

# **TRANSFER PRICING ASPECTS OF BUSINESS RESTRUCTURINGS**

## **COMMENTS TO THE DISCUSSION DRAFT ISSUED BY THE OECD ON 19 SEPTEMBER 2009**

Growing concerns on transfer pricing aspects and more generally on tax consequences of business restructurings have been developing since the late 1990's, reflecting both the economic move of business towards globalisation in an environment of fierce competition and the efforts of the various jurisdictions to protect their taxable revenue and their budget when profits are reallocated through these restructurings.

In this context the need was recognised by the OECD of developing further guidance to avoid "significant uncertainty for both business and governments as well as possible double taxation or double non taxation".

The "Public Discussion Draft" (hereinafter the "Discussion Draft") resulting from the first step of this project reflects significant efforts to achieve a balance between the respective objectives of the governments and the business community and to provide for more certainty on tax (or more precisely on transfer pricing) consequences of the business restructurings that the multinational enterprises (MNE) need to implement to maintain their competitiveness. The counterpart of this balance may however result in some uncertainty, as the draft often compromises by setting up a principle (in general positive for the business) that is immediately mitigated by restrictions or precisions (in general closer to the administrations' views).

Following the organisation of the "Discussion Draft" in four Issues notes<sup>1</sup>, our comments will try to identify, from our business perspective, the positive outcomes of that process - as significant points seem to have been set, the points on which taxpayers and tax administrations could agree, the points of uncertainty still to be clarified and the remaining ambiguous and/or difficult points that need further discussion.

In addition to this review of each Issues note, we will comment on some more general topics arising in that "Discussion Draft".

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<sup>1</sup> As the case may be we will point out items that have been also emphasised in the Introduction, meaning that they were considered as particularly important.

## ISSUES NOTE N° 1 : SPECIAL CONSIDERATIONS FOR RISKS

### KEY POSITIVE POINTS

A very positive point is the statement in § 27 according to which **“Just because a related party arrangement is one not to be seen between independent parties should not in itself mean the arrangement is non arms length”** which reads still more precise in the Introduction (§ 18.1) : **“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”**<sup>2</sup>. This situation is very frequent as typically the MNEs can and do organise their internal transactions otherwise than independent entities would do, in order to benefit of synergies, scale economies and other advantages. Therefore it is critical that the arm's length principle be interpreted in that way, which was not obvious at the starting point of the discussion.

### POINTS OF AGREEMENT<sup>3</sup>

- a) **“One important issue is to assess whether a risk – and, as a consequence, the transfer of that risk is economically significant”** (Section C and § 18.1). These paragraphs suggest that there must be some correspondence between the significance of the transferred risk and the decrease of profit potential. Although the concept of profit potential deserves some debate (see below) and although other reasons may explain such a decrease, it makes sense to recognise a link between the level of the transferred risk and the expected profit. Interestingly § 42 recognises that *“evaluating whether a risk is economically significant is a delicate exercise which might be usefully informed by a review of the accounting statements”*. Although examining if and how a risk has been recognised in the balance sheet may be useful, it can only provide an indicia, as recognised at the end of this paragraph : *“many risks ...are not capable of quantification and would not normally be represented in financial statements”*. This limitation should be emphasised, in order to avoid a possible inappropriate use of the financial statements by the tax administrations. However taxpayers should be able to explain any apparent inconsistency between their financial accounts and their transfer pricing policy.
- b) **“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”**  
In our view the whole Section B.1<sup>4</sup> brings useful guidance on this issue that is currently briefly mentioned at § 1.27 of the Transfer Pricing Guidelines (hereinafter

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<sup>2</sup> It is worthwhile mentioning that the same statement can be found in the context of recognition issues, and particularly in the discussion on commercial rationality (see § 211 : *“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”*, notwithstanding the term *“automatically”*, which could be deleted.

<sup>3</sup> Meaning points of agreement between the OECD and the taxpayers, from our perspective

<sup>4</sup> See also executive summary at § 18.1 in the Introduction.

TPG). In particular paragraphs 30 to 33 provide with a detailed interpretation of the meaning of “control”, clarifying for example that “*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)*” and illustrating this view with two interesting examples.

We do not see in which circumstances the transferor of a risk could be asked to perform the day-to-day monitoring and administration functions on behalf of the transferee “in the absence of an independent source of information”.

With regards the word “generally” at paragraph 1.27 of the TPG, we would not object to delete it, as far as § 34 of the "Discussion Draft" - which acknowledges that “*there are risks over which neither party has significant control*” - would be incorporated to the TPG.

- c) “***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***” (§ 45).

We have no problem to agree with this statement.

- d) “***It is important to examine whether the conduct of the parties conforms to the terms of the contract***” (§ 26).

We can agree with this “substance over form” statement, in particular because it may happen that inter-company contracts are not regularly updated to conform to the moving reality. However it should not mean that the tax administrations could easily ignore the terms of contractual arrangements and substitute other terms, derived from hindsight rather than actual facts.

## POINTS OF UNCERTAINTY

Paragraph 25 would need some clarification of the meaning of the statement “***it would be reasonable to expect related parties to document in writing their decisions to allocate or transfer risks before the transactions...occur***”.

