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PARIS - FRANCE
11-16 SEPTEMBER 2011
45th CONGRESS OF THE INTERNATIONAL FISCAL ASSOCIATION

Cross-Border Business Restructuring (Subject 1)

Chair of the Panel: Bruno Gibert
General Reporter: Heinz-Klaus Kroppen
Panelists: Michelle Levac, Tim McDonald, Edward Morris, Caroline Silberstein

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General introduction of the Chair

- Why the subject "Business Restructuring" ("BR") has been selected by IFA?
- What BR includes and what it does not include
- Presentation of the panelists

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Agenda

- I. General Report
- II. Presentation of two cases
- III. Discussion of the cases around the five following topics:
 1. Recharacterization
 2. Transfer
 3. Contract renegotiation/termination
 4. Alternative options
- IV. What can be done?

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I. General Report

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General Report

- We received 40 reports
 - 26 from EMEA
 - 9 from the Americas
 - 5 from Asia Pacific
- Length of reports (from 6 to more than 30 pages) and contents differed largely reflecting different experience levels with the topic

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General Report

- All national reporters agree that BR is a major issue in their country and receives a lot of attention from the tax authorities
- Contrary to this observation there is only:
 - one country – Germany – which has specific laws for BR
 - very few countries which have tax authority pronouncements (for example Australia, Austria, US)
 - a small number of court cases covering BR
 - OECD Guidelines

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General Report

- Most national reports struggle with the application of their general rules to BR
- The national reporters view the treatment of certain aspects of BR very differently which leads to a substantial risk of double taxation
- The OECD published on 22 July 2010 a new Chapter IX of the Transfer Pricing Guidelines on the Transfer Pricing Aspects of BR

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General Report

- Four different situations related to BR have to be distinguished:
 1. Transfer of a business or a partial business ⇒ generally business valuation including goodwill
 2. Transfer of one or more assets without any connection ⇒ separate valuation of those assets without goodwill

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General Report

3. Transfer of a number of assets together with an activity which are connected but which do not constitute a business yet ⇒ business valuation of a going concern or separate valuation of isolated assets?
4. Change of contractual relationships together with a change of the functional and risk profile (change from distributor to commissionaire or manufacturer to toller) and reduction of the profit potential ⇒ can there be a taxable event without the transfer of an asset?

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General Report

- Major issues identified:
 - Will tax authorities recognize a BR as undertaken or will they re-characterize it into something else?
 - Is the concept of the alternative option a valid concept and how should it be applied?
 - Has something of value been transferred (business opportunity, profit potential, goodwill) and how should it be valued?
 - What are the consequences of a contract renegotiation or termination?

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General Report

- These topics will be discussed today based on two examples

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II. Presentation of two cases

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Case 1: Toll / Commissionnaire (1/3)

Starting Point

SubCo:

- Has a non-exclusive licence to manufacture and sell products to third parties in its local market and to foreign group entities;
- Performs some technical services related to the improvement of the manufacturing processes, for its own account and for other group entities;
- Similar licenses are granted to other group entities.

Pre-reorganization

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Case 1: Toll / Commissionnaire (2/3)

Reorganization implemented

- Parent terminates the license with SubCo
- The IP is licensed to a newly created Principal, which becomes the entrepreneur.
- The Principal enters into (i) a toll manufacturing agreement and (ii) a sales commissionnaire agreement with SubCo.
- Generally, this structure (commissionnaire and toll manufacturing arrangements with Principal) is implemented with all affiliates throughout the group.

Post-reorganization

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Case 1: Toll / Commissionnaire (3/3)

Reorganization implemented (cont'd)

- Some senior managers from SubCo become employees of Principal to take up regional / global responsibilities; they physically move there;
- SubCo keeps at its level (i) managers who deal only with local issues and (ii) the team of technicians in charge of providing the services relating to the improvement of manufacturing processes.

Post-reorganization

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Case 2: Plant Closure (1/2)

Country A

- TireCo in Country A operates several factories for the manufacturing of tires.
- The tires for CAR PPP, a vehicle of a car manufacturer MMM unrelated to TireCo, are manufactured in one of those factories.
- MMM decides to produce the CAR PPP in Country B and requires TireCo to either supply the tires from a factory in Country B or cease to be a supplier for the tires of CAR PPP.

