Base Erosion and Profit Shifting (BEPS)

Document for Public Review

CONFORMING AMENDMENTS TO CHAPTER IX OF THE TRANSFER PRICING GUIDELINES

4 July - 16 August 2016

OECD
BETTER POLICIES FOR BETTER LIVES

CONFORMING AMENDMENTS TO CHAPTER IX OF THE TRANSFER PRICING GUIDELINES

INVITATION TO REVIEW

4 July 2016

This document contains conforming changes agreed by Working Party No. 6 of the Committee on Fiscal Affairs to Chapter IX of the Transfer Pricing Guidelines, entitled "Transfer Pricing Aspects of Business Restructurings." The conformed version of Chapter IX will replace the current 2010 version in a consolidated version of the Guidelines. Interested parties are invited to review the conforming amendments.

The conforming amendments are prompted by the changes to the Guidelines set out in the 2015 Base Erosion and Profit Shifting Reports, specifically the 2015 BEPS Report on Actions 8-10, "Aligning Transfer Pricing Outcomes with Value Creation," and the 2015 BEPS Report on Action 13, "Transfer Pricing Documentation and Country-by-Country Reporting." These Reports made extensive changes to the Guidelines, particularly by deleting and replacing Section D of Chapter 1, Chapter V, Chapter VI, Chapter VII, and Chapter VIII.

The Council approved these changes to the Transfer Pricing Guidelines on 23 May 2016 and noted that the CFA will continue its work in order to make conforming changes to the Transfer Pricing Guidelines and develop a consolidated version of the Transfer Pricing Guidelines. Until that is done, the Council agreed that the provisions of the Transfer Pricing Guidelines should be interpreted to be consistent with those provisions of the Transfer Pricing Guidelines which have been amended by the 2015 BEPS Report on Actions 8-10 and 13, and that in case of perceived inconsistences the modified provisions prevail.

The most significant conforming changes required to those parts of the Guidelines that have not been modified by the 2015 BEPS Reports are contained in Chapter IX, "Transfer Pricing Aspects of Business Restructurings." Before the work done under BEPS, Chapter I provided general guidance on risk and recognition of controlled transactions. In 2010, new Chapter IX expanded this guidance in the context of the project on business restructurings on, among other matters, non-recognition and the analysis of risk assumption including references to control of risk and financial capacity.

The guidance contained in the revised Chapter I resulting from the 2015 BEPS Reports continued the development of guidance found in Chapter IX. In doing so the revisions to Chapter I took concepts and examples found in Chapter IX, and further developed the guidance.

As a result, aspects of the current Chapter IX are incorporated in the updates to Chapter I, although not word-for-word, as the guidance has been refined in accordance with the updates to Chapter I and to the rest of the Guidelines. Therefore conforming changes are needed. In making those conforming changes WP6 decided not to revisit the guidance on business restructurings but to focus attention on changes necessary to address inconsistencies, real or perceived, with the revised chapters, and to remove duplication. Inevitably, some clarifications have also been adopted as part of the conforming changes, but effort was made to limit clarifications to those essential to achieve guidance fully consistent with the 2015 BEPS Reports.

The agreed conforming changes to Chapter IX found in this document will be incorporated in an internally consistent version of the Guidelines expected to be finalised during 2016. Before that version is released, WP6 invites review by interested parties of the conforming changes. **The purpose of the review is to establish that real or perceived inconsistencies with the revised parts of the Guidelines have been appropriately addressed, and duplication appropriately removed. The invitation to review should not be used as an opportunity to comment on aspects of the Guidelines which have been changed in the 2015 BEPS Reports or to comment on the guidance on business restructurings which is not affected by the conforming changes.** Since there is no new guidance contained in this document that has not already been the subject of consultation, there will be no further public consultation.

The Committee invites interested parties to send comments in relation to the review of the conforming changes by 16 August 2016 at the latest by email to TransferPricing@oecd.org in Word format (in order to facilitate their distribution to government officials). They should be addressed to the Tax Treaties, Transfer Pricing and Financial Transactions Division, OECD/CTPA.

Please note that all comments on the conforming amendments will be made publicly available. Comments submitted in the name of a collective "grouping" or "coalition", or by any person submitting comments on behalf of another person or group of persons, should identify all enterprises or individuals who are members of that collective group, or the person(s) on whose behalf the commentator(s) are acting.

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 refers to the cross-border reorganisation of the commercial or financial relations between associated enterprises, including the termination or substantial renegotiation of existing arrangements. Relationships with third parties (*e.g.* suppliers, sub-contractors, customers) may be a reason for the restructuring or be affected by it.

9.2 Business restructurings may often involve the centralisation of intangibles, risks, or functions with the profit potential attached to them. They may typically consist of:

- Conversion of full-fledged distributors (that is, enterprises with a relatively higher level of functions and risks) into limited-risk distributors, marketers, sales agents, or commissionnaires (that is, enterprises with a relatively lower level of functions and risks) for a foreign associated enterprise that may operate as a principal,

- Conversion of full-fledged manufacturers (that is, enterprises with a relatively higher level of functions and risks) into contract manufacturers or toll manufacturers (that is, enterprises with a relatively lower level of functions and risks) for a foreign associated enterprise that may operate as a principal,

- Transfers of intangibles or rights in intangibles to a central entity (*e.g.* a so-called "IP company") within the group,

- The concentration of functions in a regional or central entity, with a corresponding reduction in scope or scale of functions carried out locally; examples may include procurement, sales support, supply chain logistics.

9.3 There are also business restructurings whereby more intangibles 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 transactions comprising a business restructuring, irrespective of whether they lead to a more centralised or less centralised business model.

9.4 Some of the reasons reported by business for restructuring include 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 web-based technologies that has facilitated the emergence of global organisations. Furthermore, business restructurings may be needed to preserve profitability or limit losses, *e.g.* in the event of an over-capacity situation or in a downturn economy.

