B.7.1. Transfer Pricing Aspects of Business Restructurings

Setting the framework and definitional issues

B.7.1.1. In recent years the tax aspects of business restructurings undertaken by multinational enterprises (MNEs) have attracted much attention from tax authorities all around the globe. From a transfer pricing standpoint such reorganizations require consideration of how to apply the arm´s length principle to a sound cross-border redeployment of functions, assets and risks within the same group.

B.7.1.2. There is no legal or universally accepted definition of business restructurings. In a transfer pricing scenario these transactions are defined as the cross-border redeployment of functions, assets (tangible and/or intangible) and risks to which a profit/loss potential may be attached. In this respect business restructurings undertaken by MNEs need not be confused with the ordinary acquisition of a business or an ongoing concern. However, it may be common to proceed with a business restructuring of the supply chain operations of an MNE group following an acquisition, divestiture of a business, or in response to the changing business environment.

B.7.1.3. Common examples of business restructurings are reorganizations involving conversions of the manufacturing and/or distribution layer of an MNE such as (i) conversion of a buy-sell distributor into a commissionaire or (ii) conversion of a fully-fledged manufacturer into a provider of manufacturing services. Business restructurings may also involve the transfer of the ownership and management of intangible property rights such as patents, trademarks, brand names etc.

B.7.1.4. As a general rule businesses are entitled to organize their activities in the way they see fit. Business restructuring undertaken in a manner consistent with the arm's length principle is entirely appropriate. However, there may be situations in which business restructurings facilitate inappropriate income shifting through non-arm's length pricing or through commercially irrational structures. The guidance of Chapters I-IX of the UN Transfer Pricing manual, as supplemented by this chapter, apply to business restructurings to ensure that they are consistent with the arm's length principle.

B.7.1.5. The application of Article 9 of the United Nations Model Double Taxation Convention to business restructurings requires that the arm's length consideration for a supply, acquisition or transfer of property is that which might reasonably be expected to be made under an agreement between independent parties dealing at arm's length. As a result, a business restructuring generally involves the determination of whether at arm's length a payment would be warranted for the transfer of something of value, or for the termination or substantial renegotiation of commercial arrangements between associated enterprises, and if so what the amounts of such arm's length consideration would be.

Business Restructurings: Considerations regarding Developing Countries

B.7.1.6. The changes triggered by the implementation of a business restructuring can have significant effects on the allocation of profits (or losses) between the countries in which the entities operate, regardless of whether or not tax savings are a driver. When a multinational group changes its business model, the tax and legal structure of the group would generally require an alignment with the new business model.

B.7.1.7. Business restructurings increasingly affect developing countries. In recent years a number of large MNEs have either (i) transferred their manufacturing facilities into low-cost countries, e.g. where the cost of labor of a skilled workforce is lower and/or (ii) similarly moved certain distribution functions and/or (iii) similarly moved valuable intangible property out of the jurisdiction where they were acquired, developed or exploited. This Chapter discusses how to determine on a case by case basis whether or not the conditions of such restructurings comply with the arm's length principle.

B.7.1.8. In a business restructuring context the arm's length principle entails a comparison of the conditions (including the pricing) of a transaction or arrangement between associated enterprises and those which would have been agreed between independent enterprises dealing at arm's length in similar circumstances. Where a particular transaction is a part of a broader arrangement in respect of a business restructuring, setting (as well as testing) the arm's length consideration for that transaction requires that all the circumstances relevant to the broader arrangement are taken into account in evaluating the comparability factors that might reasonably apply under an agreement between independent parties dealing at arm's length.

B.7.1.9. In the absence of reliable uncontrolled comparable data an assessment has to be made of the consistency of the conditions of the controlled transaction with those that might reasonably be expected under an agreement between independent parties dealing at arm's length.

