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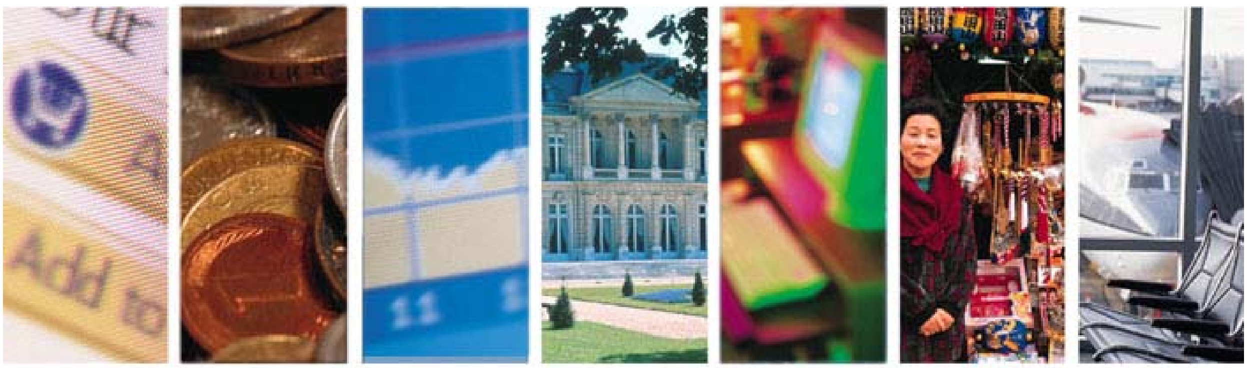

TRANSFER PRICING ASPECTS OF BUSINESS RESTRUCTURINGS:

DISCUSSION DRAFT FOR PUBLIC COMMENT

19 SEPTEMBER 2008 TO 19 FEBRUARY 2009

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Transfer Pricing Aspects of Business Restructurings
Public Discussion Draft

Business restructurings by multinational enterprises have been a widespread phenomenon in recent years. They involve the cross-border redeployment of functions, assets and / or risks between associated enterprises, with consequent effects on the profit and loss potential in each country. Restructurings may involve cross-border transfers of valuable intangibles, and they have typically consisted of the conversion of full-fledged distributors into limited-risk distributors or commissionnaires for a related party that may operate as a principal; the conversion of full-fledged manufacturers into contract-manufacturers or toll-manufacturers for a related party that may operate as a principal; and the rationalisation and / or specialisation of operations.

As evidenced by a January 2005 OECD Centre on Tax Policy and Administration Roundtable (see http://www.oecd.org/document/6/0,3343,en_2649_37989760_34535302_1_1_1_1,00.html), these restructurings raise difficult transfer pricing and treaty issues for which there is currently insufficient OECD guidance under both the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the "TP Guidelines") and the OECD Model Tax Convention on Income and on Capital (the "Model Tax Convention"). These issues involve primarily the application of transfer pricing rules upon and / or after the conversion, the determination of the existence of, and attribution of profits to, permanent establishments ("PEs"), and the recognition or non-recognition of transactions. In the absence of a common understanding on how these issues should be treated, they may lead to significant uncertainty for both business and governments as well as possible double taxation or double non-taxation. Recognising the need for work to be done in this area, the Committee on Fiscal Affairs ("CFA") decided to start a project to develop guidance on these transfer pricing and treaty issues.

In 2005 the CFA created a Joint Working Group ("the JWG") of delegates from Working Party No. 1 (responsible for the Model Tax Convention) and Working Party No. 6 (responsible for the TP Guidelines) to initiate the work on these issues (see http://www.oecd.org/document/11/0,3343,en_2649_37989760_38087051_1_1_1_1,00.html). At the end of 2007, having taken stock of the progress made to that point, the CFA referred the work on the transfer pricing aspects of business restructurings to Working Party No. 6 and the work on the PE threshold aspects to Working Party No. 1. This discussion draft has resulted from the work done on the transfer pricing issues by the JWG and Working Party No. 6. Working Party No. 1 intends to consider PE definitional issues under Article 5 of the Model Tax Convention, both in the context of business restructurings and more broadly, as part of its 2009-2010 programme of work, which will result in a separate discussion draft.

This discussion draft only covers transactions between related parties in the context of Article 9 of the Model Tax Convention and does not address the attribution of profits within a single enterprise on the basis of Article 7 of the Model Tax Convention, as this was the subject of the Report on the Attribution of Profits to Permanent Establishments which was approved by the Committee on Fiscal Affairs on 24 June 2008 and by the OECD Council for publication on 17 July 2008 (see http://www.oecd.org/document/62/0,3343,en_2649_37989746_41027006_1_1_1_1,00.html).

The analysis in this discussion draft is based on the existing transfer pricing rules. In particular, this discussion draft starts from the premise that the arm's length principle and the TP Guidelines do not and should not apply differently to post-restructuring transactions than to transactions that were structured as such from the beginning.

This discussion draft is composed of four Issues Notes.

In light of the importance of risk allocation in relation to business restructurings, the first Issues Note provides general guidance on the allocation of risks between related parties in an Article 9 context and in particular the interpretation and application of paragraphs 1.26 to 1.29 of the TP Guidelines.

The second Issues Note, "Arm's length compensation for the restructuring itself", 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 an indemnification for the termination or substantial renegotiation of the existing arrangements.

The third Issues Note examines the application of the arm's length principle and the TP Guidelines to post-restructuring arrangements.

The fourth Issues Note discusses some important notions in relation to the exceptional circumstances where a tax administration may consider not recognising 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.

The Committee invites interested parties to send comments on this discussion draft **before 19 February 2009**. Comments should be sent electronically (in Word format) to jeffrey.owens@oecd.org. Unless otherwise requested at the time of submission, comments submitted to the OECD in response to this invitation will be posted on the OECD website.

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TRANSFER PRICING ASPECTS OF BUSINESS RESTRUCTURINGS: INTRODUCTION

A - Scope of the project

1. In January 2005, in recognition of the widespread phenomenon of business restructurings by multinational enterprises ("MNEs") and of the tax issues they raised, the OECD Centre for Tax Policy and Administration organised a Roundtable on Business Restructurings ("the January 2005 CTPA Roundtable") which was attended by senior officials from OECD member countries as well as from China, South Africa and Singapore and by a wide panel of private sector representatives.[1] Government and private sector participants addressed a broad range of issues, including administrative approaches taken in examinations, treaty, transfer pricing and VAT issues. The discussions at the January 2005 CTPA Roundtable demonstrated that business restructurings raise difficult transfer pricing and treaty issues for which there is currently insufficient OECD guidance with respect to their treatment under both the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the "TP Guidelines") and the OECD Model Tax Convention on Income and on Capital (the "Model Tax Convention"). These issues, which involve primarily the application of transfer pricing rules upon and / or after the conversion, the determination of the existence of, and attribution of profits to, permanent establishments ("PEs"), and the recognition or recharacterisation of transactions, may lead to significant uncertainty for business as well as for governments and possible double taxation or double non-taxation, in the absence of a common understanding. Recognising the need for work to be done in this area, the Committee on Fiscal Affairs ("CFA") decided to start a project to develop guidance on these transfer pricing and treaty issues.

A.1 Business restructurings that are within the scope of the project

2. There is no legal or universally accepted definition of business restructuring. For the purpose of determining the scope of the project, the CFA proposed that business restructuring be defined 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. Business restructurings that are within the scope of the OECD's project primarily consist of internal reallocation of functions, assets and risks within an MNE, although relationships with third parties (*e.g.* suppliers, sub-contractors, customers) may also be a reason for the restructuring and / or be affected by it.

3. Since the mid-90's, business restructurings have typically consisted of:

- Conversion of full-fledged distributors into limited-risk distributors or commissionnaires for a related party that may operate as a principal,
- Conversion of full-fledged manufacturers into contract-manufacturers or toll-manufacturers for a related party that may operate as a principal,
- Rationalisation and / or specialization of operations (manufacturing sites and / or processes, research and development activities, sales, services),

[1] See Uhttp://www.oecd.org/document/6/0,3343,en_2649_37989760_34535302_1_1_1_1,00.htmlU.

- Transfers of intangible property rights to a central entity (*e.g.* a so-called "IP company") within the group.

4. Business representatives who participated in the January 2005 CTPA Roundtable explained that among the business reasons for restructuring are the wish to maximise synergies and economies of scale, to streamline the management of business lines and to improve the efficiency of the supply chain, taking advantage of the development of Internet-based technologies that has facilitated the emergence of global organisations.

5. Corporate reorganizations such as mergers and acquisitions are not within the scope of this project. Business restructurings of the type described at paragraphs 2 and 3 above are within the scope of this project whether or not they are implemented as a result of a merger or acquisition.

A.2 Issues that are within the scope of this project

6. The OECD project on business restructurings is concerned with the treaty and transfer pricing aspects of business restructurings, *i.e.* essentially with the application of Articles 5 (Permanent establishment), 7 (Business profits) and 9 (Associated enterprises) of the Model Tax Convention.

7. Business restructurings are typically accompanied by a reallocation of profits among the members of the MNE group, either immediately after the restructuring or over a few years. One major objective of this project in relation to Article 9 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. The implementation of integrated business models and the development of global organisations, where they are done for bona fide commercial reasons, highlight the difficulty of reasoning in the arm's length theoretical environment which treats members of an MNE group as if they were independent parties. This conceptual difficulty with applying the arm's length principle in practice is acknowledged in the TP Guidelines themselves (see paragraphs 1.9-1.10). Notwithstanding this problem, the TP Guidelines reflect the OECD Member countries' strong support for the arm's length principle and for efforts to describe its application and refine its operation in practice (see paragraph 1.14). When discussing the issues that arise in the context of business restructuring, the OECD has kept this conceptual difficulty in mind in an attempt to develop approaches that are realistic and reasonably pragmatic.

8. Domestic anti-abuse rules and CFC legislation are not within the scope of this project. The domestic tax treatment of an arm's length payment, including rules regarding the deductibility of such a payment and how domestic capital gains tax provisions may apply to an arm's length capital payment, are also not within the scope of this project. Moreover, while they raise important issues in the context of business restructurings, VAT and indirect taxes are not covered at this stage in this project.

B - Involvement of the Committee on Fiscal Affairs and subsidiary bodies

9. In 2005 the CFA created a Joint WP1-WP6 Working Group on Business Restructurings ("the JWG"), *i.e.* a group of treaty and transfer pricing experts that was formed as a subsidiary body of Working Party No. 1[2] and Working Party No. 6[3] to carry on the OECD's project on business restructurings.[4] The JWG made a detailed review of the treaty and transfer pricing issues raised by business restructurings,

[2] Working Party No. 1 is the CFA's subsidiary body with responsibility for the Model Tax Convention.

[3] Working Party No. 6 is the CFA's subsidiary body with responsibility for the TP Guidelines.

[4] See background information on the approval of a mandate for the JWG at http://www.oecd.org/document/11/0,3343,en_2649_37989760_38087051_1_1_1_1,00.html.

discussed sometimes differing country views thereon, and was able to make significant progress towards more common positions.

10. At the end of 2007, having taken stock of the progress made to that point, the CFA decided to refer the work on the transfer pricing aspects of business restructurings (*i.e.* the issues under Articles 7 and 9 of the Model Tax Convention) to a newly created Working Party No. 6 Special Session[5] on Business Restructuring, and the work on the PE threshold aspects (Article 5 of the Model Tax Convention) to Working Party No. 1. This discussion draft has resulted from the work done on the transfer pricing issues by the JWG and the WP6 Special Session. Working Party No. 1 intends to consider Article 5 issues, both in the context of business restructurings and more broadly, as part of its 2009-2010 programme of work, which will result in a separate discussion draft.

11. For purposes of the work on this discussion draft, the CFA instructed the JWG and Working Party No. 6's Special Session on Business Restructuring to base their analysis on the existing transfer pricing rules (*i.e.* on the TP Guidelines in their current form).

C - Involvement of the business community

12. The January 2005 CTPA Roundtable was attended by a wide panel of private sector representatives, and their input was taken into account by the OECD. In addition, shortly after it started its work on the treaty and transfer pricing aspects of business restructurings, the OECD decided to set up an informal group of academics, business representatives and consultants (the "Business Advisory Group")[6] in order to obtain technical and factual input from the business community on the issues discussed by the JWG in the early stages of its work. In effect it was felt that the project could greatly benefit from discussions with a small group of tax and transfer pricing specialists with significant experience with business restructurings in a variety of industry sectors, which they have acquired either as tax managers of large companies or as advisors. In drawing up the list of members of the Business Advisory Group, the OECD tried to achieve as good a geographical balance as possible while keeping the Group reasonably small for the purpose of ensuring effective discussions.

13. The Business Advisory Group met three times in 2006 and 2007 with the OECD Secretariat and with Delegates of the JWG. The outcome of these meetings was quite positive as all participants, business and governments, were able to express their views in a very constructive fashion. It should be stressed that the Business Advisory Group was by no means intended to be a substitute for a wider consultation process, and an invitation was posted on the OECD Internet site (www.oecd.org/ctp/br) for any interested parties who wished to provide input in the interim on the issues that were within the JWG's mandate to submit comments to the OECD Secretariat.

14. The OECD is now inviting comments from all interested parties on this discussion draft.

D - Presentation of this Discussion Draft and summary of the main conclusions

15. This discussion draft covers the transfer pricing aspects of business restructurings.

16. As noted above, the analysis in this discussion draft is based on the existing transfer pricing rules. In particular, this discussion draft starts from the premise that the arm's length principle and the TP

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5 Special Sessions are created by Working Party No. 6 to carry on its technical discussions on a project by project basis. They are open to all Working Party No. 6 Delegates.

6 See Uhttp://www.oecd.org/newsEvents/0,3382,en_2649_37989760_1_1_1_1_1,00.htmlU.

Guidelines do not and should not apply differently to restructurings or post-restructuring transactions than to transactions that were structured as such from the beginning.

17. This discussion draft only covers transactions between related parties in the context of Article 9 of the Model Tax Convention and does not address the attribution of profits within a single enterprise on the basis of Article 7 of the Model Tax Convention, as this is the subject of WP6's report on the Attribution of Profits to Permanent Establishments that was approved by the Committee on Fiscal Affairs on 24 June 2008 and by the OECD Council for publication on 17 July 2008.[7] The guidance that is provided under Article 9 has been developed independently from the Authorised OECD Approach ("AOA") that was developed for Article 7.

18. This discussion draft is composed of four Issues Notes.

18.1 In light of the importance of risk allocation in relation to business restructurings, the first Issues Note provides general guidance on the allocation of risks between related parties in an Article 9 context and in particular the interpretation and application of paragraphs 1.26 to 1.29 of the TP Guidelines. 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. Risk allocation and risk transfers are a significant factor in many business restructurings and warrant a separate discussion (see in particular Section B of Issues Note No. 2 for a discussion of the reallocation of profit / loss potential that follows from a reallocation of risks). Risk allocation and risk transfers can also be significant outside business restructurings and, although this first Issues Note was drafted in the context of the business restructurings project and is included in this discussion draft, its scope and significance go beyond business restructurings. The main conclusions in Issues Note No. 1 are as follows:

- The examination of risks in an Article 9 context 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 is, however, respected only to the extent that it has economic substance. Therefore, the review of contractual terms is not sufficient and has to be completed by a review of 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.
- Section A of Issues Note No. 1 discusses the examination of the contractual terms and of the actual behaviour of the parties, as well as the role of documentation. It notes that the parties' conduct should generally be taken as the best evidence concerning the true allocation of risk.
- Section B discusses how to determine whether the contractual terms provide for an arm's length allocation of risks. Where reliable data evidence a similar allocation of risk in contracts between comparably situated independent parties, then the contractual risk allocation between the related parties is regarded as arm's length. Furthermore, the mere fact that independent enterprises do not allocate risks in the same way as a taxpayer in its controlled transactions is not sufficient for not recognising that risk allocation. Where no comparables exist to support a contractual allocation of risk between related parties, it becomes necessary to determine whether that allocation of risk is one that might be expected to have been agreed between independent parties in similar circumstances. One factor that can assist in this determination is the examination of which party(ies) has (have) control over the risk. "Control" in this context should be understood as 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

7 See Uhttp://www.oecd.org/document/62/0,3343,en_2649_37989746_41027006_1_1_1_1,00.htmlU.

the company to have people – employees or directors – 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.

- Section C further notes that an important issue is to assess whether the risk – and, as a consequence, the transfer of that risk, where applicable – is economically significant. The bearing or transfer of a risk that is economically insignificant would not ordinary explain a substantial amount of or decrease in the profits of the transferor.

18.2 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, "Arm's length compensation for the restructuring itself", 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 an indemnification for the termination or substantial renegotiation of the existing arrangements. The main conclusions in Issues Note No. 2 are as follows:

- In order to determine whether at arm's length the restructuring itself would give rise to a form of compensation, 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 (see Section A of Issues Note No. 2).
- Section B of Issues Note No. 2 contains a discussion of the reallocation of profit / loss potential as a result of a reallocation of risks. It notes that 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.
- Whether a transfer of profit / loss potential that follows from a business restructuring is an arm's length transaction from the perspectives of both the transferor and the transferee depends on a number of factors, including but not limited to 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; 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 where the transferor has transferred or surrendered rights or other assets that carry that profit potential.
- Section C of Issues Note No. 2 contains a discussion of the determination of an 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.
- Section D 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. Relevant circumstances are whether the arrangement that is terminated, non-renewed or substantially renegotiated is formalised in writing and provides for an indemnification clause; whether the terms of the arrangement and the possible

existence or non-existence of an indemnification clause or other type of guarantee (as well as the terms of such a clause where it exists) are arm's length; whether indemnification rights are provided for by commercial legislation or case law; and whether at arm's length another party would have been willing to indemnify the one that suffers from the termination or re-negotiation of the agreement.

18.3 The third Issues Note examines the application of the arm's length principle and the TP Guidelines to post-restructuring arrangements.

