TRANSFER PRICING CASE STUDIES WORKSHOP
MALAYSIA
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9. Business Restructuring

Taxation of multinational enterprises

- International consensus on taxation of multinational enterprises: the arm’s length principle
  - Profits of parts of a multinational should be determined as if they were operating independently of each other
- Application:
  - Based on a comparison with enterprises dealing independently
  - The more valuable the functions, assets and risks of an affiliate, the higher the profits it should expect

Business restructuring

- In Chapter IX of the OECD TP Guidelines, defined as:

  "the cross-border redeployment by an MNE of functions, assets and/or risks"

  – may involve
    - transfers of valuable intangibles
    - termination / substantial renegotiation of existing arrangements

What do we see in practice?

- Since the mid-1990s: typically, conversion of
  - full fledged distributors → limited risk distributors or commissionaires;
  - full fledged manufacturers → contract manufacturers or toll-manufacturers; etc.
  - migration (centralisation) of intangible assets and of risks, together with associated profit potential

Illustration: traditional business model

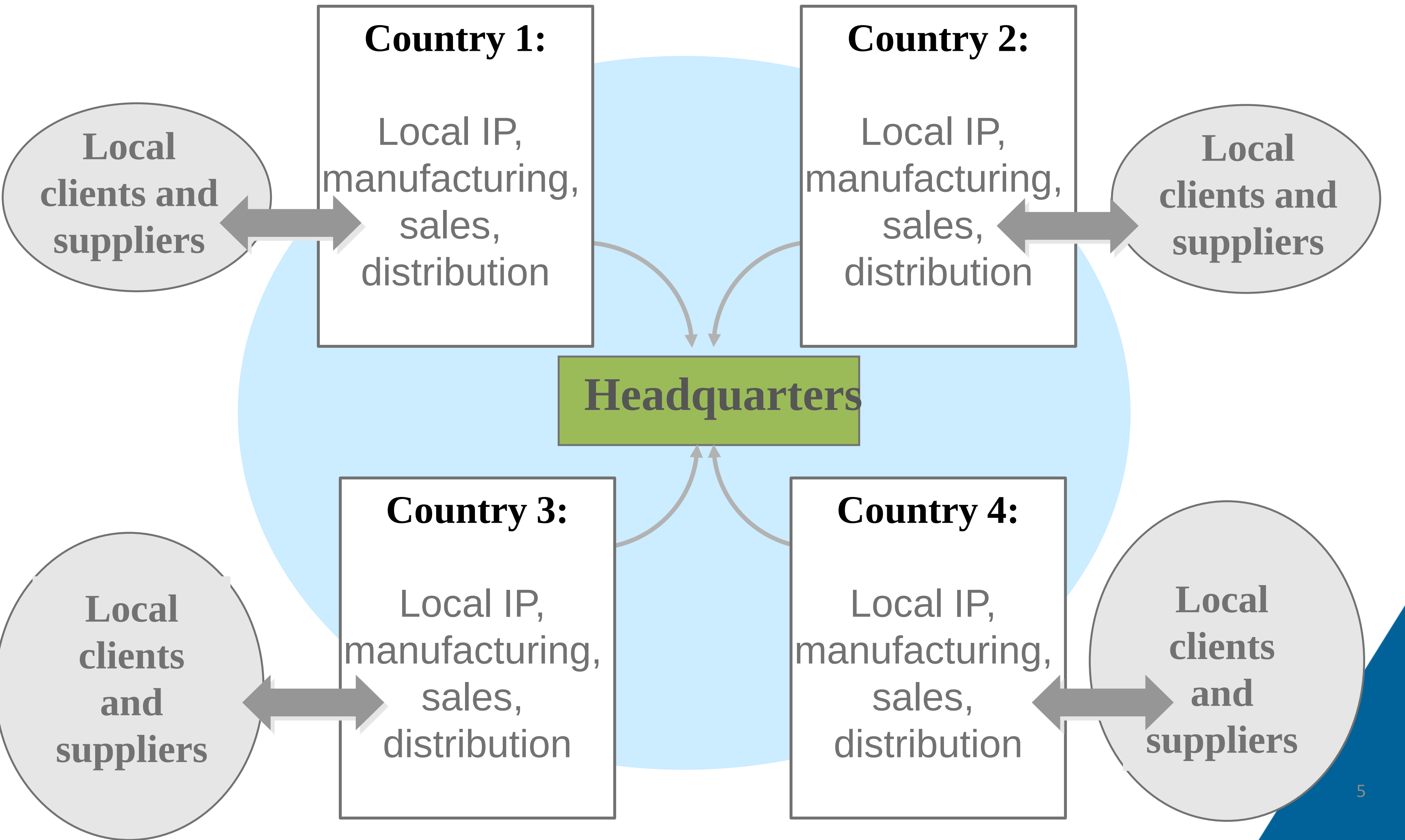
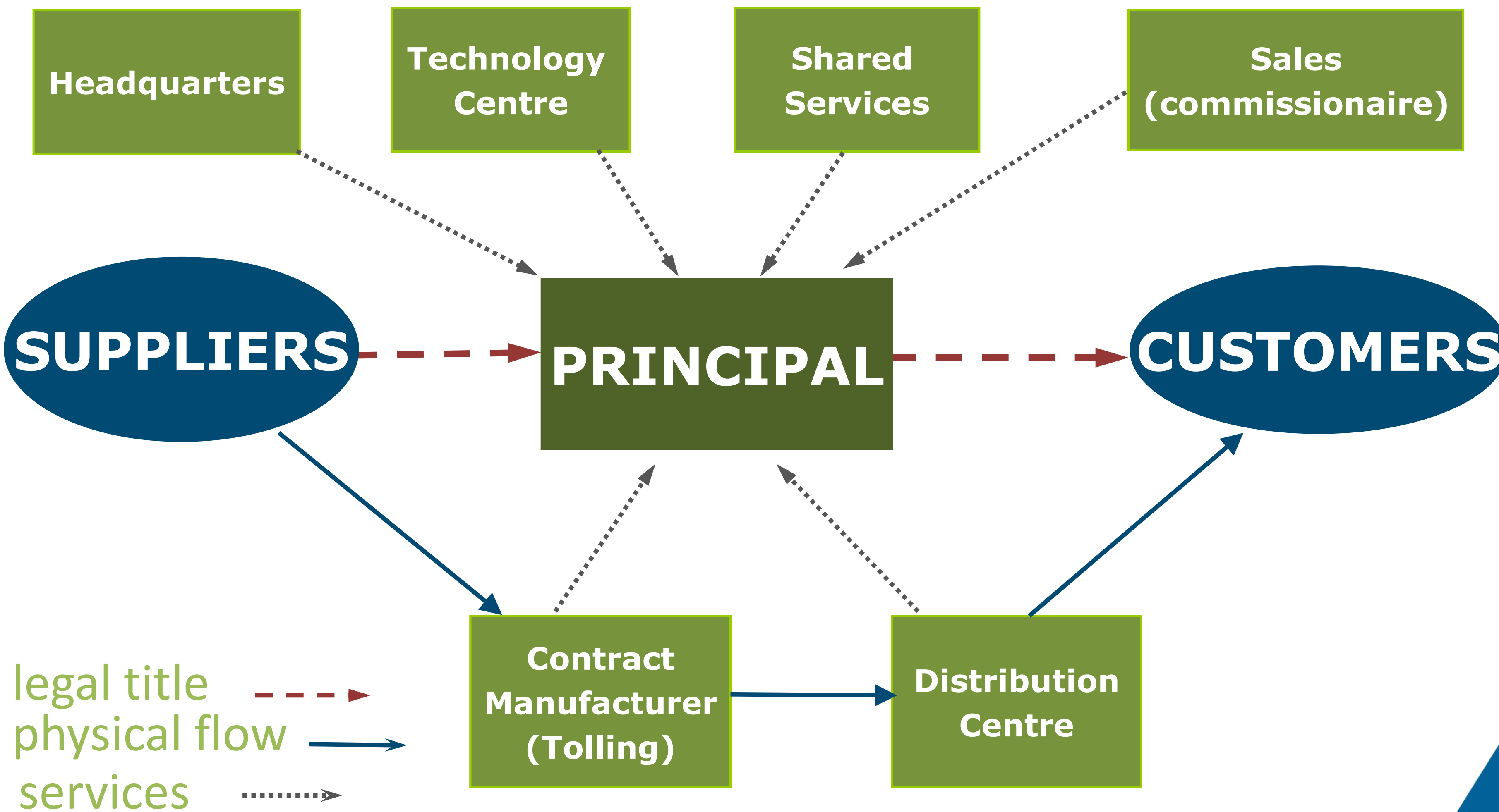