B.7.1.10. The above mentioned process with respect to the implementation of the arm's length principle highlights the need for developing countries to be alert to business restructurings and their potential consequences. As already stated in other parts of this manual, while it is for each country to determine its own tax system, the desire to avoid double taxation has been an important factor in the very broad acceptance of the arm's length principle internationally.

Process for setting or testing the arm's length principle in business restructuring operations

B.7.1.11. This paragraph describes a typical process which may be followed when setting or reviewing transfer prices in the context of a business restructuring. This process is neither prescriptive nor exhaustive

B.7.1.12. As a first step, it is important to characterize the transactions entered into by the associated enterprises, taking into account the business environment in which the MNE group is operating. This entails carrying out the following activities:

I. identification of the scope, type (e.g. supply of goods, provision of services, licensing arrangements) and economic nature of the arrangements between the associated enterprises involved in the business restructuring;

II. Performance of a functional analysis of the pre and post-business restructuring activities of associated enterprises affected by the restructuring. Such an analysis requires as a starting point reference to any relevant contract, including those entered into to implement the business restructuring (e.g. contracts transferring the legal ownership of certain intangible property and those evidencing the terms and conditions of the pre and post-restructuring arrangements for the business activities affected by the restructuring) as well as an examination of risks assumed and functions performed by the associated enterprises;

III. Examination of the consistency of the contractual terms with the outcome of the functional analysis of the associated enterprises taking part in the business restructuring, in order to determine the true nature of the transactions, including the legal, economic and tax effects thereof. It should not be automatically assumed that the contracts, though they are the starting point of any transfer pricing analysis, accurately or comprehensively capture the actual commercial or financial relations between the parties. The core part of such an examination is the performance of a thorough functional analysis, which is needed to identify the value-adding activities and functions performed, assets used and risk assumed in respect of the business activities affected by the restructuring;

B.7.1.13. The selection of the most appropriate method or methodologies applicable to the transaction(s) at stake follows from the functional analysis. As discussed in more detail below, a business restructuring is commonly implemented through a series of intertwined transactions. For instance, a business restructuring might involve transferring functions, assets and risks to a tax favorable location. This should not of itself warrant the conclusion that a non-arm's length arrangement has been implemented.

B.7.1.14. Provided the pricing of the business restructuring itself and of the post-restructuring arrangements are consistent with what would occur under an agreement between independent parties in comparable circumstances the arm's length principle and its requirements are met.

B.7.1.15. For example, an associated enterprise may transfer the ownership of an intangible asset to its foreign principal and also agree to enter into a licensing agreement with that company. In determining whether the transfer of ownership is consistent with the arm's length principle, taking into account that the transaction is part of a broader business restructuring arrangement, comparability needs to be assessed.

B.7.1.16. In practical terms, in many instances relevant third party data are not available as the types of business restructurings commonly taking place tend to be unique to the various business models existing within MNE groups. However, the lack of reliable third party data should not lead the tax authorities to automatically conclude that the business restructuring as a whole is not respecting the arm's length principle. Where such reliable uncontrolled comparable data are lacking, the consideration that might reasonably be expected in similar circumstances may be determined by taking into account the following:

(i) an arm's length outcome is one that makes business sense taking into account the options realistically available for the taxpayer involved in the business restructuring;

(ii) an independent party dealing at arm's length would seek to protect its economic interest involved in the arrangements, or be appropriately remunerated for foregoing such interest;

(iii) an independent party dealing at arm's length would compare the options realistically available in a comparable transaction and seek to leverage the overall value derived from the economic resources at its disposal. In certain cases, one realistically available option might be not to enter into a transaction in the event that it does not make commercial sense.

B.7.1.17. A key feature in understanding the underlying commercial rationale of a business restructuring is identifying the economic benefits expected from the restructuring. For purposes of this chapter, benefits expected at the MNE level from a business restructuring may be any form of economic or commercial advantage.