Does it mean that the OECD endorses additional requirements concerning contemporaneous documentation ? Until now most of the current domestic regulations do not request that this type of written documentation be established before the facts. We strongly suggest that the OECD continue not to fix rules concerning the timing of the documentation process, and rather recommend the most reasonable approaches existing in that matter.

## AMBIGUOUS AND/OR DIFFICULT POINTS

In principle we would also agree with the OECD’s view that “**another factor that may influence an independent party’s willingness to take on a risk is its anticipated financial capacity to bear that risk**”(§ 28). However this statement is too vague as such, because the

concept of “anticipated financial capacity” might be misinterpreted. Example : a group affiliate is established or qualified as a “principal” in the course of a business restructuring, bearing a large range of risks ; assuming that the likelihood of the realisation of these risks in totality and their predictability are low, this affiliate would probably not be provided with the anticipated financial capacity to actually bear all these risks simultaneously. Determination of the reasonable level of this anticipated financial capacity is a business decision that might be different for rational reasons in the context of unrelated parties and within a group. For example if this entity would have to suffer unexpected losses while actually bearing these risks, it is highly probable that the parent company would play its shareholder’s role to avoid the bankruptcy of its affiliate. In other terms, the anticipated financial capacity to bear the risks should be analysed in the context of the group because the relationships to the shareholder(s) may be different from those independent enterprises (including the parent company) may have with their shareholders outside of the group.

## ISSUES NOTE N° 2 : ARM’S LENGTH COMPENSATION FOR THE RESTRUCTURING ITSELF

### KEY POSITIVE POINTS

a) as the question was put on the table and received various responses from certain jurisdictions, the statement made at § 64 and at § 18.2 in the Introduction of the "Discussion Draft" is very important: ***“the profit/loss potential is not an asset, but a potential which is carried by some rights or other assets”***.

First we note that the "Discussion Draft" refers to a “profit/loss potential”, as opposed to the concept of “profit potential” which prevailed until now, meaning that the tax administrations had primarily and may be exclusively considered that transferring functions and risks automatically results in transfer of profits to the transferee. Although this is the normally expected outcome when restructuring a business, we are pleased that the OECD recognises that business is by nature risky, which means that a potential may be positive or negative, depending on many factors that are not under the control of the enterprises. This is particularly important, as the current economic downturn is likely to result in losses and/or less profits at the different levels of the MNEs.

Second it is essential in our view not to create artificially a new category of intangible assets without real content, while there may already exist rights or other tangible or intangible assets, qualified as such, which carry profit/loss potential. When restructuring a business rights or assets may have to be transferred while transferring functions and risks, and of course these transferred assets must be identified and valued, as a compensation for this transfer could have been observed between independent parties, depending on the circumstances<sup>5</sup>.

This position taken in the "Discussion Draft" is particularly important while some

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<sup>5</sup> Consequently in the absence of transfer of assets, a compensation should generally not be required for the transfer of a mere profit/loss potential. Unfortunately the "Discussion Draft" seems reluctant to draw this consequence and presumes that in most, if not all, cases a compensation for transferred assets would be needed at arm’s length.

administrations may have developed different views<sup>6</sup>.

b) Also important is the statement that an indemnification should not systematically be required when contracts are terminated or substantially renegotiated ; § 101 and 18.2 clearly state ***“there should be no presumption that all contract terminations or substantial renegotiations give rise to a right to indemnification at arm’s length”***. Section D.4 (§ 116 to 122) develops the idea that the determination of an indemnification, if any, *“should be based on an examination of the facts and circumstances of the case”*. Depending on the circumstances the absence of indemnification may or may not be arm’s length.

c) The consensus position of the OECD vis-à-vis the “commensurate with income standard” is confirmed in paragraph 88 : ***“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”***. Thus it is recognised that such adjustments may or may not have to be made when the outcome of the restructuring is different from the expectations at the time the pricing of the transfer of intangibles has been determined.

## POINTS OF AGREEMENT

a) Interestingly the "Discussion Draft" endorses in § 66 the idea that *“Business restructurings typically involve a trade-off between possibly higher-but-more-volatile profits or losses and lower-but-more stable profits”*. Implicitly the draft recognises two things : first this trade-off is a business decision that is rational and acceptable as such, second it will be arm’s length as far as the expected return will be in line with the new risk profile of the transactions. There should be no presumption that a business restructuring is not a normal commercial behaviour and cannot generate arm’s length results.

b) Local intangibles: as far as valuable local intangibles can be identified, we agree with § 90 that such intangibles, transferred or remaining in the restructured entity, should be remunerated, although the royalty route may give rise to difficult tax and legal issues, and adjustments in the transfer prices may be preferred. But this should not mean that local valuable intangibles could be found to be in existence and remunerated in each case. We believe that in many cases no valuable local intangibles have been developed before the restructuring, the value of the business residing in other intangibles (e.g. trademarks, patents, know-how) not belonging to the restructured entity<sup>7</sup>.

c) More generally we agree with the principle, mentioned in different parts of the "Discussion Draft", that many issues related to business restructurings must be reviewed on a case by case basis, taking into account the specific facts and circumstances of each

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<sup>6</sup> For instance the concept of « transfer package » in the new German regulations which may suggest a too extended use of the concept of on going concern described in Section C.3 paragraphs 93 and 94.

