Marginal Markets and the Value of Networking

by Jens Wittendorff

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The intergovernmental struggle for the tax revenues of multinational enterprises constantly assumes new configurations. Straightforward transfer pricing cases still make up the bulk of cross-border tax disputes. However, as governments have become more experienced in transfer pricing, and the financial crisis has caused profits and tax revenues to drop, more sophisticated arguments are applied in order to protect national tax bases. For example, it is now more common for a transfer pricing dispute to question whether a controlled transaction exists at all rather than question the pricing of a controlled transaction. Items that may trigger such discussions include local marketing intangibles, business facilities, or profit potentials. Another controversial item that this article will analyze is whether the mere presence of a subsidiary on a marginal market may constitute a compensable transaction for transfer pricing purposes.

Economies of Integration

A network of affiliated companies may create competitive advantages due to transaction cost savings, synergies, economies of scale, or creation of market barriers (economies of integration).[1] In imperfect markets, such advantages mean that affiliated companies may obtain greater overall profits than otherwise comparable independent companies. The value of an international network may be significant as evidenced in *DHL Corp.*, in which the U.S. Tax Court estimated that the value of DHL's international network represented at least the same value as the company's worldwide trademark rights.[2]

Economies of integration arguably must be considered under the arm's-length principle in order to satisfy the comparability requirement.[3] However, market data cannot be used as a benchmark for the allocation of excess profits stemming from an international network because independent companies do not have access to such benefits.[4] For this reason it has been argued that the arm's-length principle is ''inherently flawed.''[5] Moreover, a single company within an MNE cannot be pointed out as the ''owner'' of economies of integration because the effect arises as the result of affiliated

[1]*See* John H. Dunning and Sarianna M. Lundan, *Multinational Enterprises and the Global Economy* (Edward Elgar Publishing, 2008), p. 93.

[2]*DHL Corp. v. Commissioner*, T.C. Memo. 1998-461, *aff'd*, *rev'd on a different issue, and remanded*, 285 F.3d 1210 (9th Cir. 2002). Similarly, in TAM 200907024 (Nov. 10, 2008, release date Feb. 13, 2009), the IRS determined that the substantial part of the arm's-length value of an international courier company was attributable to its network.

[3]J. Wittendorff, *Transfer Pricing and the Arm's Length Principle in International Tax Law* (Kluwer Law Int'l, 2010), pp. 326 and 334.

[4]The U.S. transfer pricing regulations provide that account may be taken of the group association in relation to the comparability analysis. *See* Treas. reg. section 1.482-9(l)(3)(v) and section 1.482-1(f)(2)(i) (Example 3).

[5]Para. 1.10 of the OECD guidelines (2010). *See* Wittendorff, *supra* note 3, at 781.

companies working together.[6] This was confirmed in *ConocoPhilips* when a Norwegian court of appeal rejected the argument of the taxpayer that interest savings obtained through the group's cash pool arrangement could be attributed to the parent company that had initiated and coordinated the pool.[7] Hence, the key driver for the interest savings was the capital contributed to the pool by the subsidiaries for which reason the parent company would have found itself in a weak bargaining position regarding the subsidiaries.

Likewise, in *Merck & Co.* the U.S. Claims Court held that an organizational structure did not qualify as an intangible for transfer pricing purposes.[8] The U.S. parent company was thus not taxable on an imputed royalty from a Puerto Rican manufacturing company (MSDQ) for the use of the group's international network of sales affiliates:

> The Merck Group's structure of corporate entities that discover, develop, and produce essential materials in bulk quantities, manufacture, package and label end-products, and market those products is not unique to Merck. It is a type of organization common to large scale international businesses. The ''methods,'' and ''procedures'' involved in such organizations are not recognized as embodying rights to property so as to qualify under the regulations as intangible property with independent value. Defendant's intangible property argument essentially is no more than a recognition that Merck is the parent of the foreign affiliates and MSDQ.[9]

A 2009 IRS technical advice memorandum concerned an international delivery business of a U.S. corporation that had developed a network of contracts with a large number of foreign agents in many countries.[10] The questions raised were whether the network qualified as an intangible under section 936(h)(3)(B), and whether the transfer of the network to a foreign related company was exempt from section 367(d) on the grounds that the network represented foreign goodwill or going concern value.[11] The taxpayer argued that the intangibles (agent contracts) should be valued separately under section 367(d) and that the residual value of the business was attributable to foreign goodwill or going concern. The IRS determined that the network constituted a separate intangible under section 936(h)(3)(B). According to the advice memorandum, the network fitted into all of the following categories of intangibles:

- a collection of contracts that should be treated as a single intangible asset;
- a collection of franchises that constitute a franchise operation;
- a method, program, and procedure; and
- a system.

