

# The Impact of Location Advantages on the Transfer Pricing of Multinationals: On the Chinese Love for European Designer Handbags and Lower Production Costs in India

**The authors discuss the impact of location advantages on the transfer pricing of multinationals. Specific guidance from the OECD and United Nations on location advantages is considered, followed by a discussion of two international tax cases. The current practice on location advantages and transfer pricing in the Netherlands and in China, as examples, is also examined.**

## 1. Introduction

Article 9 of both the OECD Model Convention (OECD Model)<sup>1</sup> and the UN Model Convention<sup>2</sup> provides that if associated enterprises make or impose conditions in their commercial or financial relations which differ from those which would be agreed between independent enterprises, their profits may be determined and taxed based on the conditions which would have been agreed between independent enterprises. In short, this means that both models apply the “arm’s length principle” for the determination of taxation rights on the profits of multinationals.

So far, the application of the arm’s length principle to “location advantages” has generated quite a lot of discussion.<sup>3</sup> Multinationals are generally able to increase their profits by relocating activities within the group to locations which provide advantages compared to other locations. These advantages can materialize by means of cost savings or revenue enhancing effects. A common example is the cost saving on wages that can be realized by relocating manufacturing activities or software development to low-wage countries. The question then arises as to how the additional profits realized through the use of the location advantages should be allocated among the associated en-

terprises involved. This is especially a concern in relation to emerging economies such as China.<sup>4</sup>

This article will discuss the impact of location advantages on the transfer pricing of multinationals, first examining the concept of location advantages and the transfer pricing aspects related thereto. Specific guidance from the OECD and United Nations on location advantages will also be considered, followed by a discussion of two international tax cases. Finally, the current practice on location advantages and transfer pricing in the Netherlands and in China, as examples, will be examined.

## 2. Location Advantages

### 2.1. Concept

The concept of location advantages can be described in a number of ways. For the purposes of this article, location advantages are taken to be (i) *cost reductions* that can be acquired as a result of operating in a location with inexpensive labour, infrastructure or other operating-related expenses and (ii) *revenue-enhancing effects* that are earned as a result of operating in a locality yielding high transaction quantities or prices, due to factors such as extraordinary demand, limited market access or other location-specific characteristics.<sup>5</sup>

It is entirely possible for different kinds of location advantages to accumulate within the same value chain. One example of this is the manufacture and sale of European designer handbags. A European multinational that manufactures such handbags could do this wholly or partly in a country where the costs are relatively low (in India, for example) and thus realize cost savings. Moreover, in certain countries, people are partial to such handbags (in China, for example) and are willing to pay a high(er) price for them.<sup>6</sup> The demand in China therefore may be a revenue-enhancing effect.

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1. OECD Model Tax Convention on Income and on Capital (2010), Models IBFD.
2. UN Model Double Taxation Convention between Developed and Developing Countries (2011), Models IBFD.
3. See e.g. S. Yuan, J. Liu & G. DeSouza, *Changing Transfer Pricing Landscape: “Like It or Not”*, 20 Intl. Transfer Pricing J. 4 (2013), Journals IBFD; B. Norwood, *Location Savings and Other Location-Specific Advantages*, 19 Asia-Pac. Tax. Bull. 5 (2013), Journals IBFD; B. Pawar & S. Udeshi, *Location Savings*, 19 Asia-Pac. Tax. Bull. 5 (2013), Journals IBFD.

4. Yuan, Liu & DeSouza, *supra* n. 3, which refers to recent statements of Dr Liao Tizhong, Deputy Director of the International Tax Department of the State Administration of Taxation (the Chinese tax authorities), e.g. that “[t]here should be a link between where profits are guaranteed and where they are taxed”.
5. See Norwood, *supra* n. 3. The authors use the term “location advantages” instead of “location-specific advantages”, and refer to “cost savings” instead of “cost reductions”.
6. See [http://www.mckinsey.com/insights/marketing\\_sales/tapping\\_chinas\\_luxury\\_goods\\_market](http://www.mckinsey.com/insights/marketing_sales/tapping_chinas_luxury_goods_market).

## 2.2. Background of the discussion

The concept of location advantages is certainly not new in international taxation.<sup>7</sup> However, the tax treatment thereof has attracted significant attention over the past few years,<sup>8</sup> which (partially) may be explained by the growing influence of developing economies such as Brazil, China and India. Location advantages, and location savings in particular, are generally common to operations in developing economies. In practice, transfer pricing rules are applied in such a way that the location advantages are allocated to associated enterprises in developed economies. An example is the remuneration for low-risk, routine-like manufacturing activities, which Western multinationals often carry out through associated enterprises in emerging countries. These types of activities are generally remunerated on the basis of a markup on the relevant manufacturing costs (cost-plus method). The markup is generally determined on the basis of comparable enterprises in developed economies.