- Section A of Issues Note No. 3 provides a brief summary of existing guidance on the selection of a transfer pricing method and of the conclusions tentatively reached by the OECD in the context of its current review of transactional profit methods.
- Section B notes that the arm's length principle and the TP Guidelines do not and should not apply differently to post-restructuring transactions as opposed to transactions that were structured as such from the beginning. However, business restructuring situations involve change, and the arm's length principle must be applied not only to the post-restructuring transactions, but also to additional transactions that take place upon the restructuring and generally consist in the transfer of functions, assets and / or risks. In addition, 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 guidance in the TP Guidelines should be interpreted and 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 pre-restructuring and for the post-restructuring arrangements and that the actual changes that took place upon the restructuring be documented.
- Section C discusses some specific issues that arise in the selection and application of a transfer pricing method and in the determination, where appropriate, of the tested party and the financial indicator(s) for the post-restructuring controlled transactions. Among the questions addressed in this Section are the determination of the circumstances in which sales activities would at arm's length be remunerated using a cost plus or cost-based TNMM, and the determination of the circumstances in which a transactional profit split method would be appropriate for the post-restructuring controlled transactions. The Section provides an example in relation to the implementation of a central purchasing function.
- Section D discusses the relationship that may exist between compensation for the restructuring and post-restructuring remuneration, in the case where the restructured entity will have an ongoing commercial relationship with the party which took over some of its functions, assets and / or risks.
- Section E addresses the role that comparisons of profits earned before and after the restructuring could play. It notes that while such before-and-after comparisons would not suffice to support a transfer pricing adjustment in the face of the requirement posed by Article 9 of the Model Tax Convention for a comparison to be made with uncontrolled transactions, 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 amongst the parties.
- Section F contains a brief discussion of location savings and of whether and if so how location savings that are derived from a business restructuring should be attributed among the parties under the arm's length principle. The response obviously depends on what independent parties would have agreed at arm's length in similar circumstances and normally depends on the functions, assets and risks of each party 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.

18.4 The fourth Issues Note discusses some important notions in relation to the exceptional circumstances where a tax administration may consider not recognising 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.

- Section A of Issues Note No. 4 notes that depending on the circumstances of the case 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 (see paragraph 8 above). Paragraphs 1.36-1.41 of the TP Guidelines are limited to the recognition of transactions for the purposes of making transfer pricing adjustments covered by Article 9 of the OECD Model Tax Convention (*i.e.* in accordance with the arm's length principle). They do not provide any guidance as to a country's ability to characterise transactions differently under other aspects of its domestic law.

- Section B discusses the role of contractual terms and the relationship between paragraphs 1.36-1.41 of the TP Guidelines and other parts of the TP Guidelines. It clarifies that paragraphs 1.36-1.41 apply where there is a dispute about the fundamental nature of the transaction being examined and that the view of the OECD is that these paragraphs do not restrict a tax administration's ability to adjust the price or other conditions of a controlled transaction in situations where there is no dispute about the nature of the transaction – and hence, no recognition issue – but where such price or conditions are not arm's length according to guidance provided in other parts of the TP Guidelines. Where paragraphs 1.36-1.41 do apply, Article 9 would allow an adjustment of conditions to reflect those which 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 characterisation or structure that comports as closely as possible with the facts of the case.

- Section C.1 notes that non-recognition 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 these are consistent with the methods described in Chapters II and III of the TP Guidelines. 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.

- Section C.2 discusses the second cumulative criterion under the second circumstance at paragraph 1.37 of the TP Guidelines, *i.e.* that "the actual structure practically impedes the tax administration from determining an appropriate transfer price". If an appropriate transfer price (*i.e.* an arm's length price that takes into account the comparability - including functional - analysis of both parties to the transaction) 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 recognised under Article 9 of the Model Tax Convention. Otherwise, the tax administration may need to decide whether this is a case for not recognising the transaction.

- Section C.3 addresses the important and difficult question of the determination of whether the arrangements between related parties are consistent with those which would have been adopted by independent enterprises behaving in a commercially rational manner. Some countries consider that the "commercially rational behaviour" test of the second circumstance of paragraph 1.37 is intended to deal with cases where a transaction has no non-tax business purpose. A large majority of OECD countries however 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 non-recognition of the related party arrangements.

- The OECD is of the view 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 the option realistically available to it not to do so. In evaluating whether a party would at arm's length 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.

- Furthermore, in assessing the commerciality 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, where 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[8] for an MNE group to restructure in order to obtain tax savings.

- The OECD recognises that there can be legitimate group-level business reasons for an MNE group to restructure. In practice, where 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 re-emphasising 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 make commercial sense for the group as a whole: the transaction must be arm's length at the level of each individual taxpayer, taking account of its rights and other assets, expected benefits from the restructuring arrangement, and realistically available options.

- Section D contains three examples illustrating the views of the OECD 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.

8 This does not say anything about the possible application of domestic anti-abuse rules which are not in the scope of this paper.

ISSUES NOTE No. 1: SPECIAL CONSIDERATIONS FOR RISKS

Introduction

19. Risks are of critical importance in the context of business restructurings. In particular, business restructurings often result in local operations being converted into low risk operations (*e.g.* “low risk distributors”, or “low risk contract manufacturers”)[9] and being allocated relatively low (but generally stable) returns on the grounds that the entrepreneurial risks are borne by another party to which the residual profit is allocated. It is therefore essential for tax administrations to assess the risk transfer and its consequences on the application of the arm’s length principle to the restructuring itself and to the post-restructuring transactions. This Issues Note covers the allocation of risks between related parties in an Article 9 context and in particular the interpretation and application of paragraphs 1.26 to 1.29 of the TP Guidelines. It is intended to provide general guidance on risks which will be of relevance to specific issues addressed elsewhere in this discussion draft, including Issues Note No. 2’s analysis of the arm’s length compensation for the restructuring itself,[10] Issues Note No. 3’s analysis of the remuneration of the post-restructuring controlled transactions, and Issues Note No. 4’s analysis of the recognition or non-recognition of transactions presented by a taxpayer.

20. Unlike in the AOA that was developed for Article 7,[11] the examination of risks in an Article 9 context starts from an examination of the contractual terms between the parties, as those generally define how risks are to be divided between the parties. However, as noted at paragraphs 1.26 to 1.29 of the TP Guidelines, the contractual allocation of risk between associated enterprises is respected only to the extent that it has economic substance. Therefore, in examining the risk allocation between related parties and its transfer pricing consequences, the review of contractual terms is not sufficient and has to be completed by a review of the following additional questions:

- Whether the related parties conform to the contractual allocation of risks (see Section A below),
- Whether the contractual terms provide for an arm’s length allocation of risks (see Section B below),
- Whether the risk is economically significant (see Section C below), and
- What the transfer pricing consequences of the risk allocation are (see Section D below).

9 See paragraph 3.

10 See in particular Section B of Issues Note No. 2.

11 See paragraph 17 above.

A - Examination of the contractual terms and of the actual behaviour of the parties; Documentation.

21. The examination of the allocation of risks between related parties, which is an essential part of the functional analysis, starts from a review of the contractual terms where they exist in writing. This however is not sufficient as it is also necessary to examine whether the parties conform to the terms of the contract, as discussed at paragraphs 1.26 and 1.28-1.29 of the TP Guidelines.

22. As indicated at paragraph 1.26 of the TP Guidelines, the parties' conduct should generally be taken as the best evidence concerning the true allocation of risk. The TP Guidelines provide an example in which a manufacturer sells property to a related distributor in another country and the distributor is claimed to assume all exchange rate risks, but the transfer price appears in fact to be adjusted so as to insulate the distributor from the effects of exchange rate movements. In such a case, the TP Guidelines indicate that the tax administrations may wish to challenge the purported allocation of exchange rate risk.

23. Another example that is relevant to business restructurings is where a foreign related party assumes all the inventory risks by contract. When examining such a risk allocation, it may be necessary to examine for instance where the inventory write-downs are taken (*i.e.* whether the domestic taxpayer is in fact claiming the write-downs as deductions) and evidence may be sought to confirm that the parties' conduct supports the allocation of these risks as per the contract.

24. A third example relates to the determination of which party bears credit risk in a distribution arrangement. In full-fledged distribution agreements, the bad debt risk is generally borne by the distributor who books the sales revenue (notwithstanding any risk mitigation or risk transfer mechanism that may be put in place). This risk would generally be reflected in the balance sheet at year end. However, the extent of the risk borne by the distributor at arm's length may be different if the distributor receives indemnification from another party (*e.g.* from the supplier) for irrecoverable claims, and / or if its purchase price is determined on a resale price or commission basis that is proportionate to the cash (rather than invoiced) revenue. The examination of the actual conditions of the transactions between the parties, including the pricing of the transactions and the extent, if any, to which it is affected by credit risk, will provide evidence of whether in actual fact it is the supplier or the distributor (or both) who bear(s) the bad debt risk.

25. Contractual arrangements are the starting point for determining which party to a transaction bears the risk associated with it. Accordingly it would be reasonable to expect related parties to document in writing their decisions to allocate or transfer risks before the transactions with respect to which the risks will be borne or transferred occur.

26. As noted at paragraphs 1.28 and 1.29 of the TP Guidelines, the terms of a transaction may also be found in correspondence and / or other communications between the parties rather than in a written contract. Where no written terms exist, the contractual relationships of the parties must be deduced from their conduct and the economic principles that generally govern relationships between independent enterprises. In dealings between independent enterprises, the divergence of interests between the parties ensures that they will ordinarily seek to hold each other to the terms of the contract, and that contractual terms will be ignored or modified after the fact generally only if it is in the interests of both parties. The same divergence of interests may not exist in the case of associated enterprises, and it is therefore important to examine whether the conduct of the parties conforms to the terms of the contract or whether the parties' conduct indicates that the contractual terms have not been followed or are a sham. In such cases, further analysis is required to determine the true terms of the transaction.

B - Determining whether the contractual terms provide for an arm's length allocation of risks

27. Relevant guidance on the examination of risks in the context of the functional analysis is found at paragraphs 1.25 to 1.27 of the TP Guidelines. Where reliable data evidence a similar allocation of risk in contracts between comparably situated independent parties, then the contractual risk allocation between the related parties is regarded as arm's length. Of greater difficulty and contentiousness is the situation where no such data exist. Just because a related party arrangement is one not seen between independent parties should not of itself mean the arrangement is non-arm's length.

28. However, where no comparables exist to support a contractual allocation of risk between related parties, it becomes necessary to determine whether that allocation of risk is one that might be expected to have been agreed between independent parties in similar circumstances. One factor that can assist in this determination is the examination of which party(ies) has (have) control over the risk, as discussed in Section B.1 below. The OECD is of the view that in arm's length dealings, another factor that may influence an independent party's willingness to take on a risk is its anticipated financial capacity to bear that risk.

B.1 Risk allocation and control

29. The question of the relationship between risk allocation and control is addressed at paragraph 1.27 of the TP Guidelines as a factor relevant to economic substance as follows:

> 1.27 An additional factor to consider in examining the economic substance of a purported risk allocation is the consequence of such an allocation in arm's length transactions. In arm's length dealings it generally makes sense for parties to be allocated a greater share of those risks over which they have relatively more control. […]

30. This statement, which is based on experience, means that control over a risk can be a relevant factor to assist in the determination of whether a similar risk allocation would have been agreed between independent parties at arm's length. This raises the question of the meaning of the term "control", and in particular what functions or decisions amount to control in a given situation. The OECD is of the view 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 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 – employees or directors – who have the authority to, and effectively do, perform these control functions. Thus, 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.

31. While it is not necessary to perform the day-to-day monitoring and administration functions in order to control a risk (as it is possible to outsource these functions), the OECD is of the view that in order to control a risk one has to be able to assess the outcome of the day-to-day monitoring and administration functions by the service provider (the level of control needed and the type of performance assessment would depend on the nature of the risk).

32. Assume that an investor hires a fund manager to invest funds on its account. Depending on the agreement between the investor and the fund manager, the latter may be given the authority to make all the investment decisions on behalf of the investor on a day-to-day basis, although the risk of loss in value of the investment would be borne by the investor. In such an example, the investor is controlling its risks through three essential decisions: the decision to hire (or terminate the contract with) that particular fund manager, the decision of the extent of the authority it gives to the fund manager and objectives it assigns to the latter, and the decision of the amount of the investment that it asks this fund manager to manage.

Moreover, the fund manager would generally be required to report back to the investor on a regular basis as the investor would want to assess the outcome of the fund manager's activities. In such a case, the fund manager is providing a service and managing his business risk from his own perspective (*e.g.* to protect his credibility). The fund manager's operational risk, including the possibility of losing a client, is distinct from his client's investment risk. This illustrates the fact that an investor who gives to another person the authority to make all the day-to-day investment decisions does not necessarily transfer the investment risk to the person making these day-to-day decisions.

33. As another example, assume that a principal hires a contract researcher to perform research on its behalf. Assume the arrangement between the parties is that the principal bears the risk of failure of the research and will be the owner of the outcome of the research in case of success, while the contract researcher is allocated a guaranteed remuneration irrespective of whether the research is a success or a failure, and no right to ownership on the outcome of the research. Although the day-to-day research would be carried on by the scientific personnel of the contract researcher, the principal would be expected to make a number of important decisions in order to control its risk, such as: the decision to hire (or terminate the contract with) that particular contract researcher, the decision of the type of research that should be carried out and objectives assigned to it, and the decision of the budget allocated to the contract researcher. Moreover, the contract researcher would generally be required to report back to the principal on a regular basis, *e.g.* at predetermined milestones. The principal would be expected to be able to assess the outcome of the research activities. The contract researcher's own operational risk, *e.g.* the risk of losing its client or of suffering a penalty in case of negligence, is distinct from the failure risk borne by the principal.

34. It should be borne in mind that there are also, as acknowledged at paragraph 1.27, risks over which neither party has significant control. There are risks which are typically beyond the scope of either party to influence (*e.g.* economic conditions, money and stock market conditions, political environment, social patterns and trends, competition and availability of raw materials and labour), although the parties can make a decision whether or not to expose themselves to those risks and whether and if so how to mitigate those risks.

Comments are invited from the business community on the meaning of the word "control" in the context of paragraph 1.27 of the TP Guidelines, and on what functions or decisions typically amount to control, in particular in business restructuring situations.

Comments are especially invited from the business community on the question of whether it is possible at arm's length to ask the transferor of a risk to perform the day-to-day monitoring and administration functions on behalf of the transferee in cases where it is difficult for the latter to assess the performance of the former as service provider in the absence of an independent source of information.

Noting the word "generally" at paragraph 1.27, comments from the business community are also invited on cases where risk would be allocated at arm's length to a party that does not have greater control over it, in particular in business restructuring situations.

B.2 Difference between making a comparability adjustment and not recognising the risk allocation in the controlled transaction; Relationship between the guidance at paragraph 1.27 and paragraphs 1.36-1.41 of the TP Guidelines

35. The difference between making a comparability adjustment and not recognising the risk allocation in a controlled transaction can be illustrated with the following example which is consistent with the existing example at paragraph 1.41 of the TP Guidelines. Suppose a manufacturer in Country A has related and unrelated distributors in Country B. Suppose that the tax administration of Country A is examining the manufacturer's controlled transactions and in particular the allocation of excess inventory

risk between the manufacturer and its related distributors in Country B. As a starting point, the tax administration would examine the contractual terms between the parties and whether they have economic substance, determined by reference to the conduct of the parties, and are arm's length. Assume that in the particular case there is no doubt that the actual conduct of the parties is consistent with the contractual terms, *i.e.* that the manufacturer actually bears the excess inventory risk in its controlled transactions with related distributors.

36. In determining whether the contractual risk allocation is arm's length, the tax administration would examine whether there is reliable evidence from comparable uncontrolled transactions supporting the risk allocation in the manufacturer's controlled transactions. If such evidence exists, whether from internal or external comparables, there would be no reason to challenge the risk allocation in the taxpayer's controlled transactions.

37. Assume now that it is found that in the manufacturer's contractual relationship with its distributors, the excess inventory risk is attributed to the manufacturer in its transactions with related distributors (*e.g.* because the manufacturer has the obligation to repurchase unsold inventory from the related distributors at the latter's cost), while it is always attributed to the unrelated distributors in the manufacturer's transactions with them (*e.g.* because the manufacturer does not have the obligation to repurchase unsold inventory from the unrelated distributors). Assume further that there is no reliable evidence from comparable uncontrolled transactions (*e.g.* from external comparables) whereby the excess inventory risk would be attributed to the manufacturer. In that case it would be necessary to determine whether the contractual risk allocation in the controlled transactions would have been agreed at arm's length. One factor that can assist in this determination is an examination of which party(ies) has(ve) greater control over the excess inventory risk (see paragraph 1.27 of the TP Guidelines).[12] As noted at paragraph 28 above, the OECD further considers that in arm's length dealings, another factor that may influence an independent party's willingness to take on a risk is its anticipated financial capacity to bear that risk.

38. As noted at paragraph 1.41 of the TP Guidelines, the fact that independent enterprises do not allocate risks in the same way as the taxpayer in its controlled transactions is not sufficient for not recognising the risk allocation in the controlled transactions, but it might be a reason to examine the economic logic of the controlled distribution arrangement more closely.

- It may be the case that at arm's length, the same risk allocation would have been agreed as in the controlled transaction, *e.g.* because the manufacturer has relatively more control over the excess inventory risk as it makes the decisions on the quantities of products purchased by the distributors. In such a case, the risk allocation would be respected and a comparability adjustment might be needed in order to eliminate the effects of any material difference between the controlled and uncontrolled transactions being compared.

- Assume now that it is found that the distributors have relatively more control over the excess inventory risk as they make the decisions on the quantities of products they purchase from the manufacturer. In such a case, the tax administration may conclude that at arm's length, a manufacturer would not agree to take on substantial excess inventory risk by, for example, agreeing to repurchase from the distributors at full price any unsold inventory. In such circumstances, the tax administration may re-assign the consequences from the risk allocation to the related distributors following the guidance at paragraphs 1.25-1.27 of the TP Guidelines (*e.g.* by challenging the manufacturer's obligation to repurchase unsold inventory at full

12 See Section B.1 above for a discussion of the meaning of "control" in the context of paragraph 1.27 of the TP Guidelines.

price) if the allocation of that risk is one of the comparability factors affecting the controlled transaction under examination.