Illustration: global supply chain model



Example: Restructuring of the Sales Function

Pre-restructuring	**Post-restructuring**
"Full fledged distributor" in country A	Commissionaire in country A
Distributor purchases products from related and unrelated suppliers and on-sells them to unrelated customers.	Does not take title of inventory. Sells on behalf of the Principal who owns the products.
Distributor responsible for marketing activities and brand development in local territory.	Marketing policy decided by Principal. Commissionaire has limited role.
Distributor bears inventory risk, market risk, credit risk	Inventory risk, market risk, credit risk are transferred to Principal
Distributor 'owns' clientele (customer list, etc); has rights on the trademark	Intangibles are transferred to Principal
Remuneration taking account of functions, intangible sand risks: +++++ or -----	Remuneration taking account of functions, intangibles and risks ++ (residual profit/loss = Principal)

“Reverse” restructuring

- In a downturn economy, the model may result in the principal making a loss while the local operations record a profit
- Reverse restructurings: allocate more functions / assets/ risks to local operation?
- Have them share in the current losses (and future profits)?
- Question: consistency over time?

Business restructurings

- The transfer pricing question:

"Are there conditions made or imposed in the restructuring which differ from conditions that would be made between independent enterprises ?"

  - Article 9 of the OECD and UN Model Tax Conventions; arm's length principle

Business reasons for business restructurings

- Implementation of global business models to maximise synergies and economies of scale

- Streamlining the management of business lines 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

Four Main Issues addressed in Ch. IX

1. Special consideration for risks
2. Arm's length compensation for the restructuring itself
3. Remuneration of post-restructuring controlled transactions
4. Recognition of the actual transactions undertaken

Special considerations for risks

Examination of allocation of risks

- Risk allocation/ risk transfer are critical aspects
- Examination of the allocation of risks is an essential part of the functional analysis
- Usually, between parties dealing at arm’s length with each other:
  - Assumption of increased risk would be compensated by an increased expected return
  - Actual return may or may not increase, depending on the degree to which risks are actually realised

Examination of allocation of risks

- Examination of risks starts from **contractual terms**.
- But a tax authority is entitled to challenge the purported allocation of risks if it is inconsistent with the economic substance of the transaction. Therefore it is also important to consider:
  - Whether the conduct of the parties conforms to the contractual allocation of risks
  - Whether the allocation of risks is arm's length; and
  - What the consequences of the risk allocation are.

Whether associated enterprises conform to the contractual allocation of risks

Example

Manufacturer → **Sale of goods** → **Distributor**

Contractually assumes foreign exchange risks

What if the transfer price is in the Manufacturer's currency but is calculated in such a way that it effectively insulates the Distributor from the effects of exchange range fluctuations?

Is the allocation of risks arm's length?

Yes

The risk allocation in the controlled transaction is arm's length

Is there reliable evidence of a similar allocation of risks in comparable uncontrolled transactions?

Is the allocation of risks one that might be expected to have been agreed between independent parties in comparable circumstances?

Relevant factors:

1) Which party has greater control over risk?
2) Is the risk allocated to a party which has the financial capacity to assume it?

