BUSINESS MODELS FOR TAX AND TRANSFER PRICING PURPOSES

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Abstract: *In order to remain competitive, the multinational enterprises (MNEs) are forced by the globalization phenomenon (which manifestation has became more and more stringent) to analyze continuously their effectiveness. In this respect, the structure of the business represents an element which might have an important impact for the enterprises overall results. This is why, in the last decades, the MNEs granted special attention to business structures and put significant efforts in business restructurings, where the case, with the scope to keep the efficiency and to remain on the market. Generally, the operational business restructuring process follows one of the business model globally developed, namely manufacturer or sales business models. Thus, according to the functions performed, assets used and risks assumed, the entities within the group are labeled into limited risk units (such as toll manufacturer or commission agent), medium risk (contract manufacturer, commissionaire, stripped distributor) or high risk units (fully fledged manufacturer, fully fledged distributor). Notwithstanding the above, there should be emphasized that the operational business restructuring has to be undertaken with maximal care, as it might have important fiscal impact. Having this regard, the purpose of the present investigation is to provide, from a tax and transfer pricing point of view, a systematic and structured analysis of the generally characteristics of business models (manufacturer and sales business models) used by multinational enterprises in the process of business reorganization, with the scope to increase their performance and the sustainable competitive advantages. Thus, by using the fundamental (theoretical) and qualitative research type, this paper is aiming to present the most important characteristics of each business model (general overview of each model, the principal risk assumed, the usual transfer pricing method used for the remuneration of intra-group transactions). The principal investigation techniques (research methods) used were the literature review and the analysis of international regulation in the taxation field. The present paper follows the positive research perspective.*

Key words: *business restructuring, business model, manufacturer models, sales models, transfer pricing*

JEL classification: *H20, H25, M16*

Introduction

In the present globalised economy, the international companies (regardless of products or sectors) face the pressure of increasing competition. Thus, they are bound to examine on a continuous basis the effectiveness of their business structures and to adjust their activity to these changing circumstances. As a consequence, the business restructurings undertaken by multinational enterprises have been a widespread phenomenon in recent decades because the globally competition forces them to maximize synergies and increase related efficiencies.

The need for an international company to change / to restructure its activity is generally underlay by both internal and external factors, such us: increasing demand in certain territory, changing customer demand, proximity to the sale market, various cost related factors (transportation cost, labor cost, energy cost, raw materials cost), savings from economies of scale, the need to increase the productivity by decreasing the costs, the need for specialization, centralization of functions etc.
Due to the development of global business models, the reorganization operations affecting an entity's industrial, commercial and supply chain processes has become increasingly common in the last years while taking various forms. These kind of industrial and commercial restructurings have complex and (often) significant consequences for international tax purposes, although tax considerations by themselves are generally not the principal driver for the reorganization.
From a transfer pricing point of view, the business reorganizations are defined as "cross-border redeployment by a multinational enterprise of its functions, assets and/or risks" (OECD Report – Transfer Pricing aspects on Business Restructurings).
This paper is aiming to describe, from a tax and transfer pricing point of view, the general characteristics of the business models used in present times by multinational enterprises. We choose to analyze this subject as we consider this is a hot topic in the present globalised economy, due to the fact that business reorganizations might have a dramatic impact on the allocation of the taxable profits of a multinational enterprise among the countries in which it activates.

Research methodology

The purpose of the present investigation is to describe, from a tax and transfer pricing point of view, the general characteristics of the business models used by multinational enterprises. In this paper, the fundamental research type was applied and the deductive research method was used (meaning that general conclusions were extracted based on available data).
One of the investigation techniques used was the literature research. We analyzed the international scientific literature on accounting and taxation topics, starting from older papers (Hirshleifer, 1956 & 1957; Dean; 1955 and Cook; 1955) to newest ones (Johnson, Christensen & Kagermann, 2008; Bakker, 2009). The papers observed were found in the following databases: SpringerLink, Jstor, Emerald and ScienceDirect. As a research key, we tried to found papers discussing about "business restructuring", "business reorganization", "transfer pricing impact in case of business restructuring" etc.
Another investigation technique used was the analysis of international regulations in taxation filed (OECD reports or discussion papers on Transfer Pricing topic: Transfer Pricing Guidelines for multinational enterprises and tax administration; Transfer Pricing aspects of business restructurings chapter IX of the Transfer Pricing Guidelines), with the scope to find out how the specialized international institution estimates the impact of business restructuring for tax and transfer pricing purposes.
Moreover, we applied the comparison investigation technique, by using as comparison criteria: the assets used, the risks assumed, the function performed, the profitability (evidently, the profitability is growing up simultaneously with the functions and risks undertaken). According to the functions performed and risks assumed, the entities are labeled into limited risk units (such as toll manufacturer or commission agent), medium risk (contract manufacturer, commissionaire, stripped distributor) or high risk units (fully fledged manufacturer, fully fledged distributor). Further on in this

paper, the most important characteristics of each of the above types are presented by comparison with the other types.

