In this article, the author describes the context surrounding the location-specific advantage debate by examining the instances and circumstances that give rise to location-specific advantages – in particular location savings and market premiums. The article further discusses how such advantages should be treated from a transfer pricing perspective, taking current approaches and views into account, as well as considering new global changes in the outsourcing industry, and the current economic environment of automation of work and digital innovations and transformations.

1. Introduction

“Continue to grow and evolve,” Mahatma Gandhi said and this philosophy may suitably apply to how transfer pricing has progressed. Globalization has on the one hand allowed markets to share substantial economic gains while at the same time exposing countries to an array of new challenges. Since as early as the 1970s, multinational enterprises (MNEs) have been taking advantage of increased globalization through delocalizing operations in low-cost labour markets.

“Location-specific advantages” (LSAs) is the umbrella term predominantly used in the literature to describe specific or unique market features gained by MNEs. By exploiting price differentials between two countries and/or other advantages in a specific geographical market, MNEs may experience improved financial outcomes resulting in disagreements over the place and scope of value-creating activities. The debate is ultimately motivated by the search for a fair compensation between group members and hence for the most appropriate and sustainable dispersion of group profits.

The main objective of this article is to analyse the potential and real occasions which may give rise to a location saving and/or market premium. It will outline how location savings and market premiums should be treated from a transfer pricing perspective, whilst taking into account the current economic environment of the automation of work, digital innovations and transformations. For this purpose, the article starts by setting the context in which MNEs operate and by providing an overview of the global outsourcing industry (with a focus on the financial services’ industry). It further summarizes the views of the OECD, the United Nations and some country approaches with respect to the aforementioned sub-concepts. The conclusion will outline how best to achieve a fair treatment and apportionment of location savings and market premiums, including ways to overcome challenges in this respect.

Unlike the 1970s, when the LSA concept was exclusively discussed in the context of labour-intensive manufacturing, today LSAs are discussed across all sectors, in particular in the service sector given its high proportion of human intervention.

Due to highly dynamic business environments, MNEs are prompted to reconsider their global supply chain at regular intervals. Drivers are multiple cost considerations, evolving industry structure, market trends, competition, and geo-political and geo-economical dynamics, to name but a few. However, businesses are highly dependent on markets, which play an indispensable role in the success of MNEs.

LSAs can manifest themselves in various forms, which often leads to transfer pricing discussions with respect to their identification, quantification and about the attribution of the derived benefits. These discussions in particular show that developing countries are claiming substantial cost savings and identifying the increased degree of complexity for outsourced functions.

The call for addressing the issue of LSAs in transfer pricing matters and the aim for a consensus approach have increased recently in particular in emerging economies of the BRICS. Specifically, China and India who have a significant interest in the way transfer pricing rules are applied, are leading this debate.

---


2. Examples include lower costs, unique market qualities that result in market premiums, availability of infrastructure, skilled labour and government incentives.

3. The BRICS consists of five countries, being Brazil, Russia, India, China and South Africa.

2. The Context Surrounding the LSA Debate

2.1. The role of the industry analysis

Firstly, the industry analysis is an important factor in providing context for transfer prices. The OECD recommends that an industry analysis be prepared when providing context for the controlled transaction(s) under review. Such analysis defines the industry within which MNEs operate, in terms of products, structure, value drivers and competitors. It identifies the influences on forming industry prices and profitability, and determines the business risks faced.

The industry analysis provides therefore the context for the evaluation of MNEs’ competitive strengths through a determination of what are the critical success factors. Moreover, the economic conditions of demand and supply are examined in order to understand how prices are determined. The prevailing structure of the market and competitive conditions within the industry will substantially have an impact on the business environment in which MNEs operate.

The conclusions established throughout the industry analysis are therefore crucial when discussing location savings and other LSAs. These conclusions determine if qualities linked to a specific domestic market create competitive advantages for MNEs or are vital to the business of MNEs and how critical they are.6

2.2. The global outsourcing industry7

Outsourcing has become a key strategic tool for companies across all industries to stay ahead of the competition. In addition, stringent regulatory and compliance requirements, particularly in the financial services industry, pose a challenge and increase operational costs. Consequentially, business models are redefined to overcome this pressure and achieve efficiencies at minimal costs. Hence, outsourcing enables companies to manage their revenue growth by controlling the higher operational costs caused by additional requirements and potential profit margins declines.9

In the financial services sector, labour arbitrage is regarded as one of the major benefits of outsourcing business processes. Furthermore, the geographic location of countries, such as India, offers time zone advantages by providing 24x7 professional support allowing projects to be delivered with less turnaround time.

