Evolving Transfer Pricing Controversy -Location Savings

Increased amount of competition has forced all businesses to market their products at a competitive rate, to maintain the market share, for which they are required to reduce their operating costs of production. To attain such cost reduction, enterprises relocate their operations from high cost countries to low cost countries, giving rise to the concept of 'location savings'. Over the time, a broader concept of location specific advantages (LSAs) has also emerged, further giving rise to 'location rents'. The quantification and allocation of location savings/LSAs and location rents has evolved as a key TP issue in developing countries like India. This article capsulises the issue of location savings from India's perspective, and also provides a glimpse of principles emanating from some key rulings available in developed countries and guidance provided by the OECD and UN TP Manual. Read on to quickly empower yourself with the knowledge on the subject...

1. Introduction

Over a last decade, with the globalisation of world economies and digitisation of international trade and commerce, the multinational enterprises ('MNEs') have altered their country-specific operating model to global operating model, wherein, they centralise several functions at a regional or global level.

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Globalisation has made it easier for businesses to locate many productive activities in geographic locations that are distant from the physical location of their customers. With the increased amount of competition, all businesses, to maintain the market share, have been forced to market their product at a competitive rate for which they had to reduce their operating costs of production. Many MNEs, to attain an objective of reduction of operating costs, offshore

some of their global operations to developing economies of Asia, in particular India and China, primarily due to benefit of lower labour costs, lower raw material costs and infrastructure costs in these regions.

With the increase in number of MNEs entering India, Indian Revenue Authority ('IRA') recognises the need to protect their fair share of taxes on income generated from India for which the Finance Minister introduced the transfer pricing provisions vide the Finance Act, 2001 which regulates the inter-company transaction between such MNEs and also guides computation of the transfer price for such international transactions.

Evidently, with the increased number of MNEs establishing their group companies in India, there has been enormous increase in number of complex inter-company transactions. During the past few years, the IRA has started taking aggressive stands with respect to such inter-company transactions, due to which it has adversely affected the MNEs operating in India which ultimately also affected the flow of foreign direct investment ('FDI') in India.

During recent TP audits, the IRA has kept its prime focus majorly on the TP policies/ strategies adopted by the MNEs with respect to their inter-company transactions undertaken by them. In past few years, there are certain key TP areas / issues on which IRA has been keeping a close watch and consistently making adjustment for the same. Given below are the key TP issues affecting MNEs operating in India:

- Advertisement, marketing and sales promotion ('AMP') expenditure/marketing intangibles
- Intra-group services such as management fees
- Location savings
- Royalty fees
- Guarantee fees
- Share issue transaction
- Outstanding inter-company balances

2. Location Savings–A New Wave of Concern

As discussed above, due to stupendous surge in competition among the MNEs, the MNEs have shifted their key focus on minimising their operating costs, primarily by relocating functions or activities from a high-cost country to a low-cost country. The key benefits are typically lower cost of labour, capital, and intermediate goods as well as infrastructure costs, coupled with the tax advantages offered by the new location.

The concept of location savings has been elucidated as under:

a) Location Savings ('LS')

Location savings refer to the net cost savings realised by an MNE due to relocation of operations from a high cost jurisdiction to a low cost jurisdiction. Given below are some of the key advantages that could be achieved by relocating operation:

- Low labour cost
- Low raw material costs
- Low infrastructure costs

Additionally, some costs like supervisory costs, logistics costs, and quality control costs may have been increased by moving to lower cost countries which are collectively referred to as "dis-savings".

The net location savings are, thus, the amount of cost reduction less the amount of cost increase arising out of relation of operations.

UN Practical Manual on Transfer Pricing for Developing Countries (UN Manual) defines location savings as follows:

"Location savings are the net cost savings that an MNE realises as a result of relocation of operations from a high cost jurisdiction to a low cost jurisdiction."

Location savings also find a brief mention in the chapter on business restructuring in para 9.148 of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010 (OECD Guidelines) as follows:

"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

Location savings focus only on reduction in costs under relocation circumstances, however, other geographical benefits such as highly specialised skilled manpower and knowledge, proximity to growing local/regional market, large customer base with increased spending capacity, advanced infrastructure (e.g. information/ communication networks, distribution system) or market premium have not been considered while arriving at a location savings.

