

OECD PUBLISHED THE “TRANSFER PRICING ASPECTS OF BUSINESS RESTRUCTURINGS PUBLIC DISCUSSION DRAFT”

Paris - September 19, 2008 - OECD has published the “Transfer Pricing Aspects of Business Restructurings – a Public Discussion Draft” (59 pages document).

- I. Business restructurings by multinational enterprises have been a widespread phenomenon in recent years. They involve the cross-border redeployment of functions, assets and / or risks between associated enterprises, with consequent effects on the profit and loss potential in each country. Restructurings may involve cross-border transfers of valuable intangibles, and they have typically consisted of the conversion of full-fledged distributors into limited-risk distributors or commissionnaires for a related party that may operate as a principal; the conversion of full-fledged manufacturers into contract-manufacturers or toll-manufacturers for a related party that may operate as a principal; and the rationalisation and / or specialisation of operations.

According to OECD the analysis in this discussion draft is based on the existing transfer pricing rules. In particular, this discussion draft starts from the premise that the arm’s length principle and the TP Guidelines do not and should not apply differently to post-restructuring transactions than to transactions that were structured as such from the beginning.

- II. This discussion draft is composed of four Issues Notes of which the highlights are provided in III – VI below.
- III. In light of the importance of risk allocation in relation to business restructurings, the first Issues Note provides general guidance on the allocation of risks between related parties. A few of the main observations include:
 - One factor that can assist in this determination is the examination of which party(ies) has (have) control over the risk. “Control” in this context should be understood as the capacity to make decisions to take on the risk (decision to put the capital at risk) and decisions on whether and how to manage the risk, internally or using an external provider.
 - These decision making platforms would require the company to have people – employees or directors – who have the authority to, and effectively do, perform these control functions. Thus, when one party bears a risk, the fact that it hires another party to administer and monitor the risk on a day-to-day basis is according to OECD not sufficient to transfer the risk to that other party.

- Example: an investor is controlling its risks through three essential decisions: the decision to hire (or terminate the contract with) that particular fund manager, the decision of the extent of the authority it gives to the fund manager and objectives it assigns to the latter, and the decision of the amount of the investment that it asks this fund manager to manage.
- Comments are especially invited from the business community on the question of whether it is possible at arm's length to ask the transferor of a risk to perform the day-to-day monitoring and administration functions on behalf of the transferee, in cases where it is difficult for the latter to assess the performance of the former as service provider in the absence of an independent source of information.
- If a risk is assessed to be economically insignificant then its value in terms of profit potential is likely to be correspondingly low, and the bearing or transfer of that risk would not ordinarily explain a substantial amount of or decrease in the entity's profits.

IV. The second Issues Note, "Arm's length compensation for the restructuring itself", discusses the application of the arm's length principle and TP Guidelines to the restructuring itself.

The restructured entity would receive compensation for the transfer of functions, assets and / or risks, and / or an indemnification for the termination or substantial renegotiation of the existing arrangements. The main observations are:

- Business restructurings involve transfers of functions, assets and / or risks with associated profit / loss potential between associated enterprises. Restructurings can also involve the termination or substantial renegotiation of existing arrangements. The focus by the tax authorities will be on circumstances in which at arm's length the restructured entity would receive compensation for the transfer of functions, assets and / or risks, and / or an indemnification for the termination or substantial renegotiation of the existing arrangements.
- In order to determine whether at arm's length the restructuring itself would give rise to a form of compensation, it is essential to understand the restructuring, including the changes that have taken place, how they have affected the functional analysis of the parties, what the business reasons for and the anticipated benefits from the restructuring were, and what options would have been realistically available to the parties at arm's length.
- According to the OECD the profit / loss potential is not an asset, but a potential which is carried by some rights or other assets. The arm's length principle does not require compensation for loss of profit / loss potential per se. The question arises whether there are rights or other assets transferred that carry profit / loss potential and should be remunerated at arm's length.

- Relevant criteria are: whether compensation by the transferor to the transferee for the transfer of potential losses and liabilities would be agreed between independent parties at arm's length, taking account of both the amount of the possible losses and the probability of the risk's materialising, and whether it would be preferable for the transferor to pay the transferee to take over the activity rather than to simply stop performing the activity and incur the associated windup costs.
- Other relevant variables are: in case of a group company acting as distributor, the historical results of the distribution activity of the transferor, the historical volatility of such results, and the future profit / loss expectations of the transferor and transferee in relation to the risk at hand. The perspective of the transferor can be illustrated with the following example provided by the OECD in the draft:

Distributor's pre-conversion profits (net profit margin / sales) – full risk activity Historical data (5 years)	Future profit expectations of the distributor (if had remained full-risk, assuming it had the option realistically available to do so) (net profit margin / sales) (Next 3 years)	Post-conversion profits of the distributor – low risk activity (net profit margin / sales)
Case no. 1: Year 1: (-2%) Year 2: +4% Year 3: +2% Year 4: 0 Year 5: +6%	[-2%; + 6%] with significant uncertainties within that range	guaranteed, stable profit of +2% per year
Case no. 2: Year 1: +5% Year 2: +10% Year 3: +5% Year 4: +5% Year 5: +10%	[+5% + 10%] with significant uncertainties within that range	guaranteed, stable profit of +2% per year
Case no. 3: Year 1: +5% Year 2: +7% Year 3: +10% Year 4: +8% Year 5: +6%	[0% + 4%] with significant uncertainties within that range (e.g. due to new competitive pressures)	guaranteed, stable profit of +2% per year

In case no. 1, the distributor is trading a profit / loss potential with significant uncertainties against a relatively low but stable profit. Whether an independent would be willing to do so would depend on its level of risk tolerance and on possible compensation for the restructuring itself. In case no. 2, it is questionable whether independent parties in the distributor's situation would agree at arm's length to transfer the risks and associated profit / loss potential for no additional compensation if they had the option to do otherwise. Case no. 3 illustrates the fact that it is not sufficient to rely on historical data.