No

Search evidence of the actual conduct of independent parties

Lacking such evidence, determine whether the risk allocation is one that *would have* been agreed between independent parties in comparable circumstances

Whether the allocation of risks in the controlled transaction is arm's length

- Relevant factor: **control** (TPG 1.27)
  - Capacity to make decisions to take on the risk (decision to put the capital at risk)
  - Capacity to make decision on whether and how to manage the risk
  - … different from day to day administration and monitoring of the risk

Whether the allocation of risks in the controlled transaction is arm's length

- Relevant factor: anticipated **financial capacity** to bear the risk:
  - Whether the risk-bearer has, at the time the risk is allocated to it, the financial capacity to take on the risk, or has put in place a mechanism to do so
  - A high level of capitalisation by itself does not mean that that party carries the risk.

Consequences of the risk allocation

- The associated enterprise bearing the risk, consistently with the arm's length principle, should:
  - Bear the costs, if any, of managing or mitigating the risk
  - Bear the costs from the realisation of the risk
  - Generally be compensated by an increase in the expected return

Whether the risk is economically significant

- A risk is **economically significant** if its effect on the profit/ loss potential is material
- Depends on:
  - Nature of the risk
  - Size of the risk
  - Likelihood of realization of the risk
  - Predictability of the risk
  - Possibility to mitigate risk
- The re-allocation of profit/loss potential that is attributed to a re-allocation of risk must be consistent with the economic significance of the risk

Arm’s length compensation for the restructuring itself

Introduction

- The arm’s length principle does not require compensation for a mere decrease in the expectation of an entity’s future profits.
- The TP question is:
  - Has there been a transfer of something of value (eg rights or assets), or
  - Has there been a termination or substantial renegotiation of existing arrangements…
  - …that would be compensated between independent parties at arm’s length?

Understanding the restructuring itself

- To assess whether a restructuring would be compensated at arm's length (and if so how), it may be helpful to understand:
  - Restructuring itself: **changes** that have taken place and how they changes have affected the functional analysis
  - The **business reasons** for the restructuring; the anticipated benefits
  - **Other options** that would have been **realistically available** at arm's length

Example:
Reallocation of risks and profit potential

	Pre-conversion profits (historical data)	Future profit expectations (next 3 years) assuming it had remained full-risk	Expected post-conversion profits (from low-risk activity)
Case 1	Year 1: -2% Year 2: +4% Year 3: +2% Year 4: 0% Year 5: +6%	-2% to +6% with significant uncertainties within that range	Guaranteed, stable profit of +2% per year
Case 2	Year 1: +5% Year 2: +10% Year 3: +5% Year 4: +5% Year 5: +10%	+5% to +10% with significant uncertainties within that range	Guaranteed, stable profit of +2% per year
Case 3	Year 1: -2% Year 2: +4% Year 3: +2% Year 4: 0% Year 5: +6%	0% to +4% with significant uncertainties within that range	Guaranteed, stable profit of +2% per year

Transfer of something of value: Intangible Assets

- Disposal of intangibles (including rights in intangibles) by a local operation to a central operation, often a central “IP Co” (foreign associated enterprise)

- Intangible assets with no established value at the time of the transfer

- Local intangibles

- Contractual rights

Transfer of activity: ongoing concern

- Transfer of a functioning, economically integrated business unit
- Valuation of an activity (assets, liabilities, workforce in place…) may be different from the valuation of isolated elements
- Loss making activities: in which cases the transferee should be remunerated to take over loss-making activities?

Indemnification for the termination or renegotiation of existing arrangements

- Not all contract terminations/ renegotiations should give rise to a right to indemnification
- Consider:

1. Whether the terminated/ renegotiated arrangement was formalised in writing and provided for a indemnification clause
2. Whether the terms of the arrangement (and the existence/ non-existence of an indemnification clause, *etc*) are arm´s length
3. Whether indemnification rights are provided for by commercial law or case law
4. Whether an arm´s length party would have been willing to indemnify the one that suffers the termination or renegotiation of the agreement

Remuneration of post-restructuring controlled transactions

Remuneration of post-restructuring controlled transactions

Basic premise:

- The arm´s length principle and TPG do not and should not apply differently to post-restructuring transactions as opposed to transactions that were structured as such from the beginning
- Application of the arm´s length principle and TPG to post-restructuring arrangements based on TPG (Chapters I-III)

Remuneration of post-restructuring controlled transactions

- Business restructuring vs. structuring:
  - Comparability analysis of an arrangement resulting from a business restructuring might reveal factual differences compared to the one of an arrangement initially structured as such

  → factual differences may affect comparability analysis and outcome.