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.).”

b) Location Specific Advantages (‘LSAs’)

Location savings focus only on reduction in costs under relocation circumstances, however, other geographical benefits such as highly specialised skilled manpower and knowledge, proximity to growing local/regional market, large customer base with increased spending capacity, advanced infrastructure (*e.g.* information/communication networks, distribution system) or market premium have not been considered while arriving at a location savings.

This is where location specific advantages (LSAs) come into the picture, which also takes into account other geographical benefits apart from location savings. LSA recognises the importance and existence of various other location characteristics prevailing in the market specific to a particular country or a region. LSAs exist on both demand and supply sides. Some of the examples of LSAs are as under:

- Government subsidised technical assistance
- Lower taxes and tax holidays
- Size and growth of the market
- Access to cheaper (*e.g.* subsidised) capital
- Reduced environmental constraints

c) Location Rents (‘LR’)

The UN Manual has defined LR as “the incremental profit, if any, derived from the exploitation of LSAs”.

However, it is possible that in a particular case, even though LSAs exist, there may not be any attribution for location savings. For example, in situations in which market for the end product is highly competitive and potential competitors also have access to LSAs, almost all of the benefits of LSAs will be passed on to customers through reduced prices of products, resulting in little or no LR. Accordingly, the extent to which LSAs will lead to LR depends on competitive factors relating to the end product and to the general access to LSAs.

Mechanics to Verify and Quantify Location Savings

After understanding relevant definitions mentioned above, we have explained below mechanics to identify existence of LSAs, quantification and apportionment of LR, if they are retained within the group:

Quantification of extra profits generated due to LSAs and ensuing qualification of them as LR will require detailed analysis as it largely depends on facts of the case. The mere existence of LSAs does not imply that the entity is able to transform them into LR.

- **Step 1: Analysis of existence of LSAs**

The first step involves identifying the existence of net LSAs. To determine the potential net LSAs, the costs of operating in a low cost jurisdiction are compared with the costs of operating in a high cost jurisdiction. The cost advantages such as low labour cost, low raw material cost, low rent, *etc.* are typically coupled with certain disadvantages and dis-savings such as higher utility costs, higher transportation cost, cost for setting up infrastructure in new region, *etc.* These disadvantages/dis-savings are, thus, reduced from the cost savings to determine the net cost savings.

- **Step 2: Evaluate whether LR exists**

Under normal scenario, LRs exist if the following two conditions apply:

- There are quantifiable net LSAs; and
- Certain location specific conditions or the market characteristics prevent these advantages or savings from being passed on to the ultimate customers.

- **Step 3: Quantification of LR**

Quantification of extra profits generated due to LSAs and ensuing qualification of them as LR will require detailed analysis as it largely depends on facts of the case. The mere existence of LSAs does not imply that the entity is able to transform them into LR. The economic effect of LSAs should be considered while quantifying LR which may include factors like competitive advantage such as monopoly power, technological leadership, *etc.*

- **Step 4: Apportionment of LR**

In order to apportion LR between group entities, the bargaining power of an entity is considered to be of vital importance. The extent to which an entity can claim share of incremental profits depends on the contribution made by the entity in relation to enjoying market position and securing excessive rights over LSAs. Importantly to note that bargaining power of

an entity may not be consistent over a period of time and therefore, it needs to be analysed every year.

3. International Roundup on Location Savings

The US regulations and OECD guidelines duly recognise the concept of location savings and provide a broader view for the understanding of concept of location savings.

(i) OECD TP Guidelines on Location Savings

The OECD TP guidelines recognise the existence of location savings that pertain to the MNEs when they relocate their operations and activities to a low cost jurisdiction from a high cost jurisdiction. Such location savings can be derived through undertaking business restructuring and thereby setting up operations in a location wherein benefits of lower costs can be obtained.

The OECD TP Guidelines also address the question regarding how the location savings derived by the MNEs should be shared among the parties. In this regard, guidelines state that the sharing of location savings should be based on what independent parties would have agreed considering functions, assets and risks of each party operating under similar circumstances and with respect to their bargaining powers. Accordingly, location savings need not automatically be allocated to the related party located in the lower-cost market, but rather may justify increased profits only if the cost differences justify higher profits in an unrelated transaction, given the competitive positions of the parties.

