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The new transfer pricing landscape
A practical guide to the BEPS changes

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Location-specific advantages

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Location-specific advantages or LSAs are those location-specific market features and/or factors of production that enable a firm to achieve an improved financial outcome from the provision of the same product or service relative to alternative locations. The concept may include access to skilled labor, incentives, market premium, access to growing markets, superior infrastructure, and cost savings. The new guidelines focus on two types of LSAs:

- Location savings: These arise from cost savings due to differences in the cost of operations (arising from lower labor costs, real estate costs, etc.) between high-cost and low-cost jurisdictions.
- Other local market features: These are attributes of local markets (such as purchasing power and product preferences of households in the market, growth rate of the economy adding to increased demand for the products, and degree of competition in the market) that may allow a company to obtain a price premium for its products and/or gain access and proximity to growing local and regional markets, allowing it to gain a competitive advantage through scale economies in sale or production.

These factors account for the fact that the demand and production parameters in some countries can be significantly different than those in other countries. These differences may allow a multinational enterprise (MNE) to take advantage of better cost/demand conditions to remain competitive or edge out potential competitors.

The guidelines do not provide a formal definition of LSAs. However, they provide guidance on the concept of location savings and refer to other local market features that are synonymous with the concept of LSAs. The guidelines indicate that the location savings principles apply generally to all situations in which location savings are present, not just to business restructurings, as in the prior guidance. In addition to location savings, the guidelines expanded the discussion to other local market features, such as market advantages and disadvantages that may affect the prices and margins realized in the local market. The examples in the guidance include the purchasing power and product preferences of households, market expansion or contraction, and the degree of competition.

This article addresses some key issues in the guidance related to LSAs and compares it to the positions adopted by China and India.

Transfer pricing issues related to LSAs

Are LSAs intangibles?

The OECD initially acknowledged and addressed the issue of location savings in Chapter IX of the Transfer Pricing Guidelines, which discusses transfer pricing issues associated with business restructurings:

> The [allocation of significant location savings] that would be agreed between independent parties would normally depend on the functions, assets and risks of each party and on their respective bargaining powers. [Chapter IX, Business Restructurings, paragraph 9.149]

In the new guidance in Chapter I, the OECD refers to the discussion in Chapter IX as the principles generally applicable to all situations related to location savings. It is clear from the various discussions on LSAs, as well as the definition of intangibles for transfer pricing, that the guidance does not consider LSAs to be intangibles, because LSAs are market features the MNEs would neither be capable of owning nor controlling, but merely be able to use. The guidelines properly distinguish between features of the local market, which are not intangibles, and any contractual rights, government licenses, or know-how necessary to exploit that market, which may be intangibles. It is only in such instances that LSAs can be exploited through a process of obtaining a complementary and scarce "right" that may give rise to additional value associated with LSAs.

The mere presence of a form of LSA in a market may not be economically valuable to the MNE, because such features may be commonly available to all other market participants who can benefit from them without incurring any additional costs, thereby driving the economic value of such LSAs to zero.

Income attributable to LSAs

The starting point of any transfer pricing analysis involving LSAs should be their identification. It is important to note that the mere perception that LSAs exist within an MNE can often be unfounded, particularly because MNEs' decision to locate their manufacturing or service operations in a given location can be driven by competitive pressure from the markets that require them to lower costs simply to remain in business. Clearly, in such instances, all or a portion of any location savings are passed on to the end customers of these companies. This is consistent with the guidelines, which recommend that any allocation of location savings associated with LSAs can be determined only after ascertaining "the extent to which location savings are either retained by a member or members of the MNE group or are passed on to independent customers or suppliers."

The guidelines state that the measurement of location savings should take into account both benefits and costs associated with local market features, and that only the "net" savings are relevant for purposes of transfer pricing analyses. In the context of location savings, benefits from a location may be offset by economic costs that result in dis-savings. These dis-savings may take the form of higher transportation costs, higher warranty costs, higher cost of capital, economic costs of managing an operation in a remote location, and higher indirect costs of doing business. It is possible that part of the cost savings may be offset at times by dis-savings on account of poor infrastructure in relation to the quality and reliability of the power supply, higher costs for transportation, quality control, etc. Accordingly, only the net location savings (savings minus dis-savings) may give rise to an extra profit to an MNE due to the relocation of its business from a high-cost to a low-cost jurisdiction.