As a result, associated enterprises that carry on manufacturing activities in a country with low manufacturing costs are allocated a lower profit than comparable associated enterprises in a country with high manufacturing costs. After all, a similar markup is applied to a lower cost base. Without adjustments – such as adjustments to the cost base – the cost saving in such cases will not be allocated to the profit of the manufacturing activities in the low-cost country, but to the head office of the Western multinational in the developed economy. Emerging economies therefore have a significant interest in a different application of the transfer pricing rules with respect to location advantages. A country like China leverages its growing influence to accomplish that aim.<sup>9</sup>

## 2.3. Allocation of location advantages between independent enterprises

Under the arm's length principle, the basic question is which conditions would be agreed between independent enterprises in comparable transactions. Location advantages are thus relevant under the arm's length principle only insofar as independent enterprises take them into account when determining prices.

When a multinational transfers its manufacturing activities from an independent enterprise in a high-cost country to an independent enterprise in a low-cost country, the question arises as to whether the price for the services will be reduced. The answer generally depends on the bargaining position of the multinational and the independent enterprise in the low-cost country. This position is a

result of supply and demand, and depends – among other things – on the realistic alternatives available to the parties. In cases where the market for comparable manufacturing activities is highly competitive in the low-cost country, the location advantages are generally not allocated to the local manufacturer. On the other hand, it is also possible for the manufacturer to be the only enterprise able to meet the multinational's quality criteria, for instance by being the one manufacturer with specific knowledge of the manufacturing process. In such case, the manufacturer's bargaining position is stronger and it is logical that part of the location advantages would be allocated to the manufacturer.

## 2.4. Location advantages and the typical transfer pricing methods

The OECD provides guidance regarding the application of the arm's length principle by means of its Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the OECD Guidelines).<sup>10</sup> The United Nations has done the same for developing countries in the UN Practice Manual on Transfer Pricing for Developing Countries (UN Manual). The OECD Guidelines and UN Manual describe five transfer pricing methods that are in accordance with the arm's length principle, namely the comparable uncontrolled price (CUP) method, the resale price method, the cost-plus method, the transactional net margin method (TNMM) and the transactional profit split method.

The choice of the most appropriate method depends on various factors such as (i) the appropriateness of the method considered in view of the nature of the controlled transaction, (ii) the availability of reliable information and (iii) the degree of comparability between controlled and uncontrolled transactions (including the reliability of comparability adjustments that may be needed to eliminate material differences between them).<sup>11</sup> The presence of location advantages (and the scope thereof) is particularly relevant to the last factor and, in principle, plays a role with each of the mentioned transfer pricing methods.<sup>12</sup>

When using absolute prices as a transfer pricing method (CUP), which is generally preferred,<sup>13</sup> in the authors' opinion, location advantages will play a role if there is under-capacity on the market of the CUP.<sup>14</sup> In practice, however, a CUP is often not available, and the TNMM basically serves as a default transfer pricing method.<sup>15</sup> Under the TNMM, location advantages play a bigger role. This method compares net margins earned in a con-

7. See e.g. US: TC, 18 Nov. 1999, *Compaq Computer Corporation and Subsidiaries v. Commissioner of Internal Revenue*, 78 T.C.M. (CCH) 20 (1999), Tax Treaty Case Law IBFD (discussed below).

8. See the attention to this subject in the *UN Practice Manual on Transfer Pricing for Developing Countries* (UN 2014), the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD 2010) (OECD Guidelines), International Organizations' Documentation; and the *Revised Discussion Draft on Transfer Pricing Aspects of Intangibles (Intangibles Report)* (OECD 2013).

9. In this context, see Yuan, Liu & DeSouza, *supra* n. 3.

10. *OECD Guidelines* (2010).

11. Para. 2.2 *OECD Guidelines*.

12. This article will discuss only the CUP method and the TNMM.

13. Para. 2.3 *OECD Guidelines*.

14. In such case, the buyer of a product is not always able to buy the products on the market where the CUP has been identified due to a lack of production capacity.

15. Reasons for the frequent use of the TNMM as opposed to the other methods are that (i) it allows a lower level of comparability between the controlled transaction and uncontrolled transactions and (ii) in general there is insufficient reliable data available that enable comparisons at gross margin levels (a requirement for application of the CUP method, resale minus method and cost-plus method).

trolled transaction with net margins earned in comparable uncontrolled transactions. Thereby, one applies a net profit indicator, often the revenue or total costs. Therefore, the TNMM is often described as *net resale minus method* or *net cost-plus method*.

