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This is a working draft of a Chapter of the Practical Manual on Transfer Pricing for Developing Countries and should not at this stage be regarded as necessarily reflecting finalised views of the UN Committee of Experts on International Cooperation in Tax Matters or its Subcommittee on Transfer Pricing - Practical Issues. Comments in writing are sought and should be sent to the Secretariat to the UN Tax Committee at taxffdoffice@un.org by 8 November 2010 at the latest.

While several members of the Subcommittee have contributed to this draft and appropriate attribution will be made in a later version, the Secretariat particularly notes the contribution of Dr Michael Kobetsky in preparing this draft for the Annual Session.

Chapter 2 - Business Framework: The Theory of the Firm and the

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3. 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. 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) indicates that there are significant efficiency gains.

4. A firm's functions in providing goods and services are called its supply chain (also called the value-added chain) and through the supply chain the firm converts inputs into goods and services. Most firms begin by operating in their home market and rely on their competitive advantages to enter markets abroad. International enterprises create organisational structures and develop strategies to arrange the cross-border production of goods and services in locations around the world, and the level of intra-entity or intra-group integration.

5. In its report noted above, UNCTAD suggested that there was a trend in many international enterprises across a broad range of industries to use structures and strategies with high levels of integration in their operations. The integration included giving an associated enterprise control over a group-wide function or the sharing of group-wide functions between two or more enterprises. Successful multinational enterprises exploit their location and internalisation advantages to maximise their share of global markets and growth opportunities. Thus, multinational enterprises are able to minimise their cost through their integration economies, which are not available to domestic firms.

6. The key feature of multinational enterprises is that they are integrated (global) businesses. Globalisation has made it possible for a multinational enterprise to achieve high levels of integration and the ability to have control centralised in one location. Modern information and communications systems also provide increased horizontal communications across geographic and functional business lines. This has resulted in many multinational enterprises providing services such as advisory, research and development, legal, accounting, financial management, and data processing from one or several regional centres to group companies. Also management teams of a MNE can be based in different locations, leading the MNE from several locations.

7. International enterprises have common control, common goals, and common resources, in which the units of the enterprise — parent company, subsidiaries— are located in more than one country. Thus, many multinational enterprises are fully integrated businesses that plan and implement global strategies. UNCTAD has asserted integration of production by international enterprises and multinational enterprise groups creates challenges for policy-makers in adapting the methods for allocating the income and costs of these enterprises between jurisdictions for tax purposes.

8. In *Multinational Enterprises and the Global Economy*¹ the authors argue that the history of MNEs was shaped by political, social and cultural events that influenced the ownership, organisation and location of international production of their goods and

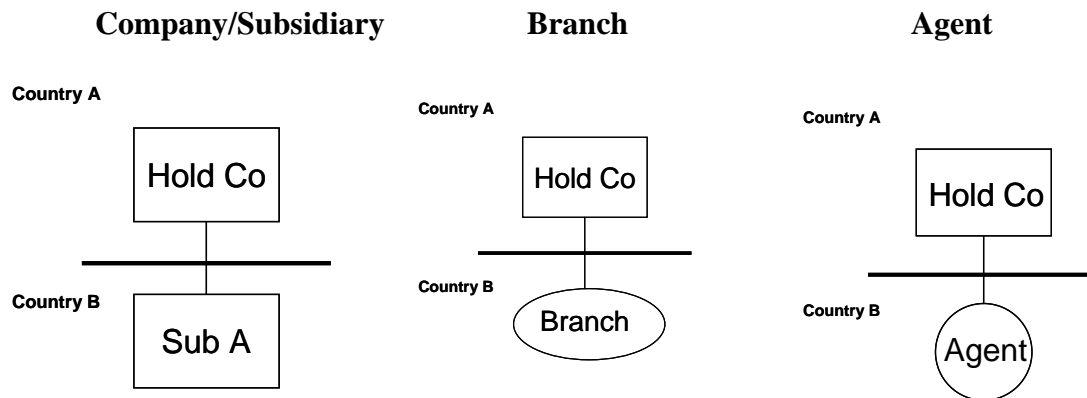
¹ *Multinational Enterprises and the Global Economy*, 2d ed, Dunning, John H. and Sarianna M. Lundan (Edward Elgar Publishing, 2008).

