Agenda Item 2

Working Draft

Chapter 2

Business Framework

[This paper is based on a paper prepared by Members of the UN Tax Committee's Subcommittee on Practical Transfer Pricing Issues, but includes Secretariat drafting and suggestions not yet considered by them – the Secretariat takes responsibility for any relevant errors and omissions.

NB This Chapter is currently under revision by a Subcommittee drafting team, with a view to ensuring a neutral tone that recognises that "transfer pricing" is an innate part of the way MNEs operate and does not itself imply manipulation, that even mis-pricing can occur without tax avoidance or evasion motives, but that some deliberate abuses including profit shifting do occur. An understanding of how Business operates and makes decisions will assist in determining what category a particular situation falls into.]

Theory of the Firm and the Reasons for the Existence of Multinational Enterprises

1. In economic theory, firms are organisations that arrange the production of goods and services. In the absence of firms, production would be carried out through a series of arm's length transactions between independent parties. 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. The expenses of making contracts are called transaction costs as expenses are incurred by individuals in finding other persons with whom to contract, negotiating the contracts, and finalising the contracts. As transactions costs would be significant in an economy without firms, it is rational economic behaviour for firms to be created to produce goods and services provided the firms' costs of production are less than the costs of outsourcing the production.

3. Within a firm, contracts between the various factors of production are eliminated and replaced with an administrative arrangement. Usually, the administrative costs of organizing production within a firm are less than the alternative of out-sourced market transactions. The theoretical limit to the expansion of a firm is the point at which its costs of organising transactions are equal to the costs of carrying out the transactions through the market.

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) indicates that there are significant efficiency gains to be had.

5. 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.

6. 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. UNCTAD claimed 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.

7. Successful multinational enterprises use 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.

8. 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.

9. 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 noted that 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.

10. In *Multinational Enterprises and the Global Economy* (2008)[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 services. They claim that MNE groups integrated their operations until the late 1980s and then more recently chose to outsource some activities in which they do not have competitive advantages.

11. For most of the twentieth century MNE groups and international enterprises tended to expand the range of their value adding activities and by the late 1980s firms had integrated their production and marketing functions. By the 1960s and 1970s, MNEs had engaged in limited or no outsourcing of operations and they become large integrated conglomerations. But the authors argue that since the late 1980s MNE began

[1] Dunning, J. H., & Lundan, S. M. 2nd edition (2008).

outsourcing many activities that were previously performed by the firms themselves. By the early 1990s, MNE 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 provide the firms with their market position and competitive edge.

12. MNE and international enterprises examined their supply-chains (also called value chains) to identify the functions in which they had no advantage over other firms. They then began deciding on which functions they would perform themselves and those which would be outsourced to independent firms, so called value chain optimisation. While the initial functions that were outsourced were non-core activities such as payroll, billing and maintenance services, outsourcing has expanded to cover core activities. The core activities may involve producing goods or providing services. For example, many firms out-source call centre activities to independent firms in countries which have educated workforces and relatively low cost labour. Consequently, modern multinational enterprise groups organise their cross-border operations through a network of contractual arrangements with independent enterprises and cooperative in-house relationships.

Legal Structure

13. One of the key decisions facing any MNE when expanding its operations to another country is the type of legal structure it will use to operate in that jurisdiction. The legal alternatives for an MNE are to operate abroad through branches or to use locally incorporated subsidiary companies in foreign countries or operate abroad using branches. Foreign subsidiaries may be either fully-owned by the parent company or partly-owned. A MNE is company and under the company law of the country in which it is incorporated it is a legal entity. This choice of legal structure will be affected by a number of factors, apart from the tax implications, include:

- Legal liability;
- Risk and control; and

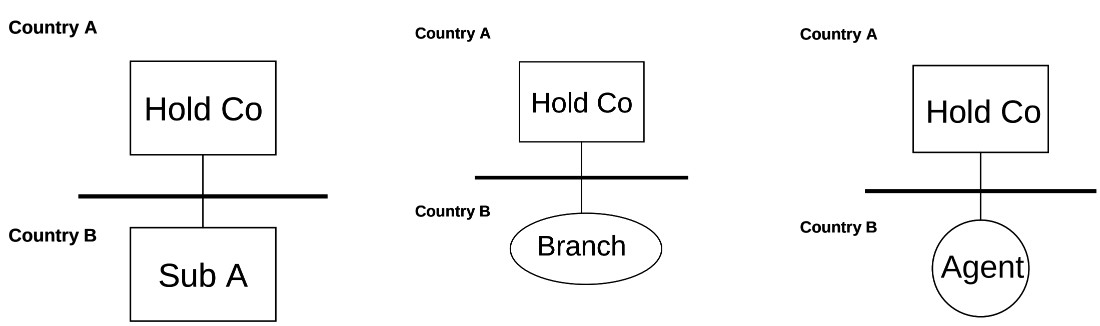
- Administrative and regulatory obligations and costs.

14. Other factors which may affect the choice of the legal form of the enterprise include:

- exchange controls;
- requirements for minimum shareholding by locals;
- administrative costs;
- extraction of profits; and
- capital requirements.

15. 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. A MNE may operate abroad using an agent, which may be an independent agent, a dependent agent or a commissionaire.

Company/Subsidiary **Branch** **Agent**



Companies and branches

16. In a MNE group, the parent company and subsidiary companies are independent legal entities and they may enter into intra-group transactions. On the other hand, an MNE with a branch abroad and the branch itself 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

17. 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 usually 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

Functional Structure

18. 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.

Divisional Structure

19. Under a divisional structure, each organisational function is grouped into a division. Each division within a divisional structure contains 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 for example be made on a geographical basis (e.g. a Chinese division or a West African division) or on a product/service basis (e.g. different products for different customers: households or companies). An automobile company may for example have a divisional structure with a division for hybrid cars and another division for other cars. Each of these divisions would have its own sales, engineering and marketing departments.

Matrix Structure

20. The matrix structure groups employees by multiple criteria. The most commonly criteria are both function and product. Alternative criteria would be function and geographic location. A matrix organisation frequently uses teams of employees to accomplish work. An example of a function-geographic matrix structure would be a company that produces two types of products (A and B) across multiple geographic locations. Using the matrix structure, this company would organise functions within the company as follows: Product A/Americas, Product B/Americas, Product A/Asia Pacific, Product B/Asia Pacific, Product A/Europe, Middle East Africa, Product B/Europe, Middle East Africa. In terms of this matrix structure a person in the Product A division in Brazil, may therefore report to the head of the global Product A division *and* the head of the Americas geographical division.

Financial Reporting

21. The MNE usually also maintains, parallel to its statutory accounts, a set of management accounts to mirror it operational structure in order to measure and report on the effectiveness of each operational unit for management purposes. Some of these divisions will for management account purposes be classified as cost centres (e.g. the HR division) whilst others will be classified as profit centres (e.g. the product/services division). It is often challenging for an MNE to attempt to segregate the corporate/statutory financial statements to align to the organisation's operational structure.

Supply Chain Analysis

22. The aim of MNEs is to maximise profits from producing goods and services. The key to business operations is to produce a profit from using resources to produce property or services of greater economic value. A useful starting point to understand how an MNE operates is by using a supply chain analysis (which will also form the basis for a functional analysis). Through its supply chain a MNE converts economic resources of lower value into economic resources of higher value. Broadly, this may involve the following steps:

1. Mapping out a generic supply chain for the industry.
2. Mapping out an MNE's supply chain.
3. Comparing the generic supply chain to the MNE's supply chain and analyse the differences which may explain why an organisation has a competitive advantage in an industry.
4. Distinguishing between what the MNE considers to be its 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 the MNE add value to the good and services it produces, which may distinguish the MNE from its competitors (i.e. a value-adding activities ("VAA")).
7. Understanding and confirming how the various functions across the supply chain are split by the MNE between the various legal entities in the group.

23. From the illustration attached below, one can see how three different MNEs could adopt different operational structures to carry out the same generic supply chain.