As under the TNMM, the net margin is determined according to a specific basis (such as the revenue or total costs), and application of this method leads to a different outcome once those factors differ (for instance because of the presence of location advantages). However, if location advantages are present and the TNMM is the method of choice, it is very well possible to make potential adjustments. The location advantages to be allocated can, for example, be taken into account by increasing the cost base for the calculation of the markup (TNMM with costs as Net Profit Indicator) or by adjusting the percentage of the revenue-dependent remuneration (when applying the TNMM with revenue as Net Profit Indicator).

### 3. Specific Guidance

#### 3.1. OECD

##### 3.1.1. Guidelines

The current OECD Guidelines pay little attention to location advantages. As mentioned, the OECD Guidelines take the arm's length principle as a starting point for the determination of prices between independent enterprises. Hence, the application of the arm's length principle is based on a comparison of the conditions of transactions between associated enterprises and those of transactions between independent enterprises.<sup>16</sup> To compare the conditions of such transactions, the economically relevant characteristics of those transactions must be sufficiently comparable. The OECD Guidelines mention the economic circumstances and geographic market in which an enterprise operates (including location advantages) as factors that can affect the comparability of transactions.<sup>17</sup>

Chapter IX of the OECD Guidelines deals with the transfer pricing aspects of business restructurings, including location advantages.<sup>18</sup> It specifically addresses the concept of location savings within the context of a relocation of activities by a multinational enterprise (MNE):

Location savings can be derived by an MNE group that relocates some of its activities to a place where costs (such as labour costs, real estate costs, etc.) are lower than in the location where the activities were initially performed, account being taken of the possible costs involved in the relocation (such as termination costs for the existing operation, possibly higher infrastructure costs in the new location, possibly higher transportation costs if the new operation is more distant from the market, training costs of local employees, etc.).<sup>19</sup>

It follows from the above that location savings are deemed present only if the cost savings related to the relocation of activities outweigh the additional costs incurred by such relocation. If present, the question arises as to the enter-

prise to which these should be allocated. The following paragraph from the OECD Guidelines discusses this:

Where significant location savings are derived further to a business restructuring, the question arises of whether and if so how the location savings should be shared among the parties. The response should obviously depend on what independent parties would have agreed in similar circumstances. The conditions 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.<sup>20</sup>

The basic question thus concerns which conditions would be agreed between independent enterprises, whereby the functions performed, assets used, risks assumed and bargaining power of the associated parties involved play a role. If the issue concerns the relocation of an activity that is a highly competitive one in the market to which it is being relocated, the multinational enterprise would generally have the option to use either an associated enterprise or an independent enterprise to carry out the activity. In that case, it should be relatively easy to identify the conditions under which an independent enterprise would be willing to carry out the activity. Moreover, in such a case, only a small portion of the location savings – or none at all – would be attributed to the associated enterprise.<sup>21</sup>

According to the OECD Guidelines, the presence of location savings, however, does not necessarily result in an allocation thereof between the associated enterprises. The Guidelines, for instance, mention the situation in which an enterprise is forced – due to competitive pressures – to pass on (part of) the location savings to external clients.<sup>22</sup>

In summary, chapter IX of the OECD Guidelines mentions four important considerations in determining how location saving are to be allocated between associated enterprises, namely (i) whether location savings exist, (ii) the amount of any location savings, (iii) the extent to which location savings are either retained by a member or members of the multinational group or are passed on to independent customers or suppliers and (iv) in situations where location savings 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.<sup>23</sup>

##### 3.1.2. The Intangibles Report

The OECD Discussion Draft on the transfer pricing aspects of intangibles (the Intangibles Report)<sup>24</sup> contains – in addition to a proposal to amend chapter VI of the OECD Guidelines regarding intangibles – a proposal to amend chapters I through III. In the proposed changes, specific attention is paid to costs savings (location savings)

16. Para. 1.33 *OECD Guidelines*.

17. Paras. 1.55-1.58 *OECD Guidelines*.

18. Para. 9.148 – 9.153 *OECD Guidelines*.

19. Para. 9.148 *OECD Guidelines*.

20. Para. 9.149 *OECD Guidelines*.

21. See example mentioned in para. 9.151 *OECD Guidelines*.

22. Para. 9.152 *OECD Guidelines*.

23. Part D.6.1, para. 3 *Intangibles Report*.

24. *Revised Discussion Draft on Transfer Pricing Aspects of Intangibles*, as published on 30 July 2013 by the OECD. In the meantime, various parties have provided their comments on the document which will be taken into consideration when drafting the final version. It is expected that a final version will be published in 2014, based on which the OECD Guidelines will be amended accordingly.



