



ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT



REPORT ON THE TRANSFER PRICING ASPECTS OF BUSINESS RESTRUCTURINGS

CHAPTER IX OF THE TRANSFER PRICING GUIDELINES

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CENTRE FOR TAX POLICY AND ADMINISTRATION

FOREWORD

This Report was approved by the Committee on Fiscal Affairs on 22 June 2010 and by the OECD Council on 22 July 2010. The Recommendation of the Council on the Determination of Transfer Pricing between Associated Enterprises [C(95)126/FINAL] was amended on 22 July 2010 to take account of the addition of the attached new Chapter IX and concomitant revision of Chapters I-III of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.

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Chapter IX

Transfer Pricing Aspects of Business Restructurings

Introduction

A. Scope

A.1 Business restructurings that are within the scope of this chapter

9.1 There is no legal or universally accepted definition of business restructuring. In the context of this chapter, business restructuring is defined as the cross-border redeployment by a multinational enterprise of functions, assets and/or risks. A business restructuring may involve cross-border transfers of valuable intangibles, although this is not always the case. It may also or alternatively involve the termination or substantial renegotiation of existing arrangements. Business restructurings that are within the scope of this chapter primarily consist of internal reallocation of functions, assets and risks within an MNE, although relationships with third parties (*e.g.* suppliers, sub-contractors, customers) may also be a reason for the restructuring and/or be affected by it.

9.2 Since the mid-90's, business restructurings have often involved the centralisation of intangible assets and of risks with the profit potential attached to them. They have typically consisted of:

- Conversion of full-fledged distributors into limited-risk distributors or commissionnaires for a foreign associated enterprise that may operate as a principal,
- Conversion of full-fledged manufacturers into contract-manufacturers or toll-manufacturers for a foreign associated enterprise that may operate as a principal,
- Transfers of intangible property rights to a central entity (*e.g.* a so-called "IP company") within the group.

9.3 There are also business restructurings whereby more intangibles and/or risks are allocated to operational entities (*e.g.* to manufacturers or distributors). Business restructurings can also consist of the rationalisation, specialisation or de-specialisation of operations (manufacturing sites and / or processes, research and development activities, sales, services), including the downsizing or closing of operations. The arm's length principle and guidance in this chapter apply in the same way to all types of business restructuring transactions that fall within the definition given at paragraph 9.1, irrespective of whether they lead to a more centralised or less centralised business model.

9.4 Business representatives who participated in the OECD consultation process in 2005-2009 explained that among the business reasons for restructuring are the wish to maximise synergies and economies of scale, to streamline the management of business lines and 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. They also indicated that business restructurings may be needed to preserve profitability or limit losses in a downturn economy, *e.g.* in the event of an over-capacity situation.

A.2 Issues that are within the scope of this chapter

9.5 This chapter contains a discussion of the transfer pricing aspects of business restructurings, *i.e.* of the application of Article 9 (Associated enterprises) of the OECD Model Tax Convention and of these Guidelines to business restructurings.

9.6 Business restructurings are typically accompanied by a reallocation of profits among the members of the MNE group, either immediately after the restructuring or over a few years. One major objective of this chapter in relation to Article 9 is to discuss the extent to which such a reallocation of profits is consistent with the arm's length principle and more generally how the arm's length principle applies to business restructurings. The implementation of integrated business models and the development of global organisations, where they are done for bona fide commercial reasons, highlight the difficulty of reasoning in the arm's length theoretical environment which treats members of an MNE group as if they were independent parties. This conceptual difficulty with applying the arm's length principle in practice is acknowledged in these Guidelines (see paragraphs 1.10-1.11). Notwithstanding this problem, these Guidelines reflect the OECD Member countries' strong support for the arm's length principle and for efforts to describe its application and refine its operation in practice (see paragraphs 1.14-1.15). When discussing the issues that arise in the context of business restructuring, the OECD has kept this conceptual difficulty in mind in an attempt to develop approaches that are realistic and reasonably pragmatic.

9.7 This chapter only covers transactions between associated enterprises in the context of Article 9 of the OECD Model Tax Convention and does not address the attribution of profits within a single enterprise on the basis of Article 7 of the OECD Model Tax Convention, as this is the subject of WP6's report on the Attribution of Profits to Permanent Establishments.¹ The guidance that is provided under Article 9 has been developed independently from the Authorised OECD Approach ("AOA") that was developed for Article 7.

9.8 Domestic anti-abuse rules and CFC legislation are not within the scope of this chapter. The domestic tax treatment of an arm's length payment, including rules regarding the deductibility of such a payment and how domestic capital gains tax provisions may apply to an arm's length capital payment, are also not within the scope of this chapter. Moreover, while they raise important issues in the context of business restructurings, VAT and indirect taxes are not covered in this chapter.

B. Applying Article 9 of the OECD Model Tax Convention and these Guidelines to business restructurings: theoretical framework

9.9 This chapter starts from the premise that the arm's length principle and these Guidelines do not and should not apply differently to restructurings or post-restructuring transactions than to transactions that were structured as such from the beginning. The relevant question under Article 9 of the OECD Model Tax Convention and the arm's length principle is whether there are conditions made or imposed in a business restructuring that differ from the conditions that would be made between independent enterprises. This is the theoretical framework in which all the guidance in this chapter should be read. This chapter is composed of four parts which should be read together.

¹ See Report on the Attribution of Profits to Permanent Establishments, approved by the Committee on Fiscal Affairs on 24 June 2008 and by the Council for publication on 17 July 2008 and the 2010 Sanitised version of the Report on the Attribution of Profits to Permanent Establishments, approved by the Committee on Fiscal Affairs on 22 June 2010 and by the Council for publication on 22 July 2010.

Part I: Special considerations for risks

A. Introduction

9.10 Risks are of critical importance in the context of business restructurings. An examination of the allocation of risks between associated enterprises is an essential part of the functional analysis. Usually, in the open market, the assumption of increased risk would also be compensated by an increase in the expected return, although the actual return may or may not increase depending on the degree to which the risks are actually realised (see paragraph 1.45). Business restructurings often result in local operations being converted into low risk operations (*e.g.* “low risk distributors”, or “low risk contract manufacturers”) and being allocated relatively low (but generally stable) returns on the grounds that the entrepreneurial risks are borne by another party to which the residual profit is allocated. It is therefore important for tax administrations to assess the reallocation of the significant risks of the business that is restructured and the consequences of that reallocation on the application of the arm’s length principle to the restructuring itself and to the post-restructuring transactions. This part covers the allocation of risks between associated enterprises in an Article 9 context and in particular the interpretation and application of paragraphs 1.47 to 1.53. It is intended to provide general guidance on risks which will be of relevance to specific issues addressed elsewhere in this chapter, including Part II’s analysis of the arm’s length compensation for the restructuring itself, Part III’s analysis of the remuneration of the post-restructuring controlled transactions, and Part IV’s analysis of the recognition or non-recognition of transactions presented by a taxpayer.

B. Contractual terms

9.11 Unlike in the AOA that was developed for Article 7, the examination of risks in an Article 9 context starts from an examination of the contractual terms between the parties, as those generally define how risks are to be divided between the parties. Contractual arrangements are the starting point for determining which party to a transaction bears the risk associated with it. Accordingly, it would be a good practice for associated enterprises to document in writing their decisions to allocate or transfer significant risks before the transactions with respect to which the risks will be borne or transferred occur, and to document the evaluation of the consequences on profit potential of significant risk reallocations. As noted at paragraph 1.52, the terms of a transaction may be found in written contracts or in correspondence and/or other communications between the parties. Where no written terms exist, the contractual relationships of the parties must be deduced from their conduct and the economic principles that generally govern relationships between independent enterprises.

9.12 However, as noted at paragraphs 1.47 to 1.53, a tax administration is entitled to challenge the purported contractual allocation of risk between associated enterprises if it is not consistent with the economic substance of the transaction. Therefore, in examining the risk allocation between associated enterprises and its transfer pricing consequences, it is important to review not only the contractual terms but also the following additional questions:

- Whether the conduct of the associated enterprises conforms to the contractual allocation of risks (see Section B.1 below),
- Whether the allocation of risks in the controlled transaction is arm’s length (see Section B.2 below), and
- What the consequences of the risk allocation are (see Section B.3 below).

B.1 Whether the conduct of the associated enterprises conforms to the contractual allocation of risks

9.13 In transactions between independent enterprises, the divergence of interests between the parties ensures that they will ordinarily seek to hold each other to the terms of the contract, and that contractual terms will be ignored or modified after the fact generally only if it is in the interests of both parties. The same divergence of interests may not exist in the case of associated enterprises, and it is therefore important to examine whether the conduct of the parties conforms to the terms of the contract or whether the parties' conduct indicates that the contractual terms have not been followed or are a sham. In such cases, further analysis is required to determine the true terms of the transaction.

9.14 The parties' conduct should generally be taken as the best evidence concerning the true allocation of risk. Paragraph 1.48 provides an example in which a manufacturer sells property to an associated distributor in another country and the distributor is claimed to assume all exchange rate risks, but the transfer price appears in fact to be adjusted so as to insulate the distributor from the effects of exchange rate movements. In such a case, the tax administrations may wish to challenge the purported allocation of exchange rate risk.

9.15 Another example that is relevant to business restructurings is where a foreign associated enterprise assumes all the inventory risks by contract. When examining such a risk allocation, it may be relevant to examine for instance where the inventory write-downs are taken (*i.e.* whether the domestic taxpayer is in fact claiming the write-downs as deductions) and evidence may be sought to confirm that the parties' conduct supports the allocation of these risks as per the contract.

9.16 A third example relates to the determination of which party bears credit risk in a distribution arrangement. In full-fledged distribution agreements, the bad debt risk is generally borne by the distributor who books the sales revenue (notwithstanding any risk mitigation or risk transfer mechanism that may be put in place). This risk would generally be reflected in the balance sheet at year end. However, the extent of the risk borne by the distributor at arm's length may be different if the distributor receives indemnification from another party (*e.g.* from the supplier) for irrecoverable claims, and/or if its purchase price is determined on a resale price or commission basis that is proportionate to the cash (rather than invoiced) revenue. The examination of the actual conditions of the transactions between the parties, including the pricing of the transactions and the extent, if any, to which it is affected by credit risk, can provide evidence of whether in actual fact it is the supplier or the distributor (or both) who bear(s) the bad debt risk.

B.2 Determining whether the allocation of risks in the controlled transaction is arm's length

9.17 Relevant guidance on the examination of risks in the context of the functional analysis is found at paragraphs 1.47-1.51.

B.2.1 Role of comparables

9.18 Where data evidence a similar allocation of risk in comparable uncontrolled transactions, then the contractual risk allocation between the associated enterprises is regarded as arm's length. In this respect, comparables data may be found either in a transaction between one party to the controlled transaction and an independent party ("internal comparable") or in a transaction between two independent enterprises, neither of which is a party to the controlled transaction ("external comparable"). Generally, the search for comparables to assess the consistency with the arm's length principle of a risk allocation will not be done in isolation from the general comparability analysis of the transactions with which the risk is associated.

The comparables data will be used to assess the consistency with the arm's length principle of the controlled transaction, including the allocation of significant risks in said transaction.

B.2.2 Cases where comparables are not found

9.19 Of greater difficulty and contentiousness is the situation where no comparable is found to evidence the consistency with the arm's length principle of the risk allocation in a controlled transaction. Just because an arrangement between associated enterprises is one not seen between independent parties should not of itself mean the arrangement is non-arm's length. However, where no comparables are found to support a contractual allocation of risk between associated enterprises, it becomes necessary to determine whether that allocation of risk is one that might be expected to have been agreed between independent parties in similar circumstances.

9.20 This determination is by nature subjective, and it is desirable to provide some guidance on how to make such a determination in order to limit to the extent possible the uncertainties and risks of double taxation it can create. One relevant, although not determinative factor that can assist in this determination is the examination of which party(ies) has (have) relatively more control over the risk, as discussed in paragraphs 9.22-9.28 below. In arm's length transactions, another factor that may influence an independent party's willingness to take on a risk is its financial capacity to assume that risk, as discussed in paragraphs 9.29-9.32. Beyond the identification of these two relevant factors, it is not possible to provide prescriptive criteria that would provide certainty in all situations. The determination that the risk allocation in a controlled transaction is not one that would have been agreed between independent parties should therefore be made with great caution considering the facts and circumstances of each case.

9.21 The reference to the notions of "control over risk" and of "financial capacity to assume the risk" is not intended to set a standard under Article 9 of the OECD Model Tax Convention whereby risks would always follow capital or people functions. The analytical framework under Article 9 is different from the AOA that was developed under Article 7 of the OECD Model Tax Convention.

B.2.2.1 Risk allocation and control

Relevance of the notion of "control"

9.22 The question of the relationship between risk allocation and control as a factor relevant to economic substance is addressed at paragraph 1.49. The statement in that paragraph is based on experience. In the absence of comparables evidencing the consistency with the arm's length principle of the risk allocation in a controlled transaction, the examination of which party has greater control over the risk can be a relevant factor to assist in the determination of whether a similar risk allocation would have been agreed between independent parties in comparable circumstances. In such situations, if risks are allocated to the party to the controlled transaction that has relatively less control over them, the tax administration may decide to challenge the arm's length nature of such risk allocation.

Meaning of "control" in this context

9.23 In the context of paragraph 1.49, "control" should be understood as the capacity to make decisions to take on the risk (decision to put the capital at risk) and decisions on whether and how to manage the risk, internally or using an external provider. This would require the company to have people – employees or directors – who have the authority to, and effectively do, perform these control functions. Thus, when one party bears a risk, the fact that it hires another party to administer and monitor the risk on a day-to-day basis is not sufficient to transfer the risk to that other party.

9.24 While 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), in order to control a risk one has to be able to assess the outcome of the day-to-day monitoring and administration functions by the service provider (the level of control needed and the type of performance assessment would depend on the nature of the risk). This can be illustrated as follows.

9.25 Assume that an investor hires a fund manager to invest funds on its account. Depending on the agreement between the investor and the fund manager, the latter may be given the authority to make all the investment decisions on behalf of the investor on a day-to-day basis, although the risk of loss in value of the investment would be borne by the investor. In such an example, the investor is controlling its risks through three relevant decisions: the decision to hire (or terminate the contract with) that particular fund manager, the decision of the extent of the authority it gives to the fund manager and objectives it assigns to the latter, and the decision of the amount of the investment that it asks this fund manager to manage. Moreover, the fund manager would generally be required to report back to the investor on a regular basis as the investor would want to assess the outcome of the fund manager's activities. In such a case, the fund manager is providing a service and managing his business risk from his own perspective (*e.g.* to protect his credibility). The fund manager's operational risk, including the possibility of losing a client, is distinct from his client's investment risk. This illustrates the fact that an investor who gives to another person the authority to make all the day-to-day investment decisions does not necessarily transfer the investment risk to the person making these day-to-day decisions.