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

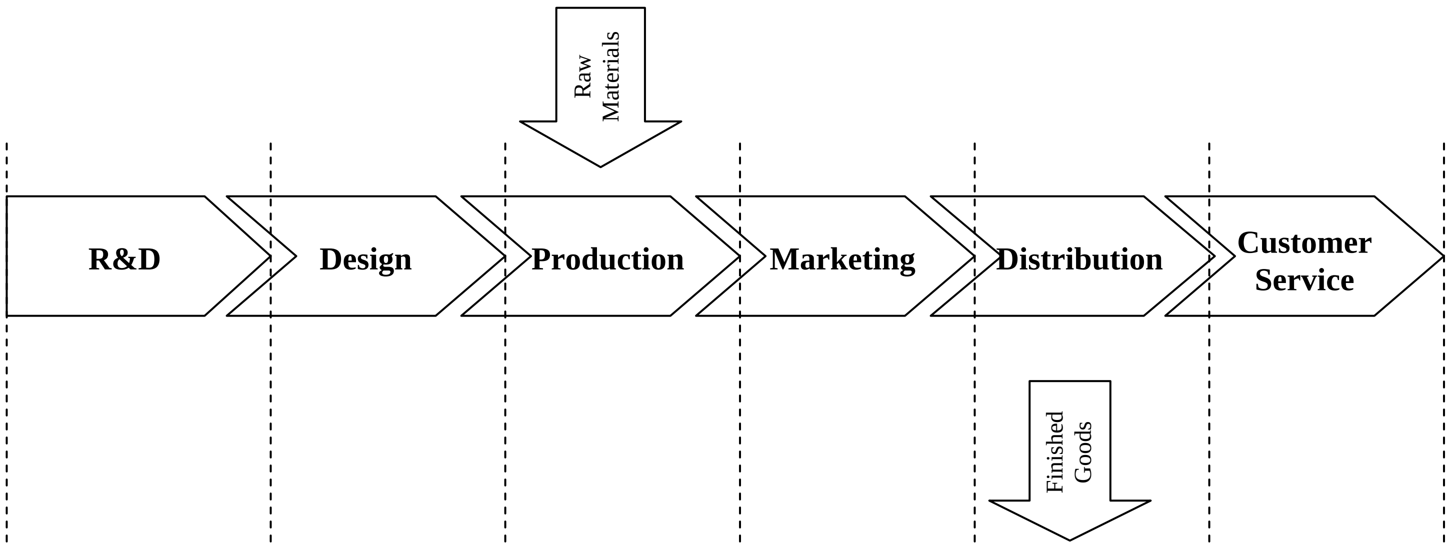
- Company 1 in Country A would typically be an R&D company carrying out R&D functions and also undertaking activities relating to the design of the products for the entire group. One would typically expect a company of this nature to employ technical personnel such as engineers, scientists, etc.
- Company 2 in Country B is a fully-fledged manufacturing company where its primary function is to manufacture products. It also performs some functions relating to the design of the products and one would generally expect these activities to be in relation to the practical application design areas of the products it manufactures as opposed to the design functions carried out by Company 1.
- Company 3 in Country C is the company in the group that is responsible for the marketing, distribution and after-sales functions within the group.

MNE Group B uses two subsidiaries which perform some of the functions across the supply chain but has also outsourced some of the activities to third parties.