and other advantages and other local market advantages or disadvantages (other local market features). The Intangibles Report confirms that the treatment of location savings as discussed in the OECD Guidelines applies not only to a business restructuring (see section 3.1.1.), but generally also to all situations where location savings are present.<sup>25</sup>

As regards “other local market features” which may influence prices and margins, the Intangibles Report mentions, among other things, the size of the geographic market in which products are sold; the purchasing power and product preferences of households in that market; whether the market is expanding or contracting; the degree of competition in the market; and other similar factors that affect prices and margins in the market. Similarly, one may take into account the relative availability of local infrastructure; the relative availability of a pool of trained or educated workers; proximity to profitable markets; and similar features in the geographic market where business operations occur.<sup>26</sup> From this non-exhaustive list, it appears that the concept of location advantages is quite broad according to the OECD. This may cause practical problems in determining transfer prices, as will be further addressed in section 5.2.2.

The Intangibles Report emphasizes the preference for using *local comparables* when location savings or other local market features are present. Local comparables can be described as comparable uncontrolled transactions in the same geographic market as the controlled transaction. Where local comparables can be identified, specific adjustments for features of the local market should not be required, as such transactions are carried out under the same market conditions as the controlled transaction.<sup>27</sup> The Intangibles Report provides general guidance only for situations where local comparables *cannot* be identified. In those situations, the determination of appropriate comparability adjustments for features of the local market should consider all the relevant facts and circumstances. Similar considerations as mentioned in the OECD Guidelines apply, which means that the functions performed, assets used, risks assumed and bargaining position of the associated parties involved play a role.<sup>28</sup> As for appropriate comparability adjustments, in the authors’ opinion, one could consider adjusting the local cost base for purposes of determining the calculation of the markup of the local associated enterprise or allocating (part of) the location benefit to the local associated enterprise.

The bargaining power of parties might lead to any location savings and other local market features not being allocated to the enterprise at the location of the advantages, but to the other associated enterprise(s) involved in the transaction. An example is an enterprise that operates in a market with overcapacity. In such a case, the bargaining power of the local associated enterprise may be limited, and an independent enterprise (as principal) would be able

to negotiate a favourable price and effectively claim the location advantages.

The Intangibles Report finally emphasizes that market-specific characteristics – which include location savings and other local market features – qualify as “intangibles”, as they may not be owned and controlled by an individual enterprise.<sup>29</sup>

### 3.2. United Nations

In addition to the OECD Guidelines and the Intangibles Report, location advantages have come under scrutiny in the recently amended UN Practice Manual on Transfer Pricing for Developing Countries (UN Manual).<sup>30</sup> The UN Manual describes location advantages as “location-specific advantages”, and distinguishes the following two elements:

- the net cost savings that a multinational enterprise realizes as a result of the relocation of operations from a high-cost jurisdiction to a low-cost jurisdiction (“location savings”). Examples include savings on labour costs, rent, transportation costs and infrastructure costs;<sup>31</sup> and
- other types of benefits related to operating at a geographic location (“other location specific benefits”). Examples include a highly specialized skilled workforce and knowledge; proximity to a growing local/regional market; a large customer base with increased spending capacity; advanced infrastructure; and market premium.<sup>32</sup>

The UN Manual labels the profit realized from the “exploitation” of location-specific advantages as “location rent”. Nonetheless, the presence of location-specific advantages does not necessarily result in such location rent. Similar to the OECD, the UN Manual points out that in a highly competitive market where potential competitors also have access to location-specific advantages, these are generally passed on to the independent clients. If location-specific advantages and location rent exist, the arm’s length attribution of location rent depends on competitive factors relating to access to the location-specific advantages and on the realistic alternatives available to the associated enterprises, given their respective bargaining power.<sup>33</sup>

Again similar to the OECD, the UN Manual emphasizes the use of local market comparables for the identification of comparable transactions. If information from the same market is not available, an uncontrolled comparable derived from a different geographic market may be considered if it can be determined that (i) there are no differences between the two markets that would materially affect the price or profit of the transaction or (ii) reasonably reliable adjustments can be made to account for such material differences between the two markets.<sup>34</sup>

25. Part D.6.1 para. 2 *Intangibles Report*.

26. Part D.6.2 para. 6 *Intangibles Report*.

27. Part D.6.2 para. 7 *Intangibles Report*.

28. Part D.6.2 para. 8 *Intangibles Report*.

29. Part A.4 under 64 and D.6.2 para. 11 *Intangibles Report*.

30. See the general description in paras. 5.3.2.35 through 5.3.2.49 *UN Manual*.

31. Para. 5.3.2.39 *UN Manual*. It considers the net “location savings”, as “dis-savings” may also be present. The net benefit is thus equal to the “cost savings” minus the “dis-savings”.