When location savings exist and suitable comparables cannot be found, the question emerges as to how to split the savings, but the guidance does not provide any answers.

Assuming that LSAs give rise to net positive location savings, the guidelines recommend that a thorough functional analysis describe the facts and circumstances surrounding an LSA, clearly identifying:

- Whether LSAs exist;
- Amount of any net LSAs;
- Extent to which LSAs are either retained by a member or members of the MNE group or are passed on to independent customers or suppliers; and
- When LSAs are not fully passed on to independent customers or suppliers, the manner in which independent enterprises operating under similar circumstances would allocate any retained net location savings.

The guidelines further state that "suitable comparability adjustments be made to account for LSAs" giving rise to location savings within the MNEs, when reliable adjustments to improve comparability can be identified.

The key question that arises in this context is whether suitable local comparables can be identified that can reliably allocate the location savings to the two (or more) entities of the MNE group. Technically, from a transfer pricing perspective, LSAs, if any, would depend on the functions, assets, and risks of each party and on their respective bargaining powers. In a perfectly competitive market, given competition and pricing pressures, the concerned party will pass any additional benefits on to the customers to remain competitive. Accordingly, it would not be able to earn more than what third-party comparables—in the same geography, performing similar functions, and assuming similar risk—would earn. Therefore, any LSAs that the specific geography has to offer (if any) are equally available to all local comparables. At arm's length, an entity cannot expect to be compensated more than what other comparables in the market would earn. Thus, the above clearly provides a logical view that the return to LSAs, if any, is already embedded in the profit margins of comparable companies.

While this view is generally accepted, such a premise would apply only if there are reliable comparables, and market forces exist to demonstrate price equilibrium in a given setting. If the market is not perfectly competitive or market imperfections give rise to monopolistic power, comparability itself breaks down and it can be concluded that comparable margins may not be a sufficient comparison.

When location savings exist and suitable comparables cannot be found, the question emerges as to how to split the savings, but the guidance does not provide answers. From an economic perspective, the allocation of location savings should reside with the parties that demonstrate higher bargaining capacity and thereby can command a greater share of the savings. This is akin to a negotiation scenario between third parties whereby price determination is often based on negotiations and economic prowess. Transfer pricing under the arm's length principle tries precisely to integrate this third-party behavior in related-party outcomes.

In an arm's length scenario, the allocation of locations savings between the parties depends on relative bargaining positions, which in turn depends on the goals, resources, and factor constraints on each of the parties. This allocation may include strength of market presence; intellectual property ownership; relative competitive position; functions, assets, and risks; and importantly, alternative options realistically available to each party.

Economic tools such as the use of a Shapley Value-based approach also provide an indication of how location savings may be split in the absence of suitable comparables. The Shapley Value concept describes an approach to the fair allocation of gains obtained among several members based on an analytical construct. The setup is as follows: a group of companies cooperates and obtains a certain overall gain from that cooperation.

Because some members may contribute more to the group than others, the question arises how to fairly distribute the gains among the members. Or phrased differently: how important is each member to the overall operation, and what payoff can they reasonably expect? Under this approach, the share of joint output of a group attributable to any single member depends on that member's contribution to the group that preceded it (that is, not the value the new member thinks it should get based on its efforts).

View from China and India

While the concepts of LSAs and particularly location savings are slowly gaining ground in developing countries around the world, it is primarily in India and China where these concepts have been adopted by the tax authorities, both in law and in audits.

China

In 2012, China's State Administration of Taxation (SAT) announced its position on transfer pricing practices in China with the release of a chapter on "China Country Practices" in the UN Transfer Pricing Manual. Location savings, according to this chapter, are "the net cost savings derived by a multinational company when it sets up its operations in a low cost jurisdiction." Market premium "relates to the additional profit derived by a multinational company by operating in a jurisdiction with unique qualities impacting on the sale and demand of a service or product."

In the China chapter of the UN Manual, the SAT provides a specific example regarding the automotive industry, listing LSAs such as the "market-for-technology" industry policy, the local customer's preference and demand, the duty saving, the local supply capacity constraints, and the low-cost suppliers.

The SAT on September 17, 2015, released a discussion draft of the revised Special Tax Adjustment Implementation Rules. The discussion draft proposed for the first time to include the concept of LSAs in Chinese transfer pricing rules. The draft also requires Chinese taxpayers to consider local economic factors in determining transfer pricing methods and comparability when selecting comparable companies, as well as to take LSAs into account in determining the presence of intangibles and their value. The SAT is expected to release the final rules by the end of 2015.

