

# Comments on the OECD Discussion Draft on Transfer Pricing Aspects of Business Restructurings

## 1. Introduction

The OECD issued its Discussion Draft on the Transfer Pricing Aspects of Business Restructurings (the Discussion Draft) on 19 September 2008. The Discussion Draft defines restructurings as “the cross-border redeployment by a multinational enterprise of functions, assets and/or risks. A business restructuring may involve cross-border transfers of valuable intangibles”.<sup>1</sup> The purpose of the Discussion Draft is to discuss “the extent to which such a reallocation of profits is consistent with the arm’s length principle and more generally how the arm’s length principle applies to business restructurings”.<sup>2</sup>

The Discussion Draft provides a detailed discussion of the way that business restructurings should be handled. In general, it applies the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines) to restructurings, and provides commentary on some of the issues that arise during restructurings.

Multinational corporations (MNEs) restructure for a variety of reasons including:

- (1) mergers and acquisitions that require merging disparate transfer pricing systems;
- (2) changes in market conditions that require changes in business operations (e.g. new markets, competition that forces the MNE to move its operations to low-cost jurisdictions); and
- (3) desire to maximize the MNE’s profits through downsizing, centralization of functions, etc.

The first two reasons have given rise to changes in corporate transfer pricing policies for many years. The second cause is particularly important today as increasing globalization of business, and the increased competition that results from globalization, have required many MNEs to centralize control of much of their business. These changes many times require that the MNEs locate significant parts of their business in low-cost countries so that they can remain competitive. Failure to do this can lead to business failure. The third cause of restructuring is not new, but in recent years many MNEs have emphasized the need to improve profits through internal means (e.g. lowering cost) rather than external means (e.g. increasing revenue).

The OECD Guidelines and the US transfer pricing regulations provide sufficient guidance for both US taxpayers and the US Internal Revenue Service (IRS) to deal with the transfer pricing issues raised by restructuring. This article will discuss some of the issues raised by the

Discussion Draft and apply US rules to those issues. As will be seen, the OECD Guidelines, the US rules (Sec. 482) and the Discussion Draft are consistent in the way that they treat the issues addressed in the Discussion Draft.

This article considers a number of restructuring scenarios and discusses the positions taken in the Discussion Draft, in the OECD Guidelines, and by the US Sec. 482 (transfer pricing) regulations. The scenarios that will be considered are:

- change of manufacturing operations from full-fledged to contract manufacturing;
- change of distribution operations from full-fledged distributor to limited risk distributor or commissionaire; and
- establishment of contract research and development (R&D) arrangements.

In addition, issues will be addressed that affect transfer pricing practices during and after the restructuring process, including:

- the relationship between compensation for the restructuring and post-restructuring remuneration;
- the recognition of transactions as structured by the taxpayer; and
- a general discussion of issues affecting pricing in the post-restructuring world.

## 2. Restructuring Scenarios

### 2.1. Conversion of a full-fledged manufacturer into a contract manufacturer

In the case of a conversion of a US manufacturing company from a full-fledged manufacturer to a contract manufacturer, the IRS has several possible avenues of attack.<sup>3</sup>

*Were contractual relationships violated?*

Intercompany agreements should be put in place when a structure is established, and they should contain termination clauses that are both arm’s length and flexible

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1. Para. 2 Discussion Draft.

2. Id., Para. 7.

3. Throughout this article, only the transfer pricing aspects of the restructuring are considered. The IRS may have other avenues to attack restructurings but a discussion thereof is beyond the scope of this article.

enough to allow for early termination. It is always a good idea to document intercompany relationships through legal agreements; however they can create problems if the contracts cannot be cancelled or substantially changed at the time the restructuring takes place.

For example, assume that an intercompany licence agreement gives the US company the right to make, use and sell specific products in specific markets using intangible property owned by a non-US related party. The agreement is entered into in Year 1 and expires in Year 10. The restructuring takes place in Year 5, and the licence agreement is terminated at the end of Year 5. Unless there is an early termination clause that allows the licensor to terminate the agreement without penalty, the early termination of such a contract usually must be accompanied by a payment from the licensor to the licensee. This indicates a tension between contract flexibility and the need to give the licensee time to recover its investment in developing a market for the products that incorporate the intangible property. This also explains why, in many third-party licences, the licensee is given the right to use the intangible property for the life of the property (if it has a specified life, such as a patent).

