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A Transfer Pricing Publication

Pricing Knowledge Network

Focusing on the impact of major intercompany pricing issues

OECD publishes final guidance on the transfer pricing aspects of business restructurings

On 22 July 2010 the OECD published final guidance on business restructurings. The guidance combines the four issues notes into a single, four-part chapter (chapter IX) of the OECD Transfer Pricing Guidelines (the Guidelines), which is to be read as a whole.

The final guidance represents the culmination of a lengthy process of drafting and consultation, and addresses several important transfer pricing aspects of the taxation of internal business restructurings. Among those issues are the allocation and transfer of risk among related parties, the question of whether and when internal business restructuring transactions require arm's length compensation and/or indemnification, the question of how transfer pricing rules should be applied to the parties to a business restructuring transaction following the restructuring, and the question of whether and when governments have the ability to disregard a taxpayer's restructuring for purposes of applying transfer pricing rules.

Like the Transfer Pricing Guidelines as a whole, the new Chapter IX reflects the OECD's desire to clarify the application of Article 9 of the OECD Model Tax Convention when applied to complex real life situations.

PricewaterhouseCoopers appreciates the efforts made by Working Party (WP) 6 to materialize the commitments voiced by the WP 6 chair after last year's June consultation meeting to (i) clarify things to better reflect the interpretation by WP 6; to (ii) strongly endorse the points of agreements in the final text; to (iii) make some wording less subjective and/or ambiguous in order to mitigate the risk of double taxation and to (iv) work on issues on which there is an apparent lack of consensus so as to take away uncertainty for business. In essence, the final deliverable has been improved compared to the draft and was finalised in a more balanced way even though areas for debate persist on which tax authorities in various jurisdictions risk to have

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diverging views. The final document reflects the consensus views of OECD member states and the differences of opinion evident in the earlier discussion draft have been resolved.

This PKN summarizes how the final version of the guidance has been amended compared to the discussion draft (19 September 2008) to reflect the key areas of debate that arose during the consultation process.

Disregard or Recharacterisation of Taxpayer Restructuring Transactions

The single issue causing greatest concern in the business community was the analysis in the discussion draft regarding the circumstances under which governments can disregard or recharacterise business transactions.

The final guidance states that the circumstances when a transaction would be disregarded are exceptional, and goes on to define exceptional as similar in meaning to "rare" or "unusual" specifying that in most cases arrangements will stand as structured.

Exceptional cases are defined as cases where:

- Substance differs from form, or
- Independent parties in comparable circumstances would not have characterized or structured their affairs as the associated enterprises have and an arm's length price can not reliably be determined

The mere fact that an associated enterprise arrangement is not seen between independent parties is not evidence that it is not arm's length, and the basis for determining what independents might have been expected to do, should be based on options realistically available, on the assumption that the restructured entity would not enter into the transaction as structured if an alternative option is clearly more attractive including not entering into the arrangement.

It is good to see that the OECD appears not to expect that associated enterprises should behave as would be expected from independent enterprises in negotiating and agreeing to the terms of a particular arrangement. The OECD seeks to strike a fair balance between the unique features of MNEs on the one hand and the need to safeguard consistency with what independent enterprises in similar circumstances would do on the other. The notion of expectation of "normal commercial behaviour" remains in place which risks to lead to a divergence in interpretations.

The assertion that the new paragraph 1.49 of the Guidelines provided an independent basis on which tax authorities could disregard the contractual allocation of risk has been dropped from the final guidance. However this does not seem to take away that the OECD offers an independent basis for reassigning risks on economic substance grounds (as set out in the next section).

The statement that 'it is not sufficient that a restructuring makes commercial sense for the group as a whole' remains, and the need to consider the restructuring from the standpoint of each restructured entity is strongly reasserted. The guidance does, however, state that where a reorganisation is commercially rational for the group as a whole, then it is likely that an appropriate transfer price for the arrangements as structured will be available, again, taking into account options realistically available to and assets of the restructured entity.

The explicit disagreement between governments around the treatment of restructuring involving high value intangibles appears to have been resolved. The dissenting paragraph which originally followed the first example at the end of Issue Note 4 in the discussion draft stated that some governments were of the view that companies would not sell 'crown jewel' assets at arm's length. Now it appears that unless the 'exceptional' standard for recharacterisation is met such cases are to be dealt with as valuation issues. The members, however, are likely to revisit some of the difficult issues surrounding transfers of intangibles in their newly announced project focused on intangibles and Chapter VI of the Guidelines.

Taxpayer Allocations of Risk

This issue is closely related to the potential disregard of business restructuring transactions. The most important change to this section is the removal of the assertion that 1.48-1.56 of the Guidelines granted license for recharacterisation of contractual terms. This means that mismatches between the contractual location of risk and the location in which control over risk is exercised are now more likely to be addressed though pricing adjustments rather than through recharacterisation, however the guidance states that a 'tax administration is entitled to challenge a contractual allocation if it is not consistent with economic substance' and 1.64 could still be applied to that effect in exceptional circumstances.