39. There can also be cases where risk allocation is a core element of the transaction and where a dispute on the allocation of risk between the parties would amount to a dispute about the fundamental nature of the transaction. Such cases would fall under the guidance at paragraphs 1.36-1.41 of the TP Guidelines which describe the exceptional circumstances where a tax administration may not recognise a transaction subject to one of the two circumstances at paragraph 1.37 being met. See Issues note No. 4 “Recognition of actual transactions undertaken”.

C - Determining whether the risk is economically significant

40. One important issue is to assess whether a risk – and, as a consequence, the transfer of that risk, where applicable – is economically significant. Not all the risks that a taxpayer bears or transfers to a related party have significant profit (or loss) potential attached to them, taking into account the size of the risk, the likelihood of its realisation and its predictability. If a risk is assessed to be economically insignificant then its value in terms of profit potential is likely to be correspondingly low, and the bearing or transfer of that risk would not ordinarily explain a substantial amount of or decrease in the entity’s profits. At arm’s length a party would not be expected to transfer a risk that is perceived as economically insignificant in exchange for a substantial decrease in its profit potential. See the discussion of whether the transfer of profit potential that is associated with a transfer of risks in business restructuring situations is arm’s length in Issues Note No. 2 “Arm’s length compensation for the restructuring itself”.

41. For instance, where a buy-sell distributor which is converted into a commissionnaire transfers the ownership of inventory to an overseas principal and where this transfer leads to a transfer of inventory risk, the tax administration would want to assess whether the inventory risk that is transferred is economically significant. It may want to ask:

- What the level of investment in inventory is,
- What the history of stock obsolescence is,
- What the cost of insuring it is, and
- What the history of loss in transit (if uninsured) is.

42. Evaluating whether a risk is economically significant is a delicate exercise which might be usefully informed by a review of accounting statements. Thus, if a risk is not recognised by the booking of a contingent liability on the balance sheet of a company, the question can be raised of the reason for that risk not to be accounted for. One possible reason may be that the risk is regarded by the management of the company as not likely enough to be realised for it to be recognised in the financial statements in application of the accounting standards. Where the risk is recognised on the balance sheet (*e.g.* through the booking of a contingent liability), the valuation method that is followed for accounting purposes may, depending on the applicable accounting standards, provide a good indication not only of the amount of the possible loss in case the risk materialises, but also of the probability of the risk materialising. However, many risks that are inherent in a business are not capable of quantification and would not normally be represented in financial statements. Such risks include possible mispricing, customer appetite, etc.

D - What the transfer pricing consequences of the risk allocation are

43. A discussion of the transfer pricing consequences of a reallocation of profit / loss potential that follows from a reallocation of risk is found in Section B.1 of Issues Note No. 2 on “Arm’s length

compensation for the restructuring itself". The determination of an arm's length remuneration for post-restructuring arrangements is the subject of Issues Note No. 3 "Remuneration of post-restructuring controlled transactions". Below are some further considerations specific to risks.

D.1 Transfer pricing consequences of a risk allocation that is recognised for tax purposes

44. In general, the consequence for one party of being allocated the risk associated with a controlled transaction, where such a risk allocation is found to be consistent with the arm's length principle, is that such party should:

(i) Bear the costs, if any, of managing (whether internally or by using related or unrelated service providers) or mitigating the risk (*e.g.* costs of hedging, or insurance premium),

(ii) Bear the costs that may arise from the realisation of the risk. This also includes, where relevant, the anticipated effects on asset valuation (*e.g.* inventory valuation) and / or the booking of provisions, subject to the application of the relevant domestic accounting and tax rules; and

(iii) Generally be compensated by an increase in the expected return (see paragraph 1.23 of the TP Guidelines: "[…] 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.").

D.2 Can the use of a transfer pricing method create a low risk environment?

45. The question of the relationship between the choice of a particular transfer pricing method and the level of risk left with the entity that is remunerated using that method is an important one in the context of business restructuring. It is quite commonly argued that because an arrangement is remunerated using a cost plus or TNMM that guarantees a certain level of gross or net margin to one of the parties, that party operates in a low risk environment. While the terms on which a party to a transaction is compensated cannot be ignored in evaluating the risk borne by that party, it is worth remembering that it is the low risk nature of a business that should dictate the choice of a given transfer pricing method, and not the contrary. In all cases it is important to ensure that the advocated risk profile and the choice of the transfer pricing method are consistent with the functional analysis of the parties. See Issues Note No. 3 for a discussion of the arm's length remuneration of the post-restructuring arrangements and in particular Section C of that note on the selection and application of a transfer pricing method.

ISSUES NOTE No. 2: ARM'S LENGTH COMPENSATION FOR THE RESTRUCTURING ITSELF

Introduction

46. Business restructurings involve transfers of functions, assets and / or risks with associated profit / loss potential between associated enterprises, for instance from a restructured operation to a foreign related principal. Restructurings can also involve the termination (including non-renewal) or substantial renegotiation of existing arrangements (whether or not formalised in writing), *e.g.* manufacturing arrangements, distribution arrangements, licenses, service agreements, etc. This note discusses the arm's length nature of compensation for the restructuring itself, including in particular the circumstances in which at arm's length the transferor would receive a form of compensation for the transfer and / or an indemnification for termination or substantial renegotiation of the existing arrangements.

47. Under Article 9 of the Model Tax Convention, where the conditions made or imposed in a transfer of functions, assets and / or risks, and / or in the termination or renegotiation of a contractual relationship between two associated enterprises located in two different countries differ from those that would be made or imposed between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

48. In order to determine whether at arm's length the restructuring itself would give rise to a form of compensation, 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. These questions are discussed in Section A. Section B contains a discussion of the reallocation of profit / loss potential as a result of a reallocation of risks; Section C covers the arm's length compensation for a transfer of something of value (*i.e.* an asset, including a right to conduct an activity) to a related party as a result of a restructuring; Section D addresses the question whether there would be compensation at arm's length for the detriment or loss suffered as a result of a restructuring.

A - Understanding the restructuring itself

A.1 Identifying the restructuring transactions; functions, assets and risks before and after the restructuring.

49. Restructurings can take a variety of different forms and may involve only two or more than two members of an MNE group. For example, a simple pre-restructuring arrangement could involve a full-fledged manufacturer producing goods and selling them to a related full-fledged distributor for on-sale into the market. The restructuring could involve a modification to that two-party arrangement, whereby the distributor is converted to a limited risk distributor or commissionnaire, with risks previously borne by the full-fledged distributor being assumed by the manufacturer (see discussion of risks in Issues Note No. 1 "Special considerations for risks"). Frequently, the restructuring will be more complicated, with functions

performed, assets used and / or risks assumed by either or both parties to a pre-restructuring arrangement shifting to one or more additional members of the group.

50. In order to determine the arm's length compensation payable upon a restructuring to any restructured entity within an MNE group, as well as the member of the group that should bear such compensation, it is important to identify the transaction or transactions occurring between the restructured entity and one or more other members of the group. This analysis must include an identification of the functions before and after the restructuring, and an evaluation of the rights and obligations of the restructured entity under the pre-restructuring arrangement (including those existing under contract and commercial law) and of the manner and extent to which those rights and obligations change as a result of the restructuring.

51. Obviously, any evaluation of the rights and obligations of the restructured entity must be based upon the requirement that those rights and obligations reflect the economic principles that generally govern relationships between independent enterprises (see paragraph 1.28 and 1.29 of the TP Guidelines). For example, a restructured entity may legally be under a short term or "at will" contractual arrangement at the time of the restructuring. However, the actual conduct of the entity in the years or decades prior to the restructuring, for example in developing its market without explicit compensation from another member of the MNE group, may be indicative of a longer-term arrangement, and hence greater rights than those indicated by the legal contractual arrangement.

52. In the absence of evidence of rights and obligations in a comparable situation, it may be necessary to determine what rights and obligations would have been put in place had the two parties transacted with each other at arm's length.

A.2 Understanding the business reasons for and the expected benefits from the restructuring; the role of synergies.

53. Private sector representatives who attended the January 2005 CTPA Roundtable[13] explained that multinational businesses, regardless of their products or sectors, increasingly needed to reorganize their structures to provide more centralized control and management of manufacturing, research and distribution functions. The pressure of competition in a globalised economy, savings from economies of scale, the need for specialization and the need to increase efficiency and lower costs were all described as important in driving business restructuring. Where anticipated synergy gains are put forward by a taxpayer as an important business reason for the restructuring, it would be reasonable for the taxpayer to document, at the time the restructuring is decided upon or implemented, what these anticipated synergy gains are and on what assumptions they are anticipated. This is a type of documentation that is likely to be produced for non-tax purposes, to support the decision-making process of the restructuring. For transfer pricing reasons, it would also be reasonable to expect such documentation to provide an analysis of the effects of the restructuring on each affiliate or taxpayer (costs and anticipated benefits) as well as an assessment of the other options realistically available to it.

54. The fact that a business restructuring may be motivated by anticipated synergy gains does not necessarily mean that the profits of the MNE group will effectively increase after the restructuring. It may be the case that enhanced synergies make it possible for the MNE group to derive additional profits compared to what the situation would have been in the future if the restructuring had not taken place, but there may not necessarily be additional profits compared to the pre-restructuring situation, for instance if the restructuring is needed to maintain competitiveness rather than to increase it.

[13] See Uhttp://www.oecd.org/document/20/0,2340,en_2649_37989760_34535252_1_1_1_1,00.htmlU.

55. In addition, expected synergy gains do not always materialise and there should be no assumption that their effects are always positive – there can be cases where the implementation of a global business model designed to derive more group synergies in fact leads to additional costs and less efficiency. Paragraph 1.51 of the TP Guidelines recommends that tax administrations avoid the use of hindsight.

56. Where anticipated synergy gains are put forward by a taxpayer as the business reason for transferring certain functions, assets and / or risks in the context of a business restructuring, and there are significant discrepancies between the anticipated and the actual synergies, the reasons for such discrepancies would need to be analysed. It might be the case that the projections were not realistic from the outset, or that there was an unforeseen event which eliminated the projected gains. Such an unforeseen event could be due to the fact that one or more parties did not perform as anticipated; or that exogenous factors (*e.g.* economic circumstances) changed unexpectedly and dramatically; or a combination of several reasons. This analysis will be useful to decide what party(ies) should at arm's length bear the consequences of the non-realisation of anticipated synergies and in what proportion.

57. One important issue is the difference between group-wide and local synergies. Even where they increase group-wide synergies, business restructurings may lead to the dismantling of local synergies. For instance, a vertically integrated entity may be split into a "stripped" manufacturer and a "stripped" distributor while its core value drivers are transferred to a foreign related principal. Assume that prior to the restructuring, the entity manufactured a whole range of products for its local market, and that after the restructuring it manufactures a limited range of products for a regional or global market. Assume that as a consequence of this restructuring, the "stripped" distributor now purchases from foreign related or unrelated parties products that it used to manufacture locally. This restructuring may create regional or group-wide synergies while possibly destroying the local synergies that might have existed between the local manufacturing and selling activities. Given that the arm's length principle applies on a separate entity rather than group-wide basis, local synergy gains or losses may contribute to the profit / loss potential of the restructured entity, and may need to be taken into account in the analysis of the transfer pricing consequences of the restructuring, depending on the rights and other assets of the restructured entity at the time of the restructuring.

A.3 Options that would have been realistically available to the restructured entity at arm's length

58. The application of the arm's length principle is based on the notion that independent enterprises, when evaluating the terms of a potential transaction, will compare the transaction to the other options realistically available to them, and they will only enter into the transaction if they see no alternative that is clearly more attractive. Consideration of the options that would be realistically available at arm's length is relevant to comparability and pricing of the transaction (see paragraph 1.15 of the TP Guidelines) and also for the assessment of whether it would be commercially rational for a party to enter into the restructuring transaction in the context of the application of the guidance on recognition of transactions at paragraphs 1.36 – 1.41 of the TP Guidelines. [14]

59. At arm's length, there are situations where an entity would have had options realistically available to it other than to accept the conditions of the restructuring, including possibly the option not to enter into the restructuring transaction. In such cases, in assessing the conditions of a business restructuring transaction, the entity would be expected to consider whether any of these other options is clearly more attractive, taking into account all the conditions including any compensation or indemnification for the restructuring.

[14] See Issues Note No. 4.

60. At arm's length, there are also situations where the restructured entity would have had no option realistically available to it other than to accept the conditions of the restructuring, *e.g.* a contract termination – with or without indemnification as discussed at Section D below. In longer-term contracts, this may occur by invoking an exit clause that allows for one party to prematurely exit the contract with just cause. In contracts that allow either party to opt out of the contract, the party terminating the arrangement may choose to do so because it has determined, subject to the terms of the termination clause, that it is more favourable to stop using the function, or to internalise it, or to engage a cheaper or more efficient provider (recipient) or to seek more lucrative opportunities (provider). In case the terminated service provider transfers rights or other assets or an ongoing concern to the new provider, it might however be compensated for such a transfer as discussed in Section C below.

61. The arm's length principle requires an evaluation of the conditions made or imposed between related parties, at the level of each of them. The fact that the cross-border redeployment of functions, assets and / or risks may be motivated by sound commercial reasons at the level of the MNE group, *e.g.* in order to try to derive synergy gains at a group level, does not answer the question whether the transfers are arm's length from the perspectives of both the transferor(s) and the transferee(s).

B - Reallocation of profit / loss potential as a result of a business restructuring

62. Transfers of functions, assets and / or risks in the context of business restructurings are typically accompanied by a reallocation of the profit / loss potential amongst the members of the MNE group. This Section concentrates on the reallocation of profit / loss potential that can follow from a business restructuring. See Section D of Issues Note No. 1 for general guidance on the transfer pricing consequences of a reallocation of risks, Section C of this Issues Note for a discussion of compensation for a transfer of something of value (*i.e.* an asset, including a right to conduct an activity) and Section D of this Issues Note for a discussion of compensation for the detriment or loss suffered as a result of a restructuring.

B.1 Transfer pricing consequences of a reallocation of profit / loss potential that follows from a reallocation of risks, rights and / or other assets

63. The reallocation of risks amongst related parties can lead to both positive and negative effects for the transferor and for the transferee: on the one hand, potential losses and possible liabilities may, as a result of the transfer, shift to the transferee; on the other hand, the expected return attached to the risk transferred may be realised by the transferee rather than the transferor. This raises the issue of whether the transfer of a profit / loss potential that results from the restructured entity's being converted into a less risk-bearing entity would have given rise to some form of compensation if carried out between independent parties.

64. The profit / loss potential is not an asset, 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 arises whether there are rights or other assets transferred that carry profit / loss potential and should be remunerated at arm's length. Here, profit / loss potential should not be interpreted as simply the profits / losses that would occur if the pre-restructuring arrangement were to continue indefinitely. On the one hand, if an entity has no discernable rights and / or other assets at the time of the restructuring, then it has no compensable profit potential. On the other hand, an entity with considerable rights and / or other assets at the time of the restructuring may have considerable profit potential, which must ultimately be appropriately remunerated in order to justify the sacrifice of such profit potential.

65. One way of valuing a transfer of rights or other assets is through an examination of the transferred profit / loss potential associated with those rights or other assets. From a transfer pricing

perspective, the determination of the arm's length remuneration for a change in the allocation of the profit / loss potential that follows from the reallocation of risks should take account of:

- Whether compensation by the transferor to the transferee for the transfer of potential losses and liabilities would be agreed between independent parties at arm's length, taking account of both the amount of the possible losses and the probability of the risk's materialising, and whether it would be preferable for the transferor to pay the transferee to take over the activity rather than to simply stop performing the activity and incur the associated windup costs;

Comments from the public are particularly invited on this issue.

- Whether compensation by the transferee to the transferor for the associated transfer of profit / loss potential would be agreed between independent parties at arm's length, taking account of the other options realistically available to the parties, and of the future profit / loss expectations in relation to the risk at hand. Accounting standards for evaluating risks can prove very helpful in that respect (see paragraph 42);

- Consequences attached to the subsequent exercise of activities by the transferor and the transferee in accordance with their new risk profiles.[15]

B.2 Compensation as a result of a business restructuring

66. Where there is a transfer of profit / loss potential that follows from a business restructuring, the question arises of whether that transfer is an arm's length transaction from the perspectives of both the transferor and the transferee and in particular whether (and if so how) it should be compensated. The answer will obviously depend on a number of factors, including but not limited to:

- 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.[16]

- The expected return to the transferor and transferee after the restructuring. Business restructurings typically involve a trade-off between possibly higher-but-more-volatile profits[17] or losses (*e.g.* for a full-fledged manufacturing activity) and lower-but-more-stable profits (*e.g.* for a contract manufacturing activity). At arm's length the expected return would depend on the new risk profile of the transactions (see paragraph 1.23 of the TP Guidelines: "[i]n the open market, the assumption of increased risk will also be compensated by an increase in the expected return.").[18]

- Compensation that might be required to appropriately remunerate the transferor's surrender of profit potential, in cases where the transferor has transferred or surrendered rights or other assets that carry that profit potential.

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15 See discussion of the remuneration of the post-restructuring transactions in Issues Note No. 3.

16 See Section A of this Issues Note.

17 This does not mean that high profits are always volatile.

18 See discussion of the remuneration of the post-restructuring transaction in Issues Note No. 3.

67. Take the example of a conversion of a full-fledged manufacturer into a contract manufacturer. In such a case, while a cost plus reward might be an arm's length remuneration for undertaking the post-restructuring contract manufacturing operations, another question is whether there should also be remuneration at arm's length for the surrender of the riskier profit / loss potential by the risk transferor, taking into account its rights and other assets.

68. As another example, assume a related party distributor is operating at its own risk under a long term contractual arrangement for a given type of transaction. Assume that, based on its rights under the long term contract with respect to these transactions, it has the option realistically available to it to accept or refuse being converted into a low risk distributor operating for a foreign related party, and that an arm's length remuneration for such a low risk distribution activity is estimated to be a stable profit of +2% per year while the excess profit / loss potential associated with the risks would be transferred to the foreign related party. From the perspective of the distributor, the question arises as to whether the new arrangement would be reasonably expected to be sufficiently profitable for it to accept the restructuring, given its realistic – albeit riskier - alternatives. If not, this would imply that the arrangement is mis-priced absent additional compensation to appropriately remunerate the risk transferor for the restructuring. From the perspective of the foreign related party, the question arises whether and if so to what extent it would be willing to accept the risk at arm's length in situations where the transferor continues to perform the same activity in a new capacity as a low risk distributor.