9.26 As another example, assume that a principal hires a contract researcher to perform research on its behalf. Assume the arrangement between the parties is that the principal bears the risk of failure of the research and will be the owner of the outcome of the research in case of success, while the contract researcher is allocated a guaranteed remuneration irrespective of whether the research is a success or a failure, and no right to ownership on the outcome of the research. Although the day-to-day research would be carried on by the scientific personnel of the contract researcher, the principal would be expected to make a number of relevant decisions in order to control its risk, such as: the decision to hire (or terminate the contract with) that particular contract researcher, the decision of the type of research that should be carried out and objectives assigned to it, and the decision of the budget allocated to the contract researcher. Moreover, the contract researcher would generally be required to report back to the principal on a regular basis, *e.g.* at predetermined milestones. The principal would be expected to be able to assess the outcome of the research activities. The contract researcher's own operational risk, *e.g.* the risk of losing a client or of suffering a penalty in case of negligence, is distinct from the failure risk borne by the principal.

9.27 As a third example, suppose now that a principal hires a contract manufacturer to manufacture products on its behalf, using technology that belongs to the principal. Assume that the arrangement between the parties is that the principal guarantees to the contract manufacturer that it will purchase 100% of the products that the latter will manufacture according to technical specifications and designs provided by the principal and following a production plan that sets the volumes and timing of product delivery, while the contract manufacturer is allocated a guaranteed remuneration irrespective of whether and if so at what price the principal is able to re-sell the products on the market. Although the day-to-day manufacturing would be carried on by the personnel of the contract manufacturer, the principal would be expected to make a number of relevant decisions in order to control its market and inventory risk, such as: the decision to hire (or terminate the contract with) that particular contract manufacturer, the decision of the type of products that should be manufactured, including their technical specifications, and the decision of the volumes to be manufactured by the contract manufacturer and of the timing of delivery. The principal would be expected to be able to assess the outcome of the manufacturing activities, including quality control of the manufacturing process and of the manufactured products. The contract manufacturer's own operational risk, *e.g.* the risk of losing a client or of suffering a penalty in case of

negligence or failure to comply with the quality and other requirements set by the principal, is distinct from the market and inventory risks borne by the principal.

9.28 It should be borne in mind that there are also, as acknowledged at paragraph 1.49, risks over which neither party has significant control. There are risks which are typically beyond the scope of either party to influence (*e.g.* economic conditions, money and stock market conditions, political environment, social patterns and trends, competition and availability of raw materials and labour), although the parties can make a decision whether or not to expose themselves to those risks and whether and if so how to mitigate those risks. As far as risks over which neither party has significant control are concerned, control would not be a helpful factor in the determination of whether their allocation between the parties is arm's length.

B.2.2.2 Financial capacity to assume the risk

9.29 Another relevant, although not determinative factor that can assist in the determination of whether a risk allocation in a controlled transaction is one which would have been agreed between independent parties in comparable circumstances is whether the risk-bearer has, at the time when risk is allocated to it, the financial capacity to assume (*i.e.* to take on) the risk.

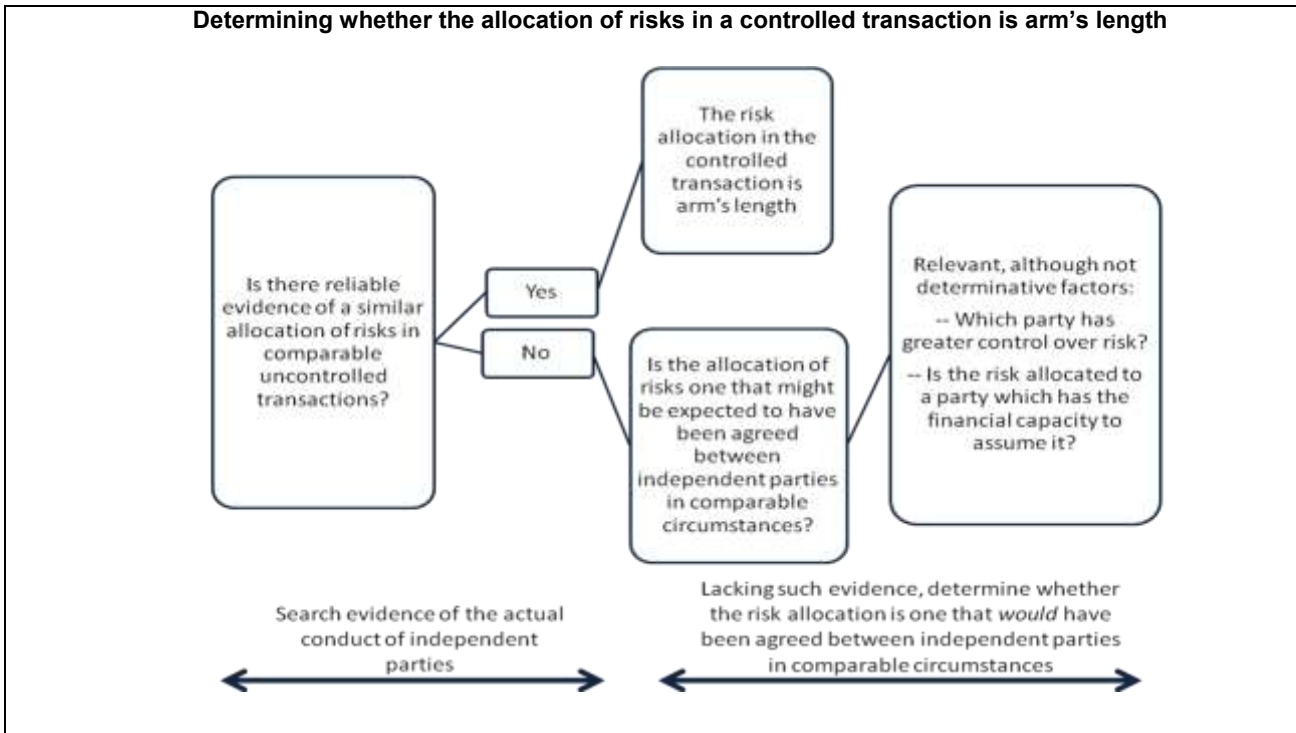
9.30 Where risk is contractually assigned to a party (hereafter "the transferee") that does not have, at the time when the contract is entered into, the financial capacity to assume it, *e.g.* because it is anticipated that it will not have the capacity to bear the consequences of the risk should it materialise and that it also does not put in place a mechanism to cover it, doubts may arise as to whether the risk would be assigned to this party at arm's length. In effect, in such a situation, the risk may have to be effectively borne by the transferor, the parent company, creditors, or another party, depending on the facts and circumstances of the case, irrespective of the contractual terms that purportedly assigned it to the transferee.

9.31 This can be illustrated as follows. Assume that Company A bears product liability towards customers and enters into a contract with Company B according to which the latter will reimburse A for any claim that A may suffer in relation to such liability. The risk is contractually transferred from A to B. Assume now that, at the time when the contract is entered into, Company B does not have the financial capacity to assume the risk, *i.e.* it is anticipated that B will not have the capacity to reimburse A, should a claim arise, and also does not put in place a mechanism to cover the risk in case it materialises. Depending on the facts and circumstances of the case, this may cause A to effectively bear the costs of the product liability risk materialising, in which case the transfer of risk from A to B would not be effective. Alternatively, it may be that the parent company of B or another party will cover the claim that A has on B, in which case the transfer of risk away from A would be effective (although the claim would not be reimbursed by B).

9.32 The financial capacity to assume the risk is not necessarily the financial capacity to bear the full consequences of the risk materialising, as it can be the capacity for the risk-bearer to protect itself from the consequences of the risk materialising. Furthermore, a high level of capitalisation by itself does not mean that the highly capitalised party carries risk.

B.2.2.3 Illustration

9.33 The overall process of determining whether the allocation of risks in a controlled transaction is arm's length can be illustrated as shown in the diagram below.



B.2.3 Difference between making a comparability adjustment and not recognising the risk allocation in the controlled transaction²

9.34 The difference between making a comparability adjustment and not recognising the risk allocation in a controlled transaction can be illustrated with the following example which is consistent with the example at paragraph 1.69. Suppose a manufacturer in Country A has associated distributors in Country B. Suppose that the tax administration of Country A is examining the manufacturer's controlled transactions and in particular the allocation of excess inventory risk between the manufacturer and its associated distributors in Country B. It is assumed that in the particular case, the excess inventory risk is significant and warrants a detailed transfer pricing analysis. As a starting point, the tax administration would examine the contractual terms between the parties and whether they have economic substance, determined by reference to the conduct of the parties, and are arm's length. Assume that in the particular case there is no doubt that the actual conduct of the parties is consistent with the contractual terms, *i.e.* that the manufacturer actually bears the excess inventory risk in its controlled transactions with associated distributors.

9.35 In determining whether the contractual risk allocation is arm's length, the tax administration would examine whether there is evidence from comparable uncontrolled transactions supporting the risk allocation in the manufacturer's controlled transactions. If such evidence exists, whether from internal or external comparables, there would be no reason to challenge the risk allocation in the taxpayer's controlled transactions.

9.36 Assume now that there is no evidence from internal or external comparable uncontrolled transactions supporting the risk allocation in the manufacturer's controlled transactions. As noted at paragraph 1.69, the fact that independent enterprises do not allocate risks in the same way as the taxpayer

² This section addresses the relationship between the guidance at paragraph 1.49 and paragraphs 1.64-1.69.

in its controlled transactions is not sufficient for not recognising the risk allocation in the controlled transactions, but it might be a reason to examine the economic logic of the controlled distribution arrangement more closely. In that case, it would be necessary to determine whether the contractual risk allocation in the controlled transactions would have been agreed at arm's length. One factor that can assist in this determination is an examination of which party(ies) has(ve) greater control over the excess inventory risk (see paragraphs 1.49 and 9.22-9.28 above). As noted at paragraph 9.20, in arm's length transactions, another factor that may influence the allocation of risk to an independent party is its financial capacity, at the time of the risk allocation, to assume that risk.

9.37 It may be the case that, despite the lack of comparable uncontrolled transactions supporting the same risk allocation as the one in the taxpayer's controlled transaction, such risk allocation is found to have economic substance and to be commercially rational, *e.g.* because the manufacturer has relatively more control over the excess inventory risk as it makes the decisions on the quantities of products purchased by the distributors. In such a case, the risk allocation would be respected and a comparability adjustment might be needed in order to eliminate the effects of any material difference between the controlled and uncontrolled transactions being compared.

9.38 Assume now that the tax administration finds that the taxpayer's arrangements made in relation to its controlled transactions, and in particular the allocation of excess inventory risk to the manufacturer, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner and that in comparable circumstances, a manufacturer would not agree at arm's length to take on substantial excess inventory risk by, for example, agreeing to repurchase from the distributors at full price any unsold inventory. In such a case, the tax administration would seek to arrive at a reasonable solution through a pricing adjustment. In the exceptional circumstances however where a reasonable solution cannot be arrived at through a pricing adjustment, the tax administration may re-assign the consequences from the risk allocation to the associated distributors following the guidance at paragraphs 1.47-1.50 (*e.g.* by challenging the manufacturer's obligation to repurchase unsold inventory at full price) if the allocation of that risk is one of the comparability factors affecting the controlled transaction under examination.

B.3 What the consequences of the risk allocation are

B.3.1 Effects of a risk allocation that is recognised for tax purposes

9.39 In general, the consequence for one party of being allocated the risk associated with a controlled transaction, where such a risk allocation is found to be consistent with the arm's length principle, is that such party should:

- a) Bear the costs, if any, of managing (whether internally or by using associated or independent service providers) or mitigating the risk (*e.g.* costs of hedging, or insurance premium),
- b) Bear the costs that may arise from the realisation of the risk. This also includes, where relevant, the anticipated effects on asset valuation (*e.g.* inventory valuation) and / or the booking of provisions, subject to the application of the relevant domestic accounting and tax rules; and
- c) Generally be compensated by an increase in the expected return (see paragraph 1.45).

9.40 The reallocation of risks amongst associated enterprises can lead to both positive and negative effects for the transferor and for the transferee: on the one hand, potential losses and possible liabilities may, as a result of the transfer, shift to the transferee; on the other hand, the expected return attached to the risk transferred may be realised by the transferee rather than the transferor.

9.41 One important issue is to assess whether a risk is economically significant, *i.e.* it carries significant profit potential, and, as a consequence, whether the reallocation of that risk may explain a significant reallocation of profit potential. The significance of a risk will depend on its size, the likelihood of its realisation and its predictability, as well as on the possibility to mitigate it. If a risk is assessed to be economically insignificant, then the bearing or reallocation of that risk would not ordinarily explain a substantial amount of or decrease in the entity's profit potential. At arm's length a party would not be expected to transfer a risk that is perceived as economically insignificant in exchange for a substantial decrease in its profit potential.

9.42 For instance, where a buy-sell distributor which is converted into a commissionaire transfers the ownership of inventory to an overseas principal and where this transfer leads to a transfer of inventory risk, the tax administration would want to assess whether the inventory risk that is transferred is economically significant. It may want to ask:

- What the level of investment in inventory is,
- What the history of stock obsolescence is,
- What the cost of insuring it is, and
- What the history of loss in transit (if uninsured) is.

9.43 Accounting statements may provide useful information on the probability and quantum of certain risks (e.g. bad debt risks, inventory risks), but there are also economically significant risks that may not be recorded as such in the financial accounts (e.g. market risks).

B.3.2 Can the use of a transfer pricing method create a low risk environment?

9.44 The question of the relationship between the choice of a particular transfer pricing method and the level of risk left with the entity that is remunerated using that method is an important one in the context of business restructuring. It is quite commonly argued that because an arrangement is remunerated using a cost plus or TNMM that guarantees a certain level of gross or net profit to one of the parties, that party operates in a low risk environment. In this regard, one should distinguish between, on the one hand, the pricing arrangement according to which prices and other financial conditions of a transaction are contractually set and, on the other hand, the transfer pricing method that is used to test whether the price, margin or profits from a transaction are arm's length.

9.45 With respect to the former, the terms on which a party to a transaction is compensated cannot be ignored in evaluating the risk borne by that party. In effect, the pricing arrangement can directly affect the allocation of certain risks between the parties and can in some cases create a low risk environment. For instance, a manufacturer may be protected from the risk of price fluctuation of raw material as a consequence of its being remunerated on a cost plus basis that takes account of its actual costs. On the other hand, there can also be some risks the allocation of which does not derive from the pricing arrangement. For instance, remunerating a manufacturing activity on a cost plus basis may not as such affect the allocation of the risk of termination of the manufacturing agreement between the parties.

9.46 Concerning the transfer pricing method used to test the prices, margins or profits from the transaction, it should be the most appropriate transfer pricing method to the circumstances of the case (see paragraph 2.2). In particular, it should be consistent with the allocation of risk between the parties (provided such allocation of risk is arm's length), as the risk allocation is an important part of the functional analysis of the transaction. Thus, it is the low (or high) risk nature of a business that will dictate

the selection of the most appropriate transfer pricing method, and not the contrary. See Part III of this chapter for a discussion of the arm's length remuneration of the post-restructuring arrangements.