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- administrative costs;
- extraction of profits; and
- capital requirements.

13. MNEs may also carry on business abroad through a partnership, trust or joint venture. In most jurisdictions partnerships are not legal entities and are fiscally transparent. For a partnership to exist an MNE would require other entities to be partners such as independent entities or subsidiaries. Trusts in common law countries are an obligation in relation to property and they are not legal entities. Trusts may be used in some jurisdictions to carry on business. Joint ventures involve independent companies working together on a specific project and a joint venture party may include a government or a government authority. MNEs may operate abroad using an agent, which may be an independent agent, a dependent agent or a commissionaire.



Companies and Branches

14. In a MNE group, the parent company and subsidiaries companies are independent legal entities and they may enter into intra-group transactions. On the other hand, an MNE with a branch abroad are part of the same legal entity and branches cannot legally enter into transactions with other part of the MNE because transactions require at least two entities. But in the transfer pricing context notional transactions between the head office and its branch are generally treated as transactions. It should be noted that for accounting and management purposes, the head office and 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.

Operational Structures

15. 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

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effectively support and help it to achieve its strategic objectives. MNEs' operational

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accordingly, that they will have a corresponding proportionate share in assets or benefit from the services. This sharing of costs and benefits is reflected in an allocation key. In effect, the participants are joint owners of the created or acquired property or services. CCAs are used to create property, including intangible property, where the benefits are predicable at the outset.

23. The benefits for an MNE using a CCA include:

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countries or regions. A participant to a CCA must be able to use the intangible property as an economic owner and thus they cannot be required to pay royalties for the use of property. CCAs may also involve participants that exploit the intangible property jointly.

29. CCAs are also used for a number of other activities such as acquiring services that benefit the participants. For example, a MNE may decide to centralise its human resources or information technology function in an associated enterprise and that the participants will share the costs of providing these services. The advantage of service CCAs is that they provide for economies of scale to the participants — the proportionate cost of these services are lower than a participant providing these services in-house. Some of the savings from centralising functions may arise from preventing unnecessary duplication of functions within the MNE. The savings that arise from centralising services providers in an associated enterprise will usually be immediate. Over time an associated enterprise providing services such as information technology may result in intellectual property being created such as know-how. The services that may be the subject of a CCA include management, administrative and technical services, marketing and purchasing of raw materials or products.

30. CCAs reflect joint venture agreements between independent enterprises. Independent enterprises enter into arrangements, such as joint venture, to share costs for research and development with others enterprises in case the research does not result in the expected benefits. A CCA will satisfy the transfer pricing arm's length principle if a participant's costs and corresponding benefits or expected benefits reflect agreements between independent enterprises in comparable circumstances.

Managing the Transfer Pricing Function in an MNE

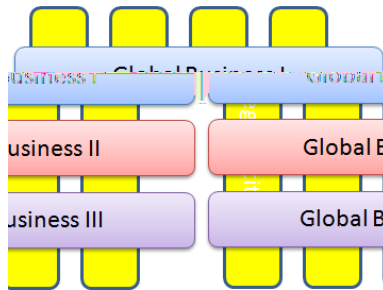
31. This section describes the challenges a MNE faces while managing the transfer pricing function. In a MNE transfer pricing refers to the setting of prices for the provision or supply of goods, services and intangible assets within a multinational business. The determination of the transfer price affects how profits are being allocated internationally among the associated enterprises of the MNE group.

32. Entities in a MNE group conduct global business that gives rise to opportunities to optimise the supply chain of goods or services and therefore look for synergies. The biggest challenge an MNE faces while conducting a global business with related parties is whether the pricing method used for internal transactions is acceptable for the tax authorities in the countries involved in the supply chain. The transfer pricing challenge becomes even bigger when the MNE has multiple global businesses with different business models and multiple cost centers. The size of the MNE adds to the complexity.

