

Transfer Pricing & Business Restructuring

IBFD

Editor
Anuschka Bakker

Table of Contents

Foreword	
Acknowledgements	
Abbreviations and Common References	
1 – Introduction	
1. Drivers of Business Restructuring	11
1.1. Global business models to maximize synergies and economies of scale.....	12
1.2. Improvement of productivity of the supply chain.....	13
1.3. Other external and internal factors.....	13
2. Business Restructuring from an Economic Perspective	15
2.1. Business perspective.....	15
2.2. Stakeholder’s perspective.....	16
3. Tension between Commercial Aims and Tax Environment	16
2 – Business Models	
1. Introduction	19
2. Business Modelling for Tax and Transfer Pricing Purposes	22
2.1. Manufacturer.....	27
2.2. Distributor.....	30
2.3. Service provider.....	35
2.4. Responsibility profile of business model.....	38
2.5. Identification of the business model and related issues.....	42
3. Business Restructurings	44
3.1. Intangible property transfers.....	46
3.2. Conversion from fully fledged to contract manufacturing model.....	51
3.3. Conversion from fully fledged distributor to stripped distributor model.....	52
4. Centralized services and cost allocation agreements	53
3 – OECD Policy Framework	
1. OECD policy framework in the area of international taxation	57
1.1. OECD in general.....	57
1.2. OECD tax work.....	58
1.3. Base erosion and profit shifting (BEPS).....	58
1.4. Arm’s length principle and OECD Guidelines.....	59
1.5. Permanent establishment issues.....	66
2. Prevention and resolution of transfer pricing and other international tax disputes	71

2.1. Dispute resolutionSee www.oecd.org/ctp/dr (accessed 28 Dec. 2017).....	71
2.2. Dispute prevention.....	74
3. OECD guidance on business restructuring	74
3.1. Restructurings that are within the scope of the OECD project.....	74
3.2. Transfer pricing dimension of business restructurings.....	75
4. Summary of the guidance in Chapter IX of the OECD Guidelines	76
4.1. Part 1: Arm’s length compensation for the restructuring itself.....	76
4.2. Part 2: Remuneration of post-restructuring controlled transactions.....	89
5. Conclusion	94

4 – EU Policy Framework.....

1. Developments Concerning Business Restructuring in EU Legislation	95
1.1. Impact of existing secondary EU law on business restructuring.....	95
1.2. Impact of proposed secondary EC law on business restructuring: Common Consolidated Corporate Tax Base and Home State taxation.....	99
1.3. Impact of proposals of the EU Joint Transfer Pricing Forum on business restructuring.....	103
1.4. Resolution on coordinating exit taxation 29 November 2008.....	104
1.5. Anti-Avoidance Tax Directive (ATAD).....	105
2. Impact of Case Law on Business Restructuring	106
2.1. General.....	106
2.2. Preliminary questions.....	107
2.3. European Commission’s formal requests and referrals to the ECJ in respect of exit taxes and transfer of assets.....	116
3. State Aid Investigations	120

5 – Article 9 of the OECD Model Convention.....

1. Introduction	124
2. Arm’s length (comparability) analysis and recognition, or non-recognition of transactions undertaken	127
2.1. Introduction.....	127
2.2. Meaning of “conduct of parties”.....	128
2.3. Determining whether terms and conditions between the respective parties are arm’s length from a commercial or financial perspective.....	129
2.4. Choice between comparability adjustment or non-recognition of (part of) a transaction.....	132
2.5. Trade-off between equity and efficiency.....	137

6 – Permanent Establishment Issues.....

1. The Presence of a Permanent Establishment	139
1.1. Tax treaty definitions of what constitutes a permanent establishment.....	140
1.2. The concept of permanent establishment in domestic law.....	144
1.3. The concept of permanent establishment in EU Legislation.....	145
2. Types of Permanent Establishments	147

3. Case Law on Permanent Establishment Issues in the Case of Business Restructurings	149
3.1. Case law on the conversion of a fully fledged distributor into a commissionaire.....	149
3.2. Case law on the transfer of part of the management of a group company to another group company in another state.....	153
4. Allocation of Profits to PEs in the Case of Business Restructurings: Possible Influence of Actions 8, 9 and 10 of the BEPS Report	156

7 – VAT Aspects of Business Restructuring	
1. Introduction	159
1.1. General.....	159
1.2. Introduction to the VAT system of the European Union and the treatment of financial activities.....	159
2. Group Financing Activities	163
3. Transfer of Assets	163
3.1. Scope of the TOGC no-supply rule.....	164
3.2. Definition of “totality of assets”.....	165
3.3. Successor’s intention to continue the business.....	165
3.4. Business licence or authorization.....	166
3.5. Right to deduct VAT.....	166
4. Transfer of Shares	167
4.1. General.....	167
4.2. Selling of shares outside the scope of VAT.....	168
4.3. Selling of shares falling within the scope of VAT.....	169
5. Issue of New Shares	169
6. Outsourcing	170
7. Changes to the Business Model as Described in Chapter 2	172
7.1. Transfer of intellectual property.....	172
7.2. From fully fledged manufacturer to contract manufacturer.....	172
7.3. From fully fledged distributor to stripped distributor.....	173
7.4. Commissionaires.....	173
7.5. Centralized services/cost allocation.....	173

8 – Customs Duties	
1. Introduction	175
2. Customs Law	175
3. General Agreement on Tariffs and Trade; World Trade Organization	177
3.1. General Agreement on Tariffs and Trade.....	177
3.2. World Trade Organization.....	178
4. The European Union	179
4.1. The European Communities: ECSC, EEC and EAEC/Euratom.....	179
4.2. EU customs law.....	180
4.3. Basic legal provisions.....	180
5. Customs in the United States	181

5.1. The Customs Modernization Act.....	181
5.2. Valuation.....	182
5.3. Free trade agreements.....	182
6. Association of Southeast Asian Nations.....	183
6.1. ASEAN Free Trade Area.....	183
6.2. Customs rules.....	183
6.3. Valuation.....	184
7. Determining the Value of Goods.....	184
7.1. Transaction value.....	184
7.2. Significance of “relationships” between buyer and seller.....	185
7.3. Alternative measures of value.....	186
7.4. Additions and exclusions to the transaction value.....	186
8. Customs value and transfer pricing See M. Fabio, Customs Law of the European Union (Kluwer Law International, 2012), para. 4.7.....	187
8.1. Two sides of the same coin.....	187
8.2. The holistic approach.....	188
8.3. Arm’s length principle: a shared principle?.....	189
8.4. Controls of transactions: an operational convergence.....	191
8.5. How to reconcile methods for determining customs values and transfer prices.....	192
9. The Strength of the Double Approach before Tax Audits.....	193
10. WCO TCCV Commentary 23.1.....	194
11. ICC Policy Statement.....	195

9 – Tax Accounting Considerations.....
1. Introduction.....	209
2. International Accounting Framework.....	211
2.1. General.....	211
2.2. Income tax accounting standards.....	211
3. Tax Law Considerations.....	214
3.1. Plant closures.....	215
3.2. Migration of intangibles.....	216
3.3. Conversion into limited-risk entities.....	217
4. Specific Tax Accounting Impacts.....	217
4.1. Transfer pricing uncertainties.....	218
4.2. Deferred tax accounting.....	227
4.3. Comprehensive example.....	232
5. Conclusion.....	237

Foreword

Author

Jonathan Schwarz

Barrister, Temple Tax Chambers, London

Latest Information:

This chapter is based on information available up to 6 September 2010.

“Business restructuring” to a visitor from Mars would have only the vaguest of meaning. In recent years it has been used as the label to describe emerging patterns of supply chain organization within multinational groups and, in particular, the process of change from so-called “traditional” organizational structures to “new” structures that involve a division of functions among different parts of the multinational group on both an entity and geographic basis.

The first public airing of concerns among tax authorities regarding the implications of this phenomenon was at an OECD roundtable meeting in January 2005. Concerns about reduction in the tax base of some countries as a result of these new business models have brought both business models and the restructuring process under close scrutiny. The gulf in perspectives on this could not be wider. Some tax authorities have taken the view that the process represents an abuse. Multinational groups have taken the view that it is simply a rational response to the current global economic environment (see [Chapter 2](#)). This heated atmosphere makes a reasoned debate difficult and highlights long-standing difficulties between enterprises and tax authorities as to what the arm’s length standard really means and how it is properly to be determined. The lack of empirical data and study hampers the process. This book will draw together divergent views, current practice of key industrial economies, as well as dispassionate analysis.

Business restructuring involves a clash between several core principles. These include:

- the company as a legal person with an identity, rights and obligations distinct from its owners;
- the nation state that exercises sovereign rights of taxation within its territory; and
- the arm’s length principle as the universally recognized method for the fair allocation of profits across borders between related parties.

Companies are recognized as distinct legal persons with their own obligations to pay tax. Complex modern business typically calls for a number of companies within a group. While the company is recognized as a distinct taxpayer, the artificiality of legal personality is also recognized, to some extent by many tax systems permitting some form of group taxation. This recognition of group taxation accords with, and parallels the interest of the shareholders in the corporate group. The shareholders are normally interested only in the total results of the group. Success in one member of the group does not necessarily imply success for the whole. Group taxation rules recognize this and strive to tax by reference to the consolidated position of the group rather than of its individual group members.

This group recognition largely breaks down in the international tax context. Nation states seek to tax business operations connected with their own jurisdiction by reason of residence or a permanent establishment. Thus, the success of the local operation is the only interest of national taxing authorities. The arm's length rule, which has formed a core value in international taxation for most of the twentieth century, serves two functions in this context. Firstly, it provides national taxing authorities with a mechanism for fair allocation of profits as between local operations of a multinational group and other parts of the group. Secondly, as nation states compete with each other for tax revenues, it provides a mechanism for fair allocation of taxing jurisdiction among nation states.

There is also increased pressure on the second fundamental concept in modern international business taxation, namely the allocation of profits on the basis of residence and source. The right to tax business profits of non-residents by reference to permanent establishments has entered its second century. Despite this, questions remain as to precisely when a permanent establishment exists, and the proper application of the arm's length standard to its profits has itself proved extremely difficult. An evaluation as to when permanent establishments might exist, along with theories allocating more profit to permanent establishments is seen by some as a second line of attack in dealing with new business models.

The perception that business restructuring involves abuse engages another central conflict in legal systems and the rule of law. The balance between legal certainty on the one hand – which is essential to maintain and prevent arbitrary or unfair administrative action – and the need to ensure that the rules are not artificially circumvented emerges in Issues Note 4 of the OECD Discussion Draft on Transfer Pricing Aspects of Business Restructurings, published on 19 September 2008. Extending the ability of tax authorities to recharacterize transactions carries risks in this area.

One of the factors driving new business models is rapid technological change. Towards the end of the twentieth century, as the commercialization of the Internet was starting, similar anxieties emerged regarding the potentially destructive effect that e-commerce might have on tax revenues. Numerous OECD studies examined the issue and, once the underlying nature of this new method of doing business became better understood, so the initial concerns proved to be unfounded.

This publication offers a view of the current application of Art. 9 of the OECD Model Convention to business restructuring ([Chapter 5](#)) and examines not only the direct tax issues in business restructuring, but also VAT ([Chapter 7](#)) and customs duty ([Chapter 8](#)) considerations. Practical insights include the accounting treatment ([Chapter 9](#)) of business restructuring. OECD work-in-progress ([Chapter 3](#)) and the effect of the EU tax system ([Chapter 4](#)) highlight the complexity of the issues and the multiplicity of possible responses. The publication provides information on the tax treatment of business restructurings in [China](#), [Germany](#), [India](#), [Switzerland](#), the [United Kingdom](#) and the [United States](#). A case study concerning the restructuring of a manufacturing operation is examined from the perspective of the aforementioned jurisdictions. The publication concludes with the editor's observations ([Chapter 10](#)).

Acknowledgements

Latest Information:

This chapter is based on information available up to 6 September 2010.

The editor would like to thank the authors for their tremendous efforts in drafting the chapters of this publication.

Special thanks go to Caroline Silberztein of the OECD, who supported this project right from the start. Caroline provided valuable input in both suggesting authors and providing very useful comments concerning the outline of the book. In addition, a word of thanks goes to Rijkele Betten (IBFD), Prof. I.J.J. Burgers (University of Groningen, the Netherlands), Monica Erasmus-Koen (Senior Tax Manager – Transfer Pricing, Ernst & Young, the Netherlands) and Danny Oosterhoff (Partner, Ernst & Young, the Netherlands) for their feedback on the content of this publication. The editor would also like to thank Giammarco Cottani (Transfer Pricing Advisor, OECD) who drafted the case study and Victor Chew (IBFD) for providing feedback on this case study.

The editor would like to express her gratitude to Jane Kerr and Arcotia Hatsidimitris of IBFD for their support.

Abbreviations and Common References

Latest Information:

This chapter is based on information available up to 6 September 2010.

APB	Accounting Principles Board
APB	Accounting Principles Board
ARB	Accounting Review Bulletin
ASEAN	Association of Southeast Asian Nations
CBP	US Customs and Border Protection
CCC	Community Customs Code
CEPT	Common Effective Preferential Tariff
CFA	Committee on Fiscal Affairs (OECD)
CUP	Comparable uncontrolled price
DBG	Bundesgesetz über die Direkte Bundessteuer (Swiss Federal Direct Tax Law)
ECJ	European Court of Justice
ECR	European Court Reports
ECSC	European Coal and Steel Community
FAS	Financial Accounting Standard
FASB	Financial Accounting Services Board
FIN	FASB Interpretation Number
FSP	FASB Staff Position
GAAP	Generally Accepted Accounting Principles
GATT	General Agreement on Tariffs and Trade
HMRC	Her Majesty's Revenue and Customs (United Kingdom)
IAS	International Accounting Standard
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standard
IRS	Internal Revenue Service (United States)
MCC	Modernized Customs Code (European Union)
MNE	Multinational enterprise
OECD Discussion Draft	"Transfer Pricing Aspects of Business Restructurings: Discussion Draft for Public Comment (19 September 2008 to 19 February 2009)"
TP Guidelines	OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations
OECD Model Convention	OECD Model Tax Convention on Income and Capital
PE	Permanent establishment
R&D	Research and development
ROS	Return on sales
SCE	European Cooperative Society
SE	Societas Europaea
StHG	Federal Law on the Harmonization of Direct Cantonal and Communal Taxes (Switzerland)
TNMM	Transactional net margin method
WTO	World Trade Organization

1 – Introduction

Authors

Sven Bremer

Head of Group Transfer Pricing, Siemens AG, Germany

This update is based on the original chapter which was co-authored by Werner Stuffer and Dr Nadine Hiller.

Latest Information:

This chapter is based on information available up to 1 September 2017.

1. Drivers of Business Restructuring

The 21st century economy has presented companies with an ever increasing dynamic in which adaptation is essential. As markets become ever more connected, and the availability of information becomes cheaper and easier, a multinational enterprise (MNE) must be able to adapt to this new competitive landscape. Without constant adaptation, an MNE would quickly become uncompetitive, stagnate and ultimately perish. Regardless of industry or position in the supply chain, international companies must therefore constantly evolve to face these new challenges.

In general, there are often both external and internal factors that underlie the need for an MNE to change or restructure its business. Decreasing transportation costs, shorter innovation cycles, changing customer demands as well as an increasingly competitive environment in hand with the encroachment of competitors located in low-cost countries are only some examples of factors that give rise to the decision to undertake business restructuring.

Often, economic cycles vary internationally, and expanding the presence in different markets is crucial for the economic survival of a company. During the last decade, and despite their slowing down in recent years in terms of growth rate, the BRIC countries (Brazil, China (People's Rep.), India and Russia) and other developing countries have become highly attractive investment targets for most companies, primarily due to the representativeness of their markets, increasing consumer demand and/or favourable production conditions in these countries. Furthermore, many of those countries are providing incentives for MNEs to establish operations in their respective countries. An example of this is the effort undertaken by the Chinese government to decrease the administrative burden and the protection of intellectual property in China, which increases the attractiveness of the location, especially for research and development (R&D) projects of international MNEs.

Another typical scenario for business restructuring is the reduction or elimination of production capacity in one country in order to transfer it to another country. Furthermore, an MNE could structure its business by transferring certain functions (e.g. production, distribution), tangible and intangible assets and risks that were previously integrated in local operations to more centralized and specialized regional or global

units.^[1] By reducing certain functions, the functions of a so-called full-fledged manufacturer could be reduced to that of a contract or limited-risk manufacturer. As the limited-risk or contract manufacturer, by definition, bears only limited risks, excluding product liability and/or warranty risk, among others, the manufacturer should earn a more stable, albeit limited, return. As the transfer or reduction of functions will coincide with a reduction in profitability, tax authorities have become increasingly aware of business restructurings and often question whether the restructuring was purely tax motivated.

Although tax considerations many times are not the drivers of business restructurings, changes in the operational structure often require corresponding changes in the tax and legal structure to align the business' new operating model. Some examples of the most common drivers for business restructurings are described in more detail below.

1.1. Global business models to maximize synergies and economies of scale

Business restructurings are often driven to reduce operational costs. Further factors are the proximity to customers, centralization of functions, bureaucracy or environmental laws, savings from economies of scale, the need for specialization and the need to increase productivity by decreasing costs. Competitive pressures in the globalized economy require MNEs to maximize synergies and increase associated efficiencies. Typically, these synergistic effects can only be achieved among related parties (e.g. MNEs, joint ventures) which can jointly benefit from their different characteristics.

Companies formerly located solely in emerging markets are now branching out to overseas locations. Similar to companies located in developed economies, these companies are seeking access to new markets and entering newer developing economies. For example, Brazilian companies that have internationalized their activities over the last 5 years and are now locating some of their production abroad to be closer to their customers. Also, many Chinese manufacturers are establishing operations in Vietnam to take advantage of even lower cost of labour.

Cost synergies are often defined as the opportunity to reduce or eliminate expenses associated with running similar operations in different locations. Synergies are created by eliminating or concentrating operations, that are viewed as previously duplicative within a group, after a legal restructuring. As an example, we have seen the automotive industry concentrate manufacturing operations by reducing the number of vehicle platforms. The higher the number of cars produced on one platform, the lower the production costs per unit.

Even functional or personnel synergies can be achieved by centralizing tasks or processes. An example is the global, regional or local centralization of corporate or back office functions, such as human resources, information technology, central procurement or logistics, into so-called shared service centres. Shared service centres do not lead only to cost savings through the economic concept of economies of scale. In addition, the centralization enables MNEs to increase the quality of the services by specializing and focusing on core competencies. For instance, the centralization of R&D functions into competency centres for similar products could lead to positive product-related side effects and inventions. The consolidation of manufacturing processes of homogenous products, or products using the same units or technologies into one production site, could lead to an optimized utilization of the site by decreasing idle times and personnel cutbacks.

1. See OECD, Centre for Tax Policy and Administration, *2nd Annual Centre for Tax Policy and Administration Roundtable: Business Restructuring*, 2005, www.oecd.org/document/20/0,2340,en_2649_37989760_34535252_1_1_1_1,00.html.

A further benefit of centralization is the risk reduction achieved by centralizing control processes for compliance with legal and regulatory requirements and intellectual property administration and management.

1.2. Improvement of productivity of the supply chain

The incentive to drive supply chain improvements also drives business restructurings. Supply chain management is a cross-functional approach to managing (i) the movement of raw materials in an organization, (ii) the processing of materials into finished goods, and (iii) the shipment of finished goods from the organization to the end-consumer. The focus on supply chain management began in the early 1990s with the aim of optimizing the network between suppliers, manufacturers and customers. Developments in supply chain management were held back by inadequate information technology and communications, as well as poor or untimely data. The latest revolutions in communication, information technology (such as three-dimensional printing) and the Internet have removed these constraints.

Restructuring changes to the supply chain are primarily driven by customer requirements and/or increased efficiency standards. It is not just about the mere purchase of materials, but rather the efficient management of the entire chain of supply, consisting of direct delivery and supplier. Therefore, information technology systems analyse and verify customer requirements, determine production unit and time standards and help choose the supplier. In the majority of cases, the contact with the local suppliers is maintained by the local company. Nevertheless, by implementing centralized distribution or procurement centres, the quality and efficiency standards might noticeably increase due to a centralized selection of suppliers. It also simultaneously reduces the associated administrative costs. In this way, the processes in the procurement can be structured to be much more efficient and flexible. Together with a maximization of synergies, the optimization of the number, size and location of distribution or purchase centres leads to an efficient supply chain, which again enables the MNE to further develop its competitive position by decreasing the response time to market changes or customers' demands. Therefore, supply chain management is important for companies in order to speed up delivery times and become more cost-efficient.

Centralization of the warehousing function is another common strategy to increase supply chain efficiency. The regionalization of warehouses increases supply chain efficiency by allowing on-demand or just-in-time orders and increases cost efficiencies by centralizing order placement towards suppliers. Furthermore, inventory levels can be decreased significantly. Excess inventory is one of the most overlooked sources of cash, typically accounting for almost half of the savings from working capital optimization projects. Nevertheless, the centralization of logistic functions must be in alignment with customer requirements. By centralizing the warehousing function, distribution companies minimize or even transfer risks and are thus enabled to focus on their core competencies. By streamlining processes within the company, as well as processes involving customers and suppliers, companies can minimize inventory levels throughout the whole value chain. As such, working capital can be more efficiently utilized.

1.3. Other external and internal factors

The customer is the most important stakeholder of an MNE. No company can afford not to focus on the fulfilment of a customer's requirements. As such, it might be necessary to restructure a business due to a customer's request for a local presence. A typical example is seen in the automotive industry, where suppliers are located near to their OEM customers. The acquisition of a new customer or a new

contract could, for example, lead to a transfer of a production site. In order to avoid a duplication of the manufacturing function, the former production facility would need to be shuttered and transferred closer to the customer's location. Additionally, supplies of material, logistics and warehousing would also need to be restructured.

Another example is governmental specifications that explicitly require companies to restructure their businesses. In particular, developing countries impose substantial import duties or include the requirement of so-called local content in order to involve and support local industry. An example of this issue is the requirement under Brazilian law for oil and gas companies. In Brazil, an oil and gas company must retain part of its investments earnings and employees in Brazil. Similar requirements exist in other developed and developing countries, including the United States and the People's Republic of China. This requirement could force an MNE to adjust domestic and international operations and processes in order to fulfil this requirement, so that the MNE can access otherwise inaccessible markets. The international restructuring could increase the global competitiveness of the MNE and support the maintenance of domestic employment.

Another factor that can provide the catalyst to business restructurings is the availability of experienced personnel. Although labour is becoming increasingly mobile, the transferring of personnel from one related company to another could be restricted by legal and/or tax considerations. Consequently, companies may enter into agreements with related parties for the provision of services. It is common, for example, for companies to create specialized centres in specific regions that typically have more qualified personnel to render services to other companies abroad. However, the maintenance of these centres may have a high cost for companies. Therefore, a business may need to be structured in a way that makes personnel and know-how available locally.

In addition, mergers and acquisitions (M&As) often require an adjustment of the functions of the acquired company in order to integrate it with the acquirer. For example, a sales-focused subsidiary with limited functionality and limited risks could be restructured into an entrepreneurially oriented, fully functional sales and distribution operation in order to distribute additional products in the local market as the company disposes of valuable customer contacts. After the restructuring, the entity takes over functions related to sales, strategic marketing, invoicing, inventory management, warehousing and logistics and strategic pricing. Before the conversion, the restructured entity earned a commission or a resale margin, while after the restructuring, the entity bears higher risks related to sales and thus receives a higher resale margin under the arm's length principle. Globally, M&A activity has been growing since the recovery from the financial crisis and it is soon expected to achieve levels last seen before the financial crisis. The strongest growth in M&A activity going forward will be middle-market momentum as companies intensify their key businesses.^[2] Moreover, according to The Boston Consulting Group (BCG), from 2010 to 2012, 25% of the M&A transactions involved at least one party from a BRIC country. There are three broad investment themes identified: "Dealmakers from the developed countries that are searching for energy and natural resources to fuel their economies, as well as opportunities to meet the surge of middle-class demand for consumer goods; emerging-market dealmakers focused on acquiring technology and management know-how from developed economies. In fact, veteran dealmakers and advisors increasingly report that BRIC-based acquirers are now seeking

2. See EY's, *Global Capital Confidence Barometer October 2014, Dealmaking Returns?*, [http://www.ey.com/Publication/vwLUAssets/PI/EY-Capital-Confidence-Barometer-Global-October-2014/\\$FILE/Global_Capital_Confidence_Barometer_Oct14.pdf](http://www.ey.com/Publication/vwLUAssets/PI/EY-Capital-Confidence-Barometer-Global-October-2014/$FILE/Global_Capital_Confidence_Barometer_Oct14.pdf), accessed 1 Sept. 2017.

targets in developed economies that can serve as platforms for global expansion”.^[3] Companies of developed countries are not only looking for lower-cost labour in emerging markets, but are targeting regions where a rising middle class and increasing disposable incomes provide new opportunities for growth. However, one curious issue to be mentioned is that usually purchasers from BRIC countries achieve higher returns in emerging-market deals than purchasers from developed countries. This could be justified due to the fact that the purchasers from BRIC countries are more familiar with the cultures and markets of the target company. However, this market advantage can be disregarded when the purchaser from a developed country has experience in emerging markets. In order to achieve a deeper knowledge of the emerging market beforehand, it can be advisable for acquirers of developed countries to consider an alternative deal structure, e.g. joint ventures and alliances.

Furthermore, another consideration is that the demand for a product could diminish due to factors such as product obsolescence, increase in substitute products and changes in market regulations. A decrease in sales could require the closure of production sites and R&D departments, and/or the termination of distribution contracts. To compensate, the MNE must focus on new or other already existing (geographic or product) markets or must address different customer groups. An alignment of the operational and managerial structure is therefore often required.

2. Business Restructuring from an Economic Perspective

2.1. Business perspective

The decision to restructure a business is primarily determined at a group level. Before a decision to restructure can be made, the current and alternate structure must be analysed to compare strengths, weaknesses, opportunities and threats (so-called SWOT analysis) of the existing and target structure. This analysis considers economic, social, legal and tax aspects and restrictions.

To analyse the total impact of a business conversion, a long-term analysis comparing costs, cash flows, profits, revenues and other financial and operational indicators before and after restructuring is necessary. A short-term analysis including start-up costs and any costs arising from quality issues should be included as well. The feasibility analysis is principally based on a global (i.e. consolidated) level. Thus, the analysis could result in a positive impact on a global enterprise level, while simultaneously resulting in a negative impact at the local or subsidiary level. As the process of restructuring is highly cost intensive on both global and local levels, smaller companies being restructured are often faced with negative financial results during the first year of the restructuring. In addition to the analysis prepared on a group wide enterprise level, a long-term, local or subsidiary-specific analysis might therefore be necessary to display the benefits or long-term gains for the local affiliate.

Aside from the creation of substance, the implementation of an alternate structure requires administrative action, such as the termination and renegotiation of agreements, the reallocation of personnel, the calculation and definition of post-restructuring transfer pricing, the implementation of accounting procedures and the implementation of the information technology and accounting systems.

3. The Boston Consulting, “BRICS Versus Mortar? Winning at M&A in Emerging Markets” see http://img-stg.bcg.com/BRICs_Versus_Mortar_Aug_2013_tcm9-95826.pdf.

2.2. Stakeholder's perspective

Although often refuted, restructuring foreign investments often provides economic benefits for the domestic economy. Specifically, tax authorities and labour unions sometimes claim a drop in tax revenue and employment if an outbound investment takes place. Those stakeholders often ignore the fact that employment is directly linked to the competitiveness of the group. Only an MNE that is competitive could operate on the market, achieve profits, employ personnel and pay salaries and taxes. Therefore, a measure necessary to remain competitive could be a foreign investment that, despite personnel reductions, enables the MNE to maintain domestic employment.

As global competition is significantly increasing, companies are forced to reduce costs. According to a 2008 study by the German Chamber of Commerce and Industry, one third of restructurings is driven by cost efficiency initiatives and two thirds were driven by the development of new markets.^[5]

3. Tension between Commercial Aims and Tax Environment

As mentioned previously, taxation is not the primary driver for cross-border business restructurings. More often than not, operational factors drive business restructuring decisions. Nevertheless, understanding and considering tax impacts of restructurings, especially transfer pricing, has become ever more crucial. In July 2013, with the endorsement of the G20 finance ministers, the OECD launched the Action Plan on Base Erosion and Profit Shifting, which has seen significant developments since 2014. The final recommendations were published on 5 October 2015 and specify 15 action items that provide governments with the proper instruments that will align the right to tax with economic activity. Specifically, action items 7, 8, 9, 10 and 13 are intended to ensure profits are appropriately allocated where value creation arises and to prevent transactions which would not occur between third parties. This, without a doubt, will affect the tax aspects of business restructurings in the coming years. Not only are governments taking notice, the media has continuously increased its attention towards the tax practices of MNEs. In 2014 and subsequent years, we have seen several MNEs required to address allegations of taking advantage of tax loopholes and transfer pricing. In addition, tax authorities are becoming ever more aggressive in enforcing and questioning transfer pricing practices given most government's budget deficits. Tax audits and negotiations are often quite costly, and as such, corporate tax departments should be involved in business restructurings at a very early stage in order to prevent subsequent disputes with tax authorities.

Even with regard to the treatment of business restructuring, no common approach exists among international tax authorities, which leads to significant uncertainties for MNEs. Some countries impose tax on a so-called conversion gain (also known as an exit charge) with regard to business restructurings leading to changes in taxable profits. An exit charge can be imposed in a country (such as Germany) if the profit potential has been transferred.^[6] The value of the transfer is calculated using a discounted cash-flow valuation of the anticipated profit of the transferor and the transferee before and after the restructuring. As most countries do not follow the exit charge approach, conflicts in tax treatment can arise that may ultimately result in double taxation.

5. Deutscher Industrie- und Handelskammertag, *Investitionen im Ausland – Ergebnisse einer DIHK-Umfrage bei der Industrie- und Handelskammer* (March 2008), at 3.

6. Other countries such as the United Kingdom and Italy do not have such a rule, but will try to argue in a similar manner.

Another issue leading to discrepancies in treatment by the tax authorities is the allocation of restructuring costs.^[7] While some tax authorities require charging the costs to the company that is responsible for the restructuring decision, other tax authorities require either charging the costs to the company taking over the function or that the costs remain at the converted company. It is obvious that especially the latter scenario is not applicable in the case where a company is converted to a mere low-risk entity that earns a low but stable profit.

Furthermore, the characterization and the requirements for the deemed existence of an agency or service permanent establishment differ significantly between countries and requires a MNE to perform a detailed analysis for every single country and every single cross-border transaction of the MNE. One factor to be considered in this regard is the difference in time periods for international assignments. While some countries already deem there to be a permanent establishment after only a few days of assignment, the time period defined by most countries is actually up to 12 months.

Finally, tax authorities in recent years have more and more focused on the question whether the changes a taxpayer has made to its transfer pricing system are actually in line with the changes made to the way the business operates (substance of the restructuring). Specifically, the fact that risks are outsourced to another company of the MNE and consequently the remuneration is much lower requires a detailed analysis of the commercial objectives, contractual framework, people and financial substance, as well as the facts and circumstances. The transfer of risk must be distinguished from outsourcing of risks for management and mitigation of risks by analysing which company has the factual control over the risk.^[8] Control over a risk would be assumed if the company has the capacity to make decisions on whether to take the risk and on how to manage this risk. This requires adequate personnel and/or financial ability.

The arm's length principle is a common starting point in almost all jurisdictions that forms the basis of transfer pricing. This principle assumes that MNEs should agree to those conditions that independent third parties would have agreed under similar circumstances. These conditions are limited by legal and/or contractual requirements. Nevertheless, in practice, structures could occur within an MNE that are not common under third-party transactions, or that lead to different results compared to transactions between independent third parties. For example, the possibility to reduce costs by establishing a centralized global procurement function is not easily open for independent third parties. Thus, a related distributor could realize a higher operating margin due to a reduction in direct and indirect material costs compared to an unrelated third party. The mere fact that there are transactions which are not available to independent third parties, however, does not allow for the conclusion that these transactions a priori are not at arm's length. Under the existing framework of the arm's length principle, rules exist to allocate synergistic advantages that only can be realized between related parties, e.g. by allocating such value to the entrepreneur in charge of a certain business or by applying the principles of the hypothetical arm's length test.

In the majority of cases, business restructurings happen as a result of economic and organizational decisions. MNEs carrying out business transformations solely for tax reasons are rare and represent only exceptional cases. The decision to restructure is generally made under an economic framework, therefore international tax authorities should not focus on the question of whether similar transactions

7. A. Musselli & A. Musselli, *Stripping the Functions of Producing Affiliates of a Multinational Group: Addressing Tax Implications via Economics of Contracts*, 15 Intl. Transfer Pricing J. 1 (2008), at 16-17, Journals IBFD.

8. OECD, Centre for Tax Policy and Administration, *Transfer Pricing Aspects of Business Restructurings: Discussion Draft for Public Comment, 19 September 2008 to 19 February 2009*, Issues Note 1, at 14, www.oecd.org/dataoecd/59/40/41346644.pdf, accessed on 1 Sept. 2017.

exist between unrelated parties, but on the commerciality of the arrangements. In fact, economic principles should apply to the remuneration of valuable intellectual property as well as the determination of the arm's length price post-restructuring. This approach also addresses the exceptional cases where a transformation is effected solely for tax purposes as such arrangements will fail the commercial substance requirement.

In order to provide a consistent framework for the treatment of business restructurings from a tax perspective, the OECD released chapter IX of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines)^[9] addressing the transfer pricing aspects of business restructurings in 2010. Chapter IX of the OECD Guidelines mainly focuses on the allocation of risks between related parties, the compensation for the restructuring itself, the application of the arm's length principle and the OECD Guidelines to post-restructuring arrangements, as well as exceptional circumstances where tax authorities may regard a transaction to be inconsistent with the economic substance of the transaction.

The OECD has further emphasized the focus on economic substance and commercial reality in the 2015 Base Erosion and Profit Shifting Report on Actions 8-10 Aligning Transfer Pricing Outcomes with Value Creation. The new guidance seeks to ensure that operational profits are allocated to the economic activities which generate them by analysing the actual conduct of the parties (i.e. what the parties actually contribute as compared to contractual terms only). The guidance also clarifies that the mere fact that the transaction does not arise between unrelated parties does not preclude it from being recognized as an arm's length dealing. The key question should be whether the actual transaction is conducted in a commercially rational manner^[10] i.e. are the related parties negotiating the terms of the arrangement as would be agreed between independent parties acting in their own self interest under comparable economic circumstances. These amendments have been incorporated into the new OECD Guidelines, published in July 2017. In the meantime, the BEPS project continues with the OECD working on implementation papers regarding still unresolved and controversial topics such as the valuation of so called "Hard-to-Value Intangibles"^[11] and profit splits^[12], all of which will have significant effects on the way restructurings of MNEs will be treated from a tax perspective in future.

-
9. OECD, Centre for Tax Policy and Administration, *Report on the Transfer Pricing Aspects of Business Restructurings; Chapter IX of the Transfer Pricing Guidelines*, 22 July 2010, <http://www.oecd.org/dataoecd/22/54/45690216.pdf>, accessed on 1 Sept. 2017.
 10. OECD, Centre for Tax Policy and Administration, *Base Erosion and Profit Shifting Project Report on Actions 8-10; Aligning Transfer Pricing Outcomes with Value Creation*, 5 Oct. 2015, at 14.
 11. OECD, Centre for Tax Policy and Administration, *Base Erosion and Profit Shifting Project Report on Actions 8-10; Public Discussion Draft, BEPS Action 8, Implementation Guidance on Hard-to-Value Intangibles*, 23 May-30 June 2017.
 12. OECD, Centre for Tax Policy and Administration, *Base Erosion and Profit Shifting Project Report on Actions 8-10; Public Discussion Draft, BEPS Action 10, Revised Guidance on Profit Splits*, 22 June-15 September 2017.

2 – Business Models

Author

Danuše Nerudova^[*]

Veronika Solilova^[**]

Original chapter written by Monique van Herksen^{[***],[1]}

Latest Information:

This chapter is based on information available up to 16 October 2017.

1. Introduction

Certain companies stand out as a result of their ability to develop themselves internationally and grow. Others have great difficulty finding access to the international market, and distribute their products or services globally. What is it that allows companies to grow, handle barriers to the market efficiently and get their products to the end-consumer in an organized and cost-effective fashion? It is generally a combination of factors that makes this happen, including the company's value proposition regarding what is offered to customers, its business strategy, its market segment, its position and activities in the value chain, customer interaction, its business network, its cost structure, and its marketing and use of resources such as assets, employees, raw materials, intangibles and competencies. Combined, these factors can be referred to as a company's business model. These factors may not be perceived as having equal value, yet with any of the factors materially flawed or not supporting the other, the company will be less efficient and operate in a more laborious fashion than its competitors.

Complex as it may appear when considering all of these factors, a business model is essentially nothing more than the method of doing business through which a company generates revenue. Few products virtually sell themselves, however, and a business model needs to be carefully chosen and well considered in order to be successful. An analysis of the company's business model is necessary to allow the customer value proposition to be clear to the end-consumer.

There are more-traditional business models and more-innovative business models. There are more-simple business models and highly-complex ones, yet none are everlasting and all business models are forced to adapt to constantly changing economies in order to remain sustainable and assist the company to generate business and turnover. A business model that worked in the past will not remain successful forever. Changes such as transport and exchange of information, global positioning satellite systems, globalization and digitalization of business and (other) technological changes have materially affected

* Head of Department of Accounting and Taxes, Faculty of Economics and Business, Mendel University in Brno; researcher, Research Centre of Faculty of Economics and Business, Mendel University in Brno, the Czech Republic.

** Researcher, Department of Accounting and Taxes, Research Centre of Faculty of Economics and Business, Faculty of Economics and Business, Mendel University in Brno, the Czech Republic.

*** At the time of writing Partner, Baker & McKenzie, the Netherlands. Currently Monique van Herksen is Ernst & Young's Global Head of Transfer Pricing Controversy and EMEA Head of Tax Controversy Partner.

1. Monique van Herksen wishes to thank Clive Jie-A-Joen for his valuable comments and input.

companies, their business models and the success thereof in generating business and turnover. Also, changes in external environment have great impact on the structure of the business models.

Due to the above-mentioned changes, multinational enterprises (MNEs) have been able to grow and allocate profits to group companies in different countries with the result of the increase of intra-group trade in volume and value. Furthermore, functions, assets and risks have not been systematically aligned in a clear and easily defined pattern of entities and locations. Moreover, the OECD framework in the form of comparability analysis has potentially led to incorrect inferences about non-compliant behaviour.^[2] Therefore, taking into account the state of the economy, existing transfer pricing rules and the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (hereinafter OECD Guidelines), it was concluded that the tax authorities did not have sufficiently comprehensive information for the assessment of the transactions between related (associated) entities in respect of the arm's length principle, i.e. there has been a lack of transparency.

Furthermore, the debt crisis had caused governments to sharply focus on the taxation of MNEs, because the allocation of profits was not perceived as usually being aligned with the economic activity that generated the profits, hence resulting in base erosion and profit shifting (BEPS). As a reaction to the changes in global economic environment, the OECD together with G20 has been working to implement its 15 Actions focused on tackling BEPS since 2013. This includes transfer pricing as a key area, particularly in Actions 8, 9, 10 and 13).^[3] According to the Final Report on Actions 8-10, the aim is to ensure that transfer pricing outcomes are aligned with the economic substance of transactions and with the value creation with respect to intangibles, risks and capital and other high-risk transactions. This is accompanied by [Action 13](#), which aims to re-examine transfer pricing documentation to ensure transparency for tax authorities mainly through country-by-country reporting. On 23 May 2016, the OECD Council approved the amendments to the OECD Guidelines, as set out in the [BEPS 2015 Final Report on Actions 8-10](#) and the [BEPS 2015 Final Report on Action 13](#). These amendments provide further clarity and transpose the BEPS recommendations into to the updated OECD Guidelines, which were released on 10 July 2017.

Naturally, the implementation of the BEPS amendments in the OECD Guidelines will undoubtedly continue to affect the ways in which MNEs can conduct their operations and income allocation in the best way, and this will require the rigorous determination of the business model used and constant monitoring by a company to both assess its usefulness for getting a product or service to the market and assure that transfer pricing outcomes are in line with value creation and other BEPS recommendations.

One of the ways to generate high profits remains through business model innovation. Business model innovation focuses on aspects such as creating new markets; developing go-to-market initiatives and innovation thereof; competitive disruption or competitive positioning; and developing new value propositions.^[4] The elements of a successful business model are cited as being customer value proposition; profit formula; key resources; and key processes.^[5] However, business model innovations are often difficult to implement and hard to value. Small changes and developments may generate significant benefits, and major changes can generate minimal improvements. It is usually difficult to

-
2. P. Pris, S. Gonnet & R. Meghames, *Understanding Risk in the Enterprise: The Key to Transfer Pricing for Today's Business Models*, Intl. Transfer Pricing J., Vol. 21, No. 6, pp. 395-401 (2014).
 3. OECD, *Action Plan on Base Erosion and Profit Shifting (OECD 2013)*. Available at: <http://www.oecd.org/ctp/BEPActionPlan.pdf>. The final reports of the project were published on 5 Oct. 2015. See <http://www.oecd.org/ctp/beps-2015-final-reports.htm>, accessed 16 Oct. 2017.
 4. M. Debruyne & M. Schoovaerts, *Innovation outside the Lab: Strategic Innovation as the Alternative*, Flanders District of Creativity Research Report (Oct. 2006).
 5. M.W. Johnson, C.M. Christensen & H. Kagermann, *Reinventing Your Business Model* at 50-59 (Harvard Business Review Dec. 2008).

assess what innovation factor can be seen as most important and contributing to the continued or improved strength of a company, and it is also difficult to determine what time period should be observed to assess whether changes are effective. In general, it is acknowledged that it is quite difficult to pull off the new growth that business model innovation can bring.^[6] It takes more than simply adjusting a business model to make it work better. Restructuring generally requires more effort than anticipated, the need for relocation of people being one challenge that is usually overlooked. Beyond the dedicated TP related actions, [BEPS 2015 Final Report on Action 7](#) becomes important in this context as it focuses on the relevant aspects to business restructuring in relation to permanent establishments.

From a tax perspective, a business model's cost base and revenue potential are highly relevant aspects. There are several business models, and all represent ways to go to market. Some are industry-specific and some are more general. Examples of commercial business models that are commonly observed are fast food chains or franchises (such as McDonald's and Burger King) and coffee parlours (such as Starbucks and The Coffee Company); multi-level marketing organizations (such as Tupperware or Tahitian Noni) can be mentioned as specific business models, as can prize-fighter airline companies such as Richard Branson's Virgin Atlantic Airways and Spain's Vueling Airlines. Xerox's give-and-sell (sometimes referred to as bait-and-hook) system where machines are leased and photocopies are individually charged when in excess of a certain number, and Gillette's well known give-and-sell system where razors are given away for nearly free or below cost and razorblades are sold, are also examples of successful business models. IKEA's retailing formula for (co-produced) home furnishings is another well-known business model. Other business models include subscription-only arrangements (magazines and publications), utility models (metered usage or subscription), and the shared entrepreneurial risk and service provider models used in the telecommunications industry.

All business models have a certain organization of functions performed, assets used and risks assumed in the value chain of getting the products to market, that assists in making the company successful overall.

If one dissects the companies listed above, all of their business models are based on a logical structuring of the following consecutive steps or functions: sourcing of and processing of raw or semi-processed materials, manufacturing end or semi-final products, logistics management, distribution, marketing, sales, services that maintain and increase the value of products (e.g. customer support, repair and installation), centralized support services (e.g. human resources, information technology, legal, management and administration), and intangible development. These steps can be done consecutively,^[7] or the inputs or services required can be bought from other firms (in that case, the company is non-vertically integrated). Most firms are partially vertically integrated. Vertical integration tends to lower transaction costs (as the costs of buying and selling to other companies are avoided).^[8] The essential functionalities observed can basically be broken down into three categories: the manufacturer, the distributor and the service provider – with some combinations and overlaps (hybrid functions) thereof. Another categorization of the business model can be done based on responsibility, which provides a more process-oriented view on the MNEs. Roles and responsibilities within an MNE and value-added decisions are identified through this process. Based on BEPS, this approach is helpful for the consideration whether transfer pricing outcomes are aligned with value creation and economic

6. Id.

7. A firm (multinational enterprise) that participates in more than one successive stage of the production or distribution of goods and services is deemed to be vertically integrated.

8. D.W. Carlton & J.M. Perloff, *Modern Industrial Organization* ch. 12, at 378-395 (Addison-Wesley 2000).

reality. Moreover, it ensures the allocations of risk to the associated enterprise which controls the risk and has the financial capacity to assume that risk.

It is necessary to mention that the BEPS Project is changing the global tax rules impacting the global business models by introducing special measures either within or beyond the arm's length principle and the change can be considered as the most comprehensive change in international taxation in history. Therefore, it is extremely important for MNEs to understand the changes and impacts of BEPS on the business models that they are using.

2. Business Modelling for Tax and Transfer Pricing Purposes

For tax and transfer pricing purposes, labelling an entity that operates within the multinational group as a manufacturer, distributor or service provider (or hybrid entity that combines some of the features of these traditional definitions) has the immediate effect of attaching consequences to the taxation of that entity. This is because related manufacturing entities (operating within a multinational enterprise context) are expected to report comparable profitability levels to comparable unrelated manufacturing entities; related distributor entities are expected to report comparable profitability levels to comparable unrelated distributor entities; and the same test is being applied to service providers, pursuant to the arm's length principle as included in article 9 of the OECD Model Tax Convention on Income and Capital (OECD Model), on Associated Enterprises.^[9]

The comparability requirement^[10] included in the arm's length principle puts multinational group entities that can be catalogued under the same functionality (including risks assumed and assets used) at par with unrelated entities that qualify as manufacturers, distributors and service providers. However, finding unrelated comparable entities is far more difficult than it seems, largely due to a lack of access to well-organized and reliable data. It should come as no surprise that it becomes even more complex to find good comparables in case of entities with hybrid functionality. For example, considering again IKEA and its business model, one can question whether the company offers more of a product or more of a service. IKEA essentially offers customers co-produced improvements to their family living. It offers interior design, safety information and equipment, insurance and shopping as form of entertainment, all of which serve for consumers to create their own value.

9. Article 9 of the OECD Model provides as follows:

1. Where

- (a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or
- (b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions have accrued to one of the enterprises but, by reason of those conditions have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

2. Where a Contracting State includes in the profits of an enterprise of that State – and taxes accordingly – profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other.

10. Chapter III., Comparability Analysis, OECD Guidelines.

To label an IKEA entity strictly a distributor or retailer would undoubtedly lead to major comparability inconsistencies.^[11] Thus, the distinction between manufacturers, distributors and service providers should probably be seen as an exercise to find closely comparable functionalities rather than as an exact comparability standard, which in practice will lead to differences of opinion and interpretation. From a transfer pricing perspective, the OECD Guidelines acknowledge that associated enterprises may engage in transactions that independent enterprises would not undertake, as members of an MNE group face different commercial circumstances than would independent enterprises.^[12] It may be difficult to apply the arm's length principle in practice, and tax authorities are advised not to assume that MNE transactions are motivated by tax avoidance merely because there are few comparable transactions available in the market as comparison.^[13]

From a transfer pricing perspective, the application of the arm's length principle depends on determining the conditions that independent parties would have agreed in comparable transactions in comparable circumstances.^[14] The arm's length transfer price should reflect the actual economically significant activities and responsibilities undertaken, the risks assumed and the assets used by the parties to the transactions, and a functional analysis is necessary because compensation between two independent enterprises usually reflects this analysis. Applying and testing the arm's length principle requires a deep understanding of the circumstances – i.e. the commercial and financial relationships, in which associated enterprises make transactions and agree on their transaction prices. However, written contracts alone are unlikely to provide all the information necessary to perform a transfer pricing analysis, further information is required by taking into consideration evidence of the commercial or financial relations provided by the economically relevant characteristics. In this case, the rule in the form of the substance-over-form is applied whereby the real behaviour of the associated enterprises and the real substance of the transaction are taken into consideration with the result of the allocation and taxation of profits in a country where the value is created.

Therefore, based on the BEPS amendments, a correct application of this principle demands an understanding of the value drivers and relevant risks involved and mapping the responsibilities of the individual associated enterprises for the different risk categories through accurately delineating functional analysis in the context of their commitment to creating joint value. It is important to understand how value is generated by the group, the interdependencies of the functions performed by the associated enterprises with the rest of the group, and the contributions that associated enterprises make to that value creation.^[15]

Another key item is the analysis of risks. The functional analysis is incomplete unless the economically significant risks assumed by each party have been identified and considered. Those risks are significant in determining the outcome of a transfer pricing analysis. The significance of risks depends on the likelihood and size of the potential profits or losses arising from the risk and can be determined as a result of a broader functional analysis. Understanding the risks is therefore crucial. Risks can be categorized in various ways, but a relevant framework in a transfer pricing analysis is to consider the sources of uncertainty which give rise to risk. The OECD Guidelines provide a framework that may assist in ensuring that a transfer pricing analysis considers the range of risks likely to arise from the

-
11. R. Normann & R. Ramirez, *From Value Chain to Value Constellation: Designing Interactive Strategy* (1993), republished in *Harvard Business Review on Managing the Value Chain* at 188-194.
 12. Para. 1.11, [OECD Guidelines](#).
 13. Id.
 14. Para. 1.35, [OECD Guidelines](#).
 15. Para. 1.51, [OECD Guidelines](#).

commercial or financial relations of the associated enterprises, and from the context in which those relations take place, particularly following the non-exclusive list of risks that are mentioned there:^[16]

- strategic risks or marketplace risks (these are largely external risks caused by the economic environment, political and regulatory events, competition, technological advance, or social and environmental changes) – for example the risk that the value of future income streams will be subject to external market prices or market rates and also to local legal requirements. Market risk occurs under adverse sales conditions due to either increased competition in the marketplace, adverse demand conditions within the market or the inability to develop markets or position products to service targeted customers. Market risk includes product price risk and sales volume risk. Product price risk is the risk that a firm will not be able to sell products for the prices it anticipated after the products were purchased, while sales volume risk refers to the fluctuations in volumes sold on the market. New product start-up risk refers to any potential failure in connection with significant investment to launch new products, the market potential of which is unknown. R&D risk involves the risk of success or failure of R&D activities performed to develop valuable assets;
- infrastructure or operational risks (these are likely to include the uncertainties associated with the company's business execution and may include the effectiveness of processes and operations) – for example the risk of loss resulting from inadequate or failed internal processes, people or systems; warranty risk, which refers to the risk of incurring the cost of a claim or return of a faulty product. Subject to the warranty terms, this cost may have to be incurred for the repair or replacement of defective products. Product-liability risk involves the risk that the (product or) output fails to perform at accepted or advertised criteria and/or creates damages as a result;
- financial risks (these are likely to affect a company's financial performance, but there are specific financial risks related to the company's ability to manage liquidity and cash flow, financial capacity, and creditworthiness) – for example credit risk/bad debt risk, which refers to the risk that a customer will not be able to fulfil its obligation to pay (on time) for its purchases or services under the contractual terms; foreign exchange risk, which results from changes in currency rates that can lead to foreign exchange profits or losses if products are purchased in one currency and then sold in another currency;
- transactional risks (these are likely to include pricing and payment terms in a commercial transaction for the supply of goods, property or services) – for example supply risk, which is the risk that a company will be incapable of supplying products (such as agreed to in contracts with customers) which can lead to foregone sales or lost customers relationships; and
- hazard risks (these are likely to include adverse external events that may cause damage or losses, including accidents and disasters) – for example inventory risk, which is the risk that products (e.g. raw materials and final products) may be lost, damaged or stolen, or become obsolete while held in inventory.

Further, those risks can be driven externally or internally with different impact on the volatility (downside impact or upside impact allowing value creation). See Figure 1.

16. Para. 1.72, OECD Guidelines.

Figure 1: The risk and volatility paradigm^[17]

Business Modelling for Tax and Transfer Pricing Purposes

Identifying risks goes hand in hand with identifying functions and assets and is integral to the process of identifying the commercial or financial relations between the associated enterprises and of accurately delineating the transactions. On the one hand, the definition of risks in business should not be performed on a primitive level – i.e. just listing the risks from the general point of view. On the other hand, risks should not be interpreted to be more important than functions or assets. The relevance of functions, assets and risks in a specific transaction should be determined through a detailed functional analysis. In practice, however, risks in a transaction can be harder to identify than functions and assets, which therefore requires careful analysis.

Therefore, the OECD Guidelines based on the BEPS Final Report on Actions 8-10 introduce a six-step process to analysing risks, which can be summarized as follows:^[18]

1. Identify economically significant risks in the relevant relational context.
2. Determine how risks are contractually assumed under the terms of the transaction.
3. Determine through a functional analysis which enterprise(s) (i) perform(s) control functions and risk mitigation functions, (ii) encounter(s) upside or downside consequences of risk outcomes, and (iii) have(s) the financial capacity^[19] to assume the risks.
4. Determine whether the contractual assumption of risks is consistent with the conduct of the associated enterprises by analysing whether (i) the associated enterprises follow the contractual terms; and (ii) the party assuming the risk exercises control over the risk and has the financial capacity to assume the risk.
5. Where the party assuming the risk does not control the risk or does not have the financial capacity to assume the risk, the risk should be allocated to the entity exercising control and having the financial capacity to assume the risk. In the case of multiple associated enterprises that both exercise control and have the financial capacity, the risk should be allocated to the entity(ies) having the most control.
6. The actual transaction should be accurately delineated by considering the evidence of all the economically relevant characteristics of the transaction and then priced taking into account the financial and other consequences of risk assumption.

During the above-mentioned analysis of risks, the risks assumed by the associated entities such as strategic, financial, operational risks and hazard risks should be identified. However, it is possible that other specific risks can be identified during the rest of the functional analysis e.g. human and intellectual capital risks.

17. S. Gonnet, *Risks Redefined in Transfer Pricing Post-BEPS*, in *Transfer Pricing in a Post-BEPS World* (M. Lang, A. Storck & R. Petrucci, eds., Kluwer Law International BV 2016), at 33-59.

18. Para. 1.60, OECD Guidelines.

19. Financial capacity in this area means an access to funding to take on the risk or to lay off the risk, to pay for the risk mitigation functions and to bear the consequences of the risk if the risk materializes. Where the financial capacity to assume a risk is absent, the allocation of risk requires consideration under step 5 of the guidelines on analysing risk.

Furthermore, risk management is closely related with this analysis. It involves the capability to make decisions to take on, lay off, or decline a risk-bearing opportunity, and the capability to make decisions on whether and how to respond to the risks associated with the opportunity. The contractual allocations of risk are respected only when they are supported by actual decision-making and thus exercising control over these risks.^[20] The control over risk and the financial capacity to bear risk are relevant factors in considering whether a controlled party should be allocated a risk return. However, the activities for the elimination of risks can be outsourced if the control over risk remains in the hands of the same entity and it can still be managed.

It is obvious that the [BEPS Final Report on Actions 8-10](#) has turned the analytical approaches from transactions towards the context of commercial and financial relations. Therefore a more comprehensive and realistic approach to risk assumed, functions performed and assets used is inevitable as well as an understanding of value drivers in the enterprise. For that purpose the value chain analysis can be applied, when the roles of the entities in the joint value creation are defined together with responsibilities in respect of their control of the different value drivers and related risks. How the associated enterprises can be rewarded depends on the analysis of how prices are set – ex ante and ex post. Moreover, the responsibilities of entities in respect of different risks affect the final remunerations for those entities, i.e. ex post outcomes can only be understood and explained in view of those responsibilities.

Therefore, not all operating models may be comparable to the one being tested. There are different types of business models, such as manufacturers, distributors and service providers, which can be further distinguished according to a certain role and responsibility profile on investment centre, profit centre, cost centre, revenue centre and expense centre. Also, for some industries and products, distribution may for example require significantly more selling, general and administrative (SGA) expenses per unit of sales than in other industries, making it more complex to draw reliable comparability conclusions once the ranges resulting from potentially comparable distributor models are established.^[21] Benchmarking as such and the related complexities are not further discussed in this section (for that, see section 2.5.).

Besides functions performed and risks assumed, the assets used within a business model also need to be considered. In this regard, the type of assets and nature of the assets are relevant factors. Important assets include working capital^[22] representing operating liquidity available to a company, plant and equipment used to manufacture products and (valuable) intangible assets used.^[23] The nature of assets used includes elements such as available property rights protection, age and market value of the asset.

Nowadays, the above-mentioned analysis of the risks and whether the associated entity assumes (and incurs) such risks (i.e. has control over the risks and financial capacity to bear them) should always be analysed, together with the functions performed and assets used in the context of its commitment to creating value, to ensure that transfer prices are in line with the value creation and based on an accurate delineation of what the associated enterprises actually contribute to the transaction, i.e. how the business model operates in practice.

-
20. R.S. Avi-Yonah & H. Xu (2016), *Global Taxation After the Crisis: Why BEPS and MAATM are Inadequate Responses, and What Can Be Done About It*. Public Law and Legal Theory Research Paper Series, Paper no. 494, January 2016. Available at <http://ssrn.com/abstract=2716124>, accessed on 16 Oct. 2017.
 21. D. Broomhall, *SG&A and Distributor Profits in Transfer Pricing*, in 16 Transfer Pricing Report at 288 (2007).
 22. Working capital is calculated as current assets (e.g. inventory and accounts receivable) less current liabilities (e.g. accounts payable).
 23. The OECD Guidelines, ch. VI, make a distinction between marketing intangibles (that assist in commercial exploitation of products/services) and trade intangibles (created through risky and costly R&D activities).

2.1. Manufacturer

Manufacturing assumes a transformation from raw materials to finished goods. It can be done manually or through use of machinery or industrialization, and can be done on a large-scale (mass production) or small-scale (artisan work product) basis. It can be sophisticated manufacturing using protected intellectual property (e.g. patents) and specialized know-how, engineering systems and designs, or be a simple manufacturing process in which the manufacturer has outsourced a function and a (small) part of the overall manufacturing; owns no intellectual property or specialized know-how; does not have responsibility for sourcing raw materials or the quality thereof; and does not incur any risks related to the manufactured output.

Manufacturing is traditionally conducted in one of four function/risk formats recognized for transfer pricing purposes: toll manufacturing, contract manufacturing, licensed manufacturing and fully fledged manufacturing. These four formats are assumed to attract different levels of expected compensation to reflect the functions performed, risks assumed and assets used which are different for each format. For example, high risk assumes the potential to earn high rewards, but can also include the suffering of steep losses, and moderate risk assumes the earning of a moderate compensation and less likelihood of suffering losses. This can be depicted as follows:

Manufacturer

2.1.1. Toll manufacturer

Toll manufacturing involves a value/risk model where the entity performing the actual manufacturing process has little or no risk. The manufacturing activity will usually consist of processing raw materials or semi-finished goods (assembly), and the manufacturing entity assumes neither risk for stock or inventory nor for the deterioration or obsolescence thereof. A toll manufacturer is essentially a service provider to the selling entity ordering its services and the resulting products. The company can be defined as a secondary company carrying out a subset of the production process. The toll manufacturer is not responsible for production scheduling, not responsible for raw material procurement (it usually uses raw materials on consignment)^[24] and owns no valuable intangibles (but just routine manufacturing or processing skills) and will typically operate based on a guaranteed volume arrangement. The manufacturing entity takes no responsibility for quality control, logistics, consumer sales or collection of revenues.^[25] End products are usually sent to the owner's warehouse, and the owner is responsible for further distribution at the latter's expense. A toll manufacturer will not have title to the raw materials, work-in-progress or the final products manufactured.

The toll manufacturer is traditionally seen as a service provider and remunerated on the basis of cost-plus (assuming that the comparable uncontrolled price (CUP) method cannot be used).^[26] The OECD Guidelines provide in relevant part that the cost-plus method is probably most useful where semi-finished goods are sold between related parties, where related parties have concluded joint facility agreements or long-term buy-and-supply arrangements or where the controlled transaction is the provision of services.^[27] In practice, benchmarking difficulties may require the use of the transactional net margin method (TNMM), however, which is applied as a modified cost-plus method at the operating

24. A toll manufacturer is also referred to as a consignment manufacturer.

25. C. Adams & P. Graham, *The Role of Transfer Pricing in Tax Planning*, in *Transfer Pricing: A UK Perspective* at 54-56 (1999).

26. Based on the OECD Guidelines, the comparable uncontrolled price (CUP) method has still been considered the best method to use, if available.

27. Para. 2.45, OECD Guidelines.

profit level, considering return on total costs rather than return on cost of goods sold, which is reviewed if the cost-plus method is applied at the gross profit level. Taxpayers may be able to obtain certainty in advance regarding the profit margin and transfer pricing method to be used, by way of seeking a (bilateral, unilateral or multilateral) advance pricing agreement, depending on the jurisdictions in which they do business.

2.1.2. Contract manufacturer

A contract manufacturer assumes manufacturing functions on a contract basis for a principal company (within an [MNE](#) context), usually after a bidding process, and is in charge of processing raw materials typically in return for a set fee per unit of production. Traditionally, this form of hired manufacturing or outsourcing of manufacturing is used by original equipment manufacturers (OEMs)^[28] in the computer, telephone, printing equipment, automotive, airline and aerospace industries and presented in the market as a value-added cost-effective alternative to tying up capital and resources in manufacturing facilities and related equipment. Contrary to a toll manufacturer, a contract manufacturer generally does take title to finished products and buys raw materials. The contract manufacturer owns no valuable protected intangible property itself, however, and some of the necessary raw materials may be provided on a consignment basis by the owner, and some of the necessary raw materials may be sourced by the contract manufacturer. The contract manufacturer may dispatch finished products directly to the sales companies at the instruction of the principal, and may or may not hold title to the (semi-)finished product. Procurement decisions, logistics and planning are all conducted by the owner, yet the contract manufacturer generally is responsible for keeping up to date with current technology requirements, machinery and procedures in order to remain competitive and to conduct quality control.

The contract manufacturer is traditionally also seen as a service provider, and is remunerated on a cost-plus basis (assuming that the [CUP](#) method cannot be used).^[29] In practice, benchmarking difficulties may require the use of the [TNMM](#), however, which is applied as a modified cost-plus method at the operating profit level, considering return on total costs rather than return on cost of goods sold – which is reviewed if the cost-plus method is applied at the gross profit level.

Toll manufacturing and contract manufacturing do not differ greatly from each other from a functional perspective. A toll manufacturer, however, does not take title to finished products manufactured. Furthermore, it is generally assumed that a contract manufacturer has slightly more responsibilities than a toll manufacturer for benchmarking and comparability purposes. Taxpayers may be able to obtain certainty in advance regarding the profit margin and transfer pricing method to be used by way of seeking a bilateral, unilateral or multilateral advance pricing agreement, depending on the jurisdictions in which they do business.

2.1.3. Licensed manufacturer and fully fledged manufacturer

Fully fledged manufacturing assumes a process where the relevant elements such as sourcing and purchasing raw materials, procurement and vendor qualification, engineering and design decisions, use of intangibles (know-how and patents), [R&D](#), production planning, responsibility for standards of production and quality control, environmental requirements, warehousing, logistics and invoicing of customers, are all handled by the manufacturing entity itself and performed for its own risk and reward.

28. An original equipment manufacturer makes a product that is subsequently embedded or built-in inside another product (e.g. the inclusion of computer chips inside a computer).

29. *Supra* n. 27.

A fully fledged manufacturer typically assumes the risks that are associated with these functions (e.g. market risk, inventory risk, warranty risk and R&D risk).

If the fully fledged manufacturer uses valuable intangible assets, it is generally not reliable to apply the cost-plus method or the [TNMM](#), as it will be difficult to identify comparable independent manufacturers owning comparable intangible assets. In such a case, it may be more reliable to test the distribution companies with which the fully fledged manufacturer transacts. The fully fledged manufacturer would then be entitled to the resulting residual profits. If both the fully fledged manufacturer and the distributor make use of valuable intangible assets, the profit split method should be applied. Taxpayers may be able to obtain certainty in advance regarding the profit margin and transfer pricing method to be used, by way of seeking a (bilateral, unilateral or multilateral) advance pricing agreement, depending on the jurisdictions in which they do business.

A licensed manufacturer assumes the same process with the same functions, risks and assets used as the fully fledged manufacturer, with one difference however. A licensed manufacturer does not own specific valuable manufacturing intangibles and therefore any functions and risks related to these intangibles, for example R&D functions and R&D risks, are not performed and assumed. A licensed manufacturer uses specific valuable manufacturing intangibles for the regular fee payments.

The above manufacturing models can be generally summarized as follows:^[30]

	Fully fledged manufacturer	Licensed manufacturer	Contract manufacturer	Toll manufacturer
Sourcing raw materials	x	x	x	
Consignment of raw materials				x
Manufacturing planning	x	x	x	x
Routine intangibles	x	x	x	x
Specific valuable manufacturing intangibles	x			
R&D	x			
Manufacturing	x	x	x	x
Title to goods	x	x	x	
Assembling and packaging	x	x	x	x
Warehousing and logistics	x	x	x	(x)
Price setting	(x)	(x)		
Invoicing and collection	x	x	x	
Marketing and advertising	x	x		
Quality control	x	x	x	x
Sales and distribution	x	x		
After sales support	x	x		

30. The figure represents three manufacturing models as having a particular function, risk and assets profile. In practice, the labels used to describe these three manufacturing models may reflect different functions, risks and assets, depending on the particular facts and circumstances of the case.

	Fully fledged manufacturer	Licensed manufacturer	Contract manufacturer	Toll manufacturer
Warranty and repair	X	X		
General administrative functions	X	X	X	X
R&D risk	X			
Market risk	X	X		
Inventory risk	X	X	X	
Operational risk	X	X	X	X
Foreign exchange risk	X	X		
(Product) liability risk	X	X	(X)	
Bad debt risk	X	X	X	

Manufacturing models can include different manufacturing strategies, such as just-in-time manufacturing or lean manufacturing. Just-in-time manufacturing focuses on reducing inventory costs and requires a close demand analysis of the products being manufactured in order to be effective. The process is also called lean manufacturing, as it strives to eliminate unnecessary steps in the process, creating a continuous flow of production using human effort, tools, space and overall expense as efficiently as possible, and was reportedly pioneered by Toyota Motor Company.^[31]

The existence of the above functionalities can in practice be tested by tax authorities and tax inspectors based on a review of several externally observable factors, such as people functions, number of employees plus their competencies, positions, titles and salary levels, investment in resources (assets such as plant property and equipment) and a description of the actual manufacturing process or function, plus review of contracts in place and decision-taking processes.