If, on the other hand, the contract is terminated under the terms of the contract (e.g. it expires or a termination clause allows termination with specified written notice), no compensation is generally required to compensate the US company for the termination of the licence. This point is more clearly made when dealing with distributors. Typically, arm's length distribution agreements have a one-year term, which means that they naturally expire annually, and can be replaced without needing to compensate the sales company for the restructuring.

*Were intangible assets transferred out of the United States?*

This is the primary way that the IRS attacks restructuring exercises. If a US manufacturer has developed product-related intangible property relating to the manufacturing process, and the ownership of this property is transferred to a non-US related party as part of the restructuring exercise, one can expect the IRS to demand payment for the US-developed and owned intangible property.

If the intangible in question, however, is not product-related, but is process-related, ownership may remain in the United States and this is consistent with treatment of the US company as a contract manufacturer. In other words, every contract manufacturer owns process-related intangibles, and the return it receives includes a return on those intangibles. Leaving these intangibles in the United States may affect the markup that the US company receives, but it does not affect the characterization of the US company as a contract manufacturer.

*Were risks moved outside the United States?*

In the situation where a US full-fledged manufacturer is converted to a contract manufacturer, two key issues arise. The first involves the potential transfer of intangible assets from the US company to a non-US related

entity, and the second involves risk stripping so that the US company has little, or no, risk. The intangible issue was discussed in the previous point. This section considers risk stripping.

The IRS may question whether or not the risks were actually moved, i.e. whether the risks, in substance, were moved to related non-US entities. Any transfer pricing analysis must involve a careful evaluation of the risks incurred by each party involved in the subject intercompany transactions. The evaluation of risk has become more important, and more demanding, than in the past. For example, the Discussion Draft raises several questions that must be answered during a business restructuring (or during any transfer pricing analysis) and that were not previously the focus of much attention during transfer pricing audits. Three issues must be addressed.

First, the contractual terms between the parties<sup>4</sup> must be evaluated. This is the place where the taxpayer can, and should, specify the risks that will be absorbed by each legal entity involved in the subject intercompany transactions. The Discussion Draft states that allocations of risk are respected only to the extent that they have economic substance, i.e. depending on whether the parties conform to the contractual allocation of risks. As the Discussion Draft points out, documentation is critically important. In the absence of acceptable documentation, the parties' conduct is the best evidence of the true allocation of risk.

Second, the Discussion Draft asks whether the contractual terms provide for an arm's length allocation of risks. The mere fact that independent enterprises do not allocate risks in the same manner as the intercompany relationship is not sufficient to disregard the company's risk allocation. The Discussion Draft emphasizes control over risk, i.e. the capacity to make decisions to take on the risk and decisions about whether and how to manage the risk (internally or through a third party). In other words, the company must have people (employees or directors) who have the authority to and effectively do perform these control functions. "... [W]hen one party bears a risk, the fact that it hires another party to administer and monitor the risks on a day-to-day basis is not sufficient to transfer the risk to that other party"<sup>5</sup> The Discussion Draft goes on to say that to control a risk, one must be able to assess the outcome of the day-to-day monitoring and administration functions by the service provider.<sup>6</sup>

Third, the Discussion Draft points out that the risk holder must be the party that bears the investment or other monetary risk, in addition to controlling the transaction. When one party hires another to administer the risks or manage the day-to-day operations, but remains the party whose investment or profitability is at risk, that person is the risk holder.

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 4. Para. 18.1 Discussion Draft.  
 5. Id., Para. 30.  
 6. Id., Para. 31

These requirements are similar to the US Sec. 482 rules. These rules specify that the determination of the party that bears a particular risk is to be made according to the contractual terms set forth in intercompany agreements.<sup>7</sup> In general, the risk allocation contained in an intercompany agreement is respected so long as it is consistent with the economic substance of the transaction. Importantly, the regulations state that risks that are allocated after the outcome of the risk is known or reasonably knowable lacks economic substance.<sup>8</sup> Thus, it is important to put intercompany agreements in place when the structure is adopted.