33. The taxable income of a MNE starts with the profits realised by the global business which is subsequently allocated to the various legal entities. This process clearly demonstrates that within the decision tree of a MNE two different decision trees are relevant. On the one hand, corporate law requires the global profit to be allocated within the company group. On the other hand, a MNE will usually be required to allocate the realised profit among the businesses lines. But in practice, there are allocation difficulties problems and accordingly transfer pricing risks for MNEs. In theory, a, MNE

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should create a global transfer pricing policy to minimise the risk of transfer pricing risks.

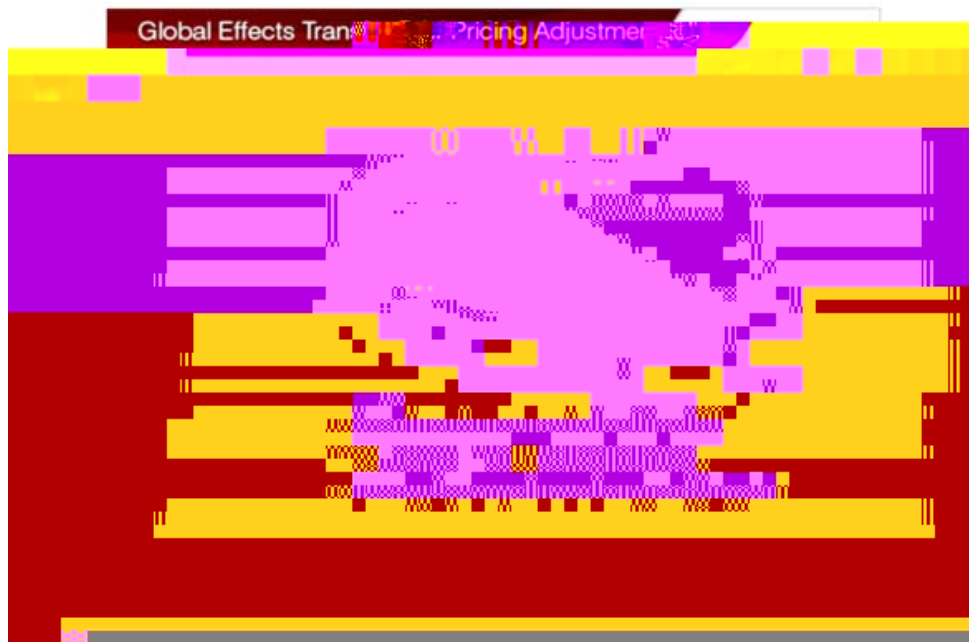


34. The allocation of the results to the various legal entities is based on the functions performed, risks assumed and assets employed. Since MNE's consist of many related companies it is very difficult to allocate the results to all the separate legal entities due to absence of market forces. It is quite a complex exercise to come up with a global consistent policy for allocating results to the legal entities.

35. The arm's length principle allows national tax authorities to adjust the terms of transaction between associated enterprises and accordingly increase the profitability of an associated enterprise. As the terms of a transaction between associated enterprises differ from those between unrelated parties and comparisons are difficult to make a MNE

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An Illustration of double taxation