69. The response depends on the historical results of the distribution activity of the transferor, the historical volatility of such results, and the future profit / loss expectations of the transferor and transferee in relation to the risk at hand. The perspective of the transferor can be illustrated with the following example:

Note: This example is for illustration only. It is not intended to say anything about the choice of a transfer pricing method, about aggregation of transactions, or about arm's length remuneration rates for distribution activities.

Distributor's pre-conversion profits (net profit margin / sales) **– full risk activity** **Historical data (5 years)**	**Future profit expectations of the distributor** **(if had remained full-risk, assuming it had the option realistically available to do so)** **(net profit margin / sales)** **(Next 3 years)**	**Post-conversion profits of the distributor – low risk activity** **(net profit margin / sales)**
Case no. 1: Year 1: (-2%) Year 2: + 4% Year 3: + 2% Year 4: 0 Year 5: + 6%	[-2%; + 6%] with significant uncertainties within that range	guaranteed, stable profit of +2% per year
Case no. 2: Year 1: +5% Year 2: + 10% Year 3: + 5% Year 4: +5% Year 5: + 10%	[+5% + 10%] with significant uncertainties within that range	guaranteed, stable profit of +2% per year

Case no. 3: Year 1: + 5% Year 2: + 7% Year 3: + 10% Year 4: +8% Year 5: +6%	[0% + 4%] with significant uncertainties within that range (*e.g.* due to new competitive pressures)	guaranteed, stable profit of +2% per year

70. In case no. 1, the distributor is trading a profit / loss potential with significant uncertainties against a relatively low but stable profit. Whether an independent would be willing to do so would depend on its level of risk tolerance and on possible compensation for the restructuring itself. In case no. 2, it is questionable whether independent parties in the distributor's situation would agree at arm's length to transfer the risks and associated profit / loss potential for no additional compensation if they had the option to do otherwise. Case no. 3 illustrates the fact that it is not sufficient to rely on historical data.

C - Transfer of something of value (*e.g.* an asset or an ongoing concern)

71. Below is a discussion of some typical transfers that can arise in business restructurings: transfers of tangible assets, of intangible assets and of activities[19] (ongoing concern).

C.1 Tangible assets

72. Business restructurings can involve the transfer of tangible assets (*e.g.* equipment) by a restructured entity to a foreign related party. Although it is generally considered that transfers of tangible assets do not raise any significant transfer pricing difficulty, one common issue relates to the valuation of inventories that are transferred upon the conversion by a restructured manufacturer or distributor to a foreign related party (*e.g.* a principal), where the latter takes title to the inventories as from the implementation of the new business model and supply chain arrangements.

Illustration

Note: The following example is solely intended to illustrate the issue around valuation of inventory transfers. It is not intended to say anything about whether or not a particular restructuring should be recognised by tax authorities or whether or not it is consistent with the arm's length principle, nor is it intended to suggest that a particular transfer pricing method is always acceptable for restructured operations.

73. Assume a taxpayer, which is a member of an MNE group, used to operate as a "fully-fledged" manufacturer and distributor. According to the pre-restructuring business model, the taxpayer purchased raw materials, manufactured finished products using tangible and intangible property that belonged to it or was rented / licensed to it, performed marketing and distribution functions and sold the finished products to third party customers. In doing so, the taxpayer was bearing a series of risks such as inventory risks, bad debt risks and market risks.

74. Assume the arrangement is restructured and the taxpayer now operates as a so-called "toll-manufacturer" and "stripped distributor". As part of the restructuring, a foreign related party is established that acquires various trade and marketing intangibles from various affiliates including the taxpayer. Further

[19] See Section C.3 for a definition of transfers of activities in this context.

to the restructuring, raw materials are to be acquired by the foreign related party, put in consignment in the premises of the taxpayer for manufacturing in exchange for a manufacturing fee. The stock of finished products will belong to the foreign related party and be acquired by the taxpayer for immediate re-sale to third party customers (*i.e.* the taxpayer will only purchase the finished products once it has concluded a sale with a customer). Under this new business model, the foreign related party will bear the inventory risks that were previously borne by the taxpayer.

75. Assume that in order to migrate from the pre-existing arrangement to the restructured one, the raw material and finished products that are on the balance sheet of the taxpayer at the time the new arrangement is put in place are transferred to the foreign related party. The question arises how to determine the arm's length transfer price for the inventories upon the conversion.

76. This is a cut-off issue that can typically be encountered where there is a transition from one business model to another. The arm's length principle applies to transfers of inventory among associated enterprises situated in different tax jurisdictions. The choice of the appropriate transfer pricing method depends upon the comparability (including functional) analysis of the parties. The functional analysis may have to cover a transition period over which the transfer is being implemented. For instance, in the above example:

- One possibility could be to determine the arm's length price for the raw material and finished products by reference to comparable uncontrolled prices, to the extent the comparability factors can be met by such comparable uncontrolled prices, *i.e.* that the conditions of the uncontrolled transaction are reasonably comparable to the conditions of the transfer that takes place in the context of the restructuring.

- Another possibility could be to determine the transfer price for the finished products as the resale price to customers minus an arm's length remuneration for the marketing and distribution functions that still remain to be performed.

- A further possibility would be to start from the manufacturing costs and add an arm's length mark-up to remunerate the manufacturer for the functions it performed, assets it used and risks it assumed with respect to these inventories. There are however cases where the market value of the inventories is too low for a profit element to be added on costs at arm's length.

77. The choice of the appropriate transfer pricing method depends in part on which part of the transaction is the less complex and can be evaluated with the greater certainty (the functions performed, assets used and risks assumed by the manufacturer, or the marketing and sales functions that remain to be performed taking account of the assets to be used and risks to be assumed to perform these functions).

C.2 Intangible assets

78. Transfers of intangible assets raise difficult questions both as to the identification of the assets transferred and as to their valuation. Identification can be difficult because not all valuable intangible assets are legally protected and registered and not all valuable intangible assets are recorded in the accounts. Relevant intangible assets might potentially include rights to use industrial assets such as patents, trademarks, trade names, designs or models, as well as copyrights of literary, artistic or scientific work (including software) and intellectual property such as know-how and trade secrets. They may also include customer lists, distribution channels, unique names, symbols or pictures. Depending on the nature of the intangible assets, on whether they were developed or acquired, and on the applicable accounting standards, intangibles might be recorded in the balance sheet or not. An essential part of the analysis of a business

restructuring is to identify what intangible assets if any were owned by the restructured entity, what intangible assets if any were actually transferred, and what their value is.

79. The determination of the arm's length price for a transfer of intangible property right should take account of both the perspective of the transferor and of the transferee (see paragraph 6.14 of the TP Guidelines). It will be affected by a number of factors among which are the amount, duration and riskiness of the expected benefits from the exploitation of the intangible property, the nature of the property right and the restrictions that may be attached to it (restrictions in the way it can be used or exploited, geographical restrictions, time limitations), the extent and remaining duration of its legal protection (if any), and any exclusivity clause that might be attached to the right. Valuation of intangibles can be complex and uncertain. The general guidance on intangible transfers that is found in Chapter VI of the TP Guidelines is applicable to intangible transfers in the context of business restructurings.

(i) Disposal of intangible rights by a local operation to a central location (foreign related party)

80. A feature of business restructurings is that intangible assets that were previously owned and managed by one or more local operation(s) are sometimes sold to a central location situated in another tax jurisdiction (*e.g.* a foreign related party that operates as a principal or as a so-called "IP company"). The intangible assets transferred may or may not be valuable for the transferor and / or for the MNE group as a whole. In some cases the transferor continues to use the intangible transferred, but does so in another legal capacity (*e.g.* as a licensee of the transferee, or through a contract that includes limited rights to the intangible such as a contract manufacturing arrangement using patents that were transferred; or a "stripped" distribution arrangement using a trademark that was transferred); in some other cases it does not.

81. MNE groups may have sound business reasons to centralize ownership and management of intangible property. An example in the context of business restructuring is a transfer of intangibles that accompanies the specialisation of manufacturing sites within an MNE group. In a pre-restructuring environment, each manufacturing entity may be the owner and manager of a series of patents – for instance if the manufacturing sites were historically acquired from third parties with their intangible property. In a global business model, each manufacturing site can be specialised by type of manufacturing process or by geographical area rather than by patent. As a consequence of such a restructuring the MNE group might proceed with the transfer of all the locally owned and managed patents to a central location which will in turn give contractual rights (through licences or manufacturing agreements) to all the group's manufacturing sites to manufacture the products falling in their new areas of competence, using patents that were initially owned either by the same or by another entity within the group.

82. The arm's length principle requires an evaluation of the conditions made or imposed between related parties, at the level of each of them. The fact that centralisation of intangible property rights may be motivated by sound commercial reasons at the level of the MNE group does not answer the question whether the disposal is arm's length from the perspectives of both the transferor and the transferee.

83. Also in the case where a local operation disposes of its intangible property rights to a foreign related party and continues to use the intangibles further to the disposal, but does so in a different legal capacity (*e.g.* as a licensee), the conditions of the transfer should be assessed from both the transferor's and the transferee's perspectives, in particular by examining the pricing at which comparable independent enterprises would be willing to transfer and acquire the property. See paragraph 79 above. The determination of an arm's length remuneration for the subsequent ownership, use and exploitation of the transferred asset should take account of the extent of the functions performed, assets used and risks assumed by the parties in relation to the intangible transferred. This is particularly relevant to business restructurings as several

countries have expressed a concern that relevant information on the functions, assets and risks of foreign related parties is often not made available to them.

84. From the perspective of the transferor, questions arise whether at arm's length it would have had other options realistically available to it that were clearly more attractive, including the option to refuse the transfer[20] and, if so, whether an independent party at arm's length would have been willing to dispose of the intangible property in comparable conditions, taking account of the entirety of the arrangement including the compensation, if any, for the transfer itself, as well as the remuneration for the post-restructuring transactions. From the perspective of the transferee also, key questions arise in relation to the determination of an arm's length remuneration both for the transfer and for the subsequent ownership, use and exploitation of the transferred asset.

85. Where the business restructuring provides for a transfer of an intangible asset followed by a new arrangement whereby the transferor will continue to use the intangible transferred, the entirety of the commercial arrangement between the parties should be examined in order to assess whether the transactions are at arm's length. If an independent party were to transfer an asset that it intends to continue exploiting, it would be prudent for it to negotiate the conditions of such a future use (*e.g.* in a license agreement) concomitantly with the conditions of the transfer. In effect, there will generally be a relationship between the determination of an arm's length compensation for the transfer, the determination of an arm's length compensation for the post-restructuring transactions in relation to the transferred intangible, such as future license fees that may be payable by the transferor to be able to continue using the asset, and the expected future profitability of the transferor from its future use of the asset. For instance, an arrangement whereby a patent is transferred for a price of 100 in Year N and a license agreement is concomitantly concluded according to which the transferor will continue to use the patent transferred in exchange for a royalty of 100 per year over a 10-year period would raise serious doubts as to its consistency with the arm's length principle.

86. In examining the entirety of the commercial arrangements between a transferor that will continue to use the asset in a different capacity and the transferee, one factor that is likely to come into play at arm's length is the capacity of the transferee to maintain and / or further develop the asset transferred (assuming further development is necessary to maintain the asset's value). See discussion of the relationship between risk allocation and control in Issues Note No. 1, Section B.1.

(ii) Intangible transferred at a point in time when it does not have an established value

87. Difficulties can arise in the context of business restructuring where an intangible is disposed of at a point in time when it does not yet have an established value (*e.g.* pre-exploitation), especially where there is a significant gap between the level of expected future profits that was taken into account in the valuation made at the time of the sale transaction and the actual profits derived by the transferee from the exploitation of the intangibles thus acquired. This raises the question of whether the valuation at the time of the transfer was an arm's length valuation that was arrived at in good faith on the basis of information reasonably available at that time. Where this is not the case, the price for the transfer may be adjusted.

88. Moreover, where the valuation was made in good faith on the basis of information reasonably available at the time of the sale transaction, the question arises of whether it may still be adjusted subsequently to account for the unexpectedly high profits or losses derived by the transferee from the intangible. The OECD consensus position is found at paragraphs 6.28 – 6.35 of the TP Guidelines. See examples at AN-15 of the TP Guidelines on intangible property and uncertain valuation. According to that consensus, the main question is to determine whether the valuation was sufficiently uncertain at the outset

20 See Section A.3 for a discussion of options that would have been realistically available at arm's length.

that the parties at arm's length would have required a price adjustment mechanism, or whether the change in value was so fundamental a development that it would have led to a renegotiation of the transaction. Where this is the case, the tax administration would be justified in determining the arm's length price for the transfer of the intangible on the basis of the adjustment clause or re-negotiation that would be provided at arm's length in a comparable uncontrolled transaction. In other circumstances, where there is no reason to consider that the valuation was sufficiently uncertain at the outset that the parties would have required a price adjustment clause or would have renegotiated the terms of the agreement, there is no reason for tax administrations to make such an adjustment as it would represent an inappropriate use of hindsight. The mere existence of uncertainty should not require an ex-post adjustment without a consideration of what third parties would have done or agreed between them.

(iii) Local intangibles

89. Where a local full-fledged operation is converted into a "limited risk, limited intangibles, low remuneration" operation, the questions arise of whether this conversion entails the transfer by the restructured local entity to a foreign related party of valuable intangible assets such as customer lists and whether there are local intangible assets that cannot be transferred because they are inherent to the local operation.

90. In particular, in the case of the conversion of a full-fledged distributor into a limited risk distributor or commissionnaire, it is important to examine whether the distributor has developed local marketing intangibles over the years prior to its being restructured and if so, what the nature and the value of these intangibles are. Where such local intangibles are found to be in existence and to be transferred to the foreign related party upon the restructuring, their transfer should be remunerated at arm's length. Where such local intangibles are found to be in existence and to remain in the restructured entity, they should be taken into account in the remuneration of the post-restructuring activities. This can be achieved for instance via royalty payments made by the foreign related party which will exploit them as from the restructuring to the restructured entity over the life-span of the intangibles; or via the determination of transfer prices for the restructured activity that duly take account of the existence of local intangibles in the determination of the appropriate transfer pricing method and comparability analysis.[21]

(iv) Contractual rights

91. Contractual rights can be valuable intangible assets. Where valuable contractual rights are transferred (or surrendered) between related parties, they should be remunerated at arm's length, taking account of the value of the rights transferred from the perspectives of both the transferor and the transferee.

92. Tax administrations have expressed concerns about cases they have observed in practice where an entity voluntarily terminates a contract that provided benefits to it, in order to allow a foreign related party to enter into a similar contract and benefit from the profit potential attached to it. For instance, assume that company A has valuable long-term contracts with unrelated customers that carry significant profit potential for A. Assume that at a certain point in time, A voluntarily terminates its contracts with its customers under circumstances where the latter are legally or commercially obligated to enter into similar arrangements with company B, a foreign entity that belongs to the same MNE group as A. As a consequence, the contractual rights and attached profit potential that used to lie with A now lie with B. If the factual situation is that B could only enter into the contracts with the customers subject to A's surrendering its own contractual rights to its benefit, and that A only terminated its contracts with its customers knowing that the latter were legally or commercially obligated to conclude similar arrangements with B, this in substance would consist in a tri-partite transaction and it may amount to a transfer of

21 See Issues Note No. 3 for a discussion of the remuneration of the post-restructuring arrangements.

valuable contractual rights from A to B that may have to be remunerated at arm's length, depending on the value of the rights surrendered by A from the perspectives of both A and B.

C.3 Transfer of activity (ongoing concern)

(i) Taking account of the goodwill

93. Business restructurings sometimes involve the transfer of an ongoing concern, *i.e.* of an activity. The transfer of an activity in this context means the transfer of the total bundle of assets (possibly including contractual rights, workforce in place, goodwill, etc.) and liabilities associated with performing particular functions, including the inherent risks. The determination of the arm's length valuation for a transfer of ongoing concern does not necessarily amount to the sum of the valuations of isolated elements that are part of the transfer. In effect, transfers of ongoing concerns between independent parties often take account of any possible "goodwill", *i.e.* of the profit / loss potential[22] (if any) of the activity transferred, from the perspective of both the transferor and the transferee. Valuation methods that are used in acquisition deals between independent parties may prove useful to value a transfer of activity, including goodwill, between associated enterprises.

94. An example is the case where a manufacturing activity that used to be performed by M1, one entity of the MNE group, is re-located to another entity, M2 (*e.g.* to benefit from location savings). Assume M1 transfers to M2 its machinery and equipment, inventories, patents, manufacturing processes and know-how, and key contracts with suppliers and clients. Assume that several employees of M1 are relocated to M2 in order to assist M2 in the start of the manufacturing activity so relocated. Assume such a transfer would be regarded as a transfer of an ongoing concern, should it take place between unrelated parties. In order to determine the arm's length remuneration of such a transfer between related parties, it should be compared with a transfer of ongoing concern between independent parties rather than with a transfer of isolated assets.

(ii) Loss-making activities

95. Not every case where a restructured entity loses functions, assets and / or risks involves an actual loss of expected future profits. In some restructuring situations, the circumstances may be such that, rather than losing a "profit-making opportunity", the restructured entity is actually being saved from the likelihood of a "loss-making opportunity". An entity may agree to a restructuring and a loss of functions, assets and / or risks as a better option than going out of business altogether. If the restructured entity is forecasting future losses absent the restructuring (*e.g.* it operates a manufacturing plant that is uneconomic due to increasing competition from low-cost imports), then there may be in fact no loss of any profit-making opportunity from restructuring rather than continuing to operate its existing business. In such circumstances, the restructuring might deliver a benefit to the restructured entity from reducing or eliminating future losses if such losses exceed the restructuring costs.