32. Para. 5.3.2.39 *UN Manual*.

33. Para. 5.3.2.44 *UN Manual*.

34. Para. 5.3.2.38 *UN Manual*.

In conclusion, the approach of the UN Manual to location advantages is largely in line with the approach taken by the Intangibles Report and the OECD Guidelines. However, the UN Manual, in its description of “location savings” and “other location specific benefits”, seems to refer only to a relocation of operations. According to the UN Manual, this could mean that location-specific advantages are present only in the case of such relocation of operations. This would be a deviation from the Intangibles Report, which states that location advantages are relevant not only in a business restructuring, but generally also in all situations where those are present.<sup>35</sup>

## 4. International Case Law

### 4.1. United States: *Compaq* case

The *Compaq* case (1999)<sup>36</sup> concerned the manufacturing of PCs in Houston by the well-known multinational, Compaq. The manufacturing of certain parts of these PCs was relocated to a Singaporean associated enterprise (Compaq Asia) in order to achieve cost savings. Within the Asian market, Compaq Asia was the only manufacturer able to meet Compaq’s quality standards and demand. Compaq Asia was remunerated according to a markup on its costs (cost-plus method), based on which the benefit of low wages was (partially) allocated to Compaq Asia. Over the first few years, this was realized by using as a cost base the costs as if Compaq Asia were situated in the United States (instead of its actual local costs). In later years, Compaq Asia was remunerated by both a markup on its local costs as well as a percentage of the location advantages calculated.<sup>37</sup>

The IRS stated that the cost-plus method could be applied, but had to be based on Compaq Asia’s actual costs. The benefit of the low wages in Singapore would then not be allocated to Compaq Asia. The dispute eventually resulted in a procedure before the US Tax Court. During this procedure, Compaq substantiated the pricing applied with a CUP. This CUP was based on prices that independent suppliers applied for comparable products. These suppliers were mainly situated in the United States. The Tax Court accepted the CUP and considered that all suppliers (including Compaq Asia) sold their products in the United States, which made the United States the relevant geographic market. Compaq Asia did not compete with local manufacturers, as they did not have the required knowledge or technology to manufacture products for Compaq. Hence, there were no differences in the geographic market which forced adjustments to be made. This meant that the (partial) allocation of the location advantages to Compaq Asia was accepted.<sup>38</sup>

### 4.2. Finland: Ruling of the Supreme Administrative Court

The Finnish Supreme Administrative Court addressed the issue of location advantages in 2013.<sup>39</sup> In the relevant case, an Estonian company (AS) had carried out manufacturing activities for its Finnish parent company (OYJ) since 2004. Before that time, these manufacturing activities were carried out in Finland. The relocation of the activities resulted in cost savings. AS was remunerated on the basis of a markup on its costs, thereby taking into account half of the cost savings in the cost base.<sup>40</sup> Based on a benchmark of mainly non-Estonian comparables, the profit markup was set at 7.95%. The two Estonian comparables included in the benchmark showed a higher profit markup of 8.08% and 26.95%, respectively.

A dispute arose regarding the transfer prices applied, which dispute found its way to the Finnish Supreme Administrative Court. The Court considered that location savings may arise only when activities are being relocated. Subsequently, the Court concluded that the Estonian manufacturing activities largely differed from the manufacturing activities previously carried out in Finland, so there was no question of there being a relocation of activities and hence no location savings were present.<sup>41</sup>

However, the Court did confirm that other amendments to the transfer prices applied would be suitable, for instance if AS were to benefit from the pricing level in the country where it is active or if it were to have specific know-how at its disposal resulting in lower than average manufacturing costs. The Court specifically addressed the bargaining power of the enterprises involved: AS had specialized assets at its disposal for the manufacturing activities and the number of competitors were limited. Therefore, it was assumed that OYJ could not immediately find a suitable replacement. On the other hand, AS could not substantiate that it had specific knowledge at its disposal that other manufacturers did not. Also, the number of potential alternative buyers had to be limited. The Court decided that for relatively simple manufacturing activities, it is possible for the profit margin in low-wage countries to be higher than in high-wage countries. Eventually, the Court came to a profit markup of AS of approximately 20.5% on actual costs (instead of, initially, an amended cost base). It is unclear how this percentage was determined and to what extent the profit markups of the Estonian comparables were taken into account. However, this outcome means that (a part of) the location advantages were actually allocated to AS.

### 4.3. Conclusion regarding case law

In the cases discussed above, there is no detailed identification or quantification of location advantages. However,

35. As regards *location savings*, this is confirmed under Part D.6.1. under 2 of the *Intangibles Report*. As regards *other local market features*, this follows from Part D.6.2. of the *Intangibles Report*.