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Case 2: Plant Closure (2/2)

- TireCo forms a new subsidiary, B Ltd., in Country B, which builds a new factory for the supply of CAR PPP tires. Location savings are expected to make B Ltd. profitable.
- TireCo closes down its existing factory in Country A, lays off nearly all the employees of the factory and sells the land and buildings and most of the machinery to a third party.
- Two valuable machines are sold by TireCo to B Ltd. and three engineers of TireCo are transferred to B Ltd. to help start the production.
- TireCo licenses the technology to B Ltd. for a royalty which is assumed to be arm's length.

Country A

Country B

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III. Discussion of the two cases around four topics

1. Recharacterization
2. Transfer
3. Contract renegotiation/termination
4. Alternative Options

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III-1. Recharacterization

Lead speaker: Tim McDonald
Additional speakers: Michelle Levac, Edward Morris

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Recharacterization - Possible transfer pricing adjustment vs. tax non-recognition of the transaction undertaken

- The Business Restructuring OECD report reflects a well developed balance between the:
 - MNC's legitimate tax efficient need to have the tools to evolve its business structure to remain competitive and
 - Tax administrator's need to enforce its tax rules under the arm's length standard.
- There is generally a strong presumption that the arm's length result can be achieved by recognizing the BR transaction actually undertaken and making, as necessary, price and/or condition adjustments to produce an arm's length result. TPGL.9.163-9.168

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Recharacterization - Recognition of the transaction undertaken

- A BR transaction may be respected as undertaken but transfer pricing adjustments may be imposed where the terms and conditions of a business restructuring differ from those that would be agreed upon between unrelated enterprises provided;
 - The economic substance is consistent with the form and behavior of the parties (TPGL 9.165 & 9.183).
 - The transaction is commercially rational from each separate participant's perspective,
 - The terms reflect the realistic opportunities of the parties.
- In the absence of a comparable, a non-arm's length transaction or arrangements which cannot be reliably adjusted to produce an arm's length result will not be recognized. (TPGL 9.169)

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Recharacterization - Non-recognition vs. TP adjustment

- To illustrate the distinction, assume a BR, as reported, causes profitability to drop by 100. Assume further, the transaction is respected but more accurate comparability adjustments are applied and the profit would only drop to 60. If the underlying transaction is respected, and the comparability adjustments are appropriate and reliable, a tax adjustment of 40 is justified. In contrast in non-recognition, an adjustment of 100 might be justified.

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Recharacterization - Non-recognition in Exceptional, Rare or Unusual Circumstances

- Based on the facts and circumstances of a transaction, non-recognition of a business restructuring for transfer pricing purposes is expected to be an exception reserved for transactions which are not credible based on the substance and business purpose of the arrangement and behavior of the parties.
 - Example TPGL 9.190 describes an asserted BR transaction with no real substance. A so called 'mere shell company'.
 - In contrast Example C, presents the same facts except substance and activity is altered for proper commercial reasons. See, TPGL 9.193-9.194

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Recharacterization - What is economic substance and proper business purpose?

- The evaluation of the business restructuring must be real and substantive based on the facts and circumstances of the actual transaction.
- Why do these restructurings occur?
- Often the restructurings are necessary to align management decision rights and incentives with the opportunity to pursue specialization and scale opportunities which are necessary to remain competitive.
- Even if there is an overall commercial rationale, are the economic terms and conditions rational for each party and reflecting the underlying economic reality behind the contractual arrangement under the arm's length standard?

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Recharacterization

Case 1

- Is there substance to the transaction? Have SubCo's relevant assets, functions and risks been effectively transferred per contractual terms?
- Is there commercial rationale to the group and is any compensation necessary to make the transaction AL for SubCo?

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Recharacterization

Case 2

- Commercial rationale is evident given the location savings
- B. Ltd is in fact acquiring the necessary resources to take on the operations of Tire Co
- Tire Co. has effectively ceased its operations with MMM

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Recharacterization

- Commercially rational from whose perspective?
- At arm's length, is it the expectation that counts?
- Is it sufficient to document and evidence a « due diligence » style process?
- What would a comparable independent do to conclude that a « good deal » could be reasonably expected?
- What should be taxed in place of the disregarded structure?