2.2. Distributor

Distribution involves the process by which a product (or service) is processed through the business system to the end-consumer. It is said that typically approximately half the price paid for a product by a customer is absorbed by the activities in getting that product to the customer.^[32] Routes to market involve one or more types of intermediaries, such as wholesalers, distributors, dealers, brokers, aggregators and retailers.^[33] Evaluating the distribution processes largely depends on whether the distribution is directly to end-consumers, via one intermediary level or two or more intermediary levels. A one-tier intermediary level, for example, is one where sales are made to a (local) retailer. The choice for this method of distribution is based on the existence of situations where there would be no perceived benefit or earnings for the supplier or distributor to persuade ultimate customers to buy the product or service, or the cost to reach customers that way would be disproportionately high. This can be due to geographic reasons or language barriers, for example, or because the end-consumer is difficult to target

31. J.P. Womack & D.T. Jones, *From Lean Production to the Lean Enterprise* (1993), republished in *Harvard Business Review on Managing the Value Chain* at 221-243.

32. J. Dent, *Distribution Channels: Understanding and Managing Channels to Market* at 9-13 (Kogan Page 2008).

33. Id.

and reach. The consequence of using an intermediary is that the latter will require a trading margin for its intermediary services or activities.

Distribution models range from that of a commissionaire/commission agent to a stripped buy-sell distributor to a fully fledged distributor. These different formats are assumed to offer different levels of added value, incur different levels of risk and attract different levels of compensation. Similar to the manufacturing formats, there are different types of distributors, as reflected in functions performed, risks assumed and assets used, which results in different levels of expected return. For example, high risk assumes potential to earn high rewards but can also include the incurrence of steep losses, and moderate risk assumes the earning of a moderate compensation and less likelihood of incurring losses. This can be depicted as follows:

Distributor

2.2.1. Commission agent

The commission agent typically serves as an intermediary that operates for a disclosed principal and seeks sales. The commission agent arranges the sale of products to customers on behalf of its principal. The principal holds title to the goods to be sold and usually signs the sales agreement with customers. The commission agent will not hold inventory, will not invoice and will have no responsibility vis-à-vis the consumer for the products sold. Because the commission agent does not hold title to the products, it does not assume inventory risk.

The commission agent typically receives a cost-plus remuneration (assuming that the CUP method cannot be used) for its functions, or a commission on its sales.^[34] Taxpayers may be able to obtain certainty in advance regarding the profit margin and transfer pricing method to be used, by way of seeking a (bilateral, unilateral or multilateral) advance pricing agreement, depending on the jurisdictions in which they do business.

2.2.2. Commissionaire

The commissionaire operates similar to a commission agent, usually with the difference that the principal is undisclosed. The commissionaire sells products to customers under its own name, but for the benefit of the principal. The main challenges in practice with regard to transfer pricing concern how to differentiate commission agents from commissionaires and distributors, and how to identify the accounting method to be used for commission revenue.^[35] Typical commissionaire (and commission agent) activities include:

- finding buyers for products and making sales calls;
- selling products, issuing invoices and collecting the sales price. The sales activity undertaken typically involves trained and employed selling agents proactively soliciting sales from existing clients or prospective clients. Commissionaires are often required to promote the sale of the principal's products through promotion and advertisements, and are often responsible for maintaining customer relations and acting as a local point of contact for customers;

34. Depending on the extent to which a commission agent is involved in the sales process, the cost-plus method may not be the appropriate transfer pricing method. It can be argued that a commission agent which is extensively involved in the sales process should be compensated based on a percentage of net sales.

35. N. Sanchez e Silva, *Benchmarking Commission Agents: Potential Pitfalls*, in *16 Transfer Pricing Report* at 352 (2007).

- conducting promotion activities, as long as these do not rise to the level of substantive marketing activities as generally conducted by fully fledged distributors;
- customer credit tracking and monitoring. Commissionaires can also be responsible for monitoring the credit rating of customers in accordance with policies set out by the principal. However, they are not usually responsible for the actual collection of receivables, nor is their income entitlement normally contingent upon the collection of monies by the principal; and
- local payroll and support. Commissionaires are generally responsible for local planning, forecasting, payroll, local legal and income tax matters. They may also assist the principal with sales forecast and market reports for their designated regions.

Under the standard allocation of functions, and in accordance with the commissionaire agreement, commissionaires cannot agree the following without the prior approval of the principal:

- sales prices outside the predetermined range;
- discounts outside the predetermined range;
- credit terms beyond the range of company policy;
- warranty extension; and
- product customization and redesigns.

The commissionaire is sheltered from any significant risks by the principal. The primary risk that a commissionaire bears in theory is that marketing expenditure will be borne with no corresponding sale (i.e. market risk).^[36] Commissionaires may report their commission in one of two ways:

- (1) report the sales revenues from products on its profit and loss statement (P&L) and on a monthly basis report an offsetting payment to the principal with deduction of the commission; or
- (2) report only the commission on its P&L, not the sales revenue.

In certain countries, domestic law may require that the first option be applied. Invoicing may be conducted by the commissionaire or the principal. There is usually a distinct treatment of commissionaires for transfer pricing and VAT purposes. Intercompany agreements need to be carefully drafted.

The commissionaire performs marketing services and is typically remunerated on the basis of a commission that can be determined based on the resale price method (assuming that the CUP method cannot be used). The OECD Guidelines indicate that the resale price method is probably most useful when it is applied to marketing operations.^[37] In practice, benchmarking difficulties may require the use of the TNMM, however, which is applied as a modified resale price method at the operating profit level, considering return on sales at the operating profit level, instead of the traditional resale price method, which is applied at the gross profit level. Taxpayers may be able to obtain certainty in advance regarding the profit margin and transfer pricing method to be used, by way of seeking a bilateral, unilateral or multilateral advance pricing agreement, depending on the jurisdictions in which they do business.

36. The commissionaire may, however, be insulated from the majority of this risk if it is remunerated on a cost-plus commission basis which guarantees the recovery of the budgeted costs. In such a case, however, the commissionaire's greatest risk lies in any differential between budgeted costs and actual costs.

37. Para. 2.27, OECD Guidelines.

2.2.3. Classic buy-sell distributor

The stripped buy-sell distributor (classic buy-sell entity or limited-risk distributor) is essentially similar to a fully fledged distributor, with that difference that it is stripped of certain functions and risks (by contract) – which has the result that it is exposed to decreased risk and as such, decreased remuneration. The classic buy-sell distributor will usually hold title to goods sold, although briefly to reduce exposure, but many of the traditional distribution-related functions are centralized within the multinational and conducted by (related) service providers rather than for the account of the buy-sell distributor itself. Products will, for example, be warehoused at the manufacturing entity and shipped directly from there to the customer, subject to quality control by the manufacturer, or alternatively from a regional distribution centre subject to quality control there, although title to the goods will pass to the buy-sell entity immediately prior to the sale to the customer (flash title). It is also possible that the entity might have some inventory responsibilities, but those will be limited. The buy-sell distributor entity in general has no, or very limited, inventory risk. Other outsourced activities may include logistics related to warehouse inventory and sales to customers, marketing and advertising. The company does deal for its own account, and negotiates the terms of resale to local customers itself, however. Invoicing and collection activities may or may not be outsourced for the classic buy-sell entity. Marketing and advertising are typically outsourced as well, and conducted for the account of another entity. In practice, there is little difference between a commissionaire and a limited-risk distributor.

Based on current transfer pricing rules, a stripped buy-sell distributor ought to be remunerated on the basis of the resale price method (assuming that the [CUP](#) method cannot be used). The OECD Guidelines indicate that an appropriate resale price margin is easiest to determine where the reseller does not add substantially to the value of the product – which tends to be the case with the classic buy-sell distributor.^[38] In practice, benchmarking difficulties may require the use of the [TNMM](#), however, which is applied as a modified resale price method at the operating profit level, considering return on sales at the operating profit level, instead of the traditional resale price method which is applied at the gross profit level. Taxpayers may be able to obtain certainty in advance regarding the profit margin and transfer pricing method to be used, by way of seeking a (bilateral, unilateral or multilateral) advance pricing agreement, depending on the jurisdictions in which they do business.

2.2.4. Fully fledged distributor

A fully fledged distributor is one that is usually highly active in the market, has access to the right consumer base and builds demand for products or services through its marketing and sales activities. It may have developed its own marketing intangibles, may own or license brands to conduct its sales and carefully assesses the market, as it tends to have inventory risk and be responsible for logistics related to both inventory and sales. The distributor conducts quality control as to its inventory, has responsibility for warehousing and logistics, and takes title to goods until sale and delivery. The fully fledged distributor typically conducts marketing activities and performs post-sales services to customers, as well. The marketing strategy may or may not be determined by the fully fledged distributor. If it is, the distributor may also be referenced as a marketer/distributor.^[39]

A fully fledged distributor may be remunerated on the basis of the resale price method (assuming that the [CUP](#) method cannot be used). The OECD Guidelines acknowledge, however, that it may be more difficult to use the resale price method to arrive at an arm's length price where, before resale, the goods

38. Para. 2.35, OECD Guidelines.

39. PricewaterhouseCoopers, *International Transfer Pricing* at 46 (2008).

are further processed or incorporated into a more complicated product so that their identity is lost or transformed (e.g. where components are joined together in finished or semi-finished goods). Another example in which the resale price margin requires particular care is where the reseller contributes substantially to the creation or maintenance of intangible property associated with the product (e.g. trademarks and trade names) which is owned by an associated enterprise.^[40]

In practice, benchmarking difficulties may require the use of the [TNMM](#), which is applied as a modified resale price method at the operating profit level, considering return on sales at the operating profit level, instead of the traditional resale price method, which is applied at the gross profit level. If the fully fledged distributor uses valuable intangibles in the distribution process, it may not be possible to reliably use the (modified) resale price method, however. In some situations, the profit split method is better suited to determine the arm's length remuneration for functions performed, risks assumed and assets used. Taxpayers may be able to obtain certainty in advance regarding the profit margin and transfer pricing method to be used, by way of seeking a bilateral, unilateral or multilateral advance pricing agreement, depending on the jurisdictions in which they do business.

The above distribution models can be summarized as follows:

	Commission agent	Commissionaire	Classicbuy-sell distributor	Fully fledged distributor
Title to goods			x	x
Warehousing and logistics			(x)	x
Purchase planning				x
Marketing and advertising	x	x	(x)	x
Quality control				x
Price setting				x
Sales and distribution	x	x	x	x
After-sales support				x
Warranty and repairs				x
Invoicing and collection		x	x	x
General administrative functions	x	x	x	x
Inventory risk				x
Market risk	(x)	x	x	x
Bad debt risk			x	x
(Product) liability risk			x	x
Foreign exchange risk				x

40. Para. 2.37, OECD Guidelines.

A distinction also observed between distributor business models is that between value-added distributors, broad line distributors and fulfilment distributors.^[41] Value added distributors are focused on distributing products where there is very limited distribution (few or only one distributor exists in the market) and where their function is that of developing the market for (specialized) products. Broad line distributors will provide mainstream market coverage using established relationships that they have built over time, and fulfilment distributors will typically sell products that need hardly any sales effort because the demand is high and already existent in the market. The value-added distributor is deemed to incur the most risk and is therefore likely to demand the highest reward for its activities, the fulfilment distributor being at the opposite side of the spectrum with little risk and earning low margins, while the broad line distributor is somewhere in the middle.^[42]

2.3. Service provider

Service provision consists of a series of activities that bring about benefits. From a transfer pricing perspective, a service provider is an entity that provides services to other entities. Many MNEs have centralized services that serve to support the manufacturing and/or distribution function (shared services centres). Not too long ago, it became much in vogue to have so-called “centres of excellence” put in place, or principal entities, that serve to manage traditionally decentralized functions and the global supply chain. Centres of excellence are seen as a way to obtain economy of scale benefits and arbitrage for low labour and material costs, but also to collect and process relevant business information centrally and to reduce administration related to cross charges within an MNE. The centre of excellence itself typically will be a sophisticated service provider and entrepreneur at the same time. Alternatively, the centre of excellence will avail itself of shared services centres and bear the risks and costs related to the services it receives.

The OECD Guidelines also refer to the fact that nearly every MNE group must arrange for a wide scope of services to be available to its members, in particular administrative, technical, financial and commercial services. Such services may include management, coordination and control functions for the whole group.^[43] The service provider generally does not manufacture tangible products or sell them, but may take on activities related to the manufacturing process, such as sourcing of materials and related procurement in order to obtain bulk discounts, or take on activities such as central warehousing and logistics to support the manufacturing and distribution functions from a centralized “hub” location to obtain economy of scale benefits. Centralization of marketing and advertising or of accounting and administration is another common example and serves the same purpose: obtaining economy of scale benefits and efficient handling of issues relevant for all distribution and manufacturing functions within an MNE by involving dedicated and qualified resources and employees in a centralized fashion.

According to the OECD Guidelines, centralized services may include planning; coordination; budgetary control; financial advice; accounting, auditing, legal, factoring and computer services; and financial services such as supervision of cash flows and solvency, capital increases, loan contracts, management of interest and exchange rate risks and refinancing.^[44] Financing services are regularly conducted by an entirely separate financing services company within an MNE, with the benefit of centrally managing cash

41. Dent, *supra* n. 33, at 29-31.

42. For a more extensive discussion of these models, see Dent, *supra* n. 33.

43. Para. 7.2 OECD Guidelines, OECD Guidelines, chapter VII *Special Considerations for Intra-Group Services*. OECD, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 – 2015 Final Reports*, OECD/G20 Base Erosion and Profit Shifting Project (OECD 2015). Available at <http://www.oecd.org/tax/aligning-transfer-pricing-outcomes-with-value-creation-actions-8-10-2015-final-reports-9789264241244-en.htm>, accessed on 16 Oct. 2017.

44. Para. 7.14 OECD Guidelines.

flow or intercompany loans and related administration and risks. Other services include assistance in the field of production, buying, distribution and marketing; and services in staff matters such as recruitment and training. Group service centres also often carry out order management, customer service and operate call centres, perform R&D or administer and protect intangible property for all parts of the MNE group.^[45] These types of activities ordinarily will be considered intra-group services because they are the type of activities that independent enterprises would have been willing to pay for or to perform themselves.

The entity rendering services usually has as core asset its skilled employees for the particular services rendered, software plus related hardware and a budget which allows it to render its services.

Services are generally distinguished between those that are performed for the benefit of the shareholders of the MNE and the parent company of the MNE group, and those that are for the benefit of (one or more of) the respective entities themselves. The distinction is relevant and made to differentiate between (1) service expenses that can be charged out to the beneficiaries of the services rendered and (2) expenses that cannot be allocated out and must be incurred by the MNE/parent company itself, usually the headquarters entity. For example, duplicative services do not confer a benefit (as they are duplicative) and cannot be allocated out. The term “stewardship activity” is also being used, mainly in the United States, and refers to services that cannot be allocated out.^[46] The US Internal Revenue Service (IRS) has in the past divided services into four classes, namely:^[47]

- Class I: expenses for the direct benefit of one or more of the subsidiary corporations;
- Class II: expenses involving stewardship such as filing a US tax return or an information report with the IRS and the Securities and Exchange Commission;
- Class III: expenses for the benefit of the operating members of the group as a whole; and
- Class IV: expenses of a parent company that are not properly includible as stewardship expenses.

In any case it is required that services rendered confer a benefit before they may be allocated out. However, how to substantiate such benefit is another and complex issue, and it should be assumed that MNEs do not incur costs to render services (centrally or otherwise) without a perceived need for those services and benefit. In Western countries, most firms are profit maximizers and it can be considered a given that MNEs strive to curb costs incurred for getting products to market. Corporations typically raise money by issuing debt and stock, and the company must ensure that its managers operate to maximize profits and do not pursue goals that would adversely affect the debt holders and shareholders.^[48] The internal review processes that apply within these companies are usually far stricter than any (external) tax audit could be, and serve to justify the purpose and benefit of incurring costs for certain activities including services rendered.

Service providers can range from a shared services centre providing centralized support services for the benefit of group companies, to a contract service provider performing activities on a contract basis for a principal company with the intention that developed intangibles are owned by the principal

45. Id.

46. Guidance in the area of stewardship in the United States appears limited to a Technical Advice Memorandum (TAM 8806002). Stewardship expenses are listed in the TAM as being “properly attributed to the parent-shareholder rather than operating expenses properly attributed to the operating profit activities of the affiliates”.

47. Id.

48. D.W. Carlton & J.M. Perloff, *Modern Industrial Organization* ch. 2, at 47-48 (Addison-Wesley 2000).

company,^[49] to sophisticated service providers that perform (highly) specialized services and are likely to own valuable intangibles (intellectual property management and marketing companies, for example). An entity rendering accounting and administrative services is as much a service provider as a dredging company engaged to assist with laying the foundations for a port or building site is, as a centre of excellence can be. Thus, modelling service providers offers a very diverse and broad range of possibilities.

The above range of service providers already indicates that determining the arm's length remuneration for service providers may present great challenges. In general, it is assumed and acceptable that a service provider's remuneration is based on the cost-plus method (assuming that the CUP method cannot be used). In practice, benchmarking will require the use of the TNMM, however, which is applied as a modified cost-plus method at the operating profit level, considering return on total cost at the operating profit level which better reflects activities of a service provider, instead of an analysis at the gross profit level, as a service provider's costs generally are not materially reflected by cost of goods sold.

It is expected that a service provider makes a profit while rendering its services, although (international) consensus seems to be building that certain services might be able to be rendered at (full) cost or with a more standard (yet relatively low) markup (3%-10%), such as for certain administrative services (payroll, audit, legal) and financial services (treasury) and procurement.^[50] However, based on the new provisions of chapter VII of the OECD Guidelines the mark-up for low value-adding services should be equal to 5% of the relevant costs i.e. the direct and indirect costs of rendering the service as well as, where relevant, the appropriate part of operating expenses.^[51] Further, the pass-through costs and costs that are attributable to an in-house activity that benefits solely the company performing the activity shall be excluded from cost base.^[52] Moreover, tax administrations can adopt the threshold for the application of the simplified approach (5% markup) i.e. if the threshold is exceeded, the simplified method would not be allowed.^[53]

The above service provider models can be summarized as follows:^[54]

	Shared service centre	Contract service provider	Sophisticated service provider
Investment in assets ^[1] used to render services	Tends to be low	Tends to be low	Tends to be (very) high

49. For example, contract R&D and contract marketing. See also para. 7.41 of the OECD TP Guidelines.

50. Para. 7.37 of the OECD Guidelines and also discussions held within the European Joint Transfer Pricing Forum during 2008/2009 regarding how to more systematically address services within the European Union. See also Netherlands Decree IFZ2004/680M, which refers to the possibility that bookkeeping, legal affairs, fiscal affairs and human resources activities can be charged out at (full) cost. See also EU Joint Transfer Pricing Forum, JTPF Report: *Guidelines on low value adding intra-group services*, from the Meeting of 4 February 2010. Doc: JTPF/020/REV3/2009/EN. The JTPF report states that, where it is appropriate to use a markup, typically agreed markups fall within a range of 3-10%, often around 5%. Furthermore, JTPF reviewed additional services that are regularly classified as shareholder costs and which are not included in the existing OECD Guidelines as shareholder activities. However, based on the results of the BEPS 2015 Final Report on Actions 8-10, the current provisions of chapter VII, OECD Guidelines include the definition of shareholder activities, which is slightly extended (see paras. 7.9-7.10).

51. Para. 7.61 and sec. D.2.4., OECD Guidelines.

52. Id.

53. Para. 7.63, OECD Guidelines.

54. The figure includes the extremes of the services spectrum, and there may be many models in between.

1 Assets could cover a wide spectrum and include items such as office equipment; (self-developed) software for a car park; standard or sophisticated and specially designed machinery and equipment or tools; warehouses; and de facto existing networks and relations.

	Shared service centre	Contract service provider	Sophisticated service provider
Human resources ^[2]	Depends on type of services rendered	Lower compensated/less sophisticated staff	Higher compensated/more sophisticated staff
Valuable intangibles			x
Routine intangibles	x	x	x
Invoicing and collection	x	(x)	x
General administrative functions	x	x	x
Market risk			x
Bad debt risk			x
Foreign exchange risk			(x)
Liability risk	x	(x)	x

- 1 Assets could cover a wide spectrum and include items such as office equipment; (self-developed) software for a car park; standard or sophisticated and specially designed machinery and equipment or tools; warehouses; and de facto existing networks and relations.
- 2 The human resources assumption is one that is a gross generalization.

One issue observed in practice is that the rendering of services tends to be expanded to constitute:

the performance of functions and risks, or use by a renderer of tangible and intangible property or other resources, capabilities or knowledge, such as knowledge of and ability to take advantage of particularly advantageous situations and circumstances, including the making available of property or resources of the renderer.^[55]

This broad definition of an activity (intentionally) blurs the distinction between services and transfers of tangible and intangible property, etc.^[56]

2.4. Responsibility profile of business model

Another categorization of the business model can be done based on responsibility, which provides a more process-oriented view on the MNEs. Roles and responsibilities within an MNE and value-added decisions are identified through this process.

From the management accounting perspective, there are different types of responsibility centres to promote alignment between individual and corporate goals, depending on the decision rights delegated to the managers of associated entities.^[57] Responsibility centres define what assets and activities each

2 The human resources assumption is one that is a gross generalization.

55. Sec. 1.482-9T (1), (2) US Temp. Reg.

56. M. Levey & S. Wrappe, *Transfer Pricing: Rules, Compliance and Controversy* para. 520, at 162 (CCH 2007).

57. C.T. Horngren, S. Datar & G. Foster, *Cost accounting, a Managerial Emphasis*. (Prentice Hall Inc. 12th. ed. 2006) and further Transfer Pricing Associates: *Manual for Responsibility Centres – Technical Information*. Available at <http://www.oecd.org/ctp/transfer-pricing/42189238.pdf>.

manager is responsible for. Moreover, they should reflect the degree to which the responsibility centre manager controls revenue, cost, profit or return on investment. Based on it, centres can be divided into investments centres, profit centres, cost centres and revenue centres.

From the tax perspective, the concept of responsibility centres ensures that each party focuses on its own roles and responsibility so that it may be considered whether transfer pricing outcomes are aligned with economic reality and value creation. Moreover, it ensures the allocations of risk to the associated enterprise which controls the risk and has the financial capacity to assume it.

2.4.1. Cost centre

Cost centres are responsible for controlling cost inputs but do not have control over revenues, profit or investment levels. There are two types of cost centres, namely engineered expense centres and expense centres.

Engineered expense centres usually produce goods or provide services (almost always exclusively for the group) which can be considered as non-core activities based on the service level agreement. The performance of such a centre is evaluated by comparing the actual costs with budgeted cost levels for the amount and type of work performed, therefore standard costs per product, actual costs per product and variances are applied.

Expense centres usually perform highly creative, non-repetitive activities e.g. strategic marketing, research and other activities (almost exclusively for the group), which can be considered as core activities based on the development contract or service level agreement. Such centres focus on quality of processes, people and technology applied. The performance of an expense centre is evaluated by comparing cost levels, i.e. the difference between the actual and budgeted costs for a given period.

For both cost centres, traditional evaluation control indicators are cost variances which are different for a purchasing and production entity and a service provider entity. Moreover, quality, response time, the ability to meet production schedules and other aspects should be taken into account to assess cost centre performance. From a transfer pricing perspective, the profit margin is applied unless a markup is charged.

2.4.2. Revenue centre

Revenue centres are primarily responsible for generating sales revenue, therefore their activities focus on market- and customer-driven activities which are considered as core activities. Revenue centres have authority over sales and distribution activities and do not possess control over costs, profit and investment in assets.

Some revenue centres control price, stock on hand and promotional activities. Such centres have control over some of the expense e.g. marketing. However, marketing functions may generate very few costs relative to the revenue produced. Revenue measures most of the value-added activities. To increase revenue, quantities or prices must be maximized.

The performance of a revenue centre is evaluated by comparing revenue levels, i.e. actual revenue with budgeted revenue. Traditional evaluation control indicators are sales variances, price variances and volume variances. From a transfer pricing perspective, the margin of sales revenue is allocated to the centre based on the service level agreements of the distribution company.

2.4.3. Profit centre

Profit centres generate both revenues and costs; managers are therefore responsible for both of them. The main purpose of the centre is to earn profit, i.e. managers have the power to set own prices and are responsible for marketing, production and service functions. Profit centres perform mainly core activities usually based on the service level agreement with cost centres.

The performance of a profit centre is evaluated by comparing actual profit with budgeted profit. The managers are more concerned with increasing revenue by increasing production and by improving distribution methods. Moreover, price levels and standard costs per product are analysed as well as turnover, costs and profits per product in the centres.

Traditional profit level indicators are gross profit or contribution margin, operating profit and net profit plus the variances for sales and cost. Their performance is evaluated by comparing revenues and expenses, rather than by the assets used. Therefore, a detailed monitoring how centres use assets is recommended and the reclassification of profit centre as an investment centre is possible. From a transfer pricing perspective, the operating margin is the primary way of measuring the profitability of those centres.

2.4.4. Investment centre

Managers of investment centres are responsible for revenues, expenses and investments i.e. profit and amounts invested in the centre. Managers have the authority to buy, sell and use assets. Investment centres mostly perform activities for shareholders, which are considered as core activities, e.g. capital market- and customer-driven activities. Further, investment centres are usually intellectual property owners.

Investment centres have both marketing, production and service functions and managers control what to produce and how to produce, based on a wide variety of legal agreements. Their performance is usually evaluated by return on investment or by economic value added.

Traditional profit level indicators are return on investment as mentioned above, capital employed and profits per product, variances on return on investments and other profitability ratios. From a transfer pricing perspective, the following measures are recommended: economic value added, return on investment and remuneration based on the residual income.

2.4.5. Link between the business model and responsibility centre profile and value creation

Responsibility centres are classified based on the economic reality and value creation with the emphasis on the responsibilities of the functions performed, risks assumed and assets used by the associated entities similarly to the case of business models. Therefore, it is possible to make a link between the business models and responsibility centres.

Expense or cost centres are included in the business models in the form of contract or toll manufacturer, contract service provider or shared services centre. All those business models usually perform their business activities based on the services agreement and can be remunerated on the basis of the CUP, cost-plus or TNMM method.

Distribution companies in the form of a commission agent or commissionaire, and classic buy-sell distributors can be considered as revenue centres which usually perform their business based on the

distribution agreement and can be remunerated on the basis of the CUP (if it is applicable), RPM and TNMM method.

Fully fledged entities or sophisticated service providers can be considered as profit centres or investment centres depending on the usage of specific valuable intangibles and the related risks assumed and functions performed. Their business activities are realized through a wide variety of legal agreements. Entities can be remunerated on the basis of the TNMM (no specific valuable intangibles) or profit split method.

Moreover, if the value creation is considered through the value chain analysis, individual processes generate different values based on the functions performed, risks assumed and assets used in the business model. Therefore expense/cost/revenue centres can be evaluated as low value added entities in contrast to profit/investment centres which can generate high value added entities.

The relationship between the above-mentioned business models, responsibility centres and value creation can be summarized as follows:

OECD Pricing methods	Transfer	Responsibility profile	Business model	Legal labels	Value creation
CUP, TNMM	Cost-plus,	Expense/cost centre	Contract manufacturer, toll manufacturer, contract service provider, shared services centre	Services agreement	Low value added
CUP, RPM, TNMM		Revenue centre	Commission agent, commissionaire, classic buy-sell distributor	Distribution agreement	Low value added
RPM, TNMM, profit split	profit	Profit centre	Fully fledged manufacturer, fully fledged distributor	Manufacturing agreement, distribution agreement, service agreement	High value added
Profit split		Investment centre	Fully fledged entities, sophisticated service provider	Wide variety of legal agreements	High value added

As described in the previous sections, the OECD Guidelines intend that transfer pricing outcomes are better aligned with the value creation of the MNE group. The conduct of parties, substance-over-form and more functional approaches towards risks have been recently highlighted as well as responsibilities in value added decisions. All those aspects will be taken into account in respect of the identification of the business model.

2.5. Identification of the business model and related issues

The OECD Guidelines refer to the importance of conducting a comparability analysis for the purpose of selecting the appropriate transfer pricing method and the determination of the arm's length range for the controlled transaction between associated entities. During the analysis, it is necessary to take into account the characteristics of the property transferred or services provided, as well as the functions performed, assets used and risks assumed by the parties, the contractual terms, the economic circumstances of the parties, the business strategies pursued by the parties and other circumstances. Therefore, in determining whether controlled and uncontrolled transactions or entities are comparable, a functional analysis is necessary and essential.

The whole analytical process of a comparability analysis can usually be undertaken without limitations if internal comparable transactions exist. On the other hand, if internal comparable transactions do not exist (i.e. internal transactions are not comparable or do not exist), then external comparable transactions (or comparable entities) must be identified (e.g. through commercial databases such as Amadeus, Orbis or others). In view of the fact that the commercial databases present only financial statements with publicly available information, it is usually impossible to obtain high-level details as to the functions performed, risks assumed, assets employed, contractual terms (it is also important to determine the legal rights and obligations of the entity in performing its functions) and business strategies pursued by the parties. The comparability analysis can be strongly affected by these facts and the identification of a business model is more subjective because the result of the comparability analysis from the database is considered the comparable business model. In order to partly eliminate the subjective result of the comparability analysis, it is necessary to filter the data from the database according to the selected criteria. In the author's view, it is recommended to apply around ten filters, e.g. NACE code, geographic area, legal status, independence indicator, entering in the market, size of the entity, financial indicators such as profitability ratios, leverage ratios, activity ratios, ratios of liquidity, working capital ratio, and other indicators. Furthermore, it is suitable to find additional information from the web sites of selected entities. Moreover, if there are assumptions that financial indicators used during the analysis have different behaviour in the case of particular forms of business models, it is necessary to use any statistical tool, e.g. a regression/correlation analysis, which proves the assumptions. However, despite efforts to ensure the most comparable data, the data may have a lesser degree of comparability based on limitations in information available on comparables. Therefore, the OECD Guidelines recommend using statistical tools that take into account the general tendency to narrow the range (e.g. the interquartile range or other percentiles) that might help to enhance the reliability of the analysis.^[58] It is worth noting that the comparability analysis performed through a commercial database requires in-depth research of all selected entities in the database with support of any statistical tools by which subjective results can be eliminated and assumptions proved.

The EU JTPF is aware of the risks and difficulties involved in the comparability analysis and thus it stated that in the area of comparables it would rather develop solutions which go beyond the OECD Guidelines in the sense of improving their application and develop a pragmatic and fair solution for all stakeholders. Therefore, in 2016 the EU JTPF released the *Report on the Use of Comparables in the EU*,^[59] containing recommendations and good practice in respect of search strategy and specific aspects of comparability adjustments in line with the arm's length principle.

58. Para. 3.57, OECD Guidelines.

59. EU JTPF, Report on the Use of Comparables in the EU, Doc: JTPF/007/2016/FINAL/EN, available at https://ec.europa.eu/taxation_customs/sites/taxation/files/jtpf0072017encomps.pdf, accessed on 16 Oct. 2017.

The current practices observed by both taxpayers and the tax administration are explained and presented in Figure 2. The first step is setting the analysis with the aim of ensuring the objectivity of the process. The second step is the quantitative analysis covering the process of e.g. a Boolean search^[60] of external potential comparables through industry sector codes, keywords, turnover thresholds, independence tests,^[61] “diagnostic ratios”^[62] and others, for which multiple-year data covering a time period of 3 to 5 years are recommended. The third step is a qualitative analysis that covers the manual analysis of potential comparables received through the previous step, namely, website, company reports, financial statements, detailed independence test and losses. The identification of external comparables requires a search process that is customized to the type of database used and screening criteria used to identify potential comparable enterprises as well as the qualitative analysis. To ensure a high degree of comparability, statistical tools such as the interquartile range, percentiles or averages, are commonly used to narrow a range of results, as is recommended by the OECD. However, the EU JTPF highlights that this practice is not necessary if the range comprises results of equal and high reliability (this regards all the comparability factors). In this context, the possibility of accepting only one or two comparables should not generally be excluded.

The last step in the process focuses on the comparability adjustments which can affect the reliability of the method applied to determine the arm’s length price/margin. The most frequently made comparability adjustments performed by taxpayers or tax authorities are the following:^[63]

- working capital adjustments, related to account payables, account receivables and inventories to ensure that the net margins reflect the same level of financing activity;
- accounting adjustments, addressing foreign exchange difference adjustments, type of costs covering in the cost base for the determination of gross margins, local/international standards of financial reporting and/or treatment for income tax purposes;
- market adjustments, related to volume of sales, terms of conditions of sales and payments, credit terms;
- other type of adjustments, such as balance sheet adjustments and asset intensity adjustments; and
- risk-related adjustments, linked to how the potential comparables include the same level of risks and management of risks.

The performance of comparability adjustments should also be considered in light of the costs and compliance burden, as it is not desirable to provide an exhaustive list of all types of adjustments, as state the TP Guidelines and EU JTPF. Further, all comparability adjustments that were made should be

60. “There are a few basic principles that you can successfully use in nearly all the search engines out there to find exactly what it is that you are looking for, and one of the most basic techniques is using the add and subtract symbols in your web search query. This is commonly known as Boolean search and is one of the most elementary techniques you can use in your search efforts (as well as one of the most successful). ... Boolean searches allow you to combine words and phrases using the words AND, OR, NOT and NEAR (otherwise known as Boolean operators) to limit, widen, or define your search.”, from <https://www.lifewire.com/what-does-boolean-search-3481475>, accessed on 11 Nov. 2017; For more details on Boolean algebra and respective applications, see also https://en.wikipedia.org/wiki/Boolean_algebra, accessed on 11 Nov. 2017.

61. It is worth noting that percent-based indicators reflecting a maximum share of interest owned in subsidiaries differ significantly among the EU member states, particularly between 20% and 50%.

62. Diagnostic ratios represent certain ratios of balance sheet/profit and losses account items of the tested party, which are compared with those of potential comparables and can help increase valuable input of the comparability analysis, namely, whether the potential comparables match these ratios of the tested party.

63. See *supra* n. 62, p. 13.

explained with respect to how the conditions affect the price/margin and how the potential comparables were adjusted, and they should be properly documented.

Figure 2: Selecting external comparables – current practice

Source: EU JTPF, 2016, adjusted.

3. Business Restructurings

Most firms seek to maximize profits. To do so, a firm must produce output at the least possible cost, given technology, the price of inputs and external costs such as taxes and regulatory-related fees.^[64] The business models discussed above are all being used in practice, depending on the industry and MNEs' needs and perceived best avenues to reduce cost without jeopardizing quality and production. For example, MNEs in the chemical, pharmaceutical and biotech industries are exposed to significant (costly) R&D for which expenses there is no certainty whatsoever that those will lead to a valuable and commercially useful research result. To reduce expenses and risk, contract manufacturing is often availed of, and consignment stock arrangements are often implemented in those industries.^[65] Contract manufacturing can be seen as an economically advantageous alternative for R&D performing chemical, pharmaceutical and biotech MNEs.^[66] It is therefore recommended to review an entity and its functionality within its industry, rather than on a stand-alone basis, in order to determine and assess the (level of the) business model that is being used and the need for restructuring a business model.

Mostly observed in practice are restructurings where intellectual property is transferred and centralized (e.g. ownership of trademarks and patents or marketing intangibles), but also restructurings regularly take place where regional, or even global, operations are centralized in favour of a principal entity which becomes responsible for managing all strategic functions and risks of its assigned territories. Looking across an MNE's full supply chain, there are different degrees of centralization which can provide cost savings from either a single part of a MNE's supply chain perspective or from the entire supply chain perspective. An MNE may view a centralization of its supply chain from both a geographic and functional perspective. Geographically, an MNE may wish to consider appointing regional principals to manage distinct markets such as North America, South America, EMEA and Asia-Pacific or other areas as determined by its geographic footprint. Functionally, the spectrum of centralization may impact only a single part of an MNE's supply chain or the entire supply chain, with each level potentially having a different degree of business impact and value (benefit). Examples of functional centralization to a principal entity which are typically seen in practice include:

- pooling administrative functions to a centralized shared services centre (to reduce duplication of local functions);
- centralizing the MNE's regional or global sourcing requirements in a specialized procurement entity (to benefit primarily from demand aggregation and more efficient supplier management);
- centralization of regional or global logistics management;

64. D.W. Carlton & J.M. Perloff, *Modern Industrial Organization* ch. 2, at 36 (Pearson Education Limited 2015).

65. K. Wundisch, *Transfer Pricing and Foreign Direct Investment Decisions*, in *14 Transfer Pricing Report* at 386 (2005).

66. Id.

- centralization of supply chain management (including supply chain planning, inventory ownership and management and manufacturing and R&D strategy);
- centralization of sales and marketing into a principal which is primarily responsible for setting the “value add” sales, marketing strategies and pricing policies; or
- full centralization of strategic functions and risk in the supply chain including brand and intellectual property management.

This chapter does not attempt to go into further detail about business restructurings in the context of a principal structure. However, it is useful for the reader to keep in mind that there are varying levels of business centralization that can provide both operational benefits and cost savings to the MNE.

Centralization of a supply chain allows local entities to focus on their core function. Accordingly, as part of a centralization exercise, it is typical that fully fledged manufacturers are converted to contract manufacturers and where fully fledged distributors are converted to classic buy-sell entities or commissionaires. This does not have to be solely for tax planning purposes and the use of tax holidays and the like, but is most often merely a business-driven process to tackle labour law hurdles, reduce cost resulting from mandatory compliance with national or regional (for example, European or industry) regulations in order to remain competitive in the market and to be closer to or more visible in the market with potential customers, or to establish a presence in a market at a low level (market penetration). Alternatively, changes in business conditions such as those observed in 2000/02 (the dot.com bubble) and in 2007/09 (the onset of the credit crisis) are likely to drive MNEs to change their business models to address changes in prices and volumes of their output or sales. The business reasons for instigating a business restructuring normally are a combination of the above factors.

Business restructurings potentially trigger two important tax issues in addition to the many operational challenges which, if unattended, may lead to unexpected tax costs. These are (1) whether a goodwill disposal or transfer has taken place and (2) whether a so-called exit charge may be required due to the transfer of a business opportunity and to compensate for forgone earnings.

The latter analysis is particularly relevant in light of the Report on the Transfer Pricing Aspects of Business Restructurings and chapter IX of the OECD Guidelines released on 22 July 2010 and subsequently on 10 July 2017 reflecting final amendments of the chapter based on the recommendations of the BEPS project.^[67] Business restructurings^[68] are defined in chapter IX of the OECD Guidelines as cross-border reorganizations of the commercial or financial relations between associated enterprises, including the termination or substantial renegotiation of existing arrangements, which often involve the centralization of intangibles, risks and functions with the profit potential attached to them. The OECD Guidelines also state typical examples of business restructurings, as follows:

- conversion of fully fledged distributors into limited-risk distributors, marketers, sales agents, or commissionaires for a foreign associated enterprise operating as a principal;
- conversion of fully fledged manufactures into contract manufacturers or toll manufacturers for a foreign associated enterprise operating as a principal;
- transfers of intangibles or rights in intangibles to a central entity within the group; and

67. OECD, *Addressing Base Erosion and Profit Shifting*. Specifically the BEPS 2015 Final Report on Actions 8-10, *Aligning Transfer Pricing Outcomes with Value Creation*, and the BEPS 2015 Final Report on Action 13, *Transfer Pricing Documentation and Country-by-Country Reporting*.

68. Para. 9.1, 9.2 and 9.3, OECD Guidelines.

- the concentration of functions in a regional or central entity, with a corresponding reduction in scope or scale of functions carried out locally.
- rationalization, specialization or de-specialization of operations (manufacturing sites and/or processes, research and development activities, sales, services), including the downsizing or closing of operations.

In all cases, the arm's length principle must be applied in the same way to all types of business restructuring, irrespective of whether they lead to a more centralized or less centralized business model.^[69]

3.1. Intangible property transfers

Intangible property is one of the main assets of a multinational enterprise and can be very important to engagement in foreign direct investment. Capital, labour and tangible assets stand alone are generally not sufficient to successfully engage in foreign direct investment. The unique character of an intangible asset tends to enable a foreign investor to neutralize the initial home advantages of a local investor. However, it is this uniqueness that makes it difficult to determine an arm's length price for the transfer of intangible property between associated enterprises.

Recognizing the importance of issues relating to the transfer of intangibles and the challenges faced in practice, the OECD, in connection with the BEPS Project, launched a project on the transfer pricing aspects of intangibles with the aim of assuring that transfer pricing outcomes are in line with value creation.^[70] In September 2014, the OECD published the final revisions of chapters I, II and VI of the OECD Guidelines, in which a broad and clearly delineated definition of intangibles was adopted. The Guidelines also provide guidance on identifying transactions involving the use or transfer of intangibles and on determining when arm's length conditions are involved, as well as a description of how to select the most appropriate transfer pricing method.^[71] In addition, in October 2015, the OECD published the Final Report on BEPS Actions 8, 9 and 10, where Action 8 provides guidance on transfer pricing aspects of intangibles with the aim to develop rules that will prevent base erosion and profit shifting by moving intangibles among group members. This is to be achieved by (i) adopting a broad and clearly delineated definition of intangibles, (ii) ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with value creation and (iii) by developing transfer pricing rules or special measures for transfers of hard-to-value intangibles.

As regards the definition of an intangible, under the new guidance, the word "intangible" is intended to address something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities,^[72] and whose use or transfer would be compensated based on the value it creates through functions performed, assets used and risks assumed in its development, enhancement, maintenance, protection and exploitation that drive value creation in a business.

69. Para. 9.3, OECD Guidelines.

70. The project on changes to the transfer pricing rules in relation to intangibles has been developed in connection with Action 8 of the BEPS Action Plan. OECD, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 – 2015 Final Reports, OECD/G20 Base Erosion and Profit Shifting Project* (OECD 2015). Available at: <http://www.oecd.org/tax/aligning-transfer-pricing-outcomes-with-value-creation-actions-8-10-2015-final-reports-9789264241244-en.htm>.

71. OECD, *Guidance on Transfer Pricing Aspects of Intangibles* (OECD 2014). Available at <http://www.oecd.org/tax/guidance-on-transfer-pricing-aspects-of-intangibles-9789264219212.en.htm>. Moreover, the guidance includes transfer pricing treatment of local market features and corporate synergies.

72. Para. 6.6, OECD Guidelines.

Based on the above definition of intangibles, the following table shows a (non-exhaustive) list of intangibles.^[73]

Product-related intangibles	Process-related intangibles
# patent, invention, pattern, methods, copyright, design/model, formulae/recipes, software, literary/musical/artistic composition/film, technical data/documentation, library, natural resources, databases, permit, regulatory licence, trade secrets and others	# know-how, software, method, procedure, system, supplier relationships, procedural manuals, technical data/documentation, managerial skills and core competencies, financial instruments, embedded work force, supply chain intelligence
Market and Marketing intangibles	Hybrids
# logo, trademark, trade name, brand, campaign, survey, customer list, import quota, customer relationships, distribution network and agreements, retail shelf space, subscription lists, publication/thought leadership, reputation, book of business	# franchise, permit/right/licence # domain name # unique location

Under the BEPS amendments to chapter VI, it is clear that returns do not depend on legal ownership but on the performing of significant value-driven functions related to development, enhancement, maintenance, protection and exploitation of intangibles. These functions are known as DEMPE functions which drive the remuneration. Moreover, control over the risks and financial capacity to assume the risks are key in respect of the DEMPE functions of intangibles. If entities are only providing funding or do not have control over risks, they should be remunerated by only a risk-free return.

Further, the new OECD Guidelines deal with the treatment of group synergies, location savings, local market features and assembled workforce. In addition, the guidance also takes into account a special approach for hard-to-value intangibles which provides a backstop to otherwise possible abuses due to the information asymmetries between taxpayers and tax administrations. Intangibles are very often a subject of scrutiny by tax administration due to several reasons. Firstly, because intangible assets are unique, it is difficult to find comparable uncontrolled transactions involving similar intangible property. Secondly, the value of intangible assets can be highly volatile and therefore difficult to predict at the time of transaction. Thirdly, intangible assets can be exceptionally profitable. Tax authorities have already been grappling with these valuation challenges for a long time. The so-called commensurate-with-income standard^[74] that was developed in the United States and included in law in 1986, was triggered in part by the occurrences in practice of transfers of intangibles at a time when the intangibles were still relatively undeveloped and had not yet reached their full value potential. For those cases, it was required that taxpayers make after-the-fact adjustments to their prices for transferred intangibles. If circumstances were to periodically change (i.e. the intangible increases in value), the taxpayer would

73. Secs. A3 and A4 of chapter VI of the OECD Guidelines and Transfer Pricing Associates: Transfer Pricing Handbook for the Oil & Gas Industry Manual.

74. Under section 482 of the US Internal Revenue Code, the IRS may distribute, apportion or allocate gross income, deductions, credits or allowances between or among controlled organizations, trades or businesses. Such an apportionment or allocation may be made if the IRS determines that it is necessary either to prevent the evasion of taxes or clearly to reflect the income of the parties. In the case of intangible property, the statute provides that income must be commensurate with the income attributable to the intangible.

basically have to break its contract with its related party so that, for tax purposes, it would pay or receive a price (or royalty) that would reflect the (increased) value of the intangible transferred, even if that differed from what they had originally agreed on.^[75]

Transactions including intangible property are by their nature more difficult to recognize compared to transactions involving tangible assets. Identification can be difficult because not all valuable intangibles are legally protected and registered and not all valuable intangibles are recognized or recorded for accounting purposes.^[76] Therefore 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.^[77] There are mentioned three main ways to transfer intangible assets between associated enterprises, namely outright sale, licensing and cost contribution arrangement.

In the case of an outright sale, the (legal) ownership of the intangible asset is being transferred, for which the owner should receive an arm's length price. The initial owner gives up (legal) ownership and related control over the intangible asset. In practice, this option may be beneficial at the time when the intangible is not yet fully developed and does not have much profit potential. The risk factor as to the potential value of the still-further-to-be developed intangible materializing will have a reducing effect on the transfer price for the intangible in that instance, although the existence of a commensurate-with-income standard allows for a claw-back provision and additional income to the transferor if the intangible ends up being very valuable going forward.

In the case of licensing, the ownership of the intangible asset remains with the licensor/owner. The (legal) owner grants certain rights to the licensee for a specified period. The rights granted to the licensee can differ (e.g. geographic rights, exclusive versus non-exclusive rights and sub-licensing rights) and should be detailed in a licensing agreement. The compensation to be received by the licensor is usually in the form of an ongoing royalty, which is a periodic payment based on the output or turnover of the licensee.

In the case of a cost contribution arrangement, associated enterprises may agree to share the costs and risks of developing intangible assets, as such becoming joint owners with exclusive rights in their respective jurisdictions.

When intangibles became the focus of attention for transfer pricing and nearly automatically equated with value and profit allocation, it became attractive for tax planning purposes to separate valuable intangibles from business operations in a tax efficient manner. That way, royalty earnings could be reported in a low-tax jurisdiction. Important in this respect were the US *Eli Lilly and company, G.D. Searle*^[78] and *Bausch and Lomb*^[79] cases. The fact patterns concerned a US parent company that transferred a valuable intangible (either by capital contribution or by licence) to a subsidiary located in a tax haven jurisdiction (Puerto Rico and Ireland, respectively). In both cases, the transaction constituted a so-called round-trip transaction. That is, the subsidiary company engaged in manufacturing activities and subsequently sold back the products to the US parent company that were manufactured with the licensed technology. In both cases, the transaction was challenged (largely unsuccessfully) by the US Internal Revenue Service.

75. See the US legislative history in this regard, H.R. Rep. 426, 99th Cong., 1st Sess. 425; 1986-3 C.B. Vol. 2, 1, at 425-6.

76. Para. 9.55, OECD Guidelines.

77. Id.

78. *Eli Lilly and Company v. Comm'r*, 84 TC 996 (1985), *G.D. Searle & CO v. Commissioner*, 88 T.C. 252(1987).

79. *Bausch & Lomb v. US*, 92 TC 525 (1989).

Another important case in the area of intangible assets is the *DHL Corp.* case^[80] on the valuation of trademarks. In this case, the taxpayer sold to its Asian affiliate the worldwide rights to its trademark for USD 20 million. At the same time, DHL sold 57.5% of the Asian affiliate to three unrelated investors. The IRS's position was that the value of IP must be consistent with the fact that the enterprise market value exceeded the value of tangible assets by USD 300 million. Its valuation was supported by discounted cash flow models. However, the court stated that the foreign affiliate owned its own process intangibles and further criticized the IRS for ignoring this fact and noted that the trademark value was a subset of the total intangible asset valuation.

The focus on intangibles reached another level when in the United States, the *Glaxo* case^[81] was filed to be litigated, which in relevant part concerned income allocable to marketing intangibles. The case was settled, yet put the importance of marketing intangibles clearly on the radar screen of tax inspectors and auditors.

The issues of valuation of intangibles also received attention in the *Veritas* case^[82] which addressed important issues regarding the valuation of cost sharing buy-ins (payment for the transfer of intangibles between the taxpayer's US entity and its Irish entity). The court rejected the attempt of the IRS to value buy-ins using a transfer pricing methodology based on net present value of perpetual income streams. Instead, the court applied the comparable uncontrolled transaction method (CUT method), which was very similar to the method which was applied by the taxpayer.

The transfer of intellectual property rights was also solved by the Supreme Court in Norway. In the *Cytec* case^[83] the court ruled that the transfer of intellectual property rights as a result of business restructuring cannot occur free of charge and that the transferring entity has to receive an arm's length remuneration for the transfer of these rights.

In the *Medtronics Inc.* case^[84] the court rejected the effort of the IRS to treat the licensee as a routine manufacturer. Concretely, the court rejected the position of the IRS, according to which the Puerto Rican subsidiary was treated as a contract manufacturer shifting all residual income back to the US parent. On the contrary, the court was inclined to the comparable uncontrolled transaction analysis proposed by the taxpayer, with the adjustment increasing the royalty rate to a rate that had been agreed in a prior audit cycle.

It is necessary to mention that in the last decade, we are witnessing increased attention being paid to the valuation of intangibles not only in the United States, but also in India. Examples include cases such as the *Maruti Suzuki* case^[85] the *Ericsson* case^[86] or the *LG Special Bench Ruling*^[87] or the *Cadbury Ltd. case.* ^[88]

Currently, it is acknowledged that separating intangibles (patented and non-patented) is legally and commercially possible, and can lead to bona fide tax planning opportunities. It is important that legal protection of the intellectual property rights be considered before a structure is put in place, however,

-
- 80. *DHL Corp. v. Commissioner*, 76 T.C.M. 1122 (1998).
 - 81. *GlaxoSmithKline Holdings (Americas) Inc. v. Comm'r*, T.C. 5750-04 and 6959-05.
 - 82. *Veritas Software Corporation v. Commissioner*, 133 T.C. 14 (2009).
 - 83. *Cytec Norge* (Utr 2007/1440).
 - 84. *Medtronics Inc. v. Commissioner*, T.C. M. No. 2016-112 (2016).
 - 85. *Maruti Suzuki India Limited v. CIT* (ITA 110/2014) (2014).
 - 86. *Sony Ericsson Mobile Communications India Private Limited v. CIT* (2015 374 ITR 118) (2015).
 - 87. *LG Electronics India Private Limited* (ITA No. 5140/Del/2011) (2011).
 - 88. *Cadbury India Ltd. v. ACIT* (ITA No. 7641/Mum/2010) (2010).

as otherwise pursuing the tax structure would thwart the intellectual property right's legal protection. Furthermore, in order to have the ownership of intangibles and functions associated with the intangibles respected from a tax perspective, it is crucial that the business structure is real (legally, economically and in substance) ^[89] and that a proper valuation^[90] is applied to the intangible. At the very least, in order to be prepared for inquiries targeting intangibles, any company will benefit from addressing the following checklist:

- What intangible rights are actually involved (from an intellectual property law perspective and tax perspective)?
- Who is (or will be) the legal owner from an intellectual property law perspective?
- Who is (or will be) the economic owner from a tax perspective?
- What protection are the intangibles afforded, if any, under intellectual property law or contract law?
- Is it legally possible to move the intangibles?
- What licences need to be put in place upon migration?
- Can the owner enforce its rights following migration?
- Does the chosen jurisdiction benefit from intellectual property protection?
- How will intangible income be taxed in the new jurisdiction?
- How should the intangible be valued?
- What are the costs involved in migrating intangibles? ^[91]

Contractual arrangements will need to be put in place for the new situation, and existing ones reviewed to make sure that any terminations take place in accordance with the termination clauses included in those agreements. The new Guidance on Transfer Pricing Aspects of Intangibles puts emphasis on comparability with terminations in situations involving unrelated parties, and contractual arrangements govern the rights of the parties in such situations. Therefore, contractual arrangements put in place should reflect what is observed in practice between unrelated parties, i.e. what is the remuneration paid and what are the conditions agreed between unrelated parties in transactions involving intangibles. Further, in respect of determining the arm's length price it is crucial to establish whether a transaction between associated enterprises conveys economic value and how an intangible contributes to the creation of value. In addition, under the new OECD Guidelines, it is clear that entities having only legal ownership of assets, or a contractual allocation of risk, should only receive a risk-free return in contrast to those entities undertaking economically significant activities. Generally, these are entities whose use or transfer of intangibles would be compensated based on the value they create through the DEMPE functions of intangibles, but legal ownership alone does not determine entitlement to returns from the exploitation of intangibles..

89. M. Levey, P. Church, M. van Herksen & P. Carmichael, *Marketing Intangibles Require Close Legal and Tax Scrutiny*, in 17 Transfer Pricing Report 3 (2008).

90. C. Jie-A-Joen & P. Biemold, *Dutch Appellate Court Rules on Trademark Rights: Allocating Purchase Price between Legal, Economic Ownership*, in 13 Transfer Pricing Report 4 (2004).

91. M. Levey, R. Fletcher, M. van Herksen & A. Odle, *Migrating IP rights: A Road Map for Success in World Finance* at 72-73 (May 2007) and M. van Herksen, M. Levey & R. Fletcher, *Identifying, Valuing and Migrating Intangibles: Trouble Ahead* in 9 Tax Planning Intl. Transfer Pricing 5 at 16-22 (2008).

3.2. Conversion from fully fledged to contract manufacturing model

The conversion from a fully fledged manufacturer to a contract manufacturer in essence is a conversion from manufacturer to service provider. This is regularly observed in practice, as MNEs can obtain economy of scale benefits by outsourcing certain manufacturing-related services to a low-cost entity, preferable located in a low labour cost and low-tax jurisdiction. The issue of compensating a contract manufacturer was addressed in the US *Sundstrand* case^[92] and actually litigated in the Netherlands *Raw Board* case.^[93] In the *Raw Board* case, a Netherlands subsidiary of an MNE purchased raw board from a related party located in Switzerland and applied a coating thereon, after which it sold the coated board back to the Swiss related party.^[94] As of 1 January 1991, the Netherlands subsidiary's activities consisted only of applying a coating on the raw board that was provided and owned by the Swiss related party, at the request and for the account of the Swiss related party. So the inventory risk had effectively transferred to the Swiss related party as of 1 January 1991. The Netherlands entity charged a different processing fee to its Swiss related party as of 1 January 1991 than it did before, and its profit dropped by 60% due to the change in its business model. The Netherlands tax authorities maintained that since 1991, the pricing between the Netherlands and Swiss entities was not at arm's length.

The Court of Appeals initially held that the tax authorities had sufficiently demonstrated that the change in business model did not justify a decrease in the profit to be reported. The Supreme Court held in favour of the taxpayer, however, stating that the Court of Appeals did not substantiate with external market prices that the price that applied prior to 1 January 1991 could be applied to the function of solely coating raw board, rather than also keeping raw board in stock.

The conversion of a fully fledged manufacturer to a contract manufacturer may involve the transfer of functions, risks and/or assets, with consequent effects on profit and loss potential in each country. One of the several transfer pricing issues that presents itself in this case is whether the restructured entity is entitled to an exit charge due to the fact that it will be foregoing earning potential under the new business model.

To ensure that the contract manufacturing structure is sufficiently substantiated and will be upheld going forward, it is essential that the principal to which the stripped manufacturing functions and/or risks are subsequently allocated, routinely and substantively exercises its responsibilities and actually has the (right) people in place and appropriate resources to manage the functions and risks allocated to it, such as marketing strategy and making advertising content decisions. Existing agreements regarding (outside) suppliers and providers (purchase orders) will need to be amended and checked for assignability and subsequently implemented. Customer acceptance-related activities need to be reviewed and re-allocated, after-sales support tasks need to be allocated and it needs to be determined which party will be in charge of the collection of receivables. All of this will affect the supply chain of the MNE and should be reflected in intercompany procedures and agreements, in order to be able to fully substantiate that functions and risks are performed and incurred where allocated after the conversion. It is also not uncommon that significant software adjustments will be required to allow the MNE to monitor

92. *Sundstrand v. Comm'r*, 96 T.C. 12 (19 February 1991). The *Sundstrand* case concerned the concept of location savings and whether these ought to be considered when determining the arm's length allocation of income in a controlled transaction. Furthermore, the issue of being a contract manufacturer was raised. The issue in *Sundstrand* concerned a round-trip transaction in which technology was transferred by a US parent company to a subsidiary located in a foreign (low-tax) jurisdiction. Products manufactured with that technology were subsequently purchased by the parent company for distribution and sale. At issue were the applicable rate of the royalty to be paid by the subsidiary and the transfer price for goods purchased by the parent company.

93. Supreme Court, 35 246 (11 October 2000).

94. Part of the coated board was also sold to another Netherlands-related party, but the pricing between these two entities did not seem to be challenged.

the new supply chain process. As the *Raw Board* case indicates, challenges are likely to focus on substance changes to support the business model changes.

3.3. Conversion from fully fledged distributor to stripped distributor model

The conversion from a fully fledged distributor to a stripped distributor in essence is a conversion to a limited-risk distributor, yet often the conversion is not all the way to that of an agent in order to avoid the permanent establishment exposure that in some countries may be associated with that business model.^[95]

A conversion to a stripped distributor model means in practice that functions and risks transferred will include items such as inventory, credit, currency and similar risks and functions previously assumed by the fully fledged distributor. Furthermore, the economic burden of marketing, advertising, etc. will be transferred to another related party, and warranty and product liability claims are also stripped out of the functionality profile of the fully fledged distributor.

One of the transfer pricing issues presented in this case is whether the restructured entity is entitled to an exit charge in connection with the transfer of functions, risks and/or assets, also considering the reduced earning capability as compared to a fully fledged distributor going forward.

To ensure that the classic buy-sell structure is sufficiently substantiated and will be upheld, it is essential that the principal to which the stripped functions are subsequently allocated, routinely and substantively exercises its responsibilities and actually has the (right) people in place and appropriate resources to manage the functions and risks allocated to it, such as marketing strategy and making advertising content decisions. Existing agreements regarding (outside) suppliers and providers (purchase orders) will need to be amended and checked for assignability, and subsequently implemented. It needs to be determined which party will be conducting logistics and delivery activities going forward, any installation, specification and customer acceptance-related activities will need to be reviewed and re-allocated, after-sales support tasks need to be allocated and it needs to be determined which party will be in charge of the collection of receivables. All of this will affect the supply chain of the MNE and should be reflected in intercompany procedures and agreements, in order to be able to fully substantiate that functions and risks are performed and incurred where allocated after the conversion. It is also not uncommon that significant software adjustments will be required in order to allow the MNE to monitor the new supply chain process.

Important in this respect is the *Zimmer case*,^[96] which has generated extensive discussion among practitioners due to the final judgment of the Supreme Court in France. The Supreme Court confirmed that: “agreements concluded by the commissionaire, even though they are concluded for the account of its principal, do not directly bind the latter vis-à-vis the commissionaire’s clients, it follows that a commissionaire cannot, in principle, be deemed to constitute a permanent establishment of its principal, solely as a result of selling the principal’s products or services by signing contracts in its own name, under application of the commissionaire agreement”.^[97]

Zimmer Ltd, a UK corporation in orthopaedics, had distributed its product through its French affiliated company Zimmer SAS. In 1995, Zimmer SAS was converted from a full-risk distributor into a commissionaire under French commercial law (acting in its own name on behalf of an undisclosed

95. *Supra* n. 36.

96. *Zimmer case*, Conseil d’Etat No. 304715, 31-3-2010. Translation by Laurence Delorme, French Supreme Tax Court Case 31 March 2010 Zimmer Ltd.

97. Translation of Supreme Court Decision by Laurence Delorme.

principal, Zimmer Ltd). The French tax authorities assessed tax against Zimmer Ltd plus a 40% penalty for failing to file a tax return for 1995 and 1996 due to the fact that Zimmer SAS constituted an agency permanent establishment of Zimmer Ltd. In 2010 the Supreme Court in France confirmed that the French affiliated company Zimmer SAD does not constitute an agency permanent establishment of Zimmer Ltd.

Moreover, the different viewpoints enunciated by courts in other jurisdictions, e.g. in the *Philip Morris* case, demonstrate the seriousness of this issue. Therefore, it is necessary to determine exactly the profile of a dependent agent (commissionaire) in business restructuring propositions and to take into account all aspects of business restructuring, including whether a new taxing right in the form of permanent establishment taxation will arise or not.

4. Centralized services and cost allocation agreements

During the discussion of the service provider model, it was mentioned that MNEs make use of centralized service centres in order to obtain economy of scale benefits.^[98] Centralizing services may be economically sound, yet a decision is to be made regarding how formalized the centralized services arrangement will be and how the cost of rendering services is to be allocated to the beneficiaries of the centralized services.

The OECD Guidelines prescribe that a direct charge mechanism is preferred, if possible (MNEs are encouraged to use direct charge methods, if services similar to those rendered to associated enterprises are also rendered to independent parties),^[99] in which the associated enterprises are charged for specific services rendered to them or for them. However, it is acknowledged that a direct charge method may be too difficult to apply and that there may be few alternatives to use cost allocation and apportionment methods as a basis for calculating an arm's length charge.^[100] This is, for example, the case where the proportion of the value of the services rendered to the various relevant entities cannot be quantified except on an approximate or estimated basis.^[101] Centralized services rendered out of centralized service centres particularly lend themselves to an indirect charge system or the use of a so-called cost allocation agreement.^[102]

An indirect-charge method should be sensitive to the commercial features of the individual case (e.g. the allocation key should be appropriate to the circumstances), contain safeguards against manipulation and follow sound accounting principles, and be capable of producing charges or allocations of costs that are commensurate with the actual or reasonably expected benefits to the recipient of the service. Furthermore, to be effective, a cost contribution system should, besides reflecting the fact that the parties to which part of the cost are allocated use (and benefit from) the services rendered, also allow for cost analysis and performance evaluation.

The OECD Guidelines refer to cost contribution arrangements, but other jurisdictions may refer to the term "cost sharing agreements" or "cost pooling arrangements" – and all of these in essence are cost allocation arrangements. Recent OECD Guidelines reflecting the BEPS amendments provide

98. See section 1.

99. Paras. 7.21- 7.22, OECD Guidelines.

100. Paras. 7.23-7.26, OECD Guidelines.

101. Id.

102. This chapter only addresses cost allocation as it regards centralized services and not in specific joint R&D efforts (R&D cost sharing arrangements) which are targeted to result in valuable intellectual property rights and may present buy-in and buy-out issues. For that discussion, see ch. VIII of the OECD Guidelines.

general guidance for determining whether the conditions established by associated enterprises for transactions covered by a cost contribution agreement (CCA) are consistent with the arm's length principle. According to the OECD Guidelines, a cost contribution arrangement may be best defined as "... a contractual arrangement among business enterprises to share the contributions and risks involved in the joint development, production or obtaining of intangibles, tangible assets or services with the understanding that such intangibles, tangible assets or services are expected to create benefits for the individual businesses of each of the participants".^[103] Recently, an explicit distinction has been made between a CCA for joint development of tangible and intangible assets and a CCA for the provision of services. The key differences between these two types of CCA are mainly in respect of benefits and risks. Development CCAs are expected to create ongoing, future benefits and involve significant risks in contrast to services CCAs, which will create current and less risky benefits.^[104]

To make a cost allocation arrangement work and be respected from a legal, fiscal and economic perspective, certain basic requirements must be met. Additional (incidental) requirements may be imposed under domestic law in individual jurisdictions which should be consulted in order to ascertain whether the cost allocation system used will be accepted and upheld.

Aspects that can be considered necessary for a cost allocation arrangement for services from a transfer pricing perspective include (but are not limited to):^[105]

- the existence of a(n) (written) agreement;
- the identification of the participants to the agreement;
- a listing of the services rendered and functions performed;
- identification of the renderer of the services, ideally including in particular situations where the beneficiaries of the services may from time to time themselves also render certain services that are to be allocated out to the participants of the agreement and become part of the overall cost base, the identification of these participants/service renderers and the services that may be rendered;^[106]
- identification of the cost allocation keys to be used for the respective services rendered (and if possible, substantiation of benefit received);
- documentary evidence of costs included in the cost pool to be allocated out to the beneficiaries;
- identification of the term (time period) to which costs relate and at what intervals they are to be charged out;
- determination of the profit margin to be applied to the cost base for services rendered; and
- an analysis to assure that services cannot be deemed duplicative.

Moreover, based on the BEPS amendments, the questions of benefits, control over the risks and financial capacity to bear those risks are taken into account during the determination whether an associated enterprise is a participant in a CCA.

103. Para. 8.3, OECD Guidelines.

104. Para. 8.10, OECD Guidelines.

105. These are general comments; in all cases, domestic law should be consulted for purposes of completeness.

106. If services are rendered by a service centre but some (group) services are also rendered by individual participants to the cost allocation agreement, such should be clearly specified to avoid challenges to inclusion of those costs in the overall cost base.

In general, it can be said that the more direct the relation between the services rendered and the allocation key is, the more accurate and more useful the cost allocation system will be. On the other hand, it should be acknowledged that a cost contribution agreement should not trigger an entirely separate and costly administration, as such would be contrary to its purpose of serving as effective solution for recovering costs incurred for centralized services.^[107] In order to be reliable and efficient, the allocation keys used are best based on and applied to existing reporting data within the MNE, although it may be that individual tax authorities may on audit require more specific allocation mechanisms from time to time.

Ideally the allocation key should be an approximate proxy for the time and effort spent, as well as benefits received. For example, if specific costs are revenue-related, the sales revenue of the respective MNE's subsidiaries or branches should ideally be the key for allocating these costs. Conversely, if specific costs relate to services specifically targeting employees (e.g. human resources, information technology users), the number of employees can serve as an appropriate allocation key. Where costs can be tied to specific services and finally to particular subsidiaries or branches of the MNE, that should provide a justifiable basis to sustain a deduction for a charge in local jurisdictions. There simply is no perfect cost allocation mechanism, however, because an allocation system is highly affected by reporting systems, software compatibility and common practice.