<sup>7</sup> See discussion on intangibles in Annex (extract of a written contribution to the BAG meeting of June 11, 2008)

one, rather than applying rigid theoretical rules. We believe that this approach will provide for the necessary flexibility to solve some complex issues, even if it does not contribute to reduce the uncertainty for taxpayers and tax administrations. Examples of this approach can be found in § 98 (outsourcing) or 99 (indemnification).

## POINTS OF UNCERTAINTY

### **a) Ex-post adjustment of the price of a transferred intangible and good faith of the initial valuation**

According to § 87 the price of a transfer may be adjusted if “*the valuation at the time of the transfer was not an arm’s length valuation that was arrived at in good faith on the basis of information reasonably available at that time*”. On which criteria can it be determined that the valuation was not arrived at in good faith ? How do they combine with domestic criteria used to determine bad and good faith ? In that matter where it is particularly difficult and subject to judgement to value an intangible based on expected profits, tax administrations should be very prudent before qualifying such a valuation as being made in bad faith. It may also be very subjective.

### **b) Ex-post adjustments justified by the uncertainty of the valuation :**

§ 88 cites § 6.28 - 6.35 of the TPG without bringing more precision in the definition of a “valuation sufficiently uncertain at the outset that the parties would have required a price adjustment clause or would have renegotiated the terms of the agreement”. How can this uncertainty be assessed ? Judgement is again at stake.

### **c) Loss-making activities**

§ 95 – 97 raise many questions but do not provide for answers.

## AMBIGUOUS OR DIFFICULT POINTS

### **a) compensation as a result of a restructuring**

To a certain extent § 66 and following paragraphs contradict the statement made in § 64 : the whole Section seems to assume that any business restructuring giving rise to a transfer of profit/loss potential should be compensated while § 64 reads “the arm’s length principle does not require compensation for loss of profit/loss potential *per se*”. There is still a tension between two different viewpoints, but the emphasis is put on the second one. Even in § 64 the last sentence seems to contradict the first ones. And the distributor example, although interesting, does not conclude on whether a compensation would be required in each case and rather evidences the possible subjectivity of the judgement on the trade off mentioned earlier. The consensus on this significant issue is not obvious and the balance seems to be in favour of a required compensation in case of any restructuring transferring a profit/loss potential.

**b)** In two different instances this Issues note 2 seems also to insist on the “**substance over form approach**” and weakens the statements of Issue notes 1 (§ 21 and 25) according to which “*Contractual arrangements are the starting point for determining which party to a transaction bears the risks associated with it*”. Paragraph 51

emphases on “*the actual conduct of the entity ...being indicative of a longer-term arrangement and hence greater rights than those indicated by the legal contractual arrangement*”. In the same manner § 107 mentions, “*on the basis of an examination of the substance of the arrangement and of the conduct of the related parties, an implicit longer term contract should be implied...*” Although we agree that the actual conduct of the parties should be in line with their legal arrangements and at least not contradict those, we are concerned that these legal arrangements might be too often ignored and re characterised, arguing on deviations of the actual conduct of the parties that could as well be analysed as routine non written amendments. Some reasonable limitations to this extensive “substance over form” approach would be welcome. Written contracts are a protection for taxpayers who respect them in substance, and this protection should not be weakened by allowing the tax administrations to ignore them without very serious reasons.

### **ISSUES NOTE N° 3 : REMUNERATION OF POST RESTRUCTURING CONTROLLED TRANSACTIONS**

#### Remark :

*We will not comment the Section C of the "Discussion Draft" which develops some guidance on the selection and the application of a transfer pricing method for the post restructuring controlled transactions : as the "Discussion Draft" assesses the general principle that there is no different application of the arm's length principle to post-restructuring transactions and to transactions structured as such from the beginning (see below), we consider that all that discussion rather relates to another process of the review of the TPG, specifically the discussion on transactional profit methods versus the traditional transactional ones.*

#### **KEY POSITIVE POINTS**

As mentioned above we think that it is important that the "Discussion Draft" establishes as a general principle that “***the arm's length principle and the TPG do not and should not apply differently to post-restructuring transactions as opposed to transactions that were structured as such from the beginning***” (§ 124, 130, 131). Noteworthy this principle is even mentioned as a premise in § 16 of the Introduction and in the foreword of the "Discussion Draft" (page 2). This statement should avoid unnecessary and unclear discussions on transfer pricing methods to be used in the context of business restructurings and replace the debate at the correct general level (appropriateness of the method to the risks and functions profile of the parties engaged in controlled transactions).

#### **POINTS OF AGREEMENT**

As a consequence we agree with the **requirement of establishing a functional analysis before**

**and after the restructuring, as well as an analysis of the restructuring itself**, as stated in § 184 : *“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 also in § 18.3 of the Introduction : *“it is essential in business restructuring cases that a comparability (including functional) analysis be performed both for the pre-structuring and for the post-restructuring arrangements and that the actual changes that took place upon the restructuring be documented”*. Such an analysis is effectively needed to assess whether the respective arrangements are arm’s length.