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 profit potential 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 profit potential 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 may complicate the application of the arm's length principle, which determines the profit of members of an MNE group by reference to the conditions which would have been made between independent enterprises in comparable transactions and comparable circumstances. This complexity in applying the arm's length principle in practice is acknowledged in these Guidelines (see paragraphs 1.10-1.11). Notwithstanding this issue, 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 restructurings, the OECD has kept this complexity 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 the Report on the Attribution of Profits to Permanent Establishments.[1]

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. The guidance in this chapter is composed of two parts, the first part provides guidance on the determination of the arm's length compensation for the restructuring itself; the second part addresses the remuneration of post-restructuring controlled transactions. Both parts should be read together, and applied in accordance with the guidance provided in the rest of these Guidelines, and in particular in Chapter I.

1 See Report on the Attribution of Profits to Permanent Establishments, approved by the Committee on Fiscal Affairs on 22-23 June 2010 and by the Council for publication on 22 July 2010.

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

A. Introduction

9.10 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, licences, service agreements, etc. The first step in analysing the transfer pricing aspects of a business restructuring is to accurately delineate the transactions that comprise the business restructuring by identifying the commercial or financial relations and the conditions attached to those relations that lead to a transfer of value among the members of the MNE group. This is discussed in Section B. Section C discusses the recognition of accurately delineated transactions that comprise the business restructuring. The relationship between a business restructuring and the reallocation of profit potential is addressed in Section D. The transfer pricing consequences of the transfer of something of value are discussed in Section E of this part and the transfer pricing consequences of the termination or substantial renegotiation of existing arrangements are discussed in Section F.

9.11 For transfer pricing purposes, the aim of the analysis is to determine whether, under Article 9 of the OECD Model Tax Convention, conditions have been made or imposed in transactions comprising a business restructuring that differ from those that would be made or imposed between independent enterprises; and, if so, to determine the profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, and include them in the profits of that enterprise and tax them accordingly.

9.12 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 a business restructuring 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.

B. Understanding the restructuring itself

9.13 The application of the arm's length principle to a business restructuring must start, as for any controlled transaction, with the identification of the commercial or financial relations between the associated enterprises involved in the business restructuring and the conditions and economically relevant circumstances attaching to those relations so that the controlled transactions comprising the business restructuring are accurately delineated. In this regard, the general guidance in Section D.1 of Chapter I is applicable. This guidance requires the examination of the economically relevant characteristics of the commercial or financial relations between the associated enterprises, and in particular the contractual terms of the business restructuring (Section D.1.1); the functions performed by each party to the restructuring, before and after the restructuring, taking into account assets used and risks assumed (Section D.1.2); the economic circumstances of the parties (Section D.1.4) and business strategies (Section D.1.5). In addition, the analysis should be informed by a review of the business reasons for and the expected benefits from the restructuring, including the role of synergies, and the options realistically available to the parties. As stated in paragraph 1.33, these conditions and economically relevant circumstances of the accurately delineated transactions that comprise the business restructuring will then be compared with the conditions and economically relevant circumstances of comparable transactions between independent enterprises.

9.14 Aspects of identifying the commercial or financial relations between the parties which are particularly relevant to determining the arm's length conditions of business restructurings, are analysed in the following sections:

- The accurate delineation of the transactions comprising the business restructuring 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 other options realistically available to the parties (see Section B.3).

B.1 Accurate delineation of the transactions comprising the business restructuring: functions, assets and risks before and after the restructuring

9.15 Restructurings can take a variety of different forms and may involve two or more 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 assumed by the full-fledged distributor being assumed by the manufacturer (taking into account the guidance in Section D.1 of Chapter I. Frequently, the restructuring will be more complicated, with functions performed, assets used and risks assumed by either or both parties to a pre-restructuring arrangement shifting to one or more members of the group.

9.16 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 accurately delineate the transactions occurring between the restructured entity and one or more other members of the group. For these purposes, the detailed guidance in Section D of Chapter I of these Guidelines is applicable.

9.17 Where the conditions of a business restructuring have been formalised by the MNE group in writing (e.g. written contractual agreements, correspondence and/or other communications), those agreements provide the starting point for delineating the transactions comprising the business restructuring between the MNEs involved. The contractual terms may describe the roles, responsibilities and rights 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. However, where no written terms exist, or where the facts of the case, including the conduct of the parties, differ materially from the written terms of any agreement between them or supplement these written terms, the actual transactions comprising the business restructuring must be deduced from the facts as established, including the conduct of the parties (see Section D.1.1 of Chapter I).

9.18 The accurate delineation of the transactions comprising the business restructuring requires performing a functional analysis that seeks to identify the economically significant activities and responsibilities undertaken, assets used or contributed, and risks assumed before and after the restructuring by the parties involved. Accordingly, the analysis focuses on what the parties actually do and the capabilities, as well as the type and nature of assets used or contributed by the parties in a pre-restructuring and post-restructuring scenarios. See Section D.1.2 of Chapter I. Given the importance of risk in the analysis of business restructurings, the following section provides specific guidance on the analysis of risk in transactions comprising the business restructuring.

B.1.1 The analysis of risk in the context of business restructurings

9.19 Risks are of critical importance in the context of business restructurings. Usually, in the open market, the assumption of risk associated with a commercial opportunity affects the profit potential of that opportunity, and the allocation of risk assumed between the parties to the arrangement affects how profits or losses resulting from the transaction are allocated through the arm's length pricing of the transaction. 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 remunerated with a relatively low (but generally stable) return on the grounds that the economically significant risks are assumed by another party to which the profits or losses associated with those risks are allocated. For this reason, an examination of the allocation of risks between associated enterprises before and after the restructuring is an essential part of the functional analysis. Such analysis should allow tax administrations to assess the transfer of the economically significant risks of the business that is restructured and the consequences of that transfer for the application of the arm’s length principle to the restructuring itself and to the post-restructuring transactions.

