

B.7.1. Transfer Pricing Aspects of Business Restructurings

Setting the framework and definitional issues

B.7.1.1. In recent years the tax aspects of business restructurings undertaken by multinational enterprises (MNEs) have attracted much attention from tax authorities all around the globe. From a transfer pricing standpoint such reorganizations require consideration of how to apply the arm's length principle to a sound cross-border redeployment of functions, assets and risks within the same group.

B.7.1.2. There is no legal or universally accepted definition of business restructurings. In a transfer pricing scenario these transactions are defined as the cross-border redeployment of functions, assets (tangible and/or intangible) and risks to which a profit/loss potential may be attached. In this respect business restructurings undertaken by MNEs need not be confused with the ordinary acquisition of a business or an ongoing concern. However, it may be common to proceed with a business restructuring of the supply chain operations of an MNE group following an acquisition, divestiture of a business, or in response to the changing business environment.

B.7.1.3. Common examples of business restructurings are reorganizations involving conversions of the manufacturing and/or distribution layer of an MNE such as (i) conversion of a buy-sell distributor into a commissionaire or (ii) conversion of a fully-fledged manufacturer into a provider of manufacturing services. Business restructurings may also involve the transfer of the ownership and management of intangible property rights such as patents, trademarks, brand names etc.

B.7.1.4. As a general rule businesses are entitled to organize their activities in the way they see fit. Business restructuring undertaken in a manner consistent with the arm's length principle is entirely appropriate. However, there may be situations in which business restructurings facilitate inappropriate income shifting through non-arm's length pricing or through commercially irrational structures. The guidance of Chapters I-IX of the UN Transfer Pricing manual, as supplemented by this chapter, apply to business restructurings to ensure that they are consistent with the arm's length principle.

B.7.1.5. The application of Article 9 of the United Nations Model Double Taxation Convention to business restructurings requires that the arm's length consideration for a supply, acquisition or transfer of property is that which might reasonably be expected to be made under an agreement between independent parties dealing at arm's length. As a result, a business restructuring generally involves the determination of whether at arm's length a payment would be warranted for the transfer of something of value, or for the termination or substantial renegotiation of commercial arrangements between associated enterprises, and if so what the amounts of such arm's length consideration would be.

Business Restructurings: Considerations regarding Developing Countries

B.7.1.6. The changes triggered by the implementation of a business restructuring can have significant effects on the allocation of profits (or losses) between the countries in which the entities operate, regardless of whether or not tax savings are a driver. When a multinational group changes its business model, the tax and legal structure of the group would generally require an alignment with the new business model.

B.7.1.7. Business restructurings increasingly affect developing countries. In recent years a number of large MNEs have either (i) transferred their manufacturing facilities into low-cost countries, e.g. where the cost of labor of a skilled workforce is lower and/or (ii) similarly moved certain distribution functions and/or (iii) similarly moved valuable intangible property out of the jurisdiction where they were acquired, developed or exploited. This Chapter discusses how to determine on a case by case basis whether or not the conditions of such restructurings comply with the arm's length principle.

B.7.1.8. In a business restructuring context the arm's length principle entails a comparison of the conditions (including the pricing) of a transaction or arrangement between associated enterprises and those which would have been agreed between independent parties.

Process for setting or testing the arm's length principle in business restructuring operations

B.7.1.11. This paragraph describes a typical process which may be followed when setting or reviewing transfer prices in the context of a business restructuring. This process is neither prescriptive nor exhaustive

B.7.1.12. As a first step, it is important to characterize the transactions entered into by the associated enterprises, taking into account the business environment in which the MNE group is operating. This entails carrying out the following activities:

- I. identification of the scope, type (e.g. supply of goods, provision of services, licensing arrangements) and economic nature of the arrangements between the associated enterprises involved in the business restructuring;
- II. Performance of a functional analysis of the pre and post-business restructuring activities of associated enterprises affected by the restructuring. Such an analysis requires as a starting point reference to any relevant contract, including those entered into to implement the business restructuring (e.g. contracts transferring the legal ownership of certain intangible property and those evidencing the terms and conditions of the pre and post-restructuring arrangements for the business activities affected by the restructuring) as well as an examination of risks assumed and functions performed by the associated enterprises;
- III. Examination of the consistency of the contractual terms with the outcome of the functional analysis of the associated enterprises taking part in the business restructuring, in order to determine the true nature of the transactions, including the legal, economic and tax effects thereof. It should not be automatically assumed that the contracts, though they are the starting point of any transfer pricing analysis, accurately or comprehensively capture the actual commercial or financial relations between the parties. The core part of such an examination is the performance of a thorough functional analysis, which is needed to identify the value-adding activities and functions performed, assets used and risk assumed in respect of the business activities affected by the restructuring;

B.7.1.13. The selection of the most appropriate method or methodologies applicable to the transaction(s) at stake follows from the functional analysis. As discussed in more detail below, a business restructuring is commonly implemented through a series of intertwined transactions. For instance, a business restructuring might involve transferring functions, assets and risks to a tax favorable location. This should not of itself warrant the conclusion that a non-arm's length arrangement has been implemented.