- Relationship between compensation for the restructurings and post-restructuring transaction

Recognition of actual transactions undertaken

Recognition / recharacterisation issues for transfer pricing purposes:

- Discussion of the exceptional circumstances in which a tax administration may consider non-recognition of a transaction or structure based on 1.64-1.69.

- Principle (TPG 1.64) In other than exceptional cases:
  - 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.

Non-recognition / re-characterisation

- Two exceptional circumstances where non-recognition / recharacterisation is justified (TPG 1.65):

1) If the economic substance of the transaction / arrangement differs from its form;

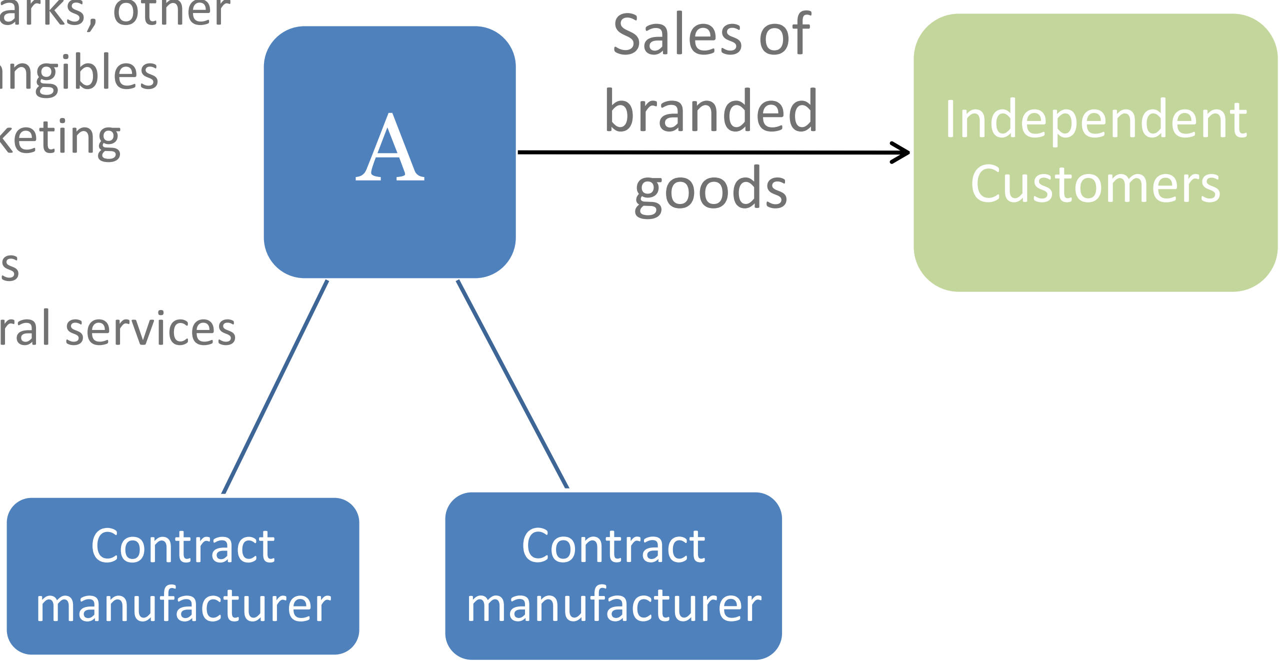
2) If the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner and the actual structure practically impedes the tax administration from determining an appropriate transfer price.