(ii) BEPS Action Plan 8 (TP on Intangibles)

The OECD in its TP guidelines (para 9.148 to 9.153) has provided detailed guidance on treatment of location savings in the context of a business restructuring. The OCED, in its report on Action Plan 8 of BEPS, states that principles described in those paras apply generally to all situations where location savings are present, and not just in the case of a business restructuring.

The guidelines provide that for determining how location savings are to be shared between two or more AEs, it is necessary to consider the followings:

(i) Whether location savings actually exist;,
(ii) The amount of such location savings;
(iii) 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;
(i) 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.

Further, it also states that where the functional analysis shows that location savings exist that are not passed on to customers or suppliers, and where comparable entities and transactions in the local market can be identified, those local market comparables will provide the most reliable indication regarding how the net location savings should be allocated amongst two or more AEs. Thus, if reliable local market comparables are available and can be used to identify arm's length prices, specific comparability adjustments for location savings should not be required.

However, when reliable local market comparables are not present, determinations regarding the existence and allocation of location savings among members of an MNE group, and any comparability adjustments required to take into account location savings, should be based on an analysis of all of the relevant facts and circumstances, including the functions performed, risks assumed, and assets used of the relevant AEs.

(iii) US regulations on Location Savings

The US Internal Revenue Service ('IRS'), in its regulation, has provided very limited guidance on location savings by stating that adjustments for differential cost between different geographic markets must be based on the impact that such differences would have on the consideration charged or paid in the controlled transaction,

The OECD TP Guidelines also address the question regarding how the location savings derived by the MNEs should be shared among the parties. In this regard, guidelines state that the sharing of location savings should be based on what independent parties would have agreed considering functions, assets and risks of each party operating under similar circumstances and with respect to their bargaining powers.

Though there is no formal articulation of the approach for identifying, quantifying, and allocating location savings under the Indian TP regulations, the IRA has been making aggressive stand in number of cases wherein location savings, if present, have not been allocated.

given the relative competitive positions of buyers and sellers in each market.

Since there are very limited guidelines, location savings has been one of the key litigated issues in United States. While the US Tax Court, in certain cases[1] has dealt with the issue of location savings, the decisions are very fact specific and the key principles, which emerge are consistent with the OECD commentary (as discussed above) on recognition of location saving, basis of allocation, *etc.*

(iv) Finland Supreme Administrative Ruling

Recently, the Supreme Administrative Court of Finland has pronounced a ruling on location savings concept wherein it has recognised the location savings and the allocation of these benefits to a low-cost subsidiary, provided similar functions were conducted in Finland prior to the reorganisation and such benefits can be clearly crystallised.

4. India's Position on Location savings

(i) Indian Tax Regulation and Judicial Precedents

Till 2012, there were no provisions relating to location savings in the Indian transfer pricing provisions. However, the Finance Act, 2012 amended the definition of international transaction, by including an explanation, to include the following categories of transactions within the scope of the meaning of international transaction:

i) Tangible property transactions,
ii) Intangible property transactions,
iii) Financial transactions,
iv) Provision of Services, and
v) Business restructuring.

Further, the Finance Act 2012 also included an explanation to define the term "intangible property", which *inter-alia* included location related intangible assets such as leasehold interest, mineral exploitation rights, easements, air rights and water rights. The said amendment is applicable with retrospective effect from 1st April, 2002.

Apart from the above, the Indian tax laws or TP provisions have neither prescribed any other provisions relating to location savings nor provided guidelines relating to apportionment of the any location savings between the group entities. However, the Indian Revenue Authority ('IRA'), taking cognizance from international tax practice of other countries, has been making an attempt to call for allocation of location savings attributed to the Indian entity. Though there is no formal articulation of the approach for identifying, quantifying, and allocating location savings under the Indian TP regulations, the IRA has been making aggressive stand in number of cases wherein location savings, if present, have not been allocated.

In the recent past, the High Court as well as the Income Tax Appellate Tribunal (ITAT') had an occasion to provide its ruling/guidance on the aspect of location savings. We have given below a synopsis of the key precedents:

(A) Li & Fung (India) (P.) Ltd. vs. Dy. CIT [2011] 16 taxmann.com 192 (Delhi)

The taxpayer *i.e.* Li & Fung (India) provided sourcing support services to its AE, Li & Fung Hong Kong. The goods have been delivered and been invoiced by third parties directly to the AE and thereby, it had incurred only operating costs required for sourcing goods from third parties. The taxpayer had recovered operating costs along with 5% markup.