2.3. Main outsourcing destinations10

In 2015, one of the key outsourcing destinations for the financial services sector was North America. In particular, the continuous regulatory and economic volatility challenges constrained financial institutions to outsource their business processes whilst keeping operational costs low. This is in contrast to Latin America where Mexico is ranked as a top outsourcing destination due to its geographic proximity, cultural understanding and similar time zones to the United States.

The EMEA market growth is also driven by the increasing pressure to improve operational efficiencies. The United Kingdom has emerged as an insurance and capital BPO destination due to its close proximity to European and US clients.

In APAC, factors such as the availability of a large talent pool and high-quality service offerings at affordable costs, have propelled the market to grow. ITO and BPO operations are highly prevalent but BPO destinations are now moving from mature markets like India, China and the Philippines to countries such as Thailand and Indonesia. In the past 3 years, traditional outsourcing destinations like Brazil, Russia, India and China have experienced an economic slowdown, leading to the emergence of alternative outsourcing destinations such as Sri Lanka and Colombia.

2.4. New trends16

The more complex, knowledge-based processes have substantially increased since 2013. Nonetheless, robotic process automation (RPA) is a rapidly emerging technology that will fundamentally change the dynamics in the global outsourcing industry by replacing human skills...
and judgement in routine and labour-intensive tasks but also in more complex, knowledge-based processes.\textsuperscript{18}

The automation of work through artificial intelligence will rapidly reduce the need for manpower, leading to a significant shift in the competitiveness of countries and cities. The financial services industry already successfully digitizes manual processes without having to replace or modify existing software. It is expected that more than half of the workforce in the IT/BPO sector in leading outsourcing locations will become obsolete in the coming years.\textsuperscript{19}

While cost considerations remain a priority, MNEs increasingly look for proximity to existing operations or headquarters. This tendency will undoubtedly add to the reshape of the outsourcing landscape, potentially leading to "repatriation" to the home country, centralization or relocations to countries welcoming foreign direct investment and/or that are culturally closer to the MNE’s home country.\textsuperscript{20}

### 3. The Concept of LSAs

#### 3.1. Preliminary remarks

There is no common or consistent definition for LSAs, nor is there consensus on concept except for the appreciation that markets play a dominant role in the business life of MNEs.

The doctrine and part of the transfer pricing guidance\textsuperscript{21} divide LSAs\textsuperscript{22} into two sub-terms: location savings and other local/market-specific benefits.\textsuperscript{23} It should be noted that different LSAs can be present in the same location.\textsuperscript{24} Consequently, the concept is primarily defined based on an assessment of all the relevant facts and circumstances in a specific domestic market\textsuperscript{25} that require consideration from a business, social, political and economic perspective. A common understanding of this concept and its sub-terms is, however, essential in order to reach satisfactory conclusions in the context of transfer pricing.\textsuperscript{26}

---

\textsuperscript{18} Deloitte, supra n. 16: According to the report, over 50% of the survey respondents indicated that they are actively exploring RPA activities.


\textsuperscript{20} C. Peng, A Rethink of Location-Specific Advantages with an Analysis of the Chinese Approach, 24 Intl. Transfer Pricing J. 6, p. 482 (2017), Journal Articles & Papers IBFD.

\textsuperscript{21} UN Manual (2017), supra n. 6, at para. B.2.3.2.3.


\textsuperscript{23} Examples of local/market-specific benefits include a growing local market, large consumer base with increased consumer purchasing power or market premiums. The concept is broadened to embrace any financial outcome improvement for MNEs as a result of benefitting from favourable conditions (features) in a specific market. See Peng, supra n. 20, at p. 484.


\textsuperscript{25} OECD Guidelines (2017), supra n. 5, at para. 1.1.46.

\textsuperscript{26} J.S. Wilkie, Intangibles and Location Benefits (Customer Base), 68 Bull. Intl. Taxn. 6/7 (special issue), p. 353 (2014), Journal Articles & Papers IBFD.

---

### 3.2. Definitions

#### 3.2.1. Location savings

"Location savings" are cost reductions achieved through the relocation of functions and/or operations from a "high-cost" to a "low-cost" country in order to take advantage of the differences in production costs. Cost savings can include labour, raw materials, rent, transportation and infrastructure.\textsuperscript{27} Any expense that may be incurred in re-establishing the operation in the host low-cost country (dis-savings\textsuperscript{28}) should be subtracted in order to estimate the "true" location saving.

Location savings can therefore be broadly defined as cost arbitrage or the net cost savings realized by MNEs when exploiting the differentials between a high-cost and a low-cost country.\textsuperscript{29} It is therefore exclusively a cost-related LSA.\textsuperscript{30} This part of the concept is more straightforward and thus less controversial from a delineation perspective.