Cost allocation keys that are observed in practice include the following (non-exhaustive list):

- information technology expenses can be charged out based on information technology users (the number of work stations/PC users per office or branch);
- tax/accounting and legal assistance, to the extent not directly charged out, can be charged out based on revenue/income or total relevant transactions/total assets;
- human resources activities, to the extent not directly charged out, can be based on employees/headcount;
- group real estate services can be charged out based on square metres or based on value of real estate owned;
- marketing or sales-related services can be charged out based on sales, production or sales volume, or gross or net profit; and
- management costs can be charged out based on sales values, production or sales volumes, gross or net profit, number of employees or capital invested.

The industry in which the MNE operates may also assist in determining the preferable allocation keys. Despite the logical attraction of using various overhead pools and various allocation keys, general practice is to use few pools and few bases. This means that, in practice, gross revenue (sales), or alternatively income, are the most popular and practical allocation keys used. Moreover, for reasons of consistency, the same allocation key or keys should be applied in determining the allocation to all recipients within the group of the same type of services, and it is expected that the same reasonable key will be used every year unless there is a justified reason to change.^[108] In addition, taxpayers will describe in their transfer pricing documentation the reasons for concluding that the allocation key produces outcomes which reasonably reflect the benefits likely to be derived by each service

^{107.} Paras. 7.24, OECD Guidelines.

^{108.} Para. 7.59, OECD Guidelines.

recipient.^[109] Taxpayers may be able to obtain certainty in advance regarding the allocation keys to be used, by seeking a bilateral, unilateral or multilateral advance pricing agreement, depending on the jurisdictions in which they do business.

Furthermore, in practice, VAT consequences related to services being rendered may greatly affect the cost of services, in particular where the recipient of the services may be VAT exempt and not able to recover VAT charged. This may be one reason why entities that are not centralized service entities, may actually render a certain part of the group services and prefer to charge those out directly to the respective beneficiaries, rather than first allocate the cost of group services to the centralized service provider and have those costs subsequently charged out, included in and based on the cost allocation formula applied. Also in those cases, it is recommended that the services and the beneficiaries be identified beforehand in order to reduce audit exposure and challenges. In all cases, it must be determined whether the cost for services needs to be subjected to a profit margin for the service provider.^[110]

^{109.} Para. 7.60, OECD Guidelines.

^{110.} Paras. 7.35-7.37, OECD Guidelines.

3 – OECD Policy Framework

Author

Caroline Silberztein^{[*][1]}

Latest Information:

This chapter is based on information available up to 5 November 2017.

1. OECD policy framework in the area of international taxation

1.1. OECD in general

The OECD is an inter-governmental organization that was established in 1961. It grew out of the Organisation for European Economic Co-operation (OEEC), which was established in 1948 with support from the United States and Canada to coordinate the Marshall Plan for the reconstruction of Europe after the Second World War.^[2] The role of the OECD is to assist governments in comparing policy experiences, seeking answers to common problems, identifying good practices and coordinating domestic and international policies. Article 1 of the Convention on the Organisation for Economic Co-operation and Development defines the OECD's mission as being to support economic growth, boost employment, raise living standards, maintain financial stability, assist other countries' economic development and contribute to growth in world trade.^[3]

The OECD currently has 35 Member countries committed to democracy and the market economy.^[4] The OECD also works extensively with non-OECD economies through an intensive partnership programme. Key partners, such as Brazil, China, India, Indonesia and South Africa, contribute to the OECD's work in a sustained and comprehensive manner. A central element of the programme is the promotion of direct and active participation of these countries in the work of substantive bodies of the OECD.

The OECD also became an active partner of the G20 since the 2009 Pittsburgh Summit. Both organizations combine their efforts to strengthen the global economy, to recover from the crisis and to frame policies. The OECD Base Erosion and Profit Shifting (BEPS) Action Plan^[5] (see section 1.3.) has been produced at the request of the G20 and introduced at the G20 Finance Minister's meeting in July 2013. As part of the OECD/G20 BEPS Project, the OECD released 13 Final Reports on 5 October 2015 which were endorsed by the G20 leaders at their summit in Antalya in November 2015.^[6]

* Partner, Baker & McKenzie, France. Previously Head of the Transfer Pricing Unit, OECD Centre for Tax Policy and Administration (2001-2011).

1. The views expressed are those of the author, not necessarily those of the OECD and its members or of Baker & McKenzie.

2. See www.oecd.org/history (accessed 28 Dec. 2017).

3. <http://www.oecd.org/general/conventionontheorganisationforeconomicco-operationanddevelopment.htm> (accessed 28 Dec. 2017).

4. Australia, Austria, Belgium, Canada, Chile, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, Korea, Latvia, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States.

5. OECD, *Action Plan on Base Erosion and Profit Shifting* (OECD 2013), International Organizations' Documentation IBFD.

6. Final Reports are available at <http://www.oecd.org/ctp/beps-2015-final-reports.htm> (accessed 28 Dec. 2017).

1.2. OECD tax work

In the tax area^[7], the work of the OECD is carried out by the Committee on Fiscal Affairs (CFA), which brings together senior tax officials from all OECD Member countries, as well as Associates, Participants and Observers^[8] including United Nations observers and a representative from the European Commission. The CFA relies on a number of Working Parties, i.e. groups of senior governmental experts, which carry out work in their respective areas of competence, under the supervision of the CFA. In particular, Working Party No. 1 is the CFA Working Party responsible for the OECD Model Tax Convention on Income and on Capital (OECD Model), while Working Party No. 6 is responsible for the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines).

The CFA contributes to the OECD objective of facilitating the development of national economies and of the global economy by developing standards, guidelines and best practices in areas where international coordination is desirable, and by monitoring the practical implementation thereof and of other recommendations.

1.3. Base erosion and profit shifting (BEPS)

BEPS is defined by the OECD as referring to “tax planning strategies that exploit loopholes in tax rules to make profits disappear for tax purposes or to shift profits to locations where there is little or no real activity but where they are lightly taxed, resulting in little or no overall corporate tax being paid”. While the OECD has a long history of doing work to protect country tax bases against base erosion and profit shifting, BEPS has been marketed as a holistic concept since 2012 and has since become the buzzword in international tax circles. In effect, with explicit support from the G20, the OECD has devoted considerable efforts to tackle what has been presented as a “serious risk to tax revenues, tax sovereignty and tax fairness for OECD member countries and non-members alike”.

Following the release in October 2015 of the “BEPS package” (i.e. a series of 13 Reports that cover the 15 BEPS Actions, G20 Leaders called on the OECD to develop a more inclusive framework with the involvement of interested non-G20 countries and jurisdictions, including developing economies. The CFA put in place an inclusive framework on BEPS. The members of the new BEPS inclusive framework participate on an equal footing in the BEPS-related work of the Committee on Fiscal Affairs and its subsidiary bodies. It held its first meeting on 30 June and 1 July 2016 in Kyoto, Japan.

To become a member of the Inclusive Framework on BEPS, a country or jurisdiction needs to commit to the BEPS package, including the four minimum standards. As of 6 July 2017, the Inclusive Framework on BEPS has brought together 102 countries and jurisdictions.^[9]

Transfer pricing was one of the key areas reviewed in the context of the BEPS Project. Thus, the Declaration on BEPS adopted at the 29-30 May 2013 meeting of the OECD Council at ministerial level encouraged efforts to develop proposals on “improvements or clarifications to transfer pricing rules to address specific areas where the current rules produce undesirable results from a policy perspective.

7. See <http://www.oecd.org/tax/administration/centre-for-tax-policy-and-administration-brochure.pdf> (accessed 28 Dec. 2017).

8. On 20 April 2017, there were one Associate (Argentina), thirteen Participants (Brazil, China (People’s Rep.), Colombia, Costa Rica, India, Indonesia, Lithuania, Malaysia, Russian Federation, Saudi Arabia, Singapore, South Africa and Uruguay) and 6 Observers (African Tax Administration Forum, Conference and Study Centre for Tax Administration Executives from French-Speaking Countries, Inter-American Center of Tax Administrations, International Monetary Fund, United Nations and World Bank).

9. See <http://www.oecd.org/tax/beps/inclusive-framework-on-beps-composition.pdf> (accessed 28 Dec. 2017; the number of members has increased to 110 by that date).

The work done on intangibles, which is a particular area of concern, would be included in a broader reflection on transfer pricing rules.”

One key dimension of the OECD BEPS Project was its strong focus on “double non-taxation” and lesser focus than in the past on avoiding and resolving double taxation. The OECD released in July 2013 its BEPS Action Plan,^[10] which included further work on the transfer pricing aspects of intangibles (including, but not limited to, adopting a broad and clearly delineated definition, ensuring that profits are allocated accordingly with the value creation and adopting special measures for hard-to-value intangibles), risk allocations and their effects on the allocation of profit potential among associated enterprises (including the question of whether risks can be separated from the control functions leading to their assumption and management), intra-group financing and the role of capital provision for transfer pricing purposes.

On 5 October 2015, the OECD released 13 Final Reports, including a [Report on Actions 8-10 “Aligning Transfer Pricing Outcomes with Value Creation”](#) and a Report on Action 13 “Transfer Pricing Documentation and Country-by-Country Reporting”, which contained changes to the OECD Guidelines.

The changes were approved by the OECD Council on 23 May 2016 and incorporated into new consolidated Guidelines, published by the OECD on 10 July 2017 (i.e. 2017 OECD Guidelines). The changes, mostly introduced by the Final Reports on Actions 8-10 and Action 13, concern, among others, the following:

- new guidance on the “accurate delineation of the actual transaction” and possible non-recognition of transactions by tax authorities, including guidance on risk allocations among associated enterprises and the relevance of control and management functions (chapter I);
- new guidance on the pricing of commodity transactions (chapter II);
- the existing guidance on the profit split method was shaded as work in progress, as the OECD is in the process of revising it (chapter II);
- revised guidance on the transfer pricing aspects of intangibles (chapter VI) and on cost contribution arrangements (chapter VIII);
- new guidance on low-value added services (chapter VII), and
- new guidance on transfer pricing documentation requirements (chapter V).

Further consistency changes were made to the Guidelines, the most important ones consisting in the revision of chapter IX on Business Restructurings.

Chapter IV was also amended to include new guidance on safe harbours that was approved by the OECD Council on 16 May 2013 (i.e. this piece of work does not result from the BEPS project).

1.4. Arm’s length principle and OECD Guidelines

The international consensus on the arm’s length principle is found in article 9 of the OECD Model and the United Nations Model Double Taxation Convention between Developed and Developing Countries (UN Model),^[11] which is reproduced in approximately 2,500 to 3,000 bilateral treaties. Article 9 of the OECD Model reads as follows:

10. OECD, *Action Plan on Base Erosion and Profit Shifting* (OECD 2013), International Organizations’ Documentation IBFD.

11. Over the years, various OECD and UN Models have been published.

Article 9 – ASSOCIATED ENTERPRISES

1. Where

a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or

b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

2. Where a Contracting State includes in the profits of an enterprise of that State – and taxes accordingly – profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other.

Guidance on the application of the arm's length principle is found in the OECD Guidelines that were adopted by the CFA on 27 June 1995 and have since been amended and supplemented with new chapters and annexes. The latest update of the OECD Guidelines was published on 10 July 2017.

The OECD Guidelines create a so-called soft law obligation, based on a Recommendation from the OECD Council^[12] to the governments of OECD member countries and to non-members adhering to this Recommendation that they “follow, when reviewing, and if necessary, adjusting transfer pricing between associated enterprises for the purposes of determining taxable income, the Guidelines [...] for arriving at arm's length pricing for transactions between associated enterprises”, “encourage taxpayers to follow the Guidelines” and “develop further co-operation, on a bilateral or multilateral basis, in matters pertaining to transfer pricing”.

1.4.1. Comparability analysis

One key concept for which there is a fair amount of guidance in the OECD Guidelines is the notion of comparability. Following the provisions of article 9 of the OECD Model, the application of the arm's length principle is generally based on a comparison of the conditions in a controlled transaction (i.e. in a transaction between associated enterprises) with the conditions in uncontrolled transactions (i.e. in transactions between enterprises which are not associated with each other).

The guidance on comparability is found in chapters I and III of the OECD Guidelines.

12. Council Recommendation C(95)126/Final, as amended.

Section D of chapter I of the OECD Guidelines defines the two key components of a comparability analysis. The first one lies in the identification of the relations between the associated enterprises and of the conditions and economically relevant circumstances attached to these relations so that the controlled transaction is accurately delineated. The second component is the comparison of the conditions and economically relevant circumstances of the controlled transaction with the conditions and economically relevant circumstances of comparable transactions between independent enterprises.

In order for comparisons between controlled and uncontrolled transactions to be meaningful, the economically relevant characteristics of the situations being compared must be sufficiently comparable. The OECD Guidelines identify five comparability factors which may be important in determining comparability and in accurately delineating the transaction: (i) contractual terms of the transaction; (ii) functions performed by each of the parties to the transaction, taking into account assets used and risks assumed, including how those functions relate to the wider generation of value by the MNE group to which the parties belong, the circumstances surrounding the transaction, and industry practices; (iii) characteristics of property transferred or services provided; (iv) economic circumstances of the parties and of the market in which the parties operate; and (v) business strategies pursued by the parties.

Comparable uncontrolled transactions do not need to be identical to the controlled transaction under review. Rather, to be comparable means that none of the differences (if any) between the situations being compared could materially affect the condition being examined in the methodology (e.g. price or margin), or that reasonably accurate adjustments can be made to eliminate the effect of any such differences. These are called “comparability adjustments”.^[13] For instance, a comparability adjustment may be performed in appropriate circumstances to eliminate the effects of differing levels of working capital in the taxpayer and in comparables.

Basically, under the arm’s length principle, the more valuable the functions, assets and risks contributed by a party to a transaction, the higher its anticipated return. In particular, the OECD Guidelines state that theoretically, in the open market, the assumption of increased risk must also be compensated by an increase in the expected return, although the actual return may or may not increase depending on the degree to which the risks are actually realized.

It is also important to note that under the OECD Guidelines (paragraph 1.11) the lack of comparables for a particular controlled transaction does not mean that the conditions of said transaction do not satisfy the arm’s length principle. First, there are cases where comparables may exist but are not found due to limitations in the publicly available information. For instance, not all countries have databases where information can be located on third party comparables. This does not mean that the controlled transactions of taxpayers in these countries are not at arm’s length, but rather that solutions must be found to use the best available data under the circumstances (for instance foreign comparables, possibly adjusted to eliminate the effects of market differences).

Secondly, just because an arrangement between associated enterprises is one not seen between independent parties should not in itself mean the arrangement is non-arm’s length. Where no comparables are found to support the conditions of a controlled transaction, it becomes necessary to determine whether such conditions might be expected to have been agreed between independent parties in similar circumstances. The OECD Guidelines acknowledge that this determination is by nature

13. Paras. 1.33 and 3.47-3.54 OECD Guidelines.

subjective and that it is desirable to provide some guidance on how to make such a determination in order to limit, to the extent possible, the uncertainties and risks of double taxation it can create. The OECD Guidelines identify some relevant factors which may assist in such determination, as discussed below in relation to risk allocations. It is also possible to use a profit split method with no comparable data in those cases where the lack of comparables is due to the uniqueness of the contributions made by each party to the transaction, as explained in section 1.4.2.

The 2017 Guidelines place significant emphasis on risk allocation among associated enterprises and the resulting allocation of profits or losses that are associated with the risk. They set out a six-step process as follows: (i) identify the economically significant risks with specificity; (ii) determine how these risks in the controlled transaction are contractually assumed by the associated enterprises under the terms of the transaction; (iii) functional analysis on the assumption and management of these risks between the associated enterprises involved (in particular regarding control and risk mitigation functions, bearing the consequences of risk outcomes, and the financial capacity to assume such risk); (iv) determine whether the contractual assumption of risk is consistent with the conduct of the associated enterprises; (v) determine if the party characterized as assuming the risk under the previous step controls the risk or has the financial capacity to assume the risk; if not, the risk is allocated to the enterprise exercising control and having the financial capacities to assume the risk, control being the decisive factor when multiple associated enterprises are involved; and (vi) pricing of the actual transaction as accurately delineated.

1.4.2. Transfer pricing methods

Guidance on the selection and application of the most appropriate transfer pricing method is found in chapter II of the OECD Guidelines. Two categories of transfer pricing methods are recognized in the OECD Guidelines to establish whether the conditions in the commercial or financial relations between associated enterprises are consistent with the arm's length principle.

First, there are three "traditional transaction methods" included in the OECD Guidelines:^[14]

- the comparable uncontrolled price (CUP) method, whereby the price charged for property or services transferred in a controlled transaction is compared to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances;^[15]
- the cost-plus method, which begins with the costs incurred by the supplier of property (or services) in a controlled transaction. An arm's length markup is then added to this cost, established by reference to the markup earned by the same or other supplier(s) in comparable uncontrolled transactions; and
- the resale price method, which begins with the price at which property that has been purchased from an associated enterprise, is resold to an independent enterprise. This resale price is then reduced by an arm's length gross margin determined by reference to the resale price margin earned by the same or other reseller(s) in comparable uncontrolled transactions.

14. See ch. II, part 2 OECD Guidelines.

15. The 2017 Guidelines contain specific guidance on the application of the CUP method to cross-border commodity transactions. The new guidance states that (i) the CUP method would generally be an appropriate transfer pricing method for commodity transactions between associated enterprises; (ii) quoted prices can be used under the CUP method, subject to a number of considerations, as a reference to determine the arm's length price for the controlled commodity transaction; and (iii) reasonably accurate comparability adjustments should be made, when needed, to ensure that the economically relevant characteristics of the controlled and uncontrolled transactions are sufficiently comparable.

Second, there are two “transactional profit methods”:^[16]

- the transactional net margin method (TNMM), whereby an arm’s length remuneration that a taxpayer realizes from controlled transactions is established by reference to the net profit margin to an appropriate base (e.g. costs, sales or assets) earned in comparable uncontrolled transactions; and
- the transactional profit split method, which seeks to determine the division of profits that independent enterprises would have expected to realize from engaging in the transaction or transactions. The profit split method first identifies the profit to be split for the associated enterprises from the controlled transactions in which the associated enterprises are engaged. It then splits those profits between the associated enterprises on an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm’s length. The guidance related to the selection and application of the transactional profit split method in the 2017 Guidelines is currently undergoing revision by Working Party No. 6. The OECD released two discussion drafts on the revised guidance on profit splits (on 4 July 2016 and on 22 June 2017). These drafts, including the one from June 2017, do not (yet) represent a consensus view of all OECD countries and do not have legal bearing. A Public Consultation was organized on 6 November 2017.

Under the OECD Guidelines,^[17] the selection of a transfer pricing method always aims at finding the most appropriate method for a particular case. For this purpose, the selection process should take account of the following four criteria:

- the respective strengths and weaknesses of the OECD recognized methods;
- the appropriateness of the method considered in view of the nature of the controlled transaction, determined in particular through a functional analysis;
- the availability of reliable information (in particular on uncontrolled comparables) needed to apply the selected method and/or other methods; and
- the degree of comparability between controlled and uncontrolled transactions, including the reliability of comparability adjustments that may be needed to eliminate material differences between them.

No one method is suitable in every possible situation, nor is it necessary to prove that a particular method is not suitable under the circumstances.

Where a traditional transaction method and a transactional profit method can both be applied as reliably to the facts and circumstances of the taxpayer’s transaction, the former should be preferred. This is because traditional transaction methods are described as the most direct means of establishing whether conditions in the commercial and financial relations between associated enterprises are arm’s length.^[18]

Multinational enterprise (MNE) groups retain the freedom to apply methods not described in the OECD Guidelines to establish prices of their controlled transactions, provided that those prices satisfy the

16. See ch. II, part 3 OECD Guidelines.

17. See ch. II, part 1 OECD Guidelines.

18. Prior to the 2010 update of the Guidelines, there was a strict preference for traditional transaction methods over transactional profit methods and the latter were only applicable “in those exceptional situations, where there are no data available or the available data are not of sufficient quality to rely solely or at all on the traditional transaction methods”.

arm's length principle. However, a taxpayer should maintain and be prepared to provide documentation regarding how its transfer prices were established. There is no requirement under the OECD Guidelines for a tax examiner or taxpayer to perform analyses under more than one method, although it is recognized that for difficult cases, where no one approach is conclusive, a flexible approach would allow the evidence of various methods to be used in combination.

The table below summarizes the current analytical path for selecting the most appropriate transfer pricing method:

Illustration of the selection of the most appropriate method to the circumstances of the case

If CUP and another method can be applied in an equally reliable manner	CUP	
If not:		
Where one party to the transaction performs "benchmarkable" functions (e.g. manufacturing, distribution, services for which comparables exist) and does not make any valuable, unique contribution (in particular does not contribute a unique, valuable intangible)	One-sided method Choice of the tested party (seller or purchaser), generally the one that has the less complex functional analysis.	
* The tested party is the seller (e.g. contract manufacturing or provision of services)	Cost plus Cost-based TNMM (i.e. testing the net profit/costs) Asset-based TNMM (i.e. testing the net profit/assets)	If cost plus and TNMM can be applied in an equally reliable manner: cost plus
* The tested party is the buyer (e.g. marketing/distribution)	Resale price Sales based TNMM (i.e. testing the net profit/sales)	If resale price and TNMM can be applied in an equally reliable manner: resale price
Where each of the parties makes valuable, unique contributions to the controlled transaction (e.g. contributes valuable unique intangibles)	Two-sided method Profit split	
MNEs retain the freedom to use "other methods" not listed above, provided they satisfy the arm's length principle. In such cases, the rejection of the above-described methods and selection of an "other method" should be justified.	Other methods	

1.4.3. Intangibles, services and cost contribution arrangements

Chapter VI of the 2017 OECD Guidelines contains guidance on the application of the arm's length principle to intangibles; this chapter is complemented with an Annex which includes examples to illustrate the guidance. Chapter VI covers the following topics:

- identification of intangibles;
- ownership of intangibles and transactions involving the development, enhancement, maintenance, protection and exploitation (so-called DEMPE) of intangibles;
- transactions involving the use or transfer of intangibles; and
- supplemental guidance for determining arm's length conditions in cases involving intangibles.

Chapter VII of the 2017 OECD Guidelines contains guidance on intra-group services. It covers the following topics:

- main issues in the analysis of transfer pricing intra-group services, i.e. (i) determining whether intra-group services have been rendered and (ii) determining an arm's length charge; and
- specific guidance relating to a particular category of intra-group services referred to as low value-adding intra-group services.^[19]

Chapter VIII of the 2017 OECD Guidelines contains guidance on cost contribution arrangements; this chapter is complemented with an Annex with examples to illustrate the guidance. The guidance covers the following topics:

- concept of a cost contribution arrangement;
- applying the arm's length principle in a cost contribution arrangement;
- entry, withdrawal or termination of a cost contribution arrangement; and
- recommendations for structuring and documenting a cost contribution arrangement.

1.4.4. Other relevant guidance in the OECD Guidelines

On the administrative side, chapter IV contains a discussion of administrative practices, e.g. for transfer pricing examination and elimination of double taxation. Section E of chapter IV was amended in 2017 to reflect new, more positive guidance on safe harbours, approved in May 2013, with draft Memoranda of Understanding for implementing bilateral safe harbours between interested countries.

Chapter V of the 2017 OECD Guidelines contains guidance on a three-tiered transfer pricing documentation; it is complemented with the following:

19. According to para. 7.45 2017 OECD Guidelines, low-value adding services are services performed by one or more members of an MNE group on behalf of one or more other group members which:

- # are of a supportive nature;
- # are not part of the core business of the MNE group (i.e. not creating the profit-earning activities or contributing to economically significant activities of the MNE group);
- # do not require the use of unique and valuable intangibles and do not lead to the creation of unique and valuable intangibles; and
- # do not involve the assumption or control of substantial or significant risk by the service provider and do not give rise to the creation of significant risk for the service provider.

- Annex I on the outline of a Master File;
- Annex II on the outline of a Local File;
- Annex III on a model template for a country-by-country report; and
- Annex IV on a country-by-country implementation package.

Many countries have already implemented country-by-country report requirements into their domestic law.^[20] The first filings take place in 2017 in most cases and cover data of fiscal year 2016.

1.5. Permanent establishment issues

1.5.1. Definition of a permanent establishment (PE)

The determination of whether a presence that an enterprise from one state has in another state, creates a PE of that enterprise in that other state can be complex and sometimes contentious. It has to be made on a case-by-case basis on the basis of the applicable domestic law and of the relevant provisions in the applicable bilateral treaty. A PE is defined under article 5 of the 2014 OECD Model as follows:

Article 5 – PERMANENT ESTABLISHMENT

1. For the purposes of this Convention, the term “permanent establishment” means a fixed place of business through which the business of an enterprise is wholly or partly carried on.
2. The term “permanent establishment” includes especially:
 - a) a place of management;
 - b) a branch;
 - c) an office;
 - d) a factory;
 - e) a workshop, and
 - f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.
3. A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months.
4. Notwithstanding the preceding provisions of this Article, the term “permanent establishment” shall be deemed not to include:
 - a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
 - b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
 - c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

20. See <http://www.oecd.org/tax/automatic-exchange/country-specific-information-on-country-by-country-reporting-implementation.htm> (accessed 28 Dec. 2017).

d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;

e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;

f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

5. Notwithstanding the provisions of paragraphs 1 and 2, where a person – other than an agent of an independent status to whom paragraph 6 applies – is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

6. An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.

7. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

As part of the OECD/G20 BEPS Project, the OECD released a Final Report on Preventing the Artificial Avoidance of Permanent Establishment Status (Action 7)^[21] proposing amendments to the wording of article 5 of the 2014 OECD Model, notably its paragraphs 4, 5 and 6, as well as the Commentary thereon.

The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (“multilateral instrument” or MLI) was signed by 67 countries in 7 June 2017.^[22] This instrument aims at transposing results from the OECD/G20 BEPS Project, including those related to Action 7, into bilateral tax treaties worldwide.

Part IV of the MLI includes provisions related to Action 7 and in particular:

- article 12: modification of the definition of a dependent agent permanent establishment to counter the artificial avoidance of permanent establishment status through commissionaire arrangements and similar strategies;
- article 13: amendments to the way in which the list of exceptions (“specific activity exemptions”) operates, to counter artificial avoidance of PE status through the specific activity exemptions;

21. The Final Report is available at <http://www.oecd.org/tax/preventing-the-artificial-avoidance-of-permanent-establishment-status-action-7-2015-final-report-9789264241220-en.htm> (accessed 28 Dec. 2017).

22. Other countries have signed it since then.

- article 14: additional provisions related to the splitting-up of contracts;
- article 15: definition of a person closely related to an enterprise.

The incorporation of these provisions into the bilateral agreements in force is subject to a series of conditions and in particular to the condition that both states that are party to a given bilateral agreement agree to cover said bilateral agreement and agree on the inclusion of the new provision. It is noteworthy that the articles on permanent establishment are not part of the minimum standards, so that a number of signatories to the MLI reserved the right to not apply part or all of these new provisions into their tax treaties.

On 11 July 2017, the OECD released the draft contents of the 2017 update to the OECD Model which integrates the changes proposed by Action 7 (as included in the MLI) as well as previous work on the interpretation and application of article 5.^[23]

Paragraphs 4 to 8 of the new article 5 of the draft 2017 update of the OECD Model read as follows:

4. Notwithstanding the preceding provisions of this Article, the term “permanent establishment” shall be deemed not to include:

- a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
- b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
- c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
- d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;
- e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;
- f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character,

provided that such activity or, in the case of subparagraph f), the overall activity of the fixed place of business, is of a preparatory or auxiliary character.

4.1 Paragraph 4 shall not apply to a fixed place of business that is used or maintained by an enterprise if the same enterprise or a closely related enterprise carries on business activities at the same place or at another place in the same Contracting State and

- a) that place or other place constitutes a permanent establishment for the enterprise or the closely related enterprise under the provisions of this Article, or

23. Interested parties were invited to provide comments. The comments received have been published on 11 August 2017.

b) the overall activity resulting from the combination of the activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, is not of a preparatory or auxiliary character,

provided that the business activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, constitute complementary functions that are part of a cohesive business operation.

5. Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 6, where a person – other than an agent of an independent status to whom paragraph 6 applies – is acting in a Contracting State on behalf of an enterprise and has, and habitually exercises, in a Contracting State, an authority to conclude contracts, in doing so, habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and these contracts are

a) in the name of the enterprise, or

b) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or

c) for the provision of services by that enterprise,

that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business (other than a fixed place of business to which paragraph 4.1 would apply), would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

6. An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business. Paragraph 5 shall not apply where the person acting in a Contracting State on behalf of an enterprise of the other Contracting State carries on business in the first-mentioned State as an independent agent and acts for the enterprise in the ordinary course of that business. Where, however, a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to any such enterprise.

7. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

8. For the purposes of this Article, a person or enterprise is closely related to an enterprise if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises. In any case, a person or enterprise shall be considered to be closely related to an enterprise if one possesses directly or indirectly more than 50 per cent of the beneficial interest in the other (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) or if another person or enterprise possesses directly or indirectly more than 50 per cent of the beneficial

interest (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) in the person and the enterprise or in the two enterprises.

1.5.2. Attribution of profits to permanent establishments^[24]

The arm's length principle also applies to the determination of the profits attributed to a PE that an enterprise of one state has in another state, and in particular to the remuneration of the dealings of that PE with other parts of the enterprise to which it belongs. The arm's length principle for attributing profits to PEs is expressed at paragraphs 1 and 2 of article 7 of the OECD Model that currently reads as follows:^[25]

Article 7 – BUSINESS PROFITS

1. Profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise that are attributable to the permanent establishment in accordance with paragraph 2 may be taxed in that other State.

2. For the purposes of this article and article 23 A and B, the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 are the profits it might be expected to make if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.

Guidance on the application of the arm's length principle to attribute profits to PEs under article 7 is the subject of the [Report on the Attribution of Profits to Permanent Establishments](#) that was approved by the Council of the OECD on 22 July 2010.^[26] This Report describes the Authorised OECD Approach to Attributing Profits to a PE (hereafter the AOA). It creates a soft law obligation on the basis of the Recommendation^[27] of 17 July 2008 from the OECD Council to the governments of Member countries that “their tax administrations follow, when applying the provisions of their bilateral tax conventions that are drafted on the basis of the pre-2010 article 7 of the Model Tax Convention, the guidance in the 2008 Report to the extent that its conclusions do not conflict with the 2008 Commentary on Article 7” and “when applying the provisions of their bilateral tax conventions that are drafted on the basis of the 2010 article 7 of the Model Tax Convention, the guidance in the 2010 Report”; and “that their tax administrations encourage taxpayers to follow the guidance in the [2008 or 2010] Report ...”.^[28]

24. See www.oecd.org/ctp/tp/pe.

25. Art. 7 and its Commentary were amended in 2010; see www.oecd.org/ctp/tp/pe.

26. An earlier version of this Report, referred to as the 2008 Report on the Attribution of Profits to Permanent Establishments, was approved by the Council of the OECD in July 2008. The 2008 and 2010 Reports are similar in substance as the 2010 Report did not change any of the conclusions of the 2008 Report; its main purpose was to update references to the pre-2010 version of art. 7 and to the pre-2010 OECD Guidelines.

27. Council Recommendation C(2008)106 as amended.

28. Depending on the version of art. 7 included in the applicable bilateral tax convention.

The Report on [Action 7 of the BEPS Action Plan](#) (Preventing the Artificial Avoidance of Permanent Establishment Status) mandated the development of additional guidance on how the rules of article 7 of the OECD Model Tax Convention would apply to PEs resulting from the changes to the definition of permanent establishments that result from the Report (see section 1.5.1.), in particular for PEs outside the financial sector. The Report highlighted the need to take account of the results of the work on other parts of the BEPS Action Plan dealing with transfer pricing, in particular the work related to intangibles, risk and capital.

The OECD released two Discussion Drafts on Additional Guidance on the Attribution of Profits to Permanent Establishments (on 4 July 2016 and on 22 June 2017), inviting comments.^[29] The Discussion Drafts focus on the attribution of profits to (i) dependent agent PEs, in particular under the form of commissionaires and similar arrangements, and (ii) PEs arising under article 5(1) (fixed place of business) to which the exemptions in article 5(4) do not apply (e.g. warehouses as fixed place of business PE). The views and proposals included in the Discussion Draft do not represent the consensus views of the Committee on Fiscal Affairs. A public consultation was organized on 7 November 2017.

2. Prevention and resolution of transfer pricing and other international tax disputes

Traditionally, one essential policy objective of the CFA has been to prevent or eliminate double taxation. Economic double taxation can arise from a transfer pricing dispute if the same profits are taxed in the hands of two taxpayers located in two jurisdictions. Juridical double taxation can arise from disputes related to the possible existence of a PE and attribution of profits thereto. The availability of efficient mechanisms for preventing or eliminating double taxation at the international level is essential.

In the context of the BEPS Project, “double non-taxation” has become a greater point of attention than double taxation. The MLI (as well as the Draft Contents of the 2017 Update to the OECD Model Tax Convention) states in its preamble that tax treaties are intended to “eliminate double taxation with respect to the taxes covered by those agreements without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in those agreements for the indirect benefit of residents of third jurisdictions)”.

2.1. Dispute resolution^[30]

Article 25 of the OECD Model provides for a mechanism whereby the competent authorities of contracting states will endeavour to resolve international tax disputes by mutual agreement, with a view to the avoidance of taxation which is not in accordance with the Convention. This article currently provides as follows:

Article 25 – MUTUAL AGREEMENT PROCEDURE

1. Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may,

29. The 2016 Discussion Draft is available at: <http://www.oecd.org/tax/transfer-pricing/BEPS-discussion-draft-on-the-attribution-of-profits-to-permanent-establishments.pdf>; the 2017 Discussion Draft is available at: <http://www.oecd.org/tax/transfer-pricing/beps-discussion-draft-additional-guidance-attribution-of-profits-to-permanent-establishments.pdf> (both accessed 28 Dec. 2017).

30. See www.oecd.org/ctp/dr (accessed 28 Dec. 2017).

irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of the Contracting State of which he is a resident or, if his case comes under paragraph 1 of article 24, to that of the Contracting State of which he is a national. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention.

2. The competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with the Convention. Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States.

3. The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention.

4. The competent authorities of the Contracting States may communicate with each other directly, including through a joint commission consisting of themselves or their representatives, for the purpose of reaching an agreement in the sense of the preceding paragraphs.

5. Where,

a) under paragraph 1, a person has presented a case to the competent authority of a Contracting State on the basis that the actions of one or both of the Contracting States have resulted for that person in taxation not in accordance with the Convention, and

b) the competent authorities are unable to reach an agreement to resolve that case pursuant to paragraph 2 within two years from the presentation of the case to the competent authority of the other Contracting State,

any unresolved issues arising from the case shall be submitted to arbitration if the person so requests. These unresolved issues shall not, however, be submitted to arbitration if a decision on these issues has already been rendered by a court or administrative tribunal of either State. Unless a person directly affected by the case does not accept the mutual agreement that implements the arbitration decision, that decision shall be binding on both Contracting States and shall be implemented notwithstanding any time limits in the domestic laws of these States. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this paragraph.<1>

<1> In some States, national law, policy or administrative considerations may not allow or justify the type of dispute resolution envisaged under this paragraph. In addition, some States may only wish to include this paragraph in treaties with certain States. For these reasons, the paragraph should only be included in the Convention where each State concludes that it would be appropriate to do so based on the factors described in paragraph 65 of the Commentary on the paragraph. As mentioned in paragraph 74 of that Commentary, however, other States may be able to agree to remove from the paragraph that condition that issues may not be submitted to arbitration if a decision on these issues has already been rendered by one of their courts or administrative tribunals.

The mutual agreement procedure (MAP) is an essential tool to achieve the CFA's policy objective of preventing or eliminating double taxation. The OECD undertook a major project to improve the efficiency of the MAP, leading to changes being made to the Commentary on article 25, as part of the 2008 update of the OECD Model.

A Manual for Effective Mutual Agreement Procedures was also released for competent authorities and taxpayers, identifying a series of best practices.^[31] Furthermore, article 25(5) above was introduced in the 2008 update of the OECD Model, establishing an arbitration mechanism for issues left unresolved after 2 years of mutual agreement procedure.

The most recent OECD statistics on mutual agreement procedures evidence a 14% increase in the number of open MAP cases in 2015 compared with 2014.^[32] Unfortunately, many countries suffer a significant lack of resources dedicated to the resolution of mutual agreement procedures, which adversely affects their ability to handle the cases in a timely manner (an average of 20.47 months in 2015 for completion of a MAP; this represents an improvement of almost 3 months compared with the 2014 figures).

As part of the OECD/G20 BEPS Project, the OECD released in October 2015 a [Final Report on Making Dispute Resolution Mechanisms More Effective \(Action 14\)](#), aimed at strengthening the effectiveness and efficiency of the MAP process. The Report was endorsed by both the OECD Council and the G20.^[33] Countries have agreed to changes in their approach to dispute resolution, in particular through a minimum standard with respect to the resolution of treaty-related disputes, commitment to its rapid implementation and agreement to ensure its effective implementation through the establishment of a robust peer-based monitoring mechanism that will report regularly through the Committee on Fiscal Affairs to the G20. The minimum standard aims at:

- ensuring that treaty obligations related to the MAP are fully implemented in good faith and that MAP cases are resolved in a timely manner;
- ensuring the implementation of administrative processes that promote the prevention and timely resolution of treaty-related disputes; and
- ensuring that taxpayers can access the MAP when eligible.

The outcomes of Action 14 were introduced in the MLI (articles 16 to 18) as well as in the Draft Contents of the 2017 Update to the OECD Model Tax Convention. They include notably a peer review mechanism.^[34]

Additionally, the MLI (and the Draft Contents of the 2017 Update to the OECD Model Tax Convention) provides the option for a jurisdiction to introduce a mandatory binding arbitration mechanism in its tax treaties. So far, 20 countries have committed to implementing such an arbitration provision.^[35]

31. See www.oecd.org/ctp/memap (accessed 28 Dec. 2017).

32. The MAP statistics to be submitted by members under the agreed MAP statistics reporting framework with effect from reporting period 2016 will be available in 2017.

33. See <http://www.oecd.org/tax/making-dispute-resolution-mechanisms-more-effective-action-14-2015-final-report-9789264241633-en.htm> (accessed 28 Dec. 2017).

34. The first six peer review reports were released by the OECD on 26 September 2017. They relate to implementation by Belgium, Canada, the Netherlands, Switzerland, the United Kingdom and the United States. They include over 110 recommendations relating to the minimum standard. The OECD indicated that, in stage 2 of the peer review process, each jurisdiction's efforts to address any shortcomings identified in its stage 1 peer review report will be monitored.

35. The committed countries are: Australia, Austria, Belgium, Canada, France, Germany, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Poland, Slovenia, Spain, Sweden, Switzerland, the United Kingdom and the United States.

2.2. Dispute prevention

An APA is an administrative approach that attempts to prevent transfer pricing disputes from arising by determining criteria for applying the arm's length principle to transactions in advance of those transactions taking place. APAs can be unilateral (where agreed between one tax administration and a taxpayer), bilateral (where agreed between two tax administrations with the taxpayer) or multilateral (involving more than two tax administrations).

In 1991, the world's first bilateral APA was concluded between the United States and Australia for Apple, and a formal APA programme was established in the United States.

In October 1999, the OECD supplemented its OECD Guidelines with an Annex containing Guidelines for conducting APAs under the mutual agreement procedure (MAP APAs), i.e. bilateral or multilateral APAs.^[36] Today, about 40 countries have formal APA programmes, including Canada, the United States, Mexico, many European countries, Australia, China, Japan and Korea, and several countries have gained experience with multilateral APAs. In appropriate circumstances, APAs can assist in providing certainty in advance of a business restructuring.

3. OECD guidance on business restructuring

The OECD guidance on the transfer pricing aspects of business restructurings is found in chapter IX of the OECD Guidelines. Chapter IX was first incorporated in the Guidelines in July 2010. It was revised in the 2017 Guidelines, for consistency with other changes approved to the OECD Guidelines in 2017 as part of the BEPS project. As a result of this update, the guidance on risks and on the recognition of the actual transactions undertaken that was found in the 2010 version of chapter IX was removed, as further guidance on these two topics was added to chapter I of the 2017 Guidelines, which is not limited to business restructuring.

3.1. Restructurings that are within the scope of the OECD project

Business restructurings are defined in chapter IX of the OECD Guidelines as “the cross-border reorganisation of the commercial or financial relations between associated enterprises, including the termination or substantial renegotiation of existing arrangements. [...] Business restructurings may often involve the centralisation of intangibles, risks, or functions with the profit potential attached to them”.

Since the 1990s and the emergence of global business models, many restructurings have consisted in the creation or strengthening by an MNE group of a global or regional “entrepreneur” which typically centralizes valuable intangible property rights, as well as key investment and operational risks within the MNE group, together with the attached profit (or loss) potential. Local fully fledged distributors have been converted into commissionaires or risk-less distributors, and local fully fledged manufacturers have been converted into contract or toll manufacturers. From a tax perspective, the implementation of such business models typically leads to attributing stable but low profits to the streamlined operations, and residual profits (or losses) to the “entrepreneur”.

The OECD notes the following examples:^[37]

36. See <http://www.oecd.org/dataoecd/10/10/38008392.pdf> (accessed 28 Dec. 2017).

37. Para. 9.2 OECD Guidelines.

- conversion of full-fledged distributors into limited-risk distributors, marketers, sales agents or commissionaires;
- conversions of full-fledged manufacturers into contract manufacturers or toll manufacturers;
- transfer of intangibles or rights in intangibles; and
- 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.

3.2. Transfer pricing dimension of business restructurings

3.2.1. Applying the arm's length principle to business restructurings

Chapter IX starts from the premise that the relevant question under article 9 of the OECD Model 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. In other words, the guidance in chapter IX is not intended to create an "exit tax" on all restructuring transactions or variations of profit potential, irrespective of what would have happened at arm's length in comparable circumstances. Rather, it is intended to provide an analytical framework to determine whether the conditions of a restructuring are consistent with the conditions which would have been agreed between independent parties in comparable circumstances, taking into account, in particular, the rights and other assets of the parties and the alternative options realistically available to them.

In some circumstances, tax authorities have questioned whether independent parties would have agreed to the restructuring at all. This question gave rise to difficult discussions about cases where a restructuring which is implemented to the benefit of the group as a whole is detrimental to a particular entity within the MNE group: how should the commercial interest of the group and the commercial interest of each particular affiliate be balanced when applying the arm's length principle in such cases?

Chapter IX starts from the premise that the arm's length principle and OECD 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. 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 the transactions that take place upon the restructuring and generally consist of the transfer of functions, assets and/or risks and/or the termination or substantial renegotiation of intra-group commercial arrangements.

The OECD notes that while 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, this circumstance does not answer the question whether it is arm's length from the perspectives of each of the restructured entities.

3.2.2. Relationship with permanent establishment and with the guidance on the attribution of profits to PEs

Business restructurings raise important questions in relation to PEs (see section 1.4.). On the definitional side, the question arises as to whether the newly implemented business model gives rise to one or several PE(s) in the country(ies) of the restructured entity(ies). The question was raised by the circumstances in which a commissionaire may constitute a PE under article 5(5) (a dependent agent

PE). A related issue is how to attribute profits to such a PE under article 7, once one is found to be in existence.

These questions are not addressed in chapter IX. As indicated in section 1.5.1., the OECD modified its definition of PE and work is ongoing on the attribution of profits to PEs.

3.2.3. Relationship with domestic anti-abuse rules

Depending on the countries involved and the conditions of the restructuring, there are circumstances where restructurings may be subject to domestic anti-abuse rules, such as the abuse of law doctrine or provisions that are aimed at targeting transactions with low-tax or non-cooperative jurisdictions. Such domestic anti-abuse rules and the extent to which they are compatible with treaty obligations are not within the scope of chapter IX of the OECD Guidelines.

4. Summary of the guidance in Chapter IX of the OECD Guidelines

Chapter IX consists of two main parts:

Part 1: Arm's length compensation for the restructuring itself;

Part 2: Remuneration of post-restructuring controlled transactions.

4.1. Part 1: Arm's length compensation for the restructuring itself

Part 1 proposes an analytical path to determine the circumstances in which, at arm's length, the restructured entity would receive compensation for the restructuring. This analytical path is as follows (section A is an introduction):

Step 1 (Section B):	1 Understanding the restructuring itself	Accurate delineation of the transactions comprising the business restructuring: functions, assets and risks before and after the restructuring (with a specific focus on risk)
		Understanding the business reasons for and the expected benefits from the restructuring, including the role of synergies
		Identifying the other options realistically available to the parties
		Transfer pricing documentation for business restructurings
Step 2 (Section C):	2 Recognition of the accurately delineated transactions that comprise the business restructuring	
Step 3 (Section D):	3 Analysing the reallocation of profit potential that results from the restructuring	
Step 4 (Section E):	4 Determining whether there has been a transfer of something of value (e.g. tangible assets, intangibles, or an activity / ongoing concern)	

Step 5 (Section F):	Identifying the situations where the termination or substantial renegotiation of existing arrangements would be indemnified at arm's length, by examining:	Whether commercial law supports rights to indemnification for the restructured entity under the facts of the case as accurately delineated
		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
		Which party should ultimately bear the costs related to the indemnification of the party that suffers from the termination or renegotiation of the agreement

These steps are discussed below.

4.1.1. Understanding the restructuring itself

(i) Accurate delineation of the transactions comprising the business restructuring: functions, assets and risks before and after the restructuring

General guidance on the accurate delineation of a controlled transaction is found in section D.1 of chapter I of the Guidelines. It requires to specifically examine the following:

- 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.);
- 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);
- economic circumstances of the parties (section D.1.4); and
- business strategies (Section D.1.5).

Contractual terms are the starting point of the analysis – but only the starting point. Where the conditions of a business restructuring have been formalized in writing (e.g. written contractual agreements, correspondence and/or communications), the written terms provide the starting point for delineating the transactions. “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.”^[38]

An examination of the actual allocation of risks between associated enterprises before and after the restructuring is an essential part of the functional analysis since business restructurings often result in a reallocation of risk between associated enterprises.

^{38.} Para. 9.17 OECD Guidelines.

Consistently with the new chapter I guidance on risk, the focus of the analysis is on whether the party that contractually assumes the risk controls the risk in practice through relevant capability and decision-making and has the financial capacity to assume such risk:

- control over risk is defined as “the capability and authority to decide to take on the risk, and to decide whether and how to respond to the risk, for example through the timing of investments, the nature of development programmes, the design of marketing strategies, or the setting of production levels”;^[39]
- financial capacity to assume risk is defined as the “access to funding to take on the risk or to lay off the risk, to pay for the risk mitigation functions and to bear the consequences of the risk if the risk materializes. Access to funding by the party assuming the risk takes into account the available assets and the options realistically available to access additional liquidity, if needed, to cover the costs anticipated to arise should the risk materialize”.^[40]

Another important issue is whether a particular risk carries significant profit potential and, as a consequence, whether the reallocation of that risk may explain a significant reallocation of profit potential. The significance of a risk will depend on the likelihood of the risk materializing and the size of the potential profits or losses arising from the risk materializing. This is illustrated with an example of a full-fledged distributor converted into a limited-risk distributor or commissionaire, resulting in the reduction or elimination of its inventory risks. To determine whether such risk is economically significant, the OECD provides the following guidance:

- the role of inventory in the business model (e.g. speed to market, comprehensive range);
- the nature of the inventory (e.g. spare parts, fresh flowers);
- the level of investment in inventory;
- the factors giving rise to inventory write-downs or obsolescence (e.g. 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 historical 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).

(ii) Understanding the business reasons for and the expected benefits from the restructuring, including the role of synergies

In response to business commentators who explained that business restructurings are generally motivated by the need to derive synergies, the OECD suggests that, 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. For the OECD, such documentation is likely to be produced at the group level for non-tax purposes, to support the decision-making process of the restructuring. However, when applying the arm’s length principle, an

39. Para. 1.65 OECD Guidelines.

40. Para. 1.64 OECD Guidelines.

analysis of the conditions of the restructuring transactions must be conducted at the level of each of the associated enterprises involved.

Where deliberate, concerted group actions are taken through a business restructuring, the associated enterprises contributing to the synergistic benefit should be appropriately remunerated. For example, assume that an MNE group sets up a central procurement operation that replaces the procurement activities of several associated enterprises in order 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. An analysis of risk 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 because it does not contribute to the creation of synergies.

The OECD also notes that:

- 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; and
- 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 materialize – 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.

(iii) Identifying the other options realistically available to the parties

For the OECD, the application of the arm's length principle is based on the notion that independent enterprises, when evaluating the terms of a potential transaction, will compare the transaction to the other options realistically available to them, and they will only enter into the transaction if they see no alternative that 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.

While the notion of alternative options was already in the 2010 Guidelines, the 2017 Guidelines have reinforced its importance, stating that “in applying the arm's length principle, tax administrations should evaluate each transaction as accurately delineated [...] and consider the economically relevant characteristics taken into account by the parties in reaching the conclusion that there is no option realistically available that offers a clearly more attractive opportunity to meet their commercial objectives than the restructuring adopted.”

The OECD recognizes that there are situations where, at arm's length, 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. 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 internalize it, or to engage a cheaper or more efficient provider or to seek more lucrative opportunities.

Conversely, the OECD also acknowledges that there are 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.

(iv) Transfer pricing documentation for business restructurings

In accordance with the transfer pricing documentation standard introduced by the BEPS Final Report on Action 13, taxpayers should describe in their Master File any important business restructuring transactions that occurred during the fiscal year documented.^[41] Further, MNE groups are recommended to (i) 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 (ii) document the evaluation of the consequences on profit potential of significant risk allocations resulting from the restructuring.

Moreover, taxpayers are required to indicate in their Local Files^[42] whether each local entity has been involved in or affected by business restructurings occurring during the year or in the immediately past year and to explain the aspects of such transactions affecting the local entity.

4.1.2. Recognition of the accurately delineated transactions that comprise the business restructuring^[43]

The OECD acknowledges that MNEs are free to organize their business operations as they see fit and that 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 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.

A tax administration should not disregard part or all of the restructuring or substitute other transactions for it unless the exceptional circumstances identified in chapter I are met, i.e. situations where the arrangements made in relation to the transaction, viewed in their totality, differ from those that

41. See annex I to ch. V OECD Guidelines.

42. See annex II to ch. V OECD Guidelines.

43. Paras. 9.34-9.38 OECD Guidelines.

would have been adopted by independent enterprises behaving in a commercially rational manner in comparable circumstances.^[44]

For transfer pricing purposes, 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. The presence of a tax motive or purpose does not of itself justify non-recognition of the parties' characterization 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. Moreover, the fact that an 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 (see paragraph 1.122 OECD Guidelines).

When assessing the commercial rationality of a business restructuring transaction, it will generally be appropriate to look at the commercial rationality of a restructuring as a whole, e.g. 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, 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 interrelated, the commercial rationality of particular changes may need to be considered separately. For example, a restructuring may involve centralizing a group's purchasing function and centralizing the ownership of valuable intangible property unrelated to the purchasing function. In such a case, the commercial rationality of centralizing the purchasing function and of centralizing the ownership of valuable intangible property may need to be evaluated separately from one another.

For the OECD, "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. any consideration of the post-restructuring arrangement plus, if applicable, 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, any compensation for the post-restructuring arrangement plus, if applicable, 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".^[45]

4.1.3. Understanding the effects of the restructuring on the reallocation of profit potential.^[46]

The guidance in chapter IX reaffirms that "an independent enterprise does not necessarily receive compensation when a change in its business arrangements results in a reduction in its profit potential or expected future profits. The arm's length principle does not require compensation for a mere decrease in the expectation of an entity's future profits. When applying the arm's length principle to business restructurings, the question is whether there is a transfer of something of value (rights or other assets) or a termination or substantial renegotiation of existing arrangements and that transfer, termination

44. See paras. 1.119-1.128 OECD Guidelines.

45. Several business commentators expressed reservations on the relevance of the reference to a "pre-tax basis", considering that independent parties would not only look at pre-tax profits but also at post-tax profits to determine whether a transaction is arm's length.

46. Sec. D, ch. IX, part 1 OECD Guidelines.

or substantial renegotiation would be compensated between independent parties in comparable circumstances.”

A definition of “profit potential” is found in the glossary of the OECD Guidelines as follows: “The 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.”

Furthermore, the OECD states that 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 and/or other assets at the time of the restructuring, then it has no compensable profit potential. On the other hand, an entity with considerable rights and/or other assets at the time of the restructuring may have considerable profit potential, which must ultimately be appropriately remunerated in order to justify the sacrifice of such profit potential.

In evaluating profit potential, it is necessary to evaluate whether historical 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.

Chapter IX contains an illustration of the relationship between risk and profit potential in the case where a fully fledged distributor is being converted into a low risk distributor.^[47]

4.1.4. Determining whether there has been a transfer of something of value (e.g. an asset or an ongoing concern).^[48]

(i) Tangible assets

With respect to transfers of tangible assets such as inventories, the main message in chapter IX is to reaffirm the need for the transfer to be made at an arm’s length price, i.e. not necessarily at cost.

Accordingly, with respect to inventory in particular, the OECD considers that the potential risks inherent in the inventory should be dealt with in the restructuring transaction. For instance, if raw materials costing 100 now have a market price of 80 or 120, then a transfer would crystallize 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.

47. Paras. 9.45-9.47 OECD Guidelines.

48. Sec. E, ch. IX, part 1 OECD Guidelines.

(ii) Intangibles

The guidance on intangibles in chapter VI of the OECD Guidelines applies to transactions involving intangibles or rights in intangibles in a business restructuring context.

Four situations involving intangibles are identified in chapter IX as being particularly relevant to business restructurings and subject to further comments, as described below.

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

The first case is where a local operation transfers legal ownership of intangibles or rights in intangibles to a foreign associated enterprise, such as a principal or intellectual property holding company, which licenses back the intangibles to the transferor.

In accordance with the guidance in chapter VI of the 2017 OECD Guidelines, 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 paragraph 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 (DEMPE) of intangibles may comprise any share of the total return anticipated to be derived from the intangibles (see paragraph 6.54). Therefore, the change in legal ownership of an intangible in a business restructuring may not necessarily affect which party is entitled to returns from that intangible, if the legal owner did not perform DEMPE functions.

- The arm's length principle requires an evaluation of the conditions made or imposed between related parties, at the level of each of them. The fact that centralization of legal ownership of intangibles may be motivated by sound commercial reasons at the level of the MNE group does not answer the question of whether the disposal is arm's length from the perspectives of both the transferor and the transferee.
- In the case where a local operation disposes of the legal ownership of its intangibles to an 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.
- 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 licence 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 with regard 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.

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

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.

The new guidance in chapter VI with respect to hard-to-value intangibles may apply in such cases.

This guidance aims at protecting tax administrations from the negative effects of information asymmetry by ensuring that tax administrations can consider ex post outcomes as presumptive evidence of the appropriateness of the ex ante pricing arrangements. At the same time, the taxpayer has the possibility to rebut such presumptive evidence by demonstrating the reliability of the information supporting the pricing methodology adopted at the time the controlled transaction took place. The development by the OECD of implementation guidance on hard-to-value intangibles is in process.

3. Local intangibles

For the OECD, 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.

An example of the conversion of a full-fledge distributor into a limited-risk distributor or commissionaire is provided. In the case provided, the distributor has developed local marketing intangibles over the years prior to it being restructured:

- If the local marketing intangibles are transferred to a new principal: the transferee, as new legal owner of the transferred intangible, should provide to the transferor an arm's length compensation (in addition to the arm's length compensation for the transferred intangibles) in the case where 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).
- 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.

4. Contractual rights

Chapter IX contains a reference to cases where valuable contracts are transferred or surrendered between associated enterprises. It addresses the example of an entity which voluntarily terminates a contract that provided benefits to it (e.g. a long-term client contract), in order to allow a foreign associated enterprise to enter into a similar contract and benefit from the profit potential attached to it. The OECD notes, that in some circumstances this may in substance consist in a tripartite transaction and amount to a transfer of valuable contractual rights between the two associated enterprises.

(iii) Transfer of activity (ongoing concern)

The transfer of an ongoing concern in the context of chapter IX 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 relevance of this notion in chapter IX relates to valuation and in particular to the question whether each element should be valued independently or should be aggregated for valuation purposes.^[49]

For the OECD:

The valuation of a transfer of an ongoing concern should reflect all the valuable elements that would be remunerated between independent parties in comparable circumstances. For example, in the case of a business restructuring that involves the transfer of a business unit that includes, among other things, research facilities staffed with an experienced research team, the valuation of such ongoing concern should reflect, among other things, the value of the facility and the impact (e.g. time and expense savings) of the assembled workforce on the arm’s length price.

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

4.1.5. Identifying the situations where the termination or substantial renegotiation of existing arrangements would be indemnified at arm’s length

The discussion of indemnification cases starts from the premise that, where an existing contractual relationship is terminated or substantially renegotiated in the context of a business restructuring, it generally involves changes in the risk and functional profiles of the parties, with consequences for the allocation of profit potential between them. In addition, the restructured entity might suffer detriments such as restructuring costs (e.g. write-off of assets, termination of employment contracts), reconversion costs (e.g. in order to adapt its existing operation to other customer needs), and/or a loss of profit potential. The question arises whether, at arm’s length, indemnification should be paid to the restructured entity and, if so, how to determine such an indemnification. In this regard, indemnification is defined as “any type of compensation that may be paid for detriments suffered by the restructured entity, whether in the form of an up-front payment, of a sharing in restructuring costs, of lower (or higher) purchase (or sale) prices in the context of the post-restructuring operations, or of any other form.” The

49. On a related issue, see United States Tax Court’s decision in *Veritas, Inc. v. Commissioner*, 133 T.C. No. 14 (2009). In this case, the IRS was of the view that the rights Veritas US granted to Veritas Ireland for its pre-existing intangibles as part of a cost sharing agreement should be aggregated and treated as a sale of Veritas US’s business rather than a sale of its discrete assets because the “assets collectively possess[ed] synergies that imbue[d] the whole with greater value than each asset standing alone”. The Court dismissed the IRS position.

discussion in chapter IX of indemnification situations opens up the possibility to establish that a form of compensation would be warranted at arm's length in some situations where no asset is transferred, if such an indemnification would be agreed between independent parties in comparable circumstances.

For the OECD, there should be no presumption that all contract terminations or substantial renegotiations should give a right to indemnification at arm's length. 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 and the options realistically available to the parties. For this purpose, the OECD identifies the following three relevant questions:

- whether commercial law supports rights to indemnification for the restructured entity under the facts of the case as accurately delineated;
- 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; and
- which party should ultimately bear the costs related to the indemnification of the party that suffers from the termination or renegotiation of the agreement.

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

In the assessment of whether the conditions of the termination or non-renewal of an existing arrangement are arm's length, the applicable commercial legislation or case law may provide useful information on indemnification rights and terms and conditions that could be expected between independent parties 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.

Whether the existence or absence of an indemnification clause or other type of guarantee (as well as the terms of such a clause where it exists) are arm's length

The determination of whether the indemnification clause or absence thereof is arm's length is the most complex part of the analysis. What needs to be determined is whether independent parties in comparable conditions would have concluded such a contract, for instance a contract that contains no indemnification clause or guarantee of any kind in case of termination, non-renewal or renegotiation.

The accurate delineation of the transaction will identify whether an indemnification clause or arrangement is in place upon termination, non-renewal or renegotiation of the arrangements and, if so, 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.

The OECD indicates that where comparables data evidence a similar indemnification clause (or absence thereof) in comparable circumstances, the indemnification clause (or absence thereof) in a controlled transaction will be regarded as arm's length.

In those cases, however, where such comparable data is 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 be assisted by an examination of the options realistically available to the parties.

The examination of the termination or indemnification clause (or absence thereof) should not be separated from the examination of the contractual arrangements as a whole and in particular of the remuneration of the transactions that are the object of the arrangement. 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.

For the OECD, the termination of employments may be relevant in the analysis, in particular to analyse 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.

This notion is of considerable importance in practice. Many intra-group contracts either do not address termination conditions or do not provide for any indemnification clause and the question posed by the OECD is whether this is consistent with the risk allocation under the contract and accordingly with its remuneration. For instance, if one of the associated enterprises is characterized as a low risk manufacturer and remunerated on a cost-plus basis with a low markup rate reflecting such characterization, is it consistent with the arm's length principle to have it bear the contract termination risk with no indemnification? As always in transfer pricing, the response will depend on the facts and circumstances of each case. The OECD notes that in some situations, it may be 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 of the contract. In some other cases, it may be that, on the basis of an examination of the substance of the arrangement and of the actual conduct of the associated enterprises, an implicit longer-term contract should be implied whereby the terminated party would have been entitled to some indemnification in case of early termination.

This is illustrated in the OECD Guidelines as follows:^[50]

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

50. Paras. 9.87-9.89 OECD Guidelines.

before the end of such period of time. The degree of the risk would depend on whether the investment was highly specialized 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.

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. \$/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 specialized and the manufacturer further to the termination would have no other choice than to write off the assets.

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.*

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 relevant 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 this analysis, the guidance relating to control over risk in section D.1.2.1 of chapter I will be relevant.”^[51]

Which party should ultimately bear the costs related to the indemnification of the party that suffers from the termination or renegotiation of the agreement

Transfer pricing is always a bilateral or even multilateral issue. It is not sufficient to determine that one party to a contract would be willing to claim an indemnification: it is also necessary to determine that another party would have been willing to pay for such indemnification at arm's length, i.e. the transfer pricing analysis of the conditions of the termination or substantial renegotiation of an agreement should

51. See para. 9.91 OECD Guidelines.

take account of both the perspectives of the transferor and of the transferee. This issue is illustrated in the OECD Guidelines as follows:^[52]

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).

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.

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 organized 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.

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.

4.2. Part 2: Remuneration of post-restructuring controlled transactions

4.2.1. Business restructurings versus "structuring"

In the early stages of the OECD discussions of business restructuring, the question was posed whether post-restructuring transactions should more often lead to the selection of a profit split method than in the case of transactions not resulting from a restructuring. The proponents of such an extended application of the profit split method argued that business restructurings are often motivated by the search for synergy gains and regarded the profit split method as the method which is the most capable of capturing such synergy gains.

52. Paras. 9.94-9.97 OECD Guidelines.

The OECD discussed this question and concluded that the arm's length principle and the OECD Guidelines 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. 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.

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 (see discussion of part 1 at section 4.1.).

In addition, the comparability analysis of an arrangement that results from a business restructuring might reveal some factual differences compared to an arrangement that was structured as such from the beginning.^[53] For the OECD, these factual differences do not affect the arm's length principle or the way the guidance in the Guidelines should be interpreted and applied, but they may affect the comparability analysis and therefore the outcome of this application.

4.2.2. Selection and application of a transfer pricing method for the post-restructuring controlled transactions

The general guidance in chapter II on the selection and application of the most appropriate method applies to post-restructuring transactions. Further, part 2 discusses some specific issues that arise in the selection and application of a transfer pricing method and in the determination, where appropriate, of the tested party and the financial indicator(s) for the post-restructuring controlled transactions.

One issue which is specific to post-restructuring transactions is that, according to the OECD, it may be particularly difficult to find reliable, independent comparables for transactions implemented in the context of a globally integrated supply chain.⁵² In this respect, the OECD acknowledges 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. The question whether integration in a global supply chain may entail the selection of a profit split method is currently being debated by the OECD in the context of the development of new guidance on the profit split method.

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

Another specific issue is that there may be a relationship between the determination of an arm's length remuneration for post-restructuring transactions and the determination of an arm's length remuneration for the restructuring itself.^[54] This may be the case in particular where a taxpayer disposes of business operations to an associated enterprise with which it must then transact business as part of those operations. This is illustrated in the OECD Guidelines with the following example:

[...] 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

53. Examples of possible factual differences are discussed in sec. A.2, ch. IX, part II OECD Guidelines.

54. Sec. C, ch. IX, part II OECD Guidelines.

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

4.2.4. Comparing the pre- and post-restructuring situations

The question was raised of what role comparisons of profits earned before and after the restructuring could play. Could a transfer pricing adjustment be justified by the mere fact that the profits of a restructured entity have decreased? Would it 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?

For the OECD, such before-and-after comparisons would generally not suffice to support a transfer pricing adjustment in the face of the requirement posed by article 9 of the OECD Model for a comparison to be made with uncontrolled transactions, where pre-restructuring transactions are controlled ones. The OECD statement in this respect is strong: "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".^[55]

That being said, before-and-after comparisons will often play a role in understanding the restructuring itself and the changes in functions, assets and risks that accounted for the changes in the allocation of profit/loss amongst the parties.

The Guidelines specifically address the situation where this comparison reveals that while some functions, assets and risks were transferred, other functions may still be carried out by the "stripped" entity; in particular in situations where an entity may have been stripped of intangibles or risk but continues to carry out some or all of the functions it previously performed:^[56]

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. 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.

55. See para. 9.118 OECD Guidelines; the response could be different in the case where the pre-restructuring transactions are uncontrolled.

56. Sec. D, ch. IX, part II OECD Guidelines, see paras. 9.122-9.124 for the given example.

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.

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.

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 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.

4.2.5. Location savings^[57] , ^[58]

General guidance on location savings is now found in chapter I of the Guidelines, which provides in particular that:

1.142 Where the functional analysis shows that location savings exist that are not passed on to customers or suppliers, and where comparable entities and transactions in the local market can be identified, those local market comparables will provide the most reliable indication regarding how the net location savings should be allocated amongst two or more associated enterprises. Thus, where reliable local market comparables are available and can be used to identify arm's length prices, specific comparability adjustments for location savings should not be required.

1.143 When reliable local market comparables are not present, determinations regarding the existence and allocation of location savings among members of an MNE group, and any comparability adjustments required to take into account location savings, should be based on an analysis of all of the relevant facts and circumstances, including the functions performed, risks assumed, and assets used of the relevant associated enterprises [...].

Part II of chapter IX OECD Guidelines also contains a discussion of location savings derived from a business restructuring.

Two examples of location savings are provided which are aligned with the general chapter I guidance on location savings:

- one relates to an enterprise that designs, manufactures and sells brand name clothes and which decides to close down its manufacturing activities and to relocate them in an affiliate where labour costs are lower. It shows that where an enterprise has the option realistically available to use a third-party manufacturer, the analysis should be based on the comparables data so that location savings may not need to be further compensated;
- the other one relates to a company in Country X that provides highly specialized and quality engineering services and decides to subcontract a large part of the work to a new subsidiary in Country Y which hires equally qualified engineers to those in Country X for substantially lower wages. In this second example, the OECD assumes that (i) there is a high demand for the type of engineering services that the company in Country X sells; (ii) 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; and (iii) that 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. It provides that, considering this, the enterprise in Country X does not have many other options available to it than to use this service provider. The remuneration

57. It is relevant to contrast the OECD guidance on location savings with the comments provided by China and India on "location specific advantages" in the United Nations' Practical Manual for Developing Countries, see <http://www.un.org/esa/ffd/wp-content/uploads/2017/04/Manual-TP-2017.pdf> (accessed 28 Dec. 2017).