The location of control over risk as an important determinant of where the consequences of risk should reside for pricing purposes is retained, and the importance of the financial capacity to assume the risk is elaborated on much more fully than in the drafts. The guidance clarifies that assuming the risk could mean having the capacity to bear the consequences of the risk should it materialize or put in place a mechanism to cover it. Furthermore, it is stated that if the purported bearer of risk does not have the financial capacity to assume the risk, this risk may have to be effectively borne by the transferor, parent company, creditors or another party.

The guidance is summarized through a diagram which illustrates the fact that risk allocation should first be determined by comparable evidence showing how third parties actually divide risk, and if no such evidence is available (which is very likely to occur), then it is necessary to determine how third parties would allocate risk. This determination is to be based on factors such as the location of control over risk and the financial capacity to bear this risk. Though these are the only factors mentioned, the guidance explicitly states that this is not intended as a standard, and stresses the difference

between this approach, which starts from the contractual allocation of risk, and the AOA for article 7 purposes.

The examples of fund management and contract R&D as instances where services might be provided on a low risk basis if significant decisions over risk are taken by a principal are retained. These examples are augmented by a useful example of how risks might be divided between a contract manufacturer and a principal.

One interesting elaboration in this section is to the effect that the operation of the pricing method can under some circumstances contribute to a low risk environment. This is a shift from the wording of the draft, however the caveat remains that the method applied should be consistent with the underlying allocation of risk.

Transfers of "Profit Potential"

This area was the subject of significant debate during the consultation. The new guidance states that:

- 'An independent enterprise does not necessarily receive compensation when a change in its business arrangements results in a reduction of its profit potential. The arm's length principle does not require compensation for a mere decrease in the expectation of an entity's future profits. The question is whether there is a transfer of something of value (rights or other assets) or a termination or substantial renegotiation and that would be compensated between independents in comparable circumstances.'

- If there is a transfer of rights or other assets or of a going concern then 'profit potential should not be interpreted as the profit or loss that would occur if the pre-restructuring arrangement would continue indefinitely'.

- There is to be 'no presumption that a termination should give rise to an indemnification. This depends on rights and other assets and options realistically available'.

The overall thrust of these assertions will be welcomed, but the concept of the transfer of 'something of value' is deliberately vague, and misgivings expressed during the consultation concerning the broad definition of assets will not be lessened by this wording. In particular the revised draft specifically rejects suggestions of some commentators that an interest in property would have to be present before indemnification is required. The term "something of value" is deliberately intended to be broader than just transfers of property interests.

The guidance expands on circumstances where a transfer of a going concern may arise. It states that it is necessary to have transferred a 'functioning, integrated business unit' this is further defined as a 'transfer of assets bundled with the ability to perform certain functions and bear certain risks'.

Some examples are provided, but this is also likely to be an area where uncertainty will prevail. Workforce in place is probably a good example of such an area of debate. It is good to see that the OECD has announced, as mentioned above, its intention to launch a project on addressing the transfer pricing aspects of intangibles, including issues related to the definition of intangible property.

Role of "options realistically available"

Overall the concept of 'options realistically available' plays a more central role throughout the document, and particularly in the section on compensation for the restructuring itself. The concept has its most important application at the individual entity level, and the alternatives theoretically available to each party should be taken into account in determining appropriate levels of compensation to be paid.

The guidance clarifies that the concept has primary application in pricing decisions (rather than a basis for recharacterisation, though this is not precluded). The OECD considers that the options available at the individual level may be relevant in applying the arm's length principle to a business restructuring. However, it states that it is not necessary to document all hypothetical options realistically available but if there is a realistically available option that is clearly more attractive it should be considered. The use of hindsight is prohibited.

The concept of options realistically available seems to build on the economic theory of opportunity cost and rational decision making. It may be potentially troublesome to couple this with the arm's length principle. Indeed, from the MNE's perspective, a decision is likely to be rational if it increases its value as a multinational enterprise. The decision to streamline is probably rational as it is expected to have a positive Net Present Value (NPV) and makes sense from an opportunity cost perspective (i.e. referring to the value of the next best alternative foregone which was the option not to streamline). The new Chapter IX seems to require that both parties engaging in a business restructuring (i.e. transferor and transferee) should assess their respective realistically available options. This would imply that both would need to value the latter on a NPV basis and then engage in a transaction only if they are both not worse off compared to their respective next best alternative.

Such an approach even brings the relative bargaining position of the parties into the equation, a topic on which relevant country specific case law was rendered and that consequently may be fertile soil for controversy going forward.

Other features

Most of the section on post-restructuring pricing has been removed, as the issues addressed therein are covered in the rewrite of Chapters I – III of the Guidelines. The helpful guidance on potential pricing approaches for procurement structures has been retained as have the examples of restructurings to illustrate the threshold for what is likely to be respected and what is not. There is a recommendation that it is 'good practice' to document

how synergies impact at the group level and at the local entity level, which might infer that there is an expectation that they will be shared. The topic of synergies is likely to be addressed in more depth throughout the intangibles project that the OECD will embark on, as mentioned above.

Inevitably there remain several areas where there is scope for significant disagreement, but overall, the OECD are to be congratulated. There is more conceptual consistency, more clarity and more consensus in the final version than in the Discussion Drafts.

The text does not carry an express date of entry into force and it can be expected that many countries will begin applying the new rules as a mere dynamic interpretation of existing OECD transfer pricing guidance and to resolve controversies related to prior years.

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