C. Compliance issues

9.47 It is a good practice for taxpayers to set up a process to establish, monitor and review their transfer prices, taking into account the size of the transactions, their complexity, the level of risk involved, and whether they are performed in a stable or changing environment (see paragraphs 3.80-3.83). The process of assessing the consistency with the arm's length principle of a taxpayer's risk allocations can be burdensome and costly. It would be reasonable to expect that the extent and depth of the analysis will depend:

- On the materiality of the risk and in particular on whether it has a significant profit potential attached to it, and
- On whether significant changes in the risk allocation have occurred, *e.g.* following a significant change of risk profile as a result of a restructuring.

Part II: Arm's length compensation for the restructuring itself

A. Introduction

9.48 A business restructuring may involve cross-border transfers of something of value, *e.g.* of valuable intangibles, although this is not always the case. It may also or alternatively involve the termination or substantial renegotiation of existing arrangements, *e.g.* manufacturing arrangements, distribution arrangements, licenses, service agreements, etc. The transfer pricing consequences of the transfer of something of value are discussed at Section D of this part and the transfer pricing consequences of the termination or substantial renegotiation of existing arrangements are discussed at Section E.

9.49 Under Article 9 of the OECD Model Tax Convention, where the conditions made or imposed in a transfer of functions, assets and/or risks, and/or in the termination or renegotiation of a contractual relationship between two associated enterprises located in two different countries differ from those that would be made or imposed between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

B. Understanding the restructuring itself

9.50 The determination of whether the conditions made or imposed in a business restructuring transaction are arm's length will generally be informed by a comparability analysis, and in particular by an examination of the functions performed, assets used and risks assumed by the parties, as well as of the contractual terms, economic circumstances and business strategies.

9.51 Where uncontrolled transactions that are potentially comparable to the restructuring transactions are identified, the comparability analysis will also aim at assessing the reliability of the comparison and, where needed and possible, at determining reasonably accurate comparability adjustments to eliminate the material effects of differences that may exist between the situations being compared.

9.52 It may be that comparable uncontrolled transactions for a restructuring transaction between associated enterprises are not found. This does not of itself mean that the restructuring is not arm's length, but it is still necessary to establish whether it satisfies the arm's length principle.³ In such cases, determining whether independent parties might be expected to have agreed to the same conditions in comparable circumstances may be usefully informed by a review of:

- The restructuring transactions and the functions, assets and risks before and after the restructuring (see Section B.1);
- The business reasons for and the expected benefits from the restructuring, including the role of synergies (see Section B.2);
- The options realistically available to the parties (see Section B.3).

³ See paragraph 1.11.

B.1 Identifying the restructuring transactions: functions, assets and risks before and after the restructuring

9.53 Restructurings can take a variety of different forms and may involve only two or more than two members of an MNE group. For example, a simple pre-restructuring arrangement could involve a full-fledged manufacturer producing goods and selling them to an associated full-fledged distributor for on-sale into the market. The restructuring could involve a modification to that two-party arrangement, whereby the distributor is converted to a limited risk distributor or commissionaire, with risks previously borne by the full-fledged distributor being assumed by the manufacturer (see discussion of risks in Part I of this chapter). Frequently, the restructuring will be more complicated, with functions performed, assets used and/or risks assumed by either or both parties to a pre-restructuring arrangement shifting to one or more additional members of the group.

9.54 In order to determine the arm's length compensation payable upon a restructuring to any restructured entity within an MNE group, as well as the member of the group that should bear such compensation, it is important to identify the transaction or transactions occurring between the restructured entity and one or more other members of the group. This analysis will typically include an identification of the functions, assets and risks before and after the restructuring. It may be important to perform an evaluation of the rights and obligations of the restructured entity under the pre-restructuring arrangement (including in relevant circumstances those existing under contract and commercial law) and of the manner and extent to which those rights and obligations change as a result of the restructuring.

9.55 Obviously, any evaluation of the rights and obligations of the restructured entity must be based upon the requirement that those rights and obligations reflect the economic principles that generally govern relationships between independent enterprises (see paragraphs 1.52 and 1.53). For example, a restructured entity may legally be under a short term or "at will" contractual arrangement at the time of the restructuring. However, the actual conduct of the entity in the years or decades prior to the restructuring may be indicative of a longer-term arrangement, and hence greater rights than those indicated by the legal contractual arrangement.

9.56 In the absence of evidence of rights and obligations in a comparable situation, it may be necessary to determine what rights and obligations would have been put in place had the two parties transacted with each other at arm's length. In making such an evaluation, care must be taken to avoid the use of hindsight (see paragraph 3.74).

B.2 Understanding the business reasons for and the expected benefits from the restructuring, including the role of synergies

9.57 Business representatives who participated in the OECD consultation process explained that multinational businesses, regardless of their products or sectors, increasingly needed to reorganize their structures to provide more centralized control and management of manufacturing, research and distribution functions. The pressure of competition in a globalised economy, savings from economies of scale, the need for specialization and the need to increase efficiency and lower costs were all described as important in driving business restructuring. Where anticipated synergies are put forward by a taxpayer as an important business reason for the restructuring, it would be a good practice for the taxpayer to document, at the time the restructuring is decided upon or implemented, what these anticipated synergies are and on what assumptions they are anticipated. This is a type of documentation that is likely to be produced at the group level for non-tax purposes, to support the decision-making process of the restructuring. For Article 9 purposes, it would be a good practice for the taxpayer to document how these anticipated synergies impact at the entity level in applying the arm's length principle. Furthermore, while anticipated synergies may be

relevant to the understanding of a business restructuring, care must be taken to avoid the use of hindsight in *ex post* analyses (see paragraph 3.74).

9.58 The fact that a business restructuring may be motivated by anticipated synergies does not necessarily mean that the profits of the MNE group will effectively increase after the restructuring. It may be the case that enhanced synergies make it possible for the MNE group to derive additional profits compared to what the situation would have been in the future if the restructuring had not taken place, but there may not necessarily be additional profits compared to the pre-restructuring situation, for instance if the restructuring is needed to maintain competitiveness rather than to increase it. In addition, expected synergies do not always materialise – there can be cases where the implementation of a global business model designed to derive more group synergies in fact leads to additional costs and less efficiency.

B.3 Other options realistically available to the parties

9.59 The application of the arm's length principle is based on the notion that independent enterprises, when evaluating the terms of a potential transaction, will compare the transaction to the other options realistically available to them, and they will only enter into the transaction if they see no alternative that is clearly more attractive. In other words, independent enterprises would only enter into a transaction if it does not make them worse off than their next best option. Consideration of the other options realistically available may be relevant to comparability analysis, to understand the respective positions of the parties.

9.60 Thus, in applying the arm's length principle, a tax administration evaluates each transaction as structured by the taxpayer, unless such transaction is not recognised in accordance with the guidance at paragraph 1.65. However, alternative structures realistically available are considered in evaluating whether the terms of the controlled transaction (particularly pricing) would be acceptable to an uncontrolled taxpayer faced with the same alternatives and operating under comparable circumstances. If a more profitable structure could have been adopted, but the economic substance of the taxpayer's structure does not differ from its form and the structure is not commercially irrational such that it would practically impede a tax administration from determining an appropriate transfer price, the transaction is not disregarded. However, the consideration in the controlled transaction may be adjusted by reference to the profits that could have been obtained in the alternative structure, since independent enterprises will only enter into a transaction if they see no alternative that is clearly more attractive.

9.61 At arm's length, there are situations where an entity would have had one or more options realistically available to it that would be clearly more attractive than to accept the conditions of the restructuring (taking into account all the relevant conditions, including the commercial and market conditions going forward, the profit potential of the various options and any compensation or indemnification for the restructuring), including possibly the option not to enter into the restructuring transaction. In such cases, an independent party may not have agreed to the conditions of the restructuring.

9.62 At arm's length, there are also situations where the restructured entity would have had no clearly more attractive option realistically available to it than to accept the conditions of the restructuring, *e.g.* a contract termination – with or without indemnification as discussed at Section E below. In longer-term contracts, this may occur by invoking an exit clause that allows for one party to prematurely exit the contract with just cause. In contracts that allow either party to opt out of the contract, the party terminating the arrangement may choose to do so because it has determined, subject to the terms of the termination clause, that it is more favourable to stop using the function, or to internalise it, or to engage a cheaper or more efficient provider (recipient) or to seek more lucrative opportunities (provider). In case the restructured entity transfers rights or other assets or an ongoing concern to another party, it might however be compensated for such a transfer as discussed in Section D below.

9.63 The arm's length principle requires an evaluation of the conditions made or imposed between associated enterprises, at the level of each of them. The fact that the cross-border redeployment of functions, assets and/or risks may be motivated by sound commercial reasons at the level of the MNE group, *e.g.* in order to try to derive synergies at a group level, does not answer the question whether it is arm's length from the perspectives of each of the restructured entities.

9.64 The reference to the notion of options realistically available is not intended to create a requirement for taxpayers to document all possible hypothetical options realistically available. As noted at paragraph 3.81, when undertaking a comparability analysis, there is no requirement for an exhaustive search of all possible relevant sources of information. Rather, the intention is to provide an indication that, if there is a realistically available option that is clearly more attractive, it should be considered in the analysis of the conditions of the restructuring.

C. Reallocation of profit potential as a result of a business restructuring

C.1 Profit potential

9.65 An independent enterprise does not necessarily receive compensation when a change in its business arrangements results in a reduction in its profit potential or expected future profits. The arm's length principle does not require compensation for a mere decrease in the expectation of an entity's future profits. When applying the arm's length principle to business restructurings, the question is whether there is a transfer of something of value (rights or other assets) or a termination or substantial renegotiation of existing arrangements and that transfer, termination or substantial renegotiation would be compensated between independent parties in comparable circumstances. These two situations are discussed in Sections D and E below.

9.66 In these Guidelines, "profit potential" means "expected future profits". In some cases it may encompass losses. The notion of "profit potential" is often used for valuation purposes, in the determination of an arm's length compensation for a transfer of intangibles or of an ongoing concern, or in the determination of an arm's length indemnification for the termination or substantial renegotiation of existing arrangements, once it is found that such compensation or indemnification would have taken place between independent parties in comparable circumstances.

9.67 In the context of business restructurings, profit potential should not be interpreted as simply the profits/losses that would occur if the pre-restructuring arrangement were to continue indefinitely. On the one hand, if an entity has no discernable rights and/or other assets at the time of the restructuring, then it has no compensable profit potential. On the other hand, an entity with considerable rights and/or other assets at the time of the restructuring may have considerable profit potential, which must ultimately be appropriately remunerated in order to justify the sacrifice of such profit potential.

9.68 In order to determine whether at arm's length the restructuring itself would give rise to a form of compensation, it is essential to understand the restructuring, including the changes that have taken place, how they have affected the functional analysis of the parties, what the business reasons for and the anticipated benefits from the restructuring were, and what options would have been realistically available to the parties, as discussed in Section B.

C.2 Reallocation of risks and profit potential

9.69 Business restructurings often involve changes in the respective risk profiles of the associated enterprises. Risk reallocations can follow from a transfer of something of value as discussed in Section D below, and/or from a termination or substantial renegotiation of existing arrangements, as discussed in Section E. General guidance on the transfer pricing aspects of risks is found in Part I of this chapter.

9.70 Take the example of a conversion of a full-fledged manufacturer into a contract manufacturer. In such a case, while a cost plus reward might be an arm's length remuneration for undertaking the post-restructuring contract manufacturing operations, a different question is whether there should be indemnification at arm's length for the change in the existing arrangements which results in the surrender of the riskier profit potential by the manufacturer, taking into account its rights and other assets.

9.71 As another example, assume a distributor is operating at its own risk under a long term contractual arrangement for a given type of transaction. Assume that, based on its rights under the long term contract with respect to these transactions, it has the option realistically available to it to accept or refuse being converted into a low risk distributor operating for a foreign associated enterprise, and that an arm's length remuneration for such a low risk distribution activity is estimated to be a stable profit of +2% per year while the excess profit potential associated with the risks would now be attributed to the foreign associated enterprise. Assume for the purpose of this example that such a restructuring would be implemented solely via a renegotiation of the existing contractual arrangements, with no transfer of assets taking place. From the perspective of the distributor, the question arises as to whether the new arrangement (taking into account both the remuneration for the post-restructuring transactions and any compensation for the restructuring itself) would make it as well off as or better off than its realistic – albeit riskier – alternatives. If not, this would imply that the post-restructuring arrangement is mis-priced or that additional compensation would be needed to appropriately remunerate the distributor for the restructuring. From the perspective of the foreign associated enterprise, the question arises whether and if so to what extent it would be willing to accept the risk at arm's length in situations where the distributor continues to perform the same activity in a new capacity.

9.72 At arm's length, the response is likely to depend on the rights and other assets of the parties, on the profit potential of the distributor and of its associated enterprise in relation to both business models (full-fledged and low risk distributor) as well as the expected duration of the new arrangement. The perspective of the distributor can be illustrated with the following example.

Note: This example is for illustration only. It is not intended to say anything about the choice of the most appropriate transfer pricing method, about aggregation of transactions, or about arm's length remuneration rates for distribution activities. It is assumed in this example that the change in the allocation of risk to the distributor derives from the renegotiation of the existing distribution arrangement which reallocates risk between the parties. This example is intended to illustrate the perspective of the distributor. It does not take account of the perspective of the foreign associated enterprise (principal), although both perspectives should be taken into account in the transfer pricing analysis.

Distributor's pre-conversion profits: historical data from the last five years (full risk activity) (net profit margin / sales)	Distributor's future profit expectations for the next three years (if had remained full-risk, assuming it had the option realistically available to do so) (net profit margin / sales)	Distributor's post-conversion profits (low risk activity) (net profit margin / sales)
Case no. 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 no. 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 no. 3: Year 1: + 5% Year 2: + 7% Year 3: + 10% Year 4: +8% Year 5: +6%	[0% to + 4%] with significant uncertainties within that range (e.g. due to new competitive pressures)	guaranteed, stable profit of +2% per year

9.73 In case no. 1, the distributor is surrendering a profit potential with significant uncertainties for a relatively low but stable profit. Whether an independent party would be willing to do so would depend on its anticipated return under both scenarios, on its level of risk tolerance, on its options realistically available and on possible compensation for the restructuring itself. In case no. 2, it is unlikely that independent parties in the distributor's situation would agree to relocate the risks and associated profit potential for no additional compensation if they had the option to do otherwise. Case no. 3 illustrates the fact that the analysis should take account of the profit potential going forward and that, where there is a significant change in the commercial or economic environment, relying on historical data alone will not be sufficient.

D. Transfer of something of value (e.g. an asset or an ongoing concern)

9.74 Sections D.1 to D.3 below contain a discussion of some typical transfers that can arise in business restructurings: transfers of tangible assets, of intangible assets and of activities (ongoing concern).

