OECD Issues Discussion Draft on Transfer Pricing Aspects of Business Restructurings

The OECD on September 19 issued a discussion draft on the transfer pricing aspects of business restructurings. The discussion draft evolved from the work of the Joint Working Group on Business Restructurings. The JWG was disbanded earlier this year; the transfer pricing issues were referred to Working Party 6 and the permanent establishment threshold issues to Working Party 1. Working Party 1 will consider the permanent establishment issues arising from ‘limited risk’ structures as part of its 2009-2010 program of work and will issue a separate discussion draft in due course.

On the whole, the discussion draft is a very helpful document and should support a principled and fact-based analysis of the tax and transfer pricing implications of business restructurings. Some aspects of the discussion draft will require discussion and clarification, but we welcome it as a constructive contribution to an extremely difficult and contentious issue for both business and tax authorities.

The deadline for submission of comments on the discussion draft is February 19, 2009.

The discussion draft is based on the existing transfer pricing rules. It starts from the premise that the arm’s length principle and the Transfer Pricing Guidelines should not apply differently to restructurings or post-restructuring transactions than to transactions that were structured as such from the beginning.

This discussion draft considers the transfer pricing issues in four Issues Notes:

- Issues Note 1 discusses special considerations relating to the allocation of risks in limited-risk structures;
- Issues Note 2 considers the possible need for compensation for the restructuring itself;
- Issues Note 3 addresses the remuneration of post-restructuring transactions; and
- Issues Note 4 discusses the circumstances in which the tax authorities may disregard the actual transactions undertaken by the taxpayer.

We have summarized below the main conclusions of the discussion draft.
Issues Note 1 – Special Considerations for Risks

The first Issues Note provides general guidance on the allocation of risks between related parties, and in particular the interpretation and application of paragraphs 1.26 to 1.29 of the TP Guidelines. Theoretically, the assumption of increased risk must be compensated by an increase in the expected return, although the actual return may or may not increase depending on the degree to which the risks are actually realized. Risk allocation and risk transfers are significant factors in many business restructurings. The main conclusions in Issues Note 1 are as follows:

- A functional analysis starts from an examination of the contractual terms between the parties, as those generally define how risks are to be divided between the parties. The contractual allocation of risk between associated enterprises, however, is respected only to the extent that it has economic substance. Therefore, the review of contractual terms must be completed by a review of the following matters:
  - whether the related parties conform to the contractual allocation of risks;
  - whether the contractual terms provide for an arm’s length allocation of risks;
  - whether the risk is economically significant; and
  - what the transfer pricing consequences of the risk allocation are.
- The parties’ conduct should generally be considered the best evidence concerning the true allocation of risk.
- When there is reliable evidence of a similar allocation of risk in contracts between comparably situated independent parties, the contractual risk allocation between the related parties is regarded as arm’s length.
- The mere fact that independent enterprises do not allocate risks in the same way as a taxpayer in its controlled transactions is not sufficient to not recognize that risk allocation. When no comparables exist to support a contractual allocation of risk between related parties, it becomes necessary to determine whether that allocation of risk might be expected between independent parties in similar circumstances. One factor that can assist in this determination is the examination of which party has control over the risk. “Control” is 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. This would require the company to have people who have the authority to, and effectively do, perform these control functions.
- 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 not sufficient to transfer the risk to that other party.

Issues Note 2 – Arm’s Length Compensation for the Restructuring Itself

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 second Issues Note discusses the application of the arm’s length principle and TP Guidelines to the restructuring itself, in particular the circumstances in which at arm’s length the restructured entity would receive compensation for the transfer of functions, assets, and/or risks, and/or indemnification for the termination or substantial renegotiation of the existing arrangements. The main conclusions in Issues Note No. 2 are as follows:

- 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.
- Profit/loss potential is not an asset in itself, but 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 is whether there are rights or other assets transferred that carry profit/loss potential and should be remunerated at arm’s length.
- Whether a transfer of profit / loss potential that follows from a business restructuring is an arm’s length transaction depends on a number of factors, including but not limited to the following:
o the options that would have been realistically available to the transferor and transferee at arm’s length, based on the rights and other assets of each at the outset of the restructuring, that determine the profit/loss potential of either; and

o the expected return to the transferor and transferee after the restructuring, and the compensation that might be required to appropriately remunerate the transferor’s surrender of profit potential, in cases in which the transferor has transferred or surrendered rights or other assets that carry that profit potential.