B.7.1.18. To this end, a business restructuring may be triggered as a response to changes in the business environment in which the associated enterprise involved is running its activities, such as competitive pressures, market conditions or changes in the regulatory environment. In the light of such changes an MNE operating at arm's length may decide to restructure to reduce its losses or to retain or improve its profit-making ability and/or financial strength. That is, even if an MNE's profitability post-restructuring is less than its pre-restructuring profitability, such a restructuring might still be commercially rational in light of the MNE's realistic alternatives in the face of the changes in the business environment.

B.7.1.19. Business restructurings may include or may be motivated by outsourcing. Outsourcing occurs between independent enterprises for example in relation to inventory management and logistics, IT support, after-sales support, customer receivables management and R&D activities. The underlying commercial rationale for a third party entering into an outsourcing agreement is that generally commercial advantages to the enterprise are expected from contracting out vis-à-vis performing the activity by itself. These expected commercial advantages may relate to cost reduction and/or retaining or increasing profits.

B.7.1.20. When restructuring, an MNE may undertake a cost-benefit analysis. Should such an analysis exist and be documented it may be helpful (as well as any other financial and commercial data relevant to the restructuring) to determine the existence of the underlying commercial rationale triggering the restructuring.

B.7.1.21. An MNE group may fragment functions across several group companies to achieve efficiencies by exerting group management coordination functions. For instance, it is nowadays quite common in restructuring the supply chain of highly integrated MNE groups to allocate into different legal entities functions such as logistics, warehousing, marketing and sales. As the functions represent generally the core of the supply chain of an MNE group this may require coordination of activities at the group management level in order for the separate activities to interact effectively.

B.7.1.22. Accordingly, when conducting a functional and risk analysis of the controlled transactions between the associated enterprises carrying out the fragmented activities, the economic benefits to the MNE group expected from the activities conducted separately should be identified within the context of the broader arrangements. .

B.7.2. Types of business restructurings

B.7.2.1. Although the list below is not exhaustive common types of restructuring carried out by MNEs involve:

(i) As concerns manufacturing activities, the conversion of fully-fledged manufacturers into contract or toll manufacturers (or vice versa);

(ii) As regards distribution activities, the conversion of fully-fledged distributors into limited-risk distributors or commissionaires (or vice versa); and

(iii) As regards the management of valuable, unique intellectual property rights, the transfer of either trade or marketing intangibles to foreign Intellectual property holding companies.

B.7.2.2. As a result the restructured entity may end up performing limited routine functions, holding minimal assets, bearing low risks and having a lower profit/loss potential attached to it. Profit/loss potential should be construed as “expected future profits or losses”. This notion is relevant in the valuation phase of determining an arm’s length compensation for a transfer of tangible and/or intangible assets or of an ongoing concern, or in the determination of an arm’s length indemnification for the termination or substantial renegotiation of existing arrangements.

B.7.2.3. In another form of reorganization sometimes referred to as “reverse restructuring” a cross-border redeployment of functions, assets and risks may be directed towards highly taxed jurisdictions.

B.7.2.4. Taxpayers are generally free to arrange their business operations as they see fit but tax authorities have the right to verify consistency with the arm’s length principle. Any restructuring as described above may be commercially rational. Disregarding or re-characterizing an arrangement entered into by an entity that is part of a multinational group should be the exception to the general rule of respecting the structuring as adopted by the taxpayer. See however section B.2.4.9.in Chapter B.2 of this Manual for a discussion of the recognition of the actual transaction.

B.7.2.5. Although a country may not have specific transfer pricing provisions dealing with cross border restructurings, transactions entered into with the sole purpose of obtaining an undue tax saving could eventually be challenged either by the application of a general or a specific anti-avoidance rule (if present in the tax system of the jurisdiction concerned).

B.7.2.6. As a result, should either a domestic general or specific anti-avoidance rule be applicable to the restructuring such rule may lead to the transaction as entered into by the taxpayer being disregarded. In such a case, there might not be room to apply any transfer pricing provision in order to set or test the arm’s length conditions of the restructuring.