D.1 Tangible assets

9.75 Business restructurings can involve the transfer of tangible assets (e.g. equipment) by a restructured entity to a foreign associated enterprise. Although it is generally considered that transfers of tangible assets do not raise any significant transfer pricing difficulty, one common issue relates to the valuation of inventories that are transferred upon the conversion by a restructured manufacturer or distributor to a foreign associated enterprise (e.g. a principal), where the latter takes title to the inventories as from the implementation of the new business model and supply chain arrangements.

Illustration

Note: The following example is solely intended to illustrate the issue around valuation of inventory transfers. It is not intended to say anything about whether or not a particular restructuring should be recognised by tax authorities or whether or not it is consistent with the arm's length principle, nor is it intended to suggest that a particular transfer pricing method is always acceptable for restructured operations.

9.76 Assume a taxpayer, which is a member of an MNE group, used to operate as a “fully-fledged” manufacturer and distributor. According to the pre-restructuring business model, the taxpayer purchased raw materials, manufactured finished products using tangible and intangible property that belonged to it or was rented/licensed to it, performed marketing and distribution functions and sold the finished products to third party customers. In doing so, the taxpayer was bearing a series of risks such as inventory risks, bad debt risks and market risks.

9.77 Assume the arrangement is restructured and the taxpayer now operates as a so-called “toll-manufacturer” and “stripped distributor”. As part of the restructuring, a foreign associated enterprise is established that acquires various trade and marketing intangibles from various affiliates including the taxpayer. Further to the restructuring, raw materials are to be acquired by the foreign associated enterprise, put in consignment in the premises of the taxpayer for manufacturing in exchange for a manufacturing fee. The stock of finished products will belong to the foreign associated enterprise and be acquired by the taxpayer for immediate re-sale to third party customers (*i.e.* the taxpayer will only purchase the finished products once it has concluded a sale with a customer). Under this new business model, the foreign associated enterprise will bear the inventory risks that were previously borne by the taxpayer.

9.78 Assume that in order to migrate from the pre-existing arrangement to the restructured one, the raw materials and finished products that are on the balance sheet of the taxpayer at the time the new arrangement is put in place are transferred to the foreign associated enterprise. The question arises how to determine the arm's length transfer price for the inventories upon the conversion. This is an issue that can typically be encountered where there is a transition from one business model to another. The arm's length principle applies to transfers of inventory among associated enterprises situated in different tax jurisdictions. The choice of the appropriate transfer pricing method depends upon the comparability (including functional) analysis of the parties. The functional analysis may have to cover a transition period over which the transfer is being implemented. For instance, in the above example:

- One possibility could be to determine the arm's length price for the raw material and finished products by reference to comparable uncontrolled prices, to the extent the comparability factors can be met by such comparable uncontrolled prices, *i.e.* that the conditions of the uncontrolled transaction are comparable to the conditions of the transfer that takes place in the context of the restructuring.
- Another possibility could be to determine the transfer price for the finished products as the resale price to customers minus an arm's length remuneration for the marketing and distribution functions that still remain to be performed.
- A further possibility would be to start from the manufacturing costs and add an arm's length mark-up to remunerate the manufacturer for the functions it performed, assets it used and risks it assumed with respect to these inventories. There are however cases where the market value of the inventories is too low for a profit element to be added on costs at arm's length.

9.79 The choice of the appropriate transfer pricing method depends in part on which part of the transaction is the less complex and can be evaluated with the greater certainty (the functions performed, assets used and risks assumed by the manufacturer, or the marketing and sales functions that remain to be performed taking account of the assets to be used and risks to be assumed to perform these functions). See paragraphs 3.18–3.19 on the choice of the tested party.

D.2 Intangible assets

9.80 Transfers of intangible assets raise difficult questions both as to the identification of the assets transferred and as to their valuation. Identification can be difficult because not all valuable intangible assets are legally protected and registered and not all valuable intangible assets are recorded in the accounts. Relevant intangible assets might potentially include rights to use industrial assets such as patents, trademarks, trade names, designs or models, as well as copyrights of literary, artistic or scientific work (including software) and intellectual property such as know-how and trade secrets. They may also include customer lists, distribution channels, unique names, symbols or pictures. An essential part of the analysis of a business restructuring is to identify the significant intangible assets that were transferred (if any), whether independent parties would have remunerated their transfer, and what their arm's length value is.

9.81 The determination of the arm's length price for a transfer of intangible property right should take account of both the perspective of the transferor and of the transferee (see paragraph 6.14). It will be affected by a number of factors among which are the amount, duration and riskiness of the expected benefits from the exploitation of the intangible property, the nature of the property right and the restrictions that may be attached to it (restrictions in the way it can be used or exploited, geographical restrictions, time limitations), the extent and remaining duration of its legal protection (if any), and any exclusivity clause that might be attached to the right. Valuation of intangibles can be complex and uncertain. The general guidance on intangibles and on cost contribution arrangements that is found in Chapters VI and VIII can be applicable in the context of business restructurings.

D.2.1 Disposal of intangible rights by a local operation to a central location (foreign associated enterprise)

9.82 Business restructurings sometimes involve the transfer of intangible assets that were previously owned and managed by one or more local operation(s) to a central location situated in another tax jurisdiction (*e.g.* a foreign associated enterprise that operates as a principal or as a so-called “IP company”). The intangible assets transferred may or may not be valuable for the transferor and/or for the MNE group as a whole. In some cases the transferor continues to use the intangible transferred, but does so in another legal capacity (*e.g.* as a licensee of the transferee, or through a contract that includes limited rights to the intangible such as a contract manufacturing arrangement using patents that were transferred; or a “stripped” distribution arrangement using a trademark that was transferred); in some other cases it does not.

9.83 MNE groups may have sound business reasons to centralize ownership and management of intangible property. An example in the context of business restructuring is a transfer of intangibles that accompanies the specialisation of manufacturing sites within an MNE group. In a pre-restructuring environment, each manufacturing entity may be the owner and manager of a series of patents – for instance if the manufacturing sites were historically acquired from third parties with their intangible property. In a global business model, each manufacturing site can be specialised by type of manufacturing process or by geographical area rather than by patent. As a consequence of such a restructuring the MNE group might proceed with the transfer of all the locally owned and managed patents to a central location which will in turn give contractual rights (through licences or manufacturing agreements) to all the group's

manufacturing sites to manufacture the products falling in their new areas of competence, using patents that were initially owned either by the same or by another entity within the group.

9.84 The arm's length principle requires an evaluation of the conditions made or imposed between associated enterprises, at the level of each of them. The fact that centralisation of intangible property rights may be motivated by sound commercial reasons at the level of the MNE group does not answer the question whether the disposal is arm's length from the perspectives of both the transferor and the transferee.

9.85 Also in the case where a local operation disposes of its intangible property rights to a foreign associated enterprise and continues to use the intangibles further to the disposal, but does so in a different legal capacity (e.g. as a licensee), the conditions of the transfer should be assessed from both the transferor's and the transferee's perspectives, in particular by examining the pricing at which comparable independent enterprises would be willing to transfer and acquire the property. See paragraph 9.81. The determination of an arm's length remuneration for the subsequent ownership, use and exploitation of the transferred asset should take account of the extent of the functions performed, assets used and risks assumed by the parties in relation to the intangible transferred. This is particularly relevant to business restructurings as several countries have expressed a concern that relevant information on the functions, assets and risks of foreign associated enterprises is often not made available to them.

9.86 Where the business restructuring provides for a transfer of an intangible asset followed by a new arrangement whereby the transferor will continue to use the intangible transferred, the entirety of the commercial arrangement between the parties should be examined in order to assess whether the transactions are at arm's length. If an independent party were to transfer an asset that it intends to continue exploiting, it would be prudent for it to negotiate the conditions of such a future use (e.g. in a license agreement) concomitantly with the conditions of the transfer. In effect, there will generally be a relationship between the determination of an arm's length compensation for the transfer, the determination of an arm's length compensation for the post-restructuring transactions in relation to the transferred intangible, such as future license fees that may be payable by the transferor to be able to continue using the asset, and the expected future profitability of the transferor from its future use of the asset. For instance, an arrangement whereby a patent is transferred for a price of 100 in Year N and a license agreement is concomitantly concluded according to which the transferor will continue to use the patent transferred in exchange for a royalty of 100 per year over a 10-year period is unlikely to be consistent with the arm's length principle.

D.2.2 Intangible transferred at a point in time when it does not have an established value

9.87 Difficulties can arise in the context of business restructuring where an intangible is disposed of at a point in time when it does not yet have an established value (e.g. pre-exploitation), especially where there is a significant gap between the level of expected future profits that was taken into account in the valuation made at the time of the sale transaction and the actual profits derived by the transferee from the exploitation of the intangibles thus acquired. When valuation of intangible property at the time of the transaction is highly uncertain, the question is raised how arm's length pricing should be determined. The question should be resolved, both by taxpayers and tax administrations, by reference to what independent enterprises would have done in comparable circumstances to take account of the valuation uncertainty in the pricing of the transaction. See paragraphs 6.28-6.35 and examples in the Annex to Chapter VI "Examples to illustrate the Transfer Pricing Guidelines on intangible property and highly uncertain valuation."

9.88 Following that guidance, the main question is to determine whether the valuation was sufficiently uncertain at the outset that the parties at arm's length would have required a price adjustment mechanism, or whether the change in value was so fundamental a development that it would have led to a renegotiation

of the transaction. Where this is the case, the tax administration would be justified in determining the arm's length price for the transfer of the intangible on the basis of the adjustment clause or re-negotiation that would be provided at arm's length in a comparable uncontrolled transaction. In other circumstances, where there is no reason to consider that the valuation was sufficiently uncertain at the outset that the parties would have required a price adjustment clause or would have renegotiated the terms of the agreement, there is no reason for tax administrations to make such an adjustment as it would represent an inappropriate use of hindsight. The mere existence of uncertainty at the time of the transaction should not require an *ex-post* adjustment without a consideration of what third parties would have done or agreed between them.

D.2.3 Local intangibles

9.89 Where a local full-fledged operation is converted into a "limited risk, limited intangibles, low remuneration" operation, the questions arise of whether this conversion entails the transfer by the restructured local entity to a foreign associated enterprise of valuable intangible assets such as customer lists and whether there are local intangible assets that remain with the local operation.

9.90 In particular, in the case of the conversion of a full-fledged distributor into a limited risk distributor or commissionaire, it may be important to examine whether the distributor has developed local marketing intangibles over the years prior to it being restructured and if so, what the nature and the value of these intangibles are, and whether they were transferred to an associated enterprise. Where such local intangibles are found to be in existence and to be transferred to a foreign associated enterprise, the arm's length principle should apply to determine whether and if so how to compensate such a transfer, based on what would be agreed between independent parties in comparable circumstances. On the other hand, where such local intangibles are found to be in existence and to remain in the restructured entity, they should be taken into account in the functional analysis of the post-restructuring activities. They may accordingly influence the selection and application of the most appropriate transfer pricing method for the post-restructuring controlled transactions, and / or be remunerated separately, *e.g.* via royalty payments made by the foreign associated enterprise which will exploit them as from the restructuring to the restructured entity over the life-span of the intangibles.⁴

D.2.4 Contractual rights

9.91 Contractual rights can be valuable intangible assets. Where valuable contractual rights are transferred (or surrendered) between associated enterprises, they should be remunerated at arm's length, taking account of the value of the rights transferred from the perspectives of both the transferor and the transferee.

9.92 Tax administrations have expressed concerns about cases they have observed in practice where an entity voluntarily terminates a contract that provided benefits to it, in order to allow a foreign associated enterprise to enter into a similar contract and benefit from the profit potential attached to it. For instance, assume that company A has valuable long-term contracts with independent customers that carry significant profit potential for A. Assume that at a certain point in time, A voluntarily terminates its contracts with its customers under circumstances where the latter are legally or commercially obligated to enter into similar arrangements with company B, a foreign entity that belongs to the same MNE group as A. As a consequence, the contractual rights and attached profit potential that used to lie with A now lie with B. If the factual situation is that B could only enter into the contracts with the customers subject to A's surrendering its own contractual rights to its benefit, and that A only terminated its contracts with its customers knowing that the latter were legally or commercially obligated to conclude similar arrangements with B, this in substance would consist in a tri-partite transaction and it may amount to a transfer of

⁴ See Part III of this chapter for a discussion of the remuneration of the post-restructuring arrangements.

valuable contractual rights from A to B that may have to be remunerated at arm's length, depending on the value of the rights surrendered by A from the perspectives of both A and B.

D.3 Transfer of activity (ongoing concern)

D.3.1 Valuing a transfer of activity

9.93 Business restructurings sometimes involve the transfer of an ongoing concern, *i.e.* a functioning, economically integrated business unit. The transfer of an ongoing concern in this context means the transfer of assets, bundled with the ability to perform certain functions and bear certain risks. Such functions, assets and risks may include, among other things: tangible and intangible property; liabilities associated with holding certain assets and performing certain functions, such as R&D and manufacturing; the capacity to carry on the activities that the transferor carried on before the transfer; and any resource, capabilities, and rights. The valuation of a transfer of an ongoing concern should reflect all the valuable elements that would be remunerated between independent parties in comparable circumstances. For example, in the case of a business restructuring that involves the transfer of a business unit that includes, among other things, research facilities staffed with an experienced research team, the valuation of such ongoing concern should reflect, among other things, the value of the facility and the value (if any) of the workforce in place that would be agreed upon at arm's length.

9.94 The determination of the arm's length compensation for a transfer of an ongoing concern does not necessarily amount to the sum of the separate valuations of each separate element that comprises the aggregate transfer. In particular, if the transfer on an ongoing concern comprises multiple contemporaneous transfers of interrelated assets, risks, or functions, valuation of those transfers on an aggregate basis may be necessary to achieve the most reliable measure of the arm's length price for the ongoing concern. Valuation methods that are used, in acquisition deals, between independent parties may prove useful to valuing the transfer of an ongoing concern between associated enterprises.

9.95 An example is the case where a manufacturing activity that used to be performed by M1, one entity of the MNE group, is re-located to another entity, M2 (*e.g.* to benefit from location savings). Assume M1 transfers to M2 its machinery and equipment, inventories, patents, manufacturing processes and know-how, and key contracts with suppliers and clients. Assume that several employees of M1 are relocated to M2 in order to assist M2 in the start of the manufacturing activity so relocated. Assume such a transfer would be regarded as a transfer of an ongoing concern, should it take place between independent parties. In order to determine the arm's length remuneration, if any, of such a transfer between associated enterprises, it should be compared with a transfer of an ongoing concern between independent parties rather than with a transfer of isolated assets.