#### 3.2.2. Market premiums

"Market premium" is one of the multiple market-specific attributes regrouping any revenue-enhancing feature offered by a specific location. It deals with the concept of location rent, which represents the monetization of such advantages. "Market premium" can therefore be clearly distinguished from "location savings" but its features remain hard to clearly establish, which makes it a highly elusive concept.

The term "market premium" is an evolving notion. It is strongly linked to market dynamics such as market size, accessibility and consumer or cultural behaviour. It considers relevant conditions in a specific market or unique qualities that may influence the demand\textsuperscript{31} for a certain product or service and not only in case functions and activities are being relocated. Examples of market premiums include consumer preferences, purchasing power (of local consumers), amount of potential local consumers and scarcity in the supply of similar products/services. These demand-sided or consumer behaviour-based factors may create the opportunity for MNEs to demand higher prices (i.e. a premium) which would result in short-term incremental profits for MNEs.

Some of the market premium features may be inherent to the local environment that may require little or no local intervention to result in revenue enhancement for MNEs. These are rather a direct consequence of intangibles (branding and other reputational features) of MNEs.

---

\textsuperscript{27} UN Manual (2017), supra n. 6, at para. D.2.4.4.3; OECD Guidelines (2017), supra n. 5, at para. 9.126.

\textsuperscript{28} Such market disadvantages can consist of costs related to the training of staff in the host country, adjustment for (initial) efficiency differences leading to reduced productivity, difference in capital costs due to factors that increase the risk of investment, costs linked to an adverse business environment, higher logistics and transportation costs in a less developed country, higher quality control and technical support costs, etc.


\textsuperscript{30} Peng, supra n. 20, at p. 484.

\textsuperscript{31} Peng, supra n. 20, at p. 484. The article distinguishes between LSAs of cost and supply, such as location savings, and LSAs of market and demand, such as market premium.
and their products or services. Other features can be the unique ability of the local subsidiary to convert its market into profitability for MNEs through increased market opportunities.\textsuperscript{32} In view of a pertinent allocation of potential location rents, it seems crucial to distinguish between price premiums resulting undeniably from market dynamics and those arising from the endeavours of local affiliates.\textsuperscript{33}

4. Quantification and Attribution of LSAs

4.1. Preliminary remarks

It is generally recognized that LSAs may under certain circumstances affect arm’s length transfer pricing. In scenarios where incremental profits materialize from LSAs, the ultimate question from a transfer pricing perspective is which country should be entitled to tax these additional profits.

For such scenarios, which potentially translate into LSAs, and which require further considerations due to lack of appropriate comparables, challenges emerge. These challenges seek to quantify the relevant net benefit and to appropriately allocate the relevant location savings or location rents (i.e. market premiums). Several analytical and economic tools, such as comparable uncontrolled price data, the value chain analysis, the bargaining strengths and other profit drivers,\textsuperscript{34} may provide some answers in this respect.

4.2. Quantification of LSAs

At first glance, location savings are rather straightforward to compute, as they constitute the net cost savings on a consolidated basis obtained through differences in the factors of production.\textsuperscript{35} With respect to market premiums, the relevant element requiring consideration is the incremental profit achieved from operating in a specific location offering unique conditions that allow MNEs to demand premium prices.

However, the computed net location saving may still not lead to a benefit for MNEs e.g. in a perfectly competitive market. The aim for lower costs may be driven by other market dynamics which require MNEs to re-position themselves in order to ensure business continuity and passing on any savings directly to the third-party supplier.\textsuperscript{36} This is particularly true for the financial services sector.\textsuperscript{37} Likewise, in the case of market premiums, the opportunity itself may not necessarily lead to additional profits. For instance, in a competitive environment, benefits may immediately or after a short period of time shift to third-party suppliers through high purchasing prices.\textsuperscript{38} It should also be noted that any profit derived from location savings or market premiums is typically only of a temporary nature.\textsuperscript{39}

4.3. Allocation of LSAs

4.3.1. The application of the bargaining power theory to LSAs

The aim with respect to location savings and market premiums is to identify the appropriate profitability level to be earned by the local subsidiary in a specific market. The “relative bargaining power” is widely proposed as the solution to identify the contributors and thus beneficiaries of benefits resulting from LSAs.\textsuperscript{40} Also in the international jurisprudence, courts have generally emphasized the important role of the parties’ bargaining power and their market position when determining the tax treatment of LSAs\textsuperscript{41} allocating the profits generated by LSAs to the party with the strongest bargaining position.