9.20 The framework and detailed guidance for analysing risk laid out in Section D.1.2.1 of Chapter I is applicable for purposes of undertaking an analysis of risks in the context of business restructurings, and in particular for determining which party assumes a specific risk by reference to control and financial capacity. It is crucial to apply this framework to determine which party assumes specific risks before the restructuring and which party assumes specific risks following the restructuring. For example, where a restructuring purports to transfer inventory risk, it is relevant to examine not only the contractual terms, but also the conduct of the parties under Step 3 in the framework (e.g. where any inventory write-downs are taken before and after the restructuring, whether there is any indemnification for those inventory write-downs, which party or parties perform risk control functions and have the financial capacity to assume the risks). The results of this analysis may establish that before the restructuring one party assumed the inventory risk and that same party continues to do so after the restructuring notwithstanding a change in contractual terms. In that situation, the risk would continue to be allocated to that same party. References in this Chapter to "transfer of risk", "relocation of risk, "shifting of risk" or "laying off of risk" should be read in the context of the guidance in Section D.1 of Chapter I. In particular, the transferee of the risk is considered to assume the risk when the conditions set out in the framework for analysing risk in controlled transactions (Section D.1.2.1 of Chapter I) are met.

9.21 [Based on 9.16] A second example relates to the purported transfer of credit risk as part of a business restructuring. The analysis under Section D.1.2.1 of Chapter I would take into account the contractual terms before and after the restructuring, but would also examine how the parties operate in relation to the risk before and after the restructuring. The analysis would then examine whether the party that contractually assumes the risk controls the risk in practice through relevant capability and decision-making as defined in paragraph 1.65 and has the financial capacity to assume such risk as defined in paragraph 1.64. It is important to note that a party that before the restructuring did not assume a risk under the analysis of Section D.1.2.1 of Chapter I cannot transfer it to another party, and a party that after the restructuring does not assume a risk under the analysis of Section D.1.2.1 of Chapter I should not be allocated the profit potential associated with that risk.

- For example, suppose a full-fledged distributor contractually assumes bad debt risks, which is reflected in the balance sheet at year end. However, the analysis described above establishes that before the business restructuring occurred decisions about the extension of credit terms to customers and debt recovery were taken by an associated enterprise and not by the distributor, and the associated enterprise reimbursed the costs of irrecoverable debts. It is determined that the associated enterprise controls the risk and has the financial capacity to assume the bad debt risk, leading to the conclusion that the risk is not assumed by the distributor. In such a case there is no risk for the distributor to transfer as part of the business restructuring.

- In other circumstances it may be found that before the business restructuring the distributor controlled the bad debt risk and had the financial capacity to assume the risk it contractually assumed, but mitigated its risk through indemnification arrangements or debt factoring arrangements with an associated enterprise in exchange for appropriate compensation. Following the business restructuring, the bad debt risk is contractually assumed by that associated enterprise which, as determined under the analysis described above, now controls the risk and has the financial capacity to assume the risk. The risk has, therefore been transferred but the impact on the profits of the distributor going forward compared with the past resulting from the transfer of this risk alone may be limited, because before the restructuring steps had been taken and costs incurred to mitigate the risk outcomes of the distributor.

9.22 In any analysis of risks in controlled transactions, one important issue is to assess whether a risk is economically significant, *i.e.* it carries significant profit potential, and, as a consequence, whether that risk may explain a significant reallocation of profit potential. The significance of a risk will depend on the likelihood of the risk materialising and the size of the potential profits or losses arising from the risk. Accounting statements may provide useful information on the probability and quantum of certain risks (e.g. bad debt risks, inventory risks), if past performance is an indicator of current risks, but there are also economically significant risks that may not be separately recorded as such in the financial accounts (e.g. market risks). If a risk is assessed to be economically insignificant for the entity, then that risk would not explain a substantial amount of the entity's profit potential. At arm's length a party would not be expected to lay off a risk that is perceived as economically insignificant in exchange for a substantial decrease in its profit potential.

9.23 For instance, where a full-fledged distributor is converted into a limited-risk distributor or commissionnaire resulting in the reduction or elimination of risks relating to inventory in the restructured enterprise, in order to determine whether such risk is economically significant the tax administration may want to analyse:

- The role of inventory in the business model (for example, speed to market, comprehensive range),
- The nature of the inventory (for example, spare parts, fresh flowers),
- The level of investment in inventory,
- The factors giving rise to inventory write-downs or obsolescence (for example, perishability, pricing pressures, speed of technical improvements, market conditions),
- The history of write-down and stock obsolescence, and whether any commercial changes affect the reliability of historic performance as an indicator of current risk,
- The cost of insuring against damage or loss of inventory, and
- The history of damage or loss (if uninsured).

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

9.24 Some businesses have indicated that multinational businesses, regardless of their products or sectors, have reorganised their structures to provide more centralised 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 specialisation and the need to increase efficiency and lower costs have all been described as important in driving business restructurings. 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 the source of these synergies and how these anticipated synergies impact at the entity level in applying the arm's length principle (see Section D.8 of Chapter I). Care should be taken to ensure that, where deliberate concerted group actions are taken through a business restructuring, the associated enterprises contributing to the synergistic benefit after the restructuring are appropriately remunerated (see the example in the following paragraph). 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).

9.25 For example, a business restructuring may involve the setting up by an MNE group of a central procurement operation that replaces the procurement activities of several associated enterprises. Similar to the guidance at 1.160 the MNE group has taken affirmative steps to centralise purchasing in a single group company to take advantage of volume discounts and potential savings in administrative costs. In accordance with the guidance in Chapter I the benefits should be allocated to the associated enterprises whose contributions create the synergies. However, in a business restructuring, the central procurement company may also contractually assume risk associated with buying, holding, and on-selling goods. As stated in the previous section, an analysis of risk under the framework provided in Section D.1.2.1 of Chapter I will determine the economic significance of the risk and which party or parties assume that risk. Where the central procurement operation is entitled to profit potential arising from its assumption of the risk associated with buying, holding, and on-selling goods, it is not entitled also to retain profits arising from the group purchasing power.

