Business Restructuring: OECD Releases Discussion Draft on Application of Transfer Pricing Guidelines

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For a number of years, tax authorities around the world have been considering how to deal with issues associated with cross-border business restructuring. The OECD has now released its long awaited discussion draft addressing how the OECD Transfer Pricing Guidelines (“the TP Guidelines”) and the corresponding treaty rules should apply to a business restructuring (“the draft”). The draft addresses transactions between related parties in the context of Article 9 of the Model Tax Convention. It has been issued to seek input from the taxpayer community.

Applicability of the draft
A business restructuring is defined as “the cross-border redeployment by a multinational enterprise of functions, assets and/or risks (among related parties) with consequent effects on the profit and loss potential in each country.” Business restructuring includes for example the conversion of full-fledged distributors (manufacturers) into limited-risk distributors (manufacturers) or the transfer of intangible property rights to the principal within the group.

The discussion draft comprises four “issues notes” which are summarized below.

Issues note 1: special considerations for risks
This note provides general guidance on the allocation of risks between related parties in an Article 9 context. The draft recognizes that contractual terms, including assignments of risk, should generally be recognized as structured by the parties. According to the draft, the taxpayer does not have to identify a transaction where independent parties assumed the same risks and functions as the controlled parties as long as controlled parties receive arm’s length consideration for functions performed, risks assumed and assets used in the controlled transactions.

However, contractual terms will not be recognized if the terms have no economic substance. Economic substance will be primarily determined by analyzing the conduct of the parties, setting the focus on the risks and functions assigned and whether risks, if any, can be financially born. The draft also concludes that changes in profits following a reallocation of risk must be consistent with the economic significance of the risk assumed. For example, if inventory risk or credit risk is assumed, how significant have inventory or bad debt losses been in the past? The attribution of profit should reflect the realistic amount of the risk assumed.

The draft provides helpful guidance regarding determination whether contractual risk allocation is one that might be expected to have been agreed between unrelated parties. The factor that is suggested in the draft relates to examination which party has control over the risk. The OECD considers that in the context of paragraph 1.27 of the TP Guidelines, “control” should be understood as the capacity to make decisions to take on the risk (decision to put the capital of the entity at risk) and to make decisions on whether and how to manage the risk, internally or using an external provider. The exercise of managerial control over risk requires the company assigned the risk to have people – employees or directors – who do perform these control functions. Thus, if one party bears a risk solely by hiring another party to administer and monitor that risk on a day-to-day basis, tax authorities will not recognize the transfer of the risk to that other party.

The OECD considers that in order to control a risk one has to be able to assess the outcome of the day-to-day monitoring and administration of functions by the service provider. The level of control needed and the type of performance assessment would depend on the nature of the risk. Another factor that may influence an independent party’s willingness to take on a risk is its anticipated financial capacity to bear that risk.

Thus, for example, contract R&D is possible with the principal being located in a different jurisdiction so long as the principal has people who can plan, control and monitor the research, and the necessary financial capacity.

Issues note 2: arm’s length compensation for the restructuring itself
This note provides guidance on the arm’s length nature of compensation for the restructuring itself, including the circumstances in which at arm’s length the transferee would receive compensation for the transfer and/or an indemnification for termination or substantial renegotiation of the existing arrangements.

The draft states that business restructuring or the potential loss of profit of a taxpayer is not a taxable event per se. However, business restructurings will usually be scrutinized to determine whether rights that are compensable under general transfer pricing principles, especially intangibles, have been transferred in connection with a business restructuring. The options available to the parties engaging in the restructuring will need to be examined as part of the analysis of rights transferred in a restructuring transaction as well as the profit (or loss) potential given up as part of the restructuring. In some cases an indemnification payment may be required under local law or such a payment may be inferred.

Issues note 3: remuneration of post-restructuring controlled transactions
This note covers the application of the arm’s length principle and transfer pricing guidelines to post-restructuring arrangements, based on existing guidance on the selection and application of transfer pricing guidelines.