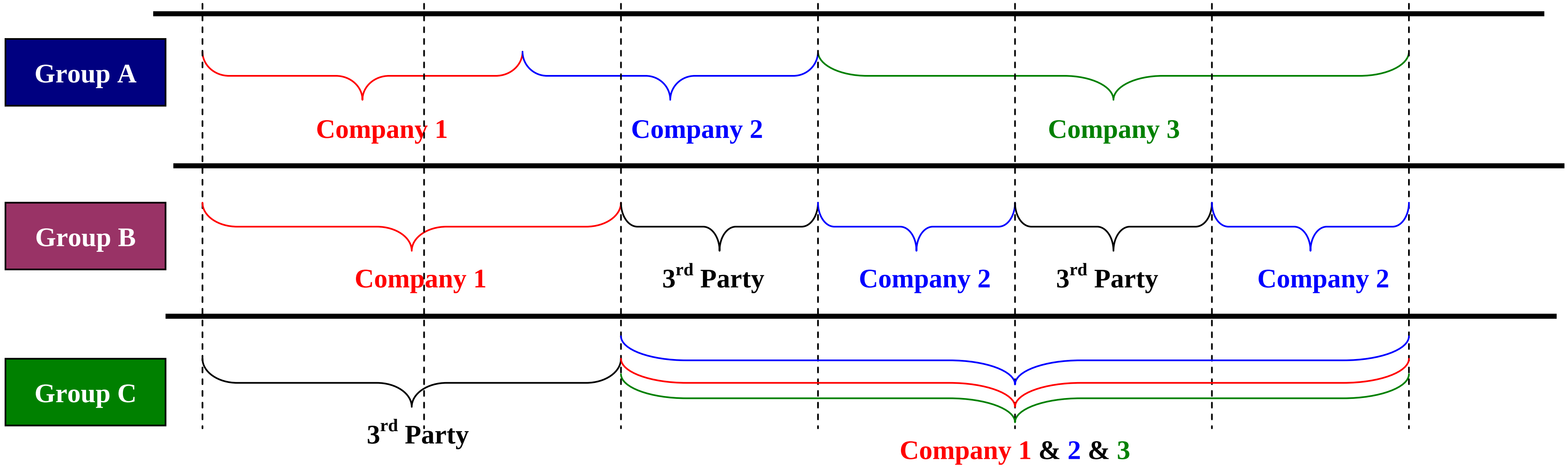
- Company 1 in Country A is a R&D company and carries out all the activities relating to the research and design of the company's products. This company is similar to Company 1 of Group A, apart from the fact that the full design function is located in Company 1 and not partly carried out by Company 2.
- Company 2 in Country B is the company in the group that is responsible for the marketing function as well as the customer service. This company is therefore the customer interface for the group.
- The MNE has decided to outsource the production and distribution functions to third party companies.

Group C uses three companies to perform the same functions in different geographical locations using intangibles developed by a third party, which would typically be used by the group under license.

SUPPLY CHAIN ANALYSIS:



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



Cost Contribution Arrangements

24. Cost contribution arrangements (CCAs) are agreements between associated enterprises in an MNE group to share the costs and risks of creating or acquiring property. There may be instances where CCAs are created between associated enterprises and third parties. CCA are also used for services that are performed in which property is not created. However, some CCAs may also involve both the creation of property and the provision of services.

25. CCAs also set out the interests of each participant in the assets or services. The key feature of CCAs is that the participants agree to share a proportionate cost of creating or acquiring an asset or providing services and accordingly, agree 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.

26. The benefits for an MNE in using a CCA include:

- exploiting economies of scale and global corporate efficiency for commonly required services;
- reducing duplication within an MNE and increasing operational effectiveness through shared activities;
- the sharing of risks among the CCA participants (which may involve such significant risks that a single associated enterprise would be unwilling or unable to bear;
- exploiting the knowledge of each participant through the sharing of know-how and best practices.

27. For example, if an MNE uses a CCA to produce intellectual property, each associated enterprise will have a proportionate interest in the IP and will be able to exploit it without paying licence fees.

The key features of CCAs are:

- having at least two participants;
- an allocation key to apportion the shared costs between the participants based on anticipated benefits; and
- each of the participants should have a reasonable expectation of benefitting from taking part in the arrangement.

28. As CCA participants agree to share a proportionate cost of creating or acquiring property or providing services, they will have a corresponding proportionate share in the property or benefit from the services. In effect, the participants are joint owners of the created or acquired property or services.

29. CCAs should list the participants and their respective interests in order to minimise the risk of disputes over the ownership of the fruits of the CCA and disputes with tax authorities. Under a CCA the legal owner of property may be one associated enterprise, but the CCA participants are the joint economic owners of the property. A feature of CCAs is that the participants must have an economic interest in the property or benefit from the services that are the subject of the CCA. In the case of property, such as intangible property, a participant must be able to exploit its economic interest in the property.