36. *Compaq* (1999).

37. S.N. Allen et al., *Location Savings – A US Perspective*, 11 Intl. Transfer Pricing J. 4 (2004), Journals IBFD.

38. Allen et al., *supra* n. 38.

39. FI: Supr. Admin. Ct., 4 Mar. 2013, KHO 2013:36. The facts are based on M. Raunio, *Supreme Administrative Court Ruling on Location Savings*, 20 Intl. Transfer Pricing J. 4 (2013), Journals IBFD.

40. It considered the TNMM with costs as net profit indicator.

41. The OECD indicated in the recent *Intangibles Report* that the issue of location savings applies not only to a business restructuring.

two conclusions may be drawn from these cases.<sup>42</sup> First, the *Compaq* case confirms that no specific adjustments for location advantages need to be made to the pricing when using local comparables. To determine whether local comparables can be identified, the relevant geographic market should be determined. In the *Compaq* case, the use of the CUP method and the lack of local competitors had the result that the country where the products were sold was the relevant geographic market.

Secondly, in both cases the bargaining power of associated enterprises played an important role. In the *Compaq* case, the bargaining power of Compaq Asia played a role when determining the relevant geographic market: Compaq Asia did not compete with local manufacturers, as they did not have the required knowledge or technology to manufacture products for Compaq. In the Finnish case, the Court concluded that AS were entitled to a higher remuneration than that following from the benchmark of non-Estonian comparables, whereby the bargaining power of the associated enterprises was taken into consideration.

## 5. Application in Practice

### 5.1. Introduction

In determining their transfer pricing policies, multinationals should take into consideration the increased attention on location advantages and the relevant transfer pricing practices in the various countries in which they are active. As an illustration, the current practice in the Netherlands and China, along with the impact of the recently signed (new) Netherlands-China Income Tax Treaty will be discussed,<sup>43</sup> and some recommendations will be provided.

### 5.2. The Netherlands

#### 5.2.1. Alignment with OECD Guidelines

In the Netherlands, the arm's length principle is codified in article 8b of the 1969 Corporate Income Tax Act (CITA). In addition, a number of Decrees, including the recently published new Transfer Pricing Decree of 14 November 2013,<sup>44</sup> provide the framework for the determination of transfer prices between associated enterprises. These Decrees do not specifically address the issue of location advantages. However, as the Netherlands takes the OECD Guidelines as a starting point in the practical application of article 8b of the CITA, the authors anticipate that the Netherlands will follow the treatment of location advantages as described in section 3.1.<sup>45</sup>

42. Both cases were decided in OECD member countries. It is unknown whether courts in non-OECD countries would have decided accordingly.

43. *Agreement between the Government of the Kingdom of the Netherlands and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income*, Treaties IBFD. It is expected that the *Neth.-China Tax Treaty* will enter into force on 1 January 2015.

44. NL: Decree of the State Secretary of Finance, 14 Nov. 2013, IFZ2013/184M.

45. NL: Decree of the State Secretary of Finance, 14 Nov. 2013, IFZ2013/184M (which even mentions that the OECD Guidelines have a direct effect in the Netherlands).

#### 5.2.2. Transactions in the Netherlands and other "developed countries"

It follows from the guidance of the OECD that there is a preference for the use of such local comparables. In such cases, specific adjustments for features of the local market should not be required, as such transactions are carried out under the same market conditions as the controlled transaction. In the Netherlands, the identification of comparable transactions generally takes place on the basis of databases which include data on companies in nearly all countries that are part of the European Union. This means that financial data on local comparables within the European Union would generally be available. The issue of identifying and quantifying location advantages for the transactions of multinationals in the Netherlands or the European Union thus seems limited because of the considerable availability of data on local comparables. The same holds true for transactions in developed economies like the United States and Canada: in general, financial data on local comparables are easy to come by.

#### 5.2.3. Transactions with "non-developed countries"

The identification of local comparables in countries with an emerging economy or in developing countries is more difficult, as financial data of local comparables are generally not readily available. If non-local comparables are then used, it should be examined which location advantages are present and how these can be quantified. However, the practical interpretation thereof is rather vague<sup>46</sup> and leaves room for discussion.