Example: Transfer of valuable intangibles to a shell company

PRE-CONVERSION

A Co.:

- Owns trade marks, other marketing intangibles
- Develops marketing strategy
- 125 employees
- Performs central services for group

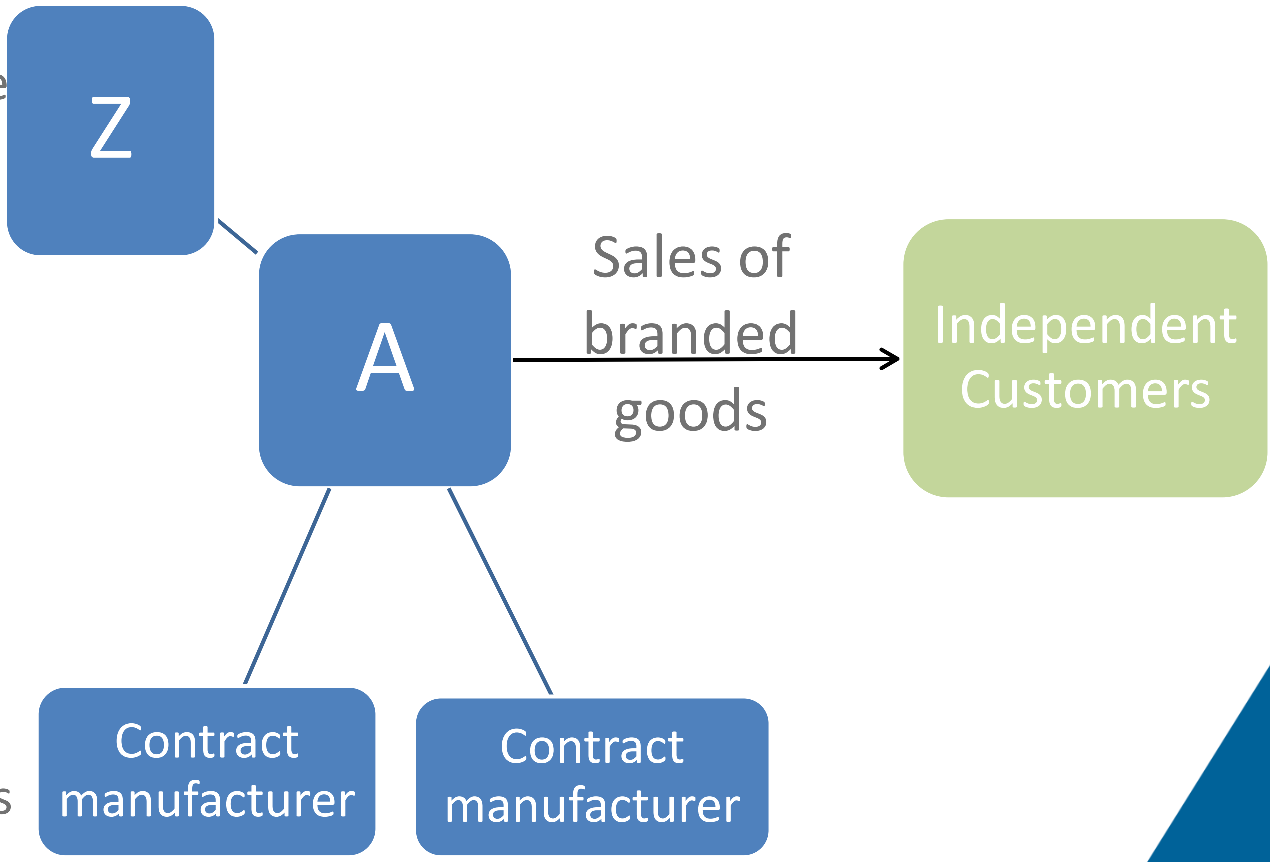


Example: Transfer of valuable intangibles to a shell company

Z Co.:
- Owns trade mark and other marketing intangibles
- Contracts A to undertake development of marketing strategy
- Managed by local trust company. No staff

A Co.:
- Performs "Brand management services" for Z
- 125 employees
- Performs central services for group