Transfer of functions and risks arising from business restructurings

B.7.2.7. Business restructurings have to comply with the arm’s length principle. This holds true both with respect to “exit scenarios” and “entry scenarios”, i.e. irrespective of whether functions, assets and risks are transferred out of or into a jurisdiction.

B.7.2.8. To this end the following situations can be envisaged:

- A key question is whether a transfer of functions, assets and/or risks conveys value and would be compensated at arm´s length. . See Chapter B.5 on intangibles;

- Further, or alternatively, it should be determined whether the termination or substantial renegotiation of existing arrangements would warrant indemnification at arm’s length. The approach likely to be followed here is a two-pronged one, namely (i) an analysis of the underlying contractual arrangements so as to identify the content of any termination clause, and (ii) the determination of whether a third party would warrant an indemnification in the event of a comparable termination or substantial renegotiation of contractual arrangements.

B.7.2.9. Some taxpayers have entered into business restructurings to contractually allocate economically significant risks to a group entity, perhaps located in a low-tax jurisdiction. Based on that risk allocation, economically significant risks (e.g. “key entrepreneurial risks”) might purportedly be allocated to such an entity that would be presented as a “principal” that contractually bears those risks justifying the premium returns. It will be relevant to determine whether the principal has the capability to and actually controls the economically significant risks allocated to it, and has the financial capacity to assume those risks, consistent with the attribution to it of a return for the risks. See the discussion of risk in Chapter B.2 of this Manual.

B.7.2.10. For example, assume that Company A was a fully-fledged manufacturer of widgets which, among others, assumed economically significant inventory risk. Further to a business restructuring Company B is set up as a principal. Under the new contractual arrangements between Company A and Company B the latter is obliged to produce widgets according to the quality standards and production plan provided for by Company A. The contractual arrangements indicate that Company B is responsible for the inventory risk. From a factual analysis it is proven that Company B does not have any control over the inventory risk, i.e. it does not exert any decision making power in relation to the production plan and has no influence over the deployment of risk mitigation strategies if the inventory quantity rises because of a sales slow-down. In such a situation the risk and associated consequences should be re-allocated to Company A, i.e. the company actually controlling and managing the risk.

Termination or substantial renegotiation of existing arrangements

B.7.2.11. In the case of a contract termination or substantial renegotiation, it should be determined whether an indemnity payment may be warranted under the arm's length principle. At arm’s length, depending on the applicable commercial law of the country concerned, an indemnity payment may be warranted, for instance in the event a party withdraws from a contract in an unjustified and unforeseeable manner. Depending on the applicable commercial law, such an indemnification may for instance encompass the loss of future expected profitability. There is a wide variety of elements that may be taken into account by commercial judges in determining whether a termination period indemnification should be applied, for instance the nature and terms of the contractual arrangements and/or the economic dependence of one party on another.

B.7.2.12. Therefore, in the event a contract between associated enterprises includes a termination clause (and assuming the terms and conditions set out in it are followed upon termination), it should be determined whether such terms and conditions are arm’s length.

B.7.2.13. From a transfer pricing standpoint, another relevant factor relates to the opportunities the terminated party will be granted to obtain alternative business opportunities. That is, there may be a commercial counterpart to the business restructuring. This appears specifically relevant in the context of a cross border business restructuring, as it is frequent in practice that in a group context the affected party having its contract terminated (or substantially renegotiated) will be entering into a different agreement with the same or another affiliate within the group. Tax administrations should examine the entirety of the commercial arrangements to determine whether or not a particular business restructuring transaction is arm’s length.

Operational Considerations on the Transfer Pricing Aspects of a Business Restructuring: Example

B.7.2.14. The following example illustrates the application of the approach to business restructurings as outlined above. The example summarises the indicative issues which might arise in addressing the application of the arm’s length principle to any specific business restructuring arrangement.