The SAT generally has taken the view that suitable comparables do not exist in the Chinese market. The tax authorities agree that valuing and allocating LSAs is a challenge in the absence of suitable comparable companies. Therefore, they tend to take a practical approach in terms of understanding the taxpayer's value chain, and analyzing the contribution factors of the China entity, including LSAs, to determine whether the local entity is properly compensated.

In many cases, to address the measurement of economic contribution resulting from LSAs, the SAT applies mathematic methods to quantify the LSAs. For example,

- For a contract R&D study (as presented in the China Country Practices chapter of the UN Manual), the SAT compares the Chinese taxpayer's cost base with the parent company's cost base in the developed country. The SAT then adjusts the full cost mark-up by reference to the cost base difference to calculate the additional profit attributable to China for location savings.
- In another case, the SAT compares the Chinese taxpayer's selling expense per unit of revenue with that of the overseas parent company, which shows that to fulfill the same unit of revenue the Chinese taxpayer incurs a lower level of selling expense. The expense level gap is viewed as the evidence of LSA in China market, which should be compensated through a residual profit split together with other factors like manufacturing and marketing intangibles.

The SAT has also applied other mathematical methods in other cases.

India

Indian regulations do not provide any specific guidance on location savings and or LSAs/local market characteristics. However, in the absence of specific regulations, the Indian tax authorities have relied on international guidance in applying the concept of location savings.

In recent audits, Indian tax authorities have made several transfer pricing adjustments wherein they have held that because of MNE's easy access to factors of production such as low-cost skilled manpower, raw materials, and infrastructure, they enjoy substantial cost savings in India. The Indian tax authorities' view is that the economic benefit arising from the shifting of operations from a high-cost jurisdiction to a low-cost jurisdiction such as India should accrue to the country where such operations are actually carried out. The Indian tax authorities do not accept taxpayers' assertions that location savings, if any, are embedded in the local comparables' margins. Accordingly, the Indian tax authorities take the position that comparability is not sufficient. Therefore, benchmarking using local comparables does not take into account the benefit of location savings, which in some cases has been computed by taking into account the cost difference between costs in the low-cost country and in the high-cost country. Thus, the arm's length compensation for cost and location savings should be such that both parties would benefit from participating in the transaction. Moreover, it should also reflect an appropriate split of the cost savings between the parties, which in some cases has been split one-half to each party.

The Indian tax administration's view is contrary to the guidelines and to several court decisions in India that ruled that no separate compensation for location savings/LSAs is required if there are local comparables. In a landmark ruling by the Mumbai Income Tax Appellate Tribunal in the case of *Watson Pharma Pvt. Ltd*., the court examined the factors in this case—a perfectly competitive business environment, the parties' bargaining power, the options realistically available to both parties, and the absence of above-normal profit in the value chain—and held that when the operating margin earned by a taxpayer is based on local market comparables operating in similar economic circumstances as the taxpayer, no further return on account of location savings is required.

The ruling is similar to that in the case of *GAP International Sourcing (India) Pvt. Ltd*. The decision in *Watson* is also in line with the views expressed in the Rangachary Committee report on safe harbor rules. In another court decision, the *Li Fung* case, the Delhi High Court denied an adjustment on the ground that the Indian tax administration failed to demonstrate the extent to which the related party benefitted from locational advantages before arbitrarily rejecting the taxpayer's economic analysis.

Similar views have been adopted in other recent judicial pronouncements. These rulings clearly reflect the maturing attitude of the Indian courts' transfer pricing position on this matter, in line with international standards.

Conclusion

The concepts of LSAs/local market characteristics and location savings are becoming increasingly important in developing countries. The BEPS guidelines for the first time have created an agreed upon framework to analyze the existence and allocation of LSA. According to the guidelines, LSAs are not intangibles but primarily a comparability adjustment issue. The key question going forward is whether the comparables in the local market are suitable for the proper allocation of location savings. The tax authorities in some countries, in particular those in China and India, have taken the position that suitable comparables do not exist. The BEPS guidelines do not provide guidance in that situation, which leaves MNEs and tax authorities to determine an acceptable approach to allocating location savings.

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