## **POINTS OF UNCERTAINTY**

It is not clear whether the term “essential” in the sentence of § 184 quoted above introduces **new obligations of documentation** for the taxpayers.

## **AMBIGUOUS AND/OR DIFFICULT POINTS**

**a)** § 133 and §134 as well as § 18.3 in the Introduction reads : *“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”*. We agree that such differences might exist and *“affect the outcome of the application of the TPG»* but in our view they are overstated by the "Discussion Draft" in the whole Section B.2 (§ 134-141). In particular it is not clear why the comparability analysis should be more complex in a post-restructuring situation compared to a similar situation structured from the beginning. In each case risks, functions and tangible or intangible assets have to be identified, and may or may not be different.

The example provided in § 135 (conversion into a limited-risk-distributor) is not fully convincing, as the converted distributor can and will probably be compared to existing distributors and not only to new ones. Behind the examples of that Section there is the presumption that some valuable intangibles always remain in the converted entity, as opposed to the new established distributor, which may be true in certain cases, but not systematically.

### **b) Comparison of profits before and after restructuring**

If it can be agreed upon the statement in § 184 that *“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 « the*

question raised in § 181 *whether it would be appropriate to determine a restructured*

*entity's post-restructuring profits by reference to its pre-restructuring profits*<sup>8</sup>, would certainly deserve a more clearly negative response. This comparison must remain informative, taking in account all necessary precautions before drawing conclusions, as many circumstances other than the restructuring itself, including external factors, may influence the level of profits before and after the restructuring. The risk for the tax administrations to adjust the profits in a too simplistic manner is high enough to need a clarification on the limits of this exercise. Could not the “tentative conclusion reached by the OECD ...that controlled transactions should by no means be used as the basis for a transfer pricing adjustment “ in § 182 be confirmed ? Similarly the language of § 18.3 in the Introduction : “ *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* ” is correct but would need to be extended as in our view additional reasons justify that no adjustment should be made on that basis.

Finally we are not sure that “before-and-after comparisons can also be used as **sanity or reasonableness check**” (§ 186) without a lot of precautions. As mentioned further : “ *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* ”. The non-arm's length character of the before or after profits is only one possible explanation. Many other factors, internal and primarily external ones, may explain unexpected profits or losses. Without a deep review of these factors the before-and after comparison cannot be conclusive on the arm's length character of the transfer pricing.

In addition this type of comparison would probably be reserved to cases where profit-based methods are used, as with other recognised methods (e.g.; CUP) there is no direct link between the arm's length prices and the resulting profits/losses. Generally the before-and-after profits should only be viewed as a piece of information amongst other ones to be collected when performing the comparability analysis.

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<sup>8</sup> even « adjusted to reflect the transfer or relinquishment of particular functions, assets and risks »

## ISSUES NOTE N° 4 : RECOGNITION OF THE ACTUAL TRANSACTIONS UNDERTAKEN

### **Remark :**

The Introduction of Issues Note N° 4 clearly states that it does not discuss whether the existing guidance at Chapter I, Section C ii) of the TPG “provides a satisfactory outcome” and “does not attempt to propose any amendments to the existing guidance other than clarification of said existing guidance”. The scope of the debate is then clearly limited.

### **KEY POSITIVE POINTS**

a) § 205 provides a welcome clarification of the meaning of the word “exceptional” and “exceptionally” at § 1.36 and 1.37 of the TPG : *“they 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...**”* and *“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”*. This statement is also included in the Introduction (§ 18.4). Thus no extension of non-recognition by the tax administrations should normally be expected under Article 9 of the Model Tax Convention.

b) **Confirmation of the conditions for not recognising a transaction under Article 9 of the MTC**, in particular the second cumulative criterion under the second exceptional circumstance discussed at § 1.37 of the TPG is confirmed at § 206. This is a positive outcome of the debate, as it confirms the limitations already existing in the TPG to the capacity of the tax administrations of not recognising transactions actually undertaken.

c) **Recognition by the OECD that “the MNEs are free to organise their business operations as they see fit” and that “In making this decision, tax considerations may be a factor”** (§ 196). These both assertions certainly constitute a progress in the attitude of the tax administrations, as far as they are not weakened by contradictory positions (see below).

### **POINTS OF AGREEMENT**

As a counterpart to the principle mentioned above in c) we can agree that *“Tax administrations have the right to determine the tax consequences of the structure put in place by a MNE”* (§ 196). We also agree with the OECD’s view mentioned in the Introduction (§ 18.4) and § 201-202 that *“paragraphs 1.36-1.41 of the TPG 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 recognition issue – but where such price or conditions are not arm’s length”* but also *“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 ...at arm's length".* As far as the criteria for not recognising the transactions are not extended, we agree that tax administrations may proceed to adjustments according to Article 9 of the MTC and/or their domestic law, to the extent that such adjustments are compatible with their treaty obligations.