Furthermore, the US regulations state that the economic substance of risk allocation must be evaluated using three factors, namely:

- whether the taxpayer's conduct over time is consistent with the allocation of risk;
- whether the taxpayer has the financial capacity to fund losses that might be expected to occur as a result of assumption of the risk in question; and
- the extent to which each controlled taxpayer exercises managerial or operational control over the business activities that directly influence the amount of income or loss realized.<sup>9</sup>

As should be obvious, these rules are substantially the same as the OECD Guidelines and the Discussion Draft. These rules can be applied to various types of structures and to restructuring. For example, restructuring of manufacturing entities from full-fledged manufacturers to contract/toll manufacturers must also involve movement of risk. The issue that the IRS may raise involves the risks that are purportedly removed from the US company. For example, a contract manufacturer does not ordinarily face defective product risk that arises due to design issues, nor does a contract manufacturer face product liability risk. If the restructuring exercise left those risks in the US company, through write-offs, legal expenses, management of US liability issues, etc., the IRS may conclude that the risk remains in the United States and the contract manufacturing structure may be challenged on that basis.

#### *What is the appropriate compensation for the assumption of the risk?*

Once it is clear that risk was moved, the question that must be answered is whether the risk is economically significant. The bearing or transfer of a risk that is economically insignificant would not ordinarily explain a substantial amount of or decrease in the profits of the transferor.<sup>10</sup>

Determining whether a risk is economically significant is a very difficult task. Ordinarily, tax authorities look to whether there have been write-offs associated with bearing the risk.<sup>11</sup> The difficulty with that approach is that actual experience with a risk is not necessarily indicative of the importance of the risk. For example if failure to adequately manage inventory risk could cause huge reductions in profit, then an MNE would manage that risk very carefully and very closely. Successful manage-

ment of the risk leads to low, or non-existent, write-offs, which could cause tax authorities to conclude that the risk is economically insignificant. A similar example occurs with credit risk. Companies manage credit risk very carefully because of its importance to a company's bottom line. Successful management of the risk leads to very low write-offs, and the potential conclusion by tax authorities that this is not an important risk.

An alternative method for evaluating the significance of risk would be to evaluate the cost of managing the risk, including insurance costs and personnel costs. The amount that a company would be willing to pay in insurance premiums for the mitigation of a risk may provide a more concrete evaluation of the risk than actual write-offs. Further, the amount of resources, such as risk management personnel, quality control and outside advisor fees that a company spends to mitigate risks may also provide evidence as to the significance of the risk.

An important point that frequently is lost in discussions of restructuring is that 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.<sup>12</sup>

#### *Were functions moved outside the United States?*

Functions may be moved outside the United States, but this needs to be done with care. One of the primary issues that the IRS may raise on audit is the extent to which the function actually moved. For example, suppose that a US full-fledged manufacturer is downgraded to a contract manufacturer, but raw materials purchasing (identifying, qualifying, and negotiating prices and other terms and conditions with materials suppliers) continues to be the responsibility of the US company under a services agreement with a non-US related party. In this case, the IRS could apply the temporary services regulations<sup>13</sup> to conclude that these services are either an "excluded transaction" or a "core service" under the new regulations. In such case, the compensation to the US company could be materially different than was contemplated at the time of the restructuring, i.e. billing at cost or cost-plus a modest markup may not be allowed.

Along with changes that take place at the US company, the IRS may perform a functional analysis on the foreign entity that has assumed the role of the full-fledged manufacturer, to determine if that entity has the substance to perform that role. Stating that functions such as production planning, quality control and raw-materials purchasing have been moved, will not be deemed to have substance if the personnel that previously performed these tasks remain in the US company and/or there are no personnel in the company that assumes control of the

7. Treas. Reg. Sec. 1.482-1(d)(3)(ii)(B).

8. Treas. Reg. Sec. 1.482-1(d)(3)(iii)(B).

9. Id.

10. Para. 18.1 Discussion Draft.

11. Id., Para. 40.

12. Id., Para. 18.1.

13. Treas. Reg. Sec. 1.482-9T.

manufacturing to perform these functions. This is especially important if the non-US company that is taking responsibility for the manufacturing was previously a shell company.<sup>14</sup> It is important to note, however, that if the function actually moved from the US company to a non-US company, that change will be respected.