9.26 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

9.27 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 offers a clearly more attractive opportunity to meet their commercial objective. 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.

9.28 Thus, in applying the arm's length principle, the tax administration should evaluate each transaction as accurately delineated under the guidance in Section D of Chapter I and consider the economically relevant characteristics taken into account by the parties in reaching the conclusion that the restructuring adopted offers a clearly more attractive opportunity to meet commercial objectives than alternative options realistically available (see paragraph 1.38). In making such assessment, it may be necessary or useful to assess the transactions comprising the business restructuring in the context of a broader arrangement of economically related transactions.

9.29 At arm's length, there are 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 F 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 or to seek more lucrative opportunities. If 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 E below.

9.30 At arm's length, there are also situations where an entity would have had one or more options realistically available to it that would clearly offer more attractive opportunities to meet their objectives 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 and adjustments to the conditions made or imposed may be necessary.

9.31 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. 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.

B.4 Transfer pricing documentation for business restructurings

9.32 Taxpayers are required to describe in the master file any important business restructuring transactions occurring during the year (see Annex I to Chapter V). In addition, in the local file, taxpayers are asked to indicate whether the local entity has been involved in or affected by business restructurings occurring during the year or immediately past year and to explain the aspects of such transactions affecting the local entity (see Annex II to Chapter V).

9.33 As part of their transfer pricing documentation, MNE groups are recommended to document their decisions and intentions regarding business restructurings, especially as regards their decisions to assume or transfer significant risks, before the relevant transactions occur, and to document the evaluation of the consequences on profit potential of significant risk allocations resulting from the restructuring. In describing the assumption of risk as part of a business restructuring, it is recommended that taxpayers use the framework set out in Section D.1.2.1 of Chapter I.

C. Recognition of the accurately delineated transactions that comprise the business restructuring

9.34 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. In making commercial decisions, 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 make, where appropriate, adjustments to profits in accordance with Article 9 of the OECD Model Tax Convention and 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.

9.35 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 may not be found between independent enterprises. This lack of comparables does not mean that the implementation of such global business models is not arm's length. Every effort should be made to determine the pricing for the restructured transactions as accurately delineated under the arm's length principle. A tax administration should not disregard part or all of the restructuring or substitute with other transactions unless the exceptional circumstances described in paragraph 1.122 are met. In those cases, the guidance in Section D.2 of Chapter I may be applicable.

9.36 In assessing the commercial rationality of a restructuring under the guidance for non-recognition under Section D.2 of Chapter I, 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.

9.37 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. Where a restructuring makes commercial sense for the group as a whole on a pre-tax basis, 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 provide arm’s length compensation for each accurately delineated transaction comprising the business restructuring for each individual group member participating in it.

9.38 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.[2] The presence of a tax motive or purpose does not of itself justify non-recognition of the parties' characterisation or structuring of the arrangement. However, tax benefits at a group level do not determine whether the arm's length principle is satisfied at the entity level for a taxpayer affected by the restructuring (see previous paragraph). Moreover, as indicated in paragraph 1.122, the fact that a MNE group as a whole is left worse off on a pre-tax basis may be a relevant pointer in determining the commercial rationality of the restructuring.

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

D.1 Profit potential

9.39 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 (an asset or an ongoing concern) 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.

9.40 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.

9.41 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 discernible rights 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 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.

9.42 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.

D.2 Reallocation of risks and profit potential

9.43 General guidance on the transfer pricing aspects of risks is found in Section D.1.2.1 of Chapter I, and the reallocation of risk following a business restructuring should be analysed under the framework set out in that Section in order to determine whether the party allocated risk following the restructuring controls the risk and has the financial capacity to assume the risk.

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

9.44 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, other assets and economically relevant characteristics. Indemnification is discussed in Section F.

9.45 As another example, assume a full-fledged distributor is operating 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 limited 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 the restructuring leads to the renegotiation of the existing contractual arrangements, but it does not entail the transfer of assets other than its rights under the long term contract. 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) is expected to make it as well off as its realistic – albeit riskier – alternatives. If not, this would imply that the post-restructuring arrangement is not priced at arm's length and that additional compensation would be needed to appropriately remunerate the distributor for the restructuring, or that an assessment of the commercial rationality of the transaction based on Section D.2 may be necessary. Furthermore, for transfer pricing purposes, it is important to determine whether risks contractually transferred as part of the business restructuring, are assumed by the foreign associated enterprise in accordance with the guidance in Section D.1 of Chapter I.

9.46 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. In particular, in evaluating profit potential, it is necessary to evaluate whether historic profits (determined in accordance with the arm's length principle) are an indicator of future profit potential, or whether there have been changes in the business environment around the time of the restructuring that mean that past performance is not an indicator of profit potential. For example, competing products could have the effect of eroding profitability, and new technology or consumer preferences could render the products less attractive. The consideration of these factors from 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.

	Scenario 1	Scenario 2	Scenario 3
Full-fledged distributor **Historical profitability data** **(last 5 years)**	Year 1: - 2% Year 2: 4% Year 3: 2% Year 4: 0% Year 5: 6%	Year 1: 5% Year 2: 10% Year 3: 5% Year 4: 5% Year 5: 10%	Year 1: 5% Year 2: 7% Year 3: 0% Year 4: 8% Year 5: 6%
Full-fledged distributor **Projected profitability** **(over remaining term of agreement)**	(-2)% to 6% With significant uncertainties within this range	5% to 10% With significant uncertainties within that range	0% to 4% With significant uncertainties within that range (due to new competitive pressures)
Limited risk distributor **Projected profitability** **(next three years)**	2% per year	2% per year	2% per year

9.47 In scenario no. 1, the distributor is surrendering a profit potential with significant uncertainties for a relatively low but stable rate of profitability. 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 scenario 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. Scenario 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.