## POINTS OF UNCERTAINTY

In general this Issues note n° 4 gives rise to a great uncertainty for the tax payers for it is evident that no consensus has been reached yet between the OECD's members on significant issues relating to the recognition of transactions. The absence of consensus means that the risk of double taxation is particularly high in cases where a jurisdiction recognises a transaction but the other jurisdiction concerned re qualifies the same transaction. The business community is highly interested in the OECD reaching a consensus on most of this issues ; at least it could be helpful to inform the taxpayers on the respective views of the OECD's members, in order for them to better assess their tax risks.

**a) The “commercially rational behaviour test» mentioned** in § 1.37 of the TPG is not interpreted in the same way by all jurisdictions. Paragraph 207 mentions that *“some countries consider that it is intended to deal with cases where a transaction has no non-tax business purpose”* therefore limiting its application to abusive tax driven scheme. But *“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»*. We are concerned by this view, which considerably enlarges the applicability of a test based on a concept that gives rise to a lot of difficulties and should, in our view, be used very prudently in very specific cases. However we note that § 18.4 of the Introduction and § 208 attenuate this view by recognising that *“tax administrations should not ordinarily interfere with the business decisions of a taxpayer as to how to structure its business arrangements”* and furthermore *“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”*. A clarification and a consensus in that direction would be welcome.

**b) Preoccupying** is also § 216 dealing with the **sale of “crown jewels”**, which notes that *“some countries”* consider that such a sale cannot be an arm's length transaction. We assume that these countries consequently would not recognise this sale, probably contrary to the other country concerned. How could this dispute be solved without double taxation for the taxpayer ? The "Discussion Draft" does not suggest any route and therefore discussions should continue until a consensus is reached. It would be advisable that the countries mentioned above (but which countries are they ?) may compromise and do not stick to such extreme views. There are probably some cases where the sale of “crown jewels” cannot be reasonably considered being at arm's length, but a detailed review conducted without prejudice would probably conclude that in other cases unrelated parties could have entered into this type of transaction,

depending on the facts and circumstances of the case.

c) § 219 concludes that in the example of the **transfer of a valuable intangible to a shell company** “*most OECD countries indicate that they would consider not recognising the arrangement as structured*”. It would be interesting to know with which arguments and on which legal basis this non-recognition would be justified. Are we still in the scope of Article 9 of the MTC, or rather, as mentioned in the footnote, in “*a possible application of general anti-avoidance rules*” or under the “*question about effective place of management*” ? This raises the question of the **respective scope of Article 9 and the TPG on one hand and of other domestic regulations on the other hand**. Although the "Discussion Draft" does not cover this issue (see § 8 in the Introduction) we think that this question deserves a discussion, as the consequences for solving cases of double taxation arising from non-recognition might be very significant, particularly in the European Union, where the application of the Arbitration Convention is limited to cases under Article 9 of MTC, but also in other countries, depending on the tax treaties and their application.

d) § 221 also gives rise to uncertainty : although it is a good point that “*the vast majority of OECD countries consider that **the transfer of intangibles to a company that exercises functions should be recognised** for transfer pricing purposes as it has economic substance*”, it should be clarified why certain countries would not adopt this sensible position, and with which arguments. And once again the respective scope of domestic law (anti-abuses rules) and TPG is on the table and should be discussed.

## AMBIGUOUS AND/OR DIFFICULT POINTS

We are in general concerned that some OECD countries may wish to enlarge the current criteria for non recognising transactions or alternatively tend to re qualify what is actually a non-recognition into a mere comparability adjustment, not subject to the same limitations.

As an example § 198 considers that “*evaluating separately transactions which are presented as a package in accordance to the guidance at paragraphs 1.43 and 6.18 of the TPG should not be viewed as consisting in the non-recognition of a controlled transaction under paragraphs 1.36 – 1.41 of the TPG*”. This assertion is not incorrect but it should be reminded that § 1.42 and 1.44§ of the TPG address positively the question of bundling transactions into a package, and that §1.43 of the TPG puts limitations to the non-recognition of a package deal. For instance it is mentioned that it is unlikely that such comprehensive packages would include sales of goods. Moreover § 1.43 states, “*In such cases, after determining separate transfer pricing for the separate elements, the tax administration should nonetheless consider whether in total the transfer pricing for the entire package is arm’s length*”. In other words the current TPG in most cases do not allow to disregard bundling of transactions, and non-recognition of a package deal should respect the limitations provided at § 1.36 – 1.41 of the TPG.

More generally § 199 tends to demonstrate that refusing a purported allocation of risks do not

fall under the provisions of § 1.36 – 1.41 that limit cases where non-recognition can be justified, but should rather be considered as a mere comparability adjustment, not subject to the limitations on non-recognition : refusing a reallocation of risk would not be qualified as a non-recognition of the transaction, which should meet the criteria described at § 1.36 – 1.41, but as a routine comparability adjustment. Paragraph 39 in Issues note n°1 does not bring more certainty on the exceptional character of non-recognition by saying that “*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... would fall under the guidance at paragraphs 1.36 – 1.41 of the TPG*”. How can it be assessed that a risk allocation is a core element of a transaction ? And will not most of the business restructurings mainly consist in a reallocation of risks ? Will or will not a reallocation of risk in the course of a business restructuring be within the scope of “exceptional circumstances” justifying the non-recognition of a transaction under the guidance of § 1.36 – 1.41 ?