B.7.2.15. OpCo is a taxpayer resident in Country A operating a fully fledged manufacturing and distribution activity of chemical components. Based on the contractual arrangements existing at the group level, OpCo has the following rights and responsibilities:

(i) OpCo owns or holds licensing rights over all the intangibles (such as patents, trademarks, and a legally protected specific “Just in Time” manufacturing planning know-how) it needs to operate its manufacturing and distribution activities;

(ii) OpCo is responsible for arranging the procurement of all raw materials (including selection of suppliers and qualification of raw materials);

(iii) OpCo owns the inventories of raw materials, work-in-process and finished goods, assumes related inventory risk and actually performs the risk management control functions;

(iv) OpCo manages and controls the production planning, sets the output budget and determines the milestones within the supply chain process;

(v) OpCo sells the finished goods to third party customers in its market and to associated enterprises acting as distributors in foreign markets.

B.7.2.16. As far as financial results are concerned OpCo has recorded relatively strong and stable profits over most of the last 10 years, although they have been gradually declining over the last 3 (three) years due to adverse global economic market conditions which triggered a steep increase of the input costs of production. The financial outlook for the next five years forecasts a continued decrease of profitability due to increased competition.

B.7.2.17. In the year 2000+X, the MNE of which OpCo is a member decides to enter into a restructuring of the supply chain manufacturing layer, by centralising its management and control activities in a regional headquarters located in Country B and operated by the associated enterprise Principal Co. The MNE’s top management highlights during the shareholder meeting that the underlying commercial rationale for entering into the restructuring is to achieve forecasted costs savings and efficiency gains allowing the group to achieve sustained profit growth over the following 5 (five) financial years.

B.7.2.18. In particular, the implementation of the business restructuring arrangements requires the implementation of the following steps:

(i) OpCo transfers to Principal Co by means of an outright sale arrangement all the intangibles rights that it owned in relationto the products. All the license agreements under which OpCo had rights over product intangibles (including the “Just in Time” know-how) are terminated as part of an arrangement whereby Principal Co will enter into similar licensing agreements with the owners of these intangibles (i.e. Principal Co is the new licensee).

(ii) OpCo enters into a toll manufacturing agreement with Principal Co, whereby the latter company will have a sole ownership interest and manage all the risks associated with the procurement of the raw materials and the inventory stock. Under the toll manufacturing agreement OpCo will continue to use the rights related to the “Just in Time” manufacturing know-how on a royalty-free basis;

(iii) Principal Co is contractually responsible for the control of the timing and quantity of the output to be produced by OpCo;

(iv) Principal Co has the right to dictate design specifications for the product, and to exert control over product quality;

(v) Principal Co will pay a service fee for the manufacturing services provided by OpCo. The fee is calculated by adding a mark-up of 10% over the costs incurred by OpCo. Moreover, OpCo does not bear any risk with respect to any potential profit or loss arising from the sale of the product (i.e. all the market and credit risk is shifted to Principal Co) and has no role in determining the marketing strategy for the sale of the product;

(vi) OpCo’s distribution agreements with associated group distributors are terminated as part of an arrangement with Principal Co whereby the latter company will enter into identical agreements with those same entities; and

(vii) OpCo retains its distribution activity in its domestic market, for which it will now purchase finished products from Principal Co (including products manufactured by Opco in its toll manufacturing function).

B.7.2.19. A suggested approach for a tax official of a developing country auditing this type of business restructuring would be to start from the transfer pricing documentation prepared by the taxpayer (see Chapter C.2) and address the following questions:

I. What is the accurate delineation, including the terms and effect, of the business restructuring arrangement and OpCo's related party transactions (in this case with Principal Co) under that arrangement?

What are the business strategies underlying the decision to enter into such a restructuring, including a high-level identification of the expected economic benefits?

II. Does the functional analysis of OpCo and Principal Co, before and after the business restructuring is implemented, accord with the changes and any difference in the terms of the contractual arrangements?