In the opinion of the IRS, *Merck & Co.* was not relevant for this case:

> However, Exam does not assert, nor do we conclude, that Taxpayer's role as the parent of DE or any other entity is itself an intangible that is subject to section 367(d). Rather, the intangible in this case consists of the methods and programs discussed above, which relate to how the agents actually carry out Business A in a carefully coordinated manner. These are not simply a function of Taxpayer's particular corporate structure. Therefore, Merck & Co. is inapposite.[12]

The technical advice memorandum thus acknowledges that a network in itself does not qualify as an intangible. In order to dissociate the case from *Merck & Co.* the IRS stated that the alleged intangible consisted of ''methods and programs'' regarding the actual conduct of the business in a coordinated manner. The memorandum thus attempts to distinguish between two separate intangible items: a network and the manner in which the network operates. On the one hand, operational know-how and so forth developed by a parent company might qualify as a compensable intangible. On the other hand, it is difficult to appreciate the difference between the basic fact pattern of the advice memorandum and *Merck & Co*. where the court did not apply such a distinction. The attempt to distinguish the network from the operation thereof is thus questionable.

If it is accepted that economies of integration must be considered under the arm's-length principle and that the benefits cannot be monopolized by a single entity of an MNE, the question arises regarding where the excess profits stemming from a network should be booked for tax purposes. In theory the answer is straightforward — those profits should be apportioned

[6]Wittendorff, *supra* note 3, at 620.

[7]Utvalget 2010/199 (*ConocoPhilips*). The decision was appealed by the taxpayer but not accepted by the Supreme Court. *See* J. Wittendorff, ''The Arm's-Length Principle and Fair Value: Identical Twins or Just Close Relatives?'' *Tax Notes Int'l*, Apr. 18, 2011, p. 223.

[8]*Merck & Co. v. United States*, 24 Cl. Ct. 73 (1991).

[9]*Id.*

[10]TAM 200907024, *supra* note 2. The facts of the memorandum resemble the facts of *First Data Corp. v. Commissioner*, T.C. No. 7074-09, petition filed Mar. 20, 2009. *See Tax Mgmt. Transfer Pricing Rep.* 18 (May 28, 2009), p. 45. This case has been settled with the IRS. *See Tax Mgmt. Transfer Pricing Rep.* 21 (May 3, 2012).

[11]The definition of an intangible under section 936(h)(3)(B) is similar to the definition for U.S. transfer pricing purposes. *See* section 482, second sentence, and Treas. reg. section 1.482-4(b).

[12]*Merck & Co. v. United States*, 24 Cl. Ct. 73 (1991).

in the same manner as independent companies would have done if they had access to similar benefits.[13] Further, adopting the axiom underlying the cost-sharing rules, excess profits should be apportioned on the basis of the contributions made by the individual companies to the production of the benefits in question.[14] However, outside the narrow scope of cost sharing, it is often impossible to identify, measure, and allocate economies of integration, and no regulatory attempt has been made to resolve the allocation issue. In practice, the way MNEs structure their businesses today mean that a principal company, which owns valuable intangibles and bears significant risks, usually reaps the benefits of the economies of integration because the profits of other companies with which it interacts are determined on the basis of market data. Hence, profits stemming from intangibles and economies of integration are both treated as residuals and are captured by the same taxpayer. An application of the arm's-length principle relying solely on the production factors of functions, risks, and assets may thus cause overcompensation of principal companies.[15] However, the magnitude of this problem and its impact on national tax bases is unknown.

Income Qualification

If an affiliated company consistently reports losses or below-normal profits, the routine reaction of tax authorities normally is to conclude that transfer prices are skewed. In most cases, a transfer pricing adjustment will cause the company to become profitable for tax purposes. However, if the company is the purchaser in the controlled transactions, there may be situations in which it will not become profitable even if a deduction for the purchase price of goods and services is fully disallowed. In such a situation the company may, of course, argue that losses are caused by genuine business reasons not connected with transfer prices. The tax authorities, on the other hand, may be reluctant to accept such an explanation, especially if the loss situation has existed for many years. So how can the company attain a profit-making and taxpaying position? The simple answer is that the tax authorities must construct a separate controlled transaction in which the company is the seller and impute income relating to this transaction.

Construction of controlled transactions is one of the measures available for tax authorities preoccupied with the collection of taxes from MNEs. The definition of a controlled transaction must be made on the basis of domestic law of each of the countries involved since it is not governed by tax treaty provisions.[16] Double taxation triggered by disagreements over income qualification may thus be difficult to resolve under mutual agreement procedures because the nature of the dispute is not one of tax treaty interpretation.

Marginal Markets

A market may be so small and competitive that it is difficult to make a profit because the fixed costs associated with organizing and maintaining a subsidiary exceed the gross profits that may be earned. In this situation, it may be impossible fully to pass on operating costs to the customers, and market participants may thus realize losses.