- OECD mentions that valuation methods that are used in acquisition deals between independent parties may prove useful to value a transfer of activity, including goodwill, between associated enterprises.
- OECD defines "indemnification" as any type of compensation that may be paid for detriments suffered by the restructured entity, whether in the form of an up-front payment, of a sharing in restructuring

costs, of lower (or higher) purchase (or sale) prices in the context of the post-restructuring operations, or of any other form.

V. The third Issues Note examines the application of the arm's length principle and the TP Guidelines to post-restructuring arrangements. This section contains, amongst others:

- At this stage, OECD states that the review of comparability and profit methods is still ongoing and the conclusions that were arrived at and are reproduced below are only tentative and will need to be updated in due course.¹
- The TP Guidelines indicate that “a residual profit split” may be appropriate in the following cases:
 - Where transactions are very interrelated as it might be that they cannot be evaluated on a separate basis (see paragraph 3.5 of the TP Guidelines).
 - Where under similar circumstances, independent enterprises might decide to set up a form of partnership and agree to a form of profit split (see paragraph 3.5 of the TP Guidelines).
 - In cases where no closely comparable transactions between independent enterprises can be relied on: the profit split method offers flexibility by taking into account specific, possibly unique, facts and circumstances of the associated enterprises that are not present in independent enterprises, while still constituting an arm's length approach to the extent that it reflects what independent enterprises reasonably would have done if faced with the same circumstances (see paragraph 3.6 of the TP Guidelines).
 - To achieve a division of the profits from economies of scale or other joint efficiencies that satisfies both the taxpayer and tax administrations (see paragraph 3.7 of the TP Guidelines).
- In business restructuring situations, even in the cases where a one-sided method is applied to transactions between a restructured entity and a foreign related party (e.g. a foreign principal), information on the activities of the latter (i.e. of the non-tested party) is needed to support the functional analysis of the controlled transactions and to support the choice of the most appropriate transfer pricing method.
- In order to determine whether a transfer pricing method is arm's length, the question is whether independent parties at arm's length would agree on a cost-based remuneration for commissionaire or

¹ See Discussion Draft on the application of transactional profit methods that was released on 25 January 2008, <http://www.oecd.org/dataoecd/18/48/39915180.pdf>

sales agent activities. The OECD view is that the arm's length remuneration of selling activities (whether buy-and-sell activities, commissionnaires or sales agents) should generally be based on a sales-related indicator, unless in comparable circumstances independent parties at arm's length would agree otherwise. A combination of a cost-based indicator (e.g. Berry ratio) and of a sales-based indicator might also be acceptable in appropriate circumstances, for instance where the sales operation (e.g. the commissionnaire or sales agent) incurs significant promotional expenditure as a service performed for the principal in addition to its selling activities (see paragraph 2.24 of the TP Guidelines in relation to the resale price method).²

- Example: Assume an MNE group puts in place a central purchasing entity that will negotiate with third party suppliers the purchases of raw materials used by all the manufacturing plants of the group in their manufacturing processes. Depending in particular on the respective functional analyses of the manufacturing plants and of the central purchasing entity and on the contractual terms they have agreed upon, a variety of remuneration schemes and transfer pricing methods could be considered. (3 cases are being addressed in the draft: from CUP, commission fee to cost plus).
- Where significant location savings are derived further to a business restructuring, the question arises of whether and if so how the location savings should be attributed among the parties. The response should obviously depend on what independent parties would have agreed at arm's length in similar circumstances. The conditions that would be agreed between independent parties would normally depend on the functions, assets and risks of each party and on their respective bargaining powers.

VI. The fourth Issues Note discusses some important notions in relation to the exceptional circumstances where a tax administration may consider not recognising a transaction or structure adopted by a taxpayer. A few main observations include:

- The OECD recognises that there can be legitimate group-level business reasons for an MNE group to restructure. In practice, where a restructuring is commercially rational for the MNE group as a whole, it is expected that an appropriate transfer price would generally be available to make it arm's length for each individual group member participating in it.
- There are two particular circumstances in which it may, exceptionally, be both appropriate and legitimate for a tax administration to consider disregarding the structure adopted by a taxpayer in entering into a controlled transaction.
 - The first circumstance arises where the economic substance of a transaction differs from its form.

² See January 2008 Discussion Draft on the application of transactional profit methods (<http://www.oecd.org/dataoecd/18/48/39915180.pdf>), Section C of Issues Note No. 6 for a similar discussion of the selection of the net profit margin indicator in the context of a transactional net margin method.

- The second circumstance arises where, while the form and substance of the transaction are the same, the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner and the actual structure practically impedes the tax administration from determining an appropriate transfer price.
- VII. The OECD invites interested parties to send comments on this discussion draft before 19 February 2009. Comments should be sent electronically (in Word format) to jeffrey.owens@oecd.org. Unless otherwise requested at the time of submission, comments submitted to the OECD in response to this invitation will be posted on the OECD website.
- VIII. TPA has made a summary/comparisons chart between the German law and OECD draft guidelines on 'business restructuring'. In addition, the chart – which is attached to the press release – discloses the existing international standards used by transfer pricing practitioners like TPA.

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