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

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

E.1 Tangible assets

9.49 Business restructurings can involve the transfer of tangible assets (*e.g.* equipment) by a restructured entity to a foreign associated enterprise. 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 undertake an analysis of the transactions comprising the business restructuring as accurately delineated under Section D.1 of Chapter I, nor is it intended to suggest that a particular transfer pricing method is always acceptable for restructured operations.

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

9.51 Assume the arrangement is restructured and the taxpayer now operates as a so-called "toll-manufacturer" and "limited risk distributor". As part of the restructuring, a foreign associated enterprise is established that acquires various 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 contractually assumes the inventory risks that were previously borne by the taxpayer, and meets the requirements of control over the risk and financial capacity to assume the risk.

9.52 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.

9.53 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.

9.54 In practice, what to do about inventory at the time of the restructuring would likely be taken into account by unrelated parties in agreeing the terms of the total deal, and inventory should be analysed as part of delineating the actual transactions comprising the business restructuring. A key consideration is how to deal with the risks inherent in the inventory, and how to avoid double counting—i.e. the party reducing its risks should not receive a price that takes into account risks it has given up, and cannot exploit. If raw materials costing 100 now have a market price of 80 or 120, then a transfer would crystallise a loss or gain which could be a significant impediment to one of the parties to the restructuring. The matter is likely to be resolved as part of the overall terms of the restructuring and should be analysed accordingly. In practice there may be a transition period where inventory is run down before starting the new arrangements, and thus avoiding transfer of inventory, particularly when there may be several complications beyond transfer pricing involved in transferring legal ownership of inventory cross-border.

E.2 Intangibles

9.55 Transfers of intangibles or rights in intangibles raise difficult questions both as to the identification of the intangibles transferred and as to their valuation. Identification can be difficult because not all valuable intangibles are legally protected and registered and not all valuable intangibles are recognised or recorded for accounting purposes. Relevant intangibles 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 with specificity the relevant intangibles or rights in intangibles that were transferred (if any), whether independent parties would have remunerated their transfer, and what their arm’s length value is.

9.56 The determination of the arm’s length price for a transfer of intangibles or rights in intangibles should be conducted in accordance with the guidance in Section D.1 of Chapter VI. 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, the nature of the intangible 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. See Section D.2.1 of Chapter VI. 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 is applicable in the context of business restructurings.

E.2.1 Disposal of intangibles or rights in intangibles by a local operation to a central location (foreign associated enterprise)

9.57 Business restructurings sometimes involve the transfer of the legal ownership of intangibles or rights in intangibles that were previously owned 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”). 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 limited risk distribution arrangement using a trademark that was transferred). In accordance with the guidance in Chapter VI, it is important to remember that the legal ownership of an intangible by itself does not confer any right ultimately to retain returns derived by the MNE group from exploiting that intangible (see 6.42). Instead, the compensation required to be paid to associated enterprises performing or controlling functions related to the development, enhancement, maintenance, protection, or exploitation of intangibles may comprise any share of the total return anticipated to be derived from the intangibles (see 6.54). Therefore, the change in legal ownership of an intangible in a business restructuring may not affect which party is entitled to returns from that intangible.

9.58 MNE groups may have sound business reasons to centralise ownership of intangibles or rights in intangibles. An example in the context of business restructuring is a transfer of legal ownership 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 intangibles. 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 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. In such a scenario it will be important to delineate the actual transaction and to understand whether the transfer of legal ownership is for administrative simplicity (as in Example 1 of the Annex to Chapter VI), or whether the restructuring changes the identity of the parties performing or controlling functions related to the development, enhancement, maintenance, protection, and exploitation of intangibles.

9.59 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 legal ownership of intangibles may be motivated by sound commercial reasons at the level of the MNE group does not answer the question whether the conditions of the transfer are arm's length from the perspectives of both the transferor and the transferee.

9.60 Also in the case where a local operation disposes of the legal ownership of its intangibles 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. The determination of an arm's length remuneration for the subsequent ownership, control and exploitation of the transferred intangible should take account of the extent of the functions performed, assets used and risks assumed by the parties in relation to the intangible transferred, and in particular analysing control of risks and control of functions performed relating to the development, enhancement, maintenance, protection, or exploitation of the intangibles.

9.61 Where the business restructuring provides for a transfer of an intangible 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 accurately delineate the transaction. 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 licence 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, in an arrangement whereby a patent is transferred for a price of 100 in Year N and a licence 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, it is likely that at least one of the two prices is not arm's length or that the arrangement should be delineated as something other than a sale and concomitant license back. In some circumstances, the accurate delineation of the transaction might conclude that the arrangements reflect the provision of financing, as illustrated in Example 16 of the Annex to Chapter VI.

E.2.2 Intangible transferred at a point in time when its valuation is highly uncertain

9.62 Difficulties can arise in the context of business restructuring where the valuation of an intangible or rights in an intangible at the time of the transaction is highly uncertain. In these cases, the question arises as to 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. To this aim, the guidance in Section D.3 of Chapter VI is relevant.

9.63 In addition, where the intangible being transferred as a result of the restructuring meets the criteria for being considered a hard-to value-intangible in paragraph 6.189, then the guidance in Section D.4 of Chapter VI is applicable.

E.2.3 Local intangibles

9.64 Where a local full-fledged operation is converted into an operation assuming limited risk, using limited intangibles and receiving low remuneration, the questions arise of whether this conversion entails the transfer by the restructured local entity to a foreign associated enterprise of valuable intangibles or rights in intangibles and whether there are local intangibles that remain with the local operation.