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III-2. Transfer

Lead speaker: Caroline Silberstein
Additional speakers: Heinz-Klaus Kroppen, Tim McDonald

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Transfer

- TP Guidelines: BR = "cross-border redeployment by a multinational enterprise of functions, assets and risks; cross-border reallocation of profits (or loss) potential"
 - Can involve the transfer of valuable intangibles, *although not always the case*
 - Can also, or alternatively, involve the termination or substantial renegotiation of existing arrangements
- The TP question: "Are there conditions made or imposed in the restructuring which differ from conditions that would be made between independent enterprises?"
 - => not a systematic taxation of variations of profit potential

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Transfer

- Is there a transfer?
 - Simple cases: e.g. tangible and intangible assets are sold by Company A to Company B
 - Controversial: e.g. activity stops in Company A and resumes in Company B
 - Complex: e.g. employees from Company A are assigned to Company B to assist Company B developing the activity previously carried out by Company A; is this a service transaction? Does it entail a transfer of intangible?

=> Application to cases 1 and 2

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Transfer

- What has been transferred?
 - Simple cases: traditional forms of intangible assets (e.g. patents, trademark...)
 - Controversial: e.g. synergy gains, location savings, business opportunities, workforce in place...
 - Complex: e.g. 1st generation intangibles

=> Application to cases 1 and 2

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Transfer

- How to price the transfer? (1/2)
 - Price different from value: take account of rights, other assets and circumstances of the transaction
- Value:
 - When is it appropriate to use one of the five TP methods?
 - When is it appropriate to use financial / accounting valuation methods (market / cost / income or discounted cash flow-based)?
 - How to deal with highly uncertain valuations? Role of contingency payments and other price adjustment mechanisms?
 - How to assess the reasonableness of the parameters used in such methods?

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Transfer

- How to price the transfer? (2/2)
 - What is the role of comparables? Are there reliable comparables for restructuring transactions?
 - What to do in the absence of comparables?
 - How to take account of the perspectives of both parties to the transaction?
 - Highest and best use?
 - Etc.

=> Application to cases 1 and 2

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Transfer

- Simple case is clear
- Our case 2 combines issues of Caroline's controversial and complex cases
- In practice, major issue is transfer of going concern/goodwill because it potentially leads to a high exit taxation
- Use of business valuation methods leads to the result that synergy gains, location savings and business opportunities are automatically included
- 9.93 TPGL ⇒ going concern: functioning economically integrated business unit
- Only for such unit the value is higher than the sum of the value of all assets

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Transfer

- Transfer of going concern requires that the business unit leaving the transferor is identical to the business unit received by the transferee
- Case 2 no transfer of going concern because the business unit is destroyed and a new different business unit in the receiving country is created
- Not comparable to the case of a business sale in which the activity can be continued at the same place in the same form without any disruption

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Transfer

- My audit experience is that evaluation of transfers of tangible and legally protected intangible assets may be a valuation dispute but that it is often much easier to resolve than assertions of a transfer of non-legally protected intangible assets such as "going concern" which often are a proxy for arguing for lost tax base.
- The key issue is identifying "...the significant intangible assets that were transferred (if any), [and] whether independent parties would have remunerated their transfer...[and at what price]". TPGL 9.80

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Transfer

- What happens if one or a few employees of the restructured company move to an affiliate?
- Top talent is regularly recruited away from an employer in the marketplace without compensation to the former employer.
- In the absence of a covenant not to compete or restrictive employment contract is there a tax issue? Does it matter if management personnel regularly moves to and from affiliates' prior to the restructuring?

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Transfer

- Most non-legally protected IP such as assembled workforce, customer lists and distribution channels have, in my experience, replacement cost type values.
- Typically a third party would only pay enough to avoid the disruption cost and delay it will take the new enterprise to create a similar asset. These type of assets do not typically represent long term assets.
- Manufacturing know-how and trade secrets in certain industries, particularly in industries that do not outsource manufacturing, may be a notable exception.

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III-3. Contract renegotiation/termination

Lead speaker: Edward Morris
Additional Speakers: Tim McDonald, Michelle Levac, Caroline Silberstein

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Contract renegotiation/termination

- What contract has been terminated?
 - Case 1 : A license to manufacture and sell
 - Case 2 : Supply contract
- What new contracts are negotiated?
 - Case 1 : A toll manufacturing contract and a sales contract
 - Case 2 : Supply contract with a different entity, a technology license, contract for sale of machinery

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Contract renegotiation/termination

- Two broad issues:
 - Compensation associated with termination (including restructuring costs)
 - Compensation under new contract

→ To class as a re-negotiation, does the new contract have to be between the same entities?
→ Under a re-negotiation, does what the parties had or did before influence the outcome or are "all bets off"?