96. The question was raised of whether the transferee should in fact be compensated by the transferor for taking over a loss-making activity. The response depends on whether an independent party at arm's length would have been willing to pay for getting rid of a loss-making activity, or whether it would have considered other options such as closing down the activity; and on whether a third party would have been willing to acquire the loss-making activity (*e.g.* because of possible synergies with its own activities) and if so in what conditions, *e.g.* subject to compensation. There can be circumstances where an independent party would be willing to pay, *e.g.* if the financial costs and social risks of closing down the activity would

[22] See Section B for a discussion of profit / loss potential.

be such that the transferor finds it more advantageous to pay a transferee who will attempt to reconvert the activity and will be responsible for any redundancy plan that may be needed.

97. The situation might however be different in case the loss-making activity provided for other benefits such as synergies with other activities performed by the same taxpayer. There can also be circumstances where a loss-making activity is maintained because it produces some benefits to the group as a whole. In such a case, the question arises whether at arm's length the entity that maintains the loss-making activity should be compensated by those who benefit from its being maintained.

C.4 Outsourcing

98. In outsourcing cases, it may happen that a party voluntarily decides to undergo a restructuring and to bear the associated restructuring costs in exchange for anticipated savings. For instance, assume a taxpayer that is manufacturing and selling products in a high-cost jurisdiction decides to outsource the manufacturing activity to a related party situated in a low-cost jurisdiction. Further to the restructuring, the taxpayer will purchase from its related party the products manufactured and will continue to sell them to third party customers. The restructuring may entail restructuring costs for the taxpayer while at the same time making it possible for it to benefit from cost savings on future procurements compared to its own manufacturing costs. Independent parties at arm's length do implement this type of outsourcing arrangement and do not necessarily require explicit compensation from the transferee if the anticipated cost savings for the transferor are greater than its restructuring costs.[23]

D - Indemnification of the restructured entity for the detriments suffered as a consequence of the restructuring

99. Where an existing contractual relationship is terminated or substantially renegotiated in the context of a business restructuring, the restructured entity might suffer detriments such as restructuring costs (*e.g.* write-off of assets, termination of employment contracts), re-conversion costs (*e.g.* in order to adapt its existing operation to other customer needs), and a loss of profit potential. The question arises of whether at arm's length independent parties in similar circumstances would have agreed for an indemnification to be paid to the restructured entity (and if so how to determine such an indemnification). As always, the answer depends on what the circumstances are, particularly the rights of the parties at the time of the restructuring.

100. For the purpose of this note, indemnification means any type of compensation that may be paid for detriments suffered by the restructured entity, whether in the form of an up-front payment, of a sharing in restructuring costs, of lower (or higher) purchase (or sale) prices in the context of the post-restructuring operations, or of any other form.

101. There should be no presumption that all contract terminations or substantial renegotiations should give a right to indemnification at arm's length.

102. 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. For this purpose, the following four conditions should be examined:

[23] A further issue is that is discussed in Section F of Issues Note No. 3 "How to determine an arm's length remuneration for the post restructuring arrangements" is whether and if so how location savings should be allocated between the parties at arm's length.

- Whether the arrangement that is terminated, non-renewed or substantially re-negotiated is formalised in writing and provides for an indemnification clause (see Section D.1 below);

- Whether the terms of the arrangement and the possible existence or non-existence of an indemnification clause or other type of guarantee (as well as the terms of such a clause where it exists) are arm's length (see Section D.2 below);

- Whether indemnification rights are provided for by commercial legislation or case law (see Section D.3 below); and

- Whether at arm's length another party would have been willing to indemnify the one that suffers from the termination or re-negotiation of the agreement (see Section D.4 below).

Each of these four questions is discussed below.

D.1 Whether the arrangement that is terminated, non-renewed or substantially re-negotiated is formalised in writing and provides for an indemnification clause

103. Where the terminated, non-renewed or re-negotiated arrangement is formalised in writing,[24] the starting point of the analysis should be a review of whether the conditions for termination, non-renewal or re-negotiation of the contract were respected (*e.g.* with regard to any required notice period) and of whether an indemnification clause or other kind of guarantee for termination, non-renewal or renegotiation is provided for. As noted at paragraph 1.29 of the TP Guidelines, "In dealings between independent enterprises, the divergence of interests between the parties ensures that they will ordinarily seek to hold each other to the terms of the contract, and that contractual terms will be ignored or modified after the fact generally only if it is in the interests of both parties."

104. However, the examination of the terms of the contract between the associated enterprises will not suffice from a transfer pricing perspective and the mere fact that a given terminated, non-renewed or re-negotiated contract did not provide for any indemnification or guarantee clause does not necessarily mean that this is arm's length, as discussed below.

D.2 Whether the terms of the arrangement and the possible existence or non-existence of an indemnification clause or other type of guarantee (as well as the terms of such a clause where it exists) are arm's length

105. Between independent parties at arm's length, there are cases of contracts that are terminated, non-renewed or substantially renegotiated with no indemnification. However, because the same divergence of interests that exists between unrelated parties may not exist in the case of associated enterprises, the question can arise whether the terms of a contract between associated enterprises are arm's length, *i.e.* whether independent parties in comparable conditions would have concluded such a contract (for instance a contract that contains no indemnification clause or guarantee of any kind in case of termination,

[24] As noted at paragraph 1.28 of the TP Guidelines, the terms of a transaction may also be found in correspondence/communications between the parties other than a written contract. Where no written terms exist, the contractual relationships of the parties must be deduced from their conduct and the economic principles that generally govern relationships between independent enterprises.

non-renewal or re-negotiation). This determination might be assisted by an examination of the options that would have been realistically available to the parties at arm's length. [25]

106. In some situations, it may be the case that an independent party at arm's length would not have had any option realistically available other than to accept the conditions of the termination or substantial renegotiation of the contract.

107. In some other cases, it may be that, on the basis of an examination of the substance of the arrangement and of the actual conduct of the related parties, an implicit longer term contract should be implied whereby the terminated party would have been entitled to some indemnification in case of early termination.

108. One circumstance that deserves particular attention, because it could have influenced the terms of the contract had it been concluded between independent parties, is the situation where the now-terminated contract required one party to make a significant investment for which an arm's length return might only be reasonably expected if the contract was maintained for an extended period of time. This created a financial risk for the party making the investment in case the contract was terminated before the end of such period of time. The degree of the risk would depend on whether the investment was highly specialised or could be used (possibly subject to some adaptations) for other clients. Where the risk was material, it would have been reasonable for independent parties in comparable circumstances to take it into account when negotiating the contract, *e.g.* by providing for a contract duration that matches the period of time needed to recover the investment and an indemnification right in case of earlier termination of the contract by the party not making the investment, or an option for the party making the investment to sell it to the other party in case of earlier termination of the contract by the latter.

109. An example would be where a manufacturing contract between associated enterprises requires the manufacturer to invest in a new manufacturing unit. Assume an arm's length return on the investment can reasonably be anticipated by the manufacturer at the time the contract is concluded, subject to the manufacturing contract lasting for at least five years, for the manufacturing activity to produce at least *x* units per year, and for the remuneration of the manufacturing activity to be calculated on a basis (*e.g.* y$/unit) that is expected to generate an arm's length return on the total investment in the new manufacturing unit. Assume that after three years, the associated enterprise terminates the contract in accordance with its terms in the context of a group-wide restructuring of the manufacturing operations. Assume the manufacturing unit is highly specialised and the manufacturer further to the termination has no other option than to write off the assets. The question arises of whether at arm's length the manufacturer in the first place would have sought to mitigate the financial risk linked to the investment in case of termination of its manufacturing contract before the end of the five-year period it needed to obtain a reasonable arm's length return on its investment.

110. At arm's length the party making the investment might not be willing to assume with no guarantee a risk (termination risk) that is controlled by the other (see paragraph 1.27 of the TP Guidelines). There can be a variety of ways in which such a risk might have been taken into account in contract negotiations, for instance by providing for an appropriate indemnification clause in case of early termination, or for an option for the party making the investment to transfer it at a given price to the other party in case the investment becomes useless to the former due to the early termination of the contract by the latter.

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25 See Section A.3 above for a discussion of the options that would have been realistically available at arm's length.

111. Another possible approach would have been to factor the risk linked with the possible termination of the contract into the determination of the remuneration of the activities covered by the contract (*e.g.* by factoring the risk into the determination of the remuneration of the manufacturing activities and using third party comparables that bear comparable risks). In such a case the party making the investment consciously accepts the risk and is rewarded for it; no separate indemnification for the termination of the contract seems necessary. However in practice this raises the question of whether the price for said activities, taking account of the remuneration of the risks that would be factored into it, would still be an acceptable price at arm's length or whether the party making the investment would ask such a high remuneration for its activities that the other party would not be willing to pay for it at arm's length.

112. Finally, in some cases, the risks might be shared between the parties, *e.g.* the party terminating the contract might bear part of the termination costs incurred by the terminated one.

113. A similar issue may arise in the case where a party has undertaken development efforts resulting in losses or low returns in the early period and above-normal returns are expected in periods following the termination of the contract.

114. In the case where the conditions made or imposed between associated enterprises with respect to the termination, non-renewal or substantial re-negotiation of their existing arrangements differ from the conditions that would be made between independent enterprises, then any profits that would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

D.3 Whether indemnification rights are provided for by commercial legislation or case law

115. In the assessment of whether the conditions of the termination or non-renewal of an existing arrangement are arm's length, the possible recourse that may be offered by the applicable commercial law might provide some helpful insights. The applicable commercial legislation or case law may provide useful information on indemnification rights and terms and conditions that could be expected in case of termination of specific types of agreements, *e.g.* of a distributorship agreement. Under such rules, it may be that the terminated party has the right to claim before the courts an indemnification irrespective of whether or not it was provided for in the contract. Where the parties belong to the same MNE group, however, the terminated party is unlikely in practice to litigate against its associated enterprise in order to seek such an indemnification, and the conditions of the termination may therefore differ from the conditions that would be made between independent enterprises in similar circumstances.

D.4 Whether at arm's length another party would have been willing to indemnify the one that suffers from the termination or re-negotiation of the agreement

116. The transfer pricing analysis of the conditions of the termination or substantial renegotiation of an agreement should take account of both the perspectives of the transferor and of the transferee. Taking account of the transferee's perspective is important both to value the amount of an arm's length indemnification, if any, and to determine what party should bear it.

117. It is not possible to derive a single answer for all cases and the response should be based on an examination of the facts and circumstances of the case, and in particular of economic rationale for the termination, of the determination of what party(ies) is (are) expected to benefit from it, and of the options that would be realistically available to the parties at arm's length. This can be illustrated as follows.

118. Assume a manufacturing contract between two related parties, entity A and entity B, is terminated by A (B being the manufacturer). Assume A decides to use another related party manufacturer,

entity C, to continue the manufacturing that was previously performed by B. Assume it is determined that in the circumstances of the case, should the transaction take place between independent parties at arm's length, B would be in a position to claim an indemnification for the detriment suffered from the termination. The question arises of whether such an indemnification should be borne by A (*i.e.* the party terminating the contract), C (*i.e.* the party taking over the manufacturing activity previously performed by B), their parent company P, or any other party. The response depends on whether at arm's length these entities would be willing to pay such a termination indemnification.

119. There can be situations where A would be willing to bear the indemnification costs at arm's length, for instance because it expects that the termination of its agreement with B will make it possible for it to derive costs savings through its new manufacturing agreement with C, and that the present value of these expected costs savings is greater than the amount of the indemnification.

120. There can be situations where C would be willing to pay such an amount as an entrance fee to obtain the manufacturing contract from A, *e.g.* if the present value of the expected profits to be derived from its new manufacturing contract makes it worth the investment for C. In such situations, the payment by C might be organised in a variety of ways, for instance it might be that C would be paying B, or that C would be paying A, or that C would be constructively paying A by meeting A's indemnification obligation to B.

121. There can be cases where at arm's length A and C would be willing to share the indemnification costs.

122. There can also be cases where neither A nor C would be willing to bear the indemnification costs at arm's length because neither of them expects to derive sufficient benefits from the change. It can be the case that such termination is part of a group-wide restructuring decided by the parent company P in order to derive group-wide synergies, and that the indemnification of entity B should be borne by P at arm's length (unless, for example, entity B, notwithstanding that its contract has been terminated or renegotiated, derives benefits from group-wide synergies that outweigh the cost to it of termination or renegotiation).

ISSUES NOTE No. 3: REMUNERATION OF POST-RESTRUCTURING CONTROLLED TRANSACTIONS

Introduction

123. This note discusses the application of the arm's length principle and TP Guidelines to post-restructuring arrangements, based on the existing guidance on the selection and application of transfer pricing methods that is found in the TP Guidelines (in particular Chapters I-III). It also takes account of the current review by the OECD of comparability and profit methods. At this stage, the review of comparability and profit methods is still ongoing and the conclusions that were arrived at and are reproduced below are only tentative and will need to be updated in due course. [26]

124. The intention is not to develop criteria for selecting and applying a transfer pricing method in post-restructuring cases that would be different from the criteria used in other transfer pricing cases. The arm's length principle and the TP Guidelines do not and should not apply differently to post-restructuring transactions as opposed to transactions that were structured as such from the beginning (see Section B below). The general guidance on the selection of transfer pricing methods applies to business restructuring cases (see Section A below for a description of this general guidance). Business restructurings however raise particular issues and deserve specific consideration (see Sections C to F below).

A - Choosing a transfer pricing method: general guidance

A.1 Existing guidance

125. The TP Guidelines establish a hierarchy among the three traditional transaction methods (comparable uncontrolled price ("CUP"), cost plus and resale minus) and the transactional profit methods (transactional net margin method and transactional profit split method). According to the TP Guidelines, transactional profit methods (*i.e.* the transactional net margin method and the profit split method) are last resort methods, *i.e.* they should only be used in the exceptional situations where there are no data available or the available data are not of sufficient quality to rely solely or at all on the traditional transaction methods (see paragraph 2.49 of the TP Guidelines). The CUP method is always preferable where it can be applied in a reliable enough manner. In the absence of satisfactory CUP, the cost plus or resale price methods are to be considered. The TP Guidelines note that the cost plus method is probably most useful where semi-finished goods are sold between related parties, where related parties have concluded joint facility agreements or long-term buy-and-supply arrangements, or where the controlled transaction is the provision of services (see paragraph 2.32 of the TP Guidelines). The resale price method is regarded as most useful where it is applied to marketing operations (see paragraph 2.14 of the TP Guidelines).

126. As far as the (residual) profit split method is concerned, the TP Guidelines further indicate that it may be appropriate in the following cases:

- Where transactions are very interrelated as it might be that they cannot be evaluated on a separate basis (see paragraph 3.5 of the TP Guidelines).

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26 See Discussion Draft on the application of transactional profit methods that was released on 25 January 2008, Uhttp://www.oecd.org/dataoecd/18/48/39915180.pdfU.

- Where under similar circumstances, independent enterprises might decide to set up a form of partnership and agree to a form of profit split (see paragraph 3.5 of the TP Guidelines).

- In cases where no closely comparable transactions between independent enterprises can be relied on: the profit split method offers flexibility by taking into account specific, possibly unique, facts and circumstances of the associated enterprises that are not present in independent enterprises, while still constituting an arm's length approach to the extent that it reflects what independent enterprises reasonably would have done if faced with the same circumstances (see paragraph 3.6 of the TP Guidelines).

- To achieve a division of the profits from economies of scale or other joint efficiencies that satisfies both the taxpayer and tax administrations (see paragraph 3.7 of the TP Guidelines).

A.2 Current review of profit methods

127. In its current review of profit methods[27], the OECD tentatively concluded that the selection of a transfer pricing method in a given situation always aims at finding the most appropriate method taking into account:

- The respective strengths and weaknesses of each of the OECD recognised methods;

- The appropriateness of the method considered in view of the comparability (including functional) analysis of the controlled transaction under review;

- The availability of sufficiently reliable information (in particular on uncontrolled comparables) in order to apply the selected method and / or other methods, and

- The degree of comparability of controlled and uncontrolled transactions including the reliability of comparability adjustments that may be needed to eliminate differences between them.

128. The proposal by the OECD is thus to remove the exceptionality and put a greater emphasis on the relative strengths and weaknesses of each method and on the importance of the comparability analysis, *i.e.* on the appropriateness of the method to the circumstances of the case. This does not mean in practice that the general preference for traditional transaction methods over transactional profit methods would simply be abolished as the OECD considers that traditional transaction methods have intrinsic strengths. Where, taking account of the comparability analysis of the controlled transaction under review and of the availability of information, a traditional transaction method and a transactional profit method can be applied in an equally reliable manner, the traditional transaction method would generally be preferred.

129. The OECD also tentatively concluded that the transactional profit split method may be found to be the most reliable method in cases where there are significant non-benchmarkable contributions[28] *(e.g.* unique intangible assets) by each party to a controlled transaction, as in such cases there might be no or insufficiently reliable comparable data to apply a traditional transaction method or a transactional net margin method and because in such cases the use of a one-sided method might not be appropriate. The OECD also tentatively concluded that a transactional profit split method may be found to be the most

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27 See Discussion Draft on the application of transactional profit methods that was released on 25 January 2008, Uhttp://www.oecd.org/dataoecd/18/48/39915180.pdfU.

28 Benchmarkable functions, assets and risks are tentatively defined as functions, assets and risks for which reasonably reliable comparables exist.

appropriate method for highly integrated transactions, for instance in the global trading of financial instruments, as in such cases it might be that the transactions cannot be evaluated on a separate basis.

B - Business restructurings versus "structuring"

B.1 General principle: no different application of the arm's length principle

130. There is consensus within the OECD that the arm's length principle and the TP Guidelines do not and should not apply differently to post-restructuring transactions as opposed to transactions that were structured as such from the beginning. Doing otherwise would create a competitive distortion between existing players who restructure their activities and new entrants who implement the same business model without having to restructure their business.

131. Comparable situations must be treated in the same way. The selection and practical application of an appropriate transfer pricing method must be determined by the comparability analysis, including the functional analysis of the parties and a review of the contractual arrangements. The same comparability standard and the same guidance on the selection and application of transfer pricing methods apply irrespective of whether or not an arrangement came into existence as a result of a restructuring of a previously existing structure.