Literature review

The resource allocation and transfer pricing problem are topics with a long debate in the accounting, management science and economics literature.

According to the study conducted by Ho (2008), the international transfer pricing is a multidisciplinary research area involving aspects of accounting, marketing, behavioral sciences, business policy, international business, economics, finance, legal sciences, taxation. On the other hand, Sikka & Willmott (2010) consider that transfer pricing is at the intersection debates regarding: the MNE accounting, the social responsibility and the states right to tax.

The earliest studies on the transfer pricing issue were realized by Hirshleifer (1956 & 1957), Dean (1955) and Cook (1955) who provided the first reasons and were between the first sustainers of the later developed *decentralization theory*. For example, Dean wrote: "…the modern integrated multiple product firm functions best if it is made into a miniature of the competitive free enterprise system". Chang & Hong (2000), adepts of the decentralization theory as well, defines the business groups as "a gathering of formally independent firms under the single common administrative and financial control". According to Golub & McAfee (2011), the modern corporation is a semi-autonomous aggregation of business units that run transactions both between them and with entities outside the group.

There are a lot of studies suggesting that business groups provide efficient forms of governance in certain circumstances by showing that companies affiliated to groups tend to exhibit higher profitability than independent companies in the same countries (Ghemawat & Khanna, 1998; Khanna & Palepu, 1999; Chan & Choi, 1998). This approach relied on the *resource-based theory*, who emphasizes the role of both intangible and tangible resources as the ultimate source of competitive advantage and performance (Barney, 1986; Wernerfelt, 1984). Certain researchers (Prahalad & Hamel, 1990; Kogut & Zander, 1992; Teece, Pisano & Shuen, 1997) consider that intangible resources like brand or technology shared among group entities are particularly important sources of sustainable competitive advantage. This approach leads to the conclusion that a group possessing more intangible resources would exhibit higher performance.

In our times, in order to increase their performance, companies are faced to reorganize their activity by operating various restructurings which may involve cross-border transfers of valuable intangibles. Business model innovation (restructuring) is seen as material to obtaining profit and "focuses on aspects such as creating new markets, developing go-to-market initiative and innovation thereof, competitive disruption or competitive positioning and developing new value propositions" (Debruyne & Schoovaerts, 2006). According to Johnson, Christensen & Kagermann (2008), the elements of a succesul business model are: customer value proposition, key resources (resource based theory), key processes (diversification theory) and profit formula. They also consider that restructuring generally requires more effort than anticipated.

From a tax perspective, a business model's cost base and revenue potential are the most relevant aspects. In the value chain of getting the products to market, all business models have a certain organization of assets used, risks assumed and functions performed, that trigger the company's overall success (Bakker, 2009).

For tax and transfer pricing purposes, the fact that a multinational group entity is labeled as manufacturer, distributor or services provider has immediate effect of attaching consequences to the taxation of that company (Bakker, 2009).

Business models for tax and transfer pricing purposes

Generally, a business model reorganization consist of "stripping out intangible assets, functions and risks which were normally integrated in local operations and transferring them to more specialized and centralized regional or global entities within the group" (OECD, 2010).

Thus, since the mid-90's, business restructurings have usually involved the centralization of intangible assets and of risks with the potential profits that might be derived by them. The most used forms of business restructurings were represented by the following processes:

- Conversion of a full – fledged distributor into a limited risks distributor or a commissionaires for a related party operating as a principal;
- Conversion of a full – fledged manufacturer into a contract manufacturer or a toll manufacturer for a related party operating as a principal;
- Transfer of intangible property (IP) rights to a central entity within the group. (OECD, 2010).

Notwithstanding the above, there are also business restructurings which involve the allocation of more intangibles and more risks to operational units (manufacturers and distributors). Moreover, there are business restructurings consisting of the rationalization, specialization or de – specialization of operations, such as: research and development, manufacturing processes, manufacturing sites, distribution activities, marketing services etc.