D.3.2 Loss-making activities

9.96 Not every case where a restructured entity loses functions, assets and / or risks involves an actual loss of expected future profits. In some restructuring situations, the circumstances may be such that, rather than losing a "profit-making opportunity", the restructured entity is actually being saved from the likelihood of a "loss-making opportunity". An entity may agree to a restructuring and a loss of functions, assets and / or risks as a better option than going out of business altogether. If the restructured entity is forecasting future losses absent the restructuring (*e.g.* it operates a manufacturing plant that is uneconomic due to increasing competition from low-cost imports), then there may be in fact no loss of any profit-making opportunity from restructuring rather than continuing to operate its existing business. In such circumstances, the restructuring might deliver a benefit to the restructured entity from reducing or eliminating future losses if such losses exceed the restructuring costs.

9.97 The question was raised of whether the transferee should in fact be compensated by the transferor for taking over a loss-making activity. The response depends on whether an independent party in comparable circumstances would have been willing to pay for getting rid of the loss-making activity, or whether it would have considered other options such as closing down the activity; and on whether a third party would have been willing to acquire the loss-making activity (*e.g.* because of possible synergies with its own activities) and if so under what conditions, *e.g.* subject to compensation. There can be circumstances where an independent party would be willing to pay, *e.g.* if the financial costs and social risks of closing down the activity would be such that the transferor finds it more advantageous to pay a transferee who will attempt to reconvert the activity and will be responsible for any redundancy plan that may be needed.

9.98 The situation might however be different where the loss-making activity provided other benefits such as synergies with other activities performed by the same taxpayer. There can also be circumstances where a loss-making activity is maintained because it produces some benefits to the group as a whole. In such a case, the question arises whether at arm's length the entity that maintains the loss-making activity should be compensated by those who benefit from it being maintained.

D.4 Outsourcing

9.99 In outsourcing cases, it may happen that a party voluntarily decides to undergo a restructuring and to bear the associated restructuring costs in exchange for anticipated savings. For instance, assume a taxpayer that is manufacturing and selling products in a high-cost jurisdiction decides to outsource the manufacturing activity to an associated enterprise situated in a low-cost jurisdiction. Further to the restructuring, the taxpayer will purchase from its associated enterprise the products manufactured and will continue to sell them to third party customers. The restructuring may entail restructuring costs for the taxpayer while at the same time making it possible for it to benefit from cost savings on future procurements compared to its own manufacturing costs. Independent parties implement this type of outsourcing arrangement and do not necessarily require explicit compensation from the transferee if the anticipated cost savings for the transferor are greater than its restructuring costs.⁵

E. Indemnification of the restructured entity for the termination or substantial renegotiation of existing arrangements

9.100 Where an existing contractual relationship is terminated or substantially renegotiated in the context of a business restructuring, the restructured entity might suffer detriments such as restructuring costs (*e.g.* write-off of assets, termination of employment contracts), re-conversion costs (*e.g.* in order to adapt its existing operation to other customer needs), and/or a loss of profit potential. In business restructurings, existing arrangements are often renegotiated in such a way that the respective risk profiles of the parties are changed, with consequences on the allocation of profit potential among them. For instance, a full-fledged distribution arrangement is converted into a low-risk distribution or commissionaire arrangement; a full-fledged manufacturing arrangement is converted into a contract-manufacturing or toll-manufacturing arrangement. In these situations, the question arises of whether independent parties in similar circumstances would have agreed for an indemnification to be paid to the restructured entity (and if so how to determine such an indemnification).

9.101 The renegotiation of existing arrangements is sometimes accompanied by a transfer of rights or other assets. For instance, the termination of a distribution contract is sometimes accompanied by a transfer of intangibles. In such cases, the guidance at Sections D and E of this part should be read together.

⁵ A further issue discussed in paragraphs 9.148-9.153 is whether and if so how location savings should be allocated between the parties at arm's length.

9.102 For the purpose of this chapter, indemnification means any type of compensation that may be paid for detriments suffered by the restructured entity, whether in the form of an up-front payment, of a sharing in restructuring costs, of lower (or higher) purchase (or sale) prices in the context of the post-restructuring operations, or of any other form.

9.103 There should be no presumption that all contract terminations or substantial renegotiations should give a right to indemnification at arm's length. In order to assess whether an indemnification would be warranted at arm's length, it is important to examine the circumstances at the time of the restructuring, particularly the rights and other assets of the parties as well as, where relevant, the options realistically available to the parties. For this purpose, the following four conditions may be important:

- Whether the arrangement that is terminated, non-renewed or substantially re-negotiated is formalised in writing and provides for an indemnification clause (see Section E.1 below);
- Whether the terms of the arrangement and the existence or non-existence of an indemnification clause or other type of guarantee (as well as the terms of such a clause where it exists) are arm's length (see Section E.2 below);
- Whether indemnification rights are provided for by commercial legislation or case law (see Section E.3 below); and
- Whether at arm's length another party would have been willing to indemnify the one that suffers from the termination or re-negotiation of the agreement (see Section E.4 below).

E.1 Whether the arrangement that is terminated, non-renewed or substantially renegotiated is formalised in writing and provides for an indemnification clause

9.104 Where the terminated, non-renewed or re-negotiated arrangement is formalised in writing,⁶ the starting point of the analysis should be a review of whether the conditions for termination, non-renewal or renegotiation of the contract were respected (*e.g.* with regard to any required notice period) and of whether an indemnification clause or other kind of guarantee for termination, non-renewal or renegotiation is provided for. As noted at paragraph 1.53, in transactions between independent enterprises, the divergence of interests between the parties ensures that they will ordinarily seek to hold each other to the terms of the contract, and that contractual terms will be ignored or modified after the fact generally only if it is in the interests of both parties.

9.105 However, the examination of the terms of the contract between the associated enterprises may not suffice from a transfer pricing perspective as the mere fact that a given terminated, non-renewed or renegotiated contract did not provide an indemnification or guarantee clause does not necessarily mean that this is arm's length, as discussed below.

⁶ As noted at paragraph 1.52, the terms of a transaction may also be found in correspondence/communications between the parties other than a written contract. Where no written terms exist, the contractual relationships of the parties must be deduced from their conduct and the economic principles that generally govern relationships between independent enterprises.

E.2 Whether the terms of the arrangement and the existence or non-existence of an indemnification clause or other type of guarantee (as well as the terms of such a clause where it exists) are arm's length

9.106 Between independent parties, there are cases of contracts that are terminated, non-renewed or substantially renegotiated with no indemnification. However, because the same divergence of interests that exists between independent parties may not exist in the case of associated enterprises, the question can arise whether the terms of a contract between associated enterprises are arm's length, *i.e.* whether independent parties in comparable conditions would have concluded such a contract (for instance a contract that contains no indemnification clause or guarantee of any kind in case of termination, non-renewal or renegotiation). Where comparables data evidence a similar indemnification clause (or absence thereof) in comparable circumstances, the indemnification clause (or absence thereof) in a controlled transaction will be regarded as arm's length. In those cases however where such comparables data are not found, the determination of whether independent parties would have agreed to such an indemnification clause (or absence thereof) should take into account the rights and other assets of the parties, at the time of entering into the arrangement and of its termination or renegotiation, and might be assisted by an examination of the options realistically available to the parties.⁷

9.107 When examining whether the conditions of an arrangement are arm's length, it may be necessary to examine both the remuneration of the transactions that are the object of the arrangement and the financial conditions of the termination thereof, as both can be inter-related. In effect, the terms of a termination clause (or the absence thereof) may be a significant element of the functional analysis of the transactions and specifically of the analysis of the risks of the parties, and may accordingly need to be taken into account in the determination of an arm's length remuneration for the transactions. Similarly, the remuneration of the transactions will affect the determination of whether the conditions of the termination of the arrangement are at arm's length.

9.108 In some situations, it may be the case that, in comparable circumstances, an independent party would not have had any option realistically available that would be clearly more attractive to it than to accept the conditions of the termination or substantial renegotiation of the contract. In some other cases, it may be that, on the basis of an examination of the substance of the arrangement and of the actual conduct of the associated enterprises, an implicit longer term contract should be implied whereby the terminated party would have been entitled to some indemnification in case of early termination.

9.109 One circumstance that deserves particular attention, because it could have influenced the terms of the contract had it been concluded between independent parties, is the situation where the now-terminated contract required one party to make a significant investment for which an arm's length return might only be reasonably expected if the contract was maintained for an extended period of time. This created a financial risk for the party making the investment in case the contract was terminated before the end of such period of time. The degree of the risk would depend on whether the investment was highly specialised or could be used (possibly subject to some adaptations) for other clients. Where the risk was material, it would have been reasonable for independent parties in comparable circumstances to take it into account when negotiating the contract.

9.110 An example would be where a manufacturing contract between associated enterprises requires the manufacturer to invest in a new manufacturing unit. Assume an arm's length return on the investment can reasonably be anticipated by the manufacturer at the time the contract is concluded, subject to the manufacturing contract lasting for at least five years, for the manufacturing activity to produce at least *x* units per year, and for the remuneration of the manufacturing activity to be calculated on a basis (*e.g.*

⁷ See paragraphs 9.59-9.64 for a discussion of options realistically available.

y\$/unit) that is expected to generate an arm's length return on the total investment in the new manufacturing unit. Assume that after three years, the associated enterprise terminates the contract in accordance with its terms in the context of a group-wide restructuring of the manufacturing operations. Assume the manufacturing unit is highly specialised and the manufacturer further to the termination has no other choice than to write off the assets. The question arises of whether in comparable circumstances, an independent manufacturer in the first place would have sought to mitigate the financial risk linked to the investment in case of termination of its manufacturing contract before the end of the five-year period it needed to obtain an arm's length return on its investment.

9.111 The general guidance in Part I of this chapter on how to determine whether a risk allocation is arm's length would be relevant in such a case. In case comparable uncontrolled transactions are found that evidence a similar allocation of risks in uncontrolled transactions (taking account in particular the conditions of the investment, the remuneration of the manufacturing activity and the conditions of the termination), then the risk allocation between the associated enterprises would be regarded as arm's length.

9.112 In case such evidence is not found, the question would be whether independent parties would have agreed to a similar allocation of risk. This will depend on the facts and circumstances of the transaction and in particular on the rights and other assets of the parties.

- At arm's length the party making the investment might not be willing to assume with no guarantee a risk (termination risk) that is controlled by the other (see paragraphs 1.49 and 9.17-9.33). There can be a variety of ways in which such a risk might have been taken into account in contract negotiations, for instance by providing for an appropriate indemnification clause in case of early termination, or for an option for the party making the investment to transfer it at a given price to the other party in case the investment becomes useless to the former due to the early termination of the contract by the latter.
- Another possible approach would have been to factor the risk linked with the possible termination of the contract into the determination of the remuneration of the activities covered by the contract (*e.g.* by factoring the risk into the determination of the remuneration of the manufacturing activities and using third party comparables that bear comparable risks). In such a case the party making the investment consciously accepts the risk and is rewarded for it; no separate indemnification for the termination of the contract seems necessary.
- Finally, in some cases, the risks might be shared between the parties, *e.g.* the party terminating the contract might bear part of the termination costs incurred by the terminated one.

9.113 A similar issue may arise in the case where a party has undertaken development efforts resulting in losses or low returns in the early period and above-normal returns are expected in periods following the termination of the contract.

9.114 In the case where the conditions made or imposed between associated enterprises with respect to the termination, non-renewal or substantial renegotiation of their existing arrangements differ from the conditions that would be made between independent enterprises, then any profits that would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

E.3 Whether indemnification rights are provided for by commercial legislation or case law

9.115 In the assessment of whether the conditions of the termination or non-renewal of an existing arrangement are arm's length, the possible recourse that may be offered by the applicable commercial law might provide some helpful insights. The applicable commercial legislation or case law may provide useful information on indemnification rights and terms and conditions that could be expected in case of termination of specific types of agreements, *e.g.* of a distributorship agreement. Under such rules, it may be that the terminated party has the right to claim before the courts an indemnification irrespective of whether or not it was provided for in the contract. Where the parties belong to the same MNE group, however, the terminated party is unlikely in practice to litigate against its associated enterprise in order to seek such an indemnification, and the conditions of the termination may therefore differ from the conditions that would be made between independent enterprises in similar circumstances.

E.4 Whether at arm's length another party would have been willing to indemnify the one that suffers from the termination or re-negotiation of the agreement

9.116 The transfer pricing analysis of the conditions of the termination or substantial renegotiation of an agreement should take account of both the perspectives of the transferor and of the transferee. Taking account of the transferee's perspective is important both to value the amount of an arm's length indemnification, if any, and to determine what party should bear it. It is not possible to derive a single answer for all cases and the response should be based on an examination of the facts and circumstances of the case, and in particular of the rights and other assets of the parties, of the economic rationale for the termination, of the determination of what party(ies) is (are) expected to benefit from it, and of the options realistically available to the parties. This can be illustrated as follows.

9.117 Assume a manufacturing contract between two associated enterprises, entity A and entity B, is terminated by A (B being the manufacturer). Assume A decides to use another associated manufacturer, entity C, to continue the manufacturing that was previously performed by B. As noted at paragraph 9.103, there should be no presumption that all contract terminations or substantial renegotiations should give a right to indemnification at arm's length. Assume that it is determined, following the guidance at Sections E.1 to E.3 above, that in the circumstances of the case, should the transaction take place between independent parties, B would be in a position to claim an indemnification for the detriment suffered from the termination. The question arises of whether such an indemnification should be borne by A (*i.e.* the party terminating the contract), C (*i.e.* the party taking over the manufacturing activity previously performed by B), their parent company P, or any other party.

9.118 As indicated in Section E.1, the starting point in the analysis would be a review of the contractual terms between A and B. In some cases, contractual terms involving C, P and/or another party might also be relevant. The response depends on whether at arm's length these entities would be willing to pay such a termination indemnification.

9.119 There can be situations where A would be willing to bear the indemnification costs at arm's length, for instance because it expects that the termination of its agreement with B will make it possible for it to derive costs savings through its new manufacturing agreement with C, and that the present value of these expected costs savings is greater than the amount of the indemnification.

9.120 There can be situations where C would be willing to pay such an amount as an entrance fee to obtain the manufacturing contract from A, *e.g.* if the present value of the expected profits to be derived from its new manufacturing contract makes it worth the investment for C. In such situations, the payment by C might be organised in a variety of ways, for instance it might be that C would be paying B, or that C

would be paying A, or that C would be constructively paying A by meeting A's indemnification obligation to B.

9.121 There can be cases where at arm's length A and C would be willing to share the indemnification costs.

9.122 There can also be cases where neither A nor C would be willing to bear the indemnification costs at arm's length because neither of them expects to derive sufficient benefits from the change. It can be the case that such termination is part of a group-wide restructuring decided by the parent company P in order to derive group-wide synergies, and that the indemnification of B should be borne by P at arm's length (unless, for example, B, notwithstanding that its contract has been terminated or renegotiated, derives benefits from group-wide synergies that outweigh the cost to it of termination or renegotiation).