This discussion here has focused on issues that arise when a US company is converted from a full-fledged manufacturer to a contract manufacturer. It is not uncommon for a US company to convert a non-US full-fledged manufacturer to a contract manufacturer. In that situation, national law of the country where the manufacturer is located is very important. US international tax rules, however, can also affect the restructuring (e.g. see the new Sec. 1.954 regulations). An analysis of these rules is beyond the scope of this article and is not pursued here; however they must be considered by any company undergoing such a restructuring.

## 2.2. Conversion of a full-fledged distributor into a limited risk distributor

Changing a US sales company from a full-fledged to a limited risk distributor can be done under US transfer pricing rules, although a number of issues must be addressed to ensure that the restructuring will be respected. As discussed above, moving functions outside the United States is acceptable; however, the functions must actually move. To illustrate this point, assume that a US company purchases finished goods from a related non-US entity. The US company performs the following functions before the reorganization:

- (1) handles all logistics functions, including US customs issues;
- (2) maintains a warehouse for storage of the goods;
- (3) performs marketing functions in the US market, including developing market strategies and marketing materials, attending trade shows and placing advertisements;
- (4) performs the selling function by calling on potential US customers, negotiates contracts with those customers and provides customer service as necessary both before and after the sale. Assume further that no US customer is a global customer of the MNE;
- (5) invoices customers and is responsible for credit analysis and collection activities; and
- (6) negotiates and signs contracts with third party suppliers for products or accessories that are not supplied by related parties.

Assume further, that the US company bears all the risks that a normal marketer/distributor would bear. If this company is converted to a limited risk distributor, but none of the functions changes, then the IRS may well challenge this arrangement on the basis that nothing has changed, i.e. the functions remain the same and the risks have not, in substance, moved (see the discussion of risk, above).

On the other hand, if the restructuring involves moving all the logistics, warehousing and marketing functions to a related, non-US company or to a third party contracted

by a non-US company, and all decisions regarding invoicing and collections are moved to a related non-US party, the structure may stand up to IRS scrutiny. Surviving an IRS audit of restructured US companies is tied to the integrity of the restructuring. Paper restructurings (where nothing changes, e.g. no headcount reductions and no functional changes) will generally not be respected by the IRS.

However, the fourth assumption is an important one. In today's world, MNEs are beginning to sign global contracts with their suppliers, whereas in the past these contracts tended to be local, i.e. each subsidiary of the MNE signed contracts with local suppliers who were sometimes subsidiaries of a global supplier. This change in facts makes it easier to convert a full-fledged distributor to a limited risk distributor because the selling function is ordinarily centralized in the country where the supplier's headquarters is located. Because of this fact, it is usually possible to characterize the sales companies as "customer service" entities that merely fill orders and follow up on any customer service issues.

Another important issue that must be addressed when converting US selling entities to limited-risk distributors concerns transfers of intangible property. The IRS, as many other tax authorities, attempts to find "marketing intangibles" in such entities and tries to tax their transfer to related parties as part of the restructure. The term "marketing intangibles" has meaning that seems very slippery, i.e. initially most practitioners believed that marketing intangibles comprise trademarks, trade names and corporate logos. These intangibles are valuable because of a variety of functions that MNEs perform with regard to their products, such as marketing, selling quality control of the products that bear the trademarks.

Recently, the definition seems to have broadened to include other aspects of selling activities, such as selling know-how, customer lists and relationships, and marketing strategies. The IRS emphasizes the level of marketing expense in determining whether marketing intangibles exist. The so-called cheese examples in the Sec. 482 regulations illustrate this point, stating that if the US company's marketing expense is higher than "normal" industry practice, a marketing intangible has been created. In recent years, the IRS has argued that marketing expenses above "normal" create a marketing intangible, as well as that some types of expense create an intangible, such as marketing strategy development.