The logic behind considering the bargaining positions as a key element when determining the allocation of LSAs is to simply apply the core of the arm’s length principle that simulates how independent enterprises would interact in comparable transactions. This fiction is broadly considered a neutral and useful tool to ultimately determine the relevance of LSAs in the pricing of a specific transaction.\textsuperscript{42}

The way a location specific advantage may affect the compensation depends strongly on the realistic alternatives available to the parties involved, their access to the market and the market characteristics (i.e. relative competitive position). The bargaining power is further determined by factors such as intangibles held by the parties\textsuperscript{43} and

\textsuperscript{32} Wilkie, supra n. 26, at p. 357. This unique ability may even have an enriching effect outside the local territory.

\textsuperscript{33} Peng, supra n. 20, at p. 484.

\textsuperscript{34} Peng, supra n. 20, at pp. 485-488. The author proposes the OLI paradigm – a combination of the ownership (firm-specific) advantage, the location/country-specific advantage and the internalization advantage (implicit support and group synergies) – developed by J.H. Dunning, suggesting to account for all three advantages when analysing LSAs. The author further suggests the LSA matrix – which considers and weights the degree of competition in the market and the opportunity to access LSAs in the low-cost country – in order to determine if LSAs transform into extra profits. See also Gonnet, Fris & Coriano, supra n. 24, at p. 6.

\textsuperscript{35} See also OECD Guidelines (2017), supra n. 5, at ch. III. 2. A for the definition of location savings.

\textsuperscript{36} This is typically the case when LSAs are generally accessible and the market is highly competitive.

\textsuperscript{37} See OECD Guidelines (2017), supra n. 5, at ch. II.2.

\textsuperscript{38} Peng, supra n. 20, at p. 486.

\textsuperscript{39} The LSAs typically last as long as a competitive advantage can be maintained in a specific market and decline gradually when the market or competitive equilibrium is reached.

\textsuperscript{40} Gonnet, Fris & Coriano, supra n. 24, at p. 6; S. N. Allen et al., Location Savings - A US Perspective, 11 Intl. Transfer Pricing J. 4, pp. 158-164 (2004), Journal Articles & Papers IBFD; see also UN Manual (2017), supra n. 6, at paras. 2.3.2.55-R 2.3.2.57.


\textsuperscript{42} UN Manual (2017), supra n. 6, at paras. B.2.3.2.56 and B.2.3.2.57.

\textsuperscript{43} Generally, the intangible-owning company has a relatively stronger bargaining position compared to the party that does not own the intangible, assigning often all or most of the LSAs to the owner of the intangibles as opposed to its counterparty. See also Allen et al., supra n. 40, at p. 162, referring to a monopoly power created by the ownership of intangibles and the necessity to evaluate the degree of power conveyed by the economic ownership of intangibles.
the degree of entrepreneurial risk borne by each party. Premium profits are often an effect of intangibles such as brands or product innovation. Typically, in a highly competitive market it is expected that the LSAs are not assigned to the local subsidiary. Under different circumstances, when a company is the only supplier meeting the demand or has exclusive access to the unique market characteristic(s), its stronger bargaining power will have an effect on the pricing.

4.3.2. Market premiums and intangibles

In order to appropriately identify, quantify and apportion extra profits resulting from market premiums, it is essential to distinguish incremental profit derived through local market features from the return on intangibles. Unlike intangibles, companies present in a certain market can in principle access those country specific advantages. It is commonly recognized that market characteristics are attributes originating from external environmental factors and not intangibles, which per se can be owned or controlled for their own use in a business activity and have a commercial value. On the other hand, unique market circumstances are not transferable and therefore cannot be elements of commercial transactions. Also, the UN differentiates between a trade intangible, a marketing intangible and the unique characteristics in a given market reconfirming that the latter are not intangibles. Unique intangibles – which justify a premium price – are rarely owned by MNEs' subsidiaries in a low-cost or developing country. The contribution of a local subsidiary in a high bargaining power in the domestic market potentially disrupting the market dynamics and ultimately influencing how prices are set. Such disrupting factors can include protection from competition or exclusive access to location benefits, resulting in a high bargaining power in the domestic market and potentially leading to the allocation of LSAs to the local affiliate.

If no comparables are identified and LSAs are indeed retained and not passed on, their allocation can only be determined by hypothesizing the commercial behaviour of independent parties in comparable circumstances based on their respective bargaining power and taking into account their contribution reasonably attributable to the benefits resulting from the LSA.

Although the application of the CUP method is generally preferred, as it represents the most direct method to apportion extra profits, in practice, a CUP is currently

4.3.3. LSAs under different transfer pricing methods

4.3.3.1. The comparable uncontrolled price method

In the comparable uncontrolled price (CUP) method, the core of the transfer pricing principles is applied. The CUP is a means to analyse whether the net saving or premium element is already embedded in the pricing of a local comparable company, assuming such reliable local market comparables are available. If no comparables are identified and LSAs are indeed retained and not passed on, their allocation can only be determined by hypothesizing the commercial behaviour of independent parties in comparable circumstances based on their respective bargaining power and taking into account their contribution reasonably attributable to the benefits resulting from the LSA.