132. However, business restructuring situations involve change, and the arm's length principle must be applied not only to the post-restructuring transactions, but also to additional transactions that take place upon the restructuring and generally consist in the transfer of functions, assets and / or risks. The application of the arm's length principle to those additional transactions is discussed in Issues Note No. 2 "Arm's length compensation for the restructuring itself".

133. In addition, the comparability analysis of an arrangement that results from a business restructuring might reveal some factual differences compared to the one of an arrangement that was structured as such from the beginning, as discussed below. These factual differences do not affect the arm's length principle or the way the guidance in the TP Guidelines should be interpreted and applied, but 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 pre-restructuring and for the post-restructuring arrangements and that the actual changes that took place upon the restructuring be documented.

B.2 Possible factual differences between situations that result from a restructuring and situations that were structured as such from the beginning

134. Where an arrangement between associated enterprises replaces an existing arrangement (restructuring), there may be factual differences in the starting position of the restructured entity compared to the position of a newly set up operation.

135. Such differences can arise for example from the fact that the post-restructuring arrangement is negotiated between parties that have had prior contractual and commercial relationships. In such a situation, depending on the facts and circumstances of the case and in particular on the rights and obligations derived by the parties from these prior arrangements, this may affect the options realistically available to the parties in negotiating the terms of the new arrangement and therefore the conditions of the restructuring and / or of the post-restructuring arrangements.[29] For instance, assume a party has proved in

[29] See Section A.3 of Issues Note No. 2 for a discussion of options realistically available in the context of determining the arm's length compensation for the restructuring itself.

the past to be able to perform well as a "full-fledged distributor" performing a whole range of marketing and selling functions, employing and developing valuable marketing intangible assets and assuming a range of risks associated with its activity such as inventory risks, bad debt risks and market risks. Assume that its distribution contract is re-negotiated and converted into a "limited risk distribution" contract whereby it will perform limited marketing activities under the supervision of a foreign related party, employ limited marketing intangibles and bear limited risks in its relationship with the foreign related party and customers. The restructured distributor may be able to negotiate an arrangement that does not contain a trial period or other similar unfavourable conditions, while such a trial period or conditions may be common for new distributors.

136. Where there is an ongoing business relationship between the parties before and after the restructuring, there may also be an inter-relationship between on the one hand the conditions of the pre-restructuring activities and / or of the restructuring itself, and on the other hand the conditions for the post-restructuring arrangements, as discussed in Section D of this note.

137. Some differences in the starting position of the restructured entity compared to the position of a newly set up operation can relate to the established presence of the operation. For instance, if one compares a situation where a long-established "full-fledged distributor" is converted into a "limited risk distributor" with a situation where a "limited risk distributor" is established in a market where the group did not have any previous commercial presence, market penetration efforts might be needed for the new entrant which are not needed for the converted entity. This may affect the comparability analysis and the determination of the arm's length remuneration in both situations.

138. When one compares a situation where a long-established "full-fledged distributor" is converted into a "limited risk distributor" with a situation where a "limited risk distributor" has been in existence in the market for the same duration, there might also be differences because the "full-fledged distributor" may have performed some functions, borne some expenses (*e.g.* marketing expenses), assumed some risks and contributed to the development of some intangibles before its conversion that the long-existing "limited risk distributor" may not have performed, borne, assumed or contributed to. The question that arises is whether at arm's length such additional functions, assets and risks should only affect the remuneration of the distributor before its being converted, whether they should be taken into account to determine a remuneration of the transfers that take place upon the conversion (and if so how), whether they should affect the remuneration of the restructured "limited risk distributor" (and if so how), or a combination of these three possibilities.

139. For instance, if it is found that the pre-restructuring activities led the "full-fledged distributor" to own some intangibles while the long-established "limited risk distributor" does not, the arm's length principle may require these intangibles either to be remunerated upon the restructuring if they are transferred by the "full-fledged distributor" to a foreign related party, or to be taken into account in the determination of the arm's length remuneration of the post-restructuring activities if they are not transferred.[30]

140. Where a restructuring involves a transfer to a foreign related party of risks that were previously assumed by a taxpayer, it is important to examine whether the transfer of risks only concerns the future risks that will arise from the post-restructuring activities or also the risks existing at the time of the restructuring as a result of pre-conversion activities, *i.e.* there is a cut-off issue. For instance, assume that a distributor was bearing bad debt risks which it will no longer bear after its being restructured as a "limited risk distributor", and that it is being compared with a long-established "limited risk distributor" that never

[30] See Section C.2 of Issues Note No. 2 "Arm's length compensation for the restructuring it self" for a discussion of the application of the arm's length principle to transfers of intangibles.

bore bad debt risk. It is important when comparing both situations to examine whether the "limited risk distributor" that results from a conversion still bears the risks associated with bad debts that arose before the restructuring at the time it was full-fledged, or whether all the bad debt risks including those that existed at the time of the conversion were transferred.

141. The same remarks and questions apply for other types of restructurings, including other types of restructuring of sales activities as well as restructurings of manufacturing activities, research and development activities, or other services activities.

C - Application to business restructuring situations: selection and application of a transfer pricing method for the post-restructuring controlled transactions

142. The selection and application of a transfer pricing method to post-restructuring controlled transactions must derive from the comparability analysis of the transaction. It is essential to understand what the functions, assets and risks involved in the post-restructuring transactions are, and what party performs, uses or assumes them. This requires information to be available on the functions, assets and risks of both parties to a transaction, *e.g.* the restructured entity and the foreign related party with which it transacts. In post-restructuring situations, particular attention should be paid to the identification of the intangible assets and the risks that effectively remain with the restructured entity (including, where applicable, local non-protected intangibles), and to whether such an allocation of intangibles and risks satisfies the arm's length principle. Issues regarding intangibles and risks are discussed in Issues Notes No. 1 "Special considerations for risks" and No. 2 "Arm's length compensation for the restructuring itself".

143. As noted in Section D.2 of Issues Note No. 1, it is quite commonly argued that because an arrangement is remunerated using a cost plus or TNMM that guarantees a certain level of gross or net margin to one of the parties, that party operates in a low risk environment. While the terms on which a party to a transaction is compensated cannot be ignored in evaluating the risk borne by that party, it is worth remembering that it is the low risk nature of a business that should dictate the choice of a given transfer pricing method, and not the contrary. In all cases it is important to ensure that the advocated risk profile and the choice of the transfer pricing method are consistent with the functional analysis of the parties.

144. In the context of its review of comparability, the OECD describes a proposed 10-step process for identifying comparable transactions and using data so obtained.[31] Step 6 of this proposed process deals with the "choice of the relevant transfer pricing method(s) and, depending on the method(s), definition of the relevant indicator (*e.g.* definition of the relevant net profit indicator in case of a TNMM)." Step 7 deals with the identification of potential comparables. As outlined further below, that guidance is relevant to determining the arm's length remuneration of post-restructuring controlled transactions.

C.1 Determination of whether the Comparable Uncontrolled Price ("CUP") method is applicable

145. In business restructuring cases as with any other type of transfer pricing situation, the CUP method, where it can be applied in a reliable enough manner, should be preferred as it is the method that provides the most direct evidence of arm's length conditions.

[31] See Discussion Draft on comparability issues released in May 2006, pages 45-46 (Uhttp://www.oecd.org/dataoecd/59/38/36651642.pdfU).

146. One example of a possible application of the CUP method would be the case where an unrelated party that used to transact independently with the MNE group is acquired, and the acquisition is followed by a restructuring of the now controlled transactions. Subject to a review of the five comparability factors, it might be the case that the conditions of the pre-acquisition uncontrolled transactions provide a CUP for the post-acquisition controlled transactions. Even where the conditions of the transactions are restructured, it might still be possible, depending on the facts and circumstances of the case, to adjust for the transfer of functions, assets and / or risks that occurred upon the restructuring. For instance, a comparability adjustment might be performed to account for a difference in what party bears bad debt risk.

147. Another example of a possible application of the CUP method would be the case where independent parties provide manufacturing, selling or service activities comparable to the ones provided by the restructured affiliate. For instance, given the recent development of outsourcing activities, it may be possible in some cases to find independent outsourcing transactions that provide a basis for using the CUP method in order to determine the arm's length remuneration of post-restructuring related party transactions. This of course is subject to the condition that the outsourcing transactions qualify as uncontrolled transactions and that the review of the five comparability factors provides sufficient comfort that either no material difference exists between the conditions of the uncontrolled outsourcing transactions and the conditions of the post-restructuring controlled transactions, or that reliable enough adjustments can be made to eliminate such differences.

C.2 Applying a one-sided method: determination of the tested party and choice of the relevant financial indicator

(i) Difference between a one-sided method and a one-sided analysis

148. When applying a one-sided method, it is not necessary to examine a financial indicator for the non-tested party. However, as discussed by the OECD in the context of its current review of profit methods,[32] a functional analysis must always be performed in order to appropriately characterize the transaction between the parties and choose the most appropriate transfer pricing method, and this functional analysis generally necessitates that some qualitative, non financial information be collected on both the tested and the non-tested parties. In other words, choosing a one-sided method does not mean that only a one-sided analysis can be performed.

149. In business restructuring situations, this implies that even in the cases where a one-sided method is applied to transactions between a restructured entity and a foreign related party (*e.g.* a foreign principal), information on the activities of the latter (*i.e.* of the non-tested party) is needed to support the functional analysis of the controlled transactions and to support the choice of the most appropriate transfer pricing method. This is important given that questions often arise as to the nature and extent of the activities of a foreign related party that benefits from the transfer by the tested party of functions, assets and risks with the associated profit.

(ii) Determination of the tested party and of whether a cost-based, sales-based, asset-based or other financial indicator should be selected

150. The OECD transfer pricing methods generally use financial indicators that are based either on costs (cost plus, cost-based TNMM), on sales (resale price, sales-based TNMM), or on assets (asset-based TNMM).

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32 See Discussion Draft on transactional profit methods released in January 2008, paragraph 52 (http://www.oecd.org/dataoecd/18/48/39915180.pdf).

151. As a general rule, when applying a one-sided method, the tested party is the one to which a transfer pricing method can be applied in the most reliable manner and for which the most reliable comparables can be found, *i.e.* in practice generally the one that has the less complex functional analysis. In general, it is observed that cost-based indicators are used for manufacturing and service activities (see paragraphs 2.32 of the TP Guidelines), sales-based indicators are used for sales activities (see paragraph 2.14 of the TP Guidelines), asset-based indicators are used for asset-intensive activities. The OECD considers that the selected financial indicator should be one that (i) is not affected by the controlled transaction itself, (ii) is linked to the main value driver of the transaction and (iii) can be reasonably measured and compared.

152. Several countries report that they have observed post-restructuring arrangements whereby sales activities performed through a commissionnaire or sales agent are remunerated using a cost plus method or cost-based TNMM. The question was raised whether this is arm's length. The argument that is often set forth by taxpayers in such cases is that the commissionnaire or sales agent does not take title to the goods sold and that it merely provides a service to the principal, for which a cost plus or cost-based TNMM might be appropriate. In order to determine whether this is arm's length, the question is whether independent parties at arm's length would agree on a cost-based remuneration for commissionnaire or sales agent activities. The OECD view is that the arm's length remuneration of selling activities (whether buy-and-sell activities, commissionnaires or sales agents) should generally be based on a sales-related indicator, unless in comparable circumstances independent parties at arm's length would agree otherwise. A combination of a cost-based indicator (*e.g.* Berry ratio) and of a sales-based indicator might also be acceptable in appropriate circumstances, for instance where the sales operation (*e.g.* the commissionnaire or sales agent) incurs significant promotional expenditure as a service performed for the principal in addition to its selling activities (see paragraph 2.24 of the TP Guidelines in relation to the resale price method).[33]

(iii) Specific considerations in relation to the cost plus method and cost-based TNMM

153. Beside the question of whether a cost plus or cost-based TNMM is appropriate to a given post-restructuring arrangement, issues arise in the application of these methods with regard to the determination of the cost base and of the mark-up rate (in a cost plus) or net margin to costs (in a cost-based TNMM).

154. With respect to the determination of an arm's length cost basis, one common issue in post-restructuring arrangements relates to the practice whereby a significant portion of the taxpayer's costs is treated as pass-through costs to which no profit element is attributed. The question arises whether such a practice is arm's length, *i.e.* to what extent independent parties in comparable circumstances would agree to treat the costs in question as pass-through rather than value-added costs. Where it is found to be acceptable at arm's length, it has consequences on the determination of the arm's length range because, in order to compare like with like, the mark-up rate (in a cost plus) or net margin to costs (in a cost-based TNMM) should be compared to those earned in comparable uncontrolled transactions calculated on a cost base that excludes the same categories of costs. Difficulties can arise in practice because publicly available financial data on uncontrolled comparable transactions often does not permit such exclusions.

155. Another issue relates to the question of whether actual costs, standard costs or budgeted costs should be used in the application of the transfer pricing method. Using actual costs may raise an issue because the tested party may have no incentive to carefully monitor the costs. In third party arrangements it is not rare that a cost savings objective is factored into the remuneration method. The question is raised

33 See January 2008 Discussion Draft on the application of transactional profit methods (http://www.oecd.org/dataoecd/18/48/39915180.pdf), Section C of Issues Note No. 6 for a similar discussion of the selection of the net profit margin indicator in the context of a transactional net margin method.

whether similar mechanisms could be taken into account in the application of the cost plus and cost-based TNMM.

156. These are issues that are not specific to business restructurings and they will therefore be discussed by the OECD in the wider context of its review of comparability and profit methods.[34]

(iv) Once the tested party and relevant financial indicator are selected: determination of whether to use a traditional transaction method (cost plus or resale price) or a transactional profit method (e.g. cost-based, sales-based, asset-based TNMM)

157. According to the TP Guidelines, traditional transaction methods should be preferred over transactional profit methods unless the lack of sufficiently reliable comparable data makes it impossible to apply a traditional transaction method in a reliable enough manner. This is because traditional transaction methods are regarded as the most direct means of establishing whether conditions in the commercial and financial relations between associated enterprises are arm's length. Accordingly, the cost plus method where it can be applied with sufficient reliability should be preferred over the cost-based TNMM, and the resale price method where it can be applied with sufficient reliability should be preferred over the sales-based TNMM.

158. As indicated at Section A.2 above, the OECD is in the process of reviewing profit methods, including the last resort status of these methods and the determination of the cases to which they should apply. The outcome of this review will need to be taken into account when finalising the guidance on the choice and application of transfer pricing methods to post-restructuring arrangements.[35]

C.3 Determination of whether a transactional profit split method is appropriate

159. Because business restructurings may involve the transfer of significant risks and / or intangibles to a foreign related party, one key transfer pricing question is to determine the nature and extent of the risks and intangibles that remain with the restructured or "stripped" entity. This analysis will in particular inform the decision of whether a transactional profit split method should be applied to the post-restructuring controlled transactions, based on the general guidance on when to apply such a method that is found in the TP Guidelines and is in the process of being updated. See Section A above.

160. In business restructuring situations as in any other transfer pricing cases, the choice of the transfer pricing method should, among other factors, be consistent with the comparability analysis including the functional analysis of the controlled transaction.

161. There can be cases where the tax administration and the taxpayer disagree on the outcome of the comparability analysis including the functional analysis and / or disagree on the choice of the transfer pricing method. This is not an issue specific to business restructuring situations. However it can be particularly acute in business restructurings in case disagreements arise as to the effectiveness and consistency with the arm's length principle of the transfers of functions, assets and / or risks presented by the taxpayer. For instance it can be the case that a taxpayer presents a restructured distribution activity as one that only performs limited benchmarkable functions, with no or limited intangible assets used and no or limited risk assumed, while the tax administration, reviewing the functional analysis, may find that the

[34] See January 2008 Discussion Draft on the application of transactional profit methods (http://www.oecd.org/dataoecd/18/48/39915180.pdf), Issues Note No. 6 paragraphs 156-160 for a discussion of these issues.

[35] See January 2008 Discussion Draft on the application of transactional profit methods (http://www.oecd.org/dataoecd/18/48/39915180.pdf), Issues Note No. 1.

restructured distributor still performs some non-benchmarkable (*e.g.* strategic) functions that may not be found in comparables, and / or owns and employs unique local intangibles and / or still bears significant market risks. Such disputes on the factual situation can sometimes lead tax authorities to disagree on the selection of the transfer pricing method proposed by the taxpayer. It may happen that, based on the comparability analysis it has prepared, the taxpayer concludes that a cost plus, resale price or TNMM method is appropriate, while the tax administration, based on its own review of the analysis and assessment of the factual situation, considers either that a transactional profit split would be more appropriate, or that the comparables used in the application of the one-sided method selected by the taxpayer should be changed and / or adjusted.

162. It is necessary to perform a sufficiently reliable comparability analysis, including a functional analysis that involves the proper identification of the functions performed, assets used and risks assumed both by the restructured entity and by the foreign related party with which it transacts, and a detailed review of the contractual terms and of their consistency with the actual behaviour of the parties. The analysis should go beyond the label assigned to the restructured entity, as a so-called "commissionnaire" or "limited distributor" can sometimes be found to own valuable local intangibles and to continue to assume significant market risks, and a so-called "contract manufacturer" can sometimes be found to pursue significant development activities or to own and use unique intangibles. In cases where significant non-benchmarkable contributions are made (*e.g.* significant non-benchmarkable intangible assets used and / or significant non-benchmarkable risks assumed) by both the foreign related party and the restructured entity, a transactional profit split method would likely be appropriate as indicated at paragraphs 126 and 129 above, irrespective of the formal label assigned to the transaction. There are also cases where a transactional profit split method would be used as a sanity check to test the outcome of the application of another primary method.[36]

163. On the other hand, not every valuable function performed, intangible used or risk borne in a controlled transaction justifies applying a transactional profit split. All businesses use some kinds of intangibles (*e.g.* business processes, software) and bear some kinds of risks. Where the intangibles used are not unique and the risks assumed are not particularly significant, it may be possible to apply a traditional method or TNMM, because comparables can be deemed to use comparable intangibles as well and to assume comparable risks, or because these intangibles and risks do not create any material difference between the controlled and uncontrolled transactions being compared, or because sufficiently reliable comparability adjustments can be performed to eliminate the effect of such differences.