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Contract renegotiation/termination

- Old contracts - Compensation for termination (1/2)
 - What is in the contract?
 - What legal rights are enjoyed?
 - What is the notice period?
 - Have the parties behaved according to the contract?
 - Have the terms of the contract given rise to the arm's length reward?
 - What transactions associated with the Business Restructuring also have to be compensated for?

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Contract renegotiation/termination

- Old contracts - Compensation for termination (2/2)
 - What would have been in the contract between third parties?
 - What happens when a contract naturally lapses and is not renewed?
 - Ex gratia payments - Would any extra compensation be paid and what factors might influence this?

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Contract renegotiation/termination

- New Contracts - Compensation for the future (1/2)
 - Is the arm's length reward for the future influenced by the arm's length reward for the past?
 - Bargaining Power and Options Realistically Available
 - in Case 2, B did not exist under the old arrangement with MMM
 - Would B have to pay more to A for the license because of the profits A used to enjoy?
 - Would A be able to dictate advantageous terms to B?
 - Would A be able to share in the fruits of the location savings enjoyed by B? (From the perspective of B, there are not savings but are the steady state situation!)
 - Does the behaviour of MMM inform the analysis? (Does MMM pay less for tires to B than it paid to A?)

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Contract renegotiation/termination

- New Contracts - Compensation for the future (2/2)
 - Can A attempt to recoup its loss through the sale of machinery or the transfer of engineers?
 - SUBJECTIVE ANALYSIS AND JUDGEMENT IS NECESSARY!

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Contract renegotiation/termination

- Assuming the business restructuring is recognized and not recharacterized for tax purposes, the first step is to review the contracts;
 - What is the notice period and is it reasonable?
 - Is there an indemnification clause for termination or substantial modification? Should there have been such a protection?
 - Would unrelated parties litigate the contract?
- What protections exist under commercial law?
- Are there other equitable judicial remedies to protect detrimental reliance? TPGL 9.54 & TPGL 9.115

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Contract renegotiation/termination

- What other realistic alternatives might exist for the parties to reject or modify the restructuring negotiations? TPGL 9.59 - 9.62 and 9.103
- What would unrelated parties do during the notice period if they knew their future profit potential may be reduced?
- Inadequate indemnification for the restructuring may have an impact on future transfer pricing terms, TPGL 9.102 & TPGL 9.140

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Contract renegotiation/termination

Case 1

- Is Principal compensating SubCo for the capacity to generate a future entrepreneurial return?
- Has SubCo lost the capacity to generate a future return without being compensated / should SubCo be compensated for investment cost to avoid a loss or to capture some of its expected profit?
- What is the industry practice?
- Is there any commercial or case law where indemnification was found appropriate?
- Have damages been suffered because of negligence, willful act or other?

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Contract renegotiation/termination

Case 2

- Irrelevant since renegotiated / terminated contract is with third parties
- Could provide a comparable?

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Contract renegotiation/termination

- Broader question about the role of contracts in an intra-group context:
 - ✓ Validity?
 - => Associated enterprises versus permanent establishments?
 - ✓ Level of detail, monitoring – cost of keeping up-to-date?
 - ✓ To what extent should they be respected by tax authorities?
 - ✓ Cost-benefits for MNEs?

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III-4. Alternative options

Lead speaker: Michelle Levac
Additional speaker: Heinz-Klaus Kroppen

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Options realistically available

Purpose is to determine an AL compensation and whether:

- any of the parties are worst off
- there was an option 'clearly' more attractive to the parties
- the terms would have been acceptable to an AL party faced with same alternatives & comparable circumstances

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Options realistically available

Case 1- perspective of SubCo

- Renegotiate the same license with Parent
- Negotiate a contract with Principal to perform additional functions, if more efficient
- Negotiate a full fledge license with a 3rd party
- Dispose of its operations to a 3rd party
- Cease operations

Where 'clearly' more attractive

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Options realistically available

Case 1-perspective of the Principal

- Acquire or license SubCo's former operations
- Acquire or license the operations of a 3rd party
- Build its own manufacturing/selling capacity and knowhow
- Renegotiate the pre-restructuring license to manufacture and sell

Where 'clearly' more attractive

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Options realistically available

Case 2- perspective of the B Ltd.

- Buy an existing manufacturing operation in Country B
- Develop its own manufacturing technology
- Develop its own workforce and knowhow
- Buy rather than license the technology

Where 'clearly' more attractive

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Options realistically available

Case 2- perspective of Tire Co.