Although the application of the CUP method is generally preferred, as it represents the most direct method to apportion extra profits, in practice, a CUP is currently
often illusory\textsuperscript{62} – in particular the OECD\textsuperscript{63} and UN\textsuperscript{64} have highlighted this for developing countries. The number of sizeable independent companies mainly supports this conclusion. However, the number of independent companies is likely to increase and therefore comparable data (if collated) may become more and more available as economies evolve in developing countries.\textsuperscript{65}

4.3.3.2. The transactional net margin method

Under the TNMM,\textsuperscript{66} the net margin to be compared is determined on the basis of either the revenue or costs as the net profit indicator. Thus, if location savings or market premiums are present, adjustments may be required on those factors. These adjustments occur either by intervening on the cost base for the calculation of the markup or by adjusting the percentage of the revenue-dependent compensation in order to allocate location savings or rents in proportion to the bargaining power.

The current limited availability of genuine comparables raises in principle similar issues for the TNMM.\textsuperscript{67} However, where comparables are available, this method is particularly appropriate when activities do not involve the development or enhancement of high-value intangibles.

The increasing degree of complexities in the outsourced functions and the claim for appropriate compensation for the access to a wide and receptive consumer base have incited tax administrations in emerging markets to take more aggressive positions.\textsuperscript{68} It is therefore appropriate that alternative methods are considered, such as the profit split method.\textsuperscript{69}

4.3.3.3. The profit split method

This method is typically used to allocate the location rents by assessing the respective contribution of each party in relation to the incremental profit resulting from the LSAs.

In order to conclude on an arm’s length apportionment of benefits arising from LSAs, the nature of the controlled transaction must be rigorously examined based on the economically relevant characteristics such as contractual terms, functions/assets/risk (FAR), the nature of the product or service, the market’s economic circumstances and the business strategies pursued by the MNE.\textsuperscript{70} Further elements such as key decision-making functions within processes that drive business profitability and other value-driving elements will potentially play a dominant role in the future.\textsuperscript{71}

It is generally expected that tax authorities will increasingly try to identify situations for which the profit split method is the most appropriate.\textsuperscript{72} However, to date, the application of this method lacks consensus on concrete allocation keys and weighting criteria. The judgment required still leads to unpredictable ad-hoc approaches.\textsuperscript{73} The reliance on subjective judgements will further increase uncertainty for taxpayers and lead to more unsolvable disputes between MNEs and tax administrations.

4.3.4. Further considerations

4.3.4.1. Availability of comparability data

It is important to distinguish between circumstances where independent comparable transactions cannot be identified and situations where comparables exist but the relevant data is not public or gathered due to the absence of statutory obligations for companies to file financial statements. In this context, it has been suggested to encourage developing countries to introduce requirements for filing accounts and make these available publicly, as is the situation in most of the developed countries.\textsuperscript{74}

As proposed by the OECD,\textsuperscript{75} if direct comparable data is not available within a specific country, comparable data may be available if combined with data from similar economies. Furthermore, alternative approaches such as benchmarking against other industries in the same geographical market, use of sector averages and consolidated global returns, usage of wider ranges, and the possibility to use the foreign counterparty or counterparty in the home country as the tested party\textsuperscript{76} have also been proposed.

\begin{itemize}
  \item \textsuperscript{62} Furthermore, in most cases, this method requires substantial adjustments in order to approach similar economic circumstances.
  \item \textsuperscript{64} See also Deloitte Comments, supra n. 62, at paras. D.1.8.11, B.1.10.6 and D.2.4.3.
  \item \textsuperscript{66} Transactional net margin method or comparable profit method.
  \item \textsuperscript{67} UN \textit{Manual} (2017), supra n. 6, at paras. B.1.8.11, B.1.10.6 and D.2.4.3.
  \item \textsuperscript{69} In order to conclude on an arm’s length apportionment of benefits arising from LSAs, the nature of the controlled transaction must be rigorously examined based on the economically relevant characteristics such as contractual terms, functions/assets/risk (FAR), the nature of the product or service, the market’s economic circumstances and the business strategies pursued by the MNE.
  \item \textsuperscript{70} Further elements such as key decision-making functions within processes that drive business profitability and other value-driving elements will potentially play a dominant role in the future.
  \item \textsuperscript{71} It is generally expected that tax authorities will increasingly try to identify situations for which the profit split method is the most appropriate. However, to date, the application of this method lacks consensus on concrete allocation keys and weighting criteria. The judgment required still leads to unpredictable ad-hoc approaches. The reliance on subjective judgements will further increase uncertainty for taxpayers and lead to more unsolvable disputes between MNEs and tax administrations.
  \item \textsuperscript{72} As proposed by the OECD, if direct comparable data is not available within a specific country, comparable data may be available if combined with data from similar economies. Furthermore, alternative approaches such as benchmarking against other industries in the same geographical market, use of sector averages and consolidated global returns, usage of wider ranges, and the possibility to use the foreign counterparty or counterparty in the home country as the tested party have also been proposed.
  \item \textsuperscript{73} As identified by the OECD, the possibility of using the foreign counterparty may pose some challenges as its operation may include functions of a more complex nature and there may be difficulties in obtain-
4.3.4.2. Alignment with value creation

