SIEMENS

Siemens AG, CF T 1, Wittelsbacherplatz 2, 80333 Muenchen

Organisation for Economic Co-Operation and Development
Centre for Tax Policy and Administration
Mr. Jeffery Owens

2, Rue Andre Pascal

75775 Paris, Cedex 16
France

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Comments on the Transfer Pricing Aspects of Business Restructuring

Dear Mr. Owens,

We are pleased to have the opportunity to provide comments on the draft paper of the OECD entiteled "Transfer Pricing Aspects of Business Restructurings". Nowadays, business restructuring is a highly important topic as international companies regardless of products or sectors face the pressure of competition in a globalized economy. Multinational Enterprises (in the following: MNE) undergo the necessity to examine the effectiveness of their business structure and adjust their business to the changing conditions on an almost continuous basis. Without constant improvement an MNE would quickly become uncompetitive, stagnate and ultimately, die.

We comment on the excellent work that is set out in the Discussion Draft and strongly support the basic principles:

- The analysis has been based on the facts and the taxpayer's contractual terms. Non-recognition of the those terms has to be limited to very limited exceptional cases. MNEs carrying out business transformations for abuse reasons are the black sheep and only exceptional cases. In the major cases business restructuring is a result of economic and organizational decisions.
- Renumeration issues only arise from the transfer of assets and other actual rights. Profit and loss potential is no asset itself.
- When arm's-length outcomes occur between related parties, they are best addressed by adjusting prices for the taxpayer's actual transactions, instead of substituting other transaction types.

Siemens AG
Corporate Finance
Management: Joe Kaeser

Wittelsbacherplatz 2
80333 Muenchen
Germany

Tel.: +49 (89) 636 00
Fax: +49 (89) 636 34242

Definition of business restructuring

For the term 'business restructuring' generally no legal or universally accepted definition exists. The draft proposes business restructuring to be defined as "[*…] the cross-border redeployment by a multinational enterprise of functions, assets and/ or risks […] with associated profit/loss potential between associated parties*"[1].

In order to avoid qualification conflicts among the international tax authorities due to different interpretation of terms, which could only be solved in MAPs, the draft should further clarify and specify the definition of business restructurings, especially the definition of the terms 'business restructuring' and 'functions'.

Economically, 'function' could be defined as a bundle of tasks being a part of the whole business. Examples are amongst other management, procurement, manufacturing, design, or warehousing. Only functions being able to "exist" indepently are potentially able to carry any goodwill or profit potential. In this context the IAS 36 approach for the impairment of assets and especially the term of the so called 'Cash Generating Unit' (in the following CGU) could be auxiliary for the definition of the term 'function'. Under the IAS apporach a CGU is defined as the smallest identifiable group of assets, that generates cash flows from continuing use, and that are largely independent of the cash inflows other assets or groups of assets. Thus, only if profit and loss is attributable to a bundle of tasks a 'function' in the context of business restructuring could exist. This requirement highlights the fact that a mere secondment of employees could not be regarded as a business restructuring as cash flow or profit and loss are not directly attributable to a single employee. As further outlined below the analysis of transactions not including the redeployment of a <u>whole function</u> is limited to the question whether the transfer price post restructuring is arm's length as those transaction do not provide any place for a profit potential.

In this regard it has to be outlined that business restructuring is the result of economic decisions and only in some cases a transfer of something takes place. Especially the termination or the non-renewal of an existing contract should not be subsumed under the term 'business restructuring'. In fact it needs to be examined whether the contract has been expired or terminated in accordance with the contractual or legal termination clause. This is required as third parties would not generally reimburse for lost profit potential that does not arise from a breach of contract or other tortuos activity (eg. without a legal basis for claims).

Profit potential

The report implies in para. 64 that "*[…] profit/loss potential is not an asset, but a potential which is carried by some rights or other assets*". In practice, a single right or asset would not enable a company to generate profit potential. In fact the company requires a framework (e.g. customers, employees, know-how) to effectively use the assets and rights and to generate profit. Consequently, to generate profit potential at least a part-business is required.

Only if a bundle of assets, which forms a part-business is transferred it needs to be further analyzed whether any possible "goodwill", e.g. profit/loss potential has been transferred. Nevertheless, a transfer of profit/loss potential could only be assumed if the advantage materializes with an utmost probability, i.e. if prices, volumes and further conditions are agreed by contract and therefore is an asset by itself. Under German case law the

[1] Para. 2 and 46.

customer's order would be accordingly regarded as assessable, consequently be considered in the business backlog and thus regarded as an asset. Consequently, the mere opportunity to enter into a contract could not be regarded as a 'property' as well as profit potential could not be linked to a single asset. Thus, if only assets or rights are transferred in the context of a business restructuring, the question has to be whether the assets or rights are priced on an arm's length basis.