- License to 3rd party(ies)
- Sell rather than license the technology
- Sell knowhow & goodwill rather than provide engineering services
- Manufacture alternative products and license its manufacturing technology/knowhow

Where 'clearly' more attractive

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Options realistically available

What information is relevant:

- Return-risk or cost-benefit analysis
- Benefits anticipated by all parties
- Evidence of due diligence, structure that maximizes return/efficiencies for a given level of risk
- Story, commercial rational, industry practices

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Options realistically available

- Life is full of realistically available options without tax consequences
- Investor for example might have the option to invest in stock, a savings account or real estate without tax authorities being able to second guess
- Likewise, a company might choose a business model of high but volatile return over one with a low but more stable return or vice versa without tax authorities being allowed to interfere

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Options realistically available

- Objective test is needed to distinguish just another option from one which taxpayer should have chosen
- Economic theory has developed the concept of the dominant option
- Option clearly more attractive because it gives a better result under any assumed future development
- Is this the understanding of the OECD of "clearly" more attractive?

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IV. What can be done?

From a taxpayer's perspective: Edward Morris
From a tax authority's perspective: Michelle Levac
From an OECD perspective: Caroline Silberstein

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What can be done from a taxpayer's perspective?

- Transfer Pricing Documentation:
 - Contracts should delineate functions and risks clearly
 - Contracts should mirror closely similar arm's length situations (if possible)
 - Associated Enterprises do not have to behave as if they were independent parties
 - Evidence should be kept of Options Realistically Available
 - Bargaining power should be examined
 - Document the business case for the reorganisation - commercial evidence is compelling
 - Document the synergies and allocate them between the entities
 - Implement your Transfer Pricing Policies properly!

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What can be done from a taxpayer's perspective?

- Mutual Agreement Procedure:
 - Business Restructuring causes double taxation which is difficult to resolve!
 - Engage early with the other country
 - Ensure you maintain your rights under the Double Tax Convention and the Arbitration Convention
- Advance Pricing Agreements:
 - An effective way of establishing which country will tax what?

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What can be done from a tax authority's perspective?

- Recognize:
 - Inherent difficulty and subjectivity in applying the ALP
 - Freedom of MNEs to organize their business as they see fit
 - No presumption of a right to compensation / indemnification
 - Need for common sense, balance and pragmatism

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What can be done from a tax authorities' perspective?

- Build intelligence:
 - Good understanding of the industry, business, market, transaction and expected benefits
 - Consistent application of the ALP, worldwide

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What can be done from an OECD perspective ?

- OECD development of guidance on the transfer pricing aspects of intangibles
- See scoping paper and further information at www.oecd.org/ctp/tp/intangibles
- Definitional issues; identifying a transfer of intangible; pricing a transfer of intangibles; alternative options; timing issues (uncertain valuations, hindsight, etc.)


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What can be done from an OECD perspective ?

- Involvement of key non-OECD economies (Argentina, Brazil, Colombia, China, India, Malaysia, Russia, Singapore, South Africa; Indonesia invited)
- Ongoing involvement of the business community from the start of the project
- Hope to be able to release a discussion draft for public comment end of 2013

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Main Subject 2

Key Practical Issues
TO ELIMINATE
DOUBLE TAXATION
Of Business Income

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PANELISTS

Carolina del Campo, Spain
Peter van Dijk, Canada
Luciana Rosanova Galhardo, Brazil
Juergen Luedicke, Germany
Larry Magid, Australia

General Reporter
Gauthier Blanluet, France

Chair
Phil West, USA

PRW 2

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Scope

Focus on **PRACTICAL ISSUES**

Setting the Scene

Seminar C: Credit vs. Exemption Policy Issues
Seminar D: Double Taxation and EU Law
- These are concurrent

PRW 3

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Scope

Topics Excluded:

- Indirect Taxes
- Domestic Double Taxation
 - Classical vs. Integrated Systems

PRW 4

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Scope

Topics Addressed Only Tangentially:

- Individual Taxes
- Double Non-Taxation
- Juridical vs. Economic Double Taxation
- Transfer Pricing

PRW 5

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Key Messages

- Double Taxation – Why do we care?
 - Disincentive to invest and create jobs
 - Double non-taxation – level playing field issue
 - Not more government revenue – the Laffer Curve

PRW 6