The draft indicates that the same transfer pricing principles should be applied to analyze a controlled transaction entered into as part of a business restructuring as would be used if the transaction was entered into as part of a business formation or other business transaction. The draft notes that the choice of a transfer pricing method will be determined by general “best method” and comparability considerations. For example, use of the TNMM to determine the profit target range for a manufacturing entity does not turn the manufacturing affiliate into a limited risk manufacturer merely because the TNMM is used. Rather, the use of TNMM should be based on the risk profile of the controlled manufacturer in comparison to the comparables.

The draft explores two specific examples: centralized purchasing and location savings.

Issues note 4: recognition (or non-recognition) of the actual transactions undertaken
This note discusses the application of the transfer pricing guidelines to the recognition of actual transactions undertaken referring to business restructurings. Specifically, the OECD emphasizes that an examination of how the arm’s length principle has been applied to controlled transactions should start with the transactions actually undertaken by the related enterprises. The contract terms will play a major role in the transfer pricing analysis, but a mere review of the contract terms is not sufficient. The draft accepts that non-recognition of transactions as structured should be “exceptional.” However, some examples are provided of “commercially irrational” transactions or transactions that impede tax administration and thus should not be recognized as structured.

The OECD’s position is that when a dispute arises over the nature of the transaction, tax authorities may re-characterize the nature of the transaction and that the tax authority is not limited to making a transfer pricing adjustment of the transactions as structured. In this respect, reference is clearly made to general or specific anti-abuse provisions.

The draft also contains three examples that discuss when tax authorities would recognize or not recognize transactions undertaken as part of a business restructuring.

Implications for taxpayers
The OECD recognizes the fact that multinational enterprises are free to organize their business operations. The OECD considers that as long as functions, assets and/or risks are actually transferred, it can be commercial rational from an Article 9 perspective to restructure in order to obtain tax savings. Moreover, the contractual allocation of risk between associated enterprises should be respected to the extent that the risk allocation has economic substance, determined by reference to the actual conduct of the parties, and transactions are conducted for arm’s length consideration.

The arm’s length principle does not require that tax authorities observe third parties in engaging in similar transactions, but the real question is what would have third parties agreed as the arm’s length consideration in...
It is not sufficient from a transfer pricing perspective that an arrangement makes commercial sense for the group as a whole. The transactions must be arm’s length at the level of each individual taxpayer, taking into account its assets, expected benefits from the restructuring agreement, and realistically available options.

Tax authorities will consider if the contractual arrangement is consistent with the actual allocation of risks.

The arm’s length principle does not of necessity require compensation for loss of profit/loss potential. The question is if there are assets transferred that carry profit/loss potential and should be remunerated at arm’s length. In some circumstances, indemnifications will be appropriate.

The draft envisages that tax authorities could assume contractual relationships in extreme circumstances. For example, a business restructuring of an entity that significantly invested in the local jurisdiction might be required to demonstrate either that its pricing included a risk premium for loss of market opportunity or remuneration for abandoning its business opportunity in the local market.

Taxpayers will need proper documentation describing: comparability (including functional) analysis performed both for the pre- and post-restructuring arrangements and a description for the actual changes that took place upon the restructuring, what the business reasons for and the anticipated benefits from the restructuring were, and what options would have been realistically available for the parties at arm’s length. The functional analysis may have to cover also a transition period over which the transfer is being implemented.

**Closing remarks**

The draft is the first focused transfer pricing analysis from OECD member countries on how they may treat controlled transactions entered into as part of business restructurings. The analysis recognises the rights of taxpayers to rationalize their operations, but certain provisions in the draft could result in “exit” charges for affiliates that are restructured in whole or part for the benefit of the group. While this is a draft document that is being issued for public comment, the document contains the thinking of a significant number of OECD countries. Many of the positions presented in the draft are already being taken in examinations of business restructurings by many tax authorities.

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3. Particularly regarding the interpretation of par. 1.26 to 1.29 of the TP Guidelines.