This marginal markets issue is touched on in several pending transfer pricing cases in Denmark in which taxpayers have argued that losses of Danish subsidiaries are due to the size of the Danish market, making it difficult to break even. This argument is addressed in transfer pricing guidelines from 2002 and 2006, which contain the following statement (unofficial translation):

> In a group relationship, the decision power is defined by the legal ownership, and it must thus on an overall basis be considered whether a strategic initiative which is initiated and required by the group management, serves the interest of the individual company or the whole group. In the latter situation the individual company must be compensated for contributions that are made to the overall profitability. For example, one could imagine a situation where representation on peripheral markets with low profitability is caused by a group strategy of being present in all markets even though it is not possible to realize a marginal profit on these peripheral markets, e.g., due to the size of the markets or other economic circumstances. In such situations companies on these markets must be compensated in a way that makes it possible to obtain a normal profit in light of the functions performed and risks incurred etc.[17]

On this basis, the Danish tax authorities have adopted the position in some cases that subsidiaries of foreign MNEs are providing a *separate* service to foreign group companies *in addition to* the sale of goods or services on the Danish market.[18] For example, if an MNE group is active in the service industry, the tax

[13]Department of the Treasury, "A Study of Intercompany Pricing Under Section 482 of the Code" (White Paper), Oct. 18, 1988; Notice 88-123, 1988-2 C.B. 486.

[14]Para. 8.13 of the OECD guidelines (2010), and Treas. reg. section 1.482-7(a)(1) and (b)(1)(i).

[15]Wittendorff, *supra* note 3, at 786.

[16]*Id.* at 222.

[17]Section 5.2.4, Transfer pricing; *Kontrolleredetransaktioner*, *Dokumentationspligt*, Ministry of Taxation, Feb. 6, 2006; and section 4.1.3, Transfer Pricing; *Dokumentationspligt*, Ministry of Taxation, Dec. 19, 2002.

[18]The issue is discussed by Stanley I. Langbein, "Transaction Cost, Production Cost, and Tax Transfer Pricing," *Tax Notes,*

(Footnote continued on next page.)

authorities may claim that the mere existence of a loss-making Danish subsidiary constitutes a compensable service to foreign group companies if the group applies a strategy of being present on the Danish market in order to satisfy the needs of multinational customers.[19] This marginal market argument has especially been relied on in cases when a Danish subsidiary has remained in a loss position even after a deduction for (explicit) controlled transactions has been fully disallowed (trademark royalties, management fee, and so forth).

The Australian tax authorities have voiced a somewhat similar line of thinking in its decision impact statement in *SNF*:

> A possible alternative argument the Commissioner might have put in this case but did not was this: instead of seeking lower prices for the goods it bought, the taxpayer, had it been dealing at arm's length, *would have sought separate compensation for the special costs and risks it incurred* in prosecuting for the chief long-term benefit of the SNF Group the strategy of building market share in Australia. This would have required the Commissioner to make a separate determination under s136AD(2) rather than, or in the alternative to, that made under s136AD(3).[20] [Emphasis added.]

The services regulations of the United States also touch on the idea underlying the marginal market argument. A contribution by a taxpayer that develops or enhances the value of intangible property owned by another taxpayer may thus qualify as a compensable service transaction.[21] Among other things, the contribution may be in the form of incremental marketing activities that causes the value of a trademark owned by another taxpayer to increase.

However, where the Australian and U.S. tax authorities are focusing on the allocation of profits stemming from a valuable (local) market, the concern of the Danish tax authorities reflected in the marginal market argument is the allocation of the overall profits from multiple markets; that is, (foreign) valuable markets and a (Danish) valueless market.

The OECD guidelines briefly address the issue twice. First, the OECD discusses situations when an MNE may need to produce a full range of products or services in order to remain competitive and realize an overall profit, but some of the individual product lines regularly lose revenue.[22] In such a situation, one member of the group might realize consistent losses because it produces the loss-making products or services. According to the OECD, a compensable service may exist in such a situation:

> An independent enterprise would perform such a service only if it were compensated by an adequate service charge. Therefore, one way to approach this type of transfer pricing problem would be to deem the loss enterprise to receive the same type of service charge that an independent enterprise would receive under the arm's length principle.[23]

Second, in the context of losses incurred by a company before a business restructuring, the OECD states:

> There can also be circumstances where a loss-making activity is maintained because it produces some benefits to the group as a whole. In such a case, the question arises whether at arm's length the entity that maintains the loss-making activity should be compensated by those who benefit from it being maintained.[24]

Hence, the OECD does not directly address the marginal market case. However, both of the above situations resemble the marginal market case because a group company is assigned with the performance of a loss-making activity that contributes to the overall profitability of the group. The issue is dealt with by the OECD in the context of the service rules.

