

Chapter2

BusinessFramework

2.1. Introduction

Thischapterprovidesbackgroundmaterial

## 2.2. Theory of the Firm and Development of Multinational Enterprises

2.2.1 In economic theory, firms are organisations that arrange the production of goods and the provision of services. The aim of a firm is to produce goods and provide services to maximise profits. In the absence of firms, production would be carried out through a series of arm's length transactions between independent parties.<sup>1</sup> These transactions would require contracts between the independent producers but a significant part of these resources would be used in the process of making contracts.

2.2.2 The expenses of making contracts are called transaction costs as expenses are incurred by individuals in finding other persons with whom to contract, negotiating and finalising the contracts. As contracts cannot cover every possible issue that may arise between the contracting parties there is a risk of disputes being created by unforeseen

2.2.4. A firm will internalise the costs of production to the extent that it can achieve economies of scale in production and distribution and establish coordination economies. The United Nations Conference on Trade and Development (UNCTAD) in its *1993 World Investment Report: Transnational Corporations and Integrated Production* noted that in many industries the expansion of internalised activities within multinational enterprises (MNEs)

2.2.8. The key feature of MNEs is that they are integrated (global) businesses.  
Globalisation has made it possible for an MNE to made

2.2.12. For most of the twentieth century MNE groups and international enterprises operating through branches or subsidiaries tended to expand the range of their value adding activities and by the late 1980s firms had integrated their production and marketing functions. Up to the 1960s and 1970s, MNEs had engaged in limited or no outsourcing of operations and they became large integrated conglomerates. But the authors argue that from the late 1980s MNEs began outsourcing many activities that were previously performed by the firms themselves. From the early 1990s, MNEs began restructuring to specialise in the areas in which they had competitive advantages, such as unique firm specific assets, in particular high value intangible assets, and capabilities that provided the firms with their market position and competitive edge.

2.2.13. MNEs examined their value chains to identify the functions in which they had no advantage over other firms. 0

b, a, o, e, p, l, a, f, i

expanding their operations abroad. Consequently, domestic transfer pricing rules which apply to SMEs should reflect the capacity of SMEs to comply and the capacity of the tax authorities to administer them. Some countries may use special simplified rules for SMEs, such as simplified documentation requirements, and use flexible approaches in handling transfer pricing issues involving SMEs. This creates the need to define an



independent companies working together on a specific project and a joint venture party may include a government or a government authority. The business structures used by an MNE may change over time, for example commencing operations in a jurisdiction using a joint venture structure and then buying out the joint venture partner and operating in that jurisdiction through an associated enterprise. An MNE may operate abroad using an agent, which may be an independent agent, a dependent agent or a commissionaire.

## Companies and permanent establishments

2.3.7. In an MNE group, the parent company and subsidiary companies are separate legal entities and they may enter into intra group transactions. On the other hand, an international enterprise with a head office in the country of residence and permanent establishments abroad is one legal entity and a permanent establishment cannot legally enter into transactions with other parts of the enterprise because transactions require at least two legal entities. In the context of the business profits article of tax treaties, notional transactions within an international enterprise (either between a head office and its permanent establishment or between permanent establishments) may be recognised provided they comply with the arm's length principle. In addition, for accounting and management purposes, the head office of an international enterprise and a branch may be treated as "transacting" with each other. Whether or not dealings between a head office and its branch are subject to transfer pricing rules would depend on the scope of a country's domestic legislation and its tax treaties.

2.3.8. Operational structures used by MNEs vary and evolve over time. There are many types of structures or hybrids which an organisation can choose to adopt, but an organisation's primary aim should be to adopt that operational structure that will most effectively support and help it to achieve its strategic objectives. MNEs' operational structures usually differ from the legal structures and as a result, employees generally operate beyond and across the boundaries of legal entities and countries. Examples of the types of modern operational structures



an MNE may adopt include a functional structure, a divisional structure or a matrix structure.

#### Types of organisational structures

2.3.9. Functional Structure: In a functional structure an MNE's functions are performed by the employees within the functional divisions. These functions are usually specialised tasks, for instance the information technology engineering department would be staffed only with software engineers. As a whole, a functional organisation is best suited as a producer of standardised goods and services at large volume and low cost to exploit economies of scale. Coordination and specialisation of tasks are centralised in a functional structure, which makes producing a limited amount of products or services efficient and predictable.

