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Issue of Location Savings in Transfer Pricing.

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What are location savings?

- Cost savings realized by a party in a high cost location through outsourcing a certain activity to a low cost location
- Examples for cost savings:
  - Labor cost
  - Raw material cost
  - Rent
  - Training cost
  - Subsidies
  - Income tax holidays?
- Need to be reduced by dissavings (to achieve net savings)
  - Transportation cost
  - Quality control cost
  - Warranty cost

Major issue for transfer pricing and tax

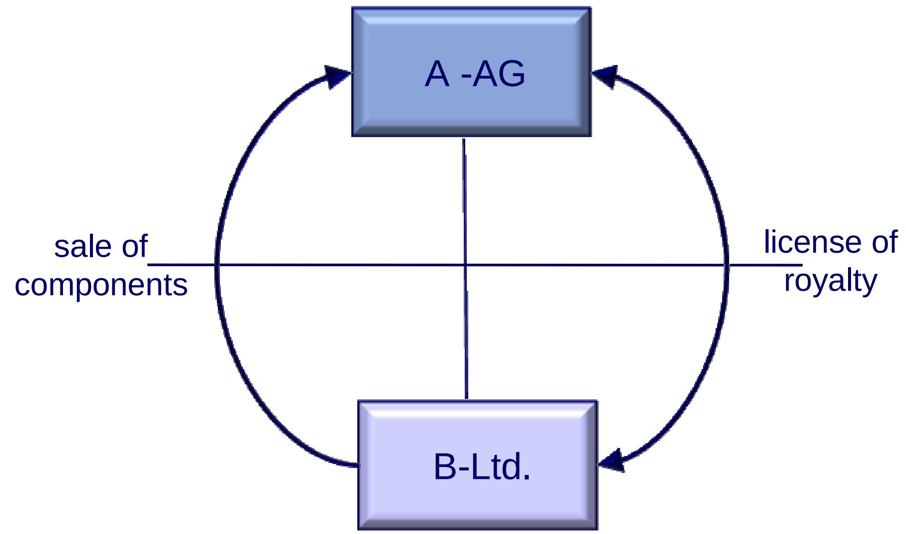
- **How to allocate benefit from location savings between taxpayers in high and low cost jurisdiction?**
  - **Relative bargaining power of parties**
    - **Ownership of intangible property**
    - **Uniqueness of intangible property**
  - **Taking of entrepreneurial risk**

Major issue for transfer pricing and tax

- **Three main situations can be distinguished**
  a) **Party in high cost location licenses intangibles to party in low cost jurisdiction which assumes entrepreneurial functions**
  b) **Party in high cost location outsources process to party in low cost jurisdiction with unique process know-how**
  c) **Party in high cost location outsources process to party in low cost jurisdiction with routine process know-how**

Court cases (Sundstrand/Bausch & Lomb situation)

A-AG in Germany is a manufacturer of components for the automotive OEMs. It owns certain patents for the technology of those components. A-AG forms a subsidiary, B-Ltd., in India for the manufacturing of some components. It licenses the technology to B for a royalty of 3 % of sales. B sells most of the components back to A for distribution but also sells some components directly to customers in the region. B assumes the volume and market risk for the entire production, i.e. A does not provide a purchase guarantee. The purchase price for the components is based on a TNMA analysis providing A with a net margin of
2 % for the sale of the products. Because of its labor cost B is very profitable.

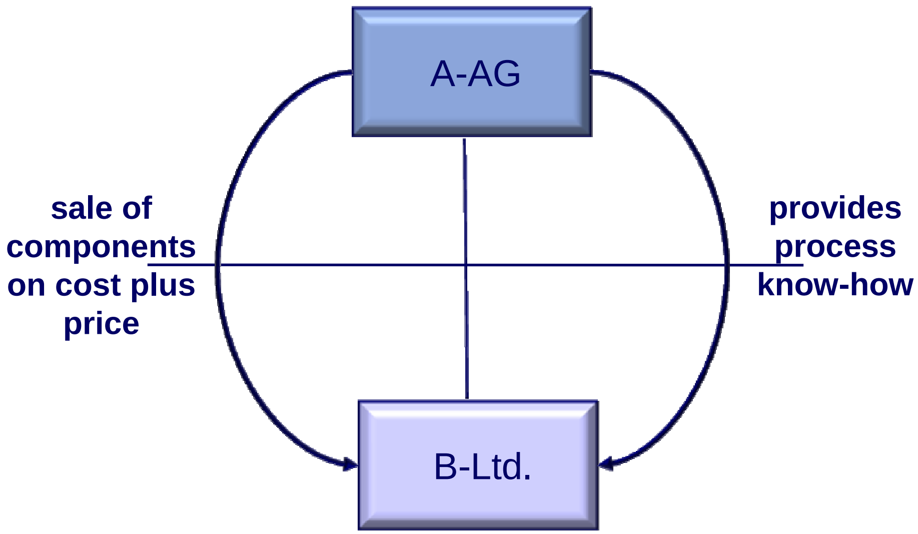


Court cases (Sundstrand/Bausch & Lomb situation)