Part III: Remuneration of post-restructuring controlled transactions

A. Business restructurings versus “structuring”

A.1 General principle: no different application of the arm’s length principle

9.123 The arm’s length principle and these Guidelines do not and should not apply differently to post-restructuring transactions as opposed to transactions that were structured as such from the beginning. Doing otherwise would create a competitive distortion between existing players who restructure their activities and new entrants who implement the same business model without having to restructure their business.

9.124 Comparable situations must be treated in the same way. The selection and practical application of an appropriate transfer pricing method must be determined by the comparability analysis, including the functional analysis of the parties and a review of the contractual arrangements. The same comparability standard and the same guidance on the selection and application of transfer pricing methods apply irrespective of whether or not an arrangement came into existence as a result of a restructuring of a previously existing structure.

9.125 However, business restructuring situations involve change, and the arm’s length principle must be applied not only to the post-restructuring transactions, but also to additional transactions that take place upon the restructuring and consist in the redeployment of functions, assets and/or risks. The application of the arm’s length principle to those additional transactions is discussed in Part II of this chapter.

9.126 In addition, 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, as discussed below. These factual differences do not affect the arm’s length principle or the way the guidance in these Guidelines should be interpreted and applied, but they may affect the comparability analysis and therefore the outcome of this application. See Section D on comparing the pre- and post-restructuring situations.

A.2 Possible factual differences between situations that result from a restructuring and situations that were structured as such from the beginning

9.127 Where an arrangement between associated enterprises replaces an existing arrangement (restructuring), there may be factual differences in the starting position of the restructured entity compared to the position of a newly set up operation. Such differences can arise for example from the fact that the post-restructuring arrangement is negotiated between parties that have had prior contractual and commercial relationships. In such a situation, depending on the facts and circumstances of the case and in particular on the rights and obligations derived by the parties from these prior arrangements, this may affect the options realistically available to the parties in negotiating the terms of the new arrangement and therefore the conditions of the restructuring and / or of the post-restructuring arrangements.⁸ For instance, assume a party has proved in the past to be able to perform well as a “full-fledged distributor” performing a whole range of marketing and selling functions, employing and developing valuable marketing intangible assets and assuming a range of risks associated with its activity such as inventory risks, bad debt risks and market risks. Assume that its distribution contract is re-negotiated and converted into a “limited risk

⁸ See paragraphs 9.59-9.64 for a discussion of options realistically available in the context of determining the arm’s length compensation for the restructuring itself.

distribution” contract whereby it will perform limited marketing activities under the supervision of a foreign associated enterprise, employ limited marketing intangibles and bear limited risks in its relationship with the foreign associated enterprise and customers. The restructured distributor may be able to negotiate an arrangement that does not contain a trial period or other similar unfavourable conditions, while such a trial period or conditions may be common for new distributors.

9.128 Where there is an ongoing business relationship between the parties before and after the restructuring, there may also be an inter-relationship between on the one hand the conditions of the pre-restructuring activities and/or of the restructuring itself, and on the other hand the conditions for the post-restructuring arrangements, as discussed in Section C below.

9.129 Some differences in the starting position of the restructured entity compared to the position of a newly set up operation can relate to the established presence of the operation. For instance, if one compares a situation where a long-established “full-fledged distributor” is converted into a “limited risk distributor” with a situation where a “limited risk distributor” is established in a market where the group did not have any previous commercial presence, market penetration efforts might be needed for the new entrant which are not needed for the converted entity. This may affect the comparability analysis and the determination of the arm’s length remuneration in both situations.

9.130 When one compares a situation where a long-established “full-fledged distributor” is converted into a “limited risk distributor” with a situation where a “limited risk distributor” has been in existence in the market for the same duration, there might also be differences because the “full-fledged distributor” may have performed some functions, borne some expenses (*e.g.* marketing expenses), assumed some risks and contributed to the development of some intangibles before its conversion that the long-existing “limited risk distributor” may not have performed, borne, assumed or contributed to. The question arises whether at arm’s length such additional functions, assets and risks should only affect the remuneration of the distributor before its being converted, whether they should be taken into account to determine a remuneration of the transfers that take place upon the conversion (and if so how), whether they should affect the remuneration of the restructured “limited risk distributor” (and if so how), or a combination of these three possibilities. For instance, if it is found that the pre-restructuring activities led the “full-fledged distributor” to own some intangibles while the long-established “limited risk distributor” does not, the arm’s length principle may require these intangibles either to be remunerated upon the restructuring if they are transferred by the “full-fledged distributor” to a foreign associated enterprise, or to be taken into account in the determination of the arm’s length remuneration of the post-restructuring activities if they are not transferred.⁹

9.131 Where a restructuring involves a transfer to a foreign associated enterprise of risks that were previously assumed by a taxpayer, it may be important to examine whether the transfer of risks only concerns the future risks that will arise from the post-restructuring activities or also the risks existing at the time of the restructuring as a result of pre-conversion activities, *i.e.* there is a cut-off issue. For instance, assume that a distributor was bearing bad debt risks which it will no longer bear after its being restructured as a “limited risk distributor”, and that it is being compared with a long-established “limited risk distributor” that never bore bad debt risk. It may be important when comparing both situations to examine whether the “limited risk distributor” that results from a conversion still bears the risks associated with bad debts that arose before the restructuring at the time it was full-fledged, or whether all the bad debt risks including those that existed at the time of the conversion were transferred.

⁹ See paragraphs 9.80-9.92 for a discussion of the application of the arm’s length principle to transfers of intangibles.

9.132 The same remarks and questions apply for other types of restructurings, including other types of restructuring of sales activities as well as restructurings of manufacturing activities, research and development activities, or other services activities.

B. Application to business restructuring situations: selection and application of a transfer pricing method for the post-restructuring controlled transactions

9.133 The selection and application of a transfer pricing method to post-restructuring controlled transactions must derive from the comparability analysis of the transaction. It is essential to understand what the functions, assets and risks involved in the post-restructuring transactions are, and what party performs, uses or assumes them. This requires information to be available on the functions, assets and risks of both parties to a transaction, *e.g.* the restructured entity and the foreign associated enterprise with which it transacts. The analysis should go beyond the label assigned to the restructured entity, as an entity that is labelled as a “commissionnaire” or “limited distributor” can sometimes be found to own valuable local intangibles and to continue to assume significant market risks, and an entity that is labelled as a “contract manufacturer” can sometimes be found to pursue significant development activities or to own and use unique intangibles. In post-restructuring situations, particular attention should be paid to the identification of the valuable intangible assets and the significant risks that effectively remain with the restructured entity (including, where applicable, local non-protected intangibles), and to whether such an allocation of intangibles and risks satisfies the arm’s length principle. Issues regarding risks and intangibles are discussed in Parts I and II of this chapter. See in particular paragraphs 9.44-9.46 for a discussion of the relationship between the selection of a transfer pricing method and the risk profile of the party.

9.134 Post-restructuring arrangements may pose certain challenges with respect to the identification of potential comparables in cases where the restructuring implements a business model that is hardly found between independent enterprises.

9.135 There are cases where comparables (including internal comparables) are available, subject to possible comparability adjustments being performed. One example of a possible application of the CUP method would be the case where an enterprise that used to transact independently with the MNE group is acquired, and the acquisition is followed by a restructuring of the now controlled transactions. Subject to a review of the five comparability factors and of the possible effect of the controlled and uncontrolled transactions taking place at different times, it might be the case that the conditions of the pre-acquisition uncontrolled transactions provide a CUP for the post-acquisition controlled transactions. Even where the conditions of the transactions are restructured, it might still be possible, depending on the facts and circumstances of the case, to adjust for the transfer of functions, assets and/or risks that occurred upon the restructuring. For instance, a comparability adjustment might be performed to account for a difference in what party bears bad debt risk.

9.136 Another example of a possible application of the CUP method would be the case where independent parties provide manufacturing, selling or service activities comparable to the ones provided by the restructured affiliate. Given the recent development of outsourcing activities, it may be possible in some cases to find independent outsourcing transactions that provide a basis for using the CUP method in order to determine the arm’s length remuneration of post-restructuring controlled transactions. This of course is subject to the condition that the outsourcing transactions qualify as uncontrolled transactions and that the review of the five comparability factors provides sufficient comfort that either no material difference exists between the conditions of the uncontrolled outsourcing transactions and the conditions of the post-restructuring controlled transactions, or that reliable enough adjustments can be made (and are effectively made) to eliminate such differences.

9.137 Whenever a comparable is proposed, it is important to ensure that a comparability analysis is performed in order to identify material differences, if any, between the controlled and uncontrolled transactions and, where necessary and possible, to adjust for such differences. In particular, the comparability analysis might reveal that the restructured entity continues to perform valuable and significant functions and/or the presence of local intangibles and/or of significant risks that remain in the “stripped” entity after the restructuring but are not found in the proposed comparables. See Section A on the possible differences between restructured activities and start-up situations.

9.138 The identification of potential comparables has to be made with the objective of finding the most reliable comparables data in the circumstances of the case, keeping in mind the limitations that may exist in availability of information and the compliance costs involved (see paragraphs 3.2 and 3.80). It is recognised that the data will not always be perfect. There are also cases where comparables data are not found. This does not necessarily mean that the controlled transaction is not arm’s length. In such cases, it may be necessary to determine whether the conditions of the controlled transaction would have been agreed, had the parties transacted with each other at arm’s length. Notwithstanding the difficulties that can arise in the process of searching comparables, it is necessary to find a reasonable solution to all transfer pricing cases. Following the guidance at paragraph 2.2, even in cases where comparables data are scarce and imperfect, the choice of the most appropriate transfer pricing method to the circumstances of the case should be consistent with the nature of the controlled transaction, determined in particular through a functional analysis.

C. Relationship between compensation for the restructuring and post-restructuring remuneration

9.139 There may in some circumstances be an important inter-relationship between the compensation for the restructuring and an arm’s length reward for operating the business post-restructuring. This can be the case where a taxpayer disposes of business operations to an associated enterprise with which it must then transact business as part of those operations. One example of such a relationship is found in paragraph 9.99 on outsourcing.¹⁰

9.140 Another example would be where a taxpayer that operates a manufacturing and distribution activity restructures by disposing of its distribution activity to a foreign associated enterprise to which the taxpayer will in the future sell the goods it manufactures. The foreign associated enterprise would expect to be able to earn an arm’s length reward for its investment in acquiring and operating the business. In this situation, the taxpayer might agree with the foreign associated enterprise to forgo receipt of part or all of the up-front compensation for the business that may be payable at arm’s length, and instead obtain comparable financial benefit over time through selling its goods to the foreign associated enterprise at prices that are higher than the latter would otherwise agree to if the up-front compensation had been paid. Alternatively, the parties might agree to set an up-front compensation payment for the restructuring that is partly offset through future lower transfer prices for the manufactured products than would have been set otherwise. See Part II of this chapter for a discussion of situations where compensation would be payable at arm’s length for the restructuring itself.

9.141 In other words, in this situation where the taxpayer will have an ongoing business relationship as supplier to the foreign associated enterprise that carries on an activity previously carried on by the taxpayer, the taxpayer and the foreign associated enterprise have the opportunity to obtain economic and commercial benefits through that relationship (*e.g.* the sale price of goods) which may explain for instance why compensation through an up-front capital payment for transfer of the business was foregone, or why the future transfer price for the products might be different from the prices that would have been agreed

¹⁰ See also paragraphs 9.82-9.86.

absent a restructuring operation. In practice, however, it might be difficult to structure and monitor such an arrangement. While taxpayers are free to choose the form of compensation payments, whether up-front or over time, tax administrations when reviewing such arrangements would want to know how the compensation for the post-restructuring activity was possibly affected to take account of the foregone compensation, if any, for the restructuring itself. Specifically, in such a case, the tax administration would want to look at the entirety of the arrangements, while being provided with a separate evaluation of the arm's length compensation for the restructuring and for the post-restructuring transactions.

D. Comparing the pre- and post-restructuring situations

9.142 A relevant question is the role if any of comparisons that can be made of the profits actually earned by a party to a controlled transaction prior to and after the restructuring. In particular, it can be asked whether it would be appropriate to determine a restructured entity's post-restructuring profits by reference to its pre-restructuring profits, adjusted to reflect the transfer or relinquishment of particular functions, assets and risks.¹¹

9.143 One important issue with such before-and-after comparisons is that a comparison of the profits from the post-restructuring controlled transactions with the profits made in controlled transactions prior to the restructuring would not suffice given Article 9 of the OECD Model Tax Convention provides for a comparison to be made with uncontrolled transactions. Comparisons of a taxpayer's controlled transactions with other controlled transactions are irrelevant to the application of the arm's length principle and therefore should not be used by a tax administration as the basis for a transfer pricing adjustment or by a taxpayer to support its transfer pricing policy.

9.144 Another issue with before-and-after comparisons is the likely difficulty of valuing the basket of functions, assets and risks that were lost by the restructured entity, keeping in mind that it is not always the case that these functions, assets and risks are transferred to another party.

9.145 That being said, in business restructurings, 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 to understand the changes that accounted for the changes in the allocation of profit / loss amongst the parties. In effect, 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 to assess whether such arrangements are arm's length. It can also shed light on the options realistically available to the restructured entity.¹²

9.146 A comparability (including functional) analysis of the business before and after the restructuring may reveal that while some functions, assets and risks were transferred, other functions may still be carried out by the "stripped" entity under contract for the foreign associated enterprise. A careful review of the respective roles of the foreign associated enterprise and of the "stripped" entity will determine what the most appropriate transfer pricing method to the circumstances of the case is, for instance whether or not it is appropriate to allocate the whole residual profit to the foreign associated enterprise in view of the actual risks and intangibles of the "stripped" entity and of the foreign associated enterprise.

¹¹ This is a different question from the one of profit potential that is discussed in Part II of this chapter.

¹² See paragraphs 9.59-9.64 for a discussion of options realistically available; see also paragraphs 9.127-9.132 for a discussion of possible factual differences between situations that result from a restructuring and situations that were structured as such from the beginning and of how such differences may affect the options realistically available to the parties in negotiating the terms of the new arrangement and therefore the conditions of the restructuring and / or of the post-restructuring arrangements.

9.147 There will also be cases where before-and-after comparisons can be made because the transactions prior to the restructuring were not controlled, for instance where the restructuring follows an acquisition, and where adjustments can reliably be made to account for the differences between the pre-restructuring uncontrolled transactions and the post-restructuring controlled transactions. See example at paragraph 9.135. Whether such uncontrolled transactions provide reliable comparables would have to be evaluated in light of the guidance at paragraph 3.2.

E. Location savings

9.148 Location savings can be derived by an MNE group that relocates some of its activities to a place where costs (such as labour costs, real estate costs, etc.) are lower than in the location where the activities were initially performed, account being taken of the possible costs involved in the relocation (such as termination costs for the existing operation, possibly higher infrastructure costs in the new location, possibly higher transportation costs if the new operation is more distant from the market, training costs of local employees, etc.). Where a business strategy aimed at deriving location savings is put forward as a business reason for restructuring, the discussion at paragraphs 1.59-1.63 is relevant.