9.65 In particular, in the case of the conversion of a full-fledged distributor into, for example, a limited risk distributor or commissionnaire, 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. In this regard it is relevant to note that the transferee, as legal owner of the transferred intangible, should provide arm's length compensation (in addition to the arm’s length compensation for the transferred intangibles) to the transferor when the transferor, after the restructuring, continues to perform functions related to the development, enhancement, maintenance, protection or exploitation of the local intangible transferred (see Section B.2.1 of Chapter VI). 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, in order that appropriate compensation can be determined.[3]

E.2.4 Contractual rights

9.66 Contractual rights can be valuable intangibles. 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.

9.67 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

[3] See Part II of this chapter for a discussion of the remuneration of the post-restructuring arrangements.

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 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.

E.3 Transfer of activity (ongoing concern)

E.3.1 Valuing a transfer of activity

9.68 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 assume certain risks. Such functions, assets and risks may include, among other things: tangible property and intangibles; 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. See Section A.4.6 of Chapter VI. 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 impact (e.g. time and expense savings) of the assembled workforce on the arm's length price. For a discussion on the transfer pricing treatment of assembled workforce, see Section D.7 of Chapter I.

9.69 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 of 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 techniques that are used, in acquisition deals, between independent parties may prove useful to valuing the transfer of an ongoing concern between associated enterprises. The guidance on the use of valuation techniques for transactions involving the transfer of intangibles or rights in intangibles contained in Section D.2.6.3 of Chapter VI should be considered.

9.70 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.

E.3.2 Loss-making activities

9.71 Not every case where a restructured entity experiences a reduction of its functions, assets and 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 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.

9.72 The question may arise 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.

9.73 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. See Section D.3 of Chapter I.

E.4 Outsourcing

9.74 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 implementing this type of outsourcing arrangement may not necessarily require explicit compensation from the transferee, for example, where the anticipated benefits for the transferor are greater than its restructuring costs.[4]

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

9.75 Section F addresses the question of whether the restructured entity, at arm's length, should receive compensation, in the form of indemnification, upon the termination or substantial renegotiation of its existing arrangements, which may or may not involve a transfer of something of value (addressed in the previous section). 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,

4 A further issue discussed in Section D.6 of Chapter I and Section E of Part II of this Chapter is whether and if so how location savings should be allocated between the parties at arm's length.

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.

9.76 Terminations or renegotiations of arrangements generally involve changes in the risk and functional profiles of the parties, with consequences for the allocation of profit potential between them. In addition, the termination or renegotiation of contractual relationships in the context of a business restructuring might cause the restructured entity to 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 these situations, the question arises of whether, at arm's length, indemnification should be paid to the restructured entity, and if so how to determine such an indemnification.

9.77 When the termination or renegotiation of existing arrangements involves the transfer of something of value (e.g. the termination of a distribution contract is sometimes accompanied by a transfer of intangibles), the guidance at Section E applies to the transfer of something of value, and this section considers whether further compensation may be warranted for any detriments suffered.

9.78 There should be no presumption that all contract terminations or substantial renegotiations should give a right to indemnification at arm’s length, as this will depend on the facts and circumstances of each case. The analysis of whether an indemnification would be warranted at arm’s length should be made on the basis of the accurate delineation of the arrangements before and after the restructuring (based on the guidance in Section D.1 of Chapter I and Section B.1 of this Part) and the options realistically available to the parties.

9.79 Once the restructuring arrangements have been accurately delineated and the options realistically available to the parties have been assessed, the following aspects should be considered:

- Whether commercial law supports rights to indemnification for the restructured entity under the facts of the case as accurately delineated (see Section F.1 below);

- Whether the existence or absence of an indemnification clause or similar provisions (as well as the terms of such a clause where it exists) under the terms of the arrangement, as accurately delineated, is arm’s length (see Section F.2 below).

- Which party should ultimately bear the costs related to the indemnification of the party that suffers from the termination or re-negotiation of the agreement (see Section F.3 below).

F.1 Whether commercial law supports rights to indemnification for the restructured entity under the facts of the case as accurately delineated

9.80 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.

F.2 Whether the existence or absence of an indemnification clause or similar provisions (as well as the terms of such a clause where it exists) under the terms of the arrangement, as accurately delineated, is arm's length.

9.81 The accurate delineation of the transaction will identify whether an indemnification clause or arrangement is in place upon termination, non-renewal or re-negotiation of the arrangements. In order to do so, the starting point should be a review of whether an indemnification clause or similar provision for termination, non-renewal or renegotiation is provided for, and of whether the conditions for termination, non-renewal or renegotiation of the contract were respected (*e.g.* with regard to any required notice period). 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 similar provision does not necessarily mean that this is arm's length, as discussed below.

9.82 As noted at paragraph 1.46, in transactions between independent enterprises, the divergence of interests between the parties ensures that: (i) contractual terms are concluded that reflect the interest of both parties, (ii) the parties will ordinarily seek to hold each other to the terms of the contract, and (iii) that contractual terms will be ignored or modified after the fact generally only if it is in the interests of both parties. However, this same divergence of interest may not exist in the case of associated enterprises or any such divergences may be managed in ways facilitated by the relationship between the associated enterprises and not solely or mainly through contractual agreements. For this reason, when the facts of the case differ from the written terms of the agreement between the parties or when no written terms exist, the absence or existence (and its terms) of an indemnification clause should be deduced from the conduct of the parties. For instance, it may be that, on the basis of the facts of the case and of the actual conduct of the associated enterprises, it is determined that the term of the contract is longer than established in the written contract, which would entitle the terminated party to some indemnification in case of early termination.

9.83 Once the existence or absence of an indemnification clause in favour of the restructured entity upon termination, non-renewal or substantial renegotiation of the agreements has been determined, the analysis should then focus on assessing whether such indemnification clause and its terms (or absence thereof) are arm's length. 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.