B.7.1.14. Provided the pricing of the business restructuring itself and of the post-restructuring arrangements are consistent with what would occur under an agreement between independent parties in comparable circumstances the arm's length principle

running its activities, such as competitive pressures, market conditions or changes in the regulatory environment. In the light of such changes an MNE operating at arm's length may decide to restructure to reduce its losses or to retain or improve its profit-making ability and/or financial strength. That is, even if an MNE's profitability post-restructuring is less than its pre-restructuring profitability, such a restructuring might still be commercially rational in light of the MNE's realistic alternatives in the face of the changes in the business environment.

B.7.1.19. Business restructurings may include or may be motivated by outsourcing. Outsourcing occurs between independent enterprises for example in relation to inventory management and logistics, IT support, after-sales support, customer receivables management and R&D activities. The underlying commercial rationale for a third party entering into an outsourcing agreement is that generally commercial advantages to the enterprise are expected from contracting out vis-à-vis performing the activity by itself. These expected commercial advantages may relate to cost reduction and/or retaining or increasing profits.

B.7.1.20. When restructuring, an MNE may undertake a cost reduction program. This may involve the sale of assets, the closure of operations, the transfer of operations to another entity, or the restructuring of operations. The underlying commercial rationale for such a program is that generally commercial advantages to the enterprise are expected from such a program. These expected commercial advantages may relate to cost reduction and/or retaining or increasing profits.

- (ii) As regards distribution activities, the conversion of fully-fledged distributors into limited-risk distributors or commissionaires (or vice versa); and

B.7.2.7. Business restructurings have to comply with the arm's length principle. This holds true both with respect to "exit scenarios" and "entry scenarios", i.e. irrespective of whether functions, assets and risks are transferred out of or into a jurisdiction.

B.7.2.8. To this end the following situations can be envisaged:

- A key question is whether a transfer of functions, assets and/or risks conveys value and would be compensated at arm's length. . See Chapter B.5 on intangibles;
- Further, or alternatively, it should be determined whether the termination or substantial renegotiation of existing arrangements would warrant indemnification at arm's length. The approach likely to be followed here is a two-pronged one, namely (i) an analysis of the underlying contractual arrangements so as to identify the content of any termination clause, and (ii) the determination of whether a third party would warrant an indemnification in the event of a comparable termination or substantial renegotiation of contractual arrangements.

B.7.2.9. Some taxpayers have entered into business restructurings to contractually allocate economically significant risks to a group entity, perhaps located in a low-tax jurisdiction. Based on that risk allocation, economically significant risks (e.g. "key entrepreneurial risks") might purportedly be allocated to such an entity by (r)7224) j [(om)7 (e t)

contractual arrangements existing at the group level, OpCo has the following rights and responsibilities:

- (i) OpCo owns or holds licensing rights over all the intangibles (such as patents, trademarks, and a legally protected specific “Just in Time” manufacturing planning know-how) it needs to operate its manufacturing and distribution activities;
- (ii) OpCo is responsible for arranging the procurement of all raw materials (including selection of suppliers and qualification of raw materials);
- (iii) OpCo owns the inventories of raw materials, work-in-process and finished goods, assumes related inventory risk and actually performs the risk management control functions;
- (iv) OpCo manages and controls the production planning, sets the output budget and determines the milestones within the supply chain process;
- (v) OpCo sells the finished goods to third party customers in its market and to associated enterprises acting as distributors in foreign markets.

B.7.2.16. As far as financial results are concerned OpCo has recorded relatively strong and stable profits over most of the last 10 years, although they have been gradually declining over the last 3 (three) years due to adverse global economic market conditions which triggered a steep increase of the input costs of production. The financial outlook for the next five years forecasts a continued decrease of profitability due to increased competition.

B.7.2.17. In the year 2000+X, the MNE of which OpCo is a member decides to enter into a restructuring of the supply chain manufacturing layer, by centralising its management and control activities in a regional headquarters located in Country B and operated by the associated enterprise Principal Co. The MNE’s top management highlights during the shareholder meeting that the underlying commercial rationale for entering into the restructuring is to achieve forecasted costs savings and efficiency gains allowing the group to achieve sustained profit growth over the following 5 (five) financial years.

B.7.2.18. In particular, the implementation of the business restructuring arrangements requires the implementation of the following steps:

B.7.2.22. D

B.7.2.28. Would Principal Co as an independent party have any option realistically available to it other than to enter into the business restructuring on the agreed terms?