The OECD’s BEPS Project aims at aligning the profits with value creation. It may therefore be argued that this premise should also apply to location savings and market premiums. Similar to the general assessment of value-creating contributions, determining the value associated in particular with market premiums requires an assessment of quality, which does not come without any difficulties. The problem with dissociating value creation from economic activity is that value creation is difficult to define and remains therefore a vague standard. In particular in the service industry, the shift from the traditional delivery methods to digital options allows value to flow freely across multiple jurisdictions without requiring local intervention. An approach based on economic activities may therefore lead to a less controversial outcome on where value is created.

5. Current Approaches and Views

5.1. The US, OECD and UN views

Initial considerations on the issue of location savings were given by the United States already in the 1990s. At that time, the Internal Revenue Service (IRS) recognized within its regulations that adjustments may be required to account for significant cost differences attributable to a geographic location and that these adjustments must be based on the bargaining power of the affiliated companies.

The OECD began in 2010 to address location savings. These were discussed in the context of business structurings and focused solely on the differences in the cost base. It is only recently in the context of intangibles that the OECD widened the scope of the concept to include other local market features by introducing amendments to chapter I in its 2017 Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. Also, its revised guidance on the application of the transactional profit split method does not bring much further clarification on this matter other than a reiteration of the view that the allocation of location savings should occur in the same manner in which independent parties would allocate such retained savings.

Overall, the OECD limits itself to proposing a high-level four-step approach. This step approach starts with the identification and quantification of LSAs and continues with an assessment of the extent to which LSAs are passed on to third-party clients or suppliers, concluding with the allocation of LSAs based on the arm’s length principle. It does not, however, provide a clear definition of the concept, nor does it articulate detailed guidance.

Nevertheless, the OECD emphasizes that the evaluation of an MNE’s competitive strengths in the specific market and business environment in which it operates is a crucial element in discussing location savings or other market features. The OECD sets out that if suitable comparables are identified, no adjustment for considerations of the geographic market would be required, as LSAs are already accounted for.

The UN addresses LSAs in various sections of its 2017 Manual on transfer pricing for developing countries (UN Manual), adopting an approach that is widely in line with the OECD. It discusses potential issues related to the geographic market primarily under the comparability analysis and in particular acknowledges that LSAs may have an influence on the profitability of MNEs and therefore require due consideration when the arm’s length outcome is being assessed. The UN also adopts the concept of “location rent” to describe profits resulting from LSAs.

Similar as the OECD, the UN further refers to the importance of bargaining power when identifying the realistic alternatives available to associated parties. Finally, China and India have provided their positions and approaches on issues related to LSAs in part D of the UN Manual.

5.2. Selected countries’ views

5.2.1. Preliminary remarks

Little guidance is provided in domestic transfer pricing regulations and court rulings on LSAs. Only China explicitly addresses the LSAs concept in its domestic law and, as mentioned in section 5.1., China and India are the only two countries that have contributed their views to the UN Manual.

LSAs have also been a topic of discussion in other countries, however, Vietnam, for instance, recently introduced
the concept of LSAs in its legislation.93 These new guidelines contain detailed transfer pricing regulations but do not provide for the determination, quantification and allocation of location savings or local market premiums. Vietnam only requires LSAs to be taken into account in comparability analysis and in case of material adjustments.94 Similarly, Indonesia has identified and considered LSAs by referring to both production cost advantages and market share advantages (market premiums), but has not issued its position in this respect or any guidance.95