The marginal market argument should thus only prevail if the presence of a subsidiary on the relevant market in itself constitutes a compensable service transaction. Whether a service transaction exists must be determined on the basis of domestic tax law since article 9(1) of the OECD model does not address income qualification.[25] However, the OECD guidelines and the U.S. Treasury regulations contain detailed rules that may assist the domestic law determination of whether a service transaction exists.

Is One Link a Compensable Service?

The OECD guidelines rely on a specific benefit test for purposes of defining a service transaction.[26] This should be contrasted with the general benefit test that

Sept. 18, 1989, p. 1391; and Jill C. Pagan and J. Scott Wilkie, *Transfer Pricing Strategy in a Global Economy* (IBFD Publications, 1993), p. 50.

[19]In *Esso*, the Danish Supreme Court acknowledged that a Danish parent company obtained a benefit from being present at the locations where its Danish subsidiaries operated petrol stations; *see* U 1976.60 H. On this basis, capital contributions made by the parent company to a number of loss-making subsidiaries were held to constitute deductible operating costs.

[20]Australian Taxation Office, Decision Impact Statement in *SNF (Australia) Pty. Ltd.* (Nov. 7, 2011).

[21]Treas. reg. section 1.482-4(f)(4)(i).

[22]Para. 1.71 of the OECD guidelines (2010).

[23]*Id.*

[24]*Id.* at para. 9.98.

[25]Wittendorff, *supra* note 3, at 222.

[26]Para. 7.6 of the OECD guidelines. *See* Wittendorff, *supra* note 3, at 487.

was applied in the United States from 1968 to 2006 under which the benefit test was met if an activity was undertaken for ''the joint benefit of the members of a group.''[27] This rule was based on the assumption that some activities provided a benefit for an MNE group as a whole. Hence, it was not a requirement that an activity provided each company with a specific and identifiable benefit.[28] In the 1980s, the Business and Industry Advisory Committee failed to convince the OECD to adopt the general benefit test.[29] The new services regulations of the United States are also based on a specific benefit test.[30]

It must thus be possible to point out specific foreign group companies that obtain ''economic or commercial value'' from the existence of the relevant subsidiary, aside from the potential benefits from direct trading with the subsidiary. The requirement to specify the recipient of a deemed service is reinforced by the arm's-length principle of article 9(1) of the OECD model presupposing that adjustments are made of ''conditions.'' It is therefore necessary to link an adjustment with specific transactions. For purposes of mutual agreement procedures it is also necessary to identify the counterparty to the controlled transaction that triggered an adjustment.

A compensable service transaction further requires a direct link between the benefit obtained by one group member and the activity performed by another member of the group; that is, indirect and remote benefits do not pass the benefit test.[31] In this context, this arguably means that the relevant subsidiary must have been established or maintained with the clear aim of providing a benefit to specific foreign group members.

Finally, benefits that stem from passive association with the group do not meet the benefit test.[32] Hence, a foreign group member should not be deemed to receive a service from the relevant subsidiary merely because the international network provides commercial benefits for all of the group members. In other words, economies of integration do not constitute compensable service transactions.[33]

The service angle of the issue was also addressed in *Merck & Co.*; the IRS wanted to impute a service charge from a Puerto Rican subsidiary for the benefits of being part of a multinational network. The U.S. Claims Court rejected this argument as follows:

> Defendant's concept of service disregards the function and use of the corporate form in large scale business operations. The creation of legal entities that have separate functions under common directors and officers is a familiar and recognized practice in the ordinary conduct of large scale business.[34]

Conclusion

This article addresses whether a single member of an international network may be deemed to provide a compensable service to other members of the network merely because it is operating on a marginal market. The analysis suggests that it may be difficult for the tax authorities to prevail with this argument because an owner of a network of affiliated companies cannot be identified for transfer pricing purposes and because the regulatory definition of a compensable service transaction will usually not be satisfied. ◆

[27]Treas. reg. (1968) section 1.482-2b(i).

[28]Wittendorff, *supra* note 3, at 486.

[29]OECD, ''The Allocation of Central Management and Service Costs,'' *Transfer Pricing and Multinational Enterprises: Three Taxation Issues* (1984), paras. 25 and 43.

[30]Treas. reg. section 1.482-9(l)(3)(i).

[31]Para. 7.12 of the OECD guidelines (2010); Treas. reg. section 1.482-9(l)(3)(ii).

[32]Para. 7.13 of the OECD guidelines (2010); Treas. reg. section 1.482-9(l)(3)(v).

[33]The U.S. regulations provide an example where the fact that a subsidiary obtains volume discount from a third-party supplier due to its affiliation with the rest of the group does not amount to a compensable service from the parent company of the group. *See* Treas. reg. section 1.482-9(i)(5) (Example 19).

[34]*Merck & Co. v. United States*, 24 Cl. Ct 73 (1991).