Transfer Pricing Aspects of Business Restructurings

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On 19 September 2008, the OECD released an important discussion draft entitled “Transfer Pricing Aspects of Business Restructurings”. This document is the result of three years of discussions among OECD member countries on what is today one of the hottest topics in international taxation.

What is at stake? Business restructurings that are addressed in the discussion draft consist in the cross-border redeployment of functions, assets and risks within multinational enterprises. They often have dramatic effects on the reallocation of the profit (or loss) potential among the members of a multinational enterprise group, and accordingly on the amount of corporate income tax paid in each of the countries where the group operates. Typically, they involve the conversion of affiliated full-fledged manufacturers into contract- or toll-manufacturers, the conversion of affiliated full-fledged distributors into limited risk distributors or commissaires, operating for an affiliated principal that will act as the main entrepreneur for the group and centralise intangible property rights, risks and profit (or loss) potential.

Business restructurings raise particularly difficult issues in the international tax area, especially for the application of tax treaties and in the area of transfer pricing, for the determination of the quantum of the tax base allocated to each country where a multinational enterprise operates. There are also issues in relation to the possible application of domestic anti-abuse rules. The discussion in the September 2008 discussion draft is limited to the transfer pricing aspects of business restructurings.

The international consensus on transfer pricing is found at Article 9 of the OECD Model Tax Convention – an article that is reproduced in several thousands of bilateral tax treaties between countries. Under this provision, the conditions of transactions between associated enterprises should be “arms’ length”. This means that tax administrations can determine, for tax purposes, whether the conditions of a transaction between associated enterprises – for instance, a restructuring transaction – differ from those which would be made between independent parties. Where this is the case, tax administrations may adjust the taxable profits of the enterprise to include the profits that would have accrued “at arms’ length” but have not so accrued, by reason of these special conditions. Guidance for the application of the arm’s length principle is found in the OECD Transfer Pricing Guidelines for Tax Administrations and Multinational enterprises.

Examples of transfer pricing questions that may arise during an examination include whether the new allocation of risk that results from the restructurings is arm’s length; whether the restructured entity should have been indemnified at arm’s length for the detriment suffered in the restructurings; whether the remuneration for the post-restructuring transactions is arm’s length; and whether the tax administration should recognise the restructuring transaction or may disregard it.

Today, countries have differing experiences and approaches in their transfer pricing examinations of business restructurings. This lack of a common understanding of how the arm’s length principle should apply to business restructurings creates significant uncertainties for businesses and for tax administrations. One objective of the OECD project is to discuss the extent to which the reallocation of profits that typically follows from a restructuring is consistent with the arm’s length principle and more generally how the arm’s length principle applies to business restructurings, in order to achieve a greater consensus, clearer guidance, less uncertainty and less risks of double taxation – or of unintended double non-taxation.

In light of the importance of risk allocation in relation to business restructurings, the discussion draft provides general guidance on the allocation of risks between related parties from a transfer pricing perspective. Theoretically, in the open market, the assumption of increased risk must also 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 realised.

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 discussion draft discusses 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 an indemnification for the termination or substantial renegotiation of the existing arrangements.

For the OECD, the profit/loss potential is not an asset in itself, 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 is whether there are rights or other assets transferred that carry profit/loss potential and should be remunerated at arm’s length, taking account of the perspectives of both the transferor and the transferee.

The discussion draft discusses situations where at arm’s length the restructured entity would be entitled to an indemnification for the detriments it suffered as a consequence of the restructuring. There should be no presumption that all contract terminations or substantial renegotiations give rise to a right to indemnification at arm’s length. In order to assess whether an 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 which would have been realistically available to the parties at arm’s length.

There are also some important issues in relation to the exceptional circumstances where a tax administration may consider not recognising for transfer pricing purposes a transaction or structure adopted by a taxpayer. Tax administrations should not ordinarily interfere with the business decisions of a taxpayer as to how to structure its business arrangements. The OECD considers that apparent non-arm’s length behaviour should as much as possible be dealt with on the basis of pricing adjustments, rather than by not recognising transactions. In some situations, however, it may not be possible to arrive at an appropriate transfer price in the circumstances of the case.

The full text of the discussion draft is available at www.oecd.org/ctp/tp/br. Interested parties are strongly encouraged to provide written comments by 19 February 2009, as this is a not-to-be missed opportunity for the business community to contribute to the shaping of the international consensus on this very sensitive subject.

The views expressed are those of the author, not necessarily those of the OECD and its members.