B.7.2.20. Where the actual conduct of the parties does not reflect their contractual arrangements (for instance, because contrary to the contractual arrangements OpCo's employees continue to manage production schedules, develop quality and design specifications and manage effectively the arrangements with the distribution affiliates), then the actual arrangements must be determined in order to select the most appropriate transfer pricing method in the circumstances of the case.

B.7.2.21. See Chapter B.3 on the selection of the most appropriate method.

Relevant comparable data in the above example may include: (i) similar uncontrolled arrangements involving a business restructuring with the conversion of an entity in a toll manufacturer; (ii) similar uncontrolled transfer/sales agreements of patents and trademark rights; (iii) the terms governing the termination of uncontrolled licensing and distribution agreements, similar to those in place in the pre-restructuring controlled agreements; and (iv) uncontrolled toll manufacturing arrangements similar to the post-restructuring controlled arrangements.

B.7.2.22. Depending upon the extent of such comparable data, any other available information relevant to determining whether the business restructuring makes commercial sense for both the transferor (OpCo) and the transferee (Principal Co) should be obtained, taking into account the options realistically available to them at arm's length.

B.7.2.23. If reliable comparables cannot be identified the tax authorities may achieve an arm's length outcome by hypothesising the conditions that might reasonably be expected to be agreed upon between independent enterprises dealing at arm's length in comparable circumstances.

B.7.2.24. Most notably, an important question to be addressed entails whether any compensation should be expected between OpCo and Principal Co had a similar agreement been entered into by independent enterprises dealing at arm's length in comparable circumstances.

B.7.2.25. This would entail firstly identifying the legal nature and economic value of the transfer of property between OpCo and Principal Co (for example, patents and trademarks) and, should the answer be affirmative, assessing whether an independent party might reasonably be expected to pay for it or to obtain compensation for supplying it.

B.7.2.26. Secondly, it would be necessary to investigate whether OpCo would at arm's length be owed an indemnification for the termination of its license agreements (e.g. for the "Just in Time" manufacturing know-how) and distribution agreements, which resulted in a substantial renegotiation of its manufacturing status.

B.7.2.27. Thirdly, as an independent party, would OpCo realistically have the option of continuing these arrangements? In particular, given all the legal, commercial, economic and financial circumstances, would OpCo as an independent party have any option realistically available to it other than to enter into the business restructuring on the agreed terms? For instance, would OpCo as an independent party legally have any option not to terminate its existing licensing and distribution agreements? Another question is whether the conditions for termination of the licensing agreements with OpCo are arm's length.

B.7.2.28. Would Principal Co as an independent party have any option realistically available to it other than to enter into the business restructuring on the agreed terms? Would Principal Co have the option of entering into similar licensing, distribution and toll manufacturing arrangements without involving OpCo?

B.7.2.29. Moreover, does Principal Co have both the decision-making capability and financial strength to assume and manage the risks transferred to it by OpCo? Does Principal Co have the decision-making capability and financial strength to assume and manage the risks associated with the ownership of the patents, trademarks and manufacturing know-how "Just in Time"?

B.7.2.30. Should the examination of the case conclude that the pricing of the business restructuring makes commercial sense for the parties, based on the information available to the taxpayer at the time the restructuring was entered into and having regard to their economic circumstances and the options realistically available to them at arm's length, this would determine the amount of the arm's length remuneration receivable or payable by OpCo under the arrangement.

B.7.2.31. Should the examination of the case conclude that the pricing of the business restructuring did not make commercial sense for the parties based on the information available to the taxpayer at the time the restructuring was entered into, then the tax administration should seek to achieve an arm's length outcome primarily by a pricing adjustment (for example, by computing upwards the taxable profits of OpCo or by adjusting any agreed amount of compensation receivable or payable by OpCo) by reference to the arrangement as entered into by the associated enterprises.