164. For instance, with regard to the resale price method, paragraph 2.24 of the TP Guidelines recognises that the activities of a reseller can range widely, from the case where the reseller performs only minimal services as a forwarding agent to the case where the reseller takes on the full risk of ownership together with the full responsibility for and the risks involved in advertising, marketing, distributing and guaranteeing the goods, financing stocks and performing other connected services. In such cases it can still be possible to apply a resale price method but it should be expected that the amount of the resale price margin will be influenced by the level of activities performed by the reseller. The TP Guidelines at paragraph 2.24 further note that "the resale price margin could be higher where it can be demonstrated that the reseller has some special expertise in the marketing of such goods, in effect bears special risks, or contributes substantially to the creation or maintenance of intangible property associated with the product," and they also provide that, when part or most of the promotional expenditure was clearly incurred as a service performed in favour of the legal owner of the trademark, the cost plus method may well supplement the resale price method. Thus, the TP Guidelines do not prescribe recourse to the transactional profit split method each time

[36] See January 2008 Discussion Draft on the application of transactional profit methods (http://www.oecd.org/dataoecd/18/48/39915180.pdf), Issues Note No. 2 for a discussion of the difference between the use of a primary method and the use of a sanity check.

special risks and intangibles are involved. This is of course subject to the availability of sufficiently reliable, possibly adjusted, comparable data (see paragraph 2.25 of the TP Guidelines).

165. Where there are no comparable data of sufficient quality to apply another method, a transactional profit split method might in appropriate circumstances (*e.g.* where the absence of comparable data is due to the presence of significant non-benchmarkable contributions made by both parties to the transaction) be considered without comparable data (see paragraph 3.6 of the TP Guidelines). However, even in cases where comparable data are scarce and imperfect, the choice of the most appropriate transfer pricing method should be consistent with the functional analysis of the parties. For instance, a transactional profit split method is unlikely to be the most appropriate method for contract manufacturing or contract service activities that do not involve significant non-benchmarkable contributions such as intangibles or risks by the contract manufacturer or service provider, despite the fact that comparables might sometimes not be easily available.

C.4 Application of the selected transfer pricing method: identification of potential comparables

166. Post-restructuring arrangements may pose certain challenges with respect to the identification of potential comparables in cases where the restructuring implements a business model that is hardly found between independents.

167. As noted at Section C.1 above in relation to the CUP method, there can however be cases where comparables including internal comparables are available, subject to possible comparability adjustments being performed.

168. Whenever a comparable is proposed, it is important to ensure that a sufficiently reliable comparability analysis is performed in order to identify any possible material difference between the controlled and uncontrolled transactions and, where necessary and possible, to adjust for such differences. In particular, the comparability analysis might reveal that the restructured entity continues to perform valuable and significant functions and / or the presence of local intangibles and / or of significant risks that remain in the “stripped” entity after the restructuring but are not be found in the proposed comparables. See Section B on the possible differences between restructured activities and start-up situations.

169. The identification of potential comparables has to be made with the objective of finding the best available data, although it is recognised that in some instances the data will not be perfect. There are also cases where, absent satisfactory comparable data, it may be necessary to determine what conditions would have been agreed, had the parties transacted with each other at arm’s length. Notwithstanding the difficulties that can arise in the process of searching comparables, it is necessary to find a reasonable solution to all transfer pricing cases. As recognised at paragraphs 142 and 160, even in cases where comparable data are scarce and imperfect, the choice of the most appropriate transfer pricing method should be consistent with the functional analysis of the parties.

C.5 Example: implementation of a central purchasing function

170. This Section illustrates the application of the arm’s length principle in the case of the implementation of a central purchasing function. It reflects the central importance of comparability analyses and in particular of the functional analysis in order to understand the role played by each of the parties in the creation of synergies, costs savings, or other integration effects. The list below is not intended to cover all the possible situations but only the most frequent ones. Which transfer pricing method(s) satisfy(ies) the arm’s length principle will depend on the facts and circumstances of the case.

171. Assume an MNE group puts in place a central purchasing entity that will negotiate with third party suppliers the purchases of raw materials used by all the manufacturing plants of the group in their

manufacturing processes. Depending in particular on the respective functional analyses of the manufacturing plants and of the central purchasing entity and on the contractual terms they have agreed upon, a variety of remuneration schemes and transfer pricing methods could be considered.

172. First, there will be cases where the comparable uncontrolled price method ("CUP") will be applicable. Assume the central purchasing entity purchases the raw materials from third party suppliers and sells them to the manufacturing plants. The CUP method might be applicable if the raw materials are traded on a commodity market (see paragraph 2.11 of the TP Guidelines). It may also be the case that the price that was paid by the manufacturing plants before the interposition of the central purchasing entity or the price paid by independent parties for comparable raw materials may, subject to a review of the facts and circumstances, be used as a comparable uncontrolled price to determine the price at which the manufacturing plants should acquire the raw materials from the central purchasing entity. However, such a CUP, if unadjusted, may well mean that all the costs savings would be attributed to the central purchasing entity. The question arises as to whether the arm's length principle requires that the CUP be adjusted in order to allocate a portion of the cost savings to the manufacturing entities. In effect, where independent parties behaving at arm's length set up joint purchasing arrangements (*e.g.* cooperatives), their objective is generally to share the costs savings among the members.

173. Where the CUP method cannot be used, *e.g.* because the price of the raw materials fluctuates and the price paid by the manufacturing entities before the setting up of the central purchasing entity cannot serve as a reference, the cost plus method might be considered. For instance, the central purchasing entity might purchase the raw materials from third party suppliers and re-sell them to the manufacturing plants at cost plus, *i.e.* the new purchase price of the raw material by the central purchasing entity plus an arm's length mark-up. In such a case, the mark-up rate attributed to the central purchasing entity should be comparable to the mark-up rate earned in comparable uncontrolled trading activities.

174. In some cases, the central purchasing entity acts as an agent either for the suppliers or for the purchasers (or both) and is remunerated by a commission fee paid either by the suppliers or by the purchasers (or both). This might be the case where the central purchasing entity negotiates with the third party suppliers but does not take title to the inventories, *i.e.* the manufacturing plants continue to acquire the raw materials directly from the suppliers but at a discounted price obtained thanks to the activity of the central purchasing entity and to the participation of the group of manufacturing plants in the arrangement. The commission fee might be proportional to the supplies (especially if paid by the supplier) or to the discounts obtained (especially if paid by the manufacturing plants). It should be comparable to the commission fee that would be charged by independent parties for comparable agency functions in similar circumstances.

175. It may happen that what would be *prima facie* regarded as an arm's length mark-up on costs or commission fee from the perspective of the central purchasing entity in effect leads to determining purchase prices for the manufacturing entities that are higher than the prices they could obtain by themselves. If the incremental costs that are created for the manufacturers are material (*e.g.* they materially affect, on a recurrent basis, the basket of products channelled through the central purchasing entity), the question arises of whether at arm's length independent manufacturers would have accepted to pay such higher prices and what would be the economic rationale, or whether at arm's length the central purchasing entity should bear part or all of the inefficiencies through a reduction of its sales prices to the manufacturers. The response will depend on the facts and circumstances of the case. Key to the analysis will be the determination of the benefits that could reasonably be expected by the parties (manufacturing entities and central purchasing entity) from the implementation of the central purchasing function, and of the options that would have been realistically available at arm's length to them, including in appropriate cases the option not to participate in the central purchasing in case the expected benefits were not as attractive as under other options. Where benefits could reasonably have been expected by the parties, it

will be key to analyse the reasons for the central purchasing entity's apparent inefficiency, the contractual terms under which the central purchasing entity operates and the functional analysis of the manufacturers and of the central purchasing entity, in particular their respective roles and responsibilities in the decisions that led to the inefficiencies. This analysis should make it possible to determine what party(ies) should be allocated the inefficiency costs and to what extent. Where this analysis indicates that inefficiencies should be allocated to the central purchasing entity, one way of doing so would be to price the sale transactions to the manufacturing entities by reference to CUP *i.e.* based on prices that the manufacturing entities could obtain on the free market for comparable supplies in comparable circumstances. No inference should be drawn however that any inefficiencies should be allocated by default to the central purchasing function, or that the positive effects of synergies should always be shared amongst the members of the group.

176. Finally, there might be some cases where the costs savings (or costs) generated by the centralisation of the purchasing function would be shared amongst the central purchasing entity and the manufacturing plants through a form of profit split.

D - Relationship between compensation for the restructuring and post-restructuring remuneration

177. There may in some circumstances be an important inter-relationship between the compensation for the restructuring and an arm's length reward for operating the business post-restructuring. This can be the case where a taxpayer disposes of business operations to a related party with which the taxpayer must then transact business as part of those operations. One example of such a relationship is found in the note on "Arm's length compensation for the restructuring itself", under Section C.4 on outsourcing.[37]

178. Another example would be where a taxpayer that operates a manufacturing and distribution activity restructures by disposing of its distribution activity to a foreign party to which the taxpayer will in future sell goods it manufactures. The foreign party would expect to be able to earn an arm's length reward for its investment in acquiring and operating the business. In this situation, the taxpayer might agree with the foreign party to forgo receipt of part or all of the up-front compensation for the business that may be payable at arm's length, and instead obtain comparable financial benefit over time through selling its goods to the foreign party at prices that are higher than the latter would otherwise agree to if the up-front compensation had been paid. Alternatively, the parties might agree to set an up-front compensation payment for the restructuring that is partly offset through future lower transfer prices for the manufactured products than would have been set otherwise. See Issues Note No. 2 for a discussion of situations where compensation would be payable at arm's length for the restructuring itself.

179. In other words, in this situation where the taxpayer will have an ongoing business relationship as supplier to the foreign party that carries on an activity previously carried on by the taxpayer, the taxpayer and the foreign party have the opportunity to obtain economic and commercial benefits through that relationship (*e.g.* the sale price of goods) which may explain for instance why compensation through an up-front capital payment for transfer of the business was foregone, or why the future transfer price for the products might be different from the prices that would have been agreed absent a restructuring operation.

180. Such a situation is a peculiar example. In practice it might be difficult to structure and monitor. While taxpayers are free to choose the form of compensation payments, whether up-front or over time, tax administrations when reviewing such arrangements would want to know how the compensation for the post-restructuring activity was possibly affected to take account of the foregone compensation, if any, for the restructuring itself. Specifically, in such a case, the tax administration would want to look at the

[37] See also Section C.2(i) of that Issues Note.

entirety of the arrangements, while being provided with a separate evaluation of the arm's length compensation for the restructuring and for the post-restructuring transactions.

E - Comparison of profits earned before and after the restructuring

181. The question was raised of the role if any of comparisons that can be made of the profits earned by a party to a controlled transaction prior to and after the restructuring. In particular, the question was raised whether it would be appropriate to determine a restructured entity's post-restructuring profits by reference to its pre-restructuring profits, adjusted to reflect the transfer or relinquishment of particular functions, assets and risks.

182. One important issue with such before-and-after comparisons is that a comparison with the profits made in controlled transactions prior to the restructuring would not suffice in the face of the requirement posed by Article 9 of the Model Tax Convention for a comparison to be made with uncontrolled transactions. The OECD has discussed the issue of comparisons with controlled transactions in the context of its review of comparability. The tentative conclusion reached by the OECD is that controlled transactions should by no means be used as the basis for a transfer pricing adjustment, but that information on controlled transactions may provide valuable indications and might be useful in particular in the risk assessment phase.

183. Another issue with before-and-after comparisons is the likely difficulty of valuing the basket of functions, assets and risks that were lost by the restructured entity, keeping in mind that it is not always the case that these functions, assets and risks are transferred to another party.[38]

184. That being said, in business restructurings, before-and-after comparisons could play a role in understanding the restructuring itself and could be part of a before-and-after comparability (including functional) analysis to understand the value drivers and the changes that accounted for the changes in the allocation of profits amongst the parties. In effect, information on the arrangements that existed prior to the restructuring and on the conditions of the restructuring itself could be essential to understand the context in which the post-restructuring arrangements were put in place and to assess whether such arrangements are arm's length. It can also shed light on the options that would have been realistically available to the restructured entity at arm's length. [39]

185. Any transfer pricing analysis of a business restructuring has to take account of what has actually changed in relation to the five comparability factors. A comparability (including functional) analysis of the business before and after the restructuring may reveal that while some functions, assets and risks were transferred, other functions may still be carried out by the "stripped" entity under contract for the foreign related party. A careful review of the respective roles of the foreign related party and of the "stripped" entity will determine what transfer pricing method should be applied as discussed in Section C of this note, for instance whether or not it is appropriate to allocate the whole residual profit to the foreign related party in view of the actual risks and intangibles of the "stripped" entity and of the foreign related party.

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38 See discussion of the transfer of functions, assets and risks in Issues Note No. 2 on "Arm's length compensation for the restructuring itself".

39 See discussion of options realistically available under Section A.3 of Issues Note No. 2 "Arm's length compensation for the restructuring itself"; see also discussion of possible factual differences between situations that result from a restructuring and situations that were structured as such from the beginning and of how such differences may affect the options realistically available to the parties in negotiating the terms of the new arrangement and therefore the conditions of the restructuring and / or of the post-restructuring arrangements, under Section B.2 of Issues Note No. 3.

186. Before-and-after comparisons can also be used as a sanity or reasonableness check. For instance, it will often be useful to benchmark the decrease in profits earned in controlled transactions by the "stripped" entity further to a restructuring against the nature and extent of the functions, assets and risks in relation to the controlled transactions that were transferred or lost upon the restructuring. In cases where the value of the functions, assets and risks effectively transferred or lost is not sufficient to explain the decrease in profits, one possible explanation could be that the post-restructuring profits are lower than arm's length; another possible explanation could be that the pre-restructuring profits were higher than arm's length; a combination of both explanations might also be appropriate depending on the circumstances of the case.

187. There will also be cases where before-and-after comparisons can be made because the transactions prior to the restructuring were not controlled, for instance where the restructuring follows an acquisition, and where adjustments can reliably be made to account for the differences between the pre-restructuring uncontrolled transactions and the post-restructuring controlled transactions. See example at paragraph 146 above. As in all cases, the use of such uncontrolled transactions as potential comparables would have to be evaluated in light of the ability to make reliable adjustments to account for those differences, relative to other potential comparables that may produce less of a need to make adjustments.

F - Location savings

188. Location savings can be derived by an MNE group that relocates some of its activities to a place where costs (such as labour costs, real estate costs, etc.) are lower than in the location where the activities were initially performed, account being taken of the possible costs involved in the relocation (such as termination costs for the existing operation, possibly higher infrastructure costs in the new location, possibly higher transportation costs if the new operation is more distant from the market, training costs of local employees, etc.). Where a business strategy aimed at deriving location savings is put forward as a business reason for restructuring, the discussion at Chapter I, Section C (i) (b) (5) of the TP Guidelines is relevant. In particular, as noted at paragraph 1.31 of the TP Guidelines, it may be relevant to consider whether business strategies have been devised by the MNE group or by a member of the group acting separately and the nature and extent of the involvement of other members of the MNE group necessary for the purpose of implementing the business strategy.

189. Where significant location savings are derived further to a business restructuring, the question arises of whether and if so how the location savings should be attributed among the parties. The response should obviously depend on what independent parties would have agreed at arm's length in similar circumstances. The conditions that would be agreed between independent parties would normally depend on the functions, assets and risks of each party and on their respective bargaining powers.

190. Take the example of an enterprise that designs, manufactures and sells branded clothes. Assume that the manufacturing process is basic and that the brand name is famous and represents a highly valuable intangible. Assume that the enterprise is established in Country A where the labour costs are high and that it decides to close down its manufacturing activities in Country A and to relocate them in an affiliate company in Country B where labour costs are significantly lower. The enterprise in Country A retains the rights on the brand name and continues designing the clothes. Further to this restructuring, the clothes will be manufactured by the affiliate in Country B under a contract manufacturing arrangement. The arrangement does not involve the use of any significant intangible owned by or licensed to the affiliate or the assumption of any significant risks by the affiliate in Country B. Once manufactured by the affiliate in Country B, the clothes will be sold to the enterprise in Country A which will on-sell them to third party customers. Assume that this restructuring makes it possible for the group formed by the enterprise in Country A and its affiliate in Country B to derive significant location savings. The question arises whether

the location savings should be attributed to the enterprise in Country A, or its affiliate in Country B, or both (and if so in what proportions).

191. In such an example, given that the relocated activity is a highly competitive one, it is likely that the enterprise in Country A has the option realistically available to it to use either the affiliate in Country B or a third party manufacturer. As a consequence, it should be possible to find reasonably reliable comparable data to determine the conditions in which a third party would be willing at arm's length to manufacture the clothes for the enterprise. In such a situation, a contract manufacturer at arm's length would generally be attributed very little, if any, part of the location savings. Doing otherwise would put the related party manufacturer in a situation different from the situation of unrelated manufacturers, and would be contrary to the arm's length principle.

192. As another example, assume now that an enterprise in Country X provides highly specialised engineering services to independent clients. The enterprise is very well known for its high quality standard. It charges a fee to its independent clients based on a fixed hourly rate that compares with the hourly rate charged by competitors for similar services in the same market. Suppose that the wages for qualified engineers in Country X are high. The enterprise subsequently opens a subsidiary in Country Y where it hires equally qualified engineers for substantially lower wages, and subcontracts a large part of its engineering work to its subsidiary in Country Y, thus deriving significant location savings for the group formed by the enterprise and its subsidiary. Clients continue to deal directly with the enterprise in Country X and are not necessarily aware of the sub-contracting arrangement. For some period of time, the well known enterprise in Country X can continue to charge its services at the original hourly rate despite the significantly reduced engineer costs. After a certain period of time, however, it is forced due to competitive pressures to decrease its hourly rate and pass on part of the location savings to its clients. In this case also, the question arises of which party(ies) within the MNE group should be attributed the location savings at arm's length: the subsidiary in Country Y, the enterprise in Country X, or both (and if so in what proportions).