30. There are numerous types of CCAs, but CCAs are often used by MNEs for the development of intangible property in the expectation that the participants will share in the exploitation of any intangible asset that is created. A CCA may provide that the participants are allowed the exclusive right to exploit the intangible property in specific 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.

31. 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.

32. 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.

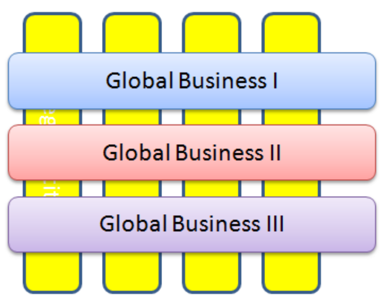
33. CCAs reflect joint venture agreements between independent enterprises. Independent enterprises enter into arrangements, such as joint ventures, to share costs for research and development with others enterprises in case the research does not result in the expected benefits. A CCA will satisfy the 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.

3. Managing the transfer pricing function in an MNE

34. 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.

35. Entities in an 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 greater when the MNE has multiple global businesses with different business models and multiple cost centers. The size of the MNE adds to the complexity.

36. 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 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 and problems, and accordingly transfer pricing risks, for MNEs. In theory, a, MNE should create a global transfer pricing policy to minimise the risk of transfer pricing risks.



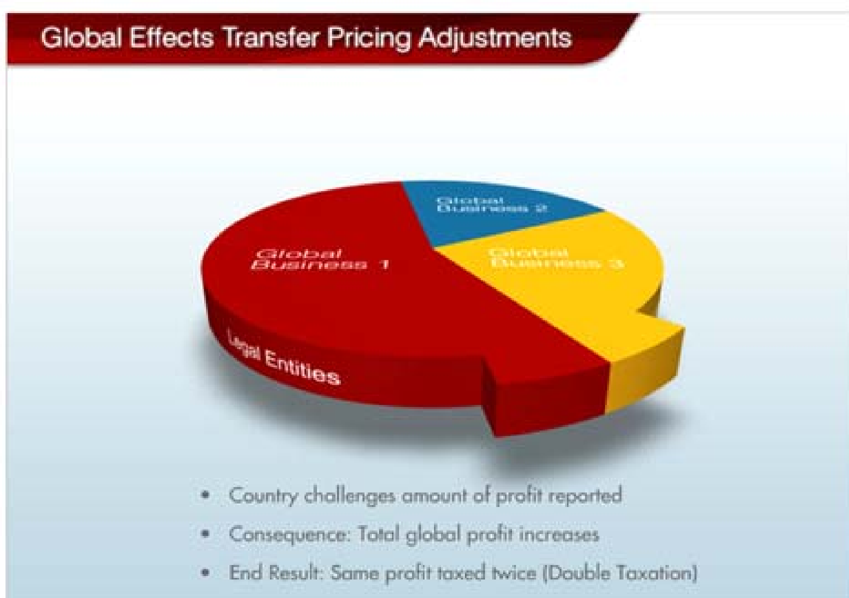
37. The allocation of the results to the various legal entities is based on the functions performed, risks assumed and assets employed. Since MNE's consist of many related companies it is very difficult to allocate the results to all the separate legal entities due to the absence of market forces. It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

38. 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 bears the risk of transfer pricing adjustments. If the income of a an associated enterprise within country A is increased as a result of a transfer pricing adjustment, it would be reasonable to expect that there would be a corresponding transfer pricing adjustment resulting is a proportionate reduction in the income of the other associated enterprise in country B, provided a consistent transfer pricing method is used by both countries.

39. But country B may use different transfer pricing methods. Consequently, if transfer prices are being 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 method and allow a corresponding transfer pricing adjustment. It is the task of the transfer pricing function within a MNE to limit risk of transfer pricing adjustments and the risk of double taxation.