The IRA challenged the cost plus model of the taxpayer and held that the taxpayer should have received a 5% commission on the FOB value of products sourced from India, due to critical functions performed, unique intangibles employed and locational advantages available to the taxpayer. By adopting the remuneration model based on the FOB value of products, the IRA had enhanced the cost base of the taxpayer by including costs of manufacture and export of finished goods, even though those costs were not the costs it has incurred.

The Delhi ITAT has upheld the action of the IRA by concluding that the taxpayer, while acting as a sourcing support service provider, had developed significant intangibles which resulted in generation of significant location savings which in turn

[1] Sundstrand Corporation and subsidiaries Vs. Commissioner, (96 T.C.M (CCH) 226 (1991) Compaq Computer Corporation Vs. Commissioner (78 T.C.M. (CCH) 20 (1999) Bausch & Lomb Vs. Comr. 92 T.C 525, 581 (1989)

enabled the AE to earn higher profits. The ITAT adjudicated that the benefits of location savings must be reflected in terms of higher remuneration for taxpayer and thereby, upheld using remuneration model based on the FOB value of goods procured. Pursuant to ITAT ruling, the taxpayer filed an appeal before the High Court.

The High Court ruled that the taxpayer's functional and risk profile was entirely different and had nothing to do with the manufacture and export of goods by unrelated third party vendors. Considering the facts of the case, taxpayer rendered merely support services in relation to the goods exported. Thus, when the taxpayer did not engage in the manufacturing activity, and more importantly, when those costs have not been incurred by the taxpayer at all, including such costs for the purpose of transfer pricing, was held to be impermissible.

Finally, the High Court held that the remuneration of operating cost plus mark-up of 5% was at arm's length.

(B) GAP International Sourcing (I) Pvt. Ltd. v. ACIT [2012] 25 taxmann.com 414 (Delhi)

The taxpayer provided support services to its AEs which were mainly in the nature of identifying local vendors, undertaking inspection and quality checks of apparel procured, and coordinating with vendors for delivery to AEs.

The IRA rejected the cost plus remuneration model stating that such remuneration did not take into account significant intangibles, in the form of human intangibles, supply chain intangibles and locational savings, developed by the taxpayer. The IRA worked out such remuneration at 5% of FOB value of goods procured by the taxpayer for its AEs.

The ITAT held that the taxpayer had not developed any human intangibles or supply chain intangibles and further, the taxpayer did not bear significant business risks. On locational savings, the ITAT acknowledged that the location savings arise to the industry as a whole and the key objective of sourcing from low-cost countries is to survive the stiff competition by providing competitively priced goods and services to the ultimate customers. Since in the case under consideration, it had been evidenced that such savings were passed on to the end-customers, the ITAT held that locational savings could not be attributed to the taxpayer.

The ITAT also held that where local market comparables were available and used, specific adjustment for location savings was not required. Further, it also noted that any advantage gained to AE was irrelevant if the profit level indicator of the taxpayer was within the range of comparables.

Further, the Delhi ITAT held that the arm's length principle required benchmarking to be done with comparables in the jurisdiction of the tested party and the location savings, if any, would be reflected in the profitability earned by comparables which were used for benchmarking. Therefore, the ITAT concluded that no further allocation on account of location savings would be required.

Accordingly, the taxpayer was adjudged a low risk procurement services provider; remuneration at cost (full cost) plus mark-up was held to be appropriate.

(C) Watson Pharma (P.) Ltd. v. DCIT 8 (3), [2015] 54 taxmann.com 88 (Mumbai)

The taxpayer was engaged in providing contract manufacturing and contract R&D services to its AEs for which it was compensated on a total operating cost plus arm's-length mark-up basis. The taxpayer has benchmarked the same companies engaged in providing similar contract manufacturing and contract R&D services.

During the course of audit proceedings, the IRA accepted the benchmarking analysis conducted by the taxpayer. However, the IRA contended that the taxpayer ought to have received extra compensation on account of location savings over and above the margins earned by the comparables for which they proceeded with the computation of location savings by use of articles appearing in various journals and websites.

Based on these articles, the IRA concluded that, in case of contract manufacturing, cost in India is around 40 per cent of cost in USA (excluding raw material cost) and in case of contract R&D, the cost of R&D in India (excluding raw material cost) is around 50 per cent of cost in USA. Based on the same, the IRA computed location savings and apportioned the same on 50:50 basis between the taxpayer and its AE.