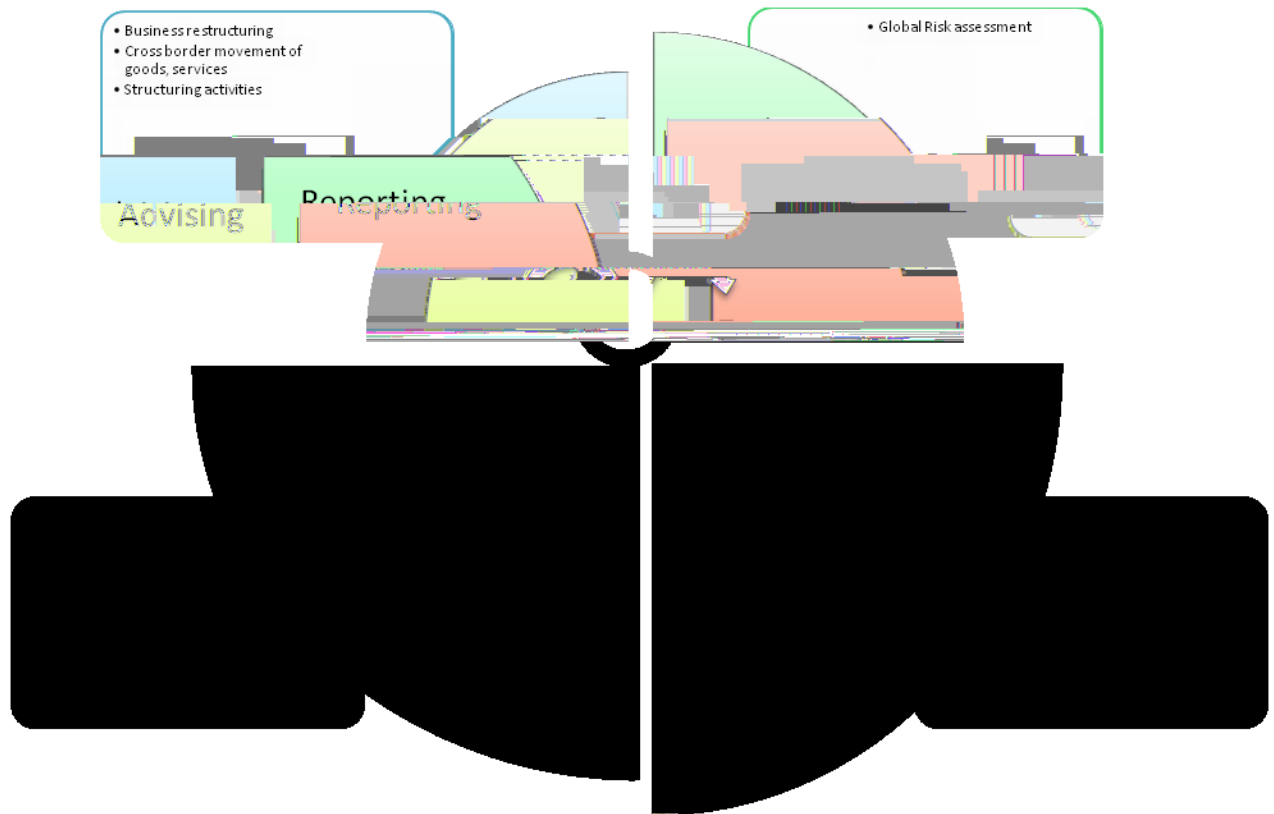


36. Designing, implementing and documenting an appropriate transfer pricing policy should not be viewed simply as a compliance issue for MNEs. The main goal is to develop a consistent global policy which can not be altered to exploit tax laws. A well developed and consistently applied transfer pricing policy should reduce the MNE's risks of transfer pricing adjustment and the potential of double taxation thereby increasing the profitability by minimizing transfer pricing costs. Moreover, the global transfer pricing policy may be used as evidence in negotiations with tax authorities when transfer pricing disputes occur.

37. A transfer pricing function should protect the MNE against double taxation and support development, expansion and growth of the company. The transfer pricing function manages the following four dimensions of transfer pricing: Advising, reporting, documentation and audit support/dispute resolution.

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38. The activities can be depicted as follows:



39. **Advising:** the advising function requires a thorough knowledge of an MNE's business operations. It is a misconception that within an MNE the tax department makes the key business decisions. In practice, an MNE will identify opportunities and provided it fits into the MNE's global business strategy, a decision may be taken to exploit the opportunity. Consequently, the best advice can be given to optimise profitability and protect against the risk of transfer pricing adjustments.

40. **Documentation:** In today's environment there is an increasing level of detail required to meet each country's transfer pricing documentation. It is impossible for a MNE to prepare the required documentation fo

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An illustration of transfer pricing double taxation