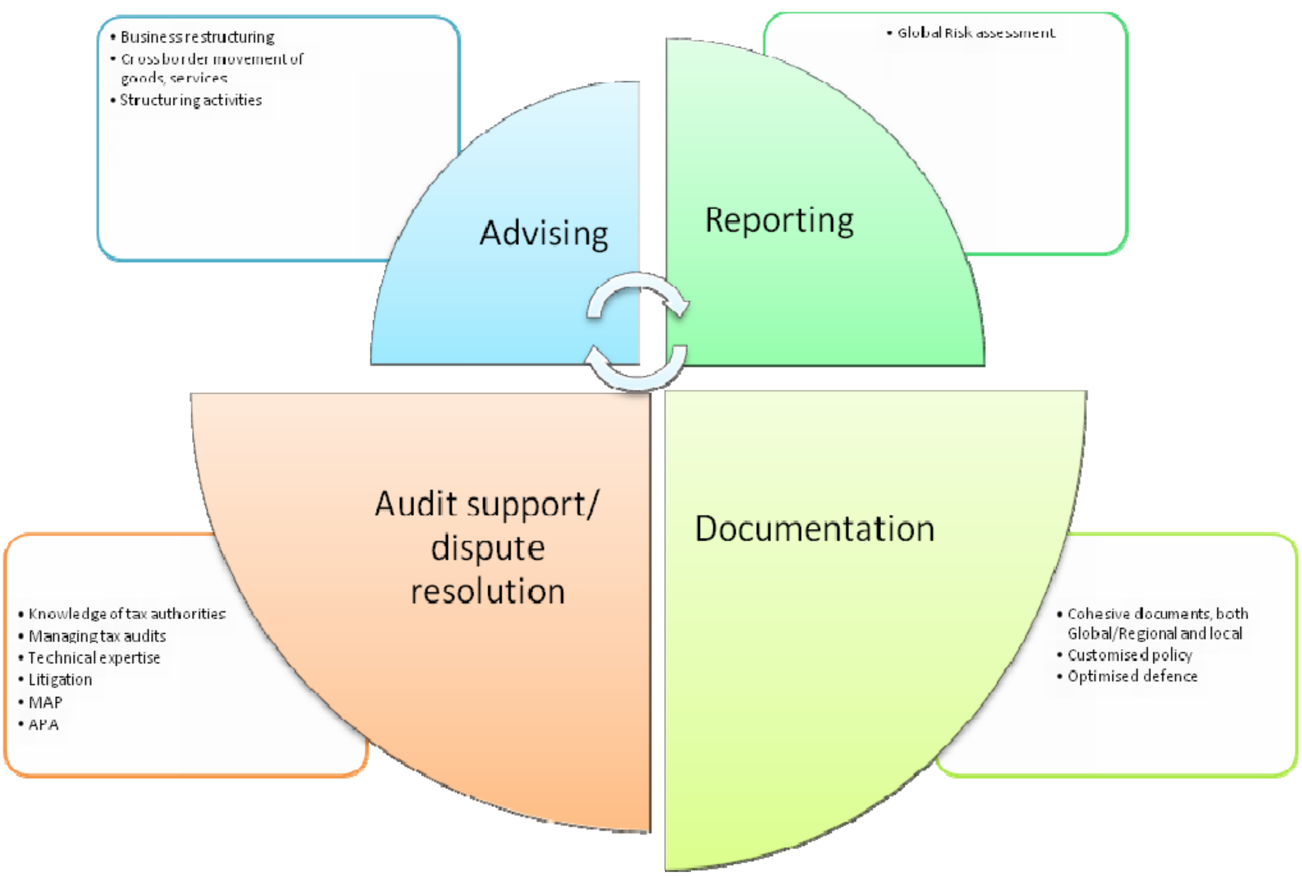
Illustration of double taxation:



40. 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.

41. 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.

The activities can be depicted as follows:



42. **Advising** 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.

43. **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 for all associated enterprises. Most MNE's therefore prepare Global/Regional documentation (Masterfiles) of the various global businesses. Subsequently, the Global/Regional reports are tailor made for local purposes based on the identified risks for each country in which the MNE operates.

