategies and relative bargaining power to substantiate their inter-company pricing.

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