58. The first part of the OECD interim *Guidance on Transfer Pricing Aspects of Intangibles*, released in September 2014, contains proposed amendments to ch. I OECD Guidelines relating to the treatment of location savings. In the meantime, the OECD BEPS Final Reports have been published, which include guidance on location savings.

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.

5. Conclusion

Business restructurings can have significant tax effects for many MNEs and governments. This is an area of taxation that should not be approached at the domestic level only, as restructurings take place on a cross-border and even global scale. Restructurings are logically subject to scrutiny by tax authorities, and an increasing number of adjustments involving transfer pricing, permanent establishment issues or the disregarding of transactions under domestic provisions is observed. Many business restructurings involve complex treaty and transfer pricing concepts. It is therefore essential to strengthen the international consensus on these questions, to engage key non-OECD economies and the business community in a constructive dialogue on these issues, which is what the OECD has been devoting considerable efforts to since more than a decade.

4 – EU Policy Framework

Authors

Irene J.J. Burgers^[*]

Anuschka Bakker^[**]

Latest Information:

This chapter is based on information available up to 28 November 2016.

1. Developments Concerning Business Restructuring in EU Legislation

1.1. Impact of existing secondary EU law on business restructuring

Business restructuring as such has not been on the agenda of the European Union. However, some of the measures taken facilitate the reorganization of businesses, including the transfer of functions, assets and risks; namely, the [Parent-Subsidiary Directive](#), the [Merger Directive](#), the [Interest and Royalties Directive](#), the Code of Conduct for business taxation and the Arbitration Convention are of direct relevance.

1.1.1. Parent-Subsidiary Directive

The aim of the Parent-Subsidiary Directive 1990/435/EEC, redrafted and updated by Directive 2011/96/EU (that entered into force on 18 January 2012), is to enable enterprises to attain a size which will permit them to meet the demands of an enlarged market and to improve their competitive strength by the formation of groups of associated corporations in which a parent corporation controls its subsidiaries. This seeks to cure two problems:

- economic double taxation in the field of corporate taxation (due to the Directive, income tax is paid in the country of residence of the subsidiary; the country of residence of the parent company should grant a credit or an exemption); and
- juridical double taxation arising from withholding tax on dividends (due to the Directive, this tax is levied at the level of the parent company only; distributions of profits from a subsidiary to its parent company should be exempted from withholding tax).

Member States have the option of not applying the Directive if the relationship between parent and subsidiary is not maintained for an uninterrupted period of at least 2 years. However, the *Denkavit I* case ([Case C-283/94](#)),^[1] decided by the Court of Justice of the European Union (ECJ) on 17 October 1996, shows that Member States may not impose the requirement that the facilities of the Directive will be granted only if the qualifying shareholder relationship has already existed for more than 2 years. The facility should be granted as from the time all requirements specified in the Directive are met. Member

* University of Groningen, the Netherlands.

** Manager VAT, Transfer Pricing and Specialist Knowledge Group, IBFD, the Netherlands.

1. DE: ECJ, 17 Oct. 1996, Case C-283/94, *Denkavit Internationaal BV, VITIC Amsterdam BV and Voormeer BV v. Bundesamt für Finanzen*, ECJ Case Law IBFD.

States are free to define procedures under their own national law to assure that the 2-year holding period will be met. Member States may also apply domestic or agreement-based anti-abuse provisions.^[2]

The effectiveness of the Parent-Subsidiary Directive as adopted in 1992 was reduced by the fact that the list of companies eligible for applying the Directive included in the Annex to the Directive did not cover all companies subject to corporation tax in the respective EU Member States, and applied solely to direct holdings of 25% or more. Furthermore, there were significant disparities in the implementation of the Directive between Member States, and changes should be made to take into account the *Societas Europaea* (SE). Therefore, on 29 July 2003, a proposal for a Council Directive amending the Parent-Subsidiary Directive was presented by the Commission.^[3] This proposal was adopted on 22 December 2003. The following amendments have been made:

- reduction of the shareholding requirement to 10% (from 25%);
- inclusion of the SE, European Cooperative Society (SCE), cooperatives, mutual companies, non-capital based companies, savings banks, funds and associations with commercial activity in the list of companies;
- the Directive also applies to profit distributions received through a permanent establishment of the parent company;
- actual management costs may be considered non-deductible (the parent company must prove it when the imputation method applies; not only is the tax from direct subsidiaries deductible, but also that from successive subsidiaries downstream); and
- as to article 4 of the Directive, a Member State may consider a subsidiary fiscally transparent, based on that state's assessment of the legal characteristics.

The Directive does not solve the problem that imputation systems of corporate taxation have an inherent bias in favour of domestic investment, as the credit is usually not available to non-resident shareholders and is not normally granted in respect of foreign dividends. Such systems have influence on related business decisions such as the location of the corporate seat and cross-border mergers. However, as a result of ECJ case law, negative harmonization took place. The Court considers the fact that imputation is granted to domestic shareholders as a distortion of the free movement of capital.

Directive 2011/96/EU did not change the content, but rather aims to provide a more logical structure for the Directive. ^{[4], [5]}

The Commission in November 2013 proposed to amend the Directive with the twofold objective of tackling hybrid loan mismatches and introducing a general anti-abuse rule. These amendments are much related to the issues dealt with by the OECD BEPS project (Action 2 – hybrid mismatch arrangements and Action 5 – harmful tax practices). The Commission adopted as a first step provisions preventing corporate groups from using hybrid loan arrangements to benefit from double non-taxation

2. The Directive, for instance, does not require France to reduce its dividend withholding tax to 0% if the dividend is distributed to a parent company resident in the Netherlands, but the final shareholder (the beneficial owner) is a non-EC resident.

3. COM/2003/462 final.

4. For an in-depth discussion, see H. van den Broek, *Cross-Border Mergers within the EU: Proposals To Remove the Remaining Tax Obstacles* (EUCOTAX Series on European Taxation, Vol. 33, Kluwer Law International, Alphen aan den Rijn 2012).

5. For a more in-depth discussion, see K. Lenaerts et al., *Taxation of Intercompany Dividends under Tax Treaties and EU Law* (G. Maisto ed., IBFD 2012), Online Books IBFD.

under the Directive, in July 2014.^[6] On 9 December 2014, the Council of the European Union approved the inclusion of a general anti-abuse clause in Directive 2011/96/EU.^[7]

1.1.2. Merger Directive

The Merger Directive 1990/434/EEC, which was updated by Directive 2009/133/EC, provides for the facility to defer taxation upon a legal merger, division, transfer of assets or exchanges of shares within the European Community, provided certain conditions are fulfilled. The facility ensures that mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States which may be necessary to ensure the establishment and effective functioning of the common/internal market are not hampered by restrictions, disadvantages or distortions arising in particular from the tax provisions of the Member States.

The Merger Directive applies to the exchange of shares, transfer of assets, legal mergers and divisions, and provides for:

- deferral of the tax on the capital gain realized by the enterprise and/or shareholder;
- the carry-over of tax-exempt reserves of the transferring company to a permanent establishment resulting after the merger; and
- the carry-over of losses to the permanent establishment if such is allowed in qualifying domestic mergers.

Article 6 of the Merger Directive stipulates that: “To the extent that, if the operations referred to in Article 1(a) were effected between companies from the Member State of the transferring company, the Member State would apply provisions allowing the receiving company to takeover the losses of the transferring company which had not yet been exhausted for tax purposes, it shall extend those provisions to cover the takeover of such losses by the receiving company’s permanent establishments situated within its territory.”

There are several limitations to this loss carry over. Amongst others, the domestic law of the Member State of the transferring company should allow a receiving company to take over the non-exhausted losses of a transferring company in a purely domestic situation. ^[8]

Similar to the [Parent-Subsidiary Directive](#), the Merger Directive allows Member States to take steps to prevent tax evasion or tax avoidance. However, the ECJ held in *Leur-Bloem* (Case C-28/95) ^[9] that such measures may not be of a general nature. Specific measures developed for the case in question are allowed. The question of whether application of the facilities of the Merger Directive may be denied if a taxpayer has structured its transactions in such a way that the levy of a tax other than the corporate income tax would be prevented was answered by the European Commissioner for Justice (CoJ) in *Zwijenburg BV v. Staatssecretaris van Financiën*. Prejudicial questions were posed by the Supreme Court of the Netherlands on 11 July 2008, 43144, VN 2008/34.13, concerning a structure in which the limited liability company seeks to buy a building from another limited liability company. In order to prevent transfer tax, the two companies merged. The CoJ ruled in favour of the taxpayer as the transfer tax is not covered by the Merger Directive and the benefit of the Directive cannot be withheld to

6. See <http://register.consilium.europa.eu/doc/srv?l=EN&f=ST%2011647%202014%20INIT>, accessed 14 January 2015.

7. See <http://register.consilium.europa.eu/doc/srv?l=EN&f=ST%2016435%202014%20INIT>, accessed 14 January 2015.

8. F. Boulogne & N. Sumrada Slavnic, *Cross-Border Restructuring and Final Losses*, 52 Eur. Taxn. 10 (2012), Journals IBFD.

9. NL: ECJ, 17 July 1997, Case C-28/95, *A. Leur-Bloem v. Inspecteur der Belastingdienst/Ondernemingen Amsterdam 2*, ECJ Case Law IBFD.

compensate for the non-payment of this tax, the basis and rate of which necessarily differs from those applicable to mergers of companies and other reorganizational operations concerning them. Pursuing a different approach would have the result of compromising the uniform and consistent interpretation of the Directive and would go beyond what is necessary to safeguard the financial interests of the Netherlands. ^[10]

And also similar to the Parent-Subsidiary Directive, the Merger Directive was amended in 2005 by Directive 2005/19/EEC such that the list of entities covered by the Directive now includes the SE and the SCE, as well as named legal forms that are treated in some countries as transparent and in other countries as non-transparent. In addition, the Directive is applicable in the case of a conversion of a permanent establishment into a subsidiary. ^[11]

In September 2014, the European Commission has launched a consultation on cross-border mergers and divisions. The Commission would like to gather information, which would allow the Commission to assess the functioning of the existing EU legal framework for cross-border operations of companies. Based on the results of the consultation one could also determine the potential need for changes in the current rules.^[12] A summary of the input received has been published.^[13]

1.1.3. Interest and Royalties Directive

The Interest and Royalties Directive is part of a tax package consisting of a Council Directive to ensure effective taxation of interest income from cross-border investment of savings that is paid to individuals within the European Union (the Savings Directive), a Code of Conduct for business taxation (requiring Member States to abolish harmful tax measures and refrain from introducing new harmful tax measures), and a Council Directive to eliminate withholding taxes on payments of interest and royalties made between associated companies of different Member States (the Interest and Royalties Directive), thus preventing burdensome administrative formalities and cash-flow problems for the companies concerned. The Interest and Royalties Directive not only focuses on preventing withholding taxes on interest and royalty payments between associated companies, but also applies to permanent establishments.

1.1.4. Arbitration Convention

The Arbitration Convention provides for a mutual agreement procedure and an arbitration procedure aimed at eliminating the double taxation which occurs if an adjustment of an enterprise's profits by the tax authorities of a Member State is not matched by a corresponding adjustment in the Member State of the associated enterprise.

In theory, the existence of an Arbitration Convention might be of relevance for companies considering cross-border business restructuring, as it ensures that both states will take into account the same transfer price for the transfer of functions, assets and associated risks.

10. CoJ, 20 May 2010, C-352/08.

11. EU Merger Directive (2009): Council Directive 2009/133/EC of 19 October 2009 on the Common System of Taxation Applicable to Mergers, Divisions, Partial Divisions, Transfers of Assets and Exchanges of Shares Concerning Companies of Different Member States and to the Transfer of the Registered Office of an SE or SCE between Member States (Codified Version), art. 10, OJ L310 (2009), EU Law IBFD.

12. See <http://europa.eu/rapid/midday-express-08-09-2014.htm?locale=en>, accessed 15 January 2015.

13. See http://ec.europa.eu/internal_market/consultations/2014/cross-border-mergers-divisions/docs/summary-of-responses_en.pdf, accessed 5 August 2016.

1.2. Impact of proposed secondary EC law on business restructuring: Common Consolidated Corporate Tax Base and Home State taxation

The Commission stressed the importance of further harmonizing the corporate income tax systems of the Member States and proposed a Common Consolidated Corporate Tax Base (CCCTB) and/or Home State taxation in 2001^[14] and drafted new proposals for harmonizing corporate income tax in 2003 and 2011. In his farewell lecture Prof. Jan van der Geld (Tilburg University) suggests that the CCCTB and the EU Anti-Avoidance Directive adopted on 17 June 2016 should be regarded as preliminary work for a real European Corporate Income Tax (as suggested in 1970 by Prof. Verloren van Themaat, who was appointed director-general of the department of competition of the European Economic Community in 1958). On the basis of the subsidiarity principle in his view a European Corporate Income Tax is desirable even if a further integration process of the EU Member States will not take place.^[15] Van der Geld warns the problem is not too much European Union, but too little European Union.

1.2.1. Common Consolidated Corporate Tax Base

A CCCTB would enable companies to follow the same rules for calculating the tax base for all their EU-wide activities, rather than in accordance with the existing 28 systems, thereby, in theory, simplifying procedures, improving efficiency and reducing compliance costs. Also, in a second stage, cross-border consolidation might be introduced. The consolidated tax base would be distributed between Member States in accordance with an agreed fair sharing mechanism, which will also form part of the proposal. Member States would retain sovereignty over their tax revenues however, as they will continue to set the applicable national tax rates.

Many political obstacles, as well as technical obstacles, pave a difficult road towards acceptance of the CCCTB. In 2007, the European Commission stated that the proposal for a CCCTB would be finalized by the end of 2008. However, this date proved not to be realistic.^[16] The final proposal was expected in autumn 2009. This deadline was also not achieved. If a directive proves not to be realistic, a CCCTB might be introduced by making use of the comitology procedure. In August 2008, at least eight Member States were prepared to make use of a CCCTB through a comitology procedure on the basis of article 43(f) of the Treaty on the Functioning of the European Union (TFEU).^[17] The long-expected proposal finally was launched on 16 March 2011.^[18] The European Commission proposes to introduce an optional CCCTB as the estimated impact on employment is more favourable than that of a compulsory CCCTB and, moreover, the enforced change by every single company in the Union to a new method of calculating its tax base is avoided.

The aim is to increase cross-border investment within the Union through further expansion of European and foreign multinational enterprises and through “de novo investment” of purely domestic companies into other Member States through the one-stop-shop principle. The proposal includes the possibility for indefinite carry forward of losses and for consolidation. The latter is determined on the basis of a two-part test based on (i) control (more than 50%) of voting rights) and (ii) ownership (more than 75%

14. COM(2001) 582 of 23 October 2001.

15. J.A.G. van der Geld, *De toekomst van de Nederlandse vennootschapsbelasting*, farewell lecture 30 September 2016, Tilburg University, The Netherlands.

16. See <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/07/593&format=HTML&aged=0&language=EN&guiLanguage=en>.

17. According to EU Commissioner László Kovács, Opening Ceremony, IFA Congress 2008 Brussels, 30 August 2008. M. Erasmus-Koen, *De Common Consolidated Corporate Tax Base (CCCTB): Mogelijke Elementen van het Toerekeningsmechanisme*, WFR 2008/1256.

18. COM(2011)121/4: Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), EU Law IBFD.

of equity) or rights to profits (more than 75% of rights giving entitlement to profits). The elimination of additional compliance costs is expected to particularly benefit small and medium-sized enterprises.

In June 2015, the Commission presented a strategy to relaunch the CCCTB. This was announced in the [Action Plan](#) for Fair and Efficient Corporate Taxation, The Commission announced five Actions.

- Relaunching the Common Consolidated Corporate Tax Base (CCCTB) in a two-step approach in which primary focus is on securing the common tax base.
- Ensuring fair taxation where profits are generated.
- Creating a better business environment.
- Increasing transparency.
- Improving EU coordination.

The European Commission started a consultation in order to gather input for the relaunch of the CCCTB. Items that were taken along in the consultation were among others: hybrid mismatches, anti-avoidance elements, treatment of costs of R&D, debt equity bias, cross-border relief.^[19] Subsequently, on 25 October 2016 a proposal for a CCTB as well as for a CCCTB was published.^[20] Suggestion is to make the C(C)CTB mandatory for the largest groups in the European Union and optional for other companies, including a new super deduction for companies that invest in R&D spending, a provision for temporary horizontal carry forward of losses, as well as anti-avoidance legislation. The rules of the C(C)CTB, if adopted, shall apply to a company that is established under the laws of a Member State, including its permanent establishments in other Member States, where the company meets all of the following conditions:

- it takes one of the company forms listed in Annex I;
- it is subject to one of the corporate taxes listed in Annex II or to a similar tax subsequently introduced;
- it belongs to a consolidated group for financial accounting purposes with a total consolidated group revenue that exceeded EUR 750 million during the financial year preceding the relevant financial year;
- it qualifies as a parent company or qualifying subsidiary as referred to in article 5 of this Directive and/or it has one or more permanent establishments as referred to in article 5 of Directive 2016/xx/EU.

Article 2 of both proposals defines a qualifying subsidiary as every immediate and lower-tier subsidiary in which the parent company holds the following rights:

- it has a right to exercise more than 50 % of the voting rights; and
- it has an ownership right amounting to more than 75 % of the subsidiary's capital or owns more than 75 % of the rights giving entitlement to profit.

19. See http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm, accessed 5 August 2016.

20. Proposal for a Council Directive on a Common Corporate Tax Base {SWD(2016) 341} {SWD(2016) 342}, Strasbourg, 25 October 2016 COM(2016) 685 final 2016/0337 (CNS), https://ec.europa.eu/taxation_customs/sites/taxation/files/com_2016_685_en.pdf.

1.2.2. Home State taxation

Home State taxation implies that a multinational group would be able to opt for calculation of the taxable profits for all its EU operations according to the tax rules of the Member State where its headquarters are based (its Home State) and is based on ideas developed by Lodin and Gammie.^[21] Up until the time of writing (28 November 2016), this initiative has not been successful.

1.2.3. Impact of C(C)CTB

Studies by, inter alia, the Centraal Planbureau (CPB)^[22] (a research institute that carries out independent economic analyses relevant for policymaking in the Netherlands) (published in 2007), as well as by Oestreicher and Koch,^[23] and by Bettendorf, Devereux, Loretz and Van der Horst (published in 2011), show that a CCCTB would reduce the total tax revenue of the EU Member States and that it is unlikely that it will bring significant benefits to the European Union in aggregate, in terms of employment, GDP or efficiency. According to Deloitte's "Expert study on the corporate tax compliance costs for businesses going EU cross border – comparison under the current regime,^[24] the CCTB and the CCCTB regime", p. 9, a CCTB would slightly reduce time spent on tax compliance whereas a CCCTB would imply a significant reduction. The study of the CPB, "The economic effects of EU-reforms in corporate income tax systems" indicates that both CCTB and CCCTB would reduce administrative costs, though significantly more under a CCCTB. This study also shows that a CCCTB is to be preferred above a CCTB and that an optional CCTB is better than a mandatory CCTB.

For its 2016 C(C)CTB proposals, the European Commission asked the Joint Research Centre (JRC) of the European Commission and the Centre for European Economic Research (*Zentrum für Europäische Wirtschaftsforschung*, ZEW), for an impact assessment with as main focus a CCCTB.

The CORTAX study provided by the JRC of the European Commission is a general equilibrium model designed to evaluate the effects of corporate tax reforms in 28 EU countries, using detailed data from various data sources.^[25]

The study by the ZEW on the effects of tax reforms on addressing the debt-equity bias on the cost of capital and effective tax rates,^[26] focuses on the current extent of the corporate debt bias in tax systems of the 28 EU Member States and analyses whether different reform options could in principle manage to address the debt bias and promote investment.

The study by the ZEW derives average and marginal effective tax rates that incorporate the possibility of sophisticated tax planning strategies by multinational companies, including the use of preferential tax regimes.

The conclusions of the European Commission based on these impact studies are as follows:

-
21. S.O. Lodin, M. Gammie & C. Spengel, *Home State Taxation* (IBFD 2001), Online Books IBFD.
 22. See http://ec.europa.eu/taxation_customs/taxation/company_tax/transfer_pricing/forum/index_en.htm#jan2011.
 23. A. Oestreicher & R. Koch, *The Revenue Consequences of Using a Common Consolidated Corporate Tax Base To Determine Taxable Income in the EU Member States*, FinanzArchiv, Public Finance Analysis, Vol. 67, March 2011, pp. 64–102; L. Bettendorf et al., *Corporate tax reform in the EU: Weighing the pros and cons*; available at: <http://www.voxeu.org/index.php?q=node/6248>.
 24. See https://ec.europa.eu/taxation_customs/sites/taxation/files/docs/body/deloitte.pdf.
 25. Joint Research Center of the European Commission – IPTS, Modelling corporate tax reform in the EU: New calibration and simulations with the CORTAX model, Taxation Papers Taxation and Customs Union WORKING PAPER N. 66 – 2016, https://ec.europa.eu/taxation_customs/sites/taxation/files/taxation_paper_66.pdf.
 26. Centre for European Economic Research (ZEW), *The Effects of Tax Reforms to Address the Debt-Equity Bias on the Cost of Capital and on Effective Tax Rates*, Taxation Papers Taxation and Customs Union working paper 65 – 2016, https://ec.europa.eu/taxation_customs/sites/taxation/files/taxation_paper_65.pdf.

Valuing the different options has led to a preferred option: a CCCTB mandatory for large companies, equipped with an 'Allowance for Growth and Investment' and with an allowance for R&D expenses. The Allowance for Growth and Investment grants deductions for financing costs for debt and equity within limits to avoid abuses and tax planning. The allowance for R&D expenses is designed to at least maintain existing R&D tax incentives. The analysis shows that the CCCTB has clear advantages over the alternative which would involve taking no action.

Implementing the preferred choice is expected to increase the fairness of tax systems and create a level-playing field as a result of effectively removing incentives for aggressive tax planning in the EU. This would facilitate to ensure that corporations pay their fair share of the tax burden and enhance taxpayer morale. Furthermore, cross-border tax obstacles would be effectively eliminated within the EU. The distortions in the financing decisions of companies are reduced with an Allowance for Growth and Investment, which puts equity and debt financing on similar footing. R&D tax incentives are not only maintained but also enhanced and streamlined.

The expected economic benefits of the proposal are positive. The common consolidated tax base with an Allowance for Growth and Investment would lead to an increase in investment and employment of up to 3.4% and 0.6%, respectively. Overall, growth would increase by up to 1.2%. Compliance costs are expected to decrease (10% in compliance time and 2.5% in compliance costs). The cost of setting up a subsidiary would decrease by up to 67%, making it easier for companies (including SMEs) to go abroad.

There are no relevant environmental impacts expected from the preferred option. Social impacts will also be limited

...

Estimated compliance costs for large companies amount to about 2% of taxes paid, while for SMEs the estimate was about 30% of taxes paid. Compliance costs are estimated to increase with cross-border activity and with the proliferation in the numbers of subsidiaries. Tax reform data show that numerous CIT reforms took place after the crisis and many measures were directed at reinforcing the international anti-abuse framework. In the light of this, the reduction of compliance costs when setting up an additional subsidiary remains a major advantage: Time costs for setting up a new subsidiary in a Member State are estimated to decrease by 62-67%. Focussing on recurring costs, i.e. ignoring one-off switching costs, the Impact Assessment estimates a decrease in time spent on compliance activities by 8% after implementation of the CCCTB. Based on these time reductions, one could endeavour a rough calculation of the order of total cost savings that would result under the CCCTB. If 5% of medium-sized companies expand abroad, a one-off cost saving of around EUR 1 billion could be expected. If all multinational entities apply the CCCTB recurring compliance costs could go down by about EUR 0.8 billion.

Tax administrations will benefit from reduced dealings with transfer pricing issues and a reduced number of cases to the extent that the tax affairs of a company group is mainly dealt with by the administration of the Member State where the parent resides. On the other side, as long as the CCCTB is not made mandatory for all firms, national administrations will experience additional compliance costs due to the required maintenance of two parallel systems

...

To meet the objective of enhancing the fairness of the tax system in a proportionate manner, the preferred option for the CCCTB suggest to make it compulsory only for a subset of firms, based on their size. Thus, micro-enterprises as well as SMEs are exempted from the mandatory application of the CCCTB. Limiting the compulsory application to groups with a consolidated turnover above EUR 750 million serves the purpose of capturing the vast majority (ca. 64%) of turnover generated by groups while limiting the risk of including purely domestic groups. The threshold is coherent with the approach taken in other EU initiatives to counter tax avoidance. At the same time, the proposal offers those companies, for which the application of the CCCTB is not compulsory, the possibility to "opt-in" to the CCCTB system. This allows for a maximum of flexibility for SMEs and micro-enterprises, offering to benefit from the advantages of a CCCTB without making it compulsory for this set of companies^[27].

The positive effect of a CCCTB can be explained not only because of a common tax base implying reduction of administrative costs, but a CCCTB can also facilitate and induce business restructuring. An important result, if CCCTB taxation was to become obligatory, is that transfer pricing problems (within the European Union) would be solved, which would be beneficial for both companies and tax administrations. If the CCCTB was to become optional, of course only the transfer pricing problems within the European Union of opting-in companies would disappear. Moreover, instead of using transfer pricing as a tool for lowering their effective tax burden, companies might seek for tax avoidance by organizing their business in such way that the weight of the factors included in the formula is towards Member States with low tax rates, thus reducing welfare in the European Union. Furthermore, if the apportionment was to be based on a single production factor, this would provide incentives for reallocating production. Low-tax countries would then be attractive as production location. The warning of Oestreicher and Koch^[28] that the number of employees should not be included in the apportionment formula, as this would allow for differences in productivity, to be taken into account is also worth mentioning.

Bettendorf, Devereux, Loretz and Van der Horst^[29] suggest that the economic benefits of a CCCTB would be far greater if tax rates were also harmonized and the tax base would include an allowance for corporate equity.

For businesses, a positive effect of the CCTB proposal, besides a common tax base, is that it provides for temporary horizontal loss compensation between group members.

1.3. Impact of proposals of the EU Joint Transfer Pricing Forum on business restructuring

Some (informal) steps towards harmonization have also been taken by the European Joint Transfer Pricing Forum. The European Commission has appointed 16 private sector tax experts as well as a chairman of the Forum. Together with representatives of the tax authorities of each of the Member States, the business experts have the task of considering ways of reducing the high compliance costs and eliminating the double taxation that often arises in the case of cross-border intergroup transactions

27. Proposal for a Council Directive on a Common Consolidated Corporate Tax Base, (CCCTB), Strasbourg, 25 October 2016 COM(2016) 683 final 2016/0336 (CNS), http://ec.europa.eu/taxation_customs/sites/taxation/files/com_2016_683_en.pdf, p. 8.

28. See *supra* n. 23.

29. See *supra* n. 23.

due to disagreements both between companies and tax authorities, and between national tax authorities with regard to the pricing of the transactions. ^[30]

Up until the time of writing, the EU Joint Transfer Pricing Forum mainly concentrated on documentation requirements, improving the functioning of the Arbitration Convention, low-value-adding intra-group services and potential approaches to non-EU triangular cases. The 2015 - 2019 agenda of the Forum covers (i) the use of comparables in the EU, (ii) the use of the transactional profit split method (PSM) in the EU, (iii) the use of economic valuation methods in the EU, (iv) CCAs in general (including intangibles), (v) efficient transfer pricing administration in the EU, and (vi) the dispute resolution.^[31] As part of this work, the following reports were adopted:

- “Cost Contribution Arrangements on Services Not Creating Intangibles” (June 2012);
- “Secondary Adjustments” (January 2013);
- “Compensating Adjustments” (January 2014); and
- “Improving the Functioning of the Arbitration Convention” (April 2015).

1.4. Resolution on coordinating exit taxation 29 November 2008

Many Member States of origin are afraid of losing taxation rights on the income accrued in their jurisdiction and so they tax accrued but unrealized capital gains not only at the time of a transfer of the place of residence, but also at the moment of transfer of the individual assets or the place of residence by the taxpayer or to another Member State.

As the result of a body of ECJ case law developed over the last decade (*X and Y* (Case C-436/00), *Lasteyrie du Saillant* (Case C-9/02), *N* (Case C-470/04), *National Grid Indus* (Case C-371/10) and *Commission v. Spain*; for further discussion of the latter two cases, see sections 2.2.4. and 2.3.) it is now clear that Member States are not allowed to immediately tax latent capital gains on assets transferred to another Member State if such taxation does not occur in similar domestic situations, nor to tax the gain but postpone payment through a bank guarantee or the obligation to appoint a fiscal representative that would guarantee payment of the tax upon realization. However, assessing the income at the time of the transfer is allowed if collection is postponed until the moment of actual realization without further conditions. Due to differences in the tax systems of the Member States, double taxation or double non-taxation may result. Double taxation arises if the exit state calculates the capital gain at the moment of the transfer of the asset or the place of residence and the entrance state taxes the entire capital gain from acquisition up until disposal, or if valuation methods differ. Similarly, non-taxation may be the result if the exit state refrains from taxing the capital gain accumulated from acquisition up until transfer and the entrance state taxes the capital gain from the transfer up until the moment of disposal, or if valuation methods differ.

In order to mitigate this effect, the Council of the European Union adopted a Resolution on coordinating exit taxation on 29 November 2008, containing the following guiding principles:

- if the exit state reserves the option to exercise its taxing rights on the reserves made ^[32] and to take back in full or in part the provisions made, ^[33] the host state may provide for the creation of

30. See <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/02/1105&format=HTML&aged=0&language=EN&guiLanguage=en>.

31. See http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/transfer_pricing/forum/jtpf0052015programmeofwork.pdf, accessed 5 August 2016.

32. Profits realized but not yet taken into account for tax purposes.

reserves or provisions of identical or different amounts, in accordance with the rules governing the tax base in that state, and allow deduction from taxable results for the year in which they were established; and

- if the exit state reserves the option to exercise its taxing rights on the unrealized gains corresponding to the assets held by the taxpayer, the host state takes the market value on the transfer date when calculating the subsequent added value in the event of disposal.

As to the Communication in case of disagreement regarding the market value of the assets on the transfer date, this should be settled by mutual agreement. Moreover, the entrance state should assist the exit state in particular for the purposes of determining the disposal date. The Mutual Assistance Directive and the OECD Council of Europe Convention on Mutual Administrative Assistance in Tax Matters provide for such procedure. If agreement is not reached, the Arbitration Convention and several bilateral income tax treaties provide for an arbitration procedure. The Exchange of Information Directive provides for the possibility to provide information spontaneously, automatically or upon request.

1.5. Anti-Avoidance Tax Directive (ATAD)

On 21 June 2016, the Council of the European Union agreed on a draft directive addressing tax avoidance practices commonly used by large companies. The directive is part of a January 2016 package of European Commission proposals to strengthen rules against corporate tax avoidance. The package builds on the 2015 OECD recommendations to address tax base erosion and profit shifting (BEPS).

The ATAD includes, among others, exit rules.^[34] Exit taxes have the function of ensuring that where a taxpayer moves assets or its tax residence out of the tax jurisdiction of a Member State, that State taxes the economic value of any capital gain created in its territory even though this gain has not yet been realized at the time of the exit. Article 5 of the ATAD states that a taxpayer is subject to tax when:

- a taxpayer transfers assets from its head office to its permanent establishment in another Member State or in a third country in so far as the Member State of the head office no longer has the right to tax the transferred assets due to the transfer;
- a taxpayer transfers assets from its permanent establishment in a Member State to its head office or another permanent establishment in another Member State or in a third country in so far as the Member State of the permanent establishment no longer has the right to tax the transferred assets due to the transfer;
- a taxpayer transfers its tax residence to another Member State or to a third country, except for those assets which remain effectively connected with a permanent establishment in the first Member State;
- a taxpayer transfers the business carried on by its permanent establishment from a Member State to another Member State or to a third country in so far as the Member State of the permanent establishment no longer has the right to tax the transferred assets due to the transfer.

Payment of the exit tax can be deferred in the following circumstances:^[35]

33. Expenditure not yet incurred but already taken into account for tax purposes.

34. See <http://data.consilium.europa.eu/doc/document/ST-10426-2016-INIT/en/pdf>, accessed 5 August 2016.

35. Article 5, paragraph 2 of the ATAD.

- a taxpayer transfers assets from its head office to its permanent establishment in another Member State or in a third country that is party to the European Economic Area Agreement (EEA Agreement);
- a taxpayer transfers assets from its permanent establishment in a Member State to its head office or another permanent establishment in another Member State or a third country that is party to the EEA Agreement;
- a taxpayer transfers its tax residence to another Member State or to a third country that is party to the EEA Agreement;
- a taxpayer transfers the business carried on by its permanent establishment to another Member State or a third country that is party to the EEA Agreement.

The taxpayer can defer the payment of exit tax in instalments of 5 years. The Member States will have until 31 December 2018 to transpose the directive into their national laws and regulations, except for the exit taxation rules, for which they will have until 31 December 2019.^[36]

2. Impact of Case Law on Business Restructuring

2.1. General

The first cases of the ECJ concerning discrimination and direct taxation were concluded in the 1980s. These cases had a major impact on the tax laws of the Member States. Some of the judgments concern parent-subsidiary relations and are of relevance for decisions on cross-border business restructuring, as they, for instance, make cross-border loss relief possible ^[37] or prevent the imposition of dividend withholding tax ^[38] or exit taxes. ^[39] Others concern permanent establishment–head office relations ^[40] and/or make possible the application of tax treaties to permanent establishments ^[41] or prevent a distinction in tax rates.

The ECJ stresses in these decisions that one of the principles of EC law is that companies have the right to freely choose their legal form. Illustrative is the decision in *CLT-UFA* (Case C-253/03) (see section 2.2.). ^[42] However, this does not seem to imply that the ECJ is of the opinion that a permanent establishment and a subsidiary should be treated equally, as is shown in the ECJ's 2006 decision in *FCE* (Case C-210/04) (see section 2.3.). ^[43] The latter case may also provide some input in the discussion of the extent to which the principles discussed in Chapter IX of the 2010 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2010 OECD Guidelines) are applicable in permanent establishment situations. Guidance on the issue is lacking as paragraph 9.2 of

36. See <http://www.consilium.europa.eu/en/press/press-releases/2016/06/21-corporate-tax-avoidance/>, accessed 5 August 2016.

37. UK: ECJ, 13 Dec. 2005, Case C-446/03, *Marks & Spencer plc v. David Halsey (Her Majesty's Inspector of Taxes)*, ECJ Case Law IBFD; FI: ECJ, 18 July 2007, Case C-231/05, *Oy AA*, ECJ Case Law IBFD; preliminary rulings on the Dutch fiscal unity rules not allowing cross-border relief were requested by the Supreme Court of the Netherlands in its decision of 11 July 2008, 43 484, V-N 2008/34.14. This preliminary question referred to the ECJ asks whether the fiscal unity is in line with article 43 of the TFEU now that it can only be entered into by companies with an effective place of management in the Netherlands.

38. FI: ECJ, 7 Sept. 2004, Case C-319/02, *Petri Manninen*, ECJ Case Law IBFD; NO: ECJ, 23 Nov. 2004, Case E-1/04, *Fokus Bank ASA v. The Norwegian State*, ECJ Case Law IBFD.

39. *Lasteyrie du Saillant* (C-364/01); ECJ, C-470/04, *N* (C-470/04).

40. LU: ECJ, 15 May 1997, Case C-250/95, *Futura Participations SA and Singer v. Administration des contributions*, ECJ Case Law IBFD; BE: ECJ, 14 Dec. 2000, Case C-141/99, *Algemene Maatschappij voor Investering en Dienstverlening NV (AMID) v. Belgische Staat*, ECJ Case Law IBFD.

41. DE: ECJ, 21 Sept. 1999, Case C-307/97, *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v. Finanzamt Aachen-Innenstadt*, ECJ Case Law IBFD.

42. DE: ECJ, 23 Feb. 2006, Case C-253/03, *CLT-UFA SA v. Finanzamt Köln-West*, ECJ Case Law IBFD.

43. IT: ECJ, 23 Mar. 2006, Case C-210/04, *Ministero dell'Economia e delle Finanze (Ministry of Economic Affairs and Finance) and Agenzia delle Entrate (Revenue Agency) v. FCE Bank plc*, ECJ Case Law IBFD.

Chapter IX of the [2010 OECD Guidelines](#) explicitly states that the chapter does not cover the attribution of profits within a single enterprise on the basis of article 7 of the OECD Model Tax Convention on Income and on Capital (OECD Model 2010).

2.2. Preliminary questions

An overview is provided below of cases in which taxpayers referred preliminary questions to the ECJ concerning business restructuring-related issues that are relevant for the taxation of permanent establishments.

2.2.1. *CLT-UFA*: Refusal to apply reduced German corporate income tax rate to branches allowed?

CLT, a public company having its seat and effective place of management in Luxembourg, carried on activities in Germany through a permanent establishment. In the financial year at issue, Germany applied a full imputation system with split-rate and levied tax at a rate of 42% on permanent establishment profits, whereas the tax rate charged on a subsidiary reinvesting the profits would be 45% and that of a subsidiary fully distributing its profits to the parent company would be 30%. In the latter case, the parent company would be taxed at a rate of 5% and thus the overall tax rate would be 33.5%. The ECJ concluded that this difference contradicted article 52 of the EC Treaty (now article 43 of the TFEU) and article 58 of the EC Treaty (now article 48 of the TFEU), as this difference in treatment restricts the freedom to choose the appropriate legal form in which to pursue activities in another Member State. Highlights of relevant paragraphs of the decision are quoted below:

2. It is for the national court to determine the tax rate which must be applied to the profits made by a branch, such as the one in dispute in the main proceedings, by reference to the overall tax rate which would have been applicable if the profits of a subsidiary had been distributed to its parent company.

14. The second sentence of the first paragraph of Article 52 expressly leaves traders free to choose the appropriate legal form in which to pursue their activities in another Member State and that freedom of choice must not be limited by discriminatory tax provisions (*Commission v. France*, paragraph 22).

15. Therefore, the freedom to choose the appropriate legal form in which to pursue activities in another Member State primarily serves to allow companies having their seat in a Member State to open a branch in another Member State in order to pursue their activities under the same conditions as those which apply to subsidiaries.

17. It follows from the above that the refusal to apply the reduced tax rate to branches renders the possibility, for companies having their seat in another Member State, of exercising the right to freedom of establishment through a branch less attractive. It follows that a national law such as the one in dispute in the main proceedings restricts the freedom to choose the appropriate legal form in which to pursue activities in another Member State.

23. In both cases the profits are made available to the company which controls the subsidiary and the branch respectively. The only real difference between the two situations lies in the fact that the distribution of the profits of a subsidiary to its parent company presupposes the existence of a

formal decision to that effect, whereas the profits of a branch of a company are part of the assets of that company even in the absence of a formal decision to that effect.

24. In addition, it is apparent from the decision to refer and the observations of the Finanzamt and the German Government that, even if the profits distributed by a subsidiary to its parent company were no longer part of the assets of that subsidiary, those profits could still be made available to that subsidiary by its parent company in the form of share capital or a shareholder loan.

25. Therefore, the fact that profits distributed by a subsidiary to its parent company are no longer part of that subsidiary's assets does not justify the application of a tax rate to the profits of such a subsidiary which is lower than that applied to the same profits made by a branch.

29. In the light of the information provided by the Bundesfinanzhof in its decision to refer, it appears, furthermore, that the national legislation on the manner of determining the taxable amount does not draw a distinction between companies with their seat in another Member State, according to whether they pursue their activities through a branch or a subsidiary, which is capable of justifying a difference in treatment between the two categories of companies.

30. In those circumstances, it seems that German subsidiaries and branches of companies having their seat in Luxembourg are in a situation in which they can be compared objectively.

2.2.2. FCE Bank case: Services provided by branch to head office VAT taxable transaction?

Although concerning VAT instead of direct taxation, the ECJ decision in the *FCE Bank* case ^[44] is nevertheless of relevance in the discussion of whether or not a distinction should be made in treatment of business restructuring issues involving permanent establishments or involving subsidiaries. In this case, the Court considered the question of whether FCE IT, a subordinate entity not having legal personality situated in Italy of a UK-resident bank (FCE Bank) could claim repayment of VAT charged on services provided by FCE Bank in the form of consultancy, management, staff training, data processing and the supply and management of application software. The Italian *Corte di Cassazione* referred the following questions for a preliminary ruling:

Must Articles 2(1) and 9(1) of the Sixth Directive be interpreted as meaning that the branch of a company established in another State (belonging to the European Union or otherwise), which has the characteristics of a production unit, may be regarded as an independent person and thus that a legal relationship between the entities can be said to exist with consequent liability for VAT in relation to supplies of services effected by the parent company? Can the "arm's length" standard laid down in Article 7(2) and (3) of the OECD Model and the Convention of 21 October 1988 between Italy and the United Kingdom of Great Britain and Northern Ireland be used to define that relationship? Can a legal relationship be said to exist where there is a cost-sharing agreement concerning the supply of services to the subordinate entity? If so, what conditions must be satisfied for such relationship to be considered to exist? Must the notion of legal relationship be dealt with under national law or Community law? ^[45]

44. C-210/04 (23 Mar. 2006).

45. Id., at para. 20.

The ECJ pointed out the following differences between a branch and a subsidiary:

- a branch does not bear the economic risk arising from its business;
- a branch does not have its own endowment capital; and
- a cost sharing agreement concerning the supply of services is irrelevant because such an agreement was not negotiated between independent parties.

The Court ruled as follows:

34. In that regard, according to the case-law of the Court, a provision of services is taxable only if there exists between the service provider and the recipient a legal relationship in which there is a reciprocal performance (see Case C-16/93 *Toisma* [1994] ECR I-743, paragraph 14, and Case C-174/00 *Kennemer Golf* [2002] ECR I-3293, paragraph 39).

35. To establish whether such a legal relationship exists between a non-resident company and one of its branches so that the supplies made may be subject to VAT, it is necessary to determine whether FCE IT carries out an independent economic activity. It is necessary in that regard to determine whether a branch such as FCE IT may be regarded as being an independent bank, in particular in that it bears the economic risk arising from its business.

36. As Advocate General Léger noted in point 46 of his Opinion, the branch does not itself bear the economic risks associated with carrying on the business of a credit institution, such as, for example, a customer defaulting on the repayment of a loan. The bank, as a legal person, bears that risk and is therefore the subject of supervision of its financial strength and solvency in the Member State of origin.

37. As a branch, FCE IT does not have any endowment capital. Consequently, the risk associated with the economic activity lies wholly with the FCE Bank. Consequently, FCE IT is dependent upon that company and, with it, constitutes a single taxable person.

38. That finding is not undermined by Article 9(1) of the Sixth Directive. That provision concerns the determination of the taxable person in transactions between a branch and third parties. It is therefore irrelevant for the purposes of the present case which concerns transactions between a company resident in a Member State and one of its branches established in another Member State.

39. It should be noted that the OECD Convention is irrelevant since it concerns direct taxation whereas VAT is an indirect tax.

40. Lastly, any agreement on the sharing of costs is also irrelevant for present purposes since such an agreement was not negotiated between independent parties.

41. In the light of the foregoing, the answer to the first question must be that Articles 2(1) and 9(1) of the Sixth Directive are to be interpreted as meaning that a fixed establishment, which is not a legal entity distinct from the company of which it forms part, established in another Member State and to which the company supplies services, should not be treated as a taxable person by reason of the costs imputed to it in respect of those supplies.

2.2.3. The SGI case: Belgian domestic profit adjusting rules allowed?

Interesting in this respect is the SGI case (Case C-311/08). The case, concerning the interpretation of the Belgian transfer pricing rules, is also of relevance for other transfer pricing legislation especially in such as the German transfer pricing rules. See also Issues Note 4 of the OECD BR Report.

The ECJ gave its decision in SGI on 21 January 2010; the Belgian Court of First Instance (*Tribunal de Première Instance*) of Mons had requested a preliminary ruling from the ECJ on 14 June 2008.

SGI was a holding company incorporated under Belgian law and active in the metallurgical industry. It owned a 65% participation in Recydem SA, a French company, and was a member of the management board of that company. A Luxembourg company, SA Cobelpin, was a member of the management board of SGI and owned a 34% participation in SGI. For the 2001 and 2002 tax years, the Belgian tax authorities made an upward adjustment of EUR 46,897 to SGI's profits for deemed interest on an interest-free loan granted to Recydem. The referring court observed that there was no economic reason for granting the loan: while Recydem had generated profits in the relevant period, SGI itself had substantial debts. In addition, the tax administration denied SGI a deduction of management fees of EUR 8,676 paid to Cobelpin, arguing that these were not at arm's length.

Under article 26 of the Belgian Income Tax Act (ITA), applicable at the material time, exceptional or gratuitous advantages granted to a related party are generally included in the tax base of the resident recipient. However, where the recipient is a non-resident related party, the value of such advantages is included in the tax base of the Belgian company granting those advantages, and taxed accordingly. The issue was whether or not the provision of the ITA at issue was compatible with articles 12 (non-discrimination), 43 (freedom of establishment) and 56 (free movement of capital) of the EC Treaty.

The ECJ held that articles 43 and 48 of the EC Treaty must be interpreted as not precluding, in principle, legislation of a Member State, under which a resident company is taxed in respect of an unusual or gratuitous advantage where the advantage has been granted to a company established in another Member State with which it has, directly or indirectly, a relationship of interdependence, whereas a resident company cannot be taxed on such an advantage where the advantage has been granted to another resident company with which it has such a relationship. Furthermore, the ECJ held that it is for the referring court to verify whether the legislation at issue goes beyond what is necessary to attain the objectives pursued by the legislation, taken together. So the ECJ ruled that:

- the rules do not violate the freedom of establishment; and
- the restriction caused by them can be justified by overriding reasons in the public interest (balanced allocation of tax powers between the Member States and the prevention of tax avoidance).

In order to be compliant with EC law, the ECJ requires that:

- such measures are only applied if the transfer prices actually are not at arm's length;
- the taxpayer is given an opportunity to provide – without undue administrative constraints – evidence of any commercial justification that there may have been for that transaction; and
- the corrective measure is confined to the part which exceeds what would have been agreed between third parties.

The meaning of the decision in *SGI* for the application of section 1 of the Foreign Tax Code (*Aussensteuergesetz*, AStG) has been discussed in German literature. General rules regarding the determination of arm's length transfer prices are included in section 1 of the AStG. Section 1 establishes a priority of transfer pricing methods, revealing a preference for the comparable uncontrolled price method, the cost-plus method and the resale minus method over other transfer pricing methods. ^[46] For more information, see the chapter on Germany.

2.2.4. National Grid Indus case: Exit charge allowed?

The ECJ issued its decision in *National Grid Indus* on 29 November 2011.

The case involved a private limited liability company which, up until 15 December 2000, had its place of effective management in the Netherlands. Since 1996, this company held a receivable of GBP 33,113,000 on a group company resident in the United Kingdom. On 15 December 2000, the deferred foreign exchange profit amounted to more than NLG 22 million as a result of a rise in the exchange rate of the British pound against the Dutch guilder. On that same date, the company relocated its effective management to the United Kingdom. Based on the tax treaty concluded between both countries, the company was regarded as a British resident company after the relocation of the real seat. Because the company was no longer resident in nor had a permanent establishment in the Netherlands after this relocation, the right to tax the profit generated by the company's business operations was, pursuant to the tax treaty, allocated exclusively to the United Kingdom.

It consequently ceased to obtain profits taxable in the Netherlands, so that, under Dutch legislation, a final settlement of the unrealized capital gains existing at the time of the transfer of the place of management was drawn up by the Dutch tax authorities, who demanded immediate payment of the tax.

National Grid Indus contested that decision, claiming that it was contrary to the principle of freedom of establishment. The *Gerechtshof Amsterdam* (Regional Court of Appeal, Amsterdam, the Netherlands), which was hearing the case, decided to refer the question to the ECJ.

In its judgment of 29 November 2011, the ECJ began by confirming that National Grid Indus may rely in this case on freedom of establishment in order to challenge the decision of the Dutch tax authorities. In reaching this conclusion, the ECJ attached relevance to the fact that the relocation of the company's effective management did not affect its status as a company incorporated under Dutch law.

Next, the Court found that a company incorporated under Dutch law wishing to transfer its place of effective business outside the Netherlands suffers a disadvantage in terms of cash flow compared to a similar company keeping its place of management in the Netherlands. Under the national legislation, the transfer of a Dutch company's place of management to another Member State entails the immediate taxation of the unrealized capital gains relating to the assets transferred, whereas such capital gains are not taxed when a Dutch company transfers its place of management within Dutch territory.

The ECJ also concluded that imposing an exit tax may be justified by the need to ensure a balanced allocation of taxing rights between Member States. However, the ECJ noted that the proportionality of the Dutch exit tax should be reviewed in order to determine the compatibility of such a measure with EU law.

46. See e.g. O. Thömmes, *Gewinnkorrektur bei Vorteilsgewährung an verbundene Unternehmen im EU-Ausland: kein grundsätzlicher Verstoß gegen Niederlassungsfreiheit*, in *IWB*, Herne (2010), No. 3, pp. 107-112, and O. Thömmes, *Gewinnkorrektur bei Vorteilsgewährung an verbundene Unternehmen im EU-Ausland*, in *IWB*, Herne (2009), No. 19, pp. 965-972; Fach 11a (*Rechtsprechung*), pp. 1261-1268.

The ECJ concluded that legislation of a Member State that prescribes the immediate recovery of tax on unrealized capital gains relating to assets of a company transferring its place of effective management to another Member State at the very time of that transfer is disproportionate. ^[47] However, in case the nature and extent of the company's assets would not cause a disproportionate administrative burden of cross-border tracing of these assets, the ECJ considers it proportionate if Member States offer a company the choice between immediate payment – thus reducing the administrative burden – and deferred payment, possibly together with interest:

71. It thus cannot be ruled out that the administrative burden that would be entailed by the annual return suggested by the Commission, which would necessarily relate to every asset in respect of which a capital gain was established at the time of the transfer of the place of effective management of the company concerned, would give rise as such, for that company, to a hindrance to freedom of establishment that would not necessarily be any less harmful to that freedom than the immediate recovery of the tax debt corresponding to the capital gain.

72. In other situations, on the other hand, the nature and extent of the company's assets would make it easy to carry out a cross-border tracing of the individual assets for which a capital gain was ascertained at the time when the company transferred its place of effective management to another Member State.

73. In those circumstances, national legislation offering a company transferring its place of effective management to another Member State the choice between, first, immediate payment of the amount of tax, which creates a disadvantage for that company in terms of cash flow but frees it from subsequent administrative burdens, and, secondly, deferred payment of the amount of tax, possibly together with interest in accordance with the applicable national legislation, which necessarily involves an administrative burden for the company in connection with tracing the transferred assets, would constitute a measure which, while being appropriate for ensuring the balanced allocation of powers of taxation between the Member States, would be less harmful to freedom of establishment than the measure at issue in the main proceedings. If a company were to consider that the administrative burden in connection with deferred recovery was excessive, it could opt for immediate payment of the tax.

74. However, account should also be taken of the risk of non-recovery of the tax, which increases with the passage of time. That risk may be taken into account by the Member State in question, in its national legislation applicable to deferred payments of tax debts, by measures such as the provision of a bank guarantee.

In order to make the income tax and corporate income tax EU-proof, the Secretary of State for Finance issued Decree BLKB 2011/2477M, Stcrt. 2011, 23186 on 14 December 2011, in which he offers the taxpayers the choice between immediate payment and deferred payment with interest.

In his annotation to this case in FED 2012/262, J.J. van den Broek correctly argues, in the present authors' view, that this rule results in discriminatory treatment since companies that transfer their place of effective management within a country do not need to pay interest. Moreover, it is submitted, the ECJ's decision leaves some leeway as regards the interpretation of the phrase "possibly together

47. B. Terra & J. Kajus, Judgment in Case C-371/10 (*National Grid Indus BV*) – Charging of tax on unrealised capital gains (5 Dec. 2011), News IBFD.

with interest in accordance with the applicable national legislation". Such interest may indeed not be proportionate under all circumstances (e.g. small and medium-sized enterprises).

Nevertheless, on 15 May 2012, the Dutch State Secretary for Finance submitted a Bill to the parliament on the deferral of the payment of exit taxes as replacement for the Decree of 14 December 2011. This Bill implements the judgment in *National Grid Indus*, in which the ECJ held that the Dutch exit tax provisions for companies were disproportionate because they provided for the immediate recovery at the time of transfer of tax on unrealized capital gains relating to assets of a company transferring its place of effective management to another Member State, without granting the option of a tax deferral.

On 23 November 2012, the Dutch State Secretary for Finance submitted an amendment to the Bill on the deferral of the payment of exit taxes. On 4 December 2012, the Lower House (Tweede Kamer) of the parliament of the Netherlands approved the Bill on the deferral of the payment of exit taxes. The Bill was submitted to the parliament on 15 May 2012. On 7 May 2013, the Upper House (*Eerste Kamer*) of the parliament approved the Bill on the deferral of the payment of exit taxes.

Bill 33262 (published in the Official Gazette 2013, 183 and effective as of 15 May 2013) has retroactive effect to 29 November 2011.

The Bill provides that, at the request of a debtor who is resident or established in a Member State of the European Union or a state party to the Agreement on the European Economic Area, deferral of payment will be granted – provided that sufficient security has been given – for tax assessments, in that it includes corporation tax or personal income tax relating to benefits in respect of assets taken into account in determining the tax liability of the debtor, while these benefits would not have been taken into account for corporate and/or personal income tax purposes when the taxpayer would have remained taxable in the Netherlands. Deferral will be provided only if the requirements of a Ministerial Decree on the issue (at the time of writing not yet published) are fulfilled.

The Bill also provides for when the tax deferral will be terminated. This is the case when (i) the taxpayer no longer resides in a Member State of the European Union or in a state that is a party to the Agreement on the European Economic Area, (ii) in case the requirements of Ministerial guidance are not met, (iii) in case no security is provided by the taxpayer and (iv) insofar as the benefits in respect of the assets referred to above would be taken into account at the level of the taxpayer if he would have been taxable in the Netherlands.

At the request of the taxpayer, the exit tax due may be paid in 10 instalments.

See section 2.3. for the opinion of Advocate-General Mengozzi in a similar case concerning the Portuguese exit tax (*Commission v. Portugal* (Case C-38/10)).

2.2.5. Verder LabTec GmbH & Co. KG v. Finanzamt Hilden

On 21 May 2015, the ECJ gave its decision in the case of *Verder LabTec* (Case C-657/13). The facts of the case were as follows.^[48] The taxpayer, a German limited partnership, mainly dealt with the administration of its own patent, trademark and utility model rights. In 2005, the taxpayer transferred those rights to its Dutch permanent establishment. The tax authorities took the position that the transfer of the intellectual property rights was to take place with disclosure of any hidden reserves at their arm's length value at the time of the transfer. Both the tax authorities and the taxpayer agreed on the value of

48. See European Union; Germany; Netherlands - ECJ Advocate General's Opinion: *Verder LabTec* (Case C-657/13) – Exit taxation – details (6 March 2015), News IBFD and DE: ECJ, 21 May 2015, Case C-657/13, *Verder LabTec GmbH & Co. KG v. Finanzamt Hilden*, ECJ Case Law IBFD.

the hidden reserves, and acknowledged that this amount was not to be immediately subject to taxation. The amount was to be neutralized for reasons of equity by a nominal figure of the same amount, which was then to be amortized, with a profit increase, on a straight line basis over a period of 10 years. The tax authorities, thus, deferred the collection on equitable grounds by spreading the hidden reserves over 10 years. The taxpayer unsuccessfully appealed against the corresponding assessment. The ECJ reasoned in paragraphs 47-53:^[49]

47 Accordingly, the disclosure of unrealised capital gains relating to those transferred assets generated prior to that transfer within the tax jurisdiction of the Federal Republic of Germany, and the taxation of those unrealised capital gains, is intended to ensure the taxation of those unrealised capital gains, generated within the tax jurisdiction of the Federal Republic of Germany. The taxation of income relating to those assets generated after such a transfer falls to the other Member State, in whose territory the permanent establishment is located. Accordingly, tax legislation such as that at issue in the main proceedings is appropriate for ensuring the preservation of the allocation of powers of taxation between the Member States concerned.

48 As regards the proportionality of the legislation at issue in the main proceedings, it should be noted, at the outset, that it is proportionate for a Member State, for the purpose of safeguarding the exercise of its powers of taxation, to determine the amount of the tax due on the unrealised capital gains that have been generated in its territory pertaining to the assets transferred outside its territory, at the time when its powers of taxation in respect of the assets concerned cease to exist, namely, in the present case, at the time of the transfer of the assets at issue outside the territory of that Member State (see, to that effect, judgments in *Commission v Spain*, C64/11, EU:C:2013:264, paragraph 31, and *DMC*, C164/12, EU:C:2014:20, paragraph 60 and the case-law cited).

49 As regards the recovery of such a tax, the Court has held that it was appropriate to give the taxable person the choice between, on the one hand, immediate payment of that tax, and, on the other hand, deferred payment of that tax, together with, if appropriate, interest in accordance with the applicable national legislation (judgment in *Commission v Germany*, C591/13, EU:C:2015:230, paragraph 67 and the case-law cited).

50 In that context, the Court further held that account should also be taken of the risk of non-recovery of the tax, which increases with the passage of time, which may be taken into account by the Member State in question, in its national legislation applicable to deferred payment of tax liabilities (see, to that effect, *National Grid Indus*, C371/10, EU:C:2011:785, paragraph 74).

51 In the present case, the question therefore arises whether a staggered recovery of the amount of tax at issue by 10 annual instalments may be a proportionate measure to attain the objective of preserving the allocation of taxation powers between the Member States.

52 In that regard, suffice it to note that recovery of tax on unrealised capital gains spread over five annual instalments, instead of immediate recovery, was considered to be a proportionate measure to attain that objective (judgment in *DMC*, C164/12, EU:C:2014:20, paragraph 64). A staggered recovery of tax on unrealised capital gains over 10 annual instalments, such as that at issue in the main proceedings, can only therefore be considered, as the Advocate General has observed in points 72 and 73 of his Opinion, as a proportionate measure to attain that objective.

49. See DE: ECJ, 21 May 2015, Case C-657/13, *Verder LabTec GmbH & Co. KG v. Finanzamt Hilden*, ECJ Case Law IBFD.

53 In the light of all the foregoing, the answer to the question referred is that Article 49 TFEU must be interpreted as not precluding tax legislation of a Member State, such as that at issue in the main proceedings, which, in the case of a transfer of assets from a company located within the territory of that Member State to a permanent establishment of that company located within the territory of another Member State, provides for the disclosure of unrealised capital gains pertaining to those assets which have been generated within the territory of that first Member State, the taxation of such capital gains and the staggered recovery of the tax relating to those gains over 10 annual instalments.

So the legislation of a Member State, which, in the case of a transfer of assets from a company located within the territory of that Member State to a permanent establishment of that company located within the territory of another Member State, provides for the disclosure of unrealised capital gains pertaining to those assets which have been generated within the territory of that first Member State and for the taxation of such capital gains and the staggered recovery of the tax relating to those gains over ten annual instalments, is compatible with the freedom of establishment.

2.2.6. No preliminary questions on transfer of assets and liabilities and emigration of individual taxpayers

At the time of writing, the ECJ has not yet issued a decision in any case concerning:

- a transfer of assets and liabilities from a permanent establishment to its head office or vice versa; or
- emigration of an entrepreneur, being an individual taxpayer, from one Member State to another Member State.

However, the European Commission adopted a Resolution on coordinating exit taxation (see section 1.4.) requesting, time and again, Member States to amend their legislation both in respect of exit taxes and transfer of assets (see section 2.3.).

On 12 May 2016, AG Wathelet of the Court of Justice of the European Union (ECJ) gave his Opinion in the case of *Commission v. Portugal* (Case C-503/14). On 11 November 2014, the Commission asked the ECJ to declare that Portugal has failed to fulfil its obligations under articles 21, 45 and 49 of the TFEU, and articles 28 and 31 of the EEA Agreement in adopting and maintaining in force legislation, in the form of articles 10 and 38 of the Law on the income tax of natural persons. AG Wathelet proposes that the Court should rule as follows: Portugal has failed to fulfil its obligations in adopting and maintaining in force legislation, in the form of articles 10 and 38 of the *Código do imposto sobre o rendimento das pessoas singulares* (Law on the income tax of natural persons), pursuant to which a taxable person who exchanges shares and transfers his place of residence abroad or transfers assets and liabilities relating to an activity carried out on an individual basis in return for shares in a non-resident company, must, in the former case, include, in relation to the transactions in question, any income not taxed in the last fiscal year in which the taxable person was still regarded as a resident taxpayer, whereas, in the latter case, he does not benefit from a deferment of tax resulting from the transaction in question.^[50]

50. See European Union; Portugal - ECJ Advocate General's Opinion: *Commission v. Portugal* (Case C-503/14) – Exit taxation; individuals (13 May 2016), News IBFD and European Union; Portugal - ECJ Advocate General's Opinion: *Commission v. Portugal* (Case C-503/14) – Exit taxation; individuals – details (19 July 2016), News IBFD.

2.3. European Commission's formal requests and referrals to the ECJ in respect of exit taxes and transfer of assets

It is not only taxpayers who challenge the exit taxes and transfer of assets legislation of Member States, but the European Commission has also started numerous infraction procedures. Below is an overview of these procedures.

Prior to the publication of this Communication, the European Commission on 18 September 2008 had formally requested Sweden, ^[51] Portugal and Spain ^[52] to change their tax provisions that impose immediate exit taxes when companies cease to be tax resident in these countries or transfer their assets to another Member State, ^[53] on the basis of the argument that the rules in question are likely to dissuade companies from exercising their right of freedom of establishment and, as a result, constitute a restriction of article 43 of the EC Treaty (now the TFEU) and the corresponding provision of the EEA Agreement by introducing less favourable treatment for them compared to those companies that remain in the country or transfer assets domestically. The Commission referred to the ECJ judgments in *Lasteyrie du Saillant* and *N.*, as well as to the Commission's Communication on exit taxation. ^[54]

At the time, Spain immediately taxed the unrealized capital gains upon transfer of the effective place of business of a company resident in Spain to another Member State or when a permanent establishment ceased its activities. Portugal and Sweden also taxed the unrealized profits of Portuguese-situs assets transferred to another Member State.

On 8 October 2009, the Commission announced that it had referred Spain and Portugal to the ECJ over restrictive exit tax provisions for companies. ^[55] On 18 March 2010, the Commission announced that it had closed the infringement procedure against Sweden regarding its exit tax legislation for companies.

^[56]

On 18 March 2010, the Commission announced that it had sent Belgium, Denmark and the Netherlands a reasoned opinion (second stage of the infringement procedure under article 258 of the TFEU) requesting them to amend their tax legislation that imposes an immediate exit tax when companies transfer their seat or assets to another Member State. ^[57] The Belgian law in question taxes capital gains immediately if the residence of a company is transferred outside Belgium. The Belgian legislation has been amended – now allowing a transfer of seat to another Member State in tax neutrality, provided the company's assets and tax-free reserves remain allocated to a permanent establishment in Belgium – from 1 January 2011 onwards. In addition, on 17 June 2016, the Belgian Council of Ministers approved a draft bill on various urgent tax measures which includes, among others, a provision providing for the options (i) to pay the exit tax immediately upon immigration, or (ii) to request a tax deferral.

The Danish law taxes capital gains on assets transferred outside Denmark. The Dutch law in question provides for exit taxation of non-incorporated businesses and companies.

On 24 November 2010, the Commission referred Denmark, the Netherlands and Spain to the ECJ for their provisions that impose an exit tax on businesses which cease to be tax residents in these

51. See www.hri.org/news/europe/midex/2008/08-09-18.midex.html#23.

52. See <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/08/1813&type=HTML>.

53. In the form of a reasoned opinion being the second step in the infraction procedure provided for in article 226 of the EC Treaty.

54. COM(2006)825 of 19 December 2006. See http://ec.europa.eu/taxation_customs/resources/documents/taxation/COM%282006%29825_en.pdf.

55. IP/09/1460, See <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/1460&format=HTML&aged=0&language=en&guiLanguage=en>.

56. IP/10/299, See <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/10/299&format=HTML&aged=0&language=EN&guiLanguage=en>.

57. IP/10/1565, See <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/10/1565&format=HTML&aged=0&language=EN&guiLanguage=en>.

countries. ^[58] On 25 April 2013, the ECJ gave its decision in *Commission v. Spain*. The Commission had referred Spain to the ECJ over its legislation that imposes an exit tax on entities which cease to be residents in Spain or transfer assets from a permanent establishment in Spain to other countries. The ECJ held that Spain has failed to fulfil its obligations under article 49 of the TFEU by establishing that where a resident entity transfers its residence to another Member State, or where there is a transfer of assets of a permanent establishment in Spain to another Member State, non-realized capital gains are included in the taxable base of the tax year concerned.

On 28 June 2012, Advocate-General Mengozzi gave his opinion in the first of the four actions for failure to fulfil obligations brought by the Commission that essentially concern immediate taxation of unrealized capital gains relating to assets of companies when their registered office and effective centre of management are transferred to other Member States. *Commission v. Portugal* concerns the immediate taxation of unrealized capital gains relating to assets of a Portuguese company transferring its registered office and effective management to another Member State. The case deviates from *National Grid Indus* for the following reasons. Contrary to the Netherlands, Portugal does not apply the incorporation theory. A Portuguese company may transfer both its effective centre of management and its registered office to another Member State. This might result in a different verdict.

Moreover, the case concerns not only the transfer of the registered office and effective centre of management to another Member State (article 76A of the Portuguese Corporation Tax Code), but also the cessation of activities of a permanent establishment in Portugal (article 76B) and the transfer of the assets of such a permanent establishment from Portugal to another Member State (article 76C).

The Advocate-General was of the opinion that in respect of each of these articles Portugal failed to fulfil its obligations under article 43 of the EC Treaty (now the TFEU) by requiring immediate payment. In respect of interest payments in case of a deferral of payment, the Advocate-General is of the same view as the ECJ in *National Grid Indus*, but his opinion concerning bank guarantees differs:

75. In my view, the Commission's criticism regarding the discriminatory character of such a requirement cannot be accepted.