- Under the set-up most of the location savings stay in India
- Many tax authorities challenge such set-ups asserting that B should only receive its cost plus a small mark-up
- In the cases Sundstrand and Bausch & Lomb the authorities have lost this argument. The courts have accepted that the taxpayers are free to create a subsidiary in a foreign jurisdiction which acts as an entrepreneur and receives technology for an arm's length license fee thereby leaving a large part of location savings in the low cost location
- Courts have increased the royalties but have not used profit based royalties
- ***Conclusion:*** Arm‘s length royalty can allow cost savings to stay in low cost country
- ***Problem:*** What is an arm‘s length royalty (fixed or profit based)?

Court cases (Compaq situation)

A-AG is a German computer manufacturer. It forms an Indian subsidiary, B-Ltd., for the manufacturing of computer components after the outsourcing to third parties was unsuccessful. A provides B with production processes and B is the only manufacturer in the region able to meet A's quality demands. B sells all components to A based on a cost plus price. Costs at the beginning are based on German equivalent cost minus a mark-down because A also purchases from a German third party and in later years at Indian actual costs plus a mark-up for location savings plus a profit mark-up. Most of the location savings therefore stay in India.

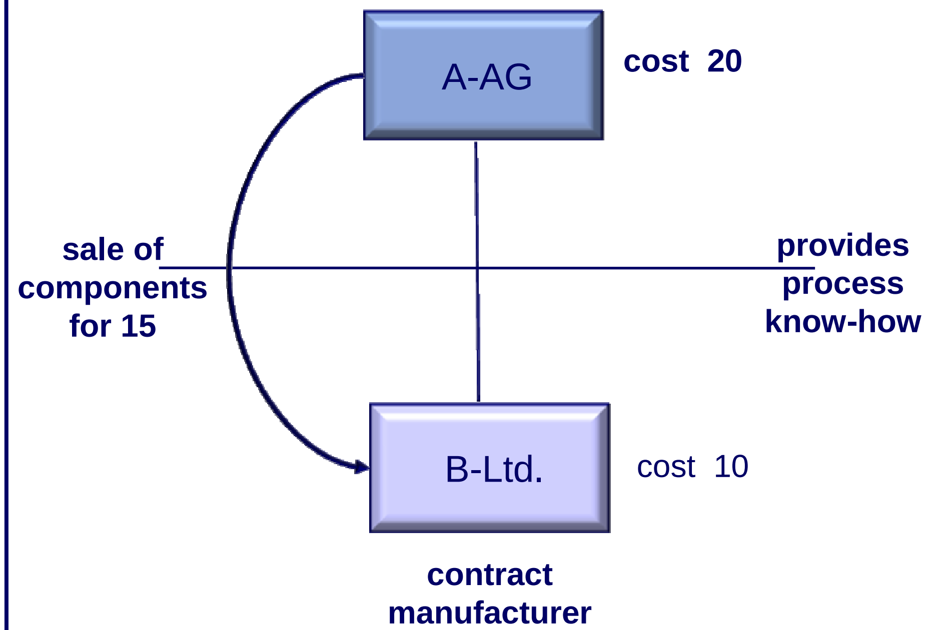


Court cases (Compaq situation)

- **Again, under the set-up location savings stay in India**
- **Tax authorities often want to apply the cost plus method based on local costs plus a small mark-up**
- **Court has allowed using a CUP based on high cost of the high cost location**
- **<u>Conclusion:</u> If Indian subsidiary has strong position due to quality and CUP can be established savings stay in India**

Court cases (German Tax Court situation)

A-AG is a manufacturer of engines. It forms B-Ltd. in India. B acts as a contract manufacturer for a component for the engine. The price is based on cost plus. The cost for manufacturing the component in Germany is € 20 and in India € 10. B sells to A for € 15.
The tax authorities allege that the price should be € 10 plus a 10 % mark-up, i.e. € 11 and make a substantial adjustment.



Court cases (German Tax Court situation)

- Under the pricing 50 % of the location savings stay in India
- Tax authorities want to apply cost plus with low mark-up
- Court held that this is not justified and that absent proof how location savings would be allocated a 50/50 split can be considered at arm‘s length
- The range of potential prices is from 10.1 to 19.9 because A would be willing to pay as much as its own costs and B would be willing to sell if its costs are covered plus a small margin
- If the bargaining power of the parties cannot be established a 50/50 split seems reasonable under economic theory

Summary

- Location saving can arise in cases where company in low tax location acts as entrepreneur and as provider of routine services
- Regardless of the situation tax authorities in high cost location try to shift savings to their country by applying the cost plus method with a small profit mark-up
- Courts have never sustained the challenges of the tax authorities but have allowed substantial parts of the savings to stay in low cost location based
  - on a royalty analysis for entrepreneurs
  - on a CUP analysis based on high cost of buyer
  - on a 50/50 split for pure contract manufacturing