However, independently of the business restructuring forms and reasons, there are certain typical transfers that might arise when such restructurings are put in place, as follows: transfer of tangible assets, transfer of intangible assets and transfer of activities (ongoing concern). Another feature common to all business restructurings is the fact that such a process always involves the reallocation of profits among the entities within the group, either immediately after the restructuring or over certain years.

Typically, the profitability of an entity depends on the functions performed and risk assumed (meaning that the higher are functions performed and risk assumed, the higher is the profitability), as presented by the below figure:

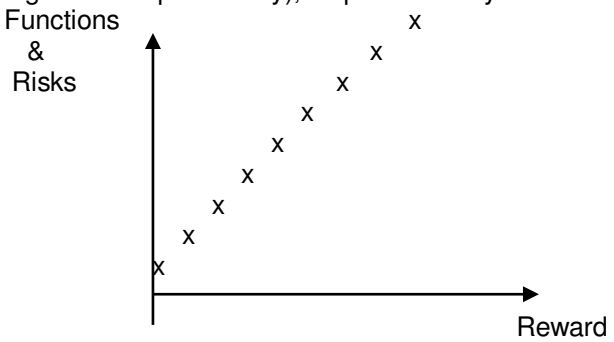

Figure1. Relation profitability – risks & functions
Source: realized by authors

In the bellow paragraphs there will be presented the most important characteristics, (from a tax and transfer pricing perspective) of manufacturer and sales business models

A. Manufacturer models

Manufacturing is the process of transformation from raw materials into finished goods. As presented in the chart below, manufacturing is generally performed in one of three risk/function models recognized for transfer pricing purposes: toll manufacturing, contract manufacturing and fully fledged manufacturing.

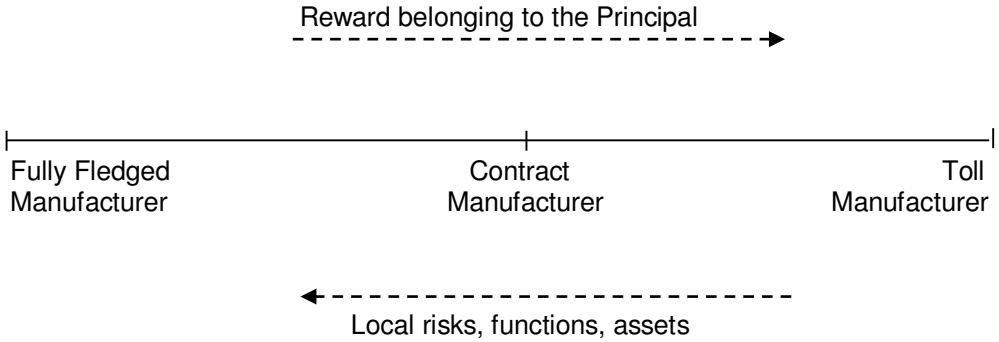

Figure 2: Manufacturer models
Source: realized by authors

A toll manufacturer is actually a service provider which activity generally consists of processing raw materials following the specification and clearly instruction of the principal. The toll manufacturer does not become the owner of the raw-materials, work-in-progress or goods manufactured; it has no responsibility for production scheduling, procurement of raw material, quality control, distribution, logistic or revenues collections (Adams & Graham, 1999). Thus, such an entity assumes neither inventory risk and usually owns no valuable intangible (just routine manufacturing/processing skills). The transfer prices used for remunerating the operations performed by a toll manufacturer can be determined by using the cost-plus method or the transactional net margin method (assuming that the comparable uncontrolled price method – CUP, cannot be used).

A contract manufacturer generally provide manufacturing functions based on a written agreement, becomes the owner of the raw materials and the finished products and is responsible for processing the raw materials (quality control). The contract manufacturer bears the inventory risk, and generally bears more risks and responsibilities than a toll manufacturer, however, the procurement decisions, production scheduling and logistics remain with the principal. Also, the contract manufacturer does not hold valuable intangibles. As in case of a toll manufacturer, the transfer prices used for remunerate a contract manufacturer might be determined by applying the cost-plus method or the transactional net margin method (assuming that the comparable uncontrolled price method – CUP, cannot be used).