9.84 However, in those cases where such comparables data are not found, the determination of whether the indemnification clause (or absence thereof) is arm's length 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. This analysis might also be assisted by an examination of the options realistically available to the parties, as 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. The guidance in Section D of Chapter I, as well as the Guidance in Section B of this Part, are applicable.

9.85 Another aspect that may be necessary to examine in assessing whether the conditions of an arrangement in relation to an indemnification clause are arm's length, is 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.

9.86 Business restructurings may lead to the termination of the employment contracts of members of an assembled workforce. In this regard, in determining whether the restructuring is undertaken on arm's length terms , the analysis should consider the facts and circumstances before and after the restructuring related to the assembled workforce, including whether something of value has been transferred upon termination of the arrangements between associated enterprises and, for example, whether there are implicit or explicit restrictive covenants (e.g. non-compete clause) in the employment contracts of the workforce members, which should be reflected in the amount of any indemnification that should be paid to the party previously undertaking the activities through that workforce.

9.87 One circumstance that deserves particular attention, 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.

9.88 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.* 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 would have no other choice than to write off the assets.

9.89 At arm's length, the manufacturer may mitigate the risks inherent in the investment by:

- Including in the contract an appropriate indemnification clause or penalties in case of early termination, or 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.

- Factoring 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 where third party comparables that bear comparable risks can be identified, perhaps by including front-end loaded fee structures). 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.

9.90 As a general matter, mitigation of risk inherent in the investment by a manufacturer is relevant to consider only if the manufacturer assumes the risk. In practice, the investment by an associated enterprise in a manufacturing plant where that enterprise is wholly dependent on another associated enterprise for the capability to generate returns is likely to require careful scrutiny in relation to the identification of risks and how those risks are controlled. As explained in Example 2 in paragraphs 1.84 and 1.102 where significant risks associated with generating a return from the manufacturing activities are controlled solely by another party (which also has the financial capacity to bear that risk), then that other party is allocated the upside and downside consequences of those risks, including under-utilisation, write-down, and closure costs. In that case, the manufacturer should not suffer the financial consequences of an early termination, as it did not control the economically significant risks that contributed to the closure, and in such a case the manufacturer would also not be expected to mitigate risks it did not in fact assume.

9.91 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. In such a case, it will be necessary to analyse the actual arrangements very carefully to determine whether the party in substance takes a stake in the results of the development efforts or has merely accepted deferred payment terms. In performing the analysis the guidance relating to control over risk in Section D.1.2.1 of Chapter I will be relevant. If the party does control the risks, it might be expected that the party would seek to protect itself from the risk of non-recovery through penalty or indemnification terms. If the party did not control the risks of non-recovery, then the terms are unlikely to be arm's length.

9.92 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.

F.3 Which party should ultimately bear the costs related to the indemnification of the party that suffers from the termination or re-negotiation of the agreement

9.93 The transfer pricing analysis of the arm's length nature 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 risks assumed by 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.

9.94 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 9.78, 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, based on the guidance in this section, that in the circumstances of the case at arm's length, B would be in a position to claim an indemnification for the detriment suffered from the termination. The question arises as to which party should ultimately bear the indemnification to be paid to B: A (*i.e.* the party terminating the contract), C (*i.e.* the party taking over the manufacturing activity previously performed by B), or another party in the MNE group benefitting from the restructuring. The analysis should start from the accurate delineation of the actual transactions comprising the business restructuring, and take into account economically related transactions with other enterprises in the MNE group that may help to delineate the controlled transaction (see paragraphs 1.36-1.38).

9.95 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.

9.96 There can be situations where C would be willing to pay an up-front fee to obtain the rights to 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 A, or that C would be constructively paying A by meeting A's indemnification obligation to B. It is also possible that C would pay B, for example, in the circumstances where B had certain rights and C would pay B for the transfer of those rights.

9.97 There can be cases where at arm's length A and C would be willing to share the indemnification costs. In cases where the benefits arising from the restructuring accrue to another party in the MNE group, then that other party may bear the costs of indemnification, either directly or indirectly.

Part II: Remuneration of post-restructuring controlled transactions

A. Business restructurings versus "structuring"

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

9.98 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.

9.99 Comparable situations must be treated in the same way, regardless of whether or not they came into existence as a result of a business restructuring of a previously existing structure. The selection and practical application of an appropriate transfer pricing method must be based on the economically relevant characteristics of the transaction leading to the accurate delineation of the actual transaction.

9.100 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 comprise the business restructuring. The application of the arm's length principle to those additional transactions is discussed in Part I of this chapter.

9.101 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

9.102 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. Sometimes, 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 of the post-restructuring arrangements (see paragraphs 9.27-9.31 for a discussion of options realistically available in the context of determining the arm's length compensation for the restructuring itself). 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 distribution" contract whereby it will perform limited marketing activities under the supervision of a foreign associated enterprise, employ limited marketing intangibles and assume limited risks in its relationship with the foreign associated enterprise and customers. In such a situation, the restructured distributor would not be in the same position as a newly established distributor.

9.103 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.

9.104 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.

9.105 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 (see Section E.2 of Part I above and Chapter VI of these Guidelines).

9.106 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, consider a situation in which a distributor was assuming bad debt risks which it will no longer assume after its being restructured as a "limited risk distributor", and that it is being compared with a long-established "limited risk distributor" that never assumed bad debt risk. It may be important when comparing both situations to examine, based on the guidance in Section D.1.2.1 of Chapter I, whether the "limited risk distributor" that results from a conversion still assumes 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.

9.107 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

9.108 The selection and application of a transfer pricing method to post-restructuring controlled transactions must derive from the analysis of the economically relevant characteristics of the controlled transaction as accurately delineated. 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 risk 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 intangibles and the economically 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. The form of remuneration cannot dictate inappropriate risk allocations. It is the determination of how the parties actually control risks, and whether they have the financial capacity to assume the risks, as set out in the process of analysing risk in Chapter I, which will determine the assumption of risks by the parties, and consequently dictate the selection of the most appropriate transfer pricing method. Issues regarding risks and intangibles are discussed in Part I of this chapter.

