ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT





LOCATION SAVINGS

JULY 2010

Disclaimer: The attached paper was prepared by the OECD Secretariat. It bears no legal status and the views expressed therein do not necessarily represent the views of the OECD member states. For a more comprehensive description of the views of the OECD and its member states in relation to the arm's length principle and transfer pricing, readers are invited to refer to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations which were approved, in their original version, by the Committee on Fiscal Affairs on 27 June 1995 and by the Council of the OECD for publication on 13 July 1995 [C(95)126/FINAL] and were supplemented and updated since. In particular, a substantial revision of the Transfer Pricing Guidelines was approved by the Council of the OECD on 22 July 2010 (see www.oecd.org/ctp/tp or http://www.oecd.org/document/4/0,3343,en_2649_33753_45690500_1_1_1_1,00.html).

CENTRE FOR TAX POLICY AND ADMINISTRATION

LOCATION SAVINGS

1. The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (hereafter "TPG") contain a brief discussion of location savings at paragraphs 9.148-9.153 in the context of the examination of the transfer pricing aspects of business restructurings.

2. Location savings are generally understood as the net savings in costs that may be derived by an MNE group that relocates some of its activities to a place where labour or real estate expenditures, to cite only a couple of examples, are lower than in the location where the activities were initially performed. The net savings arising from a change of location are determined after accounting for possible costs involved in the relocation itself, e.g., termination costs for the existing operation, higher transportation costs if the new operation is more distant from the market, training costs of local employees, etc.

3. Where significant location savings are derived, the question arises whether and, if so, they should be shared among the parties, and in particular whether part of the location savings should be allocated to the entity in the low cost jurisdiction. This could be done for instance by including a premium return in the transfer price of the products or services supplied from that low cost entity to its foreign affiliates. According to the arm's length principle, the response should depend on how independent parties would price their transactions in similar circumstances. The conditions that would be agreed between independent parties would normally depend on the functions, assets and risks of each party which will influence their respective bargaining powers.

4. Take the example of an enterprise that designs, manufactures and sells brand name clothes. Assume that the manufacturing process is basic and that the brand name is famous and represents a highly valuable intangible. Assume that the enterprise is established in Country A where the labour costs are high and that it decides to close down its manufacturing activities in Country A and to relocate them in an affiliate company in Country B where labour costs are significantly lower. Assume that the enterprise in Country A retains the rights on the brand name and continues designing the clothes; that the clothes will be manufactured by the affiliate in Country B under a contract manufacturing arrangement, which does not involve the use of any significant intangible owned by or licensed to the affiliate in Country B or the assumption of any significant risks by the affiliate in Country B.. Assume further that, once manufactured by the affiliate in Country B, the clothes will be sold to the enterprise in Country A which will on-sell them to third party customers.

5. In this example, it is assumed that the lower labour costs of the affiliate in Country B will allow significant location savings, and then the question is, simply put, if the location savings should be attributed to the enterprise in Country A or its affiliate in Country B, or to both in some proportion that would also need to be determined.

6. The arm's length principle in such an example would respond to the question by looking at how third party manufacturers in Country B would price a comparable transaction in comparable circumstances. If the activity is relocated in a highly competitive manufacturing environment, it is likely that there will be independent contract manufacturers in Country B and it should be possible to find comparables data in Country B to determine the conditions in which such third parties would be willing at arm's length to manufacture the clothes for the enterprise in Country A. In such a situation, an independent contract manufacturer would generally be attributed very little, if any, part of the location savings. Doing otherwise for the affiliated manufacturer would put it in a situation different from the situation of an independent manufacturer, and would be contrary to the arm's length principle.

Illustration	
Pre-restructuring: Enterprise in Country A manufactures and sells clothes.	
• Manufacturing costs in Country A:	**100**
• Sales price to customers:	200
Post-restructuring: Clothes are manufactured by affiliate in Country B.	
At the level of the affiliate in Country B:	
• Manufacturing costs:	**30**
• Transfer price to Enterprise in Country A (assuming this is the arm's length price, determined based on a comparability analysis):	**36**
At the level of the Enterprise in Country A:	
• Cost of goods sold:	**36**
• Sales price to customers:	200
Location savings for the MNE group **(Enterprise in Country A + affiliate in Country B):** **100-30 = 70**	
Location savings for the Enterprise in Country A: **100-36 = 64**	

7. In other circumstances, the arm's length principle might give a different outcome. For example, assume now that an enterprise in Country X provides highly specialised engineering services to independent clients. The enterprise is very well known for its high quality standard. It charges a fee to its independent clients based on a fixed hourly rate that compares with the hourly rate charged by competitors for similar services in the same market. Suppose that the wages for qualified engineers in Country X are high. The enterprise subsequently opens a subsidiary in Country Y where it hires equally qualified engineers for substantially lower wages, and subcontracts a large part of its engineering work to its subsidiary in Country Y, thus deriving significant location savings for the group formed by the enterprise and its subsidiary.

8. Assume also that clients continue to deal directly with the enterprise in Country X and are not aware of the sub-contracting arrangement and that their demand for the services continue to grow for some period of time at the original hourly rate despite the significantly reduced engineer costs. In this case the same question arises as to which party within the MNE group should, at arm's length, be attributed the

location savings that are derived by the MNE group during that period of time: the subsidiary in Country Y, the enterprise in Country X, or both (and if so in what proportions).

9. If the subsidiary in Country Y is the only one able to provide the type of engineering services in question with the required quality standard, so that the enterprise in Country X does not have any other option available to it than to use this service provider, it might be that the subsidiary in Country Y has developed a valuable intangible corresponding to its technical know-how. Such an intangible would need to be taken into account in the determination of the arm's length remuneration for the sub-contracted services. In those circumstances where there are significant unique contributions, such as the intangible just described, the relevant party to the transaction may be in a position to charge a premium over the basic engineering rate charged by engineering companies that do not have the same unique intangible. If there are significant, unique intangibles contributed by both parties to the transactions, i.e. by the enterprise in Country X and its subsidiary in Country Y, then the use of a transactional profit split method may be considered.

10. It is not evident however that locations savings may remain to the MNE group for a long period of time. In both above examples, competition in Country A or X may eventually drive down the price to final consumers, reducing the initial extra-profit obtained from relocation and thus passing on part or all of the location savings to the clients.

11. Finally, locations savings as discussed above should not be confused with geographical comparability adjustments. Where comparables from a different market from the market of the tested party are used to establish the arm's length remuneration of a controlled transaction, it is a separate issue to determine the comparability adjustments, if any, to be applied to the selected comparables in order to adapt them to the characteristics of the local market (e.g., labour costs, country risk, local regulations, etc.).