5.2.2. China

China’s introduction of the LSA concept goes back to 200896 and since then it has put significant emphasis and expressed its views assertively on the topic97 in various self-statements. The Chinese STA98 has, for instance, been deeply involved in the development of the UN Manual and has contributed to the country practices section of that document.99 In the present-day debate about the tax treatment of LSAs, China’s approach in the application of its transfer pricing rules tends to deviate in practice from the general transfer pricing principles as provided by the OECD even with the current trends in the post-BEPS environment.100 China’s distancing itself from some of those general principles is mainly based on a conviction that location savings and market premiums arise more frequently in China101 and other developing countries102 than in developed economies. China further argues that these economies are subject to a set of challenges that are not addressed in a manner to provide proper solutions with regard to the special characteristics of developed countries.103 In particular, it mentions the lack of appropriate comparables as a main concern when addressing the tax treatment of LSAs.104 Even so, to conform to the arm’s length principle, China proposes notably a four-step approach,105 which, if at first glance, appears similar to the OECD Guidelines approach.106 But looking a bit deeper into it by examining the examples from the STA in the UN manual, various differences in the practical implementation soon emerge.107

As regards location savings, China takes the position that the Chinese affiliate must be remunerated based on an average cost base considering the (higher) costs of foreign comparables and the lower costs of the Chinese affiliate. The result is that part of the location savings is allocated to China through an adjustment of the cost base. However, in practice, this has led to an alteration of the cost base to the level of the associated company in the high-cost country.108 Under this solution, the bargaining position of the affiliated companies and other relevant facts and circumstances are in essence disregarded.109 Overall, the STA omits to justify why a portion of the location savings should accrue to the Chinese affiliate.110

With regard to market premiums, China does not consider the concept only in the context of the unique features related to a product or service, but adopts a wider view adding any feature related to the Chinese market.111 It has identified multiple cases of market premiums112 such as its large population with growing spending capacity, the Chinese consumers’ general preference for foreign brands and shortage in the supply of some domestic goods or limited market access, which may lead to extra profits. By linking this unique potential of the Chinese domestic market to the additional profit derived by MNEs operating in China, the STA attributes all or partial additional profit by virtue of the existence of the unique features to the Chinese affiliate, even if these profits arise in other countries.113 By default, the STA assumes Chinese affiliates undertake local endeavours such as local promo-

---

93. VN: Circular 41/2017/TT-BTC was released by the Ministry of Finance on 22 June 2017 and aims at providing further guidance on the application of transfer pricing Decree 20/2017/ND-CP which had fundamentally changed the transfer pricing requirements for taxpayers in Vietnam. The Decree as well as the Circular are effective since 1 May 2017.


96. UN Manual (2017), supra n. 6, at para. D.2.2.5: Introduction of a comprehensive anti-avoidance regime into the legislation (including transfer pricing articles) through the “Special Tax Adjustment” provision in ch. 6 of the Enterprise Income Tax Law and its Implementation Regulation; Peng, supra n. 20, at p. 492.


98. It is also to note that under Bulletin (2016) No. 42, specific documentation of the role of LSAs is a required component of the local file. Under Bulletin (2016) No. 64, the role of LSAs is also a required topic to be addressed in APA applications.

99. As of 2019, the official name of the Chinese tax administration has been changed from State Administration of Taxation (SAT) to State Taxation Administration (STA).


101. P.T. Nguyen & B.N. Du, supra n. 6, at para. D.2.4.4.2 and D.2.5.2.

102. UN Manual (2017), supra n. 6, at paras. D.2.4.4.2 and D.2.5.2.
tion or marketing activities. Hence, it concludes that by means of local endeavours, the Chinese affiliate adds value to the original intangible and, as a result, this value-creating factor should be adequately compensated.

This position assumes that the extra profit originates by default from a “value” contributed by the Chinese economy and hence the additional realized profit should be taxed in China.

5.2.3. India

While Indian transfer pricing guidelines do not provide for any direction on the issue, same as the Chinese STA, the Indian tax administration has provided its concise view on LSAs in the UN Transfer Pricing Manual. It asserts that India not only provides location savings but also other LSAs such as a highly skilled workforce, access and proximity to a large and growing market, a large customer base with increased purchasing power and market premiums.

India’s approach builds in essence on the view provided by the UN and is in principle supportive of the concept that where truly local market comparables are available, a specific adjustment for location savings is not required. This approach is also reflected in various Indian court cases. Where reliable local comparables are not available, the Indian tax authorities consider the FAR analysis together with the bargaining power of the parties involved. Factors such as the competitive market environment and bargaining power were also considered in the cited Watson Pharma case. The court decision here evidently recognized that location savings could not be determined based on a comparison between actual costs in the low-cost country and notional costs in the high-cost country.

6. Conclusion

The common perception is that low-cost countries are allocated a lower profit than comparable subsidiaries in higher-cost countries even when a similar or the same markup is applied to the different cost bases if no further logic is used. With respect to market premiums, the allocation discussions are based on the idea that inherent characteristics of or arising from a market have a price tag and the country “owning” such unique features should thus be compensated.