• Issues Note No. 2 contains a discussion of the determination of arm’s length compensation for the transfer of something of value, such as tangible assets, intangible assets (including local intangibles and contractual rights), and/or an ongoing concern.

• There should be no presumption that all contract terminations or substantial renegotiations give rise to a right to indemnification. To assess whether indemnification would be warranted at arm’s length, it is important to examine the circumstances at the time of the restructuring, particularly the rights and other assets of the parties as well as the options that would have been realistically available to the parties at arm’s length. Relevant circumstances include the following:
  o whether the old arrangement was formalized in writing and provides for an indemnification clause;
  o whether the terms of the arrangement and the existence of an indemnification clause or other type of guarantee (as well as the terms of such a clause when it exists) are arm’s length;
  o whether indemnification rights are provided for by commercial legislation or case law; and
  o whether an arm’s length party would have been willing to indemnify the one that suffers from the termination or renegotiation of the agreement.

Issues Note 3 – Remuneration of Post-Restructuring Controlled Transactions

The third Issues Note examines the application of the TP Guidelines to post-restructuring arrangements. The main conclusions are as follows:

• The TP Guidelines do not apply differently to post-restructuring transactions than to transactions that were structured as such from the beginning.

• Business restructurings involve change, and the arm’s length principle also must be applied to transactions that take place upon the restructuring.

• The comparability analysis of an arrangement that results from a business restructuring might reveal some factual differences compared to an arrangement that was structured as such from the beginning. While these factual differences do not affect the arm’s length principle or the way the TP Guidelines should be applied, they may affect the comparability analysis and therefore the outcome of this application. For this reason, it is essential in business restructuring cases that a comparability (including functional) analysis be performed both for the prerestructuring and the post-restructuring arrangements, and that the actual changes that took place upon the restructuring be documented.

• The OECD view is that the arm’s length remuneration of selling activities (whether buy-and-sell activities, commissionaires, or sales agents) should generally be based on a sales-related indicator. A combination of a cost-based indicator (such as the Berry ratio) and of a sales-based indicator might also be acceptable in appropriate circumstances, for instance when the sales operation (the commissionaire or sales agent) incurs significant promotional expenditure as a service performed for the principal in addition to its selling activities.

• Comparisons of profits earned before and after the restructuring would not suffice to support a transfer pricing adjustment, but they could play a role in understanding the restructuring itself and could be part of a before-and-after comparability analysis to understand the value drivers and the changes that accounted for the changes in the allocation of profits among the parties.

• Location savings should be attributed among the parties depending on what independent parties would have agreed, and normally depends on each party’s functions, assets, and risks and on their respective bargaining powers, and in particular on whether or not the relocated activity that gives rise to the location savings is a highly competitive one.
Issues Note 4 – Recognition of Actual Transactions Undertaken

The fourth Issues Note discusses important notions regarding the exceptional circumstances in which a tax administration may consider not recognizing a transaction or structure adopted by a taxpayer, based on an analysis of the existing guidance at paragraphs 1.36-1.41 of the TP Guidelines and of the relationship between these paragraphs and other parts of the TP Guidelines.

- Depending on the circumstances and on the countries involved, domestic anti-abuse rules, such as CFC rules, might be applicable, but such domestic rules and their relationship with tax treaties are not within the scope of this project. Paragraphs 1.36-1.41 of the TP Guidelines are limited to the recognition of transactions for purposes of making transfer pricing adjustments covered by Article 9 of the OECD Model Tax Convention. They do not provide any guidance as to a country’s ability to characterize transactions differently under other aspects of its domestic law.

- Paragraphs 1.36-1.41 apply when there is a dispute about the fundamental nature of the transaction being examined. When there is no dispute about the nature of the transaction – and hence, no recognition issue – these paragraphs do not restrict a tax administration’s ability to adjust the price or other conditions of a controlled transaction to conform to the arm’s length standard.

- When paragraphs 1.36-1.41 do apply, Article 9 would allow an adjustment of conditions to reflect those the parties would have attained had the transaction been structured in accordance with the economic and commercial reality of parties dealing at arm’s length. In doing so, the objective should be to arrive at a characterization or structure that comports as closely as possible to the facts of the case.

- Nonrecognition of transactions is not the norm, but an exception to the general principle that a tax administration’s examination of a controlled transaction ordinarily should be based on the transaction actually undertaken by the associated enterprises as it has been structured by them, using the methods applied by the taxpayer insofar as they are consistent with the TP Guidelines. The OECD considers that apparent non-arm’s length behavior should be dealt with, to the extent possible, on the basis of pricing adjustments, rather than by not recognizing transactions. In some situations, however, it may not be possible to arrive at an appropriate transfer price in the circumstances of the case.