9.149 Where significant location savings are derived further to a business restructuring, the question arises of whether and if so how the location savings should be shared among the parties. The response should obviously depend on what independent parties would have agreed in similar circumstances. The conditions that would be agreed between independent parties would normally depend on the functions, assets and risks of each party and on their respective bargaining powers.

9.150 Take the example of an enterprise that designs, manufactures and sells brand name clothes. Assume that the manufacturing process is basic and that the brand name is famous and represents a highly valuable intangible. Assume that the enterprise is established in Country A where the labour costs are high and that it decides to close down its manufacturing activities in Country A and to relocate them in an affiliate company in Country B where labour costs are significantly lower. The enterprise in Country A retains the rights on the brand name and continues designing the clothes. Further to this restructuring, the clothes will be manufactured by the affiliate in Country B under a contract manufacturing arrangement. The arrangement does not involve the use of any significant intangible owned by or licensed to the affiliate or the assumption of any significant risks by the affiliate in Country B. Once manufactured by the affiliate in Country B, the clothes will be sold to the enterprise in Country A which will on-sell them to third party customers. Assume that this restructuring makes it possible for the group formed by the enterprise in Country A and its affiliate in Country B to derive significant location savings. The question arises whether the location savings should be attributed to the enterprise in Country A, or its affiliate in Country B, or both (and if so in what proportions).

9.151 In such an example, given that the relocated activity is a highly competitive one, it is likely that the enterprise in Country A has the option realistically available to it to use either the affiliate in Country B or a third party manufacturer. As a consequence, it should be possible to find comparables data to determine the conditions in which a third party would be willing at arm's length to manufacture the clothes for the enterprise. In such a situation, a contract manufacturer at arm's length would generally be attributed very little, if any, part of the location savings. Doing otherwise would put the associated manufacturer in a situation different from the situation of an independent manufacturer, and would be contrary to the arm's length principle.

9.152 As another example, assume now that an enterprise in Country X provides highly specialised engineering services to independent clients. The enterprise is very well known for its high quality standard. It charges a fee to its independent clients based on a fixed hourly rate that compares with the hourly rate charged by competitors for similar services in the same market. Suppose that the wages for qualified

engineers in Country X are high. The enterprise subsequently opens a subsidiary in Country Y where it hires equally qualified engineers for substantially lower wages, and subcontracts a large part of its engineering work to its subsidiary in Country Y, thus deriving significant location savings for the group formed by the enterprise and its subsidiary. Clients continue to deal directly with the enterprise in Country X and are not necessarily aware of the sub-contracting arrangement. For some period of time, the well known enterprise in Country X can continue to charge its services at the original hourly rate despite the significantly reduced engineer costs. After a certain period of time, however, it is forced due to competitive pressures to decrease its hourly rate and pass on part of the location savings to its clients. In this case also, the question arises of which party(ies) within the MNE group should be attributed the location savings at arm's length: the subsidiary in Country Y, the enterprise in Country X, or both (and if so in what proportions).

9.153 In this example, it might be that there is a high demand for the type of engineering services in question and the subsidiary in Country Y is the only one able to provide them with the required quality standard, so that the enterprise in Country X does not have many other options available to it than to use this service provider. It might be that the subsidiary in Country Y has developed a valuable intangible corresponding to its technical know-how. Such an intangible would need to be taken into account in the determination of the arm's length remuneration for the sub-contracted services. In appropriate circumstances (*e.g.* if there are significant unique contributions such as intangibles used by both the enterprise in Country X and its subsidiary in Country Y), the use of a transactional profit split method may be considered.

F. Example: implementation of a central purchasing function

9.154 This section illustrates the application of the arm's length principle in the case of the implementation of a central purchasing function. It reflects the central importance of comparability analyses and in particular of the functional analysis in order to understand the role played by each of the parties in the creation of synergies, costs savings, or other integration effects. The list below is not intended to cover all the possible situations but only the most frequent ones. Which transfer pricing method is the most appropriate will depend on the facts and circumstances of the case. In particular, a determination of which party(ies) should be allocated the cost savings or inefficiencies created by the centralisation of the purchasing function will depend on the particular circumstances of each case.

9.155 Assume an MNE group puts in place a central purchasing entity that will negotiate with third party suppliers the purchases of raw materials used by all the manufacturing plants of the group in their manufacturing processes. Depending in particular on the respective functional analyses of the manufacturing plants and of the central purchasing entity and on the contractual terms they have agreed upon, a variety of remuneration schemes and transfer pricing methods could be considered.

9.156 First, there will be cases where the CUP method will be applicable. Assume the central purchasing entity purchases the raw materials from third party suppliers and sells them to the manufacturing plants. The CUP method might be applicable if the raw materials are traded on a commodity market (see paragraph 2.18). It may also be the case that the price that was paid by the manufacturing plants before the interposition of the central purchasing entity or the price paid by independent parties for comparable raw materials may, subject to a review of the facts and circumstances and of the effects of the controlled and uncontrolled transactions taking place at different times, be used as a comparable uncontrolled price to determine the price at which the manufacturing plants should acquire the raw materials from the central purchasing entity. However, such a CUP, if unadjusted, may well mean that all the costs savings would be attributed to the central purchasing entity. As noted at paragraph 9.154, a determination of whether or not this would be an arm's length condition has to be made on a case by case basis. Should it be determined that in the circumstances of the case, a portion of the cost savings should be

attributed to the manufacturing entities, then the question would arise whether the CUP should and could be adjusted accordingly.

9.157 Where the CUP method cannot be used, *e.g.* because the price of the raw materials fluctuates and the price paid by the manufacturing entities before the setting up of the central purchasing entity cannot serve as a reference, the cost plus method might be considered. For instance, the central purchasing entity might purchase the raw materials from third party suppliers and re-sell them to the manufacturing plants at cost plus, *i.e.* the new purchase price of the raw material by the central purchasing entity plus an arm's length mark-up. In such a case, the mark-up rate attributed to the central purchasing entity should be comparable to the mark-up rate earned in comparable uncontrolled trading activities.

9.158 In some cases, the central purchasing entity acts as an agent either for the suppliers or for the purchasers (or both) and is remunerated by a commission fee paid either by the suppliers or by the purchasers (or both). This might be the case where the central purchasing entity negotiates with the third party suppliers but does not take title to the inventories, *i.e.* the manufacturing plants continue to acquire the raw materials directly from the suppliers but at a discounted price obtained thanks to the activity of the central purchasing entity and to the participation of the group of manufacturing plants in the arrangement. The commission fee might be proportional to the supplies (especially if paid by the supplier) or to the discounts obtained (especially if paid by the manufacturing plants). It should be comparable to the commission fee that would be charged by independent parties for comparable agency functions in similar circumstances.

9.159 It may happen that what would be *prima facie* regarded as an arm's length mark-up on costs or commission fee from the perspective of the central purchasing entity in effect leads to determining purchase prices for the manufacturing entities that are higher than the prices they could obtain by themselves. If the incremental costs that are created for the manufacturers are material (*e.g.* they materially affect, on a recurrent basis, the basket of products channelled through the central purchasing entity), the question arises whether independent manufacturers would have agreed to pay such higher prices and what the economic rationale would be, or whether at arm's length the central purchasing entity should bear part or all of the inefficiencies through a reduction of its sales prices to the manufacturers. The response will depend on the facts and circumstances of the case. Key to the analysis will be the determination of the benefits that could reasonably be expected by the parties (manufacturing entities and central purchasing entity) from the implementation of the central purchasing function, and of the options realistically available to them, including in appropriate cases the option not to participate in the central purchasing in case the expected benefits were not as attractive as under other options. Where benefits could reasonably have been expected by the parties, it will be key to analyse the reasons for the central purchasing entity's apparent inefficiency, the contractual terms under which the central purchasing entity operates and the functional analysis of the manufacturers and of the central purchasing entity, in particular their respective roles and responsibilities in the decisions that led to the inefficiencies. This analysis should make it possible to determine what party(ies) should be allocated the inefficiency costs and to what extent. Where this analysis indicates that inefficiencies should be allocated to the central purchasing entity, one way of doing so would be to price the sale transactions to the manufacturing entities by reference to CUP *i.e.* based on prices that the manufacturing entities could obtain on the free market for comparable supplies in comparable circumstances. No inference should be drawn however that any inefficiencies should be allocated by default to the central purchasing function, or that the positive effects of synergies should always be shared amongst the members of the group.

9.160 Finally, there might be some cases where the costs savings (or costs) generated by the centralisation of the purchasing function would be shared amongst the central purchasing entity and the manufacturing plants through a form of profit split.

Part IV: Recognition of the actual transactions undertaken

A. Introduction

9.161 An important starting point for any transfer pricing analysis is to properly identify and characterise the controlled transaction under review. Paragraphs 1.64-1.69 deal with the relevance of the actual transactions undertaken by associated enterprises and discusses the exceptional circumstances in which it may be legitimate and appropriate for a tax administration not to recognise, for transfer pricing purposes, a transaction that is presented by a taxpayer.

9.162 Paragraphs 1.64-1.69 are limited to the non-recognition of transactions for the purposes of making transfer pricing adjustments covered by Article 9 of the OECD Model Tax Convention (*i.e.* adjustments in accordance with the arm's length principle). They do not provide any guidance as to a country's ability to characterise transactions differently under other aspects of its domestic law. A discussion of the relationship between domestic anti-abuse rules and treaties is found in the Commentary on Article 1 of the OECD Model Tax Convention (see in particular paragraphs 9.5, 22 and 22.1 of the Commentary).

9.163 MNEs are free to organise their business operations as they see fit. Tax administrations do not have the right to dictate to an MNE how to design its structure or where to locate its business operations. MNE groups cannot be forced to have or maintain any particular level of business presence in a country. They are free to act in their own best commercial and economic interests in this regard. In making this decision, tax considerations may be a factor. Tax administrations, however, have the right to determine the tax consequences of the structure put in place by an MNE, subject to the application of treaties and in particular of Article 9 of the OECD Model Tax Convention. This means that tax administrations may perform where appropriate transfer pricing adjustments in accordance with Article 9 of the OECD Model Tax Convention and / or other types of adjustments allowed by their domestic law (*e.g.* under general or specific anti-abuse rules), to the extent that such adjustments are compatible with their treaty obligations.

B. Transactions actually undertaken. Role of contractual terms. Relationship between paragraphs 1.64 – 1.69 and other parts of these Guidelines

9.164 In the Article 9 context, an examination of the application of the arm's length principle to controlled transactions should start from the transactions actually undertaken by the associated enterprises, and the terms of contracts play a major role (see paragraph 1.64). As acknowledged in paragraphs 1.47-1.51 and 1.64-1.69, however, such a review of the contractual terms is not sufficient.

9.165 According to Article 9 of the OECD Model Tax Convention, a tax administration may adjust the profits of a taxpayer where the conditions of a controlled transaction differ from the conditions that would be agreed between independent enterprises. In practice transfer pricing adjustments consist in adjustments of the profits of an enterprise attributable to adjustments to the price and / or other conditions of a controlled transaction (*e.g.* payment terms or allocation of risks). This does not mean that all transfer pricing adjustments, whether involving an adjustment only to the price or also (or alternatively) to other conditions of a controlled transaction, or as a result of evaluating separately transactions which are presented as a package in accordance to the guidance at paragraphs 3.11 and 6.18, should be viewed as consisting in the non-recognition of a controlled transaction under paragraphs 1.64-1.69. In effect, such adjustments may result from the examination of comparability, see in particular paragraph 1.33. Paragraphs 1.48-1.54 provide guidance on the possibility for a tax administration to challenge contractual terms where they are not consistent with the economic substance of the transaction or where they do not conform with the conduct of the parties.

9.166 A discussion of how to determine whether the allocation of risks in a transaction between associated enterprises is arm's length is found in Part I of this chapter. As discussed at paragraph 9.11, the examination of risks in an Article 9 context starts from an examination of the contractual terms between the parties, as those generally define how risks are to be divided between the parties. However, as noted at paragraphs 1.48-1.54, a purported allocation of risk between associated enterprises is respected only to the extent that it is consistent with the economic substance of the transaction. Therefore, in examining the risk allocation between associated enterprises and its transfer pricing consequences, it is important to review not only the contractual terms but also whether the associated enterprises conform to the contractual allocation of risks and whether the contractual terms provide for an arm's length allocation of risks. In evaluating the latter, two important factors that come into play are whether there is evidence from comparable uncontrolled transactions of a comparable allocation of risks and, in the absence of such evidence, whether the risk allocation makes commercial sense (and in particular whether the risk is allocated to the party that has greater control over it). Paragraphs 9.34-9.38 contain an explanation of the difference between making a comparability adjustment and not recognising the risk allocation in the controlled transaction and a discussion of the relationship between the guidance at paragraph 1.49 and paragraphs 1.64-1.69.

9.167 A similar reasoning is developed in Part II of this chapter with respect to indemnification rights for the termination or substantial renegotiation of an existing arrangement. Paragraph 9.103 indicates that, in addition to examining whether the arrangement that is terminated, non-renewed or substantially renegotiated is formalised in writing and provides for an indemnification clause, it may be important to assess whether the terms of the arrangement and the possible existence or non-existence of an indemnification clause or other type of guarantee (as well as the terms of such a clause where it exists) are arm's length.

C. Application of paragraphs 1.64-1.69 of these Guidelines to business restructuring situations

C.1 Non-recognition only in exceptional cases

9.168 Paragraphs 1.64-1.69 explicitly limit the non-recognition of the actual transaction or arrangement to exceptional cases. This indicates 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 by the associated enterprises as it has been structured by them.¹³ The word "exceptional" in this context is similar in meaning to "rare" or "unusual". It reflects that in most cases it is expected that the arm's length principle under Article 9 can be satisfied by determining arm's length pricing for the arrangement as actually undertaken and structured.

9.169 In accordance with paragraphs 1.64-1.69, it may exceptionally be appropriate for a tax administration not to recognise the parties' characterisation or structuring of a transaction or arrangement where, having regard to all of the facts and circumstances, it concludes that:

- The economic substance of the transaction or arrangement differs from its form (Section C.2); or

¹³ As noted at paragraph 1.53, it is important to examine whether the conduct of the parties conforms to the terms of the contract or whether the parties' conduct indicates that the contractual terms have not been followed or are a sham. In such cases, further analysis is required to determine the true terms of the transaction and a pricing adjustment might not be the solution.

- Independent enterprises in comparable circumstances would not have characterised or structured the transaction or arrangement as the associated enterprises have, and arm's length pricing cannot reliably be determined for that transaction or arrangement (Sections C.3 and C.4).

Both of these situations are instances where the parties' characterisation or structuring of the transaction or arrangement is regarded as the result of conditions that would not have existed between independent enterprises (see paragraph 1.66).