Also, the Discussion Draft states that a full-fledged distributor, when converted to a limited risk distributor may have developed some intangibles for which it should be remunerated either at the time of the conver-

14. As noted elsewhere in this article, there is tension between the crux of this paragraph and the situation where a non-US legal entity hires the US company to perform the function as a service for the non-US company. Structuring of this type can work, but is potentially subject to a variety of transfer pricing challenges including the services regulations contained in Treas. Reg. etc. 1.482-9T.

sion or after the new structure is in place.<sup>15</sup> In the authors' opinion, it can be useful to examine arm's length relationships between unrelated parties to gain perspective on this matter.

Importer/distributors purchase products from unrelated foreign manufacturers and sell the products in their own markets. These companies frequently have the complete responsibility for developing the subject market even though they typically do not own or license the trademarks associated with the products in question. As a result, importer/distributors add (significant) value to the manufacturer's trademark. In short, the importer/distributor has added value to an intangible, but there is no licence between the parties, which means that if the distribution agreement is terminated under the terms of the agreement, the importer/distributor has no claim against the manufacturer for the intangible value it has created. Instead, the importer/distributor earns its return on the intangible development through the additional volume that it generates while the distribution agreement is in force.

The same theory should apply to intercompany relationships. Marketer/distributors that add value to trademarks they do not own should be remunerated through increased volumes of products sold. Therefore, it is important that either the contract be of such duration that the marketer/distributor earns a return on its investment during the term of the contract, or the transfer price cover all of the selling, general and administrative expenses of the marketer/distributor such that the cost of developing the intangible value is borne by the manufacturer.

US tax law tends to believe that "the fruit belongs to the tree that grew it", which, translated into transfer pricing language, means that the entity that bore the economic cost of developing the value of an intangible is the economic owner of the intangible and should receive the rewards attributable to it, even if that entity did not own the base intangibles (patents) when the marketing was performed.

An interesting issue arises in the conflict between law and economics. Many of the valuable intangibles owned by any company are legally protected (e.g. patents, trademarks and copyrights) while other valuable intangibles are not legally protected (e.g. know-how and strategies). Some US tax attorneys have taken the view that only legally protected property needs to be evaluated during business restructuring exercises. Transfer pricing economists tend to define legally protected property to include many of the non-protected "intangibles". For example, the IRS has frequently argued that development of a marketing strategy creates an intangible that should create (great) value for a US sales company. A transfer pricing economist could argue, quite correctly, that successful marketing strategies add value to the trademark and do not create a separate intangible.

### 2.3. Contract R&D

It is commonly the case that contract R&D arrangements become part of a business restructuring. The Discussion

Draft lays out the requirements that must be met in order to respect the contract R&D arrangement:<sup>16</sup>

- the primary day-to-day research would be carried on by the scientific personnel of the contract researcher; and
- the principal is expected to make important decisions to control its risk, e.g. (1) the decision to hire or terminate the contract with a particular contract researcher, (2) decisions relating to the type of research that should be carried out and the objectives assigned to it and (3) decisions relating to the budget allocated to the contract researcher.

The contract researcher would generally be required to report to the principal on a regular basis, and the principal would be expected to assess the outcome of the research activities. Finally, it is important to note that the contract researcher's operational risk (risk of losing its client or suffering a penalty in case of negligence) is distinct from the risk of failure borne by the principal (failure of the R&D to create a valuable intangible asset).

The IRS attacks these issues based on its services regulations.<sup>17</sup> Assume that a US company had previously been conducting R&D activities for the MNE (in whole or in part) and, as part of the restructuring exercise, the US R&D activities are changed from a free-standing group that creates intangibles for its own account to a contract R&D activity for a non-US company. In this case, the US transfer pricing rules raise a number of questions:

- Is the management of the R&D group effectively transferred? See the discussion of risk above.
- Is the risk of R&D effectively transferred outside the United States?
- Has the US company been properly compensated for the pre-existing intangibles that it developed and owns, and that form the basis for the research conducted under the contract R&D arrangement?