2.3.10. Divisional Structure: Under a divisional structure, each organisational function is grouped into a division with each division containing all the necessary resources and functions within it, such as human resources and accounts. Divisions can be categorised from different points of view. The distinction could be for example functions



1. Mapping out a generic value chain for the industry.
2. Mapping out an MNE's value chain.
3. Comparing the generic value chain to an MNE's value chain and analysing the differences which may explain why an MNE has a competitive advantage over its competitors.
4. Distinguishing between an MNE's main functions and its support functions.
5. Identifying and understanding which of the MNE's main functions are critical to the success of the organisation (i.e. a critical success factor ("CSF")).
6. Identifying and understanding which activities performed by an MNE add value to the goods and services it produces, which may distinguish the MNE from its competitors, i.e. value adding activities (VAA).
7. Understanding and confirming how the various functions across the value chain are split by the MNE between the various legal entities in the group.

2.3.14 The illustration below shows how three different MNEs could adopt different operational structures using the same generic value chain.

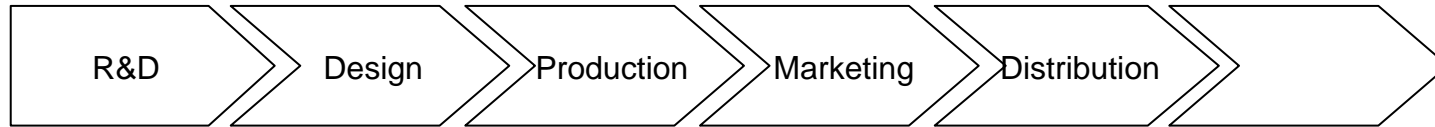
MNE Group A uses three different companies to perform very specific functions across the value chain as follows:

Company 1 in Country A is an R&D company carrying out R&D functions and also undertaking activities relating to the design of products for the entire group.

Company1

2.3.15.3. A different possible context of exactly the same

VALUECHAINANALYSIS:



Examples of how different Groups could “customise” the above generic value chain:

Company 1

Company 2

Company 1

3<sup>rd</sup> Party

Company 2

3<sup>rd</sup> Party

Company 2

3<sup>rd</sup> Party

Company 1 & 2 & 3

## 2.4. Managing the transfer pricing function in an MNE

### 2.4.1. MNE's face challenges in

2.4.4 The following is an illustrative example of the two different decision trees within an MNE:

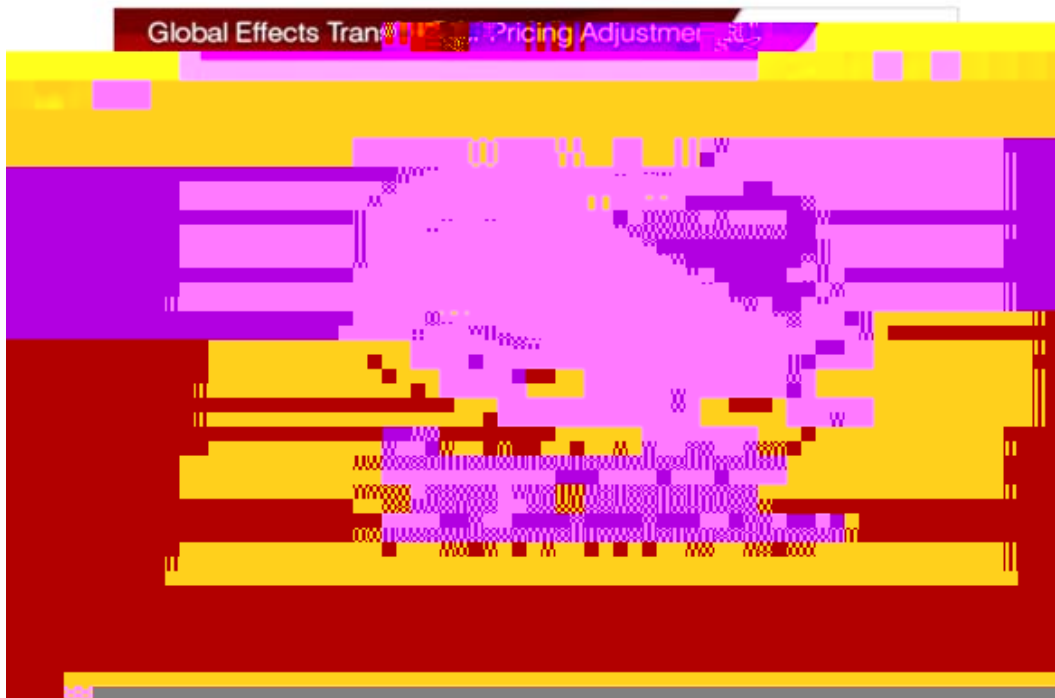




associated enterprise in country B, provided a consistent transfer pricing method is used by both countries.

2.4.7. But country B may use different transfer pricing methods. Consequently, if transfer prices are adjusted by a tax authority in one country, double taxation will occur if the tax authority in the other country does not use the same transfer pricing method and allow a corresponding transfer pricing adjustment. It is the task of the transfer pricing function within an MNE to limit the risk of transfer pricing adjustments and the risk of double taxation.