A fully fledged manufacturer typically assumes all the relevant functions related to the production process (sourcing and purchasing raw materials, finding clients, R&D - use of intangibles, production schedule, quality control, logistics) and also the associated risks (inventory risk, market risk, warranty risk etc). If the fully fledge manufacturer and the distributor with which it transacts use valuable intangible, the most appropriate method to be used for determining the transfer prices is the profit split method.

B. Sales models

The sales or distribution represent the process by which a product/service is passed through the business system to the end-consumer. As in the manufacturer case, there are different types of distributors (depending on functions performed, risks assumed and assets used), as presented in the chart below:

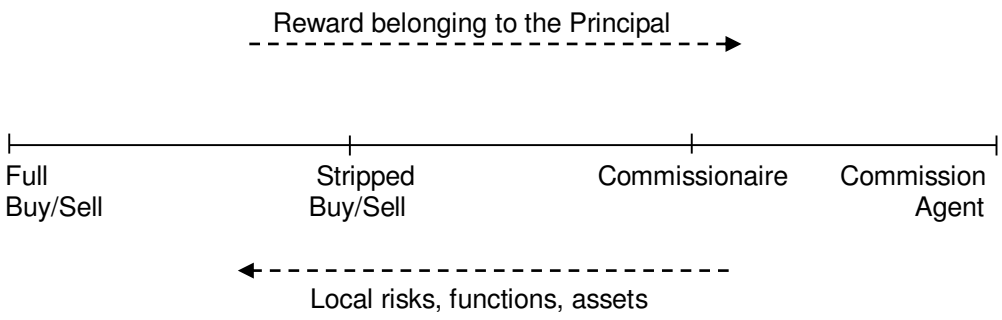

Figure 3: Sales models
Source: realized by authors

A commission agent is an intermediary that arranges the sales of products to customer on behalf and on the name of the principal, while the later is the goods' owner and generally signs the sales contracts (no inventory risk for the commission agent). The remuneration for activity performed by the commission agent is typically based on the cost-plus method (assuming that the CUP method cannot be used), or a commission (percentage) on the sales.
A commissionaire is similar with the commission agent, with the difference that it sells the goods on behalf of the principal but in its name. The commissionaire does not become the owner of the goods and does not bear any inventory risk. The transfer prices used for remunerate a commissionaire might be determined by applying the resale-price method or the transactional net margin method (assuming that the comparable uncontrolled price method – CUP, cannot be used).
A stripped buy/sell distributor is similar to fully fledged distributor, with the difference that the former is stripped of certain functions and risks. The stripped buy/sell distributor become the owner of the goods sold (immediately prior to the sale to the client) and thus bears certain limited inventory risks. Also, the distributor acts in its account and in its name. As in case of a commissionaire, the transfer prices used for remunerate a stripped buy/sell distributor might be determined by applying the

resale-price method or the transactional net margin method (assuming that the comparable uncontrolled price method – CUP, cannot be used).
A fully fledge distributor is acting more autonomously than a stripped distributor; the activity performed is decentralized, with little or no central control or consistency.

Other transfer pricing aspects relevant for business restructurings
In order for a business restructuring to be in compliance with the transfer pricing rules, then, these rules have to be respected both by the restructuring itself and by the post restructuring transactions as well.
The arm's length principle (which is the international standard that OECD member countries have agreed should be used for establishing transfer prices for tax purposes) treats the entities within a group as separate units rather than inseparables parts of a single business. Consequently, for transfer pricing purposes, it is not enough that a restructuring process makes operational and commercial sense for the group as a whole, but the process should be arm's length at the level of each individual entity (taxpayer).

Conclusions
As a consequence of the globalized economy, the pressure of competition and the need for increasing the efficiency are important drivers for business restructurings. Generally, a business reorganization consist of "stripping out" intangible assets, functions and risks which were normally integrated in local operations and transferring them to more specialized and centralized regional or global entities within the group. The industrial and commercial restructurings have complex and (often) significant consequences for international tax purposes due to the major impact they have on the allocation of the taxable profits of a multinational enterprise among the countries in which it activates.
By using the fundamental research type, the literature review and comparison as investigation techniques, this paper was aiming to present, from a transfer pricing point of view, the general characteristics of business models used in present times. More exactly, the paper presented the general features of manufacturer business models (fully fledged manufacturer, contract manufacturer, toll manufacturer) and sales business models (fully fledged distributor, stripped distributor, commissionaire, commission agent).

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