193. In this example, it might be that there is a high demand for the type of engineering services in question and the subsidiary in Country Y is the only one able to provide them with the required quality standard, so that the enterprise in Country X does not have many other options available to it than to use this service provider. It might be that the subsidiary in Country Y has developed a valuable intangible corresponding to its technical know-how. Such an intangible would need to be taken into account in the determination of the arm's length remuneration for the sub-contracted services. In appropriate circumstances (*e.g.* if there are significant non-benchmarkable contributions such as intangibles used by both the enterprise in Country X and its subsidiary in Country Y), the use of a transactional profit split method may be considered.

ISSUES NOTE No. 4: RECOGNITION OF THE ACTUAL TRANSACTIONS UNDERTAKEN

A - Introduction and scope of this note

194. An important starting point for any transfer pricing analysis is to properly identify and characterise the controlled transaction under review. The existing guidance at Chapter I, Section C ii) of the TP Guidelines deals with the relevance of the actual transactions undertaken by associated enterprises and discusses the exceptional circumstances in which it may be legitimate and appropriate for a tax administration not to recognise, for transfer pricing purposes, a transaction that is presented by a taxpayer. This note discusses some important notions in relation to the application of that existing guidance in the context of business restructurings. It does not discuss whether such existing guidance provides a satisfactory outcome and does not attempt to propose any amendments to the existing guidance other than clarification of said existing guidance.

195. Paragraphs 1.36 – 1.41 of the TP Guidelines are limited to the non-recognition of transactions for the purposes of making transfer pricing adjustments covered by Article 9 of the OECD Model Tax Convention (*i.e.* adjustments in accordance with the arm's length principle). They do not provide any guidance as to a country's ability to characterise transactions differently under other aspects of its domestic law. A discussion of the relationship between domestic anti-abuse rules and treaties is found in the Commentary on Article 1 of the Model Tax Convention (see in particular paragraphs 9.5, 22 and 22.1 of the Commentary).

196. MNEs are free to organise their business operations as they see fit. Tax administrations do not have the right to dictate to an MNE how to design its structure or where to locate its business operations. MNE groups cannot be forced to have or maintain any particular level of business presence in a country. They are free to act in their own best commercial and economic interests in this regard. In making this decision, tax considerations may be a factor. Tax administrations, however, have the right to determine the tax consequences of the structure put in place by an MNE, subject to the application of treaties and in particular of Article 9 of the Model Tax Convention. This means that tax administrations may perform where appropriate transfer pricing adjustments in accordance with Article 9 of the Model Tax Convention and / or other types of adjustments allowed by their domestic law (*e.g.* under general or specific anti-abuse rules), to the extent that such adjustments are compatible with their treaty obligations.

B - Transactions actually undertaken. Role of contractual terms. Relationship between paragraphs 1.36-1.41 of the TP Guidelines and other parts of the TP Guidelines

197. In the Article 9 context and according to the TP Guidelines, an examination of the application of the arm's length principle to controlled transactions should start from the transactions actually undertaken by the related enterprises, and the terms of contracts play a major role (see paragraph 1.36 of the TP Guidelines). As acknowledged in paragraphs 1.25-1.29 and 1.36-1.41 of the TP Guidelines, however, such a review of the contractual terms is not sufficient.

198. According to Article 9 of the Model Tax Convention, a tax administration may adjust the profits of a taxpayer where the conditions of a controlled transaction differ from the conditions that would be agreed between independents. In practice transfer pricing adjustments consist in adjustments of the profits of an enterprise attributable to adjustments to the price and / or other conditions of a controlled transaction (*e.g.* payment terms or allocation of risks). This does not mean that all transfer pricing adjustments, whether involving an adjustment only to the price or also (or alternatively) to other conditions of a

controlled transaction, or as a result of evaluating separately transactions which are presented as a package in accordance to the guidance at paragraphs 1.43 and 6.18 of the TP Guidelines, should be viewed as consisting in the non-recognition of a controlled transaction under paragraphs 1.36 – 1.41 of the TP Guidelines. In effect, such adjustments may result from the examination of comparability, see in particular paragraphs 1.15 and 1.26-1.29 of the TP Guidelines (and paragraph 38 above).

199. Paragraphs 1.26 to 1.29 of the TP Guidelines provide guidance on the possibility for a tax administration to challenge non-arm's length contractual terms. A discussion of whether the allocation of risks in a transaction between related parties is arm's length is found in Issues note No.1 "Special considerations for risks". As discussed at paragraph 20 of that other note, the examination of risks in an Article 9 context starts from an examination of the contractual terms between the parties, as those generally define how risks are to be divided between the parties. However, as noted at paragraphs 1.26 to 1.29 of the TP Guidelines, a purported allocation of risk between associated enterprises is respected only to the extent that it is consistent with the economic substance of the transaction. Therefore, in examining the risk allocation between related parties and its transfer pricing consequences, the review of contractual terms is not sufficient and has to be completed by a review of whether the related parties conform to the contractual allocation of risks and of whether the contractual terms provide for an arm's length allocation of risks. In evaluating the latter, two important factors that come into play are whether there is evidence from comparable uncontrolled transactions of a comparable allocation of risks and, in the absence of such evidence, whether the risk allocation makes commercial sense and in particular whether the risk is allocated to the party that has greater control over it. Section B.2 of Issues note No. 1 contains an explanation of the difference between making a comparability adjustment and not recognising the risk allocation in the controlled transaction and a discussion of the relationship between the guidance at paragraph 1.27 and paragraphs 1.36-1.41 of the TP Guidelines.

200. A similar reasoning is developed in Issues note No. 2 "Arm's length compensation for the restructuring itself", with respect to indemnification rights for the termination or substantial renegotiation of an existing arrangement. Paragraph 102 of that note indicates that, in addition to examining whether the arrangement that is terminated, non-renewed or substantially re-negotiated is formalised in writing and provides for an indemnification clause, it is necessary to assess whether the terms of the arrangement and the possible existence or non-existence of an indemnification clause or other type of guarantee (as well as the terms of such a clause where it exists) are arm's length.

201. Paragraphs 1.36-1.41 of the TP Guidelines apply where there is a dispute about the fundamental nature of the transaction being examined. The OECD view is that these paragraphs do not restrict a tax administration's ability to adjust the price or other conditions of a controlled transaction in situations where there is no dispute about the nature of the transaction – and hence, no recognition issue – but where such price or conditions are not arm's length according to guidance provided in other parts of the TP Guidelines.

202. Where paragraphs 1.36-1.41 of the TP Guidelines do apply, Article 9 would allow an adjustment of conditions to reflect those which 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 (see paragraph 1.38 of the TP Guidelines). In doing so, the objective should be to arrive at a characterisation or structure that comports as closely as possible with the facts of the case.

Business comments are particularly invited on the view expressed at paragraph 201 and 202.

C - Application of the guidance at paragraphs 1.36-1.41 of the TP Guidelines to business restructuring situations

203. The TP Guidelines contain a specific section dealing with the recognition of the actual transactions undertaken (paragraphs 1.36-1.41). In particular:

> 1.36 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 these are consistent with the methods described in Chapters II and III [of the TP Guidelines]. In other than exceptional cases, the tax administration should not disregard the actual transactions or substitute other transactions for them. Restructuring of legitimate business transactions would be a wholly arbitrary exercise the inequity of which could be compounded by double taxation created where the other tax administration does not share the same views as to how the transaction should be structured.
>
> 1.37 However, there are two particular circumstances in which it may, exceptionally, be both appropriate and legitimate for a tax administration to consider disregarding the structure adopted by a taxpayer in entering into a controlled transaction. The first circumstance arises where the economic substance of a transaction differs from its form. In such a case the tax administration may disregard the parties' characterisation of the transaction and re-characterise it in accordance with its substance. […] The second circumstance arises where, while the form and substance of the transaction are the same, the arrangements made in relation to the transaction, viewed in their totality, differ from those which 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. […]
>
> 1.38 In both sets of circumstances described above, the character of the transaction may derive from the relationship between the parties rather than be determined by normal commercial conditions and may have been structured by the taxpayer to avoid or minimise tax. In such cases, the totality of its terms would be the result of a condition that would not have been made if the parties had been engaged in arm's length dealings. Article 9 would thus allow an adjustment of conditions to reflect those which 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. […]

204. Below is a discussion of three important notions in relation to the application of the guidance from paragraphs 1.36-1.41 of the TP Guidelines.

C.1 Meaning of the word "exceptional"

205. The words "exceptional" or "exceptionally" at paragraphs 1.36 and 1.37 of the TP Guidelines indicate that the non-recognition of a transaction 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 these are consistent with the methods described in Chapters II and III of the TP Guidelines.[40] The OECD considers that apparent non-arm's length behaviour should as much

[40] As noted at paragraph 1.29 of the TP Guidelines, it is important to examine whether the conduct of the parties conforms to the terms of the contract or whether the parties' conduct indicates that the contractual terms have not been followed or are a sham. In such cases, further analysis is required to determine the true terms of the transaction and a pricing adjustment might not be the solution.

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.

C.2 Determining an appropriate transfer price in the circumstances of the case

206. Under the second circumstance discussed at paragraph 1.37 of the TP Guidelines, a second cumulative criterion is that "the actual structure practically impedes the tax administration from determining an appropriate transfer price". If an appropriate transfer price (*i.e.* an arm's length price that takes into account the comparability - including functional - analysis of both parties to the transaction) 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 recognised under Article 9 of the Model Tax Convention. Otherwise, the tax administration may need to decide whether this is a case for not recognising the transaction (see Section C.3 below).

C.3 Determining whether the arrangements are commercially rational

207. One important and difficult issue when applying the guidance of paragraph 1.37 of the TP Guidelines is to determine whether the arrangements between related parties are consistent with those which would have been adopted by independent enterprises behaving in a commercially rational manner. This test is explicit in the first cumulative criterion of the second circumstance described in paragraph 1.37 of the TP Guidelines. Some countries consider that this "commercially rational behaviour" test is intended to deal with cases where a transaction has no non-tax business purpose. A large majority of OECD countries however consider that it sets a benchmark as to whether "independent enterprises behaving in a commercially rational manner" would have entered into a similar arrangement.

208. The TP Guidelines lack guidance on how to determine what "independent enterprises behaving in a commercially rational manner" would have done. Consistently with paragraph 196, 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 non-recognition of the related party arrangements. In circumstances where reliable data show that similar transactions or arrangements exist between independent parties, it cannot be argued that such an arrangement between related parties would lack commercial rationality. On the other hand, however, the mere fact that a related party arrangement is not seen between independent parties does not in itself mean that it is not arm's length (paragraph 1.10 of the TP Guidelines). Although there might be situations in which it is clear from the outset that the transactions entered into are not commercially rational, depending on the circumstances of the case, it can be particularly difficult in practice for tax administrations to assess whether an arrangement is commercially rational. Problems of double taxation may arise if such an assessment is not shared by the other Contracting State. In the context of business restructurings the following remarks can be made.

209. The application of the arm's length principle is based on the notion that independent enterprises, when evaluating the terms of a potential transaction, will compare the transaction to the other options realistically available to them, and they will only enter into the transaction if they see no alternative that is clearly more attractive. See Issues Note No. 2, Section A and in particular paragraph 58. The OECD is of the view 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 the option realistically available to it not to do so. In evaluating whether a party would at arm's length 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 discussed in Issues notes No. 2 and No. 3) as well as to the commercial circumstances arising from participation in an MNE group (see paragraph 1.10 of the TP Guidelines).

210. Furthermore, in assessing the commerciality 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, where 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.

211. Business restructurings often lead MNE groups to implement global business models that are hardly if ever found between independent parties, taking advantage of the very fact that they are MNE groups and that they can work in an integrated fashion. For instance, MNE groups may implement global supply chains or centralised functions that are not found between independent parties. It is therefore often difficult to assess whether such business models are of the kind that independent enterprises behaving in a commercially rational manner would have implemented. This lack of comparables does not mean of course that the implementation of such global business models should automatically be regarded as not commercially rational.

212. 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[41] for an MNE group to restructure in order to obtain tax savings.

213. The OECD recognises that there can be legitimate group-level business reasons for an MNE group to restructure. In practice, where 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 re-emphasising 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 (paragraph 1.6 of the TP Guidelines). 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 account of its rights and other assets, expected benefits from the restructuring arrangement, and realistically available options. See discussion of options realistically available at Section A.3 of Issues note No. 2 "Arm's length compensation for the restructuring itself".

Comments from the business community are invited on the interpretations of the "commercially rational behaviour" test that are proposed at paragraphs 207-213.

D - Examples

D.1 Example (A): Conversion of a full-fledged distributor into a "risk-less" distributor

214. Company Z is a well known distributor of luxury products. It owns a valuable trade name, valuable retail points, and valuable long term contracts with suppliers. It is acquired by an MNE Group which operates under a global business model whereby all the trade names and other valuable intangibles are owned by Company V in Country V, all the key supplier contracts are held by Company W in Country W which is responsible for the management of group-wide supplier contracts, and all the retail points are owned by a real estate company in Country X. Immediately after the acquisition, the Group decides to

[41] As indicated at paragraph 8, domestic anti-abuse rules are not within the scope of this project.

restructure Company Z by transferring its trade name to Company V, its valuable supplier contracts to Company W and its retail points to Company X, all in exchange for lump sum payments. As a consequence of the transfer, Company Z is now operating as a commissionnaire for Company W. Its post-restructuring profit potential is dramatically less than its pre-restructuring one. Representatives from the MNE Group explain that the business reason for the restructuring is to align the operating model of Company Z with the operating model of the rest of the MNE Group, and that this prospect was one key factor in the acquisition deal. The management of Company Z has had no other choice than to accept the restructuring given the acquisition that has taken place. It indicates that the transfer of its trade name, contracts and retail points was priced at arm's length, and that the remuneration for its post-restructuring activities will also be priced at arm's length.

215. It is assumed that the actual conduct of the parties is consistent with the form of the restructuring. In accordance with paragraph 213, as this restructuring appears to be commercially rational for the MNE group, it would be expected that the determination of an appropriate compensation for the restructuring itself and for the post-restructuring activities would result in an arm's length outcome for each of the parties, in which case the restructuring transactions would be recognised.

216. Some countries however consider that the sale of "crown jewels" such as valuable trade names is so detrimental to the seller that it would not be possible to arrive at an appropriate price and that accordingly it would be unlikely to occur at arm's length, unless it could be demonstrated that a company had decided to exit a particular business or the seller has no option realistically available to it. These countries consider that if the company continues in the business, there is no commercial logic in this divestment which is represented as being driven by the group policy. For these countries, if the arm's length principle were applied, the group perspective would not feature.

D.2 Example (B): Transfer of valuable intangibles to a shell company

217. An MNE manufactures and distributes products the value of which is not determined by the technical features of the products, but rather by the brand name and exposure. The MNE wants to differentiate itself from its competitors through the development of brand names with great value, by implementing a carefully developed and expensive marketing strategy. The brand names are owned by Company A in Country A. The development, maintenance and execution of a worldwide marketing strategy are the main value driver of the MNE, performed by 125 employees at Company A's head office. The value of the brand names results in a high consumer price for the products. Company A's head office also provides for central services for the group affiliates (e.g. human resource management, legal, tax). The products are manufactured by affiliates under contract manufacturing arrangements with Company A. They are distributed by affiliates who purchase them from Company A. The profits derived by Company A after having allocated an arm's length remuneration to the contract manufacturers and distributors are considered to be the remuneration for the intangibles, marketing activities and central services of Company A.

218. Then a restructuring takes place. The brand names are transferred by Company A to a newly set up affiliate, Company Z in Country Z in exchange for a lump sum payment. After the restructuring, Company A is remunerated on a cost plus basis for the services it performs for Company Z and the rest of the group. The remuneration of the affiliated contract manufacturers and distributors remains the same. The excess profits after remuneration of the contract manufacturers, distributors, and Company A head office services are paid to Company Z. From the comparability analysis the following conclusions can be drawn:

- There is no reliable evidence from uncontrolled comparable transactions of the ownership of brand names and attached risks being attributed between independent parties in the same manner as in the controlled transaction between Company A and Company Z;

- Company Z is managed by a local trust company. It does not have people (employees or Directors) who have the authority to and effectively do perform control functions in relation to the risks associated with the strategic development of the brand names. It also does not have the financial or economic capacity to bear these risks.

- High ranking officials from Company A's head office fly to Country Z once a year to formally validate the strategic decisions necessary to operate the company. These decisions are prepared by Company A's head office in Country A before the meetings take place in Country Z. The MNE considers that these activities are service activities performed by Company A's head office for Z. They are remunerated at cost plus in the same way as the central services rendered to all group members (e.g. human resource management, legal, tax).

- The development, maintenance and execution of the worldwide marketing strategy are still performed by the same employees of Company A's head office and remunerated on a cost plus basis. Company A does not have a contractual incentive to maximise the value of the brand names or the market share because it is remunerated on a cost plus basis.

219. In such a case, most OECD countries indicate that they would consider not recognising the arrangement as structured.[42]

D.3 Example (C): Transfer of intangible to a company that exercises functions

220. The fact pattern is the same as in example (B), except that part of Company A's head office is effectively relocated to Country Z: 30 of the 125 head office employees are dismissed, another 30 are transferred to the new Company Z in Country Z, and 15 new employees are directly hired by Company Z in Country Z to take over functions performed by the dismissed employees. Company Z, which is now the legal owner of the brand names, actively carries on the development, maintenance and execution of a worldwide marketing strategy. The employees of Company Z have the authority to and actually perform control functions in relation to the risks associated with the strategic development of the brand names. The services provided by the remainder of Company A's head office in Country A are central services (*e.g.* human resources management, legal and tax) as well as support marketing functions that are closely monitored by the personnel of Company Z. The main reason for the group entering into this restructuring is to benefit from a favourable tax regime in Country Z compared to the tax regime in Country A.

221. The vast majority of OECD countries consider that in this case the transaction should be recognised for transfer pricing purposes as it has economic substance (see paragraph 212 above).[43]

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42 This is notwithstanding any possible application of general anti-avoidance rules and notwithstanding the question about Company Z's place of effective management.

43 This does not say anything about the possible application of domestic anti-abuse rules.