## OTHER GENERAL COMMENTS

Two key ideas are developed both in Issue notes n°2 and 4 and deserve some comments.

- ***“It is important not to examine the transaction in isolation, but to look at the totality of the arrangement”***. This recommendation, with which we agree, applies in two different circumstances <sup>9</sup>:
  - in Issue note n° 4 (§ 210) for “*assessing the commerciality of a transaction*” in order to determine whether this transaction falls under the second criterion of an exceptional circumstance in which the transaction could be disregarded,
  - in Issue note n° 2 (§ 84 – 85) for determining the options realistically available that the transferor, party to a restructuring, should review before engaging in a transfer of functions, risks or assets, and for determining the remuneration of a transferred intangible that the transferor continues to use under the new structure.
- A more problematic assertion is that “*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*”.

This applies again in two circumstances <sup>10</sup>:

- in Issue note n° 4 (§ 213) for performing the “commercially rational behaviour” test to

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<sup>9</sup> Mentioned also in the Introduction (§ 18.4)

<sup>10</sup> Mentioned also in the Introduction (§ 18.4)

determine whether a re qualification of the transaction is justified,

- in Issue note n° 2 (§ 61) for determining whether the transfer of functions, risks or assets is arm's length from the perspective of both the transferor(s) and the transferee(s) ; sound commercial reasons at the level of the MNE group nor group-wide synergy gains will not be sufficient, and furthermore "*local synergy gains or losses may need to be taken in account in the analysis of the transfer pricing consequences of the restructuring*" (§ 57).

We are somehow concerned by the emphasis put on the requirement that the arm's length principle applies on a separate rather than group-wide basis. We recognise that taxation is a domestic matter and should focus on the local taxpayers, whether part of a group or not. However we have two remarks :

- Admitting that, we can understand that the tax administrations review in detail the effects of the restructuring on the taxpayer resident in their jurisdiction, but we doubt that it could justify the same review for the foreign taxpayer. Except information on foreign entities necessary and sufficient to provide a correct understanding of the business restructuring, tax administrations should not request a two (or more) sided approach and should concentrate on their resident taxpayer. This should be particularly true in countries basing their taxation system on territoriality rather than on source.
- The "Discussion Draft" itself (§ 7) recognises "*the conceptual difficulty with applying the arm's length principle in practice*" highlighting "*the difficulty of reasoning in the arm's length theoretical environment which treats members of MNE group as if they were independent parties*", which, contrary to the MNE groups, are not in the position to implement integrated business models and develop global organisations for bona fide commercial reasons. Interestingly § 209 nonetheless mentions that "*due regard should be given to...the commercial circumstances arising from participation in an MNE group*" when determining whether the arrangements are commercially rational in the context of § 1.36 – 1.41 of the TPG. This apparent contradiction reveals the tension when applying the arm's length principle in certain complex cases. In our view however this should not lead to abandon the arm's length principle, but rather to more realistic and pragmatic approaches (such as at § 209 mentioned above).

## OTHER SENSITIVE POINTS OF DISCUSSION

- It would be worth to better clarify some terms/concepts used with regards **intangibles**.

- It would probably be helpful to better categorise the different types of intangibles to facilitate their valuation, if needed when they are transferred. For example the categorisation proposed by John Henshall<sup>11</sup> is designed from a tax perspective in the context of business restructurings and brings interesting analyses. He divides IP into four categories, namely :
  - IP that must be transferred and are transferred only by contract (patents, copyrights, database rights, etc.)
  - IP that can be regenerated (brand value as a goodwill)
  - Mandatory IP (compensation due to commercial agents according to some legislations)
  - Notional IP : transfer of the opportunity to make some profits would be for tax authorities of some countries a "right" that is an item of valuable IP, taxable as such.

- This leads to the discussion on how to determine whether there is a transfer of "on-going concern" and whether such transfers should take into account some "goodwill". Transfer of ongoing concern is defined in § 93 as the transfer of an activity, meaning *"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"*<sup>12</sup>. This definition may give rise to some questions about some items assimilated to assets (workforce, goodwill) and it would be worth to review it, in particular in comparison with domestic definitions of "transfer of activity" that may exist. We do not believe that any business restructuring is a transfer of activity nor that any transfer of activity necessary triggers the transfer of goodwill, as goodwill may or may not exist, depending on the specifics of each case. But we agree *"Valuation methods that are used in acquisition deals between independent parties may prove useful to value a transfer of activity between associated enterprises"*. In our view these methods should be applied in priority in most cases, as they are by definition used in an arm's length context. We do not see why other specific and prescriptive methods of valuation should be required in the context of business restructurings.

- As the concept of goodwill is already recognised and as its tax treatment is generally well defined, we do not see the necessity to create new categories of intangibles or concepts like "opportunity to make profits", profit/loss potential" or even very vague "transferred advantages"<sup>13</sup> to be used in the context of business restructurings<sup>14</sup>.