2.4.8. Illustration of double taxation:



2.4.9. In principle, designing, implementing and documenting an appropriate transfer pricing policy should not be viewed solely as a compliance issue for MNEs. The main goal should be to develop a consistent global policy which cannot be altered to exploit tax laws. A well developed and consistently applied transfer pricing policy should reduce an MNE's risk of transfer pricing adjustments and the potential for double taxation, thereby increasing profitability by minimising transfer pricing costs. Moreover, a global transfer pricing policy may be used as evidence in negotiations with tax authorities when transfer pricing disputes occur.

2.4.10. An MNE's transfer pricing policy should ideally reduce the risk of transfer pricing adjustments and the risks of double taxation of cross border transactions. A comprehensive transfer pricing

¾ Documentation

¾ Audit support/disputeresolution

2.4.11. Advisory requires a thorough knowledge of an MNE's business operations. It is a misconception that the tax department makes the key business decisions within an MNE. In practice, the business units of an MNE will identify business opportunities and a decision may be taken to exploit the opportunity if it fits into the MNE's global business strategy. Advice can be provided to minimise the risk of transfer pricing adjustments and therefore optimize the business opportunity if the tax department is involved in an MNE's decision making,

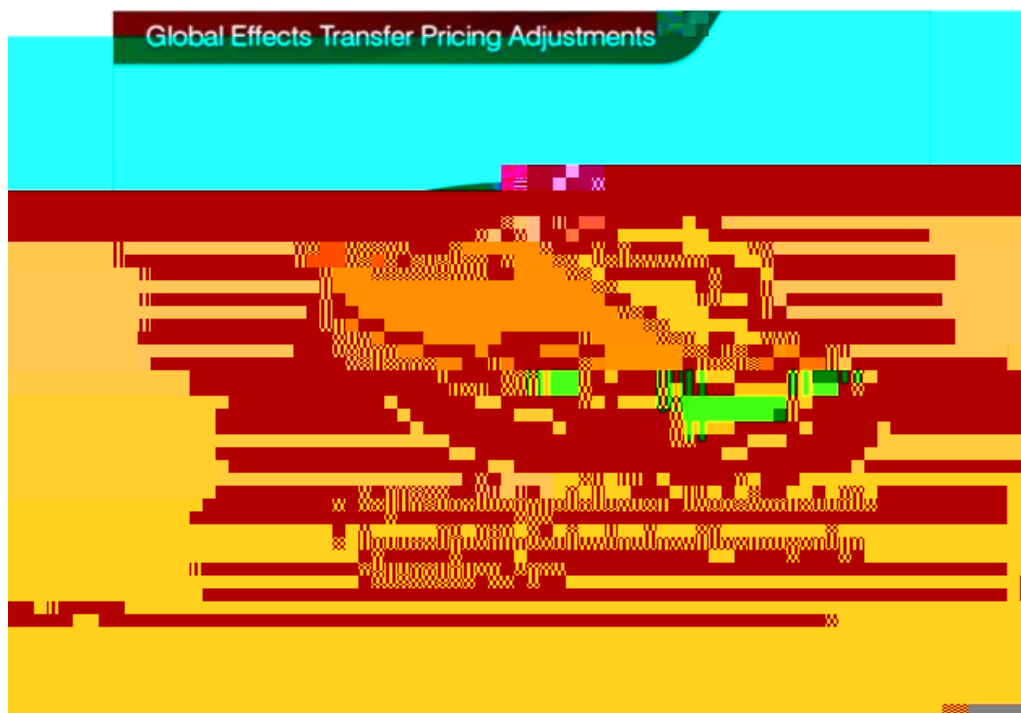
2.4.12 Documentation In today's environment there is an environment /TT5 1 Tf .8361 0 TD 0 Tc <00

prepared for

principle<sup>7</sup> receive a “corresponding adjustment”, reducing its taxable income. If there is no corresponding adjustment, the MNE will suffer double taxation. In this situation, the dispute is between two tax authorities with the MNE seeking to have consistent transfer prices accepted by both countries.

2.4.17. Countries should try to avoid such double taxation, though in some cases there may be legitimate reasons why a corresponding adjustment is not given, or is less than the original adjustment. In such a case, it is important that the two countries enter into discussions to resolve the double taxation issue under the mutual agreement procedure mechanism in a tax treaty.

2.4.18. The following diagram illustrates a transfer pricing adjustment to relieve double taxation:



<sup>7</sup> UN and OECD Model Double Tax Conventions, Article 9 (Associated Enterprises).