C.2 *Determining the economic substance of a transaction or arrangement*

9.170 The economic substance of a transaction or arrangement is determined by examining all of the facts and circumstances, such as the economic and commercial context of the transaction or arrangement, its object and effect from a practical and business point of view, and the conduct of the parties, including the functions performed, assets used and risks assumed by them.

C.3 *Determining whether arrangements would have been adopted by independent enterprises*

9.171 The second circumstance in paragraph 1.65 explicitly refers to the situation where the arrangements adopted by the associated enterprises "differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner..." Consistent with paragraph 9.163, tax administrations should not ordinarily interfere with the business decisions of a taxpayer as to how to structure its business arrangements. 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 associated enterprise arrangements.

9.172 Where reliable data show that comparable uncontrolled transactions exist, it cannot be argued that such transactions between associated enterprises would lack commercial rationality. The existence of comparables data evidencing arm's length pricing for an associated enterprise arrangement demonstrates that it is commercially rational for independent enterprises in comparable circumstances. On the other hand, however, the mere fact that an associated enterprise arrangement is not seen between independent enterprises does not in itself mean that it is not arm's length nor commercially rational (see paragraph 1.11).

9.173 Business restructurings often lead MNE groups to implement global business models that are hardly if ever found between independent enterprises, taking advantage of the very fact that they are MNE groups and that they can work in an integrated fashion. For instance, MNE groups may implement global supply chains or centralised functions that are not found between independent enterprises. It is therefore often difficult to assess whether such business models are of the kind that independent enterprises behaving in a commercially rational manner would have implemented. 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.

9.174 What is being tested is whether the outcome (the arrangement adopted) accords with what would result from normal commercial behaviour of independent enterprises; it is not a behaviour test in the sense of requiring the associated enterprises to actually behave as would independent enterprises in negotiating and agreeing to the terms of the arrangement. Thus, whether the associated enterprises actually engaged in real bargaining or simply acted in the best interests of the MNE group as a whole in agreeing to a restructuring does not determine whether the arrangement would have been adopted by independent enterprises behaving in a commercially rational manner or whether arm's length pricing has been reached.

9.175 The application of the arm's length principle is based on the notion that independent enterprises will not enter into a transaction if they see an alternative that is clearly more attractive. See paragraphs 9.59-9.64. As discussed there, a consideration of the options realistically available can be relevant to determining arm's length pricing for an arrangement. It can also be relevant to the question of whether arrangements adopted by associated enterprises differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner. There may be exceptional cases in which arm's length pricing cannot reliably be determined for the arrangement actually adopted, and it is concluded that the arrangement would not have been adopted in comparable circumstances by independent enterprises behaving in a commercially rational manner (see Section C.4).

9.176 An independent enterprise would not enter into a restructuring transaction if it sees an alternative option that is realistically available and clearly more attractive, including the option not to enter into the restructuring. In evaluating whether a party would at arm's length have had other options realistically available to it that were clearly more attractive, due regard should be given to all the relevant conditions of the restructuring, to the rights and other assets of the parties, to any compensation or indemnification for the restructuring itself and to the remuneration for the post-restructuring arrangements (as discussed in Parts II and III of this chapter) as well as to the commercial circumstances arising from participation in an MNE group (see paragraph 1.11).

9.177 In assessing the commercial rationality of a restructuring, the question may arise whether to look at one transaction in isolation or whether to examine it in a broader context, taking account of other transactions that are economically inter-related. It will generally be appropriate to look at the commercial rationality of a restructuring as a whole. For instance, where examining a sale of an intangible that is part of a broader restructuring involving changes to the arrangements relating to the development and use of the intangible, then the commercial rationality of the intangible sale should not be examined in isolation of these changes. On the other hand, where a restructuring involves changes to more than one element or aspect of a business that are not economically inter-related, the commercial rationality of particular changes may need to be separately considered. For example, a restructuring may involve centralising a group's purchasing function and centralising the ownership of valuable intangible property unrelated to the purchasing function. In such a case, the commercial rationality of centralising the purchasing function and of centralising the ownership of valuable intangible property may need to be evaluated separately from one another.

9.178 There can be group-level business reasons for an MNE group to restructure. However, it is worth re-emphasising that the arm's length principle treats the members of an MNE group as separate entities rather than as inseparable parts of a single unified business (see paragraph 1.6). As a consequence, it is not sufficient from a transfer pricing perspective that a restructuring arrangement makes commercial sense for the group as a whole: the arrangement must be arm's length at the level of each individual taxpayer, taking account of its rights and other assets, expected benefits from the arrangement (*i.e.* consideration of the post-restructuring arrangement plus any compensation payments for the restructuring itself), and realistically available options.

9.179 Where a restructuring is commercially rational for the MNE group as a whole, it is expected that an appropriate transfer price (that is, compensation for the post-restructuring arrangement plus any compensation payments for the restructuring itself) would generally be available to make it arm's length for each individual group member participating in it. See Part II of this chapter, Section B.

C.4 Determining whether a transaction or arrangement has an arm's length pricing solution

9.180 Under the second circumstance discussed at paragraph 1.65, a second cumulative criterion is that "the actual structure practically impedes the tax administration from determining an appropriate transfer

price.” If an appropriate transfer price (*i.e.* an arm’s length price that takes into account the comparability – including functional – analysis of both parties to the transaction or arrangement) can be arrived at in the circumstances of the case, irrespective of the fact that the transaction or arrangement may not be found between independent enterprises and that the tax administration might have doubts as to the commercial rationality of the taxpayer entering into the transaction or arrangement, the transaction or arrangement would not be disregarded under the second circumstance in paragraph 1.65. Otherwise, the tax administration may decide that this is a case for not recognising the transaction or arrangement under the second circumstance in paragraph 1.65.

C.5 *Relevance of tax purpose*

9.181 Under Article 9 of the OECD Model Tax Convention, the fact that a business restructuring arrangement is motivated by a purpose of obtaining tax benefits does not of itself warrant a conclusion that it is a non-arm’s length arrangement.¹⁴ The presence of a tax motive or purpose does not of itself justify non-recognition of the parties’ characterisation or structuring of the arrangement under paragraphs 1.64 to 1.69.

9.182 Provided functions, assets and/or risks are actually transferred, it can be commercially rational from an Article 9 perspective for an MNE group to restructure in order to obtain tax savings. However, this is not relevant to whether the arm’s length principle is satisfied at the entity level for a taxpayer affected by the restructuring (see paragraph 9.178).

C.6 *Consequences of non-recognition under paragraphs 1.64 to 1.69*

9.183 Under the first circumstance of paragraph 1.65, where the economic substance of a transaction differs from its form, the tax administration may disregard the parties’ characterisation of the transaction and re-characterise it in accordance with its substance.

9.184 With respect to the second circumstance, paragraph 1.65 contains an example of non-recognition of a sale and note that while it may be proper to respect the transaction as a transfer of commercial property, it would nevertheless be appropriate for a tax administration to conform the terms of that transfer in their entirety (and not simply by reference to pricing) to those that might reasonably have been expected had the transfer of property been the subject of a transaction involving independent enterprises. In such a case, the tax administration would seek to adjust the conditions of the agreement in a commercially rational manner.

9.185 In both circumstances, Article 9 would allow an adjustment of conditions to reflect those which the parties would have attained had the transaction been structured in accordance with the economic and commercial reality of parties dealing at arm’s length (see paragraph 1.66). In doing so, tax administrations would have to determine what is the underlying reality behind a contractual arrangement in applying the arm’s length principle (see paragraph 1.67).

9.186 Paragraph 1.68 provides some guidance on the case where a tax administration may find it useful to refer to alternatively structured transactions between independent enterprises to determine whether the controlled transaction as structured satisfies the arm’s length principle. Whether evidence from a particular alternative can be considered will depend on the facts and circumstances of the particular case, including the number and accuracy of the adjustments necessary to account for differences between the controlled transaction and the alternative as well as the quality of any other evidence that may be available.

¹⁴ As indicated at paragraph 9.8, domestic anti-abuse rules are not within the scope of this chapter.

9.187 That guidance indicates that the tax administration would seek to substitute for the non-recognised transaction an alternative characterisation or structure that comports as closely as possible with the facts of the case, *i.e.* one that is consistent with the functional changes to the taxpayer's business resulting from the restructuring, comports as closely as possible with the economic substance of the case, and reflects the results that would have derived had the transaction been structured in accordance with the commercial reality of independent parties. For example, where one element of a restructuring arrangement involves the closing down of a factory, any recharacterisation of the restructuring cannot ignore the reality that the factory no longer operates. Similarly, where one element of a restructuring involves the actual relocation of substantive business functions, any recharacterisation of the restructuring cannot ignore the fact that those functions were actually relocated. As another example, where a restructuring arrangement involves a transfer of property between two parties, any non-recognition of the restructuring arrangement would need to reflect that a transfer of such property occurred between the two parties, although it may be appropriate to replace the character of the transfer with an alternative characterisation that comports as closely as possible with the facts of the case (*e.g.* a purported transfer of all rights in the property might be recharacterised as a mere lease or licence of the property, or vice versa).

D. Examples

D.1 Example (A): Conversion of a full-fledged distributor into a "risk-less" distributor

9.188 Company Z is a well known distributor of luxury products. It owns a valuable trade name, valuable retail points, and valuable long term contracts with suppliers. It is acquired by an MNE Group which operates under a global business model whereby all the trade names and other valuable intangibles are owned by Company V in Country V, all the key supplier contracts are held by Company W in Country W which is responsible for the management of group-wide supplier contracts, and all the retail points are owned by a real estate company in Country X. Immediately after the acquisition, the Group decides to restructure Company Z by transferring its trade name to Company V, its valuable supplier contracts to Company W and its retail points to Company X, all in exchange for lump sum payments. As a consequence of the transfer, Company Z is now operating as a commissionaire for Company W. Its post-restructuring profit potential is dramatically less than its pre-restructuring one. Representatives from the MNE Group explain that the business reason for the restructuring is to align the operating model of Company Z with the operating model of the rest of the MNE Group, and that this prospect was one key factor in the acquisition deal. The management of Company Z has had no other choice than to accept the restructuring given the acquisition that has taken place. It indicates that the transfer of its trade name, contracts and retail points was priced at arm's length, and that the remuneration for its post-restructuring activities will also be priced at arm's length.

9.189 Assuming that in this case the actual conduct of the parties is consistent with the form of the restructuring, the economic substance of the arrangement would not differ from how it is characterised and structured by the parties. It is expected that the determination of arm's length pricing for the restructuring itself and for the post-restructuring activities would result in an arm's length outcome for each of the parties, in which case the restructuring transactions would be recognised.

D.2 Example (B): Transfer of valuable intangibles to a shell company

9.190 An MNE manufactures and distributes products the value of which is not determined by the technical features of the products, but rather by the brand name and exposure. The MNE wants to differentiate itself from its competitors through the development of brand names with great value, by implementing a carefully developed and expensive marketing strategy. The brand names are owned by Company A in Country A. The development, maintenance and execution of a worldwide marketing strategy are the main value driver of the MNE, performed by 125 employees at Company A's head office.

The value of the brand names results in a high consumer price for the products. Company A's head office also provides central services for the group affiliates (e.g. human resource management, legal, tax). The products are manufactured by affiliates under contract manufacturing arrangements with Company A. They are distributed by affiliates who purchase them from Company A. The profits derived by Company A after having allocated an arm's length remuneration to the contract manufacturers and distributors are considered to be the remuneration for the intangibles, marketing activities and central services of Company A.

9.191 Then a restructuring takes place. The brand names are transferred by Company A to a newly set up affiliate, Company Z in Country Z in exchange for a lump sum payment. After the restructuring, Company A is remunerated on a cost plus basis for the services it performs for Company Z and the rest of the group. The remuneration of the affiliated contract manufacturers and distributors remains the same. The excess profits after remuneration of the contract manufacturers, distributors, and Company A head office services are paid to Company Z. From the comparability analysis the following conclusions can be drawn:

- There is no reliable evidence from uncontrolled comparable transactions of the ownership of brand names and attached risks being attributed between independent enterprises in the same manner as in the controlled transaction between Company A and Company Z;
- Company Z is managed by a local trust company. It does not have people (employees or directors) who have the authority to and effectively do perform control functions in relation to the risks associated with the strategic development of the brand names. It also does not have the financial capacity to assume these risks.
- High ranking officials from Company A's head office fly to Country Z once a year to formally validate the strategic decisions necessary to operate the company. These decisions are prepared by Company A's head office in Country A before the meetings take place in Country Z. The MNE considers that these activities are service activities performed by Company A's head office for Z. These strategic decision-making activities are remunerated at cost plus in the same way as the central services are remunerated (e.g. human resource management, legal, tax).
- The development, maintenance and execution of the worldwide marketing strategy are still performed by the same employees of Company A's head office and remunerated on a cost plus basis. Company A does not have a contractual incentive to maximise the value of the brand names or the market share because it is remunerated on a cost plus basis.

9.192 A full consideration of all of the facts and circumstances warrants a conclusion that the economic substance of the arrangement differs from its form. In particular, the facts indicate that Company Z has no real capability to assume the risks it is allocated under the arrangement as characterised and structured by the parties. Furthermore, there is no evidence of any business reasons for the arrangement. In such a case paragraph 1.65 allows a tax administration to not recognise the structure adopted by the parties.¹⁵

D.3 Example (C): Transfer of intangible that is recognised

9.193 The fact pattern is the same as in example (B), except that part of Company A's head office is effectively relocated to Country Z: 30 of the 125 head office employees are dismissed, another 30 are

¹⁵ This is notwithstanding any possible application of general anti-avoidance rules and notwithstanding the question about Company Z's place of effective management.

transferred to the new Company Z in Country Z, and 15 new employees are directly hired by Company Z in Country Z to take over functions performed by the dismissed employees. The employees of Company Z have the skills and competences to do the strategic development of the brand name and to execute the worldwide marketing strategy. Furthermore, it is assumed in this example that Company Z has the financial capacity to assume the risks associated with the strategic development of the brand names. Company Z, which is now the legal owner of the brand names actively carries on the development, maintenance and execution of a worldwide marketing strategy. The employees of Company Z have the authority to and actually perform control functions in relation to the risks associated with the strategic development of the brand names. The services provided by the remainder of Company A's head office in Country A are central services (*e.g.* human resources management, legal and tax) as well as support marketing functions that are closely monitored by the personnel of Company Z. The main reason for the group entering into this restructuring is to benefit from a favourable tax regime in Country Z compared to the tax regime in Country A.

9.194 The changes in fact pattern from Example (B) support a conclusion that the economic substance of the arrangement does not differ from its form, and that independent enterprises in comparable circumstances acting in a commercially rational manner would have characterised or structured the arrangement as the associated enterprises have. Given this, a tax administration should seek to achieve an arm's length outcome in this situation by determining arm's length pricing for the restructuring itself and the parties' post-restructuring activities based upon recognising the arrangement actually undertaken.¹⁶

¹⁶ This does not say anything about the possible application of domestic anti-abuse rules.