The ITAT, in its ruling, noted that the taxpayer as well as the AE operates in a perfectly competitive market and hence, it does not have access to location specific advantages. As a result, there is no super

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profit that arises in the entire supply chain and further, there is no unique advantage to the assessee over competitors.

The ITAT also held that where local market comparables were available and used, specific adjustment for location savings was not required. Further, it also noted that any advantage gained to AE was irrelevant if the profit level indicator of the taxpayer was within the range of comparables.

Further, the ITAT also referred the Action Plan 8 of the BEPS Project wherein it has been specifically provided that where local market comparables are available, specific adjustment for location saving is not required.

Importantly to note that the ITAT noted that the Indian chapter of the UN TP manual, which discusses location saving issue, represents a view of the Indian tax administration and is not binding on the appellate authorities.

The ITAT, considering all the facts and international guidance available on the subject, set aside the order of the lower authorities and directed to delete the addition.

(ii) UN TP Manual–India Chapter

The committee, engaged in drafting the UN TP Manual, invited comments of tax administrations of a few developing countries (Brazil, China, India and South Africa) on their respective nations' approach towards some of the key transfer pricing issues.

The Indian tax administration has provided their comments on key aspects of the transfer pricing issues wherein one of issue was of "location savings". We have summarised below the key observations/comments which postures the view of IRA, though not formally introduced in tax laws:

- "Location savings" refer to cost savings in a low-cost jurisdiction such as India and since India offers location savings on account of being a low cost jurisdiction, same should be considered while carrying out comparability analysis;
- Location savings is a broader concept and includes any cost advantage accrued to MNEs such as lower labour or skill employee cost, lower raw material cost, lower transaction costs, lower rent, lower training cost, infrastructure cost, any form of tax incentive, *etc.*;
- India provides the following location specific advantages which need to be considered while arriving at a location rent:
  - Highly specialised and skilled manpower and knowledge;
  - Access and proximity to growing local/regional markets;
  - Large customer base with increased spending capacity;
  - Superior information networks;
  - Superior distribution networks;
  - Incentives; and
  - Market premium.
- Undertaking comparability analysis by using local comparables will not take into account the benefit of location savings as these comparables may not have enjoyed locations savings;
- Profit Split Method should be used to determine arm's length allocation of location savings and rents in cases where comparable uncontrolled transactions are not available. Further, it also states that the functional analysis and bargaining power of the parties to the transaction should be considered for determining the ALP.

The above comments provided by the Indian tax administration represent their view only on location savings and have not been converted into regulations yet and hence, are not of binding nature. The conclusion is also supported by the Mumbai ITAT ruling in the case of *Watson Pharma (P.) Ltd. vs. DCIT*.

(iii) Conclusion

As is evident, concept of location savings is at a nascent stage and still evolving in the Indian TP context. One could observe that even the rulings, wherein the question on relevance of location savings have been discussed, do not lay down an analytical framework or principles to

evaluate the existence of location savings and other LSAs, quantify them and to whom they should be attributed under the arm's length conditions.

Evidently, the comments provided by the IRA in UN TP Manual clearly contradict with the rulings pronounced by the ITAT on this subject on some key aspects. While the ITAT itself has ruled that comments given in UN TP Manual are not of binding nature, one may expect to get the same transformed into a law or guidelines in the near future. Even after having clear guidance from ITAT, one may expect the IRA to take similar stand in TP audits and thereby, it may become an emerging TP litigation issue in India.

5. Way Forward

As is evident, India has emerged as a hub for outsourced services such as software development, research and development, engineering design, and business processes as well as low-cost manufacturing. Given the widespread extent of outsourced services in India and increasing focus and aggressive stand being taken by the IRA on "location savings" aspect, it becomes imperative to carefully review inter-company transfer pricing arrangements. Furthermore, it is important to undertake and document robust TP analysis to counter any such argument put forward by the authorities during TP audits.

Considering maturing tax administration audit procedure, taxpayer should proactively consider the guidance provided in UN TP Manual as well as key principles emanating from judicial precedents on the subject matter and its application on their facts of case. Depending on facts of case, it would be imperative to analyse whether location savings/ location specific advantages actually exist and if yes, whether the same have been retained within the group and if yes, then are they properly allocated between the entities to the transaction or not and take corrective measures, if required. ■