76. If, in a domestic situation where a place of management is transferred, such interest is not demanded, this is simply because the amount of the tax debt will be ascertained and therefore payable only upon the effective realisation of the capital gains. It is then that the tax debt will have to be paid, as a rule in the absence of the grant of a deferred payment By contrast, because, in a cross-border situation, the Member States are authorised, as is confirmed in the abovementioned judgment in *National Grid Indus*, to fix the amount of the tax debt payable in connection with unrealised capital gains relating to assets of a company transferring its place of management to another Member State at the time of that transfer, but the actual payment is deferred, the interest payable on that amount may be treated in the same way as interest payable on a loan granted to that company.

77. Consequently, and in accordance with the principle of equivalence, if, in its national legislation generally applicable to the recovery of tax claims, a Member State provides that the option of deferred payment comes together with interest, there is no objective reason to exclude from it the

58. See http://online.ibfd.org/kbase/#topic=doc&url=/highlight/data/tns/docs/html/tns_2013-01-04_pt_9.html&q=%2522exit+tax%2522&WT.z_nav=Search&colid=4913.

situation of a company transferring its place of management to a Member State, whose tax debt in the Member State of exit was ascertained at the time of that transfer.

78. The provision of a bank guarantee seems to be an issue which is more difficult to resolve. Whilst, in paragraph 74 of the abovementioned judgment in *National Grid Indus*, the Court appears to envisage it as just one of several measures, the systematic application of such a requirement with a view to ensuring the recovery of tax in the context of its deferred payment could nevertheless have an equally restrictive effect as its immediate payment at the time when the place of management is transferred to another Member State, since it is likely to deprive the taxpayer of the enjoyment of the assets provided as a guarantee.

79. Moreover, I would point out that, in *Lasteyrie du Saillant ... and N, ...* the Court ruled that the provision of guarantees which was required of natural persons who transfer their residence for tax purposes to another Member State and who wish to benefit from the deferred payment of the tax on unrealised capital gains relating to their securities was disproportionate to the objectives in the public interest pursued by the Member States In *N*, the Court stated that there were methods less restrictive of fundamental freedoms, such as the mutual assistance mechanisms introduced at EU level, in particular for the recovery of tax claims

80. Whilst, in paragraph 74 of the abovementioned judgment in *National Grid Indus*, the Court did not mention these mechanisms, this silence cannot, in my view, mean that it intended to give the Member States *carte blanche*, allowing them to introduce a measure (deferred payment together with a bank guarantee) the effects of which may be just as restrictive as the measure (immediate payment) which it considered, in the preceding paragraphs of that judgment, to entail a disproportionate obstacle to freedom of establishment.

81. Consequently, in order to preserve both the internal coherence of the Court's reasoning in the abovementioned judgment in *National Grid Indus* and its external coherence with the abovementioned rulings in *Lasteyrie du Saillant* and *N*, a strict interpretation must therefore be given, in my view, to the requirement of the provision of a bank guarantee, possibly together with the option of the deferred recovery of the tax debt.

82. I essentially share the view taken by the Commission and the Danish Government to the effect that such a guarantee can be required only if there is a genuine and serious risk of non-recovery of the tax claim. Furthermore, contrary to the claims made by the French Government in its response to the written question asked by the Court and at the hearing, I consider that the amount of the required bank guarantee cannot correspond to the amount of the tax claim the payment of which is deferred, otherwise a measure which is as restrictive as immediate payment of the tax when the place of management is transferred will be reintroduced. That guarantee must nevertheless be sufficient having regard to the circumstances of each specific case.

On 6 September 2012, the ECJ gave its judgment in *Commission v. Portugal* and declared that, by adopting and maintaining in force articles 76 A and 76 B of the Corporation Tax Code (*Código do Imposto sobre o Rendimento das Pessoas Colectivas*), which are applicable in the case of transfer, by a Portuguese company, of its registered office and its effective management to another Member State or in the case of transfer, by a company not resident in Portugal, of some or all of the assets attached to a Portuguese permanent establishment from Portugal to another Member State, and which prescribe the immediate taxation of unrealized capital gains relating to the assets concerned but not of unrealized

capital gains resulting from purely national operations, the Portuguese Republic has failed to fulfil its obligations under article 49 of the TFEU.

On 31 December 2012, the president signed the 2013 Budget bill into law. The following authorizations are granted to the government with respect to exit tax provisions:^[57]

- The government is authorized to amend the exit tax regime in force applicable to the transfer of a company's head office and place of effective management to an EU or EEA Member State, as well as the permanent establishments in Portugal ceasing their activities or transferring their assets to an EU or EEA Member State residence, in accordance with the decision of the ECJ of 6 September 2012 (*Commission v. Portugal*, Case C-38/10).
- The regime to be introduced shall foresee that companies transferring its assets may opt between (i) the immediate payment of the tax due, (ii) the payment of the tax due in instalments or (iii) the deferral of the payment of tax due on the difference between the market value and the tax basis of their assets, until such assets are extinguished, transferred or unallocated to the business activities.
- In case of the option for the deferral of the payment of the tax due, interest and warranties may be due.

On 31 January 2013, the ECJ gave its decision in *Commission v. Netherlands*. The Commission had referred the Netherlands to the ECJ on 24 November 2010. The ECJ held that the Netherlands had not fulfilled its obligations under article 49 of the TFEU (freedom of establishment) on the grounds that its legislation imposes an exit tax, i.e. a tax on unrealized gains, on businesses which cease to be a resident. This case differs from *National Grid Indus* as it concerns not only the exit charge for legal entities based on articles 15c and 15d of the CITA 1969, but also the exit charges for individual taxpayers based on articles 3.60 and 3.61 of the ITA 2001. In its defence, the Netherlands acknowledges that the judgment of the ECJ in *National Grid Indus* also applies to articles 3.60 and 3.61 of the ITA 2001, as these articles have the same contents as article 15c and 15d of the CITA 1969 and that it has to change its legislation and will do so as quick as possible. The ECJ decided that although the Netherlands acknowledges that it has to change its legislation due to the decision of the ECJ in *National Grid Indus* – that the Dutch exit tax provisions for companies were disproportionate because they provided for the immediate recovery at the time of the transfer of a tax on unrealized capital gains relating to the assets of the company without granting the option of tax deferral – it has not done so before the end of the reasonable period granted and that it cannot take into account changes that took place since that date. The Netherlands therefore has to bear the costs of the procedure. On 20 November 2013, the European Commission closed the infringement procedure (Commission case reference No. 2008/2207) against the Netherlands on its exit tax rules because the Netherlands had amended its legislation.

On 18 July 2013, the ECJ gave its decision in *Commission v. Denmark*.

The Danish Corporate Income Tax Law provides that the transfer of assets outside Denmark is considered as a sale of assets subject to tax on the market value of the assets at the date of the transfer. The tax is due in the case of a Danish company transferring assets to its foreign permanent establishment or where a foreign company transfers assets from its Danish permanent establishment to its foreign head office or to a permanent establishment outside Denmark. The tax is levied immediately,

57. IP/10/1565, See <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/10/1565&format=HTML&aged=0&language=EN&guiLanguage=en>.

without having the possibility to defer the payment until the assets are actually sold and the capital gains realized.

The issue was whether immediate taxation of unrealized capital gains in the case of a Danish entity transferring its assets outside Denmark is compatible with the freedom of establishment provided by the TFEU and the EEA Agreement.

The ECJ decided that the Kingdom of Denmark failed to fulfil its obligations under article 49 of the TFEU and article 31 of the EEA Agreement by adopting and maintaining in force paragraph 8(4) of the Law on taxation of the income of share companies and other matters (*Lov om indkomstbeskatning af aktieselskaber m.v., lovbekendtgørelse nr. 1376*, 7 December 2010) concerning the immediate taxation of the income of share companies and, consequently, a tax system providing for the immediate taxation of unrealized capital gains relating to a transfer of assets by a company established in Denmark to another Member State of the European Union or to a non-member country party to the Agreement on the European Economic Area of 2 May 1992. In the meantime the European Commission announced on 16 April 2014, that an infringement procedure against Denmark, regarding its exit tax legislation, was closed because Denmark had amended its legislation. On 6 February 2014, the Bill on exit tax on companies was enacted in Denmark. The purpose of the Bill was to make the exit tax compatible with EU law.

3. State Aid Investigations

Media paid a lot of attention to tax evasion and in particular to profit shifting from high-tax to low-tax jurisdictions. The discussion much focused on the role of transfer pricing in relation to tax evasion. In 2013, the discussion on tax evasion, profit shifting very much heated. Various NGOs published reports on aggressive tax-planning structures. One example is the report “Calling Time” issued by the NGO ActionAid^[59] pointed at the aggressive tax-planning structures set up by one MNE, SABMiller, in stripping profits out of a developing country (in this case, Ghana). Other networks and organizations have published similar reports.^[60] The reports paid attention to the role of transfer pricing in relation to tax avoidance. Numerous cases had media attention, for example Google, Starbucks, Apple.^[61] In the news report it was claimed that all three groups conducted substantial business activities in the United Kingdom. Only a small portion of the groups’ UK income was taxed in the United Kingdom. Almost all of the income was removed from the country through the payment of royalties and other payments.

As a result of the abovementioned developments and the OECD BEPS project, the European Commission has opened in-depth investigations to examine whether State aid is provided by tax rulings granted by the tax authorities of several Member States. On 16 January 2015, the European

59. See http://www.actionaid.org.uk/doc_lib/calling_time_on_tax_avoidance.pdf, accessed 5 October 2014. ActionAid’s investigation used published financial information, interviews with government officials and undercover research to find out how SABMiller avoids tax across Africa and India. The cost to the governments affected may be according to this report as much as GBP 20 million per year. In 2013, ActionAid published a report entitled “Sweet nothings – The human cost of a British sugar giant avoiding taxes in southern Africa”, Feb. 2013, http://www.actionaid.org.uk/sites/default/files/doc_lib/sweet_nothings.pdf, accessed 5 October 2014. The report paid attention to Associated British Foods and concludes the Zambian sugar-producing subsidiary of Associated British Foods contributed virtually no corporation tax to the state’s exchequer between 2007 and 2012, and none at all for two of those years.

60. See “A rich seam: who benefits from rising commodity prices?”, Jan. 2007, Christian Aid, London, http://www.christianaid.org.uk/Images/a_rich_seam.pdf. This report attends to the mining industry and concludes that the mining companies which are reaping huge profits from extracting valuable and finite resources from developing countries often pay very little to the countries’ governments in taxes or royalties. Other benefits from resource extraction, such as employment, are also negligible. Also reference can be made to “Death and taxes: the true toll of tax dodging”, Christian Aid report, May 2008. Christian Aid, London, <http://www.christianaid.org.uk/images/deathandtaxes.pdf>.

61. See, for example, Rajeev Syal and Patrick Wintour, “MPs Attack Amazon, Google and Starbucks”, *The Guardian*, 12/2/12. For a discussion of these cases, reference is made to Chapter 1 Current trends in countering tax planning structures of this publication.

Commission concluded that the decision by Luxembourg's tax authorities with regard to the corporate income tax to be paid by Amazon in Luxembourg fulfils all four conditions under article 107(1) of the TFEU; the tax ruling constitutes State aid within the meaning of article 107(1) of the TFEU.^[62] Other investigations have been:

- the individual rulings issued by the Irish tax authorities on the calculation of the taxable profit allocated to the Irish branches of Apple Sales International and of Apple Operations Europe.^[63]
- the individual ruling issued by the Dutch tax authorities on the calculation of the taxable basis in the Netherlands for manufacturing activities of Starbucks Manufacturing EMEA BV;^[64]. On 21 October 2015, the European Commission held that the transfer pricing arrangements on corporate taxation of Starbucks constituted incompatible State aid.^[65] In June 2016, the European Commission has published the non-confidential version of its 2015 decision on State aid granted to Starbucks by the Netherlands.^[66]

On 13 November 2015, the State Secretary of Finance issued Letter AFP/ 2015/897U (the Letter) containing answers to questions from the lower house of the parliament relating to the decision of the European Commission stating that the transfer pricing arrangements of Starbucks constituted incompatible State aid. The Letter states, among others, that the tax authorities, even in the light of the changes proposed by OECD BEPS Actions 8-10, would still have granted Starbucks the same advance pricing agreement.^[67] On 27 November 2015, the Dutch Minister and State Secretary of Finance, by way of Letter AFP/2015/948M, informed the lower house of the parliament of the government's response to the decision of the EU Commission (the Commission) of 21 October 2015.^[68] The Dutch Minister and the State Secretary of Finance, among others, state that the Commission used its own, new interpretation to calculate the profit on the transaction(s) which is not in line with the national legislative framework or the OECD transfer pricing framework.

On 23 December 2015, the Netherlands brought an action against the European Commission (the Commission) in the case of Netherlands v. Commission (Case T-760/15). The Netherlands claimed that the Court should:^[69]

62. See http://ec.europa.eu/competition/state_aid/cases/254685/254685_1614265_70_2.pdf. For an overview of the facts and circumstances related to this ruling reference can be made to the report of the European Commission, accessed 19 January 2015.

63. From 1 January 2015, the corporate residence rules are tightened to remove the effectiveness of the "Double-Irish" type tax avoidance schemes for companies established on or after that date. The rules will take effect for existing companies from 1 January 2021. Finance Act 2015 introduced the Knowledge Development Box (KDB). Under this regime, profits qualifying for KDB are effectively taxed at the corporate income tax rate of 6.25% (section 769I(5) of the TCA 1997). Assets qualifying for KDB include patented innovations and copyrighted software that result from R&D activities. Marketing-related intellectual property, such as trademarks and brands, are explicitly excluded from the scope of qualifying assets.

64. See http://ec.europa.eu/competition/state_aid/cases/253201/253201_1596706_60_2.pdf, accessed 19 January 2015. The State Secretary of Finance is of the opinion that the ruling falls within the scope of the advance pricing agreement guidance and will not be considered State aid; see nr. AFP/2014/1004, V-N 2014/59.8, accessed 19 January 2015.

65. See http://europa.eu/rapid/press-release_STATEMENT-15-5881_en.htm, accessed 14 November 2016.

66. Commission decision, of 21 October 2015 on State aid, SA.38374 (2014/C ex 2014/NN) implemented by the Netherlands to Starbucks Brussels, 21 October 2015 C(2015) 7143 final, See http://ec.europa.eu/competition/state_aid/cases/253201/253201_1762441_575_2.pdf, accessed 14 November 2016.

67. See <https://www.rijksoverheid.nl/ministeries/ministerie-van-financien/documenten/kamerstukken/2015/11/13/antwoorden-op-kamervragen-over-starbucks>, accessed 9 August 2016.

68. See <http://njb.nl/Uploads/2015/11/kabinetsreactie-op-het-besluit-van-de-europese-commissie-inzake-starbucks-manufacturing-bv.pdf>, accessed 14 November 2016.

69. See <http://curia.europa.eu/juris/document/document.jsf?text=&docid=174409&pageIndex=0&doclang=EN&mode=lst&dir=&occ=first&part=1&cid=56729>, accessed 14 November 2016.

- annul the decision of the Commission of 21 October 2015 with reference number C(2015) 7143 concerning State aid SA.38374 (2014/C ex 2014/NN) implemented by the Netherlands in favour of Starbucks;
 - order the Commission to pay the costs.
- the individual ruling issued by the Luxembourgish tax authorities on the calculation of the taxable basis in Luxembourg for the financing activities of Fiat Finance and Trade.^[70]

On 4 December 2015, the Luxembourg government by way of a press release announced that it will appeal the European Commission's decision in the Fiat Finance and Trade case to obtain legal clarity and predictability on the practice of tax rulings.

On 30 December 2015, Luxembourg brought an action against the European Commission (the Commission) in the case of Luxembourg v. Commission (Case T-755/15). Luxembourg claimed that the Court should:^[71]

- declare the present action admissible and well founded;
- primarily, annul the Commission's decision of 21 October concerning State aid SA. 38375 implemented by the Grand Duchy of Luxembourg in favour of FIAT;
- in the alternative, annul the Commission's decision of 21 October concerning State aid SA.38375 implemented by the Grand Duchy of Luxembourg in favour of FIAT in so far as it orders the recovery of the aid; and
- order the Commission to pay the costs.

On 9 June 2016, the European Commission published the non-confidential version of the decision taken on 21 October 2015 that Luxembourg has granted selective tax advantages to Fiat Finance and Trade.^[72]

- the individual ruling provided by the Belgian tax authorities on the application of article 185 §2, b) of the *Code des impôts sur les revenus/Wetboek Inkomstenbelastingen*, the Belgian Income Tax Law. This article provides for an "excess profits" deduction: a deduction for profits registered in the accounts of the Belgian entity that allegedly result from the advantage of being part of a multinational group through a tax ruling. Belgian companies only active in Belgium cannot claim similar benefits.

On 3 February 2015, the European Commission announced that it has opened an in-depth investigation into the Belgian so-called "excess profit" tax rulings, which allows group companies to substantially reduce their corporation tax liability in Belgium.^[73] On 11 January 2016, the European Commission held that the Belgian excess profit scheme constitutes incompatible State aid under article 107 of the TFEU.^[74] On 22 March 2016, the Belgian federal Government filed

70. See http://europa.eu/rapid/press-release_IP-14-663_en.htm, accessed 19 January 2015.

71. See http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv%3AOJ.C_.2016.059.01.0048.01.ENG, accessed 14 November 2016.

72. Commission decision of 21 October 2015, on State aid SA.38375 (2014/C ex 2014/NN) which Luxembourg granted to Fiat, Brussels, 21 October 2015 C(2015) 7152 final. see http://ec.europa.eu/competition/state_aid/cases/253203/253203_1757564_318_2.pdf, accessed 9 August 2016.

73. See http://europa.eu/rapid/press-release_IP-15-4080_en.htm, accessed 14 November 2016.

74. See Commission decision of 11 January 2016, on the excess profit exemption State aid scheme, SA.37667 (2015/C) (ex 2015/NN) implemented by Belgium, Brussels, 11 January 2016 C(2015) 9837 final, http://ec.europa.eu/competition/state_aid/cases/256735/256735_1748545_185_2.pdf.

an official action for annulment with the General Court of the European Union (EU) against the European Commission (EC) final Decision on the excess profit ruling system.

In the meantime the European Commission also started State aid investigations to the treatment of the Luxembourg tax authorities of Amazon and McDonalds. Further, the EC published a [working paper on State aid and tax rulings](#). The working paper:^[75]

- summarizes the measures taken by the EC so far in respect of the tax ruling practice of Member States, and tax planning strategies utilized by corporate groups;
- points out that tax ruling practices differ significantly in quantitative terms; some Member States have issued thousands of ruling, whereas some have issued none;
- finds that most Member States follow the procedural guidance provided by the European Union and the OECD for granting a transfer pricing ruling;
- states that the focus of the Directorate General is on cases that where there is a manifest breach of the arm's length principle.

75. See http://ec.europa.eu/competition/state_aid/legislation/working_paper_tax_rulings.pdf, accessed 9 August 2016.

5 – Article 9 of the OECD Model Convention

Author

Monica Erasmus-Koen^[*]

Latest Information:

This chapter is based on information available up to 1 January 2015.

1. Introduction

In 1933, developed countries reached consensus on the creation of the fiction of the separate-entity approach for taxation, rather than being taxed as inseparable parts of a single global group enterprise. The separate-entity approach is applied via the arm's length principle. In 1979, the OECD (Organisation for Economic Co-operation and Development) released for the first time the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines) in which its Member countries unanimously reaffirmed the use of the arm's length principle.^[1] These Guidelines were updated in 1995 and in 2010. The 2010 update also specifically included a new chapter, Chapter IX, with guidance on how to deal with transfer pricing in business restructurings. Work to revise the OECD Guidelines continues with the February 2013 announcement of the BEPS (Base Erosion and Profit Shifting) Project of the OECD.^[2] The impact of the BEPS Project is already far-reaching and profound, triggering changes to the fundamentals of taxation, as well as changes to domestic law and regulation around the globe.

The arm's length principle is enshrined in article 9(1) of the OECD Model Tax Convention on Income and Capital (OECD Model), known as the "Associated enterprises" article. Although the words "arm's length" never actually appear in this article, Chapter I of the OECD Guidelines describes it as the authoritative statement of the arm's length principle.^[3] Article 9(1) of the OECD Model requires that conditions agreed upon or imposed between associated parties (such as companies within a multinational entity (MNE)) in their commercial or financial relations should be similar to those conditions which would be agreed between independent enterprises. In its simplest form, this means that article 9 governs the correct statutory profit allocation embedded in a transaction between legal entities, based on the economic value created by each of the legal entities involved in the transaction.

In general, tax authorities around the world acknowledge that, in reality, the arm's length price for a good or a service in fact constitutes a range of values, rather than simply a single point of value. Thus, in testing whether an intercompany transfer price is consistent with the prices that uncontrolled parties would agree upon after negotiating at arm's length, the tax authorities will accept a transfer price as being at arm's length if it falls within an appropriate range of prices.^[4] This approach of "arm's length range" works well in a world in which prices are set and tested against third-party benchmarked prices.

* Transfer Pricing and TP Process Consulting (owner of TP Connected).

1 OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD 2010) (*OECD Guidelines*), at para. 1.1, International Organizations' Documentation IBFD.

2 OECD, *Addressing Base Erosion and Profit Shifting* (OECD 2013), International Organizations' Documentation IBFD.

3 Para. 1.6 *OECD Guidelines* (2010).

4 Id., at para. 3.55.

However, in a profit split approach, there is no range of prices and the question becomes what the single point of value is for each part of the value chain.

The whole thinking around profit allocation has transformed fundamentally since the introduction of the arm's length principle in 1933. The industrial revolution, with its increased possibility of long-haul shipping and pan-continental railroads, led to an increase in export businesses. This period was characterized by a high number of third-party export prices. Globalization and an acceleration of technological developments led to the post-industrial period. While less vertically integrated than its predecessors, the 21st century MNE is increasingly replaced by a web of close collaborations and alliances with external suppliers, customers and employees, all facilitated by information technology, with special attention given to the Internet.

In sociology, the post-industrial society is the stage of a society's development when the service sector generates more wealth than the manufacturing sector of the economy.^[5] The service sector has introduced tension between the value creation of capital versus labour (functions). This tension seems to be at the heart of the discussion on the arm's length principle and is also manifesting itself in the dialogue on BEPS.

The post-industrialization period has led to another interrelated complex discussion, namely the identification, ownership and valuation of intangibles. The post-industrialized society is marked by an increased valuation of knowledge. This has and will continue to occur such that the "impact of the expert" will expand and power will be monopolized by knowledge.^[6] The evolution into a more economic approach to taxation started with the development and the release of the application of the working hypothesis to permanent establishments in general (Part I) and to permanent establishments of banking enterprises (Part II), which were released in February 2001. These introduced the functional approach to risk and value (and therefore profit) allocation, which seems to have also become the cornerstone for the arm's length analysis for article 9(1).

This implies that the whole "separate entity" concept has become opaque. In 2012, Wittendorff eloquently explained the confusion created by the relationship between article 5, 7 and 9 of the OECD Model by placing more emphasis on functionality for profit allocation purposes. He mentioned that at first glance, there is no direct link between the aforementioned articles, because articles 5 and 7 deal with tax nexus and income allocation between the head office and permanent establishment (PE) of an enterprise (that is, a single tax payer), whereas article 9 deals with income allocation between associate enterprises (that is, two taxpayers). However, the articles are linked because they govern the taxation of enterprises and business profits, and because a subsidiary may qualify as a PE of its parent company (subsidiary PE).^[7] This was confirmed in *Roche Vitamins Europe Ltd*, in which the Supreme Court of Spain decided that a contract manufacturer constituted a PE of its Swiss principal.^[8] In a recent interview, Marlies de Ruiters (Head of the Division on Tax Treaties, Transfer Pricing and Financial Transactions at the OECD) emphasized that the main message of the BEPS Project is that profits be aligned with the value of the activities that are undertaken. Thus, the arm's length principle is currently evolving in its assessment of (i) where and how value is created and (ii) how parties contribute to that value and the

5 *Who Makes It? Clark's Sector Model for US Economy 1850-2009* available at <http://www.63alfred.com/whomakesit/clarksmode.htm> (accessed 8 May 2015).

6 H. R. Targ, *Global Dominance and Dependence, Post-Industrialism, and International Relations Theory: A Review*, 20 *International Studies Quarterly* 3, at 461-482 (1976).

7 J. Wittendorff, *Triangular Cases: The interaction between transfer prices and PEs*, *Tax Notes International*, at 545 (2012).

8 SP: SSC, 12 Jan. 2012, *Roche Vitamins Europe Ltd v. Administracion General de Estado*, STS/202/2012 (Second Section of the Third Chamber of the Supreme Court)

management of risk to protect the value creation.^[9] In the same interview, Andrew Hickman (Head of the Transfer Pricing Unit of the OECD) stated that the OECD does not mind if a taxpayer cannot find unrelated parties entering into the same arrangement as the intercompany transaction. What matters is whether the actual arrangement makes economic sense for the related party. The issue for functional analysis to concentrate on is to determine what the actual arrangement (transaction) is between the related parties and how the transaction makes a contribution to value.^[10] This approach is a paradigm shift from the pragmatic separate entity approach of article 9 envisaged in 1933. The OECD is very clear on the interpretation of the arm's length standard: transactions cannot be defined solely by contracts, as then "paper reality" would be priced instead of "reality".

Paragraph 9.9 of the OECD Guidelines clearly states that the arm's length principle of article 9(1) of the OECD Model is also applicable to business restructurings within MNEs. The term "business restructurings" has been defined as "... the cross-border redeployment by an MNE of functions, assets and/or risks ...".^[11] Indeed, not all business restructurings involve a transfer of something. One of the core aims of any restructuring is to obtain organizational efficiencies and performance improvement, which is better expressed by the word *deployment* than *transfer*. Thus, it is helpful for taxpayers that the OECD Guidelines on business restructurings recognize that in a number of cases there might just be a termination of duplicate functions and contracts, in combination with new and different roles, technology, etc. in (an)other jurisdiction(s), without any transfer of something valuable.^[12]

As previously mentioned, there is currently substantial international discussion around clarifications to transfer pricing rules and developing best practices on how to apply the arm's length principle in practice, as part of the BEPS work being performed by the OECD. In July 2013, the OECD released its BEPS Action Plan (13). It was not expected that this work would change or override the business restructuring standards and best practices of Chapter IX of the OECD Guidelines. The work being done under the BEPS Project in the area of value creation by intangibles, risk and capital provides further guidance on the identification of value drivers and the nexus of these value drivers, especially in the context of global value chains, which is currently not dealt with in Chapter IX of the OECD Guidelines. Chapter IX aims to provide an analytical framework for the recognition of a business restructuring transaction for transfer pricing purposes, as well as guidance on how to approach conversion analysis. The latter aims to discuss the extent to which a reallocation of profits resulting from a business restructuring is consistent with the arm's length principle. With its BEPS Project, the OECD aims to achieve transfer pricing outcomes in line with the economic value creation by the relevant legal entities.

9 Bloomberg BNA, *De Ruiter, Hickman say OECD Draft on Risk Requires Arm's Length Principle to "Work Harder"*, 23 Tax Management Transfer Pricing Report 18, at 1223 (2015).

10 *Id.*, at 1220 – 1221.

11 On 22 July 2010, the OECD published final guidance on business restructurings. The final guidance resulted from a lengthy process of drafting and consultation as from January 2005 until 2009 between representatives of governments, academics and the business community. In the July 2010 update of Chapters I – III of the OECD Guidelines, a new Chapter IX dealing with transfer pricing aspects of business restructurings was included.

12 This view is shared by a number of business commentators in the public comments on the Transfer Pricing Aspects of Business Restructurings published by the OECD on 6 March 2009.

2. Arm's length (comparability) analysis and recognition, or non-recognition of transactions undertaken

2.1. Introduction

One could say that transfer pricing is about understanding the explicit or contractual (and deducing, through observing the behaviour of the parties in practice, the implicit) terms and conditions between related enterprises when they trade, and comparing that to what unrelated parties would have agreed to under similar conditions. In the market, commercial and financial decisions are driven by the trade-off between benefits and risks which result from the rights and obligations that unrelated parties are able to agree when they transact.

The good news is that the OECD reconfirmed in Chapter IX of the OECD Guidelines that the examination of a controlled transaction in the context of article 9 of the OECD Model begins with an examination of the contractual arrangement between the related parties.^[13] Thus, the contractual terms and conditions remain important for the starting position of the *transfer pricing* analysis. The reason being that the contractual terms of a transaction generally define, and make transparent, how the responsibilities, risks and benefits are to be divided between the parties. On the other hand the OECD Guidelines emphasize that the contractual allocation of risk between associated enterprises is respected only to the extent that it has economic substance, as advocated in paragraphs 1.47 to 1.53 of the OECD Guidelines.^[14]

In the context of business restructurings, this would imply that a business restructuring can occur either explicitly when there is a contractual change between (two or more) parties, or implicitly when there is a functional change between (two or more) parties.

Part I of Chapter IX of the OECD Guidelines endeavours to provide general guidance on the economic substance discussion which is relevant for all transfer pricing situations. The OECD seems to suggest that there are two cumulative tests to determine the location of the economic substance,^[15] namely:

- an assessment of whether parties conform to the contractual agreement through their conduct (the conduct test);^[16] and
- a determination of whether the allocation of risks (as well as responsibilities and benefits) between the contracting parties is economically logical (commercial and financial),^[17] where no third-party evidence might exist to confirm this (the terms-and-conditions test).^[18]

If one of these tests is not met, a pricing adjustment of some sort may be required. The main questions that arise are: What do these tests actually seek to establish? And what does it mean in practice?

¹³ Para. 9.11 *OECD Guidelines* July (2010).

¹⁴ Id., at para. 9.12.

¹⁵ It would be helpful if the OECD was to follow up on the suggestion made by David Ernick, US Treasury Department Associate International Tax Counsel and chair of the OECD Working Party No. 6, during the business consultation session on 9-10 June 2009 in Paris, to further define the concept "economic substance". The Revised Discussion Draft on Transfer Pricing Aspects of Intangibles specifically highlights important functions that have special significance in paragraph 79 with respect to attributing profits to intangibles. This seems to suggest that functionality has become the most important factor for profit allocation.

¹⁶ Paras. 9.13-9.16 *OECD Guidelines* (2010).

¹⁷ Id., at para. 9.36.

¹⁸ Id., at paras. 9.17-9.38.

2.2. Meaning of “conduct of parties”

The way the OECD Guidelines use the term *conduct of parties* has, prior to the inclusion of Chapter IX, not clearly expressed whether conduct purely relates to the allocation of the costs which resulted from the manifested risks, or also the underlying performance of the functions to prevent, mitigate or manage these risks.^[19] The guidance found in Part I of Chapter IX of the OECD Guidelines seems to suggest, through the manner Part I has been structured and explained, that the test relates to the actual accounting of the manifested risks. In the examples provided in paragraphs 9.14 – 9.16 of the OECD Guidelines, the focus is on which entity actually incurred the inventory write-down, foreign exchange results or bad-debt related costs.

This line of thinking is supported by the fact that the terms-and-conditions test specifically deals in detail with the functional element of economic substance through the control-over-the-risk test. Further, at the end of Part I, it is clearly stated that if the significant risks are allocated to a party under the terms-and-conditions test, the consequences of the risk allocation are that the party which receives the risks should:

- bear the costs, if any, of managing (whether internally or by using associated or independent service providers) or mitigating the risk (e.g. costs of hedging, or insurance premium);
- bear the costs that may arise from the realization of the risk. This also includes, where relevant, the anticipated effects on asset valuation (e.g. inventory valuation) and/or the booking of provisions, subject to the application of the relevant domestic accounting and tax rules; and
- generally be compensated by an increase in the expected return (see paragraph 1.45 of the OECD Guidelines).^[20]

There is, though, potential tension between the way the “conduct test” of Chapter IX of the OECD Guidelines has been drafted compared to the OECD Guidance on Transfer Pricing Aspects of Intangibles: Action 8 (hereinafter, “Intangible Guidance”).^[21] The text of the Intangible Guidance links the conduct of parties with decisions concerning the exploitation of intangibles, meaning where these activities are performed.^[22] One wonders why in Chapter IX the arm’s length allocation of risks with its functional approach is presented as a step that is separate to the assessment of the conduct of parties. It is clear that the OECD is struggling to find a balance between compensating functions (“substance”) against risk taking and capital. Recent discussion drafts, such as the Discussion Draft on the digital economy related to draft action 1 of BEPS and the nexus approach to fight harmful tax practices, which is related to BEPS Action 5, all consistently take the conduct of parties (managing real business risks) as leading for profit allocation. In an interview with Marlies de Ruyter (Head of the Division on Tax Treaties, Transfer Pricing and Financial Transactions at the OECD) and Andrew Hickman (Head of the Transfer Pricing Unit at the OECD) this approach was endorsed by explaining that the rationale behind the draft on risk is to analyse the related transaction at issue rather than looking at the label applied to it by written agreement.^[23]

¹⁹ Id., at para. 1.48.

²⁰ Id., at para. 9.39.

²¹ OECD, *Guidance on Transfer Pricing Aspects of Intangibles Action 8: 2014 Deliverable* (OECD 2014), International Organizations’ Documentation IBFD.

²² Id., at 40, para. 6.36, and at 41, para. 6.40.

²³ Bloomberg BNA, De Ruyter, Hickman say OECD Draft on Risk Requires Arm’s Length Principle to “Work Harder”, 23 Tax Management Transfer Pricing Report 18, at 1219 (2015).

Chapter IX has, though, revealed the increasing importance of having internal control procedures between the tax, operational and the financial accounting departments of an MNE to ensure that the contractual terms and conditions are also enforced by the underlying functions and correctly recorded. Paragraph 9.13 of Chapter IX of the OECD Guidelines states that in the view of the OECD, divergence in practice from formal contracts with regard to the actual sharing of costs from manifested risks, is not ordinarily business practice between third parties. This would mean that in the absence of correspondence and/or other communications to explain why the two parties diverted from the contractual terms, the tax authorities could make an assessment based on the economic principles that generally govern relationships between independent parties. The latter seems to give tax authorities much latitude to infer scenarios that are the most beneficial to the interests of the tax authorities.

2.3. Determining whether terms and conditions between the respective parties are arm's length from a commercial or financial perspective

In the first instance, where reliable data evidence a similar allocation of contractual risk in comparable uncontrolled transactions, the contractual risk allocation between the related parties is regarded as arm's length.^[24] In the absence of reliable data to prove third-party conditions in similar circumstances, the OECD suggests two criteria for the terms-and-conditions test, namely:

- which party (or parties) has (or have) control over the risk (the control test), and
- whether the relevant party (or parties) has (or have) the required financial capacity to bear the risk (financial capacity test).^[25]

With regard to the concept of control, it seems that the OECD aims, although denies,^[26] to align the concept of significant people functions found in the OECD Report on the Attribution of Profits to Permanent Establishments (Part I) as finalized in July 2010 (OECD PE Report), with the term "economically significant activity" mentioned in the Functional Analysis section of Chapter I-D of the OECD Guidelines.^[27]

The working hypothesis in the OECD PE Report is that a permanent establishment (PE) should be treated as a functionally distinct and separate enterprise. Given the absence of (legal) contractual relationships within different parts of the same legal entity, the mechanism of significant people functions is used to attribute economic ownership of assets, as well as risks to a PE.^[28]

According to the OECD Guidelines *control* should be understood as:

the capacity to make decisions to take on the risk (decision to put the capital at risk) and decisions on whether and how to manage the risk, internally or using an external provider ... people ... who have the authority to, and effectively do, perform these control functions.^[29]

Similar to the OECD PE Report, this analysis takes into account the functions performed by the personnel of the enterprise as a whole, and assesses what significance they have in generating profits. The OECD PE Report points out that active decision-making and management often occur below the

²⁴ Para. 9.18. *OECD Guidelines* (2010).

²⁵ Id., at para. 9.20.

²⁶ Id., at para. 9.21.

²⁷ Paras. 1.42 and 1.43 *OECD Guidelines* (2010) and OECD, *2010 Report on the Attribution of Profits to Permanent Establishments (Part I)* (OECD 2010) at paras. 8 and 16.

²⁸ Para. 10 *OECD Report on the Attribution of Profits to Permanent Establishments (Part I)* (2010).

²⁹ Para. 9.23 *OECD Guidelines* (2010).

strategic level of senior management on a more tactical level. The level of control needed and the type of performance assessment would depend on the nature of the risk.^[30]

In an outsourcing arrangement, the OECD is of the view that in order to be able to perform an economically significant activity, the person(s) that authorized the outsourcing must be able to assess the outcome of the day-to-day monitoring and administration functions of the service provider.^[31] Specifically, the language used in the contract research and development (R&D) example is similar to the language in a similar contract R&D example discussed in the OECD PE Report.^[32] The guidance included in the chapter on intra-group services in the OECD Guidelines on contract R&D has not provided the same level of detail as that explained in the business restructurings section of the OECD Guidelines.^[33] If one also takes into account the minimum competency threshold assumed for the investor of the hedge fund example in paragraph 9.25 of the OECD Guidelines, one could conclude that control implies that the principal should have the technical competency (relating to the necessary know-how to manage and monitor the relevant activities) and managerial functional role.

Although unavoidable, it seems that the same problematic labyrinth of mapping the significant people functions for analysing intra-entity transactions is now relevant for analysing intra-group transactions, which is particularly problematic as, in practice, many MNE Groups apply business models whereby virtual teams created by using the most talented people in the organization, work from different geographical locations. Further the end-to-end processes “from concept-to-market” meet through stage-gate processes, each of which contains a set of concurring, cross-functional activities (e.g. commercial and technical activities). Between the stages are “GO/NO-GO” decision milestones that determine whether projects may continue to the next stage. These types of geographically spread responsibilities (i.e. gatekeeper roles in different countries) complicate the functional and factual analysis that is required to determine where risks are managed and where economic substance lies.

A growing concern among taxpayers and tax practitioners is that tax authorities will even more subjectively apply this economically-significant-activity test, and it is seen in practice that tax authorities are increasingly lowering the threshold of what constitutes an economically significant activity with respect to activities exercised in their respective jurisdictions. Although the OECD suggested in the final business restructurings guidance of Chapter IX that control is one factor used to assess whether a pricing adjustment might be needed. The use of the “control test” therefore already seemed to be broader. In paragraphs 9.34 to 9.38 of the OECD Guidelines, the OECD endeavours to explain the relationship between paragraph 1.49 and paragraph 1.65 of the OECD Guidelines which concerns circumstances in which tax authorities may disregard a taxpayer’s structure or part of it. This is important given that the control test described in Part I of Chapter IX represents a novel interpretation of paragraph 1.49 of the OECD Guidelines. As a result, the same control test may also be considered (by implication) as a relevant test for paragraph 1.65.^[34] This has now been confirmed with the release of the OECD’s

30 Paras. 62 and 87 *OECD Report on the Attribution of Profits to Permanent Establishments (Part I)* (2010).

31 Para. 9.24 *OECD Guidelines* (2010).

32 Para. 9.26 *OECD Guidelines* (2010); para. 85 and 88 *OECD Report on the Attribution of Profits to Permanent Establishments (Part I)* (2010).

33 Para. 7.41 *OECD Guidelines* (2010).

34 Although the term control is not specifically mentioned in Part IV of the OECD Guidelines, paragraph 9.170 implies that the conduct of parties, including the functions performed are important factors to determine the economic substance of a transaction or arrangement. Example B at the end of Part IV specifically refers to the control function of the new intellectual property company, Company Z) to be lacking and, therefore, one of the reasons why the arrangement (sale of intangibles to Company Z) as explained in example B would not be recognized for transfer pricing purposes.

Discussion Draft on risk, recharacterization and special measures.^[35] As previously explained, in recent interviews De Ruiters said that in determining the actual related-party transaction “ you really need to look at the conduct of parties, and that conduct should be analysed very carefully to assess whether it is aligned with the original contractual arrangements that are also in place”. Andrew Hickman actually went as far as to state that accurately characterizing the related-party transaction based on what actually occurs does not amount to non-recognition; rather, it is recognizing the actual transaction.^[36]

In order to ensure that a pure functional approach is not taken to the arm’s length allocation of risks, language was added in Chapter IX to explain what is meant by the requirement that a party should also have the financial capacity to assume risk and that the financial capacity to assume risk is tested at the time that the contract was entered into (thus, at the time that the risk was allocated to an associated enterprise).^[37]

Even though the OECD has included additional text in the Chapter IX that emphasizes that not only control, but also a factor like financial capacity should be considered, the examples mentioned in paragraphs 9.37 and 9.193 (see also paragraph 9.166) appear to use control as the most decisive criterion to test the economic substance of a structure. Again, as a result of the emphasis on control, it is difficult to understand what is now exactly the difference in the transfer pricing analysis, specifically with regard to the allocation of risks, from an economic substance perspective between intra-entity transactions and intra-group transactions. In addition, it is also still very unclear what the significance is of having the *financial capacity* (thus, capital) to bear the actual risks.

The equation of economic substance purely with economically significant activities has two significant, fundamental errors:

- it potentially undervalues the role of financial risk taking in entrepreneurial activity; and
- it disregards the legal principle that the residual value of intellectual property remains with the legal owner of the intellectual property, who ultimately controls (the use of) the intellectual property. This has been endorsed in a number of US court cases between third parties, for example the *McDonalds’s case*.^[38]

Reading paragraphs 9.37 and 9.38 together, it seems to imply that in a situation where there are no third party comparables to confirm the contractual allocation of a specific risk between two related parties, and, whereas it was concluded that there is a divergence between the contractual allocation of the risk

35 On 19 December 2014, the OECD published its Discussion Draft on Action 8, 9 and 10 (“Assure that transfer pricing outcomes are in line with value creation”). The Discussion Draft includes guidance on: (i) the conduct of parties, (ii) the allocation and management of risk and (iii) the non-recognition of transactions. See OECD, *Public Discussion Draft BEPS Actions 8, 9 and 10: Discussion Draft on Revision to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures)* (OECD 2014), available at <http://www.oecd.org/ctp/transfer-pricing/discussion-draft-actions-8-9-10-chapter-1-TP-Guidelines-risk-recharacterisation-special-measures.pdf>.

36 Bloomberg BNA, *OECD’s Draft on Risks Clarifies “Proper” Transfer Pricing Analysis, De Ruiters says*, 23 Tax Management Transfer Pricing Report 18, at 1211 (2015).

37 Paras. 9.29 to 9.32 *OECD Guidelines* (2010).

38 G. Ossi, *The Significance of Intangible Property Rights in Transfer Pricing*, Special Report, Tax Notes International (September 1999), at 1006. Ossi explains that the courts found that the intangible value of the licensee’s or distributor’s business had to be attributed to intangibles ultimately controlled by the trademark owner, and could not have been considered part of the value of goodwill or other intangible asset independently owned by the licensee or distributor. The courts reached the same conclusion regardless of whether the intangible value arose from the efforts of the legal owner of the trademark or from the efforts of its licensee, franchisee or distributor. In a landmark case involving McDonald’s restaurants franchisees, *Canterbury v. Comm’r*, 99 T.C. 223 (1992), the Tax Court recognized that McDonald’s (the franchisor) was the exclusive owner of the McDonald’s system, trade name, trademarks and other intellectual property rights associated with McDonald’s restaurants, even though the goodwill inherent in the McDonald’s trade name and trademarks resulted from the quality and service provided by its franchisee restaurants, and from massive advertising efforts that were funded by the franchisees. The important point is that it is irrelevant which party created the intangible value, but that intangible value arose from customer preference for the trademarked product, not from any customer loyalty to the particular supplier of the product.

and the actual control over the risk, the contract is still recognized and that a solution should be sought in comparability adjustments (implying a higher or lower price for the party assuming the risk). It is worth noting that for paragraph 1.65 (the second circumstance) it is advocated that tax authorities may only adjust the conditions of an agreement if no solution through a pricing adjustment can be made. A re-assignment of risk would result in a financial correction with respect to all the consequences of the relevant risk allocation, as explained in paragraph 9.39 of the OECD Guidelines. It seems that in the evolution of the OECD and G20 thinking, the whole discussion around non-recognition has been turned upside down, given that in the view of the OECD it is not about non-recognition of the legal transaction, but recognition of the actual transaction based on the control behaviour of the relevant parties. One could say that the OECD is moving from arm's length pricing to arm's length behaviour.

In the cases where neither party has significant control over the risk, it appears that the actual allocation of risk should be subject to the financial capacity test only. Admittedly, however this is not explicitly stated in paragraph 9.28 of the OECD Guidelines.

2.4. Choice between comparability adjustment or non-recognition of (part of) a transaction

Paragraph 1.65 of the OECD Guidelines functions as a general anti-avoidance rule for article 9 of the OECD Model. Therefore, it is welcomed that Chapter IX of the OECD Guidelines reiterates the main rules regarding the non-recognition of a transaction, namely that:

- the fact that independent enterprises might not always allocate risks in the same manner as the taxpayer in its controlled transactions is not sufficient grounds for not recognizing the risk allocation in the controlled transaction;^[39] and
- the assessment that a transaction is not commercially rational (commercial test) and which results in the non-recognition of a transaction, should only happen in exceptional circumstances. In the preference of the OECD, apparent non-arm's length behaviour should as much as possible be dealt with on the basis of pricing adjustments.^[40]

Chapter IX of the OECD Guidelines brings clarity to the acceptability of tax savings as a driver for the commercial test. According to the OECD, as long as functions, assets and/or risks are actually transferred, it can be commercially rational from the perspective of article 9 of the OECD Guidelines for an MNE group to restructure in order to obtain tax savings.^[41]

With regard to the commercially-rational test of the first cumulative criterion of the second circumstance described in paragraph 1.65 of the OECD Guidelines it seems a taxpayer should only be required to demonstrate that the conditions of its transactions are present in the arm's length range of possible outcomes, not that they must constitute the "most likely" arm's length outcome.^[42] This commercially-rational test for a party to enter into the relevant business restructuring transaction has unfortunately been linked with the new concept of "options realistically available" to the restructured entity, as introduced in Part II of Chapter IX of the OECD Guidelines.^[43] The concept of options realistically available seems to have evolved from a comparability issue in the OECD Guidelines to a behavioural

³⁹ Paras. 9.172 and 9.173 *OECD Guidelines* (2010).

⁴⁰ *Id.*, at paras. 9.168, 9.171 and 9.180.

⁴¹ *Id.*, at para. 9.181.

⁴² *Id.*, at para. 9.174.

⁴³ *Id.*, at paras. 9.175 and 9.176.

issue (commercially rational test) in Chapter IX of the Guidelines, causing very real problems in expressing how the concept is meant to work in practice. Although the difference between options realistically available can be qualified when talking about price, in practice it is impossible to qualify them if it is a matter of behaviour.

Experience teaches that a dominant option cannot always be identified ex ante, and the relative attractiveness of options is dependent on parameters that are almost impossible to document, including level of risk aversion, subjective probability of future events, and personal prejudice.^[44] In reality the range of possible market-related outcomes is very wide, especially for intangibles. For example, in the examples provided in paragraphs 9.154 to 9.160 of Chapter IX of the OECD Guidelines, four potential arm's length means of implementing a central purchasing function are contemplated. In the situation where the transaction (or part thereof) is deemed by the tax authorities not to be typical for third parties, the test seems to consider what might have been expected to have been agreed between independent parties in similar circumstances. In the rare instance where the conditions presented were not in the realm of possible arm's length conditions, it is not clear what would be interposed. Paragraph 9.184 suggests the possibility that the tax authorities may interpose conditions that "may reasonably have been expected". The actual guidance on how this would be determined, is unfortunately not very clear^[45] and the problem is further compounded by the practical reality that such analysis can involve a complex valuation methodology and detailed commercial and financial information. Posing the question of whether causing comparability analysis and valuations to become more complex puts an overly unfair burden on taxpayers.

Chapter IX of the OECD Guidance advocates that the question of whether the commercially-rational test is met, should be answered from the perspectives of both of the individual companies, namely the transferor and transferee. The fact that the cross-border redeployment of functions, assets and/or risks may be motivated by sound commercial reasons at the level of the MNE group, is irrelevant for purposes of the arm's length test of the relevant transaction.^[46] Although this requirement is understandable from the perspective of the arm's length philosophy, it amplifies the catch-22 between this philosophy and the main reason that the concept of MNEs came into existence, namely group synergies. In the view of the OECD, the draft on risk, recharacterization and special measures includes an improved approach to the non-recognition of transactions by stipulating that if you have transactions and arrangements that do not provide each of the parties to the transaction with the possibility of improving their financial and commercial positions, the transaction as such may lack the real, fundamental arm's-length attributes that a related-party transaction should have.^[47]

In itself, the goal of a market-based approach is understandable because it endeavours to attribute income in the same manner that the market would distribute the income, and to ensure that the return on an economic activity is allocated to the location of the economic activity.^[48] The philosophy is that the arm's length principle puts independent and dependent enterprises on a more equal footing for tax purposes, and therefore it ensures that the tax advantages and disadvantages linked to either type of entity do not distort their relative competitive positions. The paradox is that presumably an integrated

44 K.A. Bell, *OECD Delegates Debate How to Price Business Restructurings, Taxpayer Representatives Bemoan Non-Recognition Proposal*, 18 Tax Management Transfer Pricing Report 4, at 162 (2009).

45 Paras. 9.185 to 9.187 *OECD Guidelines* (2010).

46 *Id.*, at para. 9.178.

47 OECD, *Public Discussion Draft BEPS Actions 8, 9 and 10: Discussion Draft on Revision to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures)*, at para. 89 (OECD 2014), available at <http://www.oecd.org/ctp/transfer-pricing/discussion-draft-actions-8-9-10-chapter-1-TP-Guidelines-risk-recharacterisation-special-measures.pdf>.

48 B.L. Rollinson & D.J. Frisch, *Recent Issues in Transfer Pricing*, US Treasury Department, OTA Paper 61 (November 1988), at 1-2.

enterprise is more efficient and will be able to execute an integrated economic activity at a lower cost than a series of independent firms the joint efforts of which are necessary to execute the same series of transactions. The omission creates a situation in which the sum of the returns for individual services rendered by independent parties would be less than the actual return of the combined group.^[49]

In this regard, it is also worth noting that, by nature, MNEs are usually involved in a series of transactions related to a variety of products or services over a long period. They work together to achieve an optimal result and both parties have an interest in keeping the partner in the cooperation in an advantageous position and motivated to contribute to the joint value creation. A cooperative relationship suggests an open-book approach to the pricing of a specific transaction. The OECD recognizes that the arm's length principle may not always account for the economies of scale and interrelation of diverse activities created by integrated businesses,^[50] nor is there any consensus within the OECD countries on objective criteria for allocating the economies of scale or benefits of integration between associated enterprises.^[51] The text of Chapter IX of the OECD Guidelines also supports an open-book analysis in situations where the transferor and transferee will continue to work together in the future. In this context, an important element to (again) bear in mind is that even under an open-book approach, the relationships between third parties are very much governed by the bargaining power each party brings to the negotiation table. In practice, this would mean that it is not the profitability of the tested affiliate that is compared to the profitability of third parties who perform similar transactions; rather, the bargaining positions of affiliate parties are compared to those of independent parties. This would lead to an entirely different "benchmark" approach than the current transfer pricing practices of today.

It is also worth mentioning that in one of the business consultation meetings related to the OECD Business Restructurings project, the working group mentioned that the better the taxpayer's comparables, the less need there is to turn to the realistic alternatives principle to ensure proper pricing. When there are good comparables, the realistic alternatives option is, per se, met. In the absence of these good comparables, it was strongly suggested that a bargaining-theory approach becomes more important. Lee Corrick, who was at the time the Assistant Director of Her Majesty's Revenue & Customs, said the bargaining power of related parties is a key element in terms of the arm's length position and price. Corrick pointed out that in a UK transfer pricing case, the tribunal focused its decision on the bargaining power of the two parties. In this case, the UK Special Commissioners held that DSG International plc, one of Europe's largest consumer electronics retailers, paid reinsurance premiums on extended warranties in excess of arm's length compensation to its captive related-party Isle of Man insurer. The tribunal rejected the retailer's proffered comparable because of a significant difference in bargaining power between the proffered comparable and the captive insurer. Corrick said that realistically available options are important in the context of comparability and that bargaining power will be a key element in determining what options are open to the parties. He suggested that Working Party No. 6 of the OECD develop the concept of bargaining power.^[52]

As previously mentioned, paragraph 9.174 of Chapter IX of the OECD Guidelines clearly advocates that what is being tested is whether the outcome (the arrangement adopted) accords with what would result from the normal commercial behaviour of third parties; it is not a behaviour test in the sense of requiring the associated enterprises to actually behave as would third parties in negotiating and agreeing to the

49 Id., at 4.

50 Para. 1.9 *OECD Guidelines* (2010).

51 Id., at para. 1.10.

52 K.A. Bell, *OECD Delegates Debate How to Price Business Restructurings, Taxpayer Representatives Bemoan Non-Recognition Proposal*, 18 *Tax Management Transfer Pricing Report* 4 (2009), Bloomberg BNA Tax, at 161 and 162.

terms of the arrangement. Thus, whether the associated enterprises actually engaged in real bargaining or simply acted in the best interest of the MNE is not relevant at a domestic level.

On the other hand, support for the contention that MNEs exist because of firm-specific economies does not automatically imply a rejection of the arm's length principle. One can approach the arm's length question by asking what unrelated parties would do if they had the opportunities available to related parties. The goal would be to distribute income in the manner that unrelated parties would distribute the (incremental) income if they were considering affiliation. For example, the decision to affiliate could take the form of a joint venture, an acquisition, a merger or a decision to hire necessary labour and capital within a subsidiary.^[53] The OECD should consider revisiting the current transfer pricing methods, developed in a different technological era, and consider expanding valuation options to take into account the changing nature of undertaking business in a virtually borderless and integrated world.^[54] The Discussion Draft on Action 10 on The Use of Profit Splits in the Context of Global Value Chains^[55] The increased focus on the PSM is an interesting development given that PSMs are, in essence, a form of formulary apportionment. The residual profit split operates with a traditional transactional method as a safeguard against complete formulary apportionment, whereas the contribution to profit split approach is closer to pure formulary apportionment, except for its transactional scope. Worth noting is that the PSM cannot be assimilated to pure or global formulary apportionment. Given their transactional scope, the PSM allocates the transactional profit (i.e. the profit pertaining to the controlled transaction under examination) between related parties to the transaction. It does not allocate the aggregated profit of the Multi-National Entities between all of its constituents.^[56] For both PSMs, bargaining theory could be a valuable tool to establish the weighting between contributing entities.

Given the highly subjective nature of a PSM approach, it is fundamentally important that contracts are used to remind of the respective functions and risks of different entities engaged in the core intangible-producing functions of an MN, and to specify the manner in which each entity will be compensated under a profit split approach.^[57]

The question raised by the commercially rational test (i.e. the general anti-avoidance test) under Para. 1.65 of the OECD Guidelines is whether this test takes priority over domestic anti-abuse rules. Chapter IX of the OECD Guidelines explicitly mentions that domestic anti-abuse and CFC laws are not within the scope of the business restructurings review and, thus, the Chapter IX of the OECD Guidelines.^[58] First of all, there is a large public debate on the question to what extent article 9(1) of the OECD Model not only covers pricing corrections, but also corrections to the transaction itself, thus transactional adjustments. The wording of article 9(1) of the OECD Model and the Commentaries does not disclose their main purpose. An analysis of paragraph 11 of the Commentaries on article 25 of the OECD Model indicates that the reason for inserting the provisions such as article 9(1) in a treaty is to cover, within the scope, economic double taxation. This is also suggested by its relationship with articles 7(1) and article 8 of the OECD Model, and is in strategic location: among the distributive articles. In addition to its main purpose,

⁵³ Rollinson & Frisch, *supra* n. 49, at 5.

⁵⁴ P. Anderson, Australia, *International Tax Review*, 1997. In this regard it is worth noting that the OECD has started a project on the transfer pricing consequences of intangibles. The OECD endeavours to provide final revised guidance on Chapter VI of the OECD Guidelines by the end of 2013.

⁵⁵ invited the business community to share their experience on a number of scenarios in which one-sided analysis, in the view of the OECD, would not be possible. The questions involved focus on the circumstances in which the application of the transactional profit split method (PSM) is likely to be appropriate and the ways in which the factors used to split the profits can align profits and value creation.

⁵⁶ D. Francescucci, *The Arm's Length Principle and Group Dynamics – Part 1: The Conceptual Shortcomings*, 11 *Int. Transfer Pricing J.* 6 (2004), *Journals IBFD* and D. Francescucci, *The Arm's Length Principle and Group Dynamics – Part 2: The Solutions to Conceptual Shortcomings*, 11 *Int. Transfer Pricing J.* 6 (2004), at 241-242, *Journals IBFD*.

⁵⁷ *Id.*, Part 1 at 243.

⁵⁸ Para. 9.161 *OECD Guidelines* (2010).

its aim is also the prevention of tax evasion and tax avoidance as well as an equitable inter-nation allocation of taxing rights (although it does not govern the allocation of the taxing rights of the contracting states over a specific income category).^[59] The latter is also supported by the view of Wittendorff, who states that in an article 9(1) OECD Model context, the tax base may not just be enhanced by making transfer pricing adjustments, but also by creating or disregarding controlled transactions. Article 9 of the OECD Model does not state how business profits should be defined for treaty purposes. The term “business profits” should remain subject to a domestic-law interpretation. For example, one contracting state may determine under its domestic law that a controlled transaction has taken place and make a primary adjustment sanctioned by article 9(1) of the OECD Model, whereas the other contracting state may argue that no controlled transaction exists and refuse to make a corresponding adjustment under article 9(2) of the OECD Model. Such problems arise due to the lack of international harmonization of domestic laws, and such issues are not addressed by the arm’s length principle.^[60]

In order to promote more certainty, in literature it is advocated that one of the distinctive features of the arm’s length principle is that the actual transaction undertaken should be recognized for tax purposes. The recognition should encompass the controlled transaction as such, its form, all of its conditions other than the price, and the circumstances of transaction. It seems that the OECD attempts to supplement the “traditional” approach to the arm’s length principle (meaning just looking at the price) with a broader arm’s length principle (looking at all conditions around the transaction) and a substance-over-form approach. The OECD may be criticized for seeking to accomplish a fundamental reform of the arm’s length principle by changing the Commentaries to the OECD Model and the OECD Guidelines without amending the wording of article 9(1) of the OECD Model. This is bound to cause considerable uncertainty regarding the meaning of article 9(1) of the OECD Model and the domestic transfer pricing provisions relying on article 9(1) of the OECD Model. Moreover, the position that article 9(1) of the OECD Model and domestic transfer pricing provisions relying on the arm’s length principle of article 9(1) of the OECD Model already include a substance-over-form principle is not recognized in the heated debate on the adoption of a general anti-avoidance rule in many countries and will probably be new to many tax professionals outside the transfer pricing area.^[61]

Worth noting is that most countries include a “general” business-rational test in “general” domestic anti-abuse rules. According to the adjusted Commentary to article 1 in 2003, and thus the official position of the OECD, there is no conflict between domestic anti-abuse rules and tax treaties. Such rules may be applied not only to base companies, but also to conduit companies and more generally to every kind of perceived treaty abuse.^[62] It has further been suggested that article 3(2) of the OECD Model offers a legal basis for a broad application of domestic anti-abuse provisions. This is because article 3(2) of the OECD Model is responsible for the preservation of the coherence and autonomy of the domestic laws of the contracting states.^[63] De Broe believes that based on the text of article 3(2) of the OECD Model and the application of article 31 of the Vienna Convention on the Law of Treaties, article 3(2) of the OECD Model permits recourse to domestic anti-avoidance rules only to the extent that such rules provide the meaning of an undefined treaty term.^[64]

⁵⁹ M. J. C. Mauricio, *Transfer Pricing and the Arm’s Length Principle in the European Union Law and Domestic Law*, at 15 – 16 (2014).

⁶⁰ J. Wittendorff, *The Object of Art.9(1) of the OECD Model Convention: Commercial or Financial Relations*, 17 Intl. Transfer Pricing J. 3 (2010), at 200 and 204, Journals IBFD.

⁶¹ J. Wittendorff, *The Transactional Ghost of Article 9(1) of the OECD Model*, 63 Bull. Intl. Fiscal Docn. 3 (2009), Journals IBFD.

⁶² L. De Broe, *International Tax Planning and Preservation of Abuse*, at 403 (IBFD, Vol. 14, Doctoral Series, 2008), Online Books IBFD.

⁶³ Id., at 284.

⁶⁴ Id., at 284 and 285.

When a treaty provides no clear anti-abuse terminology, De Broe argues that the question of whether a domestic anti-avoidance provision or judicial doctrine has effect for treaty purposes is a matter of determining the scope and effect of the domestic legal provision, and of proper interpretation of the terms of the treaty to ascertain whether the result obtained under domestic law is in accordance with the common intention of the contracting states as expressed or implied in the treaty terms. It follows that the OECD's unqualified conclusion that domestic anti-abuse rules are unaffected by tax treaties is incorrect. If the result obtained by applying domestic legal provisions does not square with the terms of the treaty (as the authentic expression of the parties' intention), there is a conflict. In the case of such conflict, whether a domestic anti-abuse rule will be effective depends on how the state in question resolves conflicts between international and domestic law.^[65] This seems to suggest that dualistic countries and countries which allow treaty override would apply their local anti-abuse rules (e.g. local business purposes tests) over the OECD guidance on any general anti-abuse rule. In practice, this would potentially lead to different interpretations by different tax authorities.

Thus, unfortunately there is great uncertainty and ambiguity regarding the interaction of domestic anti-abuse measures and tax treaties based on the OECD Model (and its Commentaries).

2.5. Trade-off between equity and efficiency

There is no such thing as a perfect tax mechanism. No tax system realizes a perfect balance between equity and efficiency. In the words of the European Commission in its pursuit of a simpler tax system, "taxation ultimately involves a political choice and may entail a trade-off between pure economic efficiency and other legitimate national policy goals and preferences".^[66] Budgetary concerns regarding the taxation of excess profits by sovereign states must be weighed against the efficiency concerns of MNEs.

Every taxpayer recognizes that under international tax principles, countries have a legitimate right to tax the profits of a taxpayer based on income and expenses that can reasonably be considered to arise within their territory, with the need to avoid the taxation of the same income by more than one tax jurisdiction.^[67] Time will tell in practice whether Chapter IX of the OECD Guidelines will bring a higher degree of certainty of the tax outcome for an MNE or provide tax authorities with more room for piecemeal interpretation. Especially when dealing with interwoven issues concerning:

- how a taxpayer that is restructuring should compare the other options that would have been realistically available to it at arm's length;
- the proposed use of "control" to test the allocation of risk under related-party contracts in a world where modern multinationals' have virtual management structures and where group – rather than entity level – decisions predominate;
- the scope of comparability as a result of the fact that restructurings by their intrinsic nature lack third-party comparables; Simpson confirmed, during the 2-day face-to-face business consultation meetings on 9 and 10 June 2009 in Paris, that "whether we like the term 'commercially rational', whether we recon 'control' is the right word, whether we like the concept of 'economic substance', those terms are used in the guidelines and it is not part of the Working

⁶⁵ Id., at 287.

⁶⁶ European Commission, *Towards an Internal Market without Tax Obstacles*, COM(2001)582 final, at 30.

⁶⁷ Paras. 6 and 8 *OECD Guidelines* (2010).

Party's mandate to revise the guidelines or to craft better wording".^[68] In the Transfer Pricing Aspects of Intangibles project that is currently being undertaken by the OECD, these terms would most likely be, either, applied consistently or be subject of further analysis and interpretation with the aim to arrive at single consistent interpretations thereof.

In order to retain the arm's length principle as basis for establishing intercompany prices, Chapter IX of the OECD Guidelines endeavours to advocate a trade-off, shifting from seeking "the precise economic" answer to "workable efficiency". This is very much in line with the updated language of Chapters I to III of the OECD Guidelines which were also released in July 2010. One should not forget that economic models have been characterized by reference to a particular view of mankind: human beings are fundamentally the same across time and space. This means that human motives and natures are the same, and thus all people have similar natures that obey certain economic principles, but (notably) through different behaviour.^[69] Allen has captured the reality, and thus the uncertainty, for taxpayers, with great clarity by stating that economics is part religion, part science and part art. It takes talent and intuition to play with the ideas known as economic principles. Each idea by itself is quite simple, but they fit together in many different ways.^[70] In practice, the competency set and experience level of tax authorities and taxpayers, in most countries, are not rooted in economics, nor the study of entrepreneurial behaviour, nor markets, which increases the risk of a broad range of subjective interpretations.

The reality seems to be that in order to mitigate the risk of reclassification, more pressure is put on the taxpayer to document in detail the context of the business rationale, the decision-taking process for each transaction, as well as the implementation of internal controls to ensure that the transfer pricing system is adhered to by the parties. This seems like a disproportionate burden on taxpayers.

68 K.A. Bell, *OECD Delegates Debate How to Price Business Restructurings, Taxpayer Representatives Bemoan Non-Recognition Proposal*, 18 Tax Management Transfer Pricing Report 4 (2009), at 159 and 165.

69 D.W. Adams, *Economic Principles: Seven Ideas for Thinking About Almost Anything* (McInnes Creek Press, 2008), at 9.

70 *Id.*, at 11.

6 – Permanent Establishment Issues

Authors

Irene J.J. Burgers^[*]

Anuschka Bakker^[**]

Latest Information:

This chapter is based on information available up to 1 September 2017.

1. The Presence of a Permanent Establishment

Business restructuring may result in the creation of a permanent establishment (PE), for example where a full-fledged manufacturer has been converted in a toll manufacturer. The threshold for a permanent establishment, however, needs to be met. There are different definitions of the concept of PE used in tax treaties, European law and in domestic legislation, as discussed below.

Tax treaties are interpreted statically or dynamically. Therefore, it is also important to note that throughout the years the OECD has taken steps towards adapting the concept of PE to fit changing circumstances. Since the beginning of this century, the Commentary on Article 5 of the OECD Model Tax Convention on Income and Capital (OECD Model) has been amended several times, in 2003, 2005 and 2008 respectively. On 12 October 2011, the OECD released a Discussion Draft on the [Interpretation and Application of Article 5 \(Permanent Establishment\) of the OECD Model](#). A revised version of the Discussion Draft was published on 19 October 2012 and was prepared on the basis of the [comments that were received on the October 2011 Discussion Draft](#), including the discussion at a public consultation meeting held on 7 September 2012. The very detailed recommendations of this report have not been included in the 2014 Update to the OECD Model, probably as in 2013 the OECD started working on its BEPS project, including work on the concept of PE (Action 7 Preventing the Artificial Avoidance of Permanent Establishment Status and Action 1 Addressing the Tax Challenges of the Digital Economy) of which the Final Reports were published on 5 October 2017. Proposals relate to the use of commissionaire arrangements, splitting up of contracts and the specific activity exemptions. The issue of the taxation of PEs in the context of business restructurings has been on the agenda of the OECD since 2005, when the Committee on Fiscal Affairs created a Joint Working Group of Delegates from Working Party 1 (tax treaty issues) and Working Party 6 (transfer pricing issues) to discuss the topic. At the end of 2007, the Committee decided to stop the joint discussions as sufficient progress had been made. Working Party 1 drafted a Discussion Draft Report on The Interpretation and Application of Article 5 (Permanent Establishment) of the OECD Model Tax Convention and Working Party 6 drafted a report on Transfer Pricing Aspects of Business Restructurings, which is included as Chapter IX in the 2010 and the 2017 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines). In paragraph 9.7 of chapter IX of the OECD Guidelines, the OECD explicitly states that the chapter does not cover the attribution of profits within a single enterprise on the basis of article 7 of the OECD Model, as this is the subject of Working Party 6's report on the

* University of Groningen, the Netherlands.