- In the absence of comparables to assess the arm's length character of a transaction, and particularly of a business restructuring, the "Discussion Draft", starting from the existing guidance of the TPG, put a great emphasis on the "commercially rational behaviour test", and more generally insists on the related parties simulating the supposed rational decision process followed by unrelated parties in similar circumstances. The "Discussion Draft" reiterates for example in a great number of circumstances covered by Issues notes 2 and 4 that the taxpayers must compare the contemplated

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<sup>11</sup> J ; Henshall : « Supply chain restructuring : IP transfer pricing and taxation » in Tax Planning International Transfer Pricing 05/08 page 13-15.

<sup>12</sup> It would be worth to compare the concept of transfer of activity to the German concept of "transfer package"

<sup>13</sup> We did not find this term in the "Discussion Draft" but it may be used in certain countries

<sup>14</sup> It would be useful to see how these concepts applied to so-called transferred assets would be translated in the financial statements in application of the accounting standards.

transaction to the other options “realistically available to them”<sup>15</sup>. Hence the reference should be a hypothetical business conduct, viewed in a very theoretical manner. We understand that a substitutive method is needed in the absence of comparables ; however there is a great danger that judgements on “rational commercial behaviour” be very subjective and be not supported by non-rebuttable arguments.

In addition, it is not sure at all that, in the real world, unrelated parties always make business decisions in a pure rational manner. Businessmen not systematically rely on academic theories and econometric models, as they may have other talents...

In conclusion we are of the opinion that the “commercially rational behaviour “ test should be applied in limited cases and with great caution.

In conclusion the "Discussion Draft" brings less ready-made solutions to the complex transfer pricing issues related to business restructurings than interesting indications on the right questions to address in order to solve a number of issues. In that sense it is in line with the existing TPG. Although some uncertainties still remain and some difficult points still need further discussion to attain a good balance between the respective concerns of taxpayers and tax administrations, significant progresses have been made in determining some key principles. But the greatest merit of this document is perhaps to have permitted, in the course of a 3 year extensive discussion, to attenuate the real tensions that existed at the beginning of the process between tax administrations highly concerned by the erosion of their revenues and taxpayers keen to continue their business restructurings without excessive tax risk and costs to maintain their competitiveness. It is a positive outcome, particularly in these times of economic downturn, which still might increase these tensions. At least they can discuss together.

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<sup>15</sup> see interesting developments on the application of the bargaining theory by Robert Miall in Ernst & Young's Global Transfer Pricing Survey Series, Business Restructuring Three Taxation Issues, June 2007, pages 13-18

**EXTRACT OF THE WRITTEN CONTRIBUTION TO THE BAG MEETING OF JUNE 11,2008  
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**a) Transfer of Intangibles**

In certain circumstances transferring functions (and attached risks) may require that some intangibles, without which the functions cannot be performed, be transferred by the stripped entity to the principal. Transfer may mean sale of these intangibles or simply grant of a right to use. In both cases remuneration is due, and as the transaction is made between related parties, this remuneration must be determined in accordance with the arm's length principle.

The first issue is then to determine what kind of intangibles and in which cases intangibles must be transferred to make a business conversion effective.

Some examples may illustrate how this question can be addressed.

For analysing intangible assets that can be concerned, it may be referred to the IFRS 3 classification (see annex) from which we will extract the most significant ones in the context of the most frequent business restructurings.

**• Technology-based intangible assets**

When converting a full fledged manufacturer into a contract or toll manufacturer, it is necessary to determine whether, for performing the manufacturing function, the manufacturer is using valuable technologies, patented or not, industrial know how or trade secrets ("tour de main" in French), the ownership or the right to use belongs to him. If the answer is yes, then these intangibles must be transferred versus an appropriate consideration, so that the manufacturing function becomes a mere routine function, remunerated as such. In the same manner if the relocation of a production to another site requires that such valuable technology be transferred, there must be a sale or a licence of this intangible asset.

But that does not mean that any transfer of production, or any conversion into a routine manufacturer requires the transfer of a valuable intangible asset. In many cases either no valuable technology-based asset is required to perform the manufacturing function, or the manufacturer does not own this asset (he has just a right to use the technology).

To illustrate the first question (is or is not a valuable technology to be transferred ?) we can review a few examples :

- I. In the pharmaceutical industry producing a pharmaceutical product needs a two step process : the chemical manufacturing of the active substance, and the formulation and packaging of the finished drug. Typically the packaging activity is not specific to the pharmaceutical products and does not require an elaborate and unique technology (even if the regulatory constraints are higher than for other consumer goods) ; it is very easy to find on the market alternative manufacturers. Except in some rare cases,

the same analysis applies for the formulation of drugs. Then generally, transferring these activities to another party or converting them into contract or toll manufacturing does not require any transfer of valuable intangibles, and therefore any compensation.

II. Concerning the chemical manufacturing of the active ingredients, the situation may be different, and may also vary to a large extent, depending on the substances. For example the synthesis of substances like aspirin or paracetamol is very simple and the corresponding technology is or can be largely shared by many chemical manufacturers. In such cases there are probably no valuable intangible assets used by the manufacturers. On the opposite there are a certain number of molecules, the synthesis of which is particularly complex and/or long (sometimes until more than 15 steps), sometimes hazardous, with a high risk of failure, requiring a particular know how from the manufacturer, that may be very difficult to duplicate. It has been for example noticed by the financial community that some molecules facing severe attacks against their patent, might nevertheless not suffer from the competition of generics manufacturers in the short or even middle term, due to the technical difficulty of producing them on an industrial basis (e.g. enoxaparine and more generally low molecular weight heparins, or biotech substances, see also the example of hydroxychloroquine or Plaquenyl® in the US some years ago). It is clear that in such cases, there may be a valuable technology based asset, developed/owned by the manufacturer that cannot be reduced to the specifications and the description of the process by the inventor/patent holder, if this latter is different from the manufacturer. For restructuring the manufacturing activity, such intangibles may then have to be transferred, with an adequate remuneration.