9.109 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. It should be noted that the mere fact that an arrangement is not seen between independent enterprises does not in itself mean that it is not arm's length nor commercially irrational. Furthermore, every effort should be made to determine the pricing for the restructuring transactions as accurately delineated under the arm's length principle.

9.110 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 economically relevant characteristics or 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 the fact that a different party assumes bad debt risk.

9.111 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 economically relevant characteristics or 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.

9.112 Whenever a comparable is proposed, it is important to ensure that a comparability analysis of the controlled and uncontrolled transactions is performed in order to identify material differences, if any, between them 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 economically 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.

9.113 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, for instance where the restructuring has led to fragmentation of integrated functions across several group companies in a way that is not found between unrelated parties. This does not necessarily mean that the conditions of the controlled transaction as accurately delineated are not 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

9.114 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 9.74 regarding outsourcing.

9.115 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 I of this chapter for a discussion of situations where compensation would be payable at arm's length for the restructuring itself.

9.116 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 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

9.117 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.[5]

9.118 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.

9.119 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.

9.120 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. [6]

9.121 The 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. Typically, as part of the restructuring the entity may have been purportedly stripped of intangibles or risk, but after the restructuring it continues to carry out some or all of the functions it previously performed. Following the restructuring, however, the "stripped" entity performs those functions under contract to a foreign associated enterprise. The accurate delineation of the actual transaction between the foreign associated enterprise and the "stripped" entity will determine the actual commercial or financial relations between them, including whether the contractual terms are consistent with the conduct of the parties and other facts of the case. Arm's length compensation for each party should be consistent with its actual functions performed, assets used and risks assumed after the restructuring.

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

6 See paragraphs 9.27-9.9.31] for a discussion of options realistically available; see also paragraphs [9.102-9.106 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.

9.122 For example, an MNE manufactures and distributes products the value of which is not determined by the technical features of the products, but rather by consumer recognition of the brand[7]. The MNE wants to differentiate itself from its competitors through the development of brands with great value, by implementing a carefully developed and expensive marketing strategy. The trademarks, trade names and other intangibles represented by the brand are owned by Company A in Country A and Company A assumes the risks associated with the ownership, development and exploitation of those intangibles. The development, maintenance and execution of a worldwide marketing strategy are the main value drivers of the MNE, performed by 125 employees at Company A's head office. The value of the intangibles 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.

9.123 Then a restructuring takes place. Legal ownership of the trademarks, trade names and other intangibles represented by the brand is 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 remaining profits after remuneration of the contract manufacturers, distributors, and Company A head office services are paid to Company Z. The accurate delineation of the transactions before and after the restructuring determines that:

- Company Z is managed by a local trust company. It does not have people (employees or directors) who have the capability to perform, and who in fact do not perform control functions in relation to the risks associated with the ownership or the strategic development of the trademarks, trade names or other intangibles represented by the brand. 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.

9.124 Based on these findings, it can be concluded that Company A continues to perform the same functions and assume the same risks as before the restructuring took place. In particular, Company A continues to have the capability and actually performs control functions in relation to the risk of exploitation of the intangibles. It also carries on the functions related to the development, maintenance and execution of the worldwide marketing strategy. Company Z has no capability to perform control functions, and does not in fact perform the control functions needed to assume the intangible related risks. Accordingly, the accurate delineation of the transaction after the restructuring may lead to the conclusion that this is in substance a funding arrangement between Company A and Company Z, rather than a

7 For an explanation of the term "brand", please see paragraph 6.23.

restructuring for the centralisation of intangible management. An assessment may be necessary of the commercial rationality of the transaction based on the guidance in Section D.2 of Chapter I taking into account the full facts and circumstances of the transaction[8].

9.125 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 9.110. Whether such uncontrolled transactions provide reliable comparables would have to be evaluated in light of the guidance at paragraph 3.2.

E. Location savings

9.126 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 in Section D.1.5 of Chapter I is relevant.

9.127 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. In addressing this matter, the guidance in Section D.6 of Chapter I is relevant.

9.128 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).

9.129 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.

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

9.130 As another example, assume now that an enterprise in Country X provides highly specialised and quality engineering services to independent clients. 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 subcontracts a large part of its engineering work to a new subsidiary in Country Y. The subsidiary in Country Y hires equally qualified engineers to those in Country X for substantially lower wages, 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 (at an amount that would not allow the company in Country X to cover the wages for qualified engineers in Country X, but that would still yield a benefit if those services are provided by qualified engineers in Country Y). Part of the location savings are passed on to its clients. In this case also, the question arises of which party(ies) within the MNE group should, at arm's length, be attributed the part of the location savings not passed on to the clients: the subsidiary in Country Y, the enterprise in Country X, or both (and if so in what proportions).

9.131 In determining which party(ies) should be attributed the location savings at arm's length, it will be important to consider the functions, risks and assets of the parties, as well as the options realistically available to each of them. In this example, assume that there is a high demand for the type of engineering services that the company in Country X sells. Assume also that the subsidiary in Country Y is the only company operating in a lower-cost location that is able to provide such services with the required quality standard, and Company Y is able to withstand competitive pricing pressures because the technical know-how it has established acts as a barrier to competition. Furthermore, the company in Country X does not have the option of engaging qualified engineers in Country X to provide these services, as the cost of their wages would be too high compared to the hourly rate charged to clients. Considering this, the enterprise in Country X does not have many other options available to it than to use this service provider. The remuneration payable by Company X to Company Y should take into account the location savings created by Company Y, in addition to the value of its services including any intangibles used in providing those services. In some instances, the nature of the contributions made by the enterprise in Country X and its subsidiary in Country Y may meet the criteria for the use of a transactional profit split method.