The discussions surrounding the allocation of benefits resulting from LSAs are therefore primarily a culmination of profoundly diverging interests between taxpayers and countries. Furthermore, perspectives may also diverge between developed countries and emerging economies. There are calls for more consideration to the LSAs, which are heavily politicized and rarely supported by quantitative economic analysis.

The attribution of a certain value to LSAs is not per se in contradiction with the arm’s length principle. A tiered approach or arm’s length override in favour of developing economies may however have an influence on MNEs’ decisions to invest in a certain country, in particular in the services industry where functions are highly mobile.

A commonly accepted solution can only be based on a sound observation and analysis of the economic and political circumstances in a specific geographic market and the interaction between the relevant industry and the markets in which MNEs operate. This requires drilling down to it has been held that once the TNMM is accepted as benchmarking method, then any benefit accruing to an affiliate on account of an LSA is irrelevant, if the profit level indicator is within the range of comparable companies. See also D. Supkar & A. Dhadphale, Development of Transfer Pricing Jurisprudence, 19 Asia-Pac. Tax Bull. 1, pp 44-50 (2013), Journal Articles & Papers IBFD. The authors discuss in depth various TP jurisprudence considering LSAs.

124. UN Manual (2017), supra n. 6, at para. D.3.7.3. However, the Indian tax authorities do not exclude the possibility of using the profit split method to determine the arm’s length allocation of additional profits derived from LSAs.


126. See S. Gonnet, Location Specific Advantages - China, 12 Transfer Pricing Intl. J. 10, pp. 31-41 (2011). The author discusses macro-indicators based on the example of China demonstrating that the outcome based on quantitative economic analysis may differ from the perception that LSAs exist by default when outsourcing from a high-cost to a low-cost country.

For market premiums in the luxury industry based on the example of China, see McKinsey & Company, supra n. 117. The authors report a global shopping behaviour of wealthy Chinese with Hong Kong as top destination, followed by South Korea and Japan, and Europe and the United States being only secondary overseas shopping destinations.
the factors affecting profitability in a specific industry and market such as the competitive position of a company and the attractiveness of a market in order to understand how the relevant market functions. Certain proposed methodologies may lead to a misinterpretation of the situation in a specific country. Generally, the OECD, the UN and the courts have taken the view that, as a starting point, local market comparables should be used to identify arm's length prices. Only when it has been determined that no such reliable local comparable data is available, location savings and market premiums should be determined and allocated based on the evaluation of the hypothetical commercial behaviour between independent third parties such as the bargaining strength.

With respect to market premiums, the allocation of the profits resulting from unique market features should not follow a simplistic destination-based taxation. Profit taxation should be based on the economic activity, assets used and risk assumed.

Referring to industries such as the financial services industry but also increasingly the pharma industry and new dynamics dictated by RPA, it becomes evident that the concept of location savings and market premiums will need to evolve. LSAs may still play a role in specific industries such as the manufacturing industry. However, the debate does not necessarily hold for the service industry, which is increasingly influenced by highly mobile features such as digital technology and artificial intelligence. This sector has the global capacity and agility to create value from anywhere and with few people. Automation already exists for routine activities and large MNEs are by now aligning their business models to digital innovation and transformation, provoking a significant shift in the competitiveness of countries and cities. Consequently, actual controversies around LSAs and in particular location transformation, provoking a significant shift in the commercial behaviour between independent third parties such as the bargaining strength.

Where LSAs may still be a point of discussion, an MNE may navigate the challenges and reduce its risk by maintaining comprehensive documentation that addresses all the relevant attention points such as functions, assets and risks. Also, the analysis of the competitive situation and bargaining power of the relevant associated companies is a crucial element and may provide an answer on how best to quantify and attribute LSAs. In principle, where an extensive and complete FAR analysis is conducted and the general logic of transfer pricing is applied, an acceptable outcome also with respect to LSAs should be guaranteed, as long as the arm’s length principle is considered by countries as the best way to allocate profits among affiliates.

In order to reduce even further potential exposure and vulnerabilities, MNEs may consider concluding bilateral advanced pricing agreements (APAs), as far as their operations are appropriate for application for such pricing agreements. For certain industries, compensation for LSAs is however a precondition for obtaining an APA. Regrettably, the average length of time to complete bilateral but also unilateral APAs involving developing countries is steadily increasing and MNEs may lose the confidence that the APA is an efficient way to reduce risks.

It is always imperative to carefully examine the type of operations MNEs actually undertake in a specific country and how and where value is added by each individual subsidiary, before arriving at a conclusion of how further profit is to be allocated to that country. In conclusion robust documentation will certainly provide a strong defence. However, the allocation debate will continue for many years to come, due to the lack of consensus on how to apportion LSAs, potentially opening the door for a global formulary apportionment system.