III. The same type of distinction could be observed in other sectors, for example in the clothing industry. On one side we have straightforward manufacturing of standard products on a large scale, on the opposite extreme, we have the “haute couture” the value of which depends partly on the rare and valuable know how of the highly specialised workers. And there is of course a range of intermediate situations, where a detailed analysis of the value drivers will be necessary to assert whether valuable intangibles are transferred or not. But even then, a valuable know how may already be reflected, at least partly, in the costs (e.g. hourly rates higher than those observed in standard manufacturing activities) and there may be a risk of accounting twice for the same “intangible” : once as such, once through the costs paid for the products.

These two examples clearly show that there is no simple response to the question whether intangibles are or are not transferred when restructuring a manufacturing activity. As for many transfer pricing issues, the answer will depend on facts and circumstances, on a case-by-case basis.

If and once it is established that such intangibles are transferred, two issues still remain to be addressed :

- The valuation of these intangibles and the characterisation of their transfer (sale, licence) ; in our view there should not be any specific discussion in the context of business restructuring, and the general principles concerning the valuation of intangibles should apply.

- The timing of this transfer.

- **Marketing and customer-related intangible assets**

This is probably the most controversial issue regarding the potential transfer of intangible assets when restructuring a commercial activity, although for registered intangible assets (brands, trade names, trade dresses...) the ownership can be easily attributed to a party, and the necessity to transfer them to another party in order to set up a new business model will generally not be subject to discussion : e.g. if the former licensee converted into a limited distributor or commissionnaire is the owner of the brands for its territory, these brands will probably be sold or licensed to the new principal. But if there is no doubt on the transfer of an intangible asset, the question still is : what is its value ?

For customer-related intangibles listed in IFRS 3 (customer lists, contractual or non contractual relationships...) the question is more complex, as, depending on the businesses, they may or may not constitute actual, i.e. valuable, intangibles. In some industries all the value may be in the brands, which means that even if transferred, the other marketing intangibles will be transferred at zero value.

In other terms, the question is less whether such intangibles are or are not transferred upon a business conversion, but rather which is the respective value of the two main categories : brands and other similar assets versus customer-based intangible assets.

For a detailed analysis of this issue, it can be helpful to refer to a recent paper published in *Intellectual Asset Management*<sup>16</sup>, although this question is rather addressed in the context of valuations for mergers and acquisitions. In summary, this article develops the idea that i) besides the brands, which continue to be a key driver, the customer relations may also be a valuable asset and ii) their respective value will depend on the industries and on other factors (such as the size of the companies). This is illustrated by a series of examples, most of them referring to recent acquisitions :

- Industries where the value is in the brand<sup>17</sup> : typically consumer goods industries such as Procter & Gamble purchasing Gillette, or L'Oréal purchasing The Body Shop, but also Unilever, Coca-Cola, Quaker. Interesting is the beer industry where for some beers (Stella Artois or Carlsberg) "all the value is in the brands", and for less well-known beers (such as Wells Eagle IPA) "the majority of value is likely to be with the customer or business relationships and not the brand". The author also cites the example of Rolls Royce, but more generally the value of industries of luxury goods is based on brands.

- Industries where customer relationships have a high value : telecom (NTL's acquisition of Virgin Mobile, Telefonica's acquisition of O2), financial services, banking and insurance (Aviva's acquisition of RAC, Banco de Santander's acquisition of Abbey)

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<sup>16</sup> « The importance of customer valuation » by Thayne Forbes, IAM August/September 2006, pages 17-21  
<http://www.intangiblebusiness.com/Brand-Services/Marketing-Services/Press-Coverage/Valuing-customers-195.html>

<sup>17</sup> Other examples of industries where the value is in the brands can be found in another article published by the same author in IAM January 2007 : "The failure of IFRS 3"  
<http://www.intangiblebusiness.com/store/data/files/76>  
[The failure of IFRS 3 Intellectual Asset Management January 2007.pdf](#) :  
Diageo's acquisition of Bushmills, Cadbury Schweppes's acquisition of Green and Blacks.

19/02/2009

Once again a case-by-case analysis, based on facts and circumstances, is needed to determine whether a valuable intangible is transferred upon a business conversion, and which is its arm's length value, if any. In other terms, a business restructuring does not automatically imply that a valuable intangible must be compensated. On the other hand it should be recognized that such transfers of intangibles might happen in the course of a business restructuring, and need to be compensated at arm's length, even if this valuation may be complex. A detailed analysis of the key drivers has always to be performed to assess the transfer of an intangible and its value.

CONTRIBUTION TO THE BAG MEETING OF JUNE 11, 2007  
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