POST-CONVERSION



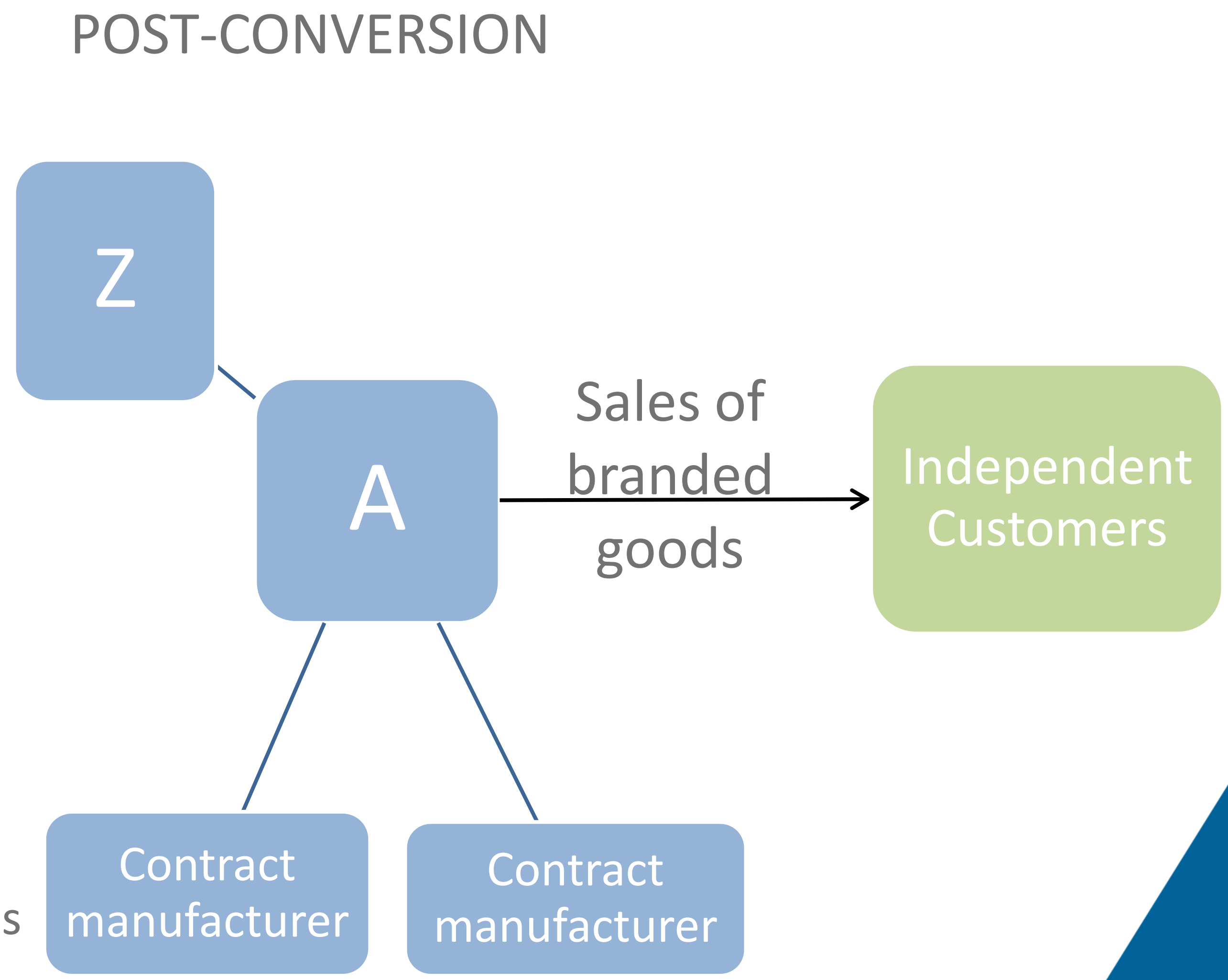
Example: Transfer of valuable intangibles

Z Co.:

- Owns trade mark and other marketing intangibles
- Has 45 staff who develop, maintain, execute worldwide marketing strategy & supervise outsourced services

A Co.:

- 30 employees transferred to Z
- Performs marketing services for Z
- Performs central services for group



Questions or comments?

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