- The actual transactions can be disregarded when two conditions exist:
  - the arrangements made in relation to the transaction, viewed in their totality, differ from those that 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.

- If an appropriate transfer price can be arrived at in the circumstances of the case, irrespective of the fact that the transaction may not be found between independent parties and that the tax administration might have doubts as to the commercial rationale for the taxpayer entering into a transaction, the transaction would be recognized under Article 9 of the Model Tax Convention. Otherwise, the tax administration may need to decide whether this is a case for not recognizing the transaction.

- Some countries consider that the “commercially rational behavior” test is intended to deal with cases in which a transaction has no nontax business purpose. However, a large majority of OECD countries consider that it sets a benchmark as to whether “independent enterprises behaving in a commercially rational manner” would have entered into a similar arrangement. The TP Guidelines lack guidance on how to determine what “independent enterprises behaving in a commercially rational manner” would have done. Tax administrations should not ordinarily interfere with the business decisions of a taxpayer as to how to structure its business arrangements. A determination that a controlled transaction is not commercially rational must therefore be made with great caution, and only in exceptional circumstances lead to the nonrecognition of the related-party arrangements.

- The OECD believes that at arm’s length, an independent party would not enter into a restructuring transaction that is expected to be clearly detrimental to it, if it has a realistic option not to do so. In evaluating whether a party at arm’s length would have had other options realistically available to it that were clearly more attractive, due regard should be given to all the relevant conditions of the restructuring, to the rights and other assets of the parties, to any compensation or indemnification for
the restructuring itself, and to the remuneration for the post-restructuring arrangements, as well as to the commercial circumstances arising from participation in an MNE group.

- In assessing the commercial nature of a transaction that is part of a broader overall arrangement, it is important not to examine the transaction in isolation, but to look at the totality of the arrangements to determine whether the terms make commercial sense for the parties. For instance, when examining a transaction consisting in a sale of an intangible by a taxpayer to a foreign related party, it would be relevant to consider whether the sale is part of a broader restructuring involving changes to the arrangements relating to the development and use of the intangible.

- The OECD considers that as long as functions, assets, and/or risks are actually transferred, it can be commercially rational from an Article 9 perspective for an MNE group to restructure to obtain tax savings.

- The OECD recognizes that there can be legitimate group-level business reasons for an MNE group to restructure. In practice, when 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. In this respect, it is worth emphasizing that the arm’s length principle treats the members of an MNE group as separate entities rather than as inseparable parts of a single unified business. As a consequence, it is not sufficient from a transfer pricing perspective that an arrangement makes commercial sense for the group as a whole: the transaction must be arm’s length at the level of each individual taxpayer, taking into account its rights and other assets, expected benefits from the restructuring arrangement, and realistically available options.

- Three examples illustrate the OECD’s views on typical case patterns involving (A) the conversion of a full-fledged distributor into a “risk-less” distributor; (B) a transfer of valuable intangibles to a shell company; and (C) a transfer of intangible to a company that exercises functions.

Conclusion

Business restructuring transactions can be very contentious due to the material impact they can have on the tax profile of a multinational group in a particular country. The discussion draft should prove to be useful guidance on the application of the Transfer Pricing Guidelines to business restructurings. It broadly supports the view that the arm’s length standard must be applied to business restructurings based on a thorough analysis of the facts and circumstances and consideration of what independent enterprises acting at arm’s length would have agreed. This should be helpful in ensuring a balanced and principled approach is taken to the consideration of the tax and transfer pricing implications of business restructurings.

Some aspects of the discussion draft are likely to prompt discussion in the business community, including a seemingly new requirement that taxpayers demonstrate that risk allocations within a group are consistent with those observed between unrelated parties; the need for more specific guidance about the circumstances when a restructuring transaction that results in a transfer of risk and/or potential for profit or loss constitutes a transfer of a valuable asset; potentially significant additional compliance burdens relating to analyzing expected and actual synergies and analysing the options realistically available to an entity participating in a restructuring; the role of comparison of pre- and post-restructuring profits; and clarification of the OECD position on the meaning of ‘behaving in a commercially rational manner,’ in view of the lack of consensus disclosed in the discussion draft.

Taxpayers with comments on the discussion draft or who would like to discuss the implications for their companies should contact their local Deloitte representative.