As mentioned, the concept of location advantages is quite broad according to the OECD. In certain situations, this may result in an accumulation of multiple location advantages. For example, an associated enterprise may be situated at a location with a specialized working force, with proximity to a growing market and a customer base with high buying power, whereas the independent enterprise that serves as a benchmark is situated in a location with low wage costs and a strong preference by local consumers for the products manufactured. The question then arises as to whether all these location advantages should be identified and quantified. The multinational and the tax authorities of the country where the potential location advantages "arise" may take conflicting positions. For the time being, it is uncertain how all location advantages should be identified and quantified in such cases. The OECD does not provide clear guidance on this in either the OECD Guidelines or the Intangibles Report. This leaves room for discussions between multinationals and tax administrations.

### 5.3. China

#### 5.3.1. Different approach

Although China is not an OECD member country, the framework of its transfer pricing rules is generally in accordance with the OECD Guidelines.<sup>47</sup> Recently, however,

46. See section 3.1.2.

47. Yuan, Liu & DeSouza, *supra* n. 3, at 259.



it seems that China is increasingly deviating from the OECD Guidelines in the practical application of its transfer pricing rules. The current debate about the tax treatment of location advantages perfectly illustrates this. In its contribution to the UN Manual,<sup>48</sup> (the China Country Practice), China has taken positions which are not in accordance with the OECD guidance. China's justification for doing so is basically that developing countries face a set of unique issues that have not been addressed, or at least not sufficiently or practically addressed by the OECD Guidelines.<sup>49</sup> China therefore refers to the problem of a lack of reliable, public information on comparables in developing countries. To reconcile the arm's length principle with the lack of reliable comparables in developing countries, China has adopted a four-step approach on the issue of location-specific advantages:

- identify whether any location-specific advantage exists;
- determine whether the location-specific advantage generates additional profit;
- quantify and measure the additional profits arising from the location-specific advantage; and
- determine the transfer pricing method to allocate the profits arising from the location-specific advantage.<sup>50</sup>

It is generally assumed that the China Country Practice must be considered a clear signal to multinationals that these rules must take into account the allocation of location advantages to China.<sup>51</sup> In fact, there are already a number of examples of adjustments imposed by the Chinese tax authorities.<sup>52</sup>

### 5.3.2. Potential differences

Even though the Chinese four-step approach to a certain extent seems similar to the four considerations in chapter IX of the OECD Guidelines, differences may appear in practice. Three potential differences are noted here.

First, one difference may result from to the allocation of location advantages between associated enterprises. This follows, among other things, from the example on contract research and development (R&D) activities as included in the China Country Practice. The example discusses a Chinese taxpayer performing R&D activities for a foreign associated enterprise. The assumptions are that (i) the Chinese taxpayer's cost base is 100, (ii) the average costs base for the company's R&D centres in developed countries is 150<sup>53</sup> and (iii) the remuneration for the R&D

centre was a markup of 8% on the average cost base (based on foreign comparables, mostly in developed countries). Without adjustments, the Chinese taxpayer would realize a profit of 8. However, China takes the position that the Chinese taxpayer must be remunerated on the basis of the average cost base of R&D centres in developed countries. This means a total profit of 12 (i.e. 8% of 150) for the Chinese taxpayer.<sup>54</sup>

Thus, according to this example, a part of the location advantages in the form of cost savings is being allocated to the Chinese taxpayer through an adjustment to the cost base (actually 4 of 50), without considering other facts and circumstances such as the bargaining power of the Chinese taxpayer. Although the adjustment seems relatively modest, it may very well be the case that the Chinese taxpayer – based on its bargaining power – would not be able to attract the location advantages. In that case, allocating location advantages seems not so obvious.

Another difference may result from the availability of local comparables to substantiate the transfer prices applied. An example is the remuneration of a highly competitive routine-like distribution activity of a multinational in China. It may very well be the case that, according to the OECD approach, local comparables can be identified (as it concerns a highly competitive activity). China seems to rather conclude that local comparables cannot be identified.<sup>55</sup> In that case, China may conclude that allocating location advantages to China is pursuant to its four-step approach.

Given the development of the Chinese economy, the authors envisage that the availability of local Chinese comparables will be enhanced. Because of this, in future one may also use local comparables in China in order to avoid the difficult identification and quantification of location advantages.

Finally, China applies a broad concept of location advantages. The China Country Practice refers to six examples of location-specific advantages for the automotive industry. One of these examples is the general preference of Chinese consumers for foreign brands and imported products. This would create opportunities for multinationals to charge higher prices and earn additional profits on automotive products sold in China.<sup>56</sup> China could take the position that these additional profits are the result of location advantages that are (partially) taxable in China. On the other hand, it may very well be that foreign tax authorities in OECD member countries take the position that the price in China does not exceed the price in the home market, or that these additional profits originate from the property of the brand.