The temporary services regulations<sup>18</sup> contain several examples of contract R&D and conclude in some cases that arm's length compensation should be determined under a profit split method or under the contingent payment terms section of those regulations. MNEs contemplating changing or establishing a US R&D facility must take these new regulations into account when establishing their transfer pricing structure.

## 3. Post- Restructuring Issues

### 3.1. Relationship between compensation for restructuring and post-restructuring remuneration

From a US perspective, several important issues arise when a US taxpayer disposes of business operations to a related party with which the US taxpayer must then transact business as part of those operations. The issues

15. Para. 138 Discussion Draft.

16. Id., Para. 33.

17. Treas. Reg. Sec. 1.482-9T.

18. Treas. Reg. Sec. 1.482-9T.

that arise during the act of the restructuring are distinct from the post-restructuring remuneration. These issues, which may involve compensation for the transfer of assets, risks, or intangibles, are discussed in Note 2 of the Discussion Draft.

*First*, the IRS may view the restructuring as early termination of existing intercompany contracts. For example, if the US company is a licensee, and the early termination of the licence may be a taxable event, i.e. at arm's length, it is unlikely that a manufacturer would agree to terminate a licence that allows it to earn the returns attributable to product-related intangible property in exchange for conversion of its operations to a contract manufacturer. It is tempting to conclude that such is always the case, however, there are circumstances where a licensee may welcome the change to a contract manufacturer.

This could occur, for example, in cases where the product that the US company manufactures is unprofitable and is unlikely to return to profitability. In that case, conversion to a contract manufacturing structure would be beneficial to the US company in that it would convert a loss-making entity into a profitable one (albeit at a low level).

The analysis is not simple, however. There may be situations where a full-fledged manufacturer would be happy to continue to be a licensee with respect to a loss-making product. For example, if the product in question is part of a product line that includes highly profitable products, the manufacturer may want to continue to licence intangibles associated with the loss-making product so that it can offer its customers an entire product line. The key to "getting to the right answer" is to perform a careful functional and industry analysis, so that decisions mimic those that would have occurred had the parties been unrelated, but otherwise unchanged.

These issues apply only to termination of licences prior to the termination date provided in the intercompany agreement. If the licence is allowed to expire and is not renewed by the licensor, there is little that the licensee can do about it. The only avenue of argument would be that the intercompany agreement was not arm's length because it did not contain a sufficient number of years to allow the licensee to recover the investment that it made in plant and equipment to produce the product profitably. Obviously, the arguments of both the MNE and the IRS rely on detailed fact gathering as well as industry practice in the MNE's industry. Restructurings of this sort require significant analysis prior to implementation if the MNE wishes to maximize the probability that the restructuring will be respected.

For selling/marketing companies, several scenarios could exist:

(1) Failure to renew a distribution agreement that has expired. Normally, third-party distribution agreements are one-year agreements. In those cases, failure to renew the agreement is not a taxable event from a transfer pricing standpoint. At the end of the

existing agreement, the parties are free to renegotiate whatever relationship they wish to use.

- (2) Termination of a distribution agreement under the termination clause contained in the agreement. The analysis here is similar to (1) in that termination under the terms of the agreement ordinarily carries no penalty.
- (3) Termination of a distribution agreement after the sales company has made a significant investment in the development of the US market and before the sales company has had a chance to earn a return on that investment.

The third scenario is the example close to the cheese examples described above. If the US sales company invests in market development at its own expense (i.e. the costs are not reimbursed through the transfer price), the intercompany distribution agreement must provide an opportunity for the sales company to recoup its investment (i.e. earn above-normal profits for a period of time to compensate for the market development that it carried out). Again, the analysis is not simple. In cases where the investment was not successful and the US company is marginally profitable or unprofitable, an independent selling company might well be happy to cancel the agreement and become a limited risk reseller.

*Second*, the restructuring may require a transfer of customer contracts to a related party. For example, suppose that the US reseller is converted from a full-fledged distributor to a commissionaire. As part of that restructuring, customer contracts may be transferred to the related non-US company. Generally, this is treated as a transfer of an intangible asset and compensation must be paid to the US company as a result.

*Third*, the IRS may well identify other types of intangibles for both the manufacturing restructuring case (production know-how) and the reseller restructuring ("marketing intangibles") that are transferred from the US company to a related foreign entity for which compensation is needed. These issues were discussed above and are not repeated here.

*Finally*, the temporary services regulations may come into play as well. To the extent that a function remains in the United States and is treated as a "service agreement", the IRS may categorize the service as "core", which means that the profit split method, for example, may be used to compensate the US company for its contribution to worldwide profitability.

### 3.2. Recognition of transactions as structured by the taxpayer

The Discussion Draft states that the structures created by the restructuring will be respected as they are arranged, except in exceptional circumstances. As a generalization, the Discussion Draft takes the position that if it is possible to compute a transfer price for the taxpayer's structure, it must be respected unless it lacks substance. The Discussion Draft also points out that tax

authorities may adjust the transfer price if they believe that the price is not arm's length under the taxpayer's structure. Furthermore, the Discussion Draft states that it is not required that the taxpayer's structure exist between arm's length parties to be respected, although it does state that "alternatives realistically available" to the parties should be taken into account in evaluating the structure.

The US rules are a bit simpler than the Discussion Draft and the OECD Guidelines. US regulations state that the IRS will evaluate the results of a transaction as it was actually structured by the taxpayer unless the structure lacks economic substance.<sup>19</sup> The IRS is also allowed to consider alternatives realistically available in determining whether transfer prices should be adjusted. This provision under Sec. 482 was added in 1994 in response to a number of Tax Court decisions wherein the IRS attempted to change a taxpayer's transfer pricing structure. The Tax Court determined that the structures in question had substance and should, therefore, be respected. This is consistent with the OECD Guidelines and current IRS practice in audits.

The Discussion Draft states that the OECD Guidelines "do not and should not apply differently to post-restructuring transactions as opposed to transactions that were structured as such from the beginning."<sup>20</sup> This is the view of the US transfer pricing regulations, however, a restructuring that reduces US income can be expected to be subjected to significant scrutiny whereas the same transaction that had existed from the beginning is likely to be subjected to less scrutiny.

In reality, structures that have been in place from the beginning are ordinarily a bit different than structures that occur as a result of a business restructuring project. Specifically, it is not unusual for some (important) functions to remain in the restructured entity that would not be in the entity if it had been a limited risk company from the beginning. As the Discussion Draft points out, it is extremely important to do a careful, thorough functional analysis and to document the changes that have occurred.<sup>21</sup> For the functions that must remain in the restructured entity, appropriate recognition of the functions actually performed must be part of the transfer pricing analysis.

The Discussion Draft further discusses the fact that some countries contend that sales of "crown jewels" such as valuable trade names should not be respected because it would not be possible to arrive at an appropriate price, which means that it would be unlikely to occur at arm's length.<sup>22</sup> This issue has been addressed in the United States and led to the so-called "commensurate with income" standard that is now part of US transfer pricing law. Under that standard, sales or other types of transfers of "crown jewels" must be priced in a way that compensates the owner commensurate with the income generated by the intangibles.

### 3.3. Transfer pricing methods in the post-restructuring world: additional thoughts

In the United States, these days it is very important to take great care in putting intercompany legal agreements in place. Properly prepared, these agreements describe the transaction; the functions and risks that each party to the transaction will be responsible for; and the pricing mechanism that will be used. Care should also be taken to ensure that the termination clause is arm's length.

In addition, it is critical to benchmark all significant intercompany transactions. The IRS routinely asks companies for their transfer pricing documentation. This is the place to set out the structure, the reasons that the structure was changed and the arm's length nature of the new structure. Benchmarking is a necessary part of that documentation. The issue, from a US perspective, is how to define "significant intercompany transactions". Most companies have determined the de minimus level, and they benchmark only transactions that exceed the minimum threshold. There is no guarantee that the IRS will agree to that threshold, however, and this sometimes causes conflict between taxpayers and the IRS.

The Discussion Draft makes an important point regarding the selection of a transfer pricing method, stating that the low-risk nature of a business dictates the choice of the transfer pricing method, and not the reverse.<sup>23</sup> Of course this is true. The choice of method is dictated by the facts, and it is important that the method and the facts be consistent with each other. In dealing with a tax authority, however, it is important to emphasize that the entire picture is consistent, i.e. the facts, transfer pricing method, comparable transactions/companies, intercompany agreements and the actual conduct of the parties.

The OECD continues to prefer transaction-based methods to profit-based methods, as is appropriate; however, it is important to remember that the availability of comparable transactions/companies always dictates what transfer pricing method can be applied. The comparable uncontrolled price (CUP) method is obviously the best method when it can be applied. Unfortunately, it is rare that such a method can be applied because it is rare to have comparable transactions that provide reliable results (comparability as well as financial information). While it is common in the United States to use the comparable profits method, just as it is common in Europe to use the transactional net margin method, this does not obviate the need to seek comparable transactions that can be used to apply transaction-based methods.

Para. 148 of the Discussion Draft contains an interesting and important point, stating that "choosing a one-sided method does not mean that only a one-sided analysis can be performed". This statement is significant for analyses that are commissioned by subsidiaries of MNEs where

19. Treas. Reg. Sec. 1.482-1(f)(2)(ii)(A).

20. Para. 124 Discussion Draft.

21. Id., Para. 133.

22. Id., Para. 216.

23. Id., Para. 143.

the parent company does not cooperate with the analysis. In these cases, the analyst must conduct the functional analysis on the subsidiary, choose a pricing method based on those facts and derive conclusions based solely on information available from the subsidiary. Typically, the assumption is made that the functions, risks and intangibles associated with the transactions at issue are outside the subsidiary's country if they are not performed by the subsidiary. This generally will be true, and it is generally possible to determine arm's length transfer prices based on that one-sided information.

Potential errors arise, however, when the nature and value of the intangible property associated with the

transactions are unknown. It is important to subject any transfer pricing analysis to a "sanity" or "common sense" test to ensure that the result is reasonable. With a one-sided analysis, it is not possible to apply the common-sense test to ensure that both parties receive a reasonable return on the transactions. In cases where intangibles are inherently more or less valuable than the researcher assumed, the non-tested party may be inappropriately compensated. For this reason, one-sided analyses are inherently dangerous, but cannot be avoided when parent companies do not participate in transfer pricing studies that are necessary to satisfy local documentation requirements.

#### 4. Conclusion

The Discussion Draft issued by the OECD addresses restructuring exercises conducted by MNEs. This is an important issue, as business restructuring is fairly common in today's world. Some business restructuring is driven by internal business needs (to lower costs and improve profitability), while other restructuring is driven by the marketplace (e.g. increased competition that makes it imperative to move operations to lower-cost locations, to emerging markets). The transfer pricing aspects of restructuring are complex and extremely important.

The Discussion Draft and the US Sec. 482 transfer pricing regulations are very similar, which is necessary for MNEs that need to satisfy the transfer pricing rules of all jurisdictions in which they operate. Satisfying the transfer pricing requirements is simple to describe:

- recognize any intangible transfers that occur as a result of the restructuring and properly compensate for them;
- ensure that substance matches form with respect to the movement of functions and risks from one legal entity to another. In both the Discussion Draft and the US transfer pricing rules, significant emphasis is

placed on the movement of risk. To be respected, the risk-taker must actively manage the risk and must have the financial capacity to absorb any adverse consequences of risk-bearing;

- transfer prices must be set at arm's length. This is particularly challenging with respect to the movement of risk, i.e. the profits attributable to risk bearing must be commensurate with the economic significance of the risk; and
- the structure must be properly documented, including entering into intercompany legal agreements that formalize the structure, and benchmarking the prices used to implement the new structure.

While these requirements are easy to describe, they can be challenging to implement. A careful, thorough functional and industry analysis is needed to properly plan the transfer pricing aspects of a corporate restructuring. Change can be disturbing to tax authorities, particularly to tax authorities that lose taxable income as a result. MNEs are advised to expect challenges and to prepare for them during the restructuring exercise.