** Manager Topical Publications, IBFD, the Netherlands.

Attribution of Profits to PEs. The guidance provided under article 9 has been developed independently from the OECD AOA developed for the purposes of article 7.

More work of the OECD on the issue of transfer pricing and business restructuring can be found in the Report on BEPS Actions 8-10, *Aligning Transfer Pricing Outcomes with Value Creation*. Though the Report does not refer to PEs, we assume this work is of relevance not only for associated companies, but also in respect of PEs, as according to the 2010 OECD view on the allocation of profits to PEs “internal dealings” between parts situated in different countries of an internationally operating company should be rewarded according to the standards developed in the OECD Guidelines.

1.1. Tax treaty definitions of what constitutes a permanent establishment

1.1.1. Model tax treaties

Article 5 of the OECD Model provides for a model treaty provision for the concept of PE. The Commentary on Article 5 of the OECD Model (2014) explains the way the PE article should be interpreted and provides for examples. Reference can be made to the chapter [Commentary on Article 5 of the OECD Model](#) of IBFD’s Permanent Establishments collection.

A largely similar provision is included in article 5 of the United Nations Model Double Taxation Convention between Developed and Developing Countries (UN Model). Deviations can be found in:

- article 5(3), which reads:

The term “permanent establishment” also encompasses:

- a. A building site, a construction, assembly or installation project or supervisory activities in connection therewith, but only if such site, project or activities last for a period of more than six months;
 - b. The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than six months within any twelve-month period.
- article 5(5), which not only deems a PE to exist in the case of persons habitually exercising in a Contracting State an authority to conclude contracts in the name of the enterprise, but also in the case of persons having no such authority, but habitually maintaining a stock of goods or merchandise from which they regularly deliver goods or merchandise on behalf of the enterprise;
 - article 5(6), which reads:

Notwithstanding the preceding provisions of this article, an insurance enterprise of a Contracting State shall, except in regard to re-insurance, be deemed to have a permanent establishment in the other Contracting State if it collects premiums in the territory of that other State or insures risks situated therein through a person other than an agent of an independent status to whom paragraph 7 applies.

- article 5(7), which, in addition to the OECD exclusion of brokers, general commission agents and any other agent of an independent status, acting in the ordinary course of their business from the concept of PE, explicitly states that agents whose activities are devoted wholly or almost wholly on behalf of that enterprise while conditions are made or imposed between that enterprise and the agent in their commercial and financial relations which differ from those which would have been made between independent enterprises will not be considered an agent of an independent status within the meaning of the article.

1.1.2. Bilateral tax treaties

Definitions in tax treaties usually resemble the definition provided in article 5 of the OECD Model, although deviations occur. This may be (i) due to specific views of the respective tax treaty partners on what is a PE; (ii) caused by the fact that one or both of the contracting states are developing countries and therefore the UN Model is (also) used as input; and (iii) because treaties were concluded before the publication of the first OECD Model in 1963.

Below some examples are provided which reflect specific views of states:

- article 5(4) of the Netherlands-Ethiopia (2013) Treaty determines that notwithstanding the provisions of paragraphs 1, 2 and 3, an enterprise of a contracting state which carries on activities in the territorial sea, and any area beyond the territorial sea within which the other contracting state, in accordance with international law, exercises jurisdiction or sovereign rights (offshore activities), shall be deemed to carry on, in respect of those activities except as regards paragraph 2 of article 15, business in that other state through a PE situated therein, unless the activities in question are carried on in the other state for a period or periods of less than in the aggregate 30 days in any 12-month period. However, as to article 5(5) for the purposes of paragraph 4, offshore activities shall be deemed not to include:
 - (a) one or any combination of the activities mentioned in paragraph 7;
 - (b) towing or anchor handling by ships primarily designed for that purpose and any other activities performed by such ships; and
 - (c) the transport of supplies or personnel by ships or aircraft in international traffic.
- in the Netherlands-Russia (1996) Treaty, the facilitation of the conclusion of (including the mere signing of) contracts concerning loans, the delivery of goods or merchandise, or technical services is excluded from the definition of a PE (article 5(4)(e)), whereas in the Netherlands-Ethiopia treaty (2013) the maintenance of a stock of goods or merchandise belonging to the enterprise, which is exhibited at a trade fair or exhibition, and which is sold by the enterprise at the end of such fair or exhibition, provided that the frequency of such trade fair or exhibition shall not exceed once in a year is excluded;
- article 5(3)(b) of the Netherlands-Vietnam (1995) Treaty contains the article 5(3)(b) UN Model 2001 provision that “[t]he term “permanent establishment” also encompasses ... the furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or a connected project) within a Contracting State (UN)/ the country (NL-Vietnam) for a period or periods aggregating more than six months within any twelve-month period”;

- article 5(3)(e) of the France-Italy (1989) Treaty provides that a PE includes “the maintenance of a fixed place of business solely for the purpose of advertising, for the supply of information, for scientific research or for similar activities which have a preparatory or auxiliary character, for the enterprise”; and
- article 5(3)(e) of the United Kingdom-Uruguay (2016) Treaty provides that the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, publicity, the supply of information, scientific research or any other activity of a preparatory or auxiliary character is deemed a non-PE.

In 2010 and 2012, the Netherlands concluded new treaties with Switzerland and Germany respectively. The 1949/1959 treaties with these countries do not contain provisions similar to those of article 5(3) and 5(4) of the OECD Model. The 2010 Netherlands-Switzerland Treaty reads similar to article 5 of the OECD Model, whereas article 5 of the Netherlands-Germany Treaty (2012) contains additional provisions for activities carried out in territorial waters and offshore activities (articles 5(4) and 5(6) of the Treaty).

1.1.3. The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosions and Profit Shifting

The focus of OECD BEPS Action 7 is on developing changes to the OECD Model on the definition of a PE to prevent the artificial avoidance of PE status in relation to BEPS, including through the use of commissionaire arrangements and under the exceptions for preparatory or auxiliary activities. On 7 June 2017, over 70 ministers and other high-level representatives participated in the signing ceremony of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (Multilateral Instrument or MLI). In general terms, the MLI seeks to implement the treaty related BEPS measures in a swift and coherent manner, including rules related to the expansion of PE concepts. The MLI, signed by more than 70 jurisdictions, contains four provisions concerning permanent establishments:

a. Article 12 of the MLI “Artificial Avoidance of Permanent Establishment Status through Commissionaire Arrangements and Similar Strategies”

This provision lowers the threshold for an “agency-PE”. The legal authority for the agent to conclude contracts on behalf of the principal is not the only decisive criterion anymore. If the agent habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, it is deemed a permanent establishment if the contracts are:

- in the name of the enterprise; or
- for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use; or
- for the provision of services by that enterprise,

unless these activities, if they were exercised by the enterprise through a fixed place of business of that enterprise situated in that contracting jurisdiction, would not cause that fixed place of business to be deemed to constitute a permanent establishment under the definition of permanent establishment included in the Covered Tax Agreement (as it may be modified by this Convention).

b. Article 13 of the MLI “Artificial Avoidance of Permanent Establishment Status through the Specific Activity Exemptions”

This provision amends the non-PE provision in bilateral treaties which generally reads similar to article 5(4) of the OECD Model. A state has two options. Selecting Option A implies that the non-PEs mentioned in article 5(4)(a)-(e) of the OECD Model 2014 will not be regarded as permanent establishment only if the activity is of a preliminary or auxiliary character notwithstanding the position of the parties to the Covered Tax Agreement on whether or not this requirement has a general character in that the activities mentioned in article 5(4)(a)-(e) of OECD Model 1963–2017 have a preparatory or auxiliary character or treats these exemptions as “per se exemptions” (e.g. warehouses of Bol.com or Amazon). Some states have the view that some of the activities referred to in article 5(4) of the OECD Model 2014 are intrinsically preparatory or auxiliary and, in order to provide greater certainty for both tax administrations and taxpayers, take the view that these activities should not be subject to the condition that they be of a preparatory or auxiliary character, and that concern about inappropriate use of the specific activity exemptions can be addressed through anti-fragmentation rules (article 13(2) of the MLI). The effect of applying Option B (article 13(3) of the MLI) would not be to preserve the exceptions for activities described in article 5(4)(a)-(d) of the Covered Tax Agreement, but to ensure that those exceptions will apply irrespective of whether the activity is of a preparatory or auxiliary character. This would be true whether that contracting jurisdiction takes the position that the exceptions in article 5(4)(a)-(d) of that Covered Tax Agreement are considered per se exceptions to the permanent establishment status, or the position that they are already contingent on the activity being of a preparatory or auxiliary character. An exception is provided in article 13(3)(a) of the MLI, however, in order to preserve existing provisions of a Covered Tax Agreement that explicitly provide that a specific activity shall be deemed not to constitute a permanent establishment provided that the activity is of a preparatory or auxiliary character. These states can choose Option B.

c. Article 13(4) of the MLI: The Anti-Fragmentation Rule

Article 13(4) contains the anti-fragmentation rule. This means that the preparatory and auxiliary exemption does not apply in situations where the business activities constitute complementary functions that are part of a cohesive business operation. So, this rule prevents splitting up activities in order to make use of the non-PE provision. It reads:

“A provision of a Covered Tax Agreement (as it may be modified by paragraph 2 or 3) that lists specific activities deemed not to constitute a permanent establishment shall not apply to a fixed place of business that is used or maintained by an enterprise if the same enterprise or a closely related enterprise carries on business activities at the same place or at another place in the same Contracting Jurisdiction and:

- a) that place or other place constitutes a permanent establishment for the enterprise or the closely related enterprise under the provisions of a Covered Tax Agreement defining a permanent establishment; or
- b) the overall activity resulting from the combination of the activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, is not of a preparatory or auxiliary character,

provided that the business activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, constitute complementary functions that are part of a cohesive business operation”.

The aforementioned means that if the same company or related company within a group performs different activities in the same jurisdiction, which among others consist of activities that have a preparatory or auxiliary character, the exception that this company does not have a deemed permanent establishment for its preparatory and/or auxiliary activities should not apply.

d. Article 14 of the MLI “Splitting-up of Contracts”

Generally, article 14 aggregates periods of time spent (in excess of 30 days in the aggregate) at a building site or construction or installation project by the enterprise and connected activities carried out (during periods that exceed 30 days) by closely related enterprises at the same building site or construction or installation project during different periods of time. Many jurisdictions opted out of the rule relating to splitting up contracts, but some elected to adopt the rule (although some only with respect to activities other than natural resource exploration and exploitation), including Argentina, Australia, France, India, Indonesia, Ireland, the Netherlands and New Zealand.

1.2. The concept of permanent establishment in domestic law

Domestic laws generally also contain a definition of the term “permanent establishment”. Some of these definitions resemble the OECD definitions. Under such circumstances, the Commentary on Article 5 of the OECD Model may be of importance for the interpretation of domestic law as well. For example, the definition of domestic law PE in section 1141 of the UK Corporations Tax Act (CTA) 2010 is similar to article 5 of the OECD Model. Section 1141 of the CTA 2010 (“section 1141”) defines PE under domestic law in the following terms:

a company has a permanent establishment in a territory if (and only if) -

- (a) it has a fixed place of business there through which the business of the company is wholly or partly carried on, or
- (b) an agent acting on behalf of the company has and habitually exercises there authority to do business on behalf of the company.

Under section 2 of the Taxation (International and Other Provisions) Act 2010, the terms of treaties override UK law in specific circumstances. The [OECD Commentary](#) which existed at the time a treaty was entered into will be relevant in interpreting the treaty for the purposes of UK law. The weight to be attached to versions of the OECD Commentary which come after the date of the treaty depends on the circumstances, but generally subsequent versions of the OECD Commentary will be taken into account by the courts to the extent that the Commentary is relevant to the case in hand.^[1] Other domestic law definitions of PE differ from the OECD definitions. The definition included in article 162 of the Italian Income Tax Act, having effect as from 1 January 2004, follows the wording of article 5 of the OECD Model, with the following deviations:

1. D. Hill, United Kingdom - Permanent Establishments sec. 2.1., Topical Analyses IBFD (accessed 1 Sept. 2017).

- computers and auxiliary equipment for the collection of information and the transmission of data for the sale of goods or services will not of themselves constitute a PE; and
- maritime trade agents or trade brokers entitled to manage vessels of non-residents will not of themselves constitute a PE.

The income tax law and corporate income tax law of some countries do not provide for a definition. The Danish Corporate Income Tax Act does not provide for a definition of a “permanent establishment”, even though it employs the term when detailing the rules applicable to the taxation of foreign companies in Denmark. However, pursuant to case law, the term shall be interpreted in accordance with the guidelines in article 5 of the OECD Model. No reference to the concept of a “permanent establishment” is made in the tax legislation of several countries, such as Brazil,^[2] France,^[3] Ireland,^[4] Norway^[5] and South Africa (with the exception of the capital gains tax).^[6] The US Internal Revenue Code uses the concept of “income effectively connected with” the United States, instead of the concept of PE. Note that the underlying principle of the US income tax is the principle of origin, requiring “economic allegiance”,^[7] whereas that of states using the PE concept is the principle of source, requiring a territorial binding of the taxable object with the state. For an in-depth analysis, see [IBFD’s Permanent Establishments collection](#).

1.3. The concept of permanent establishment in EU Legislation

The term “permanent establishment” is also used and defined in EU legislation. For example, article 2(2) of the [Parent-Subsidiary Directive](#) defines a permanent establishment as a fixed place of business situated in a Member State through which the business of a company of another Member State is wholly or partly carried on in so far as the profits of that place of business are subject to tax in the Member State in which it is situated by virtue of an applicable bilateral tax treaty or, in the absence of such a treaty, by virtue of domestic law. Reference can be made to the chapter on [EU Policy Framework](#) of IBFD’s Permanent Establishments collection.

Remarkably, the definition in article 3(c) of the [Interest and Royalties Directive](#) does not contain a reference to tax treaties or domestic law, but simply contains the same definition as in article 5(1) of

2. Law 5,172/1966 establishes that, regardless of whether or not a legal entity is duly incorporated under corporate law, it should be subject to tax if characterized as a business or professional unit.

3. In the case of corporations, art. 209 I [CGI](#) provides that French corporate income tax is payable exclusively on:

- income realized from enterprises carried out in France;
- income and profits derived from real estate assets located in France; and
- income which is taxable in France based on a tax treaty.

There is no legal definition of the concept “enterprises carried out in France”.

4. If:

- a non-resident company carries on a “trade” in Ireland through an Irish “branch or agency”, the company is liable to Irish corporation tax on the profits of that trade; and

- a non-resident individual “exercises a trade” in Ireland, the individual will be liable to Irish income tax on the profits of that trade.

5. The Norwegian Tax Act does not use the term “permanent establishment”, but lays down a broader definition of business activities. Under sec. 2-3(1)(b) NTA, a foreign resident individual or company will be taxable for income and wealth from business carried out or managed in Norway.

6. [ITA 1962](#) generally taxes non-residents on a source basis, irrespective of whether or not they have a permanent establishment in South Africa. Non-residents are taxed on capital gains attributable to a permanent establishment in South Africa, as well as capital gains from immovable property in South Africa. The term permanent establishment is defined in sec. 1 [ITA 1962](#) with reference to art. 5 [OECD Model](#).

7. This is a doctrine according to which a given jurisdiction’s right to tax is determined by reference to the relative proximity of certain economic characteristics to that jurisdiction as compared with another competing jurisdiction. The two most important characteristics used are the place where wealth is produced and the place where it is consumed or otherwise disposed of. *Glossary*, Online Books IBFD (accessed 1 Oct. 2017).

the OECD Model: “the term ‘permanent establishment’ means a fixed place of business situated in a Member State through which the business of a company of another Member State is wholly or partly carried on.”

Articles 4(2)(b) and 12(1) of the Merger Directive 1990/434/EEC, which was updated by Directive 2009/133/EC, require for its application that the assets and liabilities of the transferring company be effectively connected with a permanent establishment, but the Merger Directive does not contain a definition of the term. The Directive does, however, contain a definition of “a branch of activity”, being a division of a company which, from an organizational perspective, constitutes an independent business; that is to say an entity capable of functioning by its own means. The relationship between the two terms is not explained. Thus, although a branch of activity is likely a permanent establishment, a permanent establishment may not be a branch of activity. At the time of writing this chapter, there was no case law on the question and therefore it is unclear whether in applying the Merger Directive, the definitions of the term contained in domestic law, in the Parent-Subsidiary Directive or the Interest and Royalties Directive, in the applicable tax treaties or in the OECD Model should be used.

The EU Anti Tax Avoidance Directive 2016/1164 (ATAD 1),^[8] agreed on by the Council on 21 June 2016,^[9] is also applicable to permanent establishments. The ATAD does not contain a definition of the term “permanent establishment”, but it does contain a definition of “transfer of a business carried on by a permanent establishment”,^[10] meaning an operation whereby a taxpayer ceases to have taxable presence in a Member State whilst acquiring such presence in another Member State or third country without becoming resident for tax purposes in that Member State or third country.

Moreover article 5 of the ATAD 1 provides for an exit tax in case of certain business restructurings, in which:

- a taxpayer transfers assets from its head office to its permanent establishment in another Member State or in a third country in so far as the Member State of the head office no longer has the right to tax the transferred assets due to the transfer;
- a taxpayer transfers assets from its permanent establishment in a Member State to its head office or another permanent establishment in another Member State or in a third country in so far as the Member State of the permanent establishment no longer has the right to tax the transferred assets due to the transfer;
- a taxpayer transfers its tax residence to another Member State or to a third country, except for those assets which remain effectively connected with a permanent establishment in the first Member State;
- a taxpayer transfers the business carried on by its permanent establishment from a Member State to another Member State or to a third country in so far as the Member State of the permanent establishment no longer has the right to tax the transferred assets due to the transfer.

Deferral of payment of exit tax will be provided – in that the tax will be paid in five yearly instalments – if:

8. See <http://www.consilium.europa.eu/en/press/press-releases/2016/06/21-corporate-tax-avoidance/>, (accessed 8 Oct. 2017).

9. See <http://www.consilium.europa.eu/en/press/press-releases/2016/06/21-corporate-tax-avoidance/>, (accessed 8 Oct. 2017). On 21 June, the Council of the European Union agreed on the Anti Tax Avoidance Directive (ATAD 1). The agreement was reached following discussion by the Economic and Financial Affairs Council on 17 June 2016, subject to a silence procedure.

10. Art. 2(8) draft ATAD, see <http://data.consilium.europa.eu/doc/document/ST-10426-2016-INIT/en/pdf>, accessed 8 Oct. 2017.

- a taxpayer transfers assets from its head office to its permanent establishment in another Member State or in a third country that is party to the European Economic Area Agreement (EEA Agreement);
- a taxpayer transfers assets from its PE in a Member State to its head office or another PE in another Member State or a third country that is party to the EEA Agreement;
- a taxpayer transfers its tax residence to another Member State or to a third country that is party to the EEA Agreement;
- a taxpayer transfers the business carried on by its PE to another Member State or a third country that is party to the EEA Agreement.

This paragraph applies to third countries that are party to the EEA Agreement if they have concluded an agreement with the Member State of the taxpayer or with the European Union on the mutual assistance for the recovery of tax claims, equivalent to the mutual assistance provided for in Directive 2010/24/EU.

ATAD 2, adopted on 29 May 2017, contains provisions preventing hybrid mismatch-permanent establishments.^[11] Reference can be made to [chapter 4 – EU Policy Framework](#) of this publication.

2. Types of Permanent Establishments

Business restructurings may result in one of the following types of PEs

- *A fixed place of business PE.* Kroppen and Silva, general reporters of Subject I (Cross-border business restructuring) of the IFA Congress 2011 ^[12] conclude on the basis of 40 national reports that the assumption of a fixed place of business PE will be the exception in case countries follow the OECD Model approach to article 5. This view may now need to be amended taking into consideration the changed PE definition under the OECD BEPS Action 7.
- *A dependent agent PE.* Paragraph 32 of the Commentary on Article 5 of the OECD Model (2014) defines a dependent agent as a person whose activities may create a PE for the enterprise, whether or not employees, who are not independent agents falling under paragraph 6 and who involve the enterprise to a particular extent in business activities in the state concerned in view of the scope of their authority or the nature of their activity. A person will not constitute a PE of the enterprise on whose behalf he acts only if he is independent of the enterprise both legally and economically and acts in the ordinary course of his business when acting on behalf of the enterprise. There may be a difference between common law countries, whereby a commissionaire or undisclosed agent can actually bind the principal, and civil law countries, whereby the commissionaire concludes the contracts in its own name. However, not all civil law countries find the legal form of the contract decisive. Some countries apply an economic approach, in case the commissionaire effectively binds the principal or bears very little risk.^[13] The dependent agent PE definition changed under OECD BEPS Action 7. Article 12 of the MLI expands the standard for when a dependent agent creates a PE of the principal to include situations in which the dependent agent “habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the

11. See http://europa.eu/rapid/press-release_IP-17-1433_en.htm, accessed 1 Oct. 2017.

12. H. Kroppen & J.C. Silva, *General Report*, in *IFA Cahiers 2011*, Vol. 96A, *Cross-border business restructuring* (SDU 2011).

13. See *further*, id., at para. 2.7. and also the National Reports.

enterprise”. Quite some countries opted out of this provision, among others Australia, Belgium, Canada, Germany and the United Kingdom. The Netherlands elected to include article 12.^[14]

- A *service PE*. Some treaties contain the alternative services PE provision suggested by the OECD in paragraph 42.23 of the Commentary on Article 5 of the OECD Model (2014):

Notwithstanding the provisions of paragraphs 1, 2 and 3, where an enterprise of a Contracting State performs services in the other Contracting State

- a. through an individual who is present in that other State for a period or periods exceeding in the aggregate 183 days in any twelve month period, and more than 50 per cent of the gross revenues attributable to active business activities of the enterprise during this period or periods are derived from the services performed in that other State through that individual, or
- b. for a period or periods exceeding in the aggregate 183 days in any twelve month period, and these services are performed for the same project or for connected projects through one or more individuals who are present and performing such services in that other State; the activities carried on in that other State in performing these services shall be deemed to be carried on through a permanent establishment of the enterprise in that other State, unless these services are limited to those mentioned in paragraph 4 which, if performed through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph. For the purposes of this paragraph, services performed by an individual on behalf of one enterprise shall not be considered to be performed by another enterprise through that individual unless that other enterprise supervises, directs or controls the manner in which these services, directs or controls the manner in which these services are performed by the individual.

The business restructuring may result in a permanent establishment providing such services if the days of presence test and the gross revenues test laid down in this alternative provision are met.

A service PE may also arise after a business restructuring if the conditions of article 5.3(b) of the UN Model are met and the tax treaty includes such provision:

The term permanent establishment also encompasses the furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than six months within any twelve-months period.

Other types of PEs might arise where specific (and sometimes unique) treaty provisions that deviate from the OECD and UN Models apply; for example, where one party manufactures goods on behalf of the other (see Australia-Japan Treaty) or where a person fulfils orders on behalf of the enterprise

14. See also <https://home.kpmg.com/xx/en/home/insights/2017/06/tnf-kpmg-analysis-mli-implementing-treaty-related-beps.html>, accessed 12 Jan. 2018.

from a stock of goods maintained in the country by the person (see Russia-Thailand Treaty and South Africa-Nigeria Treaty).^[15]

Whether or not the source state is allowed to tax in such cases will depend on the domestic law of that state.

3. Case Law on Permanent Establishment Issues in the Case of Business Restructurings

Below, case law concerning PEs is discussed which is relevant for business restructuring, i.e. case law on the conversion of a fully fledged distributor into a commissionaire (section 3.1.) and case law on the transfer of part of the management of a group company to another group company in another state (section 3.2.).

3.1. Case law on the conversion of a fully fledged distributor into a commissionaire

The question whether the commissionaire in the case of conversion of a member of a group of companies that is a fully fledged distributor into a commissionaire is sufficiently independent so as to be regarded as an independent agent as referred to in article 5(6) of the OECD Model, and thus not as a PE, has been debated by a number of authors.^[16] The question was also the topic of the well-known [Zimmer Limited](#) case,^[17] as well as the [Dell Products](#) case. Other cases of interest are [Boston Scientific International BV v. Italian Revenue Agency](#) and [Roche Vitamins](#). The court decisions show that commissionaire activities do not necessarily give rise to a PE (*Zimmer*, *Dell*, *Boston Scientific International*), but that stripped local operations may create a PE of the non-resident principal (*Roche*).

Zimmer Limited

This case, in which the Court of Appeals of Paris rendered its decision on 2 February 2007, concerned a UK Ltd specializing in orthopaedics. The Ltd sold its products in France through its affiliated company Zimmer SAS in first instance under a buy/sell arrangement. The French entity was converted into a commissionaire in 1995.

The French tax authorities claimed that Zimmer Ltd had a “fixed place of business” in France. Also, they considered Zimmer SAS to be a dependent agent with the power to bind Zimmer Ltd in commercial transactions pertaining to the latter’s own activities. The Court of Appeals judged Zimmer SAS to be a permanent representative as referred to in article 4(4) of the France–United Kingdom Tax Treaty. The commissionaire agreement showed that Zimmer SAS had the ability to bind Zimmer Ltd in commercial transactions pertaining to Zimmer Ltd’s own activity, as it could accept orders from customers, display quotes and documents in the context of tender offers, conclude sales contracts on behalf of Zimmer Ltd, enter into price negotiations, grant discounts or payment terms to current or new customers without specific prior approval from Zimmer Ltd, and although it could not actually conclude contracts in the name of the principal, it could bind its UK principal in commercial transactions. It acted under the control

15. J. Cooper & S.B. Law, *Business Restructuring and Permanent Establishments*, 17 Intl. Transfer Pricing J. 4, p. 249, sec. 3.5. (2010), Journals IBFD.

16. See *supra* n. 5.

17. Case 05PA02361.

and instructions of Zimmer Ltd with regard to sales terms, promotion projects and the development of new brochures, acted exclusively for Zimmer Ltd and did not assume the risk of the business.

Zimmer Ltd appealed against this decision before the French Supreme Administrative Court, which rendered its decision on 31 March 2010. The Court held that, pursuant to article 209 of the French Tax Code and articles 4 and 6 of the France–UK Tax Treaty, a French resident company may constitute a PE of the latter only if the following conditions are met:

- the French resident company cannot be regarded as an independent agent of the UK resident company; and
- the French resident company had the authority to bind the UK resident company into a commercial relationship relating to the activities carried out by the latter.

The Court concluded that pursuant to the provisions of the French Commercial Code, the contracts concluded with its clients by a commissionaire do not bind the foreign principal with the commissionaire's clients. The Court concluded that in the case at hand the commissionaire could not be considered a PE of the foreign principal. The Court also concluded that the premises and personnel of Zimmer SAS used for its commissionaire activities could not be considered a fixed place of business for Zimmer Ltd under article 4(1) and (2) of the France–UK Tax Treaty.^[18]

Dell Products ^[19]

The Norwegian Supreme Court gave its decision on 2 December 2011 in the case of *Dell Products (Europe) BV v. Skatt Øst*. A company, Dell Products (Dell Sales), the principal in the commissionaire structure, was owned by Dell Products (Europe) BV (Dell Europe). Both companies were tax resident in Ireland. Dell Europe produced Dell products in Ireland for the European, Middle Eastern and African markets. Dell Sales purchased products from Dell Europe and sold them in the market through local Dell subsidiaries.

In Norway, products were sold by Dell AS (the Agent), under a commission agreement with Dell Sales (the Principal). Dell AS sold and marketed Dell products in the Norwegian market in its own name but for the risk and account of Dell Sales. The Agent, Dell AS, received a commission amounting to 1% of sales for its services.

Article 5(5) of the Ireland–Norway Income and Capital Tax Treaty (2000) (the Treaty) stipulates that where a person is acting on behalf of an enterprise and has, and habitually exercises, in a contracting

18. For a comparative study of agency PEs and the *Zimmer* case, see D. Oosterhoff & J. Tiele, *Commissionaire/Agency Permanent Establishment Structures* (Netherlands); S.G. Andresen & E. Funuseth, *Agency Permanent Establishments* (Norway); J. Monsenego, *Agency Permanent Establishment and Commissionaire Structures* (Sweden) and R. Peel & S. Pope, *Commissionaire Agency Permanent Establishment Structures and the Impact of the Zimmer Case* (United Kingdom), 17 Intl. Transfer Pricing J. 6 (2010), Journals IBFD. The Norwegian authorities conclude that *Zimmer* will be used as a central source of law when interpreting commissionaire issues under a tax treaty. The other authors conclude the case will not have a significant impact on the tax and transfer pricing practice in their country. The Dutch authors come to this conclusion as so far the Dutch tax authorities have challenged the transfer prices applied between the commissionaire and its principal. The Swedish authors mention that the authorities in their country have not considered commissionaires as a PE of their foreign principal in the past and the UK authors base their opinion on the fact that *Zimmer* only applies to civil law scenarios because such structures do not exist under UK common law.

19. **Norway; Ireland – Treaty between Norway and Ireland – Norwegian Supreme Administrative Court rules on agency PE in commissionaire arrangement (Dell case) (07 Dec. 2011), News IBFD.**

state an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a PE in that state in respect of any activities which that person undertakes for the enterprise.

The issue was whether the commissionaire structure in question created a PE and consequently tax liability for the Principal in Norway. The Supreme Court focused on interpreting the wordings “on behalf of” and “have authority to conclude contracts on behalf of” as stipulated in article 5(5).

The Court started with the literal interpretation of the Treaty and concluded that the commissionaire must enter into legally binding agreement in the name of the principal. Due to the fact that article 5(5) of the Treaty was identical with the OECD Model, relevance was given to the OECD Commentary on Article 5. In this respect, the Court, however, concluded that the Commentary did not give any specific guidelines to the present case.

Furthermore, the Court gave relevance to the domestic case law from third countries by referring to the *Zimmer* case. The Court pointed out that the Dell group has similar commissionaire structures in 15 other countries but the PE issue had not arisen in any of those (except in Spain).

Finally, the Court made reference to technical and practical considerations by stating that if the argument put forth by the tax authorities (i.e. that an overall evaluation on a case-by-case basis should be undertaken on whether the commissionaire binds the principal) was accepted, it would be very difficult to apply article 5(5) in practice. Consequently, the Court ruled that the Principal, Dell Sales, did not have a PE in Norway.

Boston Scientific International BV v. Italian Revenue Agency ^[20]

The Italian Supreme Court ruled on a PE issue related to an Italian company that acted as a commissionaire of a Dutch principal (Ruling 3769 of 9 March 2012). The Court ruled that the Italian company did not constitute an agency PE of the Dutch principal because it did not qualify as a dependent agent due to its operational autonomy and the business risks borne. The fact that the Italian company worked exclusively for the Dutch principal was judged as not indicative of any dependent agency status, but rather considered a common practice in the market.

In 2005, the Italian Tax Police carried out a tax inspection (related to fiscal year 2000) at the premises of Boston Scientific S.p.a. (BS), the Italian subsidiary of Boston Scientific International BV (BSI), a Dutch resident company. Following the tax inspection, the Italian Revenue Agency issued a notice of assessment arguing that the Italian company was acting as a dependent agent of its parent company and that a deemed agency PE existed thereof. BSI initiated a tax controversy before the tax court and won the first, second and final level of judgment.

BS was responsible for the sales of BSI's goods in Italy and bore the costs related to the sales organization. Its remuneration was based on a commission proportioned to the volume of goods sold. According to the agreement signed by the two companies, BS was acting in its name and on its own behalf before Italian clients. BS received purchase orders from clients and automatically transferred them to BSI, which processed the orders and carried out the relevant logistic activities, since the inventory was located and managed in the Netherlands and not in Italy.

20. See https://www.taxconnections.com/user_uploads/pubs/pub_b5ab4744323fd14c2d401a958b9cf82dc527264c7dab614dac8825b990c1f66c337c4fe70906af5bfda49314865a5f32.pdf and G. Cottani, Italy – Transfer Pricing & Business Restructuring, Topical Analyses IBFD (accessed 1 Oct. 2015).

Technically, the Supreme Court did not decide *Boston Scientific* on the merits, but rejected the tax authorities' appeal of the Regional Tax Court of Lombardy's decision in favour of BSI BV on the procedural grounds that the Advocate-General failed to provide a legal basis on which the Supreme Court could overturn the Regional Tax Court's ruling.

Accordingly, the tax authorities are free to re-litigate the issues in *Boston Scientific* in a subsequent matter involving Boston Scientific or another taxpayer. *Boston Scientific* nevertheless represents a positive development for taxpayers using European civil law commissionaire structures because the Italian Supreme Court upheld a decision that employed reasoning consistent with the French Supreme Administrative Court's decision in *Zimmer Limited* and the Norwegian Supreme Court's decision in *Dell Products*.^[21]

Roche ^[22]

The Spanish Supreme Court gave its decision on 12 January 2012 in *Roche* (Appeal number 1626/2008), stating that a Spanish affiliate (Roche Vitaminas, S.A. (RV)), which performed manufacturing and promotional activities at the request of a Swiss company (Roche Vitamins Europe Ltd. (RVE)), was deemed to be a PE of RVE under article 5 of the Spain–Switzerland Income and Capital Tax Treaty (1966) (the Treaty).

In 1999, two contracts were signed between RV and RVE. Under the first contract, RV committed to manufacture and pack products ordered by RVE. The remuneration to be charged by RV for such services was determined as a cost-plus pricing, adding a 3.3% mark-up on the cost of the product. In the second contract, RVE designated RV as its agent to promote RVE's products. Remuneration in exchange for the agent's services was set at 2% on sales promoted by RV.

The Spanish tax authorities considered that RVE had a PE in Spain as RV was acting as a dependent agent of RVE under article 5 of the Treaty. In this respect, RV manufactured RVE's products by following its instructions and without assuming the manufacturing and promotional risks associated with such products. RVE was the only company which dictated instructions and the only one taking the risks of the operations.

The Supreme Court held that, according to article 5 of the Treaty, in the case at stake, any of the following two circumstances could determine that RVE was deemed to have a PE in Spain:

- the existence of a fixed place of business through which the business was carried on; or
- the performance of its activities through a dependent agent with authority to conclude contracts in the name of RVE, provided the activities were not restricted to the acquisition and sales of goods.

21. See http://www.bakermckenzie.com/files/Publication/8d2986b9-09b6-46d6-a891-4926f91020f5/Presentation/PublicationAttachment/9601ba4a-2518-4106-aedb-81d591014eb3/nl_na_taxnewsdevelopments_jun12.pdf.

22. See http://online.ibfd.org/kbase/#topic=doc&url=/highlight/data/tns/docs/html/tns_2012-02-29_es_1.html&q=roche&WT.z_nav=Search&colid=4913 and http://online.ibfd.org/kbase/#topic=doc&url=/collections/ttcls/html/cl_es_2012-01-12_1-summary.html&WT.z_nav=Navigation&colid=4938.

3.2. Case law on the transfer of part of the management of a group company to another group company in another state

Case law of the Supreme Courts of Italy (Philip Morris) and the Netherlands (Court of Amsterdam 24 April 1987 and Dutch Supreme Court 14 October 2005) shows that business restructuring may give rise to a PE if part of the management of a group company is transferred to another group company in another country.

Philip Morris

In [Philip Morris](#) ^[23] in Italy, Philip Morris GmbH, a resident taxpayer of Germany, received royalties from the Italian Tobacco Administration for a licence to produce and supply cigarettes and tobacco products with the Philip Morris trademark. The execution of the contract was supervised by the Italian member of the group, Intertaba SpA, which performed agency and promotional activities in relation to sales of Philip Morris products in duty-free areas. The main business purpose of Intertaba was to manufacture and distribute cigarette filters both in Italy and abroad. The Italian tax authorities argued that the Italian subsidiary, Intertaba SpA, was a multiple PE of the group, as it participated in the negotiations between Philip Morris GmbH and the Italian Tobacco Administration, as well as in the business activities of the group without any autonomy and executed the contract with the Italian Tobacco Administration, and, moreover, incurred costs for the benefit of the group for which no consideration was received. Therefore, royalties were allocated to the PE.

The Italian tax authorities based their position on legal opinions and other documentation gathered during the investigations which indicated that the formation of the subsidiary and the shifting of functions within the group were intended to avoid triggering the existence of a PE.

The case reveals that the Italian Supreme Court is of the opinion that an Italian company may constitute a multiple PE of foreign companies belonging to the same group and pursuing a common strategy. In general, the supervision or control of the performance of a contract between a resident entity and a non-resident entity cannot be regarded as an auxiliary activity within the meaning of treaty provisions that are similar to article 5(4) of the OECD Model if it contributes significantly to the group's regional income. In addition, authority to conclude contracts in the name of the foreign company may consist of the participation of representatives or employees of a resident company in concluding a contract between a foreign company and another resident entity, and a PE will be established if the non-resident company entrusts a resident company with the management of some of its business operations.

Hof Amsterdam 24 April 1987 and Hoge Raad 14 October 2005

A similar issue was at stake in cases decided by the Court of Amsterdam on 24 April 1987^[24] and the Dutch Supreme Court on 14 October 2005.^[25] These cases indicate that management activities performed by the parent on behalf of a subsidiary may constitute a PE, but that this is not the case if the top management has a general managerial function and the board of management of the subsidiary has sufficient expertise in the field of financing and factoring and the power to take operational decisions.

23. Corte Suprema di Cassazione, 25 May 2002, 7682/02, *L. Ministry of Finance (Tax Office) v. Philip Morris (GmbH)*. See e.g. M. Gazzo, *Permanent Establishment through Related Corporations: New Case Law in Italy and Its Impact on Multinational Flows*, 57 Bull. Intl. Taxn. 6, pp. 257-264 (2003), Journals IBFD; C. Romano, *Subsidiaries as Permanent Establishments: The Philip Morris Case*, 38 Eur. Taxn. 9, p. 315 (1998); R. Russo & E. Pedrazzini, *Permanent Establishments under Italian Law: An Overview*, 47 Eur. Taxn. 8, p. 389 (2007), Journals IBFD; L.A. Sheppard, *News Analysis: Revenge of the Source Countries?*, Tax Notes, p. 1362 (21 March 2005).

24. BNB 1990/337 (follow-up of the cases decided by the Supreme Court on 21 August 1985, BNB 1985/301* and 302*).

25. BNB 2006/79.

A famous Dutch case concerns a public company situated in the Netherlands, a parent company of a group of companies, that established a captive insurance company incorporated in the Netherlands Antilles. The director and the other personnel of the captive had no specific knowledge of insurance. The director did have knowledge of the enterprises of the insured and the objects to be insured. The reasons for establishing the captive in the Netherlands Antilles were as follows:

- the Netherlands Antilles did not impose any legal requirements on setting up the captive;
- several other parts of the group were also resident of the Netherlands Antilles;
- the insurance broker of the group was a resident of the Netherlands Antilles; and
- the Netherlands Antilles was prepared to give a ruling.

The captive had an office in the Netherlands Antilles.

The Court of The Hague in its decision of 15 February 1984 held that the captive did not have its effective place of management in the Netherlands, as management tasks were not carried out by personnel of the parent company other than on an incidental basis. However, the Supreme Court in its decision on 21 August 1985^[26] found the rationale for this verdict deficient and therefore directed the Court of Amsterdam to decide on the interpretation of the facts. The Court of Amsterdam concluded on 24 April 1987, BNB 1987/337, that the captive's management partly took place at the head office, as the management decisions taken there were more than the usual influence of the board of management of a company. Therefore, the captive was deemed to have a PE in the Netherlands.

In the case decided by the Dutch *Hoge Raad* on 14 October 2005, the tax authorities were less successful. The facts of the case were as follows. The taxpayer was a public company incorporated under Belgian law, being part of a multinational having its head office in the Netherlands. Its shares were held by a Dutch-resident public company. Two questions were at stake, namely:

- Did the subsidiary have its effective place of management in the Netherlands?
- Did the subsidiary have a PE in the Netherlands in the form of a place of management?

The multinational had a decentralized division structure. Strategic business units performed a coordinating role for parts of the business activities. The task of the Belgian subsidiary was twofold. First, it functioned as a strategic business unit for Europe and the United States in respect of coordinating activities concerning flexible packing materials. Furthermore, it functioned as a coordination centre, developing and centralizing one or more specific activities for the group or part of the group, such as providing information, insurance, scientific research, administration, centralizing financial transactions and hedging.

Some of the members of the board of management of the subsidiary were also part of the board of management of the top holding company and/or the parent company. These persons lived partly in Belgium and partly in the Netherlands. The meetings of the board of management of the subsidiary and the shareholders' meetings took place in Belgium. The top holding company gave directions for acquisitions and reorganizations of the multinational. The staff departments of the head office gave advice and/or instructions with regard to loan and factoring agreements. Personnel of the taxpayer had a coordinating function as a strategic business unit and fulfilled their financial and related activities at

26. BNB 1985/302c*.

the head office in Belgium. The persons performing daily management of the financial activities of the taxpayer could dispose of the bank accounts of the taxpayer.

According to the Dutch tax inspector, the effective management of the strategic business unit activities of the taxpayer were carried out by personnel of the taxpayer, but the financial activities were carried out by the board of management or certain staff departments (Group Treasury and tax and acquisitions) of the top holding company, being incorporated in the Netherlands and having its effective place of management in the Netherlands. Therefore, the tax authorities argued that the taxpayer had its central place of management, or a place of management as referred to in article 5 of the Treaty (Permanent Establishment), in the Netherlands.

The Court of Amsterdam referred to a Supreme Court decision of 23 September 1992^[27] and refined that decision with the following argument: decisive for determining the place of effective management are the activities of the company as described in its statutes and its key activities, being the economic tasks actually fulfilled by the taxpayer. It is not decisive whether the top management of the multinational has a general managerial function in respect of the taxpayer (as is generally the case in a multinational due to the shareholder relationship) and in view of the necessary strategic coordination, but it is decisive whether top management had such a steering role in respect of the key activities of the taxpayer that these activities are no longer fulfilled by the taxpayer or under the guidance of the taxpayer's own statutory management.

In the case under consideration, it is not decisive that the board of management of the top holding company took the initiative for the incorporation of *B NV*, that the reasons for establishing *B BV* were mainly to reduce the tax burden and that top management took the decision that the taxpayer would function as a strategic business unit and financing company of the multinational, nor that an extensive amount of own funds of the multinational had been transferred to the Belgium company in order to reduce the tax burden. These decisions and policy considerations are not in the field of the key activities of the taxpayer, but are key activities of a central holding company. Neither are the activities of the top holding company in respect of acquisitions and reorganizations of the multinational of importance, nor the fact that the multinational aims, from a tax perspective, at an optimal structure. The subsidiary had its central place of management in Belgium, as a considerable and essential part of the key activities of the subsidiary (i.e. its coordinating role as a strategic business unit) were actually performed by staff members of the subsidiary and at the head office of the subsidiary, and these activities were managed by the daily management of the taxpayer as appointed by its statutory board of management.

Taking into account that the financial activities and the administration thereof took place in the office of the taxpayer in Belgium, the central place of management of the taxpayer was in Belgium. In addition, the Court concluded that no PE was present in the Netherlands, as the tax inspector did not make a plausible argument that the day-to-day-management of the taxpayer did not have sufficient expertise to fulfil their tasks in the field of financing and factoring, if required with the help of third parties. The board of management of the subsidiary had the power to take decisions, and taking decisions with regard to the methods of financing the subsidiary is a task that is usually taken at the level of the head office. The staff departments only offered advice, often based on the policy of the multinational, and did not have the power to take decisions. In determining whether or not a place of management was present in the Netherlands, the Court considered it decisive that the tax inspector did not prove that day-to-day management of the subsidiary did not take decisions concerning the risks of concluding contracts

27. BNB 1993/193.

appropriate for a financing and factoring company of a multinational. To the extent that (the staff of) the head office took direct operational decisions, this was merely incidental.

In the Netherlands, the Supreme Court is not permitted to interpret facts. Thus, it is not surprising that the *Hoge Raad*, in its decision of 14 October 2005,^[28] rejected the appeal. According to the Court, there were no questions of importance for the development of the law or the unanimous application of the law.^[29]

4. Allocation of Profits to PEs in the Case of Business Restructurings: Possible Influence of Actions 8, 9 and 10 of the BEPS Report

According to the authors' knowledge, the OECD does not have the intention to write a report on the business restructuring issue in a PE context concerning the attribution of profits to PEs. The work of the OECD in its Attribution of Profits to Permanent Establishment Reports of 2008 and 2010 will therefore be of importance in case of business restructurings that involve PEs.^[30] The allocation of profits to PEs may, however, be impacted by Actions 8, 9 and 10 of the BEPS report. These actions are focused on allocating the value to the companies that add value or run risks in the process. Action 8 reads as follows:

Develop rules to prevent BEPS by moving intangibles among group members. This will involve: (i) adopting a broad and clearly delineated definition of intangibles; (ii) ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with (rather than divorced from) value creation; (iii) developing transfer pricing rules or special measures for transfers of hard-to-value intangibles; and (iv) updating the guidance on cost contribution arrangements.

Action 9 reads:

Develop rules to prevent BEPS by transferring risks among, or allocating excessive capital to, group members. This will involve adopting transfer pricing rules or special measures to ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital. The rules to be developed will also require alignment of returns with value creation. This work will be co-ordinated with the work on interest expense deductions and other financial payments.^[31]

Action 10 reads:

Develop rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties. This will involve adopting transfer pricing rules or special

28. BNB 2006/79.

29. For a more in-depth analysis of this case and suggestions for refinement of (the Commentary on) Article 4(3) of the OECD Model, see I.J.J. Burgers, *Some Thoughts on Further Refinement of the Concept of Place of Effective Management for Tax Treaty Purposes*, 35 *Intertax* 6/7, p. 378 (2007).

30. For further information on these Reports, see I.J.J. Burgers, *OECD – Analysis Art. 7 OECD Model Convention: Allocation of Profits to a Permanent Establishment*, Topical Analyses IBFD (accessed 1 Oct. 2017).

31. OECD, *Action Plan on Base Erosion and Profit Shifting (BEPS Action Plan)* (OECD 2013), p. 20, International Organizations' Documentation IBFD.

measures to: (i) clarify the circumstances in which transactions can be recharacterized; (ii) clarify the application of transfer pricing methods, in particular profit splits, in the context of global value chains; and (iii) provide protection against common types of base eroding payments, such as management fees and head office expenses.^[32]

The rules that follow from Actions 8, 9 and 10 are likely to impact the OECD position on the attribution of profits to PEs. In the meantime, the OECD published its [OECD Action 8-10 Final Report on 5 October 2015](#).^[33] This report includes guidance on (i) the conduct of parties; (ii) the allocation and management of risk; and (iii) the non-recognition of transactions. So, this report is focused on substance.^[34] The allocation and management of risk is also attended to in this report. This Report is discussed in chapter [OECD Policy Framework](#) of this publication.

The [Final Report on Action 7 of the BEPS Action Plan](#) (Preventing the Artificial Avoidance of Permanent Establishment Status)^[35] mandates follow-up work to develop additional guidance on the issue of attribution of profits to PEs. On 22 June 2017, the OECD issued Public Discussion Draft, BEPS Action 7, Additional Guidance on the Attribution of Profits to Permanent Establishments (PE Discussion Draft).^[36]

The OECD states in its PE Discussion Draft that the profits to be attributed to a permanent establishments identified under article 5(5) of the OECD Model are to be determined in accordance with article 7 of the relevant tax treaty.^[37] The PE Discussion Draft states that the OECD Model and its Commentary do not explicitly prioritize the application of either article 9 or article 7 of the OECD Model in cases where a dependent agent PE is recognized as a result of the activities of the intermediary located in that country.^[38]

The OECD continues that the order in which articles 7 and 9 of the OECD Model are applied should not impact the amount of profits over which the source country has taxing rights as a result of the activities of the intermediary on behalf of its associated non-resident enterprise in the source country. Furthermore, any approach to the application of articles 7 and 9 to cases of deemed PEs under article 5(5) must ensure that there is no double taxation in the source country, i.e. taxation of the same profits in the hands of the PE (under profit attribution rules) and in the hands of the intermediary (under transfer pricing rules). Therefore, “jurisdictions are expected to have in place within their domestic legal and/or administrative systems the necessary principles, doctrines, or other mechanisms to eliminate double taxation in the source country”^[39]. Four examples are included in the PE Discussion Draft. The OECD invited the tax community to provide feedback. A public consultation on the PE Discussion Draft will be held on 6 and 7 November 2017.

32. OECD, *Action Plan on Base Erosion and Profit Shifting (BEPS Action Plan)* (OECD 2013), p. 20-21, International Organizations' Documentation IBFD.

33. OECD, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10: 2015 Final Reports, OECD/G20 Base Erosion and Profit Shifting Project* (OECD 2015), International Organizations' Documentation IBFD.

34. For a clarification on substance requirements in the OECD Guidelines, reference can be made to J. Monsenengo, *The Substance Requirements in the OECD Transfer Pricing Guidelines: What is the Substance of the Substance Requirement?*, 21 Intl. Transfer Pricing J. 1, pp. 9-23 (2014), Journals IBFD.

35. OECD, *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7: 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project* (OECD 2015), International Organizations' Documentation IBFD.

36. See <http://www.oecd.org/tax/transfer-pricing/beps-discussion-draft-additional-guidance-attribution-of-profits-to-permanent-establishments.pdf>, accessed 1 Oct. 2017.

37. Para. 9 PE Discussion Draft.

38. Para. 12 PE Discussion Draft.

39. Id.

Quite some practitioners raised the issue that the administrative burden on companies increases as a result of the changed dependent agent PE definition. As a result of this changed definition, a dependent agent PE may exist in a jurisdiction and, consequently, among others, a corporate income tax return needs to be filed. It may however well be that, based on the rules laid out in the PE Discussion Draft, hardly any or zero profits would be allocated to the dependent agent PE.

7 – VAT Aspects of Business Restructuring

Authors

Oskar Henkow^[*]

René van der Paardt^[**]

Ynze van der Tempel

Latest Information:

This chapter is based on information available up to 1 October 2017.

1. Introduction

1.1. General

If a company changes its business, the VAT consequences of such change should certainly be considered. A company that does not pay sufficient attention to VAT issues exposes itself to significant financial risks.

First, a business should realize that a business restructuring may result in (additional) amounts of VAT that must be paid by the company without the company being able to claim a refund from the tax authorities. Such non-deductible VAT may significantly increase the cost of the services and goods purchased by a company. Second, the taxpayer should be certain that all legal requirements regarding VAT are met. These requirements are often very strict. When they are not met, most countries impose substantial fines (often a percentage of the VAT amounts involved). Third, the taxpayer should realize that actual VAT payments may have a material impact on working capital. With correct planning, these risks can often be handled but without proper attention unexpected additional costs may arise.

This chapter addresses certain VAT aspects of transactions that may form part of a business restructuring. It solely addresses the VAT system as applicable within the European Union.

1.2. Introduction to the VAT system of the European Union and the treatment of financial activities

The VAT systems of the Member States of the European Union are harmonized in detail by, foremost, the VAT Directive (2006/112/EU) (VAT Directive). In this chapter, the VAT consequences are described based on the EU VAT Directive as interpreted by the Court of Justice of the European Union (ECJ). Today, all major economies in the world apply a VAT system with the exception of the United States. These systems share the main characteristics of that of the EU VAT system. Consequently, also in countries outside the EU, similar issues often arise as in the EU VAT system. The VAT consequences of a business restructuring must however always also be based on an analysis of the national VAT legislation involved, as is the case with any VAT issue.

* Associated Professor (LDD) Oskar Henkow is a researcher and teacher of indirect taxes at Lund University, Sweden.

** The chapter was originally written by René van der Paardt and Ynze van der Tempel. Both are partners at Loyens & Loeff, the Netherlands.

In the EU VAT system, in essence, all supplies between different legal persons are liable to VAT. Between taxable persons, VAT charged is, as a main rule, deductible. So in the normal course of events VAT should not be a cost in a business restructuring but simply a matter of cash-flow. However, when a business is restructured the parties involved are not always acting as taxable persons. And some transactions, such as share sales, are exempt from VAT. In both these situations there may be an effect on the right to deduct input VAT on acquisitions for the activity and also on the liability to charge VAT on sales. Hence, every transaction in a business restructuring needs to be assessed to ensure that no adverse VAT consequences occur.

Under the EU VAT system, VAT is due on supplies made for consideration by taxable persons acting as such within the territory of the country (article 2 of the VAT Directive^[1]). Article 9, paragraph 1 of the VAT Directive defines “taxable person” as any person who, independently, carries out in any place any economic activity, whatever the purpose or results of that activity. Any activity of producers, traders or persons supplying services, including mining and agricultural activities and activities of the professions, is regarded as “economic activity”. The exploitation of tangible or intangible property for the purposes of obtaining income therefrom on a continuing basis is specifically regarded as an economic activity.

A VAT taxable person is, in principle, entitled to a refund of VAT paid by him to other taxable persons (input VAT). Most often, input VAT is not actually refunded but deducted from VAT payable on supplies made (output VAT). If tax-exempt services (such as financial services or insurance activities) are performed,^[2] in principle no entitlement exists to a refund of input VAT that is related to such activities. The same is generally the case when acquired goods and services are related to non-taxable activities or outside the scope of VAT activities (such as certain financial activities).

The taxable amount for VAT is the transaction price that the parties agree upon. There is generally no correction mechanism to change the tax base to a fair (open) market value of goods or services. Also in related situations and/or intercompany transactions (which may cause transfer pricing issues for corporate income tax and/or customs valuation purposes), the actual invoice price is considered to be the tax base for VAT. In the case where transactions are performed between related parties that have a limited right to deduct input VAT, there may however be an obligation to adjust the taxable amount to the open market value (article 80 of the VAT Directive). Also in the case of *fraus legis*^[3] may an adjustment be made for VAT, either in the taxable base or in the (revoked) right to deduct VAT as input tax.

The companies involved in a business restructuring are often performing various financial activities. A company that is involved in financial activities faces a very complex situation with regards to VAT. Its activities could either fall outside the scope of VAT (being non-economic activities for VAT purposes), fall within the scope of VAT and be taxed, or fall within the scope of VAT and be exempt for VAT purposes. The ECJ has held that the passive holding of shares in subsidiaries (passive holding company) does not, in itself, constitute an economic activity for VAT purposes. Consequently, a company solely holding shares in subsidiaries does not qualify as a taxable person for VAT purposes. (See, for example, [Case C-29/08 AB SKF](#), p. 28 with references to further case law.) The same applies to the managing of other financial assets as a private investor, i.e. excluding share-dealing activities (brokers etc.) and similar

1 2006/112/EC77/388/EEC.

2 Article 135(1)(b) to (g) of the VAT Directive (formerly article 13(B)(d)(1-6) of the Sixth Directive) provides for a series of exemptions relating to banking and financing. See B.J.M. Terra, J. Kajus & O. Henkov, *Commentary – A Guide to the Recast VAT Directive – Chapter 9 – Exemptions, Topical Analyses IBFD* (last reviewed: 22 Sept. 2014; accessed 5 Mar. 2015).

3 Reference is made to UK: ECJ, 21 Feb. 2006, [Case C-255/02, Halifax plc, Leeds Permanent Development Services Ltd, County Wide Property Investments Ltd v. Commissioners of Customs & Excise, BUPA Hospitals Ltd, Goldsborough Developments Ltd v. Commissioners of Customs and Excise and University of Huddersfield Higher Education Corporation v. Commissioners of Customs and Excise](#), ECJ Case Law IBFD.

activities which are not performed “as a private investor”. However, if a holding company is involved in the management of its subsidiaries (active holding company) providing management services to them for a fee, the holding company is involved in an economic activity, providing the management services. When shares held by an active holding company are later sold, the share sale also constitutes an economic activity, according to the *AB SKF* case (Case C-29/08 AB SKF); see *further* below.

In case the activities in question are economic activities falling within the scope of VAT, the exemptions for financial services in article 135(1)(b)-(f) of the VAT Directive are of particular importance. A range of financial services are exempt from VAT, meaning that no output VAT is chargeable but also that no input VAT is deductible if it pertains directly to the exempt activity.

The right to deduct input VAT charged on acquisitions made in the business is an inherent feature of the VAT Directive. The main rule regarding the deduction of input VAT is included in article 168 of the VAT Directive, which states that insofar as the goods and services are used for the purposes of the taxed transactions of a taxable person, the taxable person is entitled, in the Member State in which he carries out these transactions, to deduct the input VAT from the VAT which he is liable to pay. As is apparent from this provision, the acquisition has to be made by a taxable person. Consequently, a distinction must be made between input VAT incurred for economic activities and input VAT incurred for non-economic activities.

In principle, VAT must pertain to an economic activity to be deductible. If input VAT pertains to a non-economic activity, no right to deduct exists, but a number of exemptions exist from that rule when the input VAT also pertains to the business as a whole. For example, an issue of shares in a company is not an economic activity, but input VAT pertaining to the issue is nevertheless deductible as a general cost (*Kretztechnik*, Case C-465/03) (see *further* section 5.). VAT on costs for acquiring capital to the business, for example by taking up a bank loan, is generally considered to be related to the business and input VAT deductible as acquisitions are part of the general costs (Case C-4/94 BLP). If the input VAT cannot be considered to pertain to the business as a whole, Member States are in principle required to limit the right to deduct input VAT to the extent that the VAT relates to non-economic activities (and calculate a deductible proportion similar to the one calculated when exempt and taxed activities are performed, see below) (Case C-437/06 *Securenta*).

When the input relates to economic activities, a distinction must furthermore be made between (1) input VAT that can be directly related to taxed activities and (2) input VAT that cannot be directly related to taxed or exempt activities. The second category consists of the “general costs” of a company.

If under the main rule in article 168 of the VAT Directive no deduction may be claimed, article 169 of the VAT Directive provides a number of special situations in which it is nevertheless possible to deduct input VAT. According to article 169(c) of the VAT Directive, where the customer is established outside the European Union or where the transactions relate directly to goods to be exported out of the European Union, exempt financial transactions pursuant to points (a) to (f) of article 135(1) of the VAT Directive, entail the right to deduct. Consequently, even though these financial transactions are exempt, they still entail a right to deduct input VAT when provided to customers outside the European Union or relate to exported goods.

Article 173 of the VAT Directive provides that in the case of goods or services used by a taxable person both for transactions in respect of which VAT is deductible and for transactions in respect of which VAT is not deductible, only such proportion of the VAT as is attributable to the transactions for which VAT is

deductible, will be deductible. Under article 174 of the VAT Directive, the deductible proportion is made up of a fraction comprising the following amounts:

- as numerator, the total amount, exclusive of VAT, of turnover per year attributable to transactions in respect of which VAT is deductible; and
- as denominator, the total amount, exclusive of VAT, of turnover per year attributable to transactions included in the numerator and to transactions in respect of which VAT is not deductible.

In the *EDM* case,^[4] the ECJ ruled that the turnover attributable to the annual granting by a holding company of interest-bearing loans to companies in which it has a shareholding and placements by that holding company in bank deposits or in securities (such as Treasury notes or certificates of deposit) must be excluded from the calculation of the deductible proportion if they are incidental transactions. They must in that respect be regarded as such insofar as they involve only very limited use of assets or services subject to VAT. Although the scale of the income generated by financial transactions within the scope of VAT may, according to the ECJ, be an indication that those transactions should not be regarded as incidental within the meaning of that provision. The fact that income generated by such transactions is greater than the income produced by the activity stated by the undertaking concerned to be its main activity, does not suffice to preclude their classification as “incidental transactions”.

In the *NCC* case ([Case C-174/08 NCC Construction Denmark A/S](#)), the Court found that the VAT exempt sale of real estate by a building business was not incidental but should be taken into account in the calculation of the deductible proportion.

It should also be mentioned that even if, after a business restructuring, a cost arises that pertains to the personnel of the selling company, but the personnel perform work for the acquirer’s business, it could still be possible to deduct VAT on these costs. In this regard, the ECJ ruled in [Case C-124/12 AES](#) that AES could deduct input VAT on working clothes and protective equipment used by the employees of another company. The employees in question worked in the business of AES and the input VAT was therefore linked to the business of AES, even though the employees in question were not employed by AES. The question of deduction is, however, a contentious issue, especially if a cost relates to another legal entity, compare *Iberdrola Inmobiliaria* ([Case C-132/16](#)). In principle the right to deduct exists in so far as the acquisitions were necessary for the business conducted.

The discussion below will consider the VAT consequences of the following transactions that may form part of a business restructuring:

- changes to group financing (debt);
- a transfer of assets;
- a transfer of shares;
- the issuance of new shares;
- outsourcing of activities; and
- other changes to the business model as described in [Chapter 2](#) (Business Models).

⁴ PT: ECJ, 29 Apr. 2004, [Case C-77/01](#), *Empresa de Desenvolvimento Mineiro, SA v. Fazenda Pública*, ECJ Case Law IBFD, ECR I-4295.

2. Group Financing Activities

In the normal course of events, to grant a loan is an economic activity for VAT purposes. In the *Floridienne & Berginvest* case ([Case C-142/99](#), p. 24), the ECJ ruled, however, that the mere reinvestment of dividends received as loans to subsidiaries does not constitute an economic activity for VAT purposes. Consequently, not all group-financing activities constitute economic activities. If the lending activity is not an economic activity, the right to deduct input VAT may be affected (as discussed in section 1.2.).

In case the lending activity falls within the scope of VAT, the exemption for “the granting and the negotiation of credit and the management of credit by the person granting it” should be noted (article 135(1)(b) of the VAT Directive). The granting of loans is thus VAT exempt. The consequence of this exemption is that the lender has VAT-exempt activities. Exempt activities generally have consequences for the right to deduct input VAT, as pointed out in section 1.2.

If under article 168 of the VAT Directive no deduction may be claimed, article 169 of the VAT Directive provides a number of special situations in which it is nevertheless possible to deduct input VAT. One of these situations is the granting and negotiation of credit and the management of credit by the person granting it, if the borrower is established outside the European Union. This means that granting loans to a non-EU borrower does not have adverse VAT consequences for a lender – input VAT is deductible. However, when a loan is granted to an EU borrower, in principle no deduction of input VAT directly related to this activity is allowed.

This has consequences when structuring group financing activities. Loans provided between group companies may entail a restriction of the right to deduct input VAT. However, when granted to a company outside the EU from a company established within the EU, a right to deduct input VAT is present. There are thus potential cost-savings if the VAT consequences are considered when the group financing structure is set.

In this regard, when a business restructuring involves changes to group financing activities, the following should be considered:

- if an EU-resident company is involved in financing activities of other EU companies, such activity will in principle affect the ability of this company to deduct input VAT (on costs related to the financing activities, as well as general costs);
- non-deductible VAT increases the costs of a company;
- granting loans to non-EU borrowers does not have an adverse effect on the ability to deduct input VAT (it will increase the pro rata in the case of partial right to deduct VAT); and
- from a VAT perspective, granting loans to EU borrowers is preferably done by a company outside the European Union (such lender typically does not pay VAT in the European Union; no increase of costs due to non-deductible VAT).

3. Transfer of Assets

Under article 2(1) of the VAT Directive, VAT is chargeable on the supply of goods and services effected for consideration within the territory of the country by a taxable person acting as such. Under article 14 of the VAT Directive, “supply of goods” means the transfer of the right to dispose of tangible property as

owner. In addition, every transaction that is not a supply of goods but entails the provision of something for consideration is a supply of services (see article 24 of the VAT Directive). Thus, the transfers of non-tangible assets also constitute supplies for VAT purposes. As a consequence, a transfer of assets is, in principle, a VAT taxable event.

However, article 19 of the VAT Directive contains the so-called no-supply rule for Transfers of a Going Concern (TOGC). The provision reads as follows:

In the event of a transfer, whether for consideration or not or as a contribution to a company, of a totality of assets or part thereof, Member States may consider that no supply of goods has taken place and in that event the recipient shall be treated as the successor to the transferor. Where appropriate, Member States may take the necessary measures to prevent distortion of competition in cases where the recipient is not wholly liable to tax.

The same applies to transfers of services (article 29). For simplicity, only article 19 is referred to below. It is the author's understanding that all Member States have included in full or to some extent (in some cases very limited) this optional regime in their domestic VAT legislation.

3.1. Scope of the TOGC no-supply rule

In the [Zita Modes Sàrl](#) case, ^[5] the question to the ECJ was raised whether, when a Member State has made use of the option in the first sentence of the paragraph to consider that for the purposes of VAT no supply of goods has taken place in the event of a transfer of a totality of assets, that no-supply rule applies to any transfer of a totality of assets or only to those in which the transferee pursues the same type of economic activity as the transferor.

The EU Commission pointed out, in general terms, relying in particular on paragraphs 24 and 35 of the [Abbey National case](#), ^[6] that (now) article 19 of the VAT Directive pursues the sole aim of administrative simplification and protection of the resources of taxable persons. Fiscally, in accordance with the principle of neutrality, the application of this provision should lead to exactly the same result whether the VAT is charged by the transferor and then deducted by the transferee or whether the transaction is not taxed. Moreover, the second sentence of the article is intended to make clear that, if the transfer of a totality of assets is made in favour of a taxable person who does not have a full right of deduction, the effect of not taxing the transaction is that a person partially liable to tax does not have to bear part of the non-deductible VAT, whereas he would have to bear such a charge if the transaction had been taxed in the normal way.

The ECJ ruled that Member States may exclude from the application of the no-supply rule transfers of a totality of assets in favour of a transferee who is not a taxable person within the meaning of the Sixth Directive or who acts as a taxable person only in relation to part of his activities, if this is necessary to prevent distortion of competition. This provision should be regarded as exhaustive in relation to the conditions under which a Member State that makes use of the option laid down in the first sentence of this paragraph may limit the application of the no-supply rule. It follows that a Member State that makes use of the option granted in the first sentence of the article must apply the no-supply rule to any transfer

⁵ FR: ECJ, 27 Nov. 2003, Case C-497/01, *Zita Modes SARL v. Administration de l'enregistrement et des domaines*, ECJ Case Law IBFD, ECR I-14393.
⁶ E2: ECJ, 22 Feb. 2001, Case C-408/98, *Abbey National plc against Commissioners of Customs and Excise*, ECJ Case Law IBFD, ECR I-1361.

of a totality of assets or part thereof, and may not therefore restrict the application of the rule to certain transfers only, save under the conditions laid down in the second sentence of the same paragraph.