Options realistically available

For the evaluation of a potential transaction, the draft states with high emphasis, that in accordance with the arm's length principle the options realistically available - both for the transferor and the transferee - have to be considered. The options should be relevant for the comparability and the pricing of the transaction and for the assessment of whether it would be "*[…] commercially rational to enter into the restructuring*". Of course, a restructuring within an MNE should not be articifal; nevertheless drivers within an MNE might exist, which might not occur between independent parties. For example, independent third parties do not have the opportunity to benefit from economies of scale resulting from the centralization of the purchasing or procurement. Thus, the option to transfer the procurement function to an entity carrying out this function centrally would not be realistically available to a third party, which is even stated by the draft as follows: *"[b]usiness restructurings often lead MNE groups to implement global business models that are hardly ever found between independent third parties, taking advantage of the very fact that they are MNE groups and they can work in an integrated fashion*" and clarrifies in the same section that this *"[…] does not mean of course that the implication of such global business models should automatically be regarded as not commercially rational"*[2]. The discussion of options realistically available between the taxpayer and the tax authorities could only be of a hypothetical nature and limits the freedom of business decisions in related party transactions. Even for transactions between independent third parties other options are not always available. An example is the strong position of a customer which forces the supplier to establish a further location near the customer's production facilities. Furthermore, national law often requires the provision of local content from the MNEs. Thus, other options are per law not available than to restructure the business in order to follow the local content requirement.

Taking into account both the difficulties and the differences, the question should not be whether on its merits the transaction is arm's length but whether the transaction is remunerated on an arm's length principle.

Treatment of synergies

The draft makes a distinction (para. 53) between group-wide and local synergies concluding that "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 transfer price analysis.

The concept of synergies is typically vague and elusive already in the business world. In business and valuation practice, capturing synergies, is a notoriously vague exercise. It is logically impossible to allocate to individual entities gains that result from joint cooperation if the measure of allocation shall be market behavior

[2] Para. 211. Similar para. 38.

of unrelated parties. The only exception is present where independent parties enter into a joint venture or a co-development arrangement sharing profits or costs in a defined way. Only where analogous arrangements are implemented by related parties is it a feasible exercise to allocate income on the basis of the arm’s length principle. Indeed, transfer pricing practice has developed practical approaches to allocate synergies in those situations with the help of profit splits and cost sharing/cost allocation methodologies. These are and should remain the exceptions rather than the rule. Therfore, it would be wise to leave the allocation of synergies to bona fide substantive taxpayer arrangements which are usually well founded in business.

Risk allocation

Due to the transfer pricing principles a company bearing a higher portion of risks should receive a higher portion of profits/ losses. The draft states that a risk should be borne by an entity if it has the control over the risk, which requires economic substance which in turn is reflected by functions like monitoring and management of risks. When determining which related party should bear a given risk, the draft recommends to focus on the question which party can make the decision on how to manage the risk. This is referred to as the ‘control’ criteria. Control over a risk has to be differentiated from the mere day-to-day management of a risk. To control a risk rather means to bear the negative impacts if the risk materializes. Thus, the draft states that the day-to-day management of a risk could be outsourced to another entity, while the outsourcing company continues to bear the risk. In practice the differentiation between entrepreneurial control and mere (day-to-day) risk management could be difficult. For example, in most cases the warranty risk is borne by the manufacturer usually having direct ‘control’ of the risks. Nevertheless, it could be the case that the distributor agrees to bear the risks if he is reimbursed by a lower transfer price respectively a risk premium. Therefor, the manufacturer transfers the risk to the distributor via an “insurance premium”.

In order to differentiate between entrepreneurial risk management and day-to-day risk management the draft provides the example of a fund manager given the authority by the investor to make all investment decisions on behalf of the investor on a day-by-day basis. This approach differs significantly from the ‘significant people functions’-approach outlined in the authorized OECD approach to the attribution of profits to permanent establishments. Hence, significant people functions - amongst other relevant for the attribution of risks - are *“[…] those which require active decision-making with regard to the taking on and management of the individual risk and portfolios of risks […]”*[3]. Under the latter approach the risk would be attributable to the fund manager as the funtion carried out is “more” than a mere day-by-day-management but less than an entrepreneurial risk taking function.

Financial Capacity

A further factor listed by the OECD which influences an independent party’s willingness to bear a risk is the financial capacity of the party to bear a risk. Under an arm’s length dealing the willingness to bear the risk is not limited to the financial capacity but to the ability of the party to “reinsure” the risk by another party. Thus, even under a related party transaction the financial capacity is not the explicit criteria for the risk allocation. A

[3] PE report, Part I, para. 116.

company may either outsource the risk (remunerated by an appropriate "compensation") or the company could face other advantages in compensation for the risk. With regard to stripping down of functions by transferring risk bearing functions to another entity, a reimbursement may not be appropriate. Especially the transfer of a risk-bearing activity which is supported by an adequately capitalized entity should not require a remuneration to the entity that bore the risk previously. In fact the proper question should be whether the post-restructuring remuneration is appropriate.