48. Para. 10.3.3.2 *UN Manual*.

49. Para. 10.3.1.1 *UN Manual*.

50. Para. 10.3.3.4 *UN Manual*.

51. See *supra* n. 3.

52. For example, China Taxation News published a case on 19 July 2013 (at B3). This considered a transfer pricing audit at a Chinese enterprise that was part of a multinational. Because of the change of this enterprise from a simple manufacturer to a multi-functional enterprise, the Chinese tax authority concluded that there was a shift in functions which potentially resulted in location savings. After quantification thereof, a part of the location savings was allocated to the Chinese enterprise, which resulted in additional taxation of RMB 50 million (approximately EUR 6 million).

53. The comparison of the costs of the Chinese enterprise and the foreign enterprises is based on similar indicators such as the total costs per unit manufactured.

54. See paras. 10.3.3.8 and 10.3.3.9 *UN Manual*.

55. China mentions in the China Country Practice that for developing countries there are usually only a small number of public companies, while information on domestic private companies is lacking or inadequate. This position is not reflected in the *OECD Guidelines* or the *Intangibles Report*.

56. *Supra* n. 11.

#### 5.4. Netherlands-China Income Tax Treaty

Because of the potential differences in the allocation of location advantages, there is a risk of double taxation. The question revolves around how things would be resolved under the Netherlands-China Income Tax Treaty. Article 9 of the Netherlands-China Income Tax Treaty deals with the allocation of profits between associated enterprises and is fully in accordance with article 9 of the OECD Model. In the Dutch parliamentary explanation to the Netherlands-China Income Tax Treaty, there is no consideration of the different position of China as regards location advantages. There is only a general reference to China's willingness to enhance those contacts between the competent authorities and mutual agreement procedures, as expressed during the treaty negotiations.<sup>57</sup> During the parliamentary proceedings, a further explanation to the consequences of the article was requested, as China's explanation of article 9 may differ from the OECD Guidelines.<sup>58</sup> The Dutch State Secretary of Finance acknowledges in his response that

China deviates from the OECD Guidelines in certain aspects and refers to the mutual agreement procedure for any potential transfer pricing disputes.<sup>59</sup>

#### 5.5. Recommendations

Multinationals would prefer to avoid the risk of double taxation as much as possible. There are various ways for them to do so. First, multinationals may consider concluding a bilateral advance pricing agreement. In addition, the risk may be minimized by carefully considering and documenting all functions performed, assets used and risks assumed, as well as the bargaining power of all associated enterprises involved in the specific transaction(s). The factors that deserve specific attention include whether location advantages are present, whether these result in a higher profit for the multinational and to which enterprise(s) these location advantages would be allocated in transactions between independent enterprises.

### 6. Conclusion

This article has discussed the impact of location advantages on the transfer pricing of multinationals. Worldwide, there is much discussion on the application of the arm's length principle to location advantages, also because of the increased influence of emerging economies like China.

Both the OECD and the United Nations have paid attention to location advantages. As regards the identification and allocation of location advantages between associated enterprises, there seems to be a certain level of mutual understanding. It can be argued that if local comparables are present, no adjustments need to be made for location advantages. In absence of local comparables, one should consider all facts and circumstances of the case in order to determine whether adjustments need to be made. The bargaining power of the associated enterprises involved then plays an important role. A potential difference between the OECD Guidelines and the UN Manual is the recognition of location advantages outside the scope of relocation of operations. The UN Manual seems more limited in this regard.

The allocation of location advantages has also been addressed in a few international court cases. It can be concluded from the *Compaq* case that no specific adjustments for location advantages need to be made to the pricing when using local comparables. Further,

from the *Compaq* case and the Finnish case it can be concluded that the bargaining power of associated enterprises plays an important role in allocating location advantages among them.

In practice, the Netherlands will probably follow the lines described by the OECD with regard to location advantages. The issue of the identification and quantification of controlled transactions in the Netherlands, EU and other "developed countries" seems to be limited because of the considerable availability of data on local comparables. For controlled transactions in "non-developed countries", this availability is less. If then non-local comparables are used, it should be examined which location advantages are present and how these can be quantified. However, the practical interpretation thereof is rather vague and leaves room for discussion.

Through the UN Manual, China has given a clear signal to multinationals that these rules must take into account the allocation of location advantages to China. Potential differences may result from the allocation of location advantages between associated enterprise; the use of local comparables; and the (broad) concept of location advantages. These differences may result in double taxation. Multinationals may reduce the risk thereof by concluding a (bilateral) advance pricing agreement and preparing comprehensive documentation.

57. Kamerstukken II, 2012/2013, 33 718, no. 3, at 12.

58. Kamerstukken II, 2012/2013, 33 718, no. 4, at 6.

59. Kamerstukken II, 2012/2013, 33 718, no. 5, at 7.