In the *AB SKF* case (C-29/08), the ECJ furthermore considered that the sale of shares in a subsidiary could in certain circumstances be assimilated to a TOGC covered by article 19 of the VAT Directive. In that case, the Court accepted the Commission's submission that a sale of the shares in a subsidiary as part of a restructuring of the group's business could be assimilated with a TOGC. The ECJ in case C-651/11 *X BV* ruled that this "assimilation" does not extend to a situation where 30% of the shares in a company are transferred. As a result, the judgment in *X BV* entails a limitation of the reach of the ruling in *AB SKF*. The ECJ's reasoning indicates that the transfer of shares typically is not a TOGC.

3.2. Definition of "totality of assets"

As to the assets transferred and the use made of those assets by the transferee after the transfer, first, the VAT Directive does not include any definition of "a transfer, whether for consideration or not or as a contribution to a company, of a totality of assets or part thereof". However, according to settled case law, the need for uniform application of EU law and the principle of equality require that the terms of a provision of EU law which makes no express reference to the law of the Member States for the purpose of determining its meaning and scope, must normally be given an autonomous and uniform interpretation throughout the Community; that interpretation must take into account the context of the provision and the purpose of the legislation in question (see, in particular, Case 327/82, *Ekro*, paragraph 11; Case C-287/98, *Linster*, paragraph 43; Case C-357/98, *Yiadam*, paragraph 26; and Case C-373/00, *Adolf Truley*, paragraph 35). ^[7]

It is undisputed that article 19 of the VAT Directive makes no express reference to the law of the Member States for the purpose of determining the meaning and scope of the concept of a transfer of a totality of assets or part thereof. Furthermore, the context of the provision and the purpose of the VAT Directive make it clear that that provision is intended to enable the Member States to facilitate transfers of undertakings or parts of undertakings by simplifying them and preventing the overburdening of the resources of the transferee with a disproportionate charge to tax which would in any event ultimately be recovered by deduction of the input VAT paid. Therefore, the concept of "a transfer, whether for consideration or not or as a contribution to a company, of a totality of assets or part thereof" must be interpreted as meaning that it covers the transfer of a business or an independent part of an undertaking including tangible elements and, as the case may be, intangible elements which, together, constitute an undertaking or a part of an undertaking capable of carrying on an independent economic activity, but that it does not cover the simple transfer of assets, such as the sale of an inventory of products.

In the *Schriever* case (Case C-444/10) the Court ruled that there is a transfer of a totality of assets, or a part thereof, for the purposes of (now) article 19 of the VAT Directive, where the stock and fittings of a retail outlet are transferred concomitantly with the conclusion of a lease contract, to the transferee, of the premises of that outlet for an indefinite period of time but terminable at short notice by either party.

3.3. Successor's intention to continue the business

As regards the fact that (now) article 19 of the VAT Directive allows that the transferee is to be treated as the successor to the transferor, it follows from the wording of that paragraph, as the Commission

⁷ ECJ, C-327/82, *Ekro* (18 January 1984), ECR 107; E2: ECJ, 19 Sep. 2000, Case C-287/98, *Grand Duchy of Luxembourg v. Berthe Linster, Aloyse Linster and Yvonne Linster*, ECJ Case Law IBFD, ECR I-6917; ECJ, C-357/98, *Yiadam* (9 Nov. 2000), ECR I-9265; ECJ, C-373/00, *Adolf Truley* (27 Feb. 2003), ECR I-1931.

correctly points out, that the succession does not constitute a condition for the application of the paragraph, but is merely a result of the fact that no supply is considered to have taken place. However, it is apparent from the purpose of the provision and from the interpretation of the concept of “a transfer of a totality of assets or part thereof” which flows from it, that the transfers referred to in that provision are those in which the transferee intends to operate the business or the part of the undertaking transferred, and not simply to immediately liquidate the activity concerned and sell the stock, if any.

3.4. Business licence or authorization

In the [Zita Modes case](#), ^[8] the ECJ also ruled that the transfer of a business or a part of an undertaking is generally subject to VAT even if the transferee does not hold the business authorization required by the Member State concerned for the pursuit of the economic activity which that business or that part of the undertaking enables to be carried on. However, when a Member State makes use of the option in the first sentence of article 19 of the VAT Directive, that transfer may not be excluded from the application of the no-supply rule for the sole reason that the transferee does not hold such an authorization. The Member State, therefore, may not impose a restriction on the application of that no-supply rule to transfers of a totality of assets where the transferee holds the authorization for the pursuit of the economic activity which that totality enables to be carried on infringes that provision.

3.5. Right to deduct VAT

In the 2004 *Faxworld* case, ^[9] the ECJ considered whether VAT was deductible by a company the object of which is to prepare the means necessary for the activities of a capital company to be formed, where its sole output in performance of its object is to transfer the totality of its assets to that company once it has been formed.

As regards the right to deduct, the ECJ stated that (now) article 168 of the VAT Directive provides that the taxable person is entitled to deduct from the tax which he is liable to pay, the VAT due or paid in respect of goods or services supplied or to be supplied to him by another taxable person insofar as the goods and services are used for the purposes of his taxed transactions. Thus, it is clear from the wording of this provision that, in order for a person to be entitled to deduct VAT, he must be a “taxable person” within the meaning of the VAT Directive and the goods and services in question must have been used for the purposes of his taxable transactions. However, where a Member State has exercised the options provided for in (now) articles 19 and 29 of the VAT Directive, no supply of goods or services is deemed to take place upon the transfer of a totality of assets or part thereof.

As its only output transaction was the transfer of the totality of its assets and given that the Federal Republic of Germany has exercised the options provided for in articles 19 and 29 of the VAT Directive, *Faxworld GbR* itself effected no taxable transactions within the meaning of (now) article 168 of the VAT Directive.

In the case giving rise to the judgment in *Abbey National*, ^[10] the taxable person in question had transferred a business and wished to deduct the VAT which it had paid on the services received by it for the purpose of that transfer in circumstances in which the transfer did not constitute a taxable

8 FR: ECJ, 27 Nov. 2003, Case C-497/01, *Zita Modes SARL v. Administration de l'enregistrement et des domaines*, ECJ Case Law IBFD, ECR I-14393.

9 DE: ECJ, 29 Apr. 2004, [Case C-137/02](#), *Finanzamt Offenbach am Main-Land v. Faxworld Vorgründungsgesellschaft Peter Hünninghausen und Wolfgang Klein GbR*, ECJ Case Law IBFD, ECR I-5547.

10 E2: ECJ, 22 Feb. 2001, [Case C-408/98](#), *Abbey National plc against Commissioners of Customs and Excise*, ECJ Case Law IBFD, ECR I-1361.

transaction because the Member State concerned had exercised its option under (now) article 19 of the VAT Directive.

Recognizing that the taxable person was, in principle, entitled to deduct the VAT, the ECJ found that the costs of the services in question formed part of the taxable person's overhead and that, even in the case of a transfer of a totality of assets, where the taxable person no longer effects transactions after using those services, their costs must be regarded as part of the economic activity of the business as a whole before the transfer. Otherwise, an arbitrary distinction would be drawn between, on the one hand, expenditure incurred for the purposes of a business before it is actually operated and that incurred during its operation and, on the other hand, the expenditure incurred in order to terminate its operation.

That interpretation made it possible to relieve the taxable person in question of the burden of the VAT paid in the course of its economic activity. Accordingly, the taxable person's additional argument that it had to be able to rely on the recipient's taxable operations in order to be entitled to deduct all the VAT incurred on those services, was rejected.

However, in contrast to the facts of the case giving rise to the judgment in *Abbey National*, the taxable person in the case before the national court, namely Faxworld GbR, did not even intend to effect itself taxable operations, its sole object being to prepare the activities of the limited company. Nonetheless, the VAT which Faxworld GbR sought to deduct was considered to relate to supplies acquired for the purpose of effecting taxable transactions, even though those transactions were only the planned transactions of Faxworld AG.

In those precise circumstances, and in order to ensure the neutrality of taxation, the ECJ concluded that, where the Member State has exercised the options provided for in (now) articles 19 and 29 of the VAT Directive, as a result of the fact that, according to those provisions, "the recipient shall be treated as the successor to the transferor", as the transferor must be entitled to take account of the taxable transactions of the recipient, namely the Faxworld AG, so as to be entitled to deduct the VAT paid on input services which have been procured for purposes of the recipient's taxable operations.

The ECJ has also confirmed the ruling in [Faxworld](#), and that VAT in a start-up of a partnership is deductible, even if there is formally no transfer of a going concern, in the *Słaby* and *Kuč* cases (joined cases *Słaby* (C-180/10) and *Kuč* (C-181/10)). In contrast hereto, in *Malburg* (Case C-204/13), the Court found that Mr Malburg, when acquiring a client stock from an old partnership and contributing it to a new partnership without consideration, could not deduct input VAT on the acquisition of the client stock. It is noticeable that Malburg did not contribute the client stock as a capital contribution but as a transfer free of charge.

4. Transfer of Shares

4.1. General

As pointed out in the introduction, section 1.2., it follows from the case law of the ECJ that a person who only holds shares of a company does in principle not qualify as taxable person. It was also pointed out there that as an exception to the main rule and the broad scope of VAT, the VAT Directive contains a number of exemptions. One of the exemptions is laid down in article 135(1f), which contains an exemption for "transactions, including negotiation, excluding management and safekeeping, in shares, interests in companies or associations, debentures and other securities ...". If a transaction involving shares is performed by a taxable person, this exemption may apply. This exemption not only includes

the activities of stockbrokers and other traders who regularly buy and sell shares and other financial commodities. It follows from the *AB SKF* case ([Case C-29/08](#)) that when an active holding company, which supplies services to its subsidiaries, sells the shares in the subsidiaries, it is engaged as a taxable person in the sale. Consequently, if shares are held by an active holding company, the sale of the shares fall inside the scope of VAT (and the sale is exempt) but if they are held by a passive holding company, they fall outside the scope (and no output VAT is due because of that).

Consequently, when shares are transferred the transfer could both fall within and outside the scope of VAT. In the following two sections, the law as it stands, insofar as it can be ascertained, is described for both scenarios.

4.2. Selling of shares outside the scope of VAT

Under article 173(1) of the VAT Directive, if the taxable person uses goods and/or services, on which he has paid input tax, both for transactions in respect of which VAT is deductible and for transactions in respect of which it is not deductible, it is necessary to calculate, in accordance with article 174 and 175 of that Directive, the deductible proportion to be applied to the amount of the input tax paid. Transactions falling outside the scope of the VAT Directive, which do not give rise to a right to deduct, should be excluded from the calculation of that proportion.

The case law regarding the scope of VAT in relation to share sales can be summarized as follows ([Case C-29/08 AB SKF](#), pp. 28-31):

The mere acquisition, holding and sale of shares do not, in themselves, constitute economic activities. Only payments which are the consideration for a transaction or an economic activity come within the scope of VAT and such is not the case in respect of payments which arise simply from ownership of the asset, as in the case of dividends or other yields from a shareholding. The position is otherwise where a financial holding in another company is accompanied by direct or indirect involvement in the management of the company in which the holding has been acquired in so far as involvement of that kind entails carrying out transactions which are subject to VAT. Moreover, it is clear from ECJ's case law that transactions relating to shares or holdings in a company are subject to VAT when they are carried out as part of a commercial share-dealing activity or in order to secure a direct or indirect involvement in the management of the companies in which the holding has been acquired, or where they constitute the direct, permanent and necessary extension of the taxable activity.

With regard to the right to deduct input VAT incurred in relation to the share sale, the ECJ has held ^[11] that there is a right to deduct VAT paid on consultancy services used for the purposes of various financial transactions, on the ground that those services were directly attributable to the economic activities of the taxable persons. So is the case inter alia with regard to input VAT linked to the issue of shares (see *further* below) and to shares in a subsidiary that is acquired; see *Cibo* (Case [C-16/00](#)) and *Larentia + Minerva* ([Joined Cases C-108/14 and C-109/15](#)). It must in each case be assessed whether the input relates directly to outputs that entail the right to deduct. Even if such a link does not exist, it has to be determined whether there is a link to the business as a whole. In either circumstance whether there is a direct link to a specific output or to the business as a whole depends upon whether the cost of the input

¹¹ In the *AB SKF* case, p. 64.

is incorporated in specific outputs or constitutes part of the general costs (see also *Eon Aset* (Case C-118/11), p. 46-48). Notably, the Court also implicitly states in the *AB SKF* case that consultancy costs pertaining to a share sale that falls outside the scope of VAT could be part of the general costs and input VAT on the costs deductible (*AB SKF*, p. 68).

The issue that a sale of shares may constitute a TOGC has been discussed in section 3.

4.3. Selling of shares falling within the scope of VAT

In the *AB SKF* case, one issue was whether AB SKF could deduct input VAT incurred that related to the sale of shares in a subsidiary. The Court found, as discussed above, that the sale of the shares fell within the scope of VAT as AB SKF was an active holding company in relation to the subsidiary. The sale of shares was therefore falling within the scope and also exempt from VAT. The Court did, however, not rule out that a right to deduct input VAT existed. After outlining the law as it stands (see section 4.1.), and pointing at its case law from which it follows that a right to deduct could exist when the share sale falls outside the scope of VAT, the Court stated that if the consultancy costs relating to disposals of shareholdings are considered to form part of the taxable person's general costs in cases where the disposal itself is outside the scope of VAT, the same tax treatment must be allowed if the disposal is classified as an exempted transaction. It was therefore for the national court to determine whether the acquisitions constituted cost components of the general business or specific, exempt outputs and, thus, whether a direct link existed with outputs giving rise to the right to deduct input VAT.

The situation with regard to share sales as part of a restructuring is highly uncertain terrain. Practices, in the author's experience, differ between the Member States as to whether input VAT is indeed deductible. When a business is restructured, the way costs for the restructuring are incurred should be considered. If incurred by a holding company acquiring the shares, input VAT is deductible following the *Cibo* case, and confirmed in *Larentia + Minerva* (Joined Cases C-108/14 and C-109/15), decided on 16 July 2015.^[12] However, if the VAT is incurred by the selling company, it must be closely scrutinized whether the sale of the shares is a TOGC, falls outside the scope or falls inside the scope. The question whether VAT charged on acquisitions for the restructuring is deductible must be checked on a country by country basis.

5. Issue of New Shares

In the *Kretztechnik* case,^[13] the ECJ held that a company which issues new shares is increasing its assets by acquiring additional capital, while at the same time granting the new shareholders a right of ownership of part of the capital thus increased. From the issuing company's perspective, the aim is to raise capital, not to provide services. As far as the shareholder is concerned, payment of the amounts necessary for the increase of capital does not constitute payment of consideration, but rather the investment or employment of capital. In view of the fact that the applicant – notwithstanding its rights as shareholder or partner – is neither directly nor indirectly involved in the management of the companies the financial holdings of which it acquires, holds or transfers, the applicant's activities do not fall to be regarded as economic activity.

¹² DE: ECJ, 16 July 2015, [Joined Cases C-108/14 and C-109/15](#), *Larentia + Minerva*, ECJ Case Law IBFD.

¹³ ECJ, 28 May 2005, Case C-58/04, *Kretztechnik*, ECR I-4357.

It was in *Rompelman* ^[14] that the ECJ first pointed out that the deduction system is meant to relieve the trader entirely of the burden of the VAT payable or paid in the course of all his economic activities. The common system of VAT consequently ensures that all economic activities, whatever their purpose or results, provided that they are themselves subject to VAT, are taxed in a wholly neutral way (principle of neutrality).

The last-mentioned condition shows that, for VAT to be deductible, the input transactions must have a direct and immediate link with the output transactions giving rise to the right of deduction. In *Investrand*, ^[15] the ECJ held that “the right to deduct VAT charged on the acquisition of input goods or services presupposes that the expenditure incurred in acquiring them was a component of the cost of the output transactions that gave rise to the right to deduct”.

In paragraph 36 of the *Kretztechnik* ruling, the ECJ held that:

in view of the fact that, first, a share issue is an operation not falling within the scope of the Sixth Directive and, second, that operation was carried out by Kretztechnik in order to increase its capital for the benefit of its economic activity in general, it must be considered that the costs of the supplies acquired by that company in connection with the operation concerned form part of its overheads and are therefore, as such, component parts of the price of its products. Those supplies have a direct and immediate link with the whole economic activity of the taxable person.

The ECJ went on to hold, in paragraph 37 of that judgment, that

under article 17(1) and (2) of the Sixth Directive (now, articles 167 and 168 of the VAT Directive/OH), Kretztechnik is entitled to deduct all the VAT charged on the expenses incurred by that company for the various supplies which it acquired in the context of the share issue carried out by it, provided, however, that all the transactions carried out by that company in the context of its economic activity constitute taxed transactions. A taxable person who effects both transactions in respect of which VAT is deductible and transactions in respect of which it is not may, under the first subparagraph of article 17(5) of the Sixth Directive (now articles 173 of the VAT Directive/OH), deduct only that proportion of the VAT which is attributable to the former transactions.

6. Outsourcing

Part of a business restructuring may be the outsourcing of certain activities to a third-party service provider or a group company. No VAT is due on services rendered within a single taxable person, between a branch and its head office ^[16] or within a group of taxable persons if this group forms part of a fiscal unity for VAT purposes. ^[17] If activities are outsourced, VAT is, in principle, due on the services

¹⁴ ECJ, 14 February 1985, Case C-268/83, *Rompelman*, ECR 655.

¹⁵ NL: ECJ, 8 Feb. 2007, Case C-435/05, *Investrand B.V. v. Staatssecretaris van Financiën*, ECJ Case Law IBFD, ECR I-1315.

¹⁶ IT: ECJ, 23 Mar. 2006, Case C-210/04, *Ministero dell'Economia e delle Finanze (Ministry of Economic Affairs and Finance) and Agenzia delle Entrate (Revenue Agency) v. FCE Bank plc*, ECJ Case Law IBFD, ECR I-2803.

¹⁷ Under article 11 of the VAT Directive, each Member State may regard as a single taxable person any persons established in the territory of that Member State who, while legally independent, are closely bound to one another by financial, economic and organizational links.

rendered by the new service provider, unless a VAT exemption exists. The following situations should be distinguished:

- the outsourcing entity is entitled to a deduction of all input VAT; or
- the outsourcing entity is not entitled to a deduction of all input VAT.

Full entitlement to VAT deduction

If the outsourcing party is entitled to a refund of all input VAT, it can be expected that this will continue to be the case (although this should of course be verified). If after the outsourcing a full entitlement still exists to a VAT deduction, the outsourcing itself will normally not create adverse VAT consequences, although it may be possible that the payment of VAT to the third party has an impact on working capital.

However, in this situation it cannot be completely ruled out that the outsourcing results in indirect adverse VAT consequences. Adverse consequences may occur if the outsourced activities are VAT exempt. In that situation, the new service provider is not able to deduct input VAT due to the fact that this VAT relates to VAT-exempt activities. The new service provider will then be confronted with increased costs which he will try to charge to the outsourcing entity. In this situation VAT may be a hurdle for the outsourcing of activities.

No full entitlement to VAT deduction

Adverse VAT consequences should, however, be expected if the outsourcing entity is not entitled to a full refund of input VAT. In that case, it should be expected that not the entire amount of VAT that is charged to the outsourcing entity can be deducted, thereby resulting in an increase of the total costs.

^[18] One should realize that the increase of costs is not equal to the VAT rate multiplied by the amount of the invoices of the service provider. The outsourcing entity itself was also not entitled to a full deduction of input VAT. These VAT damages are now transferred to the new service provider. If, however, value is added by the new service provider which was in the past created in whole or in part by the outsourcing entity, on an overall basis the VAT damage will increase. From an economic perspective, the outsourcing is then viable only if the VAT disadvantage is offset by an increase in efficiency.

VAT damages may be mitigated if the services that are outsourced are VAT exempt. This is, for instance, the case if the outsourced activities can be seen as financial transactions. The ECJ has ruled that outsourced services must form a separate service which has the essential characteristics of a VAT-exempt activity, so that the VAT exemption may be applied for these services. (This is not the case with, for example, SWIFT services.) ^[19] No VAT damages arise if the new service provider will have the same VAT recovery right as the outsourcing entity. If the right to deduct input VAT differs, a more detailed analysis should be made of the VAT consequences of a decision to outsource activities.

One should bear in mind that the outsourcing of activities may have significant VAT consequences. VAT may be the hurdle for obtaining a reduction of costs through outsourcing, especially in the case where the company that outsourced (VAT taxable activities) is not (fully) entitled to deduct input tax, such as insurance companies and banking and financial institutions.

¹⁸ This would of course be different if only activities are outsourced that relate to VAT taxable activities of the outsourcing entity.

¹⁹ See in particular NL: ECJ, 3 Mar. 2005, [Case C-472/03, *Staatssecretaris van Financiën v. the single taxable entity Arthur Andersen & Co Accountants c.s.*](#), ECJ Case Law IBFD, ECR I-1719; E2: ECJ, 5 June 1997, [Case C-2/95, *Sparekassernes Datacenter \(SDC\) v. Skatteministeriet*](#), ECJ Case Law IBFD, ECR I-3017; DE: ECJ, 21 June 2007, [Case C-453/05, *Volker*](#), ECJ Case Law IBFD, ECR 1-0000; NL: ECJ, 3 Apr. 2008, [Case C-124/07, *J.C.M. Beheer B.V. v. Staatssecretaris van Financiën*](#), ECJ Case Law IBFD, ECR 1-0000 and FI: ECJ, 28 July 2011, [Case C-350/10, *Nordea Pankki Suomi Oyj*](#), ECJ Case Law IBFD.

7. Changes to the Business Model as Described in Chapter 2

Under section 1.3. of Chapter 2, certain types of business restructuring are described that follow from a change to the business model of a company. Below, the author will provide a high-level analysis of certain VAT consequences of these restructurings. As a general remark, all changes to the supply chain should be analysed from a VAT perspective. Although such changes generally do not result in adverse VAT consequences (i.e. non-recoverable VAT resulting in increased costs), it should be ensured that the company meets its obligations under the VAT legislation in the relevant Member States. A consequence of changes to the business structure may be, for example, that a company will have to register itself in more jurisdictions and will have to meet certain filing obligations there. Furthermore, from a cash flow perspective, it is more attractive to be able to avoid actual VAT payments instead of making actual payments and claiming VAT refunds periodically.

7.1. Transfer of intellectual property

The transfer and licensing of intellectual property is treated as a service for VAT purposes. In the case of a cross-border service between taxable persons for VAT purposes, no actual VAT payments should be made as the main rule for the provision of services between businesses (B2B), article 44 of the VAT Directive, applies. VAT is accounted for based on the so-called reverse charge mechanism. Under this mechanism, the service is regarded as being rendered to the recipient of the service. This recipient should self-assess the VAT due. This can be done in the regular VAT returns that must be filed periodically. If the recipient of the service utilizes the intellectual property for VAT taxable purposes, ^[20] a refund may be claimed for the VAT amount due in the same VAT return. In this situation, there are no actual cash flows. ^[21] The transaction must be reported in the recapitulative statements for services.

It should be ensured that the intellectual property is being used for a VAT taxable transaction. This may, for instance, not be the case where the head office of an MNE transfers logos or the company name and does not charge its subsidiaries for the use of this intellectual property.

7.2. From fully fledged manufacturer to contract manufacturer

A contract manufacturer typically renders a service to the owner of the materials. The VAT treatment of the supply of goods differs to the VAT treatment of services. In cross-border situations, no actual VAT payments are normally made in connection with a supply of goods (payment of VAT is transferred to the recipient within the European Union based on exemption with the right to deduct (zero rate) for intra-community transactions, or a zero rate for exports outside the European Union). The services of a contract manufacturer to the owner of the goods could, however, trigger actual VAT payments. ^[22] This may have an impact on the working capital of the companies involved.

The transition from fully fledged manufacturer to contract manufacturer could result in a supply of goods or services, or the transfer of a business. In the first scenario, VAT may be due, while in the second scenario, a transfer of a totality of assets may be present (see section 3.).

²⁰ It is not necessary that VAT is actually being levied. A taxable transaction is deemed to be present if the transaction could in principle result in VAT being due.

²¹ If the service is rendered within one jurisdiction, VAT should be paid (no reverse charge).

²² An exemption for VAT may be applicable for imported goods which, after processing, return to a country outside the European Union or within the European Union to another Member State.

7.3. From fully fledged distributor to stripped distributor

When a fully fledged distributor is transformed into a stripped distributor, functions are transferred to another entity. This transfer may have VAT consequences, which will depend on the facts and circumstances. Basically, two situations may be present. In the first, the transaction can be qualified as the transfer of a totality of assets (see section 3.). If no such transfer is present, individual transactions may be identified for VAT purposes, each of which may trigger VAT. If, for example, a payment is made to end an agreement, it should be expected that VAT will be due on this payment.

7.4. Commissionaires

Article 14(2)(c) of the VAT Directive treats the transfer of goods pursuant to a contract under which commission is payable on a purchase or sale, as a supply of goods. For VAT purposes a commissionaire structure therefore doubles the number of supplies in a structure. This may result in an increase in the VAT compliance burden and higher amounts of VAT payable (cash flow disadvantages). In principle, supplies of goods within a Member State trigger actual VAT payments.

For example, B is an intermediary in the sale of e-readers for A for its sales in Member State B. B sells the readers in its own name to the customers, but on behalf of A (i.e. as an undisclosed agent). From a civil law perspective, the common treatment would be to regard the sale as one between A and C, with B only being an intermediary. However, for VAT purposes a legal fiction of two sales is created, one from A to B and one from B to C. Thus, B accounts for VAT as if he is the reseller of the readers. B accounts for an acquisition from A (deducting any VAT chargeable by A), and a sale to C (charging output VAT on the sale provided the sale is VATable).

7.5. Centralized services/cost allocation

When certain functions are concentrated in a service centre that renders services to group entities in various countries, the VAT treatment of intragroup charges should be investigated. Preferably it would be possible to apply the main rule for B2B, article 44 of the VAT Directive, and the so-called reverse charge mechanism. As described above, under this mechanism, the service is considered to be rendered to the recipient of the service (no actual VAT cash flows). This recipient should self-assess the VAT due. This can be done in the regular VAT returns that must be filed periodically. However, it is also possible that the services do not fall under the main rule but, for example, are linked to immovable property. In that case, whether the reverse charge mechanism applies is determined by the Member State where the transaction takes place (i.e. where the immovable property is located). The service provider may be obliged to send its invoices including local VAT, and the recipients of the services would then subsequently have to claim a refund of VAT paid in the other Member State.

This is often considered as an administrative burden, and in most countries there is a considerable cash flow disadvantage. It is even possible that Member States might qualify the service rendered differently. One Member State could then argue that a general service is rendered, while the other Member State takes the position that the reverse charge mechanism applies. This could result in double or no taxation. Especially in situations where VAT is an actual cost, double taxation should of course be avoided.

It should be noted that only where cost allocation occurs between different taxable persons is there a supply for consideration and do the consequences outlined above arise. Thus, transactions between head offices and its branches, and between various branches, do not constitute supplies for VAT purposes but internal allocation and are thus not subject to VAT (*FCE Bank* (Case C-210/14)). However,

if the head office or branch is a member of a VAT group, this may result in that supplies for consideration are present and VAT must be accounted for in accordance with the discussion above (compare *Skandia America Corporation* ([Case C-7/13](#))).

8 – Customs Duties

Author

Massimo Fabio^[1]

Latest Information:

This chapter is based on information available up to 1 June 2016.

1. Introduction

In the present global market, companies dealing with international trade struggle with how efficiently to determine intercompany prices for tangible products that cross international borders. This challenge is created in large part by the different and distinct guidelines, principles and objectives governing the customs and tax aspects of related-party transactions. Although the World Trade Organization (WTO) and OECD have acknowledged the differences that exist within their conflicting guidelines, convergence of these conflicting methodologies has yet to occur.

Accordingly, companies must comply with both guidelines or they may find themselves subject to incremental taxes, duties and penalties, as well as subject to the burden of complying with potentially onerous customs valuation methodologies. In general, companies set, test and document intercompany prices with a focus on transfer pricing rules. In many instances, these companies do not consider customs standards in addressing this tax process. If ever scrutinized by the customs authorities, companies would often rely on the transfer pricing analysis to prove compliance with the arm's length principle. ^[1]

2. Customs Law

Customs law can be considered the best example of harmonized tax law in an international context. In fact, in modern times, after the Second World War, it has certainly been one of the areas on which countries have focused their efforts more to reconcile different needs in the worldwide market.^[2] Hence, customs provisions were structured on a common basis and governed by the same principles. With regard to substantive law, in fact, in a worldwide context, the necessity was recognized to refer to the three fundamentals of classification of the goods and their origin, and the value of the transactions.

Furthermore, almost all the countries in the global market that have participated in the evolutionary process (which is still in progress) resort to the same legal schemes governing the operational aspects of crossing borders, for example, with regard to customs warehousing, inward processing and temporary admission. Under these regimes, goods traded between countries are assigned a customs-approved treatment. In other words, in a worldwide context, with very few exceptions, customs follow similar schemes with regard to both qualifying and quantifying the overall customs burden.

* Partner, Studio Associato, KPMG Tax and Legal Services, Italy.

1. *Nexus between Valuation for Customs and for Transfer Pricing Purposes*, KPMG's Trade and Customs Services and KPMG's Global Transfer Pricing Services.

2. See M. Fabio, *Manuale di Diritto e Pratica Doganale* (IPSOA, 2014); *Customs Law of the European Union* (Kluwer Law International, 2012).

The concept of customs law is extremely broad. It covers all charges applied to customs operations which customs authorities must collect in accordance with the law. It therefore deals with any pecuniary charge due with regard to situations that are significant for customs activities, including those situations that can be of interest for organizational and administrative bodies of the country and are liable to pecuniary charges by virtue of the law.

On the basis of this observation, scholars consider that customs charges cover pecuniary charges of different kinds, not necessarily of tax kind, except for some charges ^[3] (frontier charges).

The distinction between duties and charges mainly lies in the fact that duties are applied on final import and/or export and have historically served the purpose of regulating commercial flows across borders, in order to encourage or protect national markets. Conversely, even though they could indirectly serve the purpose of customs duties, charges connected to the completion of customs procedures (storage charges, statistical levies and public health inspector charges) are applied when a specific service is rendered to the trader.

In this regard, according to a principle of the General Agreement on Tariffs and Trade ([GATT](#)), the amount of fees and charges of whatever character imposed by contracting parties on or in connection with importation or exportation are limited to the approximate cost of services rendered, and may not represent an indirect protection of domestic products or a taxation of imports or exports for tax purposes.

^[4]

Customs charges may also cover indirect taxes on consumption, such as value added tax and excise duties (both where applicable), which are applied to products imported from other customs territories, as they are connected to customs operations.

Customs duties can be applied to the value (ad valorem customs duties) or to the quantity of products (specific customs duties). Ad valorem customs duties are generally applied, while specific customs duties on the quantity or measurement of goods are applied more rarely. Specific customs duties consist of a fixed amount relevant to the unit of measurement taken into account. They are not considered equitable, as they are levied indiscriminately on low- and high-value products.

It is common view that customs duties fall in the general category of indirect taxes on consumption, as they are passed on to the consumer. As almost all customs duties on imports are imposed on an ad valorem basis, a correct valuation of transactions is a necessary starting point for identifying the taxable base. Uniform rules have been needed for the valuation of goods, so as to enable different markets to easily manage international trade and relevant customs compliance. The valuation of goods requires a uniform determination mainly to avoid distortions in the application of customs duties as agreed within GATT, which might actually represent non-tariff barriers.

These considerations constituted the basis of an Agreement on the Implementation of Article VII of GATT, signed in Geneva on 12 April 1979 (Customs Valuation Code), within the Tokyo Round negotiations (1973-1979). This Agreement established a “fair, uniform and neutral system” for the valuation of goods, and replaces the past use of arbitrary or fictitious customs values by major international partners. The international definition has also been adopted by the European Community

3. For example import and export duties, levies and other import or export charges, monopolies, frontier surcharges and any other consumption charge or surcharge paid to the advantage of the state.

4. Art. VII [GATT](#) 1994.

in Council Regulation (EEC) 1224/80 of 1 July 1980, then transposed into article 69 et seq. of the Union Customs Code (EU Regulation 952/2013) ^[5] (UCC).

3. General Agreement on Tariffs and Trade; World Trade Organization

3.1. General Agreement on Tariffs and Trade

3.1.1. The Geneva Conference

After the Second World War, with a view towards easing and stimulating international trade, in Geneva 23 countries ^[6] engaged in a round of tariff negotiations on a country-by-country, product-by-product basis, and in October 1947 the concessions thus obtained were set forth in GATT. Under the Protocol of Provisional Application, GATT was to enter into force provisionally on 1 January 1948, if eight countries, including Canada, France, the United Kingdom and the United States, had signed it by 14 November 1947. ^[7]

These countries complied, and the “Agreement entered into force provisionally”, as planned. By 30 June 1948 all but one of the Geneva Conference participants had signed the Agreement and thereby became “original contracting parties”. GATT has never been accepted definitely, and has not been elevated to the status of Specialized Agency at the United Nations. In spite of these disadvantages, it has become the most important agency dealing with the regulation of international trade.

By now, more than 100 countries have acceded to GATT. Its provisions have become the leading guidelines for most of the trade regulation of its signatories, and its procedures are the norm for further intergovernmental endeavours to reduce trade barriers. ^[8]

3.1.2. Fundamental principles

Trade is to be conducted on a non-discriminatory basis. More specifically, all contracting parties are required by the most-favoured-nation clause of article I of GATT to apply duties and similar charges on the import of goods equally, without regard, as among contracting parties, to the country of origin of the goods. Government-imposed restrictions on the free movement of goods are to be kept to a minimum and, if changed, should be reduced, not increased. Although the Protocol of Provisional Application allowed certain discriminatory arrangements inconsistent with the basic principles of GATT to survive, any change in them had to be in the direction of liberalization. Also, the contracting parties are required to submit Schedules of Import Restrictions which become part of GATT; they may not impose “duties in excess of those set forth and provided for therein” (article II(I)(b)).

Terms of trade, including tariff rates and other restrictions, must be negotiated and agreed upon on a multilateral basis. Article XXVIII bis of GATT provides for negotiations “from time to time” among contracting parties seeking to reduction of trade barriers. During the first four decades of its existence, eight rounds of negotiations have taken place, the present being the Uruguay Round, which was completed at the end of 1994.

No prohibitions or restrictions other than tariffs are to be instituted or maintained by contracting parties (article XI GATT), which means that quantitative import restrictions are not allowed. Severe restrictions

5. EU Reg. 952/2013 of the European Parliament and of the Council, of 9 Oct. 2013, published in OJ L269 of 10 Oct. 2013.

6. Australia, Belgium, Brazil, Burma, Canada, Ceylon, Chile, China, Cuba, Czechoslovakia, France, India, Lebanon, Luxembourg, the Netherlands, New Zealand, Norway, Pakistan, South Africa, Southern Rhodesia, Syria, the United Kingdom and the United States.

7. See D. Lasok, *The Trade and Customs Law of the European Union* (Kluwer Law International 1998, 3rd ed.).

8. A.F. Lowenfeld, *Public Controls on International Trade* (M. Bender 1979), at 17-23.

are placed upon subsidies on exports, as these could have a distorting effect on international trade similar to that of import tariffs.

3.2. World Trade Organization

3.2.1. Uruguay Round

As a result of the protracted negotiations within the Uruguay Round (which started in 1986 and ended in 1994), [GATT](#) has been transformed into the [WTO](#). The main thrust of the new approach to the liberalization of trade was the extension of trade in goods to the trade in services in a broad sense. The European negotiators were much influenced by their objective to complete the internal Community market and, faced with the charge of having created “Fortress Europe”,^[9] pressed hard for an equitable definition of “liberalization”. Regional integration (of which the European Community is a prime example) must fit into the concept of a world trading system based on non-discrimination and reciprocity. Interests of groups of states or individual powers and economic giants such as the United States, the European Community and Japan, tend to pay lip service to world interests and obscure the issue by one-sided interpretations and rhetoric. Such was the heated dialogue between the European Community and the United States during the Uruguay Round.^[10]

3.2.2. New order

On the authority of articles 100 and 235 and several other provisions of the EC Treaty, the Council adopted Decision 94/800^[11] which approved the agreement reached in the Uruguay Round of multilateral negotiations (1986-1994). Thus, the European Community became party to the Agreement establishing the [WTO](#) (WTO Agreement) and some 19 annexes comprising separate agreements on specific issues. The WTO Agreement builds on [GATT](#), although GATT 1994 as specified in Annex 1A is legally distinct from GATT 1947 annexed to the Final Act adopted at the United Nations Conference on Trade and Employment as subsequently rectified, amended and modified.^[12] The scope of the WTO includes “the common institutional framework for the conduct of trade relations among its Members”. The functions of the WTO include the implementation of the WTO Agreement, acting as a forum for negotiations, the administration of the Understanding on Rules and Procedures Governing the Settlement of Disputes, the administration of the Trade Policy Review Mechanism and cooperation with the International Monetary Fund and with the International Bank for Reconstruction and Development.

The WTO has taken aboard the decisions, procedures and customary practices followed by the contracting parties to GATT 1947 and the bodies established in its framework.^[13] Thus, members are to be guided by such rules unless otherwise provided under the present Agreement or the Multilateral Trade Agreement. In the event of a conflict between a provision of the present Agreement and a provision of the Multilateral Trade Agreement, the provisions of the former will prevail.

The [WTO](#) has imposed an obligation upon its members to ensure the conformity of their laws, regulations and administrative procedures with the Annexed Agreements. It does not allow any reservations in respect of the provisions of the WTO Agreement. However, it allows reservations in

9. S. Woolcock, *Market Access Issues in EC-US Relations: Trading Partners or Trading Blows* (Royal Institute of International Affairs 1991), at 13-15.

10. See, e.g., E.U. Petersmann, *The EEC as a GATT Member: Legal Conflicts between GATT and European Community Law*, in *The European Community and GATT*, M. Hiff, F.G. Jacobs and E.U. Petersmann (eds.), 2nd ed. (1989), at 40-43.

11. OJ 1994, L.336/1.

12. Art. 11(4) [WTO Agreement](#).

13. Art. XVI(l) [WTO Agreement](#).

respect of any provisions of the Multilateral Trade Agreements, but only to the extent provided in those Agreements. The same applies to multilateral trade agreements.

As a detailed analysis of all the annexes to the WTO Agreement is beyond the scope of this chapter, it may suffice to highlight in general terms the contents of the one concerning valuation. The Agreement on Implementation of article VII of [GATT 1994](#) concerns basic rules for the determination of the value of goods for customs purposes. Annex I to GATT 1994 contains interpretative notes. Annex II to GATT 1994 establishes a technical Committee on Customs Valuation, and Annex III to GATT 1994 provides a derogation in favour of developing countries.

4. The European Union

From the ashes of the Second World War arose the aspiration for unification, which, at that time, was confined to the management of resources necessary for reconstruction. The integration process, intended to unify institutional functions in Member States – at least originally – was also (and mainly) founded on the harmonization of customs systems in force in Member States.

4.1. The European Communities: ECSC, EEC and EAEC/Euratom

The Europeanist impetus, so typical of the early 1950s, followed different directions according to the operational objectives to be achieved by Community bodies. The prevailing approach was “functionalist”, pursuing the union and cooperation among Member States in specific sectors. It was the sector-by-sector approach, as subsequently defined.

In this context, on 18 April 1951, the European Coal and Steel Community ([ECSC](#)) was established in Paris, when Belgium, the Federal Republic of Germany, France, Italy, Luxembourg and the Netherlands signed the Treaty establishing the European Coal and Steel Community. Apart from the pooling of resources covered by this agreement, the organization pursued the major objective of building an economic, yet nevertheless embryonic, union among Member States. In any case, it was significant that, for the first time, Member States agreed to restrict their own sovereignty on matters to be dealt with at the Community level. The ECSC Treaty, therefore, reflected the very first surrender of national sovereignty (which still hinders full tax harmonization), but facilitated the birth of new legal rules at the Community level.

On 1 June 1955, in Messina, the ECSC Foreign Ministers identified other two sectors of interest, namely common market and energy. Moreover, differently from what was adopted within the ECSC, it was recognized that the concept of vertical integration should be replaced with horizontal integration. Finally, after many rounds of negotiations, on 25 March 1957, two other treaties (primary Community law) were signed: the Treaties establishing the European Economic Community (EEC) ^[14] and the European Atomic Energy Community (EAEC/Euratom). For purposes of this chapter, one should bear in mind that while the ECSC Treaty created a free trade area for coal and steel, the EEC and Euratom Treaties supported the establishment of a customs union.

It is just the case to specify that free trade area abolishes domestic customs duties and any restriction on imports and exports across Member States, while the customs union implies also that a common customs tariff will be adopted when dealing with third countries. In 1968, the customs union was launched with the approval of a common customs tariff. Afterwards, Member States strove for an

14. The Treaty establishing the EEC is referred to as the Treaty, being the charter founding the European Union.

economic union by way of establishing a single market in which goods, services, capital and persons can circulate freely.

In this context, the Treaty of Maastricht, signed on 7 February 1992, has initiated the most interesting phase of the integration process, in that it sets out the major objective of the Union towards the establishment of a true federation, while considering the Treaties more than mere economic arrangements. ^[15]

4.2. EU customs law

With regard to customs, the current legal context is organized in a complex structure of national and Community rules, which accumulated as European integration progress developed. Originally, the Treaty establishing the European Economic Community primarily aimed at a common market featuring an economic union (based on the four fundamental freedoms of movement of persons, goods, services and capital) and a customs union between Member States, involving the abolition of customs duties and charges of equivalent effect on internal trade and the adoption of a common tariff in their relations with third countries. In addition to customs duties, the Treaty has given the Community exclusive powers in the three sectors of commercial policy, agriculture and transportation. Accordingly, Member States transferred their sovereignty also in relation to foreign trade (involving quantitative restrictions, tariff quotas, anti-dumping measures and prohibitions on the importation of counterfeit goods) to the European Community – in a definitive way. ^[16]

As from 1 January 1993, after entering into the customs territory of the Community through any border crossings along maritime and continental borders, persons, goods and capital coming from third countries may freely circulate throughout all Member States. In fact, they are not liable to comply with any customs or quasi-tariff regulations, with the only exception of prohibitions and controls justified on grounds of public security; the protection of health and life of humans; the protection of national treasures possessing artistic, historic or archaeological value; and the protection of industrial and commercial property, as laid down in articles 30 and 296 (former articles 36 and 223) of the EC Treaty. ^[17]

The last steps of the integration process were the Treaty of Amsterdam, which was signed on 2 October 1997, the Treaty of Nice of 11 December 2000, which entered into force on 1 January 2003, and the Treaty of Lisbon, signed by the [EU member states](#) on 13 December 2007, entered into force on 1 December 2009. The latter treaty amends the [Maastricht Treaty](#) (1993), known in updated form as the [Treaty on European Union](#) (2007) or TEU, and the [Treaty of Rome](#) (1958), known in updated form as the [Treaty on the Functioning of the European Union](#) (2007) or TFEU.

4.3. Basic legal provisions

It is possible to identify basic legal provisions of customs law in the following Regulations:

-
15. In this framework, the Maastricht Treaty significantly amended the EEC Treaty, Title II. The symbolic value given to the change of the name from EEC (European Economic Community) to EC (European Community) in the whole Treaty of Rome of 1957, is significant. To sum up, by virtue of the Maastricht agreements, the Community does not confine itself solely to economic objectives, but extends the agreement among Member States to cover various sectors falling within the national sovereignty up to that time. Moreover, the Treaty of Amsterdam, signed on 2 Oct. 1997, has introduced substantial changes and new aspects to the Treaties establishing the Communities (EC, [ECSC](#) and Euratom), which constitute the primary Community law, mainly after the expansions to include Eastern countries on 1 May 2004 and 1 Jan. 2007.
 16. The Single European Act of 17 Feb. 1986 was an important step towards the establishment of the Union, moving from common market to internal market, after the elimination of physical barriers and frontier controls across Member States.
 17. Under the Treaty of Lisbon, which entered into force on 1 Dec. 2009, the Treaty on (the) European Union and the Treaty establishing the European Community have been amended, and the latter Treaty has been renamed as Treaty on the Functioning of the European Union (TFEU).

- the [UCC](#), introduced by Council Regulation (EU) 952/2013 of 9 October 2013, compiles the substantive rules of application of customs duties and relevant measures to goods traded with third countries. ^[18] It concerns:
 - 1 the scope and persons covered by customs duties;
 - 2 the basic features of a customs duty, namely customs value, the tariff classification of goods and their origin;
 - 3 the procedures governing the introduction of goods into the EU customs territory and the assignment of a customs-approved treatment. This covers the obligations of taxpayers and relevant customs controls; and
 - 4 all the technicalities concerning release for free circulation, export, transit, warehousing, inward and outward processing, processing under customs control and temporary admission;
- Commission Delegated Regulation (EU) 2015/2446 of 28 July 2015, supplementing Regulation (EU) No 952/2013 of the European Parliament and of the Council as regards detailed rules concerning certain provisions of the Union Customs Code; and
- Commission Implementing Regulation (EU) 2015/2447 of 24 November 2015 laying down detailed rules for implementing certain provisions of Regulation (EU) No 952/2013 of the European Parliament and of the Council laying down the Union Customs Code.

Article 23 (former article 9) of the TFEU states that:

The Community shall be based upon a customs union which shall cover all trade in goods and which shall involve the prohibition between Member States of customs duties on imports and exports and of all charges having equivalent effect, and the adoption of a common customs tariff in their relations with third countries.

As an evolution of the original [ECSC](#) free trade area, the customs union essentially supplements the prohibition of customs duties between Member States with a common customs tariff. The customs union, which entered into force on 1 January 1968, actually reflected an intermediate step towards the economic union allowing the free circulation of persons, goods, services and capital. ^[19]

5. Customs in the United States

5.1. The Customs Modernization Act

Businesses that import goods into the United States are subject to the Customs Modernization Act (the so-called Mod Act), which came into effect in 1993. Under this Act, the concepts of “informed compliance” and “shared responsibility” emerged. The US Customs and Border Protection ([CBP](#)) ^[20] is

18. The Union Customs Code (UCC) has been published in the EU Official Journal L 269, of 10 Oct. 2013. The UCC wholly replaced the former [CCC](#) by 1 May 2016.

19. From the early 1980s, Member States determined to finalize the integration process through the establishment of the economic union and thus of the Single European Market. The CCC (article 3 of Council Regulation (ECC) 2913/92 of 12 Oct. 1992) restricts the territorial scope of relevant rules and indicates that the customs territory of the Community is based on the territories of the 27 Member States, identifying special exceptions.

20. A bureau of the US Department of Homeland Security.

responsible for informing members of the trade community of their rights and duties under the various trade regulations and laws. It is the shared responsibility of the trade community as well as CBP to carry out the requirements. One of the major requirements of “shared responsibility” is the duty of importers to use “reasonable care” when entering, classifying and determining the value of imported goods. CBP is responsible for fixing the classification and the value of the goods. When an importer fails to use reasonable care, there can be delays in the release of goods by CBP, or even the assessment of fines and penalties up to the value of the goods.

The CBP is assigned the role of administering the entry of goods into the United States. Extensive regulations governing the entry of goods are outlined under Title 19 of the Code of Federal Regulations. Goods that are imported into the United States must be identified and assigned a value. The process of identification is called classification. Identification can be divided into two separate forms of classification, namely (1) the nature of the product and (2) the country or countries in which the product was made. Understanding the nature of a specific item allows an importer and the CBP to determine the proper tariff rate. The proper tariff code and rate are derived from the Harmonized Tariff Code of the United States. Tariffs differ for each foreign nation. As a consequence, knowing the country of origin lets the importer and the CBP determine which tariff will apply. This is particularly true in the application of free trade agreements.

The CBP administers import laws and regulations. The majority of permanent imports do not require a licence, but must be declared to US Customs with a description including country of origin and tariff classification. Customs then determines the amount of duty to be paid on the import.

5.2. Valuation

A value must be declared for goods entering the United States for immediate consumption. The law applicable to valuation is included in the US Tariff Act of 1930, as amended, but within the confines of the US commitment to the [GATT](#) Customs Valuation Code, and the successor [WTO](#) provisions relating to customs valuation.

As in EU and in most of the WTO signatory countries, imports are valued according to a hierarchy of alternate methods. However, these are not alternative methods in the sense that the [CBP](#) may use any method it chooses. Nor may the CBP reject information provided if such information is based on the use of generally accepted accounting procedures.

Transaction value is used in the vast majority of cases. The order of valuation is:

- transaction value;
- transaction value of identical merchandise and similar merchandise;
- deductive value; and
- computed value.

5.3. Free trade agreements

The United States has maintained its commitment to trade liberalization through its support of the [WTO](#). While maintaining its support of the WTO, the United States also has pursued trade liberalization with other nations. As a result, the US government has entered into various free trade agreements. While many of these free trade agreements are bilateral, there are two significant multilateral trade

agreements to which the United States is a party, namely the North American Free Trade Agreement (NAFTA) and the Dominican Republic-Central American Free Trade Agreement (CAFTA-DR). In order to take advantage of free trade agreements, the rules of origin must be consulted to verify that an import qualifies for beneficial treatment under the relevant agreement.

6. Association of Southeast Asian Nations

The Association of Southeast Asian Nations ([ASEAN](#)) was established on 8 August 1967 in Bangkok by the five original member countries, namely Indonesia, Malaysia, the Philippines, Singapore and Thailand. ^[21] The ASEAN Declaration states that the aims and purposes of the Association are (1) to accelerate economic growth, social progress and cultural development in the region and (2) to promote regional peace and stability through abiding respect for justice and the rule of law in the relationship among countries in the region and adherence to the principles of the UN Charter.

In 2003, the ASEAN leaders resolved that an ASEAN Community will be established comprising three pillars, namely ASEAN Security Community, ASEAN Economic Community and ASEAN Socio-Cultural Community.

6.1. ASEAN Free Trade Area

The ASEAN Free Trade Area (AFTA) has now been virtually established. ASEAN member countries have made significant progress in the lowering of intraregional tariffs through the Common Effective Preferential Tariff (CEPT) Scheme for the ASEAN Free Trade Area. More than 99% of the products in the CEPT Inclusion List of ASEAN-6, comprising Brunei Darussalam, Indonesia, Malaysia, the Philippines, Singapore and Thailand, have been brought down to the 0%-5% tariff range.

ASEAN's newer members, namely Cambodia, Laos, Myanmar and Vietnam, are not far behind in the implementation of their CEPT commitments, with almost 80% of their products having been moved into their respective CEPT Inclusion Lists. Of these items, about 66% already have tariffs within the 0%-5% tariff band. Vietnam had until 2006 to bring down tariffs on products in the Inclusion List to no more than 5% duties, while Laos and Myanmar had until 2008 and Cambodia to 2010. All of them met the requirements. ^[22]

6.2. Customs rules

The recommendations of the High Level Task Force (HLTF) on the [ASEAN](#) Economic Integration, endorsed by the Ninth ASEAN Summit in October 2003, included customs facilitation matters. These include the adoption of:

- the green-lane system for [CEPT](#) products at entry points of all member countries by 2004;
- [WTO](#) agreement on customs valuation and development of implementation guidelines appropriate for ASEAN by the end of 2004;
- service commitment (client charter) by ASEAN customs authorities; and

21. Brunei Darussalam joined on 8 Jan. 1984; Vietnam on 28 July 1995; Lao PDR and Myanmar on 23 July 1997; and Cambodia on 30 Apr. 1999. As of 2006, the [ASEAN](#) region has a population of approximately 560 million, a total area of 4.5 million square kilometres, a combined gross domestic product of almost USD 1,100 billion and a total trade of approximately USD 1,400 billion.

22. See www.aseansec.org/14261.htm.

- the single-window approach, including electronic processing of trade documents at the national and regional level.

Thus, ASEAN customs officials have been working on the ASEAN Customs Valuation Guide for publication and dissemination, establishment of the Client Service Charter and an ASEAN single window.

6.3. Valuation

Responsibility for customs valuation policy, which formerly rested with the now defunct GATT Secretariat, now rests with the Committee on Customs Valuation of the WTO. Responsibility for detailed administration remains, as before, with the Technical Committee on Customs Valuation of the World Customs Organization (WCO), formerly the Customs Cooperation Council.

As a result of the replacement of the GATT Secretariat by the WTO, the valuation system is now sometimes referred to as the WTO Valuation System or WTO Valuation Agreement. However, GATT remains in force, and Uruguay Round documents refer to the valuation system as “the Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade 1994”.

Implementation of the WTO Valuation Agreement ^[23] requires national legislation. The text of the Agreement is a guide to framing national legislation; it cannot simply be adopted as national law, as is made clear by the wording of some provisions, such as articles 8(2) and 11(1) of the WTO Valuation Agreement. In addition, certain options are available to developing countries adopting the Agreement.

In order to comply with articles 2 and 3 of the WTO Valuation Agreement, countries need information on the values of identical and similar goods which have been previously imported into the country. In connection with the application of the Uruguay Round Ministerial Decision regarding Cases Where Customs Administrations Have Reason To Doubt the Truth or Accuracy of the Declared Value, ^[24] these values are essential for checking the credibility of declared values, and countries may also find information on the price of goods for export to a country other than the country of importation useful to check the credibility of declared values. However, these latter values must be used only for that purpose and must not be used as the basis of determination of value, as that is prohibited by article 7 of the Agreement.

7. Determining the Value of Goods

Worldwide, ^[25] the fundamental basis for determining the value of goods is the transaction value, i.e. the price actually paid or payable for goods presented to customs, as provided by article VII of GATT. Where it is not possible to apply the transaction value, the same international agreement lists five alternative methods for establishing the customs value (see below). As an example of the implementation of the GATT principles, we can focus on the European approach.

7.1. Transaction value

Under article 70 of the Union Customs Code, EU Reg. 952/2013 (UCC), the customs value of imported goods is based on the transaction value, which is the price actually paid or payable for the goods when sold for export to the customs territory of the Community. However, this general rule is subject

23. The Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade 1994.

24. Uruguay Round of Multilateral Trade Negotiations documents, I.1, at 61.

25. At least, in any WTO country.

to a number of exceptions contained in specific provisions, which exclude or include certain matters in determining the taxable basis for customs purposes. The transaction value method is fundamental in establishing the customs value. The fact that goods are declared for free circulation is to be regarded as an adequate indication that they were entered for consumption within the Community. This consideration applies both where an individual sale was made and where goods have been subject to a series of sales before being imported into the Community, in respect of the last sale prior to export to the customs territory of the Community.

In order for the transaction value method to be fair and central in any situation that contracting parties may happen to face, it is necessary to comply with certain conditions (otherwise this rule is not applicable and alternative methods are to be used in ascertaining the value of goods):

- there must be no restrictions on the disposal or use of the goods by the buyer, other than restrictions that are imposed or required by law or by public authorities in the Community, those that limit the geographic area in which the goods may be resold and those that do not substantially affect the value of goods;
- the sale or price must not be subject to some condition or consideration for which a value cannot be determined with regard to the goods being valued;
- no part of the proceeds of any subsequent resale, disposal or use of the goods by the buyer will accrue directly or indirectly to the seller, unless an appropriate adjustment can be made; and
- there must be no relationships between buyer and seller which affected the price.

7.2. Significance of “relationships” between buyer and seller

For the sake of completeness, it is proper to analyse the provisions concerning the determination of customs value when buyers and sellers are related. Under article 70(3d) of the UCC, the fact that a buyer and a seller are related is not of itself a sufficient ground for regarding the transaction value as “unacceptable”, provided that the relationship did not influence the price. However, if the customs authorities have grounds for considering that the relationship between the parties concerned did influence the price of the goods being imported, they are to ask the declarant to demonstrate that the transaction value is settled consistently with the pricing that would have been settled with unrelated buyers.

Article 127 of the EU Regulation 2015/2447 identifies the situations in which buyers and sellers are regarded as related under article 70 (3d) of the UCC.

Two persons shall be deemed to be related if one of the following conditions is fulfilled:

- they are officers or directors of the other person’s business;
- they are legally recognized partners in business;
- they are employer and employee;
- a third party directly or indirectly owns, controls or holds 5% or more of the outstanding voting stock or shares of both of them;
- one of them directly or indirectly controls the other;
- both of them are directly or indirectly controlled by a third person;

- together they control a third person directly or indirectly; or
- they are members of the same family.

Article 127(2) of the Regulation 2447/2015 provides that persons who are associated in business with one another in that one is the sole agent, sole distributor or sole concessionaire, however described, of the other will be deemed to be related only if they fall within the criteria of article 127(1).

7.3. Alternative measures of value

Where the customs value cannot be determined by reference to the transaction value, it is to be determined by the alternatives as provided for in article 74 of the UCC, taking into consideration that each of them may be applied only where the prior one is inadequate.

The value of identical goods. The prerequisite is that the import took place under the same conditions as those used by the previous method. “Similar goods” means goods produced in the same country, which although not alike in all respects, have like characteristics and like component materials, which enable them to perform the same functions and be commercially interchangeable. Obviously, the quality of the goods, their reputation and the existence of a trademark are among the factors to be considered in determining whether goods are similar.

The deductive value. The value in question here is that at which identical or similar goods are sold in the European Union, in the greatest aggregate quantity, at approximately the same time of importation as the goods being valued, to persons not related to the sellers, subject to the deductions for extra costs of marketing the goods in question (additions made for profit, or commissions due in connection with sales after the customs clearance; costs of transport and insurance incurred within the Community; and customs clearance charges, including duties).

The computed value. The computed value is calculated on the basis of the production cost in the country of export (raw materials and semi-finished products, fabrication processing, profits and general expenses), plus other factors, such as royalties and any other licence fees.

The value based on the data available in the Community. This is a residual method (the so-called reasonable method) under which the customs value of imported goods is determined under the general provisions of the Geneva Agreement, which provides that the customs value is determined by using “reasonable means” consistent with the principles of the Agreement and article VII of [GATT](#).

7.4. Additions and exclusions to the transaction value

Under article 71 of the [UCC](#), while determining the customs value of the goods, there are a number of required additions to the price actually paid or payable.

Under article 72 of the UCC, provided that they are shown separately from the price actually paid or payable, the costs listed in the same article are excluded from the value of the goods only upon the request of the trader. The indication of the taxable value and relevant deductions may be regarded as satisfying that prerequisite, provided that the trader can substantiate the request for deduction.

8. Customs value and transfer pricing ^[26]

8.1. Two sides of the same coin

The correct determination of the customs value is certainly one of the most delicate issues to deal with when crossing a border. As already noted, the valuation of goods is one of the three fundamental areas in the context of customs law, along with the origin and classification of goods.

With a view to ascertaining the amount of duty owed, Community law identifies a closed category of methods for determining the customs value, the application of which is strictly hierarchical. ^[27] In the context of cross-border transactions, the “importation/purchase” is relevant not only for the purposes of customs duties payable by the purchaser, but also for direct taxation purposes. This is of major importance for the transfer pricing issues involved in a related-party transaction. In fact, where various enterprises belonging to the same group are located in different countries, a transfer pricing analysis is necessary in order to verify that the transactions are not aimed at transferring profits to foreign countries (especially low-tax jurisdictions).

Unlike what has already occurred in the customs field, neither OECD countries nor EU Member States have initiated a process for harmonizing direct taxation, so that profits are taxed under different rules and at different rates. In this regard, one should bear in mind that although the valuation of the debt for customs duties and direct taxes is equally important for international transactions, relevant values may differ even significantly in accordance with respective specific rules. More specifically, as to direct taxation, it is necessary to take into account transfer pricing policies as linked to the determination of customs value. This link is not recent, at least in the context of international principles, but is rooted in “old” analysis at the broadest international level.

The international community typically refers to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, which is an update of the 1995 version (OECD Guidelines) (which itself was an adaptation of the original 1979 Guidelines) The OECD Guidelines are not binding per se (unless specifically provided for under a country’s domestic law), but are of significant practical relevance to traders and tax authorities in OECD countries and many non-OECD countries.

Also in 1995, the [WTO](#) signed its Customs Valuation Agreement. In this case, however, relevant principles are referred to in Community customs law almost slavishly. The provisions of the Community Customs Code relating to customs value are a virtual cut-and-paste of article VII of [GATT](#) on customs valuation.

It could be thought that these issues – being so “old” – have been absorbed in the business community, without further review. However, that is not actually the case. In fact, even though they have different origins and objectives, both valuations, transfer pricing and customs valuation, are increasingly linked to each other in view of coordination, mainly in order to comply with the different tax liabilities in respect of revenue and customs, and for other reasons (described below). These new considerations arise from a constant evolution in the world market, where not even medium-sized enterprises restrict their business to the domestic market. Many enterprises root their interest in foreign countries through location savings, in order to benefit from economies of scale.

26. See M. Fabio, *Customs Law of the European Union* (Kluwer Law International, 2012), para. 4.7.

27. Art. 70 UCC.

For example, in the textile sector, it is a very common practice for Western brands to manufacture in Eastern countries, regardless of the business size. This actually occurs in almost all industrial and commercial sectors. Delocalization leads to new kinds of business organizations, which buy and manufacture with a view towards reselling the finished products to their parent companies. Indeed, these relationships are sensitive to the issues of transfer pricing and customs valuation. In fact, they imply the crossing of a border of goods and concern transactions between related companies. In the past, the relationship between seller and buyer, as well as the crossing of a border, were almost always managed separately. In Europe and the United States, taking into account also Italy, transfer pricing has (correctly) been regarded as a matter of direct taxation. Instead, the approach to customs, being harmonized indirect taxation, has been linked mainly to a matter of logistics.

Direct taxation and customs rarely coincide in respect of valuation. It follows that there might be, on the one hand, proper and accurate transfer pricing policies and, on the other hand, over-estimated and penalizing customs valuations. In other words, it might happen that while transfer pricing policies are regarded as adequate and acceptable by the tax authorities, the customs valuation may attract criticism. One can think of the different expectations that tax and customs authorities (where separate, as in Italy) might have, for example:

- for the tax authorities, costs borne by the buyer should be reasonably low, in order to prevent profits from being transferred to countries with preferential tax regimes and not to affect adversely the determination of the taxable base for the purposes of direct taxation; and
- for the customs authorities, the customs value should be reasonably high, in order to determine a higher dutiable base to which a relevant rate is applicable.

It is evident that the different valuation of goods has always led to concerns in the tax field, also because of the different perspectives of tax authorities and taxpayers.

To conclude, transfer pricing and customs value are the two opposing and necessary sides of the same coin, the respective values of which unavoidably affect the overall balance of a system of closely connected valuations.

8.2. The holistic approach

As the original differences between the two areas are fading, enterprises are reconsidering the methods for determining transaction values, which was dealt with only from a single perspective (customs or direct taxation) in the past. This reconsideration has been triggered ultimately by two international conferences on the “Valuation of Related Parties Transactions for Transfer Pricing, Customs and VAT”, which were organized by the World Customs Organization and the OECD in May 2006 and 2007.

The two organizations have thus launched a new way of dealing with this particular area in international trade. In fact, it emerged that multinational enterprises are more aware (and more concerned) that two different regimes may lead to different determinations of values. Furthermore, as already noted, this difference in determination is not only based on different laws and facts, but in many countries is exacerbated by the existence of two different tax authorities in charge of direct taxation and customs duties, thus making cross-border trade increasingly complicated and burdensome.

The process of being aware of the existing dichotomy in valuation matters is accelerating thanks to the shift by many countries to the use of electronic declarations. Many tax authorities, especially the customs authorities, are using advanced means to analyse and compare data from different sources,

thus benefiting from a greater quantity of data than in the past. Furthermore, it is increasingly frequent that customs offices request that enterprises submit their “master files” ^[28] relating to transfer pricing analysis to justify the values indicated in their declarations. Examining this corporate income tax-oriented documentation may enable the customs authorities to detect transfer pricing data that might be significant for customs value purposes.

For example, it is a well-established practice that intangibles are rarely controlled for customs purposes, which traditionally cover supplies of goods. Actually, as already noted, the CCC provides that intangibles are also liable to customs duties (royalties) when they are related to imported goods and constitute a condition of the sale. It follows that even if the transfer pricing policy is absolutely adequate and justified by correct valuations, it might not be considered that licence fees which are paid as distinct from importation, should be liable to customs duties in any case.

This consideration reflects once again what is going on in the field of intangibles. To give some figures of relevant exports, the amount of royalties and licence fees paid, for example to US corporations, tripled from 1990 to 2004. On 7 November 2005, the *Wall Street Journal* reported that in 2004, the total amount of taxable income of Microsoft’s Round Island One, an Irish intellectual property holding company, was approximately USD 9 billion, derived from the use of intangibles. In 2004, this small company paid taxes to the Irish Revenue of more than USD 300 million. It is not surprising that these figures may attract the attention of customs authorities with a view to evaluating whether such intangibles are liable to customs duties. And for these considerations (and figures), intangibles will be the hot topic of future disputes on customs value in all EU member countries.

The first question in this regard is whether transfer pricing can affect the customs value, or whether the opposite is true. As usual, the truth is somewhere in the middle. Both issues must be analysed with a view to achieving an adequate, correct and transparent result.

8.3. Arm’s length principle: a shared principle?

The second question has a more theoretical background. On the basis of the international guidelines provided by the WCO and the OECD, customs and tax authorities of member countries have developed a set of rules and principles relating to value, so as to arrive at an “acceptable” price or to verify whether the price proposed (by the taxpayer) is acceptable for tax or customs purposes. As a general rule, both “sets of rules” provide that related-party transactions must refer to the arm’s length principle or fair value principle, under which the price of the supply of goods or services between related parties should be the same as that adopted between independent parties dealing at arm’s length. The objective of both sets of rules is that the transfer price should not be affected by the fact that the transactions have been entered into between associated enterprises, ^[29] or better that this fact should be disregarded.

Apparently, tax authorities speak the same language. However, there are significant differences in the application of the mentioned principles in a broad sense. In fact, the methods for determining the value are different, as are the time at which the debt is incurred and relevant valuation becomes definitive, requested documentation, controls of the procedures and dispute resolution

28. On 27 June 2006, a Resolution of the Council and the representative of the governments of the Member States within the Council introduced the Transfer Pricing Documentation Code of Conduct. This Code provides for multinational enterprises to adopt one set of documentation containing common standardized information relevant for the whole EU group (the so-called “master file”).

29. Art. 9(1) OECD Model Tax Convention on Income and Capital (OECD Model) states: “conditions...which differ from those which would be made between independent enterprises”.

mechanisms. Consequently, multinational enterprises aim at reducing and managing the risk of potential inconsistencies between the two different matters.