Transfer of intangible assets

The draft states that difficulties could arise in the context of business restructuring where an intangible is transferred at a point in time when it does not have an established value. The draft further suggests that the price for the transfer may not be adjusted if the valuation was made in '*good faith'*.[4] This leads to the question how to determine and how to document whether a valuation was made in good faith. Furthermore, according to the report the transfer of IP at a point in time when it does not have an established value should be subject to an ex-post price adjustment clause. Especially transfer pricing adjustments ex-post would result in international conflicts not at least to the fact that an ex-post adjustment is not in accordance with the arm's length principle. Third parties under comparable circumstances would agree on a fixed price for the IP and would not agree to an adjustment ex-post if the circumstances develop different as expected (independent of whether in a positive or negative way) as this is part and content of the negotiation. Price adjustment clauses between third parties are the rare exception and if entered into, limited to a very short period of time (most times not exceeding 1 year and based on specifically identified and agreed value drivers).

Furthermore, a clear definition of what constitutes an intangible asset is required. Especially the concept of non-transferable intangibles being *"[…] inherent to the local operation […]"* as mentioned in para. 89 requires further definition and/ or examples. Whether an intangible is legally protected and could be transferred could be derived from local law, which nevertheless could lead to inconsistencies due to the different national regulations.

However, if an intangible asset is found to be transferred the question of valuation of the intangible asset arises. The draft does not provide any guidance on the method to evaluate the intangible asset, which could lead to conflicts and double taxation.

Transfer of activity (ongoing concern)

The draft outlines that the transfer of an ongoing concern should be equal to the transfer of the total bundle of assets. This appropriately implicates that goodwill in not an asset. Nevertheless, it should be outline in more detail that the valuation of an activity including a bundle of assets, risks and functions as well as goodwill is only exceptional and limited to the transfer of a whole business. In para. 94 the draft provides an example of a production activity which is transferred. The transfer includes machinery and equipment, inventories, patents, manufacturing processes, know-how, and key contracts with suppliers. In addition to those assets transferred the draft assumes the transfer of 'ongoing concern'. It should be noted that no 'function' as outlined above has

[4] Para. 87.

been transferred; rather single assets have been transferred in order to set-up a new organisation. The single assets transferred do not enable the transferee to set-up exactly the same functions as carried out by the transferor. In order to carry out the functions at least new employees, infrastructure, and licenses are required. Only if a part-business is transferred, an ‘ongoing concern’ might be assumed. In addition, reference is made to the explanations on ‘Profit potential’.

Recognition of transactions - Commercially rational

Generally, the draft states that MNEs are free to organize their business operations as they see fit and tax administrations do not have the right to dictate to an MNE how to design its business and where to locate its operations. Further, the draft recognizes that it is commercially rational to restructure the business to obtain tax savings as long as functions, assets and risks are actually transferred. However, the draft enables the tax authorities in exceptional cases to take on the role of the business manager and to analyze what third parties would have decided under comparable circumstances ans thus, what would have been commercially rational. If the tax authorities might – under this solely theoratically analysis – draw the conclusion that the transaction is not commercially rational, they are enabled to non-recognize the entire transaction (not only the price).
The criteria of the ‘commercially rational manner’ is included in para. 1.37 of the TP Guidelines supplemented by the the fact that *“[…] the actual structure practically impedes the tax authorities from determining an appropriate transfer price”*. The latter requirement is not explicitly included in the draft. Missing this requirement will lead to discussions with the tax atuhorities on basic principles of business restructurings and their commercial rationality. Instead, any discussion between the tax payer and the tax authorities should focus on the arm’s length principle, i.e. the conditions of the transaction and the question if third parties would have agreed to it.

Documentation requirements

The draft states in para. 25 that *“[…] it would be reasonable to expect related parties to document in writing their decisions to allocate or transfer risks before the transactions […] occur”*. The draft should contain further guidance on the documentation required and should make clear that no further documents have to be prepared for documentation than the tax payer prepares in course of its ordinary dealings with third parties (e.g. business plans, calculations, contracts).

Concluding Remarks

MNEs underlie the necessesity to adjust their business to changing conditions and increasing globalization. By focusing on the avoidance of possible abuse cases the OECD should not complicate the necessary process of conforming business to changing conditions in all other cases. Thus, it is necessary to summarize the considerations of abuse cases in a single paragraph instead of spreading it in the whole document.
Furthermore, the OECD should specify and clearly define terms like ‘function’ or ‘business restructuring’ in more detail in order to enable the taxpayers to identify possible transactions.

In order to avoid hypothetical discussions leading to challenges and audit issues the OECD should outline that tax authorities should focus on the question whether the transfer price is arm's length instead of whether the transaction *per se* is arm's length. Consequently, adjustments by the tax authorities should be limited to transfer price adjustments and not to the non-recognition of the whole transaction.

If we can be of any further assistance, please feel free to contact us.

Very truly yours,

Siemens AG

ppa. Werner Stuffer　　　　i.V. Dr. Sven Bremer