44. **Audit support/dispute resolution**: Tax authorities around the world are expanding their transfer pricing capabilities and have a focus on transfer pricing issues and are often prepared to litigate when necessary. Many tax authorities around the world are focusing increasingly on transfer pricing.

45. MNE's need to find a way through increasingly detailed, complex and often conflicting local transfer pricing legislation in countries. Some countries follow guidance from international bodies, others only implement part of the guidance while others develop transfer pricing rules independently.

46. Tax authorities should not start from the assumption that MNE's are manipulating their results in order to obtain tax benefits. Many MNE's and certainly those with shares quoted on a stock exchange (listed MNEs) have published Codes of Conduct or a set of Business Principles or both. These Codes or Principles dictate that an MNE must comply with the tax rules of the countries in which they operate. Violations of these codes may result in severe consequences for a listed MNE.

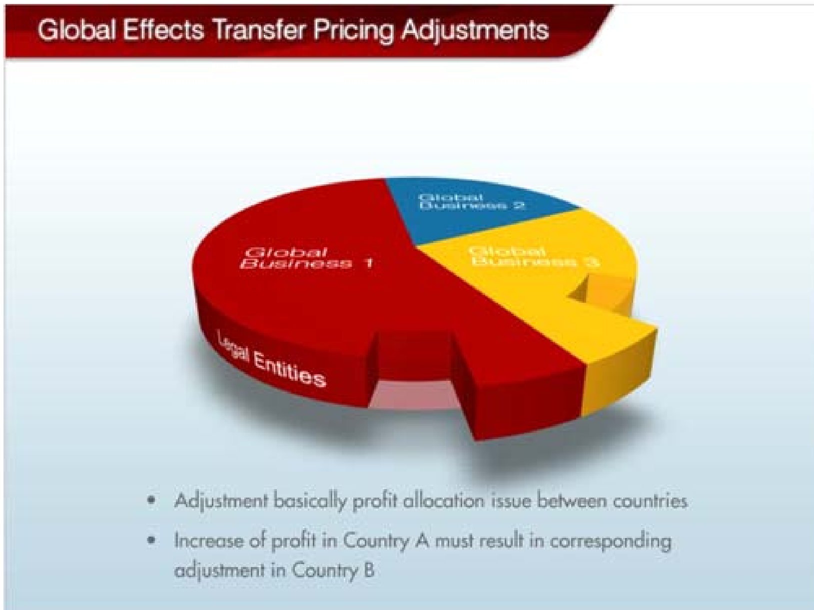
47. As transfer pricing is often referred to as an art, not a science, the resulting uncertainty creates the potential for transfer pricing disputes with tax authorities, even if the MNE is not seeking to manipulate its transfer prices. Despite the efforts MNEs invest in setting the right transfer price, preparing comprehensive documentation, there is always the risk that tax authorities disagree with the approach taken and thus there are risks of a transfer pricing adjustment. This implies uncertainty for MNE's with the possibility of a high tax burden, high costs of preparing qualifying documentation, high costs of managing tax audits and high costs of litigation. There are, however, cases where transfer prices are manipulated to reduce apparent profits in one country, while apparent profits of parts of the MNE in low or no tax jurisdictions are increased.

48. Transfer Pricing rules are considered very useful by MNE's if they are able to achieve a globally consistent approach and eliminate the risk of transfer pricing disputes. If in one country an MNE's transfer prices are adjusted, resulting in a higher taxable profit, the associated enterprise in the other country should in principle[2] receive a "corresponding adjustment", resulting in a lower taxable profit. If there is no corresponding adjustment, the MNE will suffer double taxation. In this situation, the dispute is between two authorities with the MNE seeking to have consistent transfer prices accepted by both countries.

49. 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 talk with each other to seek to resolve the issue without double taxation.

50. The following diagram illustrates transfer pricing double taxation:

[2] UN and OECD Model Double Tax Conventions, Article 9 (Associated Enterprises).


Global Effects Transfer Pricing Adjustments
Global Business 2
Global Business 1
Global Business 3
Legal Entities
• Adjustment basically profit allocation issue between countries
• Increase of profit in Country A must result in corresponding adjustment in Country B