After having considered the different approaches of the tax authorities concerned, other critical aspects must be considered. In the field of direct taxation, there is no harmonization at the international level, so that also at the Community level it is difficult to manage different national laws and their different interpretations of transfer pricing. However, although there are differences in the legislation of each country concerning the arm's length principle, the fact that these laws are based on the OECD Guidelines helps in interpreting for purposes of tax planning.

It follows that even though there are more tax risks for international strategies than for domestic solutions, a global transfer pricing policy can be used to determine an appropriate range of values representing the application of the arm's length principle to transactions carried out in a multinational context. In this regard, it must be pointed out that a range can give rise to an approximate value that can be acceptable for transfer pricing purposes, but not for customs purposes. The tax authorities of different countries may accept different prices of related-party transactions for economic reasons. The situation becomes complicated when customs authorities wish to examine relevant data and effects on customs law.

From a customs law perspective, the fact that parties are related does not affect the price proposed by a trader. Article 70(3d) of the UCC states, *inter alia*:

The transaction value shall apply provided that ... if the buyer and seller are not related or the relationship did not influence the price. In other words, customs authorities may not reject the price declared unless the rejection is justified by the results of an investigation which gave evidences that the relation influenced the price.

Art. 134 of the Eu Reg. 2447/2015 states:

1. Where the buyer and the seller are related, and in order to determine whether such relationship did not influence the price, the circumstances surrounding the sale shall be examined as may be necessary, and the declarant shall be given an opportunity to supply further detailed information as may be necessary about those circumstances.
2. However, the goods shall be valued in accordance with Article 70(1) of the Code where the declarant demonstrates that the declared transaction value closely approximates to one of the following test values, determined at or about the same time:
 - (a) the transaction value in sales, between buyers and sellers who are not related in any particular case, of identical or similar goods for export to the customs territory of the Union;
 - (b) the customs value of identical or similar goods, determined in accordance with Article 74(2)(c) of the Code;
 - (c) the customs value of identical or similar goods, determined in accordance with Article 74(2)(d) of the Code.

Furthermore, the Interpretations Notes to the [GATT](#) Valuation Agreement provide that investigations may be carried out only if the customs authorities have doubt about the price. Conversely, where the

customs authorities have no doubts in that regard, that value must be accepted without requesting more information.

At the international level, the customs authorities might reverse the burden of proof in the hands of the importer, while their challenge is based on suspicions instead of well-grounded arguments. This leads to delays, additional costs and uncertainty which are almost always unnecessary.

8.4. Controls of transactions: an operational convergence

It is helpful to identify the transactions that might be subject to oversight by customs and tax authorities (where these tax administrations are separate). First, in the context of Community law, the different interests of tax authorities can converge only in the case of related-party transactions that involve the crossing of a border from third countries to the European Union and vice versa, and the subsequent release for free circulation.

Actually, if the transaction were carried out between an EU company and a US associated company, and the goods purchased were placed in a customs warehouse and subsequently removed for export as a result of a sale, it would not be relevant for customs purposes. In this case, the goods would not be released for free circulation and thus no customs liability would be incurred.

Apart from the transfer pricing issues involved, the dealings between EU associated companies would be not relevant for customs purposes, as well. In fact, EU Member States do not apply customs duties domestically.

A different example could be the following: Hong Kong is part of the political territory of China, but comprises a different customs territory. In principle, transfer pricing and customs valuation issues might overlap where there is a movement of goods between these two jurisdictions. However, it is worthwhile considering that a customs liability may be incurred only against China, as Hong Kong is a free zone and does not apply customs duties on most imported goods.

Second, prices of the goods crossing a customs border are mainly referred to on an ad valorem basis. Many countries apply different valuation methods, among which the ad valorem criterion is certainly the most used. However, other criteria may be used, such as volume and weight, value brackets, seasonal duties and mixed or alternative duties. For example, agricultural products are often taxed at specific rates.

Third, as already noted, customs law does not provide that intangibles (on which, e.g., royalties and licence fees are paid) are directly liable to customs duties, but rather as additions relating to imported goods under certain circumstances. Under article 71(1)(c) of the UCC, royalties and licence fees must be added to the value of the imported goods, where they are not included in the price paid or payable by the purchaser, only if they are related to the goods being valued and constitute a condition of the sale. In other words, in a customs duties context, the payment for intangibles includes a part of the transfer price. Furthermore, for customs value purposes, customs duties are not applied to royalties and licence fees by virtue of specific reasons, but as a mere cost connected to the transfer price to be added to the price of the goods imported.

Finally, it is necessary to remember that concerns may arise from situations where the two tax authorities concerned should sort out conflicting interests. For example, consider an importation of goods with a high duty rate, say at 22%, as indicated by the EU tariff. In order to avoid the loss of own resources, the customs authorities will verify whether the declared goods have been underestimated to some extent.

Where the importing country applies high taxes on income, the tax authorities will verify whether the declared value has been overestimated inappropriately, so as to restrict excessive cost deductions and protect the financial interests of the country.

8.5. How to reconcile methods for determining customs values and transfer prices

In intra-group transactions where goods cross a border, it is not sufficient then to restrict the determination of value only to transfer pricing issues. It is necessary to deal with how the determination of value for income tax purposes could affect the customs value. It is thus necessary to reconcile the two determinations of value, so to justify them in respect of any kind of claim. This reconciliation lacks the support of provisions of Community and national law. However, it is possible to consider what the current scenario can offer for this purpose.

First, the reconciliation seems possible only in principle. In fact, on the one hand, the customs context is completely harmonized and structured by provisions of Community law, which are binding for traders and customs authorities. The UCC and Implementing Provisions analytically describe the methods for determining the customs value to adopt, and provide a precise, logical scheme. As already noted, the starting point is the transaction price, with a move to a subsequent method only where the customs value cannot be determined by reference to the transaction value.

It follows that in moving on to a subsequent method, under justified circumstances, it is possible to adopt more or less complex methods that are based on the law. More specifically, traders (as well as the customs authorities) may not simply adopt a “favourite” method, unless they arrive at this by logically scrolling down the hierarchical sequence as laid down in article 70 of the UCC. On the other hand, for direct taxation and transfer pricing purposes, under the OECD Guidelines the adoption of a valuation method is left to the discretion of the traders (not the tax authorities). They may select the most appropriate method to the circumstances of the case.

Thus, from a legal perspective, including Community law, there is a lack of balance – which is not really explainable. Actually, Community authorities were expected to be more determined to “formalize” the Code of Conduct, which is contained in a mere resolution, and as such is not binding at all. However, with a view to reaching a break-even point for the determination of value, for transfer pricing purposes it seems wiser to apply the traditional methods, namely the comparable uncontrolled price (CUP), resale price and cost-plus methods. These correspond somewhat to the following methods for determining customs values:

- identical or similar value; ^[30]
- deductive value; ^[31] and
- computed value. ^[32]

That being considered, a possible solution could be to “choose” a customs method and match it with the corresponding transfer price method. It is not that simple, unfortunately. As already pointed out, the customs value may not be chosen, but must be applied based on the facts to ascertain whether it is necessary to apply alternatives to the transaction price. However, once the correct customs value is identified, this can be matched with the value for transfer pricing.

30. Art. 74(2)(a) and (b) UCC.

31. Art. 74(2)(c) UCC.

32. Art. 74(2)(d) UCC.

Consider supplies the customs value of which is not based on the transaction price or the deductive value (in accordance with the hierarchy). In this case, the computed value should be applied. If the customs authorities accept this value, the group may use the corresponding cost-plus method also for tax purposes. Reasonably, once the value is accepted by the customs authorities on the basis of the applicable provision of law, there should not be any particular problem, so that the value will be calculated in accordance with the principles of fair value to be applied to both areas. Conversely, once the value is determined for transfer pricing purposes, the relevant method can be used for the purposes of customs value.

However, this solution can indeed be criticized. If, for example, a multinational enterprise chooses to adopt the resale price method, this may not be used for customs value purposes where there is not an invoice at the time of importation. In these cases, customs law enables EU-resident traders to be authorized to release the goods through a provisional indication. ^[33] Within a prescribed period of time, the definitive value can be indicated to enable the customs authorities to verify the ad valorem duties.

To conclude, it may be possible to achieve values acceptable by the tax authorities concerned by exploiting the force of customs law, which can provide stricter rules. The proposed solution, far from being final, can give increased certainty to those who based their values on customs law and received the acceptance of the customs offices, while supporting the corresponding price for a transparent transfer pricing policy.

9. The Strength of the Double Approach before Tax Audits

In general, companies set, test and document intercompany prices with a focus on transfer pricing rules. In many instances, these companies do not consider customs principles as part of this tax process. If ever scrutinized by the customs authorities, companies would often rely on their transfer pricing analysis to prove arm's length values. The discussion below will consider types of transactions that may come under the scrutiny of both customs and tax authorities.

First, the convergence can only apply to intercompany transactions that result in the crossing of customs borders. Customs borders may or may not converge with national borders. For example underlying the European Union is a customs union. The members of the customs union do not levy customs duties on the trade among themselves, and customs valuation rules do not apply.

Second, the goods that cross the border must be taxed on the basis of their value, usually referred to as ad valorem. Countries apply a wide range of duty assessment criteria, including value, specific criteria like weight or volume, value thresholds, seasonal duties and mixed or alternative duties. Most goods are taxed for customs purposes on the basis of their value. ^[34]

Third, from a general perspective, import duties do not apply to intangibles such as those on which royalties and licence fees are paid. However, the value of intangibles may form part of the value on which duty is levied if it is related to the imported goods. To this end, royalties and licence fees are to be added to the value of the merchandise imported if they are not included in the price paid or payable by the buyer if (1) they are related to the goods being valued that the buyer must pay and (2) they are a condition of sale of the goods being valued. In other words, in a customs duty context, compensation for intangibles comprises part of the transfer price, being endorsed in the value assessed for customs duty

33. Art. 73 of the UCC.

34. However, especially for goods that countries regard as sensitive, for whatever reason, other types of duties may arise. For example, agricultural products are often taxed against specific rates.

accordingly. Therefore, for valuation purposes, customs authorities do not subject royalties and licence fees to dedicated provisions, but merely regard them as price-related costs to be added to the price paid upon importation, to the extent that they have not already been incorporated into the price of the goods.

Finally, it is important to bear in mind that issues are likely to arise in situations where customs and tax authorities have conflicting interests. On a given import transaction with a high tariff, for example the import of trucks that in the European Union attract a tariff of 22%, the natural inclination of the customs officer would be to verify whether or not the value declared by the importer was under-estimated, as the customs officer would be interested in maximizing the duty collection. If these trucks are imported in a high-tax country, the tax officer's natural inclination would be to verify whether or not the value declared was over-estimated, as the tax officer would be interested in limiting what would be regarded as an excessive tax-deductible amount in his or her jurisdiction.

Companies must comply with both guidelines or they may find themselves subject to incremental taxes, duties and penalties, as well as subject to the burden of complying with potentially onerous customs valuation methodologies.

10. WCO TCCV Commentary 23.1

In October 2010, the WCO TCCV ^[35] approved the commentary 23.1 (Examination of the expression “circumstances surrounding the sale” under article 1.2 (a) in relation to the use of transfer pricing studies).

The Commentary seeks to provide guidance on the use of a transfer pricing study, prepared in accordance with the OECD Guidelines, and provided by importers as a basis for examining “the circumstances surrounding the sale” under article 1.2 (a) of the Agreement.

Under article 1 of the Agreement, a transaction value is acceptable as the customs value when the buyer and the seller are not related, or if related, provided that the relationship did not influence the price. ^[36]

Where the buyer and seller are related, article 1.2 of the Agreement provides different means of establishing the acceptability of the transaction value:

- the circumstances surrounding the sale shall be examined to determine whether the relationship influenced the price (article 1.2 (a));
- the importer has an opportunity to demonstrate that the price closely approximates to one of three test values (article 1.2 (b)).

The Interpretative Note to article 1.2 of the Agreement provides that:

“It is not intended that there should be an examination of the circumstances in all cases where the buyer and the seller are related. Such examination will only be required where there are doubts about the acceptability of the price. Where the Customs administration has no doubts about the acceptability of the price, it should be accepted without requesting further information from the importer.”

35. Commentary 23.1 of the World Customs Organization TCCV (Technical Committee on Customs Valuation), Oct. 2010.

36. See M. Fabio, *Customs Law of the European Union* (Kluwer Law International, 2012), para. 4.9.

In light of this, states the new Commentary 23.1, where the Customs administration has doubts about the acceptability of the price, the administration will examine the circumstances surrounding the sale, based on information provided by the importer.

The Interpretative Note to Article 1.2 states that where the Customs administration is unable to accept the transaction value without further enquiry, it should give the importer an opportunity to supply such further detailed information as may be necessary. The Note also sets forth illustrative examples of how to determine if the relationship between the buyer and the seller does not influence the price.

The question which then arises is whether a transfer pricing study prepared for tax purposes, and provided by the importer, can be utilized by the Customs administration as a basis for examining the circumstances surrounding the sale.

On one hand, a transfer pricing study submitted by an importer may be a good source of information, if it contains relevant information about the circumstances surrounding the sale. On the other hand, a transfer pricing study might not be relevant or adequate in examining the circumstances surrounding the sale because of the substantial and significant differences which exist between the methods in the Agreement to determine the value of the imported goods and those of the OECD Guidelines.

Accordingly, the use of a transfer pricing study as a possible basis for examining the circumstances of the sale should be considered on a case-by-case basis. As a conclusion, any relevant information and documents provided by an importer may be utilized for examining the circumstances of the sale. A transfer pricing study could be one source of such information.

11. ICC Policy Statement

Transfer pricing and customs value became an interesting and challenging field of discussion, also at the level of the International Chamber of Commerce (ICC).

In February 2012, the ICC confirmed that multinational companies from all sectors and in every part of the world face difficulties with respect to the valuation of goods.^[37] These difficulties arise because transactions between related parties are subject to both customs and fiscal examinations and are thereby bound by differing rules and contradictory interests. The ICC believes these examinations should yield the same value and that a resolution to the problem is in the interests of all concerned.

In its Policy Statement, the ICC identifies two reasons underlying the complex issue of valuation in cross-border transactions:^[38]

- (1) Tax and customs administrations, even within one country and sometimes within the same government department, have different approaches: tax administration focuses on intra-group sales for which prices may be perceived as higher than they should be, whereas customs authorities control imported goods for which prices may be perceived as lower than the market price. While both administrations seek to achieve the same goal (i.e. arm's length pricing), revenue interests in the transaction remain at odds.
- (2) Tax and customs administrations often set rules independently for the same transaction/good. Tax authorities seek conformity with the OECD Transfer Pricing Guidelines for Multinational

37. See the "Policy Statement" on Transfer pricing and customs value, prepared by the ICC Commission on Taxation and the ICC Committee on Customs and Trade Regulations (Doc. No. 180/103-6-521, Feb. 2012).

38. See M. Fabio, *Customs Law of the European Union* (Kluwer Law International, 2012), para. 4.9.2.

Enterprises and Tax Administrations (OECD Guidelines), which have been largely codified in many countries. This set of rules provides guidance on the application of the arm's length principle for the valuation of cross-border transactions between associated enterprises, whereas customs authorities conform to article VII of the General Agreement on Tariffs and Trade (GATT) Valuation Code.

This dichotomy, present in both developed and developing countries, creates a climate of uncertainty and complexity compounded by economic globalization. It also leads to increases in compliance and implementation costs, in absence of flexibility in the conduct of business operations, and furthermore creates a significant risk of penalties. Indeed, even when a company complies with both the OECD Guidelines/principles and the WTO Valuation Agreement, there is no guarantee that there will not be a dispute between two countries or two administrations in the same country on the determination of the arm's length price. This means that valuation conflicts can arise not only prior to but also after an audit.

Given estimates that intercompany transactions account for more than 60% of global trade in terms of value, the divergence of customs and transfer pricing valuation presents an obstacle to the liberalization of trade and inhibits international development for companies of all sizes.

In its policy statement, the ICC explores the key features of this challenging field observing that, although numerous points of divergence can be listed between customs and tax approaches, it is important to stress that points of convergence also exist.

Therefore, while it may not be necessary to change WTO rules or the OECD Guidelines, the ICC believes that the two can and should be aligned by finding a common way of interpreting the arm's length principle. As a basic principle, the ICC recommends that tax administrations assess and appreciate how the enterprise has arrived at the declared customs value (and vice versa – as the case may be – the customs administration assess and appreciate how the enterprise has arrived at the transfer price) prior to issuing a formal tax or duty assessment. In case the conflict between the enterprise and the relevant fiscal administration cannot be resolved, then the tax administration and the customs administration of the respective country should work in concert and attempt to harmonize valuation determinations.

A recommended method of accomplishing this is to incorporate into the transfer pricing studies those elements additionally needed by customs administrations to determine acceptable customs valuation. Indeed, the ICC notes that the WCO has already considered the appropriateness of transfer pricing documentation in Commentary 23.1 of the Technical Committee on Customs Valuation (TCCV).

This approach, as the ICC specifies in its policy statement, considers that it is not currently conceivable to try to find solutions outside existing and well-recognized principles, nor is it realistic to seek a total harmonization of customs and tax rules or even to impose one's view onto another. Furthermore, the business community believes that creating yet another set of rules will not solve these problems.

The ICC therefore recommends a focus on how these principles can be more closely aligned and made acceptable to both governmental authorities and the private sector. The perspective of the Policy Statement is to offer an input from the business sector to international organizations working on these issues.

The Policy Statement provides some proposals in order to solve the issue of conciliate transfer pricing and customs value.

The goals of the proposals are to:

- secure harmonized tax and customs valuation of transactions between related parties in an international context;
- clarify rules for both companies and administrations;
- suppress, or at least reduce, financial impact linked to divergent valuation; and
- simplify regulations;

and thereby:

- reduce compliance costs to companies resulting from disputes arising from divergent views taken by customs and tax authorities; and
- streamline intercompany operations and facilitate international business.

Since the proposals listed by the ICC provide an interesting overview of the global scenario in the dynamic field of cross-border valuation, it is worthwhile reporting all of them below^[39].

Proposal 1

Concerning related parties, formal recognition by the customs administration of the arm's length principle (as per article 9 OECD Model) in order to determine the customs value.

The customs value is normally based on article VII of the GATT Agreement 1994 which states that, in article I, Rules on Customs Valuation:

1. The customs value of imported goods shall be the transaction value, that is the price actually paid or payable for the goods when sold for export to the country of importation adjusted in accordance with the provisions of Article 8 (...)

Thus, customs authorities prefer to determine customs duties on the sales price of imported goods, which is deemed to represent an arm's length value. When the seller and the buyer are related, and arm's length pricing comes into question, the transaction value can still be used for customs valuation purposes if the importer can demonstrate that the declared transaction value meets 1) the circumstances of sale test; or 2) test values.

As explained below in article I, Rules on Customs Valuation of GATT article VII:

1. The customs value of imported goods shall be the transaction value (...) provided (...) 3 (d) that the buyer and seller are not related, or where the buyer and seller are related, that the transaction value is acceptable for customs purposes under the provisions of paragraph 2.

2.(a) In determining whether the transaction value is acceptable for the purposes of paragraph 1, the fact that the buyer and the seller are related within the meaning of Article 15 shall not in itself be grounds for regarding the transaction value as unacceptable. In such a case the circumstances surrounding the sale shall be examined and the transaction value shall be accepted provided that

39. See the ICC "Policy Statement", pp. 3-7, available at [http://www.iccwbo.org/Advocacy-Codes-and-Rules/Document-centre/2015/ICC-Policy-Statement-Transfer-Pricing-and-Customs-Valuation-\(2015\)](http://www.iccwbo.org/Advocacy-Codes-and-Rules/Document-centre/2015/ICC-Policy-Statement-Transfer-Pricing-and-Customs-Valuation-(2015)).

the relationship did not influence the price. If, in the light of information provided by the importer or otherwise, the customs administration has grounds for considering that the relationship influenced the price, it shall communicate its grounds to the importer, and the importer shall be given a reasonable opportunity to respond. If the importer so requests, the communication of the grounds shall be in writing.

(b) In a sale between related persons, the transaction value shall be accepted and the goods valued in accordance with the provisions of paragraph 1 whenever the importer demonstrates that such value closely approximates to one of the following occurring at or about the same time: (i) the transaction value in sales to unrelated buyers of identical or similar goods for export to the same country of importation; (ii) the customs value of identical or similar goods as determined under the provisions of Article 5; or (iii) the customs value of identical or similar goods as determined under the provisions of Article 6.

With regard to 2(b), customs administrations require that the test values must be previously determined, pursuant to an actual appraisal of imported merchandise. If there are no previous importations of identical or similar merchandise that were appraised by customs authorities under the transaction, deductive or computed value methods, there may not exist any test values that will be accepted by the customs administration. Therefore, it is common practice to evaluate the circumstances surrounding the sale in relation to the above 2(a).

The Interpretative Notes to 2(a) provide examples of how to evaluate the circumstances of sales in order to satisfy the customs administrations that the relationship of the parties did not influence the transaction value. The Interpretative Note to Article 1, 2(a) of GATT article VII reads as follows:

2. Paragraph 2(a) provides that where the buyer and the seller are related, the circumstances surrounding the sale shall be examined and the transaction value shall be accepted as the customs value provided that the relationship did not influence the price. It is not intended that there should be an examination of the circumstances in all cases where the buyer and the seller are related.

Such examination will only be required where there are doubts about the acceptability of the price. Where the customs administration has no doubts about the acceptability of the price, it should be accepted without requesting further information from the importer. For example, the customs administration may have previously examined the relationship, or it may already have detailed information concerning the buyer and the seller, and may already be satisfied from such examination or information that the relationship did not influence the price.

3. Where the customs administration is unable to accept the transaction value without further inquiry, it should give the importer an opportunity to supply such further detailed information as may be necessary to enable it to examine the circumstances surrounding the sale. In this context, the customs administration should be prepared to examine relevant aspects of the transaction, including the way in which the buyer and seller organize their commercial relations and the way in which the price in question was arrived at, in order to determine whether the relationship influenced the price. Where it can be shown that the buyer and seller, although related under the provisions of Article 15, buy from and sell to each other as if they were not related, this would demonstrate that the price had not been influenced by the relationship. As an example of this, if the price had

been settled in a manner consistent with the normal pricing practices of the industry in question or with the way the seller settles prices for sales to buyers who are not related to the seller, this would demonstrate that the price had not been influenced by the relationship. As a further example, where it is shown that the price is adequate to ensure recovery of all costs plus a profit which is representative of the firm's overall profit realized over a representative period of time (e.g. on an annual basis) in sales of goods of the same class or kind, this would demonstrate that the price had not been influenced.

Consistent with Commentary 23.1 of the WCO Technical Committee on Customs Valuation (TCCV), for importers that establish related party pricing policies in accordance with the OECD Guidelines and provide the necessary transfer price documentation, such documentation should be considered a solid basis on which customs administrations can evaluate the circumstances surrounding the sale. The OECD Guidelines are based on sound underlying economic principles designed to result in arm's length prices being charged – the same result sought by customs administrations when determining that prices have not been influenced by the relationship.

Consequently, consistent with Commentary 23.1, in certain instances, the ICC recommends that importers who set prices in accordance with the OECD Guidelines demonstrate that the relationship between the buyer and the seller did not influence the price.

Accordingly, the arm's length principle (article 9 OECD Model) may be directly aligned with the rules for determining the acceptability of transaction value under either the circumstances of sale test or test values. This should be formally recognized by customs administrations and doing so will set up a formal link between the OECD and WTO rules with regard to the value of transactions between related parties.

Moreover, there are many situations where voluntary or a fortiori imposed adjustments were not foreseeable at the time the import declaration had been made. The propositions 2 and 3 concern cases where the customs implications of any such transfer pricing adjustment need to be duly dealt with.

Proposal 2

Recognition by the customs administration of post-transaction transfer pricing adjustments (upward or downward). This recognition should be applicable for adjustments made either as a result of a voluntary compensating adjustment – as agreed upon by the two related parties – or as a result of a tax audit.

Post-transactions adjustments are permitted by both the OECD Guidelines and WTO customs valuation rules. These post-transaction adjustments can be done for a variety of reasons, including voluntary adjustments, but also for year-end adjustments when trying to get within a pre-agreed range or price at the end of a year or period. However, such adjustments are subject to separate sets of rules and are often disregarded by customs when the adjustments are downward.

Should companies be permitted to perform customs value adjustments without being required to set up a provisional valuation procedure or being subject to penalties due to valuation adjustments.

Proposal 3

It is recommended that in the event of post-transaction transfer pricing adjustments (upward or downward), customs administrations accede to review the customs value according to one of the

following methods as selected by the importer. These methods are applicable to the value of the goods impacted by the adjustment:

- Application of the weighted average customs duty rate: the weighted average customs duty rate is calculated by dividing the customs duties' total amount for the year by the respective customs value total amount for the same year. This may include the possibility of a lump-sum adjustment at the end of the year. For example, if at the end of the year the transfer price adjustments result in an additional payment to the seller, we recommend that the importer be able to report this lump-sum amount. That way customs will be able to allocate this to all entries declared within the year, and the duty adjustment will be the weighted average duty rate.
- Allocation of the transfer pricing adjustment, according to the nomenclature code and to information provided by the importer or customs authorities disclosing all commodity codes and all relevant import data available in their national statistics.

Proposal 4

It is recommended that in the case of post-transaction transfer pricing adjustments (upward or downward), companies be relieved from:

- the obligation to submit an amended declaration for each initial customs declaration. Instead, a single recapitulative return referring to all the initial customs declarations would be lodged; and
- the payment of penalties, as variations of the transfer price. In fact, these variations depend on various factors which have absolutely nothing to do with an intention to evade customs duties.

Proposal 5

It is recommended that OECD TP methods be acceptable to customs administrations with an accommodation of the following elements:

- identical or similar goods: recognition of the geographical and temporal circumstances of the market to enable a simplification in the level of requirements according to the needs of the country of import and to permit an approach based on market segment, regional area and comparable market conditions; and
- recognition of corporate legal entities (performing specific functions and adding value within a group) in order to enable customs authorities to acknowledge transfer pricing documentation and functional analysis in the broad economic context, and not narrowly according to the chronology of transactions.

Proposal 6

Recognition of the acceptability of transfer pricing documentation by the customs administration.

Tax transfer pricing documentation is a tax legal requirement almost everywhere in the world. Its content is largely aligned across countries and can hence be considered fairly standard. It normally includes all of the information required to analyse the circumstances of sale, the parties involved, the added value and the functions performed by each party. It is recommended that customs requirements, in addition to those of tax authorities, be defined so as to enable incorporation of those requirements into transfer pricing documentation to serve both purposes.

In conclusion, the ICC Policy Statement is currently a good attempt to ease the conciliation of the “two sides of the same coin” even if it appears still too generic. In fact, no specific mention has been made about the different criteria of transfer pricing valuation (traditional ones and profit ones) and the relevant customs methods. Nevertheless, it is, in the author’s view, a considerable step forward in this complex area, even if most of the customs authorities across WTO member states do not yet explicitly provide a domestic tool to reconcile transfer pricing adjustments with customs value.

12. Thoughts and potential solutions to reconcile transfer pricing adjustments with customs value

Transfer pricing in relation to customs duties continues to generate challenges for multinational companies operating in various countries.

Current issues

As part of an intercompany transaction to which a transfer pricing policy has been applied, it is possible that for economic evaluations made *ex post* related to a reference period (a quarter, semester or year), some changes occur to “adjust” the value originally invoiced. This circumstance may occur both in import and in export situations.

Should this happen at import, the importing company must account for the differences in value, reporting the increase or the decrease (expressed with a credit or debit note), which will obviously have an impact on the amount of costs incurred for the purchase of raw materials and finished goods from intercompany suppliers that are not resident in the European Union.

These differences, duly reconciled to the general account for income tax purposes, are not usually “given to customs” with the ritual reporting to the same customs offices through which the goods have been cleared so that customs can make a new assessment and liquidate the highest duties (for increases) or grant a refund (for decreases). In fact, more frequently, customs reconciliation is not considered as necessary or, rather, is considered too burdensome for the current configuration of the review of the assessment. In fact, in most WTO member countries, such a review involves a reconsideration of all elements at the time they are presented to customs, and this should to be done on an “entry declaration by entry declaration” basis.

However, it must be kept in mind that the issue of adjustments operated as a result of a transfer pricing policy now encompasses more than 60% of international trade. All of this trade, when related to transactions between EU countries and third countries, also draws attention to customs valuation.

As an example, it is worth specifying that in the European Union, customs law already provides tools for reconciliation.

As is already known, the CCC allows adjustments and corrections to be made in the final balance in different ways. Firstly, article 65 of the CCC allows unilateral adjustment to be applied, promoted by the importer after acceptance of the declaration. This assumption is, however, possible only until the goods are released for free circulation and it is therefore not expendable in the case of adjustments for transfer pricing.

For transfer pricing adjustments, it will therefore be necessary to use different assumptions that allow the importer to review the declared value even after the release of the goods. Having said that, it is necessary to recall what EU resident companies who have applied a transfer pricing policy can do to report the amended prices in customs declarations.

Instruments under current EU legislation

In Community customs law, legal tools that can be used for reconciliation already exist, which, in different ways, allow for reporting to the customs office through which goods have been declared if the import components of value that have already been identified (and on which the relevant duty has already been paid) have been modified. This is the “flat rate” of the customs value (article 73 of the UCC) and the simplified declaration (article 166 of the UCC).

It is worth citing the example of the European Union, since the EU harmonized customs regulation just adopted the same wording as the GATT on the topic of valuation, by simply using a “copy and paste” method. In this way, the European Union applies a consolidated global approach which has been transposed into most domestic customs laws worldwide.

The “flat rate” customs value

Article 73 of the UCC provides that, where the importer has knowledge that its valuation of goods in the customs assessment could be affected by some components of value which are not determinable on importation, he may ask to be allowed (as a result of specific sharing with the competent customs office) to identify an amount defined *ex ante* that will represent the tax base for the application of the customs tax.

In particular, article 73 states that the customs authorities may, upon application, authorize that amounts be determined on the basis of specific criteria, where they are not quantifiable on the date on which the customs declaration is accepted.

This means that, within a TP policy which may generate TP adjustments, the company is entitled to approach the customs authorities, disclose its policy and obtain the authorization to reconcile its values according to the new values given by the adjustments.

This provision, in essence, gives the possibility to derogate from the strict application of the criteria set by article 71 of the UCC, provided that the person concerned has specifically asked for and has received express authorization from the customs office. Likewise, the same rule allows the importer to identify the components that should not be part of the customs valuation (as provided by article 72 of the UCC). Such “neutral components”, without specific permission, could not benefit from being non-dutiable, if not identified separately in an invoice.

The UCC estimates that the amounts of these components to be added (article 71 of the UCC)^[40] or not to be included (article 72 of the UCC) in the customs value, should be calculated “on the basis of specific criteria”. Such criteria, simply because it should represent a simplification tool, must be identified specifically according to the needs of the single company, respecting the legitimate claim of “adequacy” invoked by the UCC in a timely manner.

As it is clear from the wording of the specific provision, the special “flat rate” tool, applied to the adjustments induced in transfer pricing policy, can be highly effective if the importer expects only an increase in value. Instead, when the transfer pricing policy also envisages potential decreases in value after import, such decreases could not generate any potential refund for the importer. In fact, in its application of the transfer pricing policy, an importing company that purchases goods from non-resident entities belonging to the same group is not objectively able to represent the final valuation of

40. See arts. 7 and 8 GATT Agreement.

a transaction at the time of import. Such a circumstance, the essence of a transfer pricing policy, will qualify the customs value declared at import as “provisional” only.

In any event, article 73 of the UCC offers a tool that allows the importer to close the customs declaration, finding in advance an agreement for any future increase in the value of the transaction due to transfer pricing with a “flat rate” formula being negotiated with the customs office. In fact, it offers the possibility to negotiate a pre-determination of the price with the customs office. This pre-determination will be reported in any following declaration and will represent the tax base for any import duties.

A simplified declaration can be managed only by companies that have the same level of compliance required for AEOs (article 39, lett. a, of the UCC).

Simplified declaration (EU solution)

The simplified declaration is provided for in article 166 of the UCC. With this tool, sharing the contractual agreements underlying the transfer pricing policy with the customs office in advance and illustrating the features of any transfer pricing adjustments may allow customs to authorize an importer to provide a provisional value for each import representing a purchase from an intercompany relation.

In particular, article 166 states that customs authorities may accept that a person has goods placed under a customs procedure on the basis of a simplified declaration which may omit certain of the particulars expected for a standard declaration (article 162 of the UCC) or the related supporting documents (article 163 of the UCC). The regular use of a simplified declaration shall be subject to an authorization from the customs authorities.

In the past, the main theme was to determine whether the proposed value at import to support evaluations of transfer pricing could be acceptable to customs. Customs authorities were not keen on recognizing the customs dignity of transfer pricing policy because it was not considered relevant for the purposes of the transaction value. To date, the recent evolution of the international context has reformulated the relevance of transfer pricing customs policy.

In fact, as mentioned in section 10., in October 2010 the TCCV WCO approved Commentary 23.1, (Examination of the expression “circumstances surrounding the sale” under article 1.2 (a) of the Agreement in relation to the use of transfer pricing studies).

As noted in a previous analysis, the Commentary was intended to provide a closer link between the Agreement on the value of the WTO (see section 3.2.2.) and the OECD Guidelines. In fact, the Commentary provides guidance on the eligibility of a transfer pricing study by the importer as a basis for examining the “circumstances surrounding the sale”. This position finally represents a new approach from which certain economic principles used by the OECD to determine the arm’s length price are now recognized as valid to support the “transaction value” required by the customs legislation.

Article 1 of the “Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade 1994” (subsequently referred to as “the Agreement”) states that the “transaction value” is acceptable as the customs value when the buyer and seller are not related, or, if related, provided that the relation does not influence the price. Moreover, it is the same provision given in article 70, paragraph 3, lett. d, of the UCC. Commentary 23.1 has considered the expression “circumstances surrounding the sale”, mentioned in article 1.2 (a) of the Agreement, in relation to the use of transfer pricing analysis in determining the customs value.

Where the buyer and seller are related, article 1.2 of the Agreement provides for different instruments to determine the acceptability of the “transaction value”, as previously mentioned. That is to say, where the customs authorities have doubts about the price charged (and declared at import), they will examine the “circumstances surrounding the sale” based on the information provided by the importer.

The interpretative note to article 1.2 of the Agreement stipulates that where customs is unable to accept the transaction value without further investigation, they should give the importer an opportunity to provide more detailed information. The note also provides some examples in order to determine whether the relationship between the buyer and the seller influences the price, such as:

- a) if the pricing shows that the vendor applies the same prices to independent buyers, it can be argued that the same price charged to “controlled” entities is not affected by the report; or
- b) where it is shown that the price is adequate to ensure the remuneration of all costs “plus a profit” which is representative of the firm’s overall profit in a given period of time (i.e. on an annual basis) for the sale of goods of the same kind, it has been proved that the price was not affected.

It should be remembered that the central question that the new Commentary has raised was aimed at understanding whether the transfer pricing study prepared for the purposes of direct taxation, and possibly provided by the importer, could be ritually used by the tax administration as a customs basis to examine the circumstances surrounding the sale.

On the one hand, WCO Commentary 23.1 points out that a study of transfer pricing submitted by an importer can certainly be a good source of information if it is material in relation to the circumstances surrounding the sale. On the other hand, it adds that the existence of a transfer pricing study may not in itself be “automatically” relevant or appropriate for the examination of “circumstances surrounding the sale” because of the substantial and significant differences that exist between the criteria laid down by the Agreement for the GATT customs value and the methods described by the OECD for transfer pricing.

The Commentary concludes that the use of a transfer pricing study as a possible basis for examining the “circumstances surrounding the sale” should be considered on a case by case basis, not distinguishing between traditional methods and profit methods, which must therefore be considered as equally expendable without any discrimination of the former over the latter. Therefore, the transfer pricing policy ultimately has its own customs relevance and can be spent at the use of understatement, even with methods such as profit TNMM (Transnational Net Margin Method) and PSM (Profit Split Method).

With the use of an incomplete procedure, the values can be reconciled due to the changes induced by transfer pricing (whatever the method used, be it traditional or profit) without the need to systematically revise the assessment and with no impact on the “customs reliability” of the importing company, reflected automatically in the risk analysis circuit of the customs authority.

Transfer pricing adjustments at export

Another perspective related to transfer pricing adjustments is that of which actions must be taken in the case of adjustments made at export. In fact, while the commercial community – at least in recent months – has been occupied with finding a way to report the intercompany transfer price for customs declarations filed at import, the question of how to reconsider the values declared at export has rarely been broached. In reality, simply due to the adjustments of transfer pricing, exporting companies are obliged to issue a note (debit or credit) to non-EU resident subsidiaries. Such notes,

and the consequent value changes, should be reported to the customs office of exit as well. Again, the incomplete declaration allows to manage transfer pricing adjustments also in export transactions with the same procedure mentioned above for import.

Reconciliation of value: what is the situation worldwide?

It appears that, while tax authorities (revenue offices) are concerned with transfer pricing adjustments in order to precisely determine the domestic taxable basis for income tax, globally a clear procedure to easily offset transfer pricing adjustments with customs value does not exist.

In fact, as mentioned above, in the European Union (and in some other non-EU countries) there is the possibility to use a legal tool (the incomplete declaration tool or similar) in order to inform customs that the declared value is not supposed to be definitive. Under such a tool, customs law provides the opportunity to revert to customs offices at a later date and to reconcile the values.

However, use of the incomplete procedure (and similar tools) is not yet fully convenient for the importers. In fact, to date, no customs authorities have accepted the proposals of the ICC concerning the opportunity to use a “single note” applying an “average duty rate”.

Some countries still explicitly refuse any changes to the customs value which depends on transfer pricing policy. Such countries include Argentina, Brazil, Chile, China, Ecuador, India, Indonesia, Japan, Kenya, Malaysia, New Zealand, Peru, Philippines, Russia, Saudi Arabia, Singapore, South Africa, Taiwan, Thailand and Vietnam.

Notwithstanding an EU harmonized customs law, and despite the presence of a specific rule given by the EU Regulations, different approaches are used in the different Member States and there is no possibility for companies to identify a best practice solution.

The result is that, to date, the agreement with customs authorities is not as straightforward as it should be, even within the European Union.

For the global commercial community, it would be desirable for the WCO to renew its official involvement, stating explicitly that customs solutions (as incomplete procedures) must be granted globally to the companies that need to reconcile transfer pricing adjustments with customs value. The WCO should also evaluate the proposals of simplification envisaged by the ICC (International Chamber of Commerce) in order to make them effective, instructing domestic customs authorities to accept a “single note” for the revision of the assessment and by applying an “average duty rate”.

In conclusion, a resident company that has adopted a pricing policy in relations with foreign affiliates can opt primarily for the understatement (including export) and, where this is found to be too expensive, can choose the “flat-rate”.

Whichever of the two options is adopted, the need for a company that has an ongoing customs relationship must be emphasized, in the context of intercompany transactions, to apply for the AEO (Authorized Economic Operator) certification in view of the significant discontinuities that occurred after May 2016. From May 2016, in fact, most of the customs benefit provided by the UCC will be granted only to the AEO entities. All forms of negotiation and facilitation will be easier (sometimes exclusive) only to those who will be certified as Authorized Economic Operators (AEO).

In this latter regard, it is worth remembering that, regardless of the ability to interact with the locally competent customs office, a resident company that wants to lead a centralized negotiation may submit a

request for a decision under article 22 of the UCC regarding transfer pricing or may obtain authorization pursuant to article 73.

WCO Guide to Transfer Pricing and Customs Valuation

In June 2015, the WCO delivered a specific guide describing the relation between transfer pricing and customs valuation (the Guide).

It was a strong contribute for the commercial community in order to generate awareness about the issue, especially among the customs authorities pertaining to the WCO member states.

The WCO gave instructions in order to better comply with the customs law across the world. It is said in the Guide that transfer pricing adjustments are a common feature of MNEs' pricing strategies. The Guide also explains that adjustments take place for different reasons and with different results. It is therefore necessary for customs to gain an understanding of the different types of transfer pricing adjustments and then consider which may have an impact on the customs value and how this should be dealt with.^[41]

It can be argued that, given that the effect of a transfer pricing adjustment is to achieve an arm's length price, in some cases – depending on the type of transfer pricing adjustment – the adjusted price will be closer to the “un-influenced” price actually paid or payable for customs valuation purposes. In other cases, such as tax-only transfer pricing adjustments, it may demonstrate that the price was in fact influenced by the relationship. To put it another way, customs may not be able to make a final decision on the question of price influence until any adjustments have been made (or quantified). It is therefore in customs' interest to study the impact of transfer pricing adjustments on the customs value.

Customs' treatment of transfer pricing adjustments, however, is currently inconsistent around the world. Some customs administrations consider price adjustments both upward and downward and make corresponding duty adjustments where appropriate, others do not, or only consider upward adjustments (with additional duty payment) but do not consider downward adjustments (duty refund). Some consider tax only adjustments, whilst others only consider actual price adjustments. This inconsistency has been one of the main concerns expressed by the business community.

According to the WCO Guide, it is therefore desirable that the customs community strives to achieve a more consistent approach when considering the impact of transfer pricing adjustments on the customs value.

An important principle is established in an instrument of the TCCV; Commentary 4.1 - Price review clauses.^[42] This instrument considers the customs value implications of goods contracts which include a “price review clause”, whereby the price is only provisionally fixed at the time of importation; “the final determination of the price payable being subject to certain factors which are set forth in the provisions of the contract itself”. It concludes that such clauses: “should not, of themselves, preclude valuation under Article 1 of the Agreement”. This scenario can be compared to situations where the price declared to customs at importation is based on a transfer price which may be subject to subsequent adjustment (for example, to achieve a pre-determined profit margin). The possibility of a transfer pricing adjustment exists at the time of importation.

41. WCO Guide, June 2015, para. 5.3, p. 65 et seq.

42. See Annex IV WCO Guide.

The basic principle of effecting a repayment of duties in the event of an overcharge by customs is established in the Revised Kyoto Convention:

The Revised Kyoto Convention: International Convention On The Simplification And Harmonization Of Customs Procedures: General Annex, Chapter 4, Duties and Taxes

C. REPAYMENT OF DUTIES AND TAXES

4.18. Standard

Repayment shall be granted where it is established that duties and taxes have been overcharged as a result of an error in their assessment.

As explained in chapter 3 of the WCO Guide, there are a number of reasons why a transfer pricing adjustment may take place and different ways that it can be initiated.

Where an adjustment is initiated by the taxpayer, the adjustment is recorded in the accounts of the taxpayer, and a debit or credit note is issued, it could be, depending on the nature of the adjustment, considered to have an impact on the price actually paid or payable for the imported goods, for customs valuation purposes. In other cases, particularly where the adjustment has been initiated by the tax administration, the impact may be only on the tax liability and not on the price actually paid or payable for the goods.

Where such an adjustment takes place before the goods are imported, the price declared to customs should take into account the adjustment.

If, on the other hand, the adjustment takes place after importation of the goods (i.e. it is recorded in the accounts of the taxpayer and the debit or credit note is issued after customs clearance of the goods), customs may consider that the customs value is to be determined on the basis of the adjusted price, applying the principles established in WCO Commentary 4.1.

Regarding transfer pricing adjustments which affect only the tax liability (i.e. no actual change to the amount paid for the goods), customs may consider whether this is an indication of price influence. In other words, there is an acknowledgement that the original price was not arm's length for transfer pricing purposes but the price actually paid has not been adjusted.

Assuming that customs agree that the customs value should be based on the price after the transfer pricing adjustment and consequent financial or accounting adjustment, it is then necessary to consider the appropriate customs procedures for dealing with this.

Commentary 4.1 makes reference to article 13 of the Customs Valuation Agreement which provides for the possibility of delaying the final determination of customs value. Article 13 states that "the importer of the goods shall nevertheless be able to withdraw them from customs if, where so required, the importer provides sufficient guarantee in the form of a surety, a deposit or some other appropriate instrument, covering the ultimate payment of customs duties for which the goods may be liable".

The question arises whether it is necessary to require importers to lodge customs declarations on the basis of a provisional declaration of value, covered by a security for the potential duty due. This creates

a major resource implication for both business and customs in terms of accounting and reconciliation procedures, particularly where a large number of customs declarations are involved.

This issue has been raised as a concern by business. As stated in the above-mentioned ICC's Policy Statement, Proposal 2:

Companies should be permitted to perform customs value adjustments without being required to set up a provisional valuation procedure or being subject to penalties due to valuation adjustments.

Pending any international guidance on this point, it is for national customs administrations to determine the customs procedures required in these circumstances. As a basic requirement for customs to consider an adjustment to the customs value, it is clear that a transfer pricing policy should be in place prior to the importation or clearance of the goods concerned, which indicates the criteria (or formula) that will be applied to establish the final transfer price. Customs may require that the importer reports the existence of the transfer pricing policy in advance of importations. The policy may have been established in the context of an Advance Pricing Agreement. Customs would also typically require the business to report the final transfer price with details of the adjustment; this should be mandatory in the case of an upward adjustment.

Another important consideration for customs in the post-importation environment is the treatment of adjustments under article 8 of the Agreement. Typically, it is during the course of a customs audit that such adjustments come to light and can be quantified. Customs should therefore take into account other payments made after importation to or for the benefit of the parent company (for example, contributions for design and development fees) or other payments based on subsequent resale, disposal, or use of imported goods that accrue to the vendor, in order to determine whether or not they should be included in the customs value.

The WCO Guide underlines that, where customs decide that an adjustment to the customs value is appropriate, it is then necessary to determine the mechanism and calculation method. Customs' focus is on individual transactions whereas transfer pricing data is at the aggregate level. Hence, it is necessary to find means to calculate and apportion to each consignment an appropriate value.

In this case, the criteria given by Proposal 3 of the ICC are helpful, suggesting to adopt an average duty rate including the possibility of a lump sum adjustment at the end of the year.

Another issue is the timing of the customs audit: what happens if a transfer pricing adjustment is anticipated but has not yet taken place at the time customs are conducting an audit? Customs will need to decide whether to wait until the adjustment has been made or take a decision at that stage.

9 – Tax Accounting Considerations

Authors

Chris Tierney

Koen De Grave

Nele Vandervelden^[1]

Latest Information:

This chapter is based on information available up to 1 August 2016. Please find below the main changes made to this chapter up to that date:

On 20 November 2015, the FASB issued Accounting Standards Update 2015-17, Balance Sheet Classification of Deferred Taxes (ASU 2015-17).

1. Introduction

Business restructurings have pervasive impacts on a company's operations, policies and financial position. Such impacts also extend to income taxation, which is directly and often significantly affected by the movement or redeployment of assets and profits that is common to restructurings.

The income tax consequences of business restructurings are typically viewed from a cash tax perspective and for good reason – taxes have a direct impact on the cash available for use in other areas of the business. However, the effect of income taxes on financial reporting is increasingly also becoming a top consideration of the finance function, given the impact on financial results and the increased scrutiny of this area by regulatory bodies, especially in the United States and Europe. For example, a company's effective tax rate, which is calculated via income tax accounting, is a key component used to determine earnings per share. As commonly known in the investment community, earnings per share is a key financial indicator in evaluating a company's performance and therefore attractiveness as an investment opportunity. Earnings per share may also be used internally as a basis on which management bonuses or other types of employee compensation are determined. Needless to say, the effective tax rate is a very important metric for many companies, and effects on the effective tax rate, including those that may arise from business restructurings, are important to understand. Deferred tax accounting – to be explained in more detail throughout this chapter – is another area of importance in income tax accounting. This is not to say that deferred taxes are more important than current taxes. But rather, deferred tax accounting is an area of income tax accounting to be highlighted because for many, this is a relatively new concept and one that can be very complex and result in a significant impact on the financial statements.

It is nearly impossible to assess the income tax consequences – and therefore the income tax accounting consequences – of business restructurings without consideration of transfer pricing. In fact, transfer pricing is a key consideration, if not *the* key consideration, of such assessments, given that

* Koen De Grave, Senior Tax Director, PwC Belgium Tax Accounting Services Leader, koen.de.grave@be.pwc.com; Nele Vandervelden, Senior Tax Manager, nele.vandervelden@be.pwc.com; both of PwC Belgium's Tax Accounting Services Group and Chris Tierney, Tax Partner, PwC Chicago, d.chris.tierney@us.pwc.com.

intercompany transactions are inherent to most business restructurings. Accordingly, this chapter will focus primarily on “common” transfer pricing issues associated with business restructurings and their related income tax accounting implications. In addition, this chapter will walk through the most significant technical accounting aspects of income tax accounting for business restructurings. Certain important but secondary implications, including interim reporting, financial statement disclosures and accounting for business combinations, ^[1] are omitted from this chapter for the sake of brevity. Further, one should bear in mind that the income tax accounting considerations discussed in this chapter do not constitute an exhaustive list, but rather a sampling of the most common and significant issues encountered when determining the income tax accounting for business restructurings.

In order to understand the income tax accounting impacts of business restructurings, it is first imperative to understand tax accounting itself and the guiding frameworks and standards. Given the prevalence of accounting under US Generally Accepted Accounting Principles (US GAAP) and the continued global migration to International Financial Reporting Standards (IFRS), the tax accounting discussion in this chapter will primarily address these two frameworks, specifically the respective tax accounting standards, Accounting Standards Codification (ASC) 740 (formerly known as Financial Accounting Standard (FAS) 109 ^[2]) and International Accounting Standard (IAS) 12, and related guidance and interpretations as effective at 1 August 2016.

Income tax accounting at its basic level is accounting for income taxes in the context of financial reporting requirements. In contrast to many local (or statutory) GAAPs, the IFRS and US GAAP introduce the concept of accounting for future tax consequences of current and past events, i.e. deferred tax accounting. These frameworks also introduce stringent requirements for recognizing tax benefits in the financial statements as compared to the tax return, particularly related to future tax deductions (or exclusions of income) that may not be realizable, or tax positions taken (or to be taken) on a tax return that may be uncertain. Said another way, the concept of income taxes for financial reporting purposes is often much more than the expected tax liability(ies) on the tax return(s) for a given reporting year. Its impact often extends beyond income tax expense in the income statement, and even beyond income taxes payable and cash on the balance sheet.

Of course to appropriately apply income tax accounting, one must also know the treatment of events and transactions under the relevant tax law as compared to the pre-tax financial accounting treatment of such items. It is, after all, these differences in treatment between financial accounting and tax law that give rise to deferred taxes and effective tax rate impact. A complete discussion of all tax law and pre-tax accounting implications of specific events and transactions associated with business restructurings is far beyond the scope of this discussion; however, a brief overview of general tax law considerations is provided later in the chapter, and pre-tax accounting principles are discussed throughout the chapter where appropriate.

1. “Business combination” as defined by IFRS 3/3R and ASC 805.

2. In 2009, the Financial Accounting Standards Board (FASB), which is the US body that governs US GAAP, undertook a codification project to organize all US GAAP accounting standards and related guidance into a uniformly referenced structure. The new structure, indicated by “ASC”, became effective for interim and annual financial reporting periods ending after 15 September 2009, and as from this date, all references to US GAAP standards and related guidance included in US GAAP financial statements must use the new ASC reference. Note that the ASC structure did not change the underlying accounting texts, only the way in which it is organized and referenced.

2. International Accounting Framework

2.1. General

For many reasons, an increasing number of enterprises worldwide are required to draw up their (consolidated) financial statements or to report their figures for group purposes using internationally recognized accounting standards, typically IFRS or US GAAP. These reasons may include the requirement for many European publicly traded companies, depending on local country rules, to report financial results in both local GAAP and IFRS, or financial reporting obligations in the United States for foreign private issuers or subsidiaries (or certain other equity investees) of US publicly traded companies. Whatever the reason, both IFRS and US GAAP provide a comprehensive – and generally similar – set of accounting principles for income taxes.

The number of companies subject to IFRS reporting is expected to continue to increase as an increasing number of countries adopt IFRS as the primary local-country financial reporting framework. The International Accounting Standards Board (IASB), the UK-based body responsible for the development and maintenance of the IFRS framework, and its US/US GAAP equivalent, the Financial Accounting Standards Board (FASB), continue to collaborate. This collaboration has been and continues to be accomplished via ongoing convergence projects by the IASB and FASB on a standard-by-standard basis. However, in practice convergence is not that straightforward and consequently the IASB and FASB continue to make their own decisions.

2.2. Income tax accounting standards

The [IFRS](#) and US [GAAP](#) frameworks each encompass a specific standard dedicated to the accounting treatment for income taxes. As noted previously, this standard is [IAS 12](#) for IFRS, and [ASC 740](#) for US GAAP. ^[3] Using the various sections of these two standards (and related guidance and interpretations), one should be able to handle the principle issue in accounting for income taxes, i.e. how to account for the tax consequences of:

- the future recovery (settlement) of the carrying amount of assets (liabilities) that are recognized in an entity's balance sheet (i.e. deferred taxes); and
- operations, transactions and other events of the current period that are recognized in an entity's financial statements (i.e. current taxes).

For purposes of these standards, income taxes include all domestic and foreign taxes that are based on taxable profits. Income taxes also include taxes that are paid by a subsidiary, associate (equity investee) or interests in joint arrangements on distributions to the reporting entity, such as withholding taxes.

Most of the basic principles utilized by [IAS 12](#) and [ASC 740](#) are similar. The main principles which have identical meaning within the two standards are notably:

- current tax is the amount of income taxes payable (recoverable) in future periods in respect of the taxable profit (tax loss) for a period;
- deferred tax liabilities are the amounts of income taxes payable in future periods in respect of taxable temporary differences;

3. There is significantly more tax accounting guidance under US [GAAP](#) than to fully apply tax accounting under US GAAP and IFRS, however, it is also essential to have sufficient understanding of other relevant accounting standards.

- deferred tax assets are the amounts of income taxes recoverable in future periods in respect of (1) deductible temporary differences, (2) the carry-forward of unused tax losses and (3) the carry-forward of unused tax credits; and
- temporary differences are differences between the carrying amount of an asset or liability on the balance sheet and its tax base. Temporary differences may be either:
 - taxable temporary differences, which are temporary differences that will result in taxable amounts in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or the liability is recovered or settled; or
 - deductible temporary differences, which are temporary differences that will result in amounts that are deductible in determining taxable profit (loss) of future tax periods when the carrying amount of the asset or liability is recovered or settled.

Although ASC 740 and IAS 12 are similar models, they still contain a number of important differences which could be relevant in practice. Indeed, the devil is often in the details!

As described above, deductible temporary differences and unused tax attributes, including tax losses and tax credits, could give rise to the recognition of a deferred tax asset. This recognition is not systematic. In this regard, both IAS 12 and ASC 740 provide a “recoverability test” to evaluate whether, and if so, the extent to which deferred tax assets may be recognized on these deductible temporary differences and tax attributes.

In some circumstances, the recognition of a deferred tax asset is particularly complex insofar as the criteria prevailing in this regard are very subjective, and therefore the documentary evidence to support the decision taken by management is key.

Example

Assume a business restructuring within Group XYZ resulted in the transfer of an intangible from Subsidiary A located in Country X to Subsidiary B located in Country Y. Along with the transfer of the intangible asset was the transfer of the associated licence revenue. Assume also that prior to the transfer of the intangible asset, Subsidiary B was historically in a loss position with substantial tax loss carry-forwards for which no deferred tax asset had been previously recognized. However, moving forward, Subsidiary B expects to be in a taxable income position as the result of the licence revenue stream. On this basis, Subsidiary B may be tempted to recognize a deferred tax asset in its financial statements, as there is a greater than 50% likelihood that it will be able to offset its tax losses against taxable profits within the foreseeable future. However, assume now that Subsidiary B is not in a position to provide convincing transfer pricing documentation in respect of the income shifted into its hands as a result of the intangible acquisition. Then, the most reasonable position may be continued non-recognition of the deferred tax asset.

In this regard, guidance provided by IAS 12 and ASC 740, which is expected to assist the management of a business enterprise in its decision, is further explained below.

IAS 12 (paragraphs 24 and 34-36) provides that deferred taxes on deductible temporary differences, unused tax losses and unused tax credits may be recognized to the extent that it is probable that future

taxable profit will be available against which said deductible temporary differences, unused tax losses and unused tax credits can be utilized. ^[4]

Often, the difficulty resides in the assessment of the probability that sufficient taxable profit will be available. IAS 12, Para. 36 provides criteria which can be utilized when assessing this probability (“more likely than not” approach), namely:

- whether the entity has sufficient taxable temporary differences (i.e. deferred tax liabilities) relating to the same taxation authority and the same taxable entity, which will result in taxable amounts against which the deductible temporary differences, unused tax losses or unused tax credits may be utilized before they expire;
- whether it is probable that the entity will have taxable profits before unused tax losses or unused tax credits expire;
- whether the unused tax losses result from identifiable causes which are unlikely to recur; and
- whether tax planning opportunities are available to the entity that will create taxable profit in the period in which the unused tax losses or tax credits can be utilized.

This section of IAS 12 also prescribes that, to the extent that it is not probable that taxable profit will be available against which the unused tax losses and the unused tax credits can be utilized, the deferred tax asset is not recognized. One can regret that while IAS 12 provides guidance with regard to recognition, it is silent as how to measure the amount to be recognized as a deferred tax asset.

When it is more likely than not (i.e. a probability of more than 50%) that deferred tax assets will not be realized, which depends on the existence of future taxable income, the deferred tax assets should be reversed. Such reversal should be based on management’s judgement of the probability considering all available information, both quantitative and qualitative. All available evidence, positive and negative, should be considered, i.e. historical information supplemented by all currently available information about future years.

The framework and criteria for determining the recognizable value of deferred tax assets are very similar between IFRS and US GAAP. In fact, the key difference between the two frameworks is terminology. IAS 12 requires that only the net realizable deferred tax asset be recorded in the financial statements. ASC 740 requires the same, but the net realizable value is achieved through use of a valuation allowance, a contra-asset used to reduce a deferred tax asset to its net realizable value. It is also vital to appropriately compute and understand the valuation allowance under US GAAP, as it is required to be disclosed in the footnotes to the financial statements.

Also under IFRS, disclosure is key in respect of deferred tax asset recognition. When the utilization of the deferred tax asset is dependent on future taxable profits in excess of the profits arising from the reversal of existing taxable temporary differences or when the entity has suffered a loss in either the current or preceding period in the tax jurisdiction to which deferred tax assets relate, paragraph 82 of IAS 12 requires the disclosure of the amount of a deferred tax asset and the nature of the evidence supporting its recognition.

4. An exception to this general rule is the so-called “initial recognition exception”, where recognition of deferred taxes is prohibited for certain assets and liabilities the book carrying amounts of which differ to their initial tax bases.

The European Securities and Markets Authority (ESMA)^[5], in its public statement dated 28 October 2014, mentioned the recognition and measurement of deferred tax assets as one of its common enforcement priorities for 2014 IFRS financial statements. On 29 March 2016, the ESMA issued its public Report on Enforcement and Regulatory Activities of Accounting Enforcers in 2015.^[6] This report presented findings of the European accounting enforcers with respect to the ESMA's enforcement priorities for 2014. In this report, the ESMA noted room for improvement, in particular in the application of IAS 12 requirements related to recognition, measurement and disclosures of deferred tax assets arising from tax losses. This area will continue to be one of the ESMA's areas of focus in 2016.

As to the entities which are required to apply US GAAP, those with fiscal years that begin on or after 15 December 2006 must adopt ASC 740-10 (formally known as Financial Accounting Standards Board (FASB) Interpretation 48 (Accounting for Uncertainty in Income Taxes)). This interpretation of ASC 740 is intended to provide specific guidance to all business enterprises, not-for-profit organizations, pass-through entities and entities whose tax liability is subject to 100% credit for dividends paid that are potentially subject to income taxes, when they must recognize or measure uncertain tax positions.^[7] It applies to all jurisdictions (including therefore non-US parent enterprises) and all tax positions accounted for under ASC 740, regardless of the nature of the enterprise or taxing jurisdiction.

For various reasons, business enterprises can take tax positions which will result in a permanent reduction of income taxes payable, a deferral of income taxes otherwise currently payable to future financial years or a change in the expected realization of deferred tax assets. The term "tax position" notably includes:

- a decision not to file a return;
- an allocation or a shift of income between jurisdictions;
- the characterization of income or a decision to exclude;
- reporting taxable income in a tax return; and
- a decision to classify a transaction, entity or other position in a tax return as tax exempt.

Due to the significant implications of accounting for uncertain tax positions in respect of business restructurings, the requirements and application of ASC 740-10 and its equivalent under IAS 12 are discussed at greater length in sections 4.1.2. and 4.1.3.

3. Tax Law Considerations

In its 2010 Report on the Transfer Pricing Aspects of business restructurings,^[8] the OECD defines business restructurings as:

-
5. The ESMA is an independent EU Authority, whose predominant role is to serve as the EU's securities market regulator. One of ESMA's areas of responsibility is to promote the effective and consistent application of the European Securities and Markets legislation with respect to financial reporting.
 6. See https://www.esma.europa.eu/sites/default/files/library/2016-410_esma_report_on_enforcement_and_regulatory_activities_of_accounting_enforcers_in_2015.pdf, accessed 6 September 2016.
 7. As indicated in FASB Staff Position (FSP) 48-3 issued on 30 December 2008, the adoption of FIN 48/ASC 740-10 by certain non-public companies was deferred. Such companies as defined in the FSP and ASC 740 were not required to adopt ASC 740-10 until the financial year beginning on or after 15 December 2008.
 8. OECD, Centre for Tax Policy and Administration, "Report on the Transfer Pricing Aspects of Business Restructurings", Chapter IX of the OECD the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 22 July 2010.

the cross-border redeployment by a multinational enterprise of functions, assets and/or risks. It may involve cross-border transfers of valuable intangibles. They primarily consist of internal reallocation of functions, assets and risks within a multinational enterprise, although relationships with third parties may also be the reason for the restructuring and/or be affected by it. ^[9]

Business restructuring represents an area of growing attention in the regulatory and tax environments. While the pressure of competition, the savings from economies of scale, the need for specialization, the increase of efficiency and the focus on cost control are all drivers of restructurings, one should not forget that restructurings generally entail a movement of activities and thus a shift of sources of income and expenses from one country to another.

In order to determine the tax considerations, it is essential to clearly identify the restructuring transaction(s) and to understand the resulting changes to the business, both in substance and in form. Areas to consider include pre- and post-reorganization functions; changes to entity and asset rights and obligations; and the manner in which all functions, risks and/or assets were transferred.

Business restructurings come in many shapes and sizes, and identification of all possible tax implications across all industries and tax regimes in one document is nearly impossible. Accordingly, the following tax discussion briefly addresses the most common events and transactions in reorganizations, together with their most important tax considerations. The OECD published a discussion draft on business restructurings on 4 July 2016.^[10] The amendments to Chapter IX of the Transfer Pricing Guidelines are prompted by the changes to the Guidelines set out in the 2015 base erosion and profit shifting (BEPS) 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](#).

3.1. Plant closures

Plant closures are typical of reorganizations of manufacturing companies and business segments. The same or similar events and transactions associated with plant closures largely apply also to facilities closures and other operational shut-downs of non-manufacturing companies.

Many reasons may lead to the decision to close a plant, including a company's desire to shed loss-making operations or to relocate operations to another jurisdiction where the cost to manufacture is significantly lower (e.g. due to lower labour and supply costs). No matter the reason, plant closures typically involve termination or relocation of employees, lease terminations, intercompany transfers of assets (tangible and intangible) and/or movement of functions or risks to other members of the group.

Lease termination costs and severance wages associated with employee terminations are generally accrued as part of a restructuring provision for accounting purposes prior to the closure of the plant. As a general rule, such expenses are tax deductible when paid, and payment may often occur in a later fiscal year than the accrual of the restructuring provision. However, the tax laws of some countries may provide for exceptions to this rule so as to allow partial or full deductibility of the provision in the year accrued if certain criteria are met. Restructuring provisions are often large expenses, and therefore it

9. Id. at 6.

10. See <http://www.oecd.org/ctp/transfer-pricing/public-review-sought-of-beps-conforming-changes-to-chapter-ix-of-the-oecd-transfer-pricing-guidelines.htm>. The details of this report will not be discussed in detail since this falls outside the scope of this chapter.

is important to be aware of the timing of the related tax deductions and to ensure compliance with all applicable criteria should an accelerated deduction be taken. Also, in such a situation, there will be a transfer of an activity (being the assets and liabilities related to the activity which can be profit- and/or loss-making) with regard to which it should be verified whether a compensation should be paid and, if so, what the arm's length price is. This compensation will be taxable within the company transferring its activity. The (stepped-up) price paid for the activity may be depreciated in the company receiving the activity.

Given the fact that the available carried-forward tax losses ^[11] may be definitively lost when closing down a company, the recorded deferred tax asset may need to be revised in the period in which the decision to close down the company is taken.

Depending on the functions and risks assumed by the plant, it must be verified whether the plant that will be closed down or another group company will have to account for the closing costs.

3.2. Migration of intangibles

Intangibles may be transferred as the group has, for example, reasons to centralize ownership and management of intangible property.

The first important consideration is to have the intangibles identified and valued. The transfer of the intangibles can be effected by means of a simple sale or a contribution, and should take into account the arm's length principle. Unfortunately, the valuation of intangibles is quite difficult as they are generally, by definition, unique. The valuation is to be seen as a judgement made on the basis of available facts regarding the intangibles and the market in which they are exploited.

In valuing the intangibles, the following three approaches are internationally accepted:

- the cost approach: an estimate of the cost to replace or recreate;
- the market approach: a study of the market to create or discover guidelines; and
- the income approach: the earnings expected from the exploitation of the intangibles are valued.

When selecting the approach to be used to value the intangibles, various factors are to be considered, including the quality and quantity of the available data and the access to the available data.

As a result of the transfer, it might be that contractual rights are given (through licences of manufacturing agreements) to the local company to use the intangible property that it initially owned. Again, the compensation to be paid should be in line with the arm's length criteria in order to avoid the situation where, for example, part of the compensation paid, is not tax deductible, leading to economic double taxation (as the company receiving the compensation is also taxed on its revenue).

Special attention should be given when determining the price for transferring intangibles that do not yet have an established value (e.g. new intangibles with a high future profit potential).

The company selling the intangibles will, in principle, be taxed on the realized gains. The company purchasing the intangibles generally may depreciate the (stepped-up) value of the intangible asset.

When setting up or having an intellectual property (IP) centre in a number of countries, special deductions (additional to the depreciation on the IP) might be available. For example, Belgian

11. The same reasoning may be applied for other carried-over tax attributes.

companies may be allowed a deduction related to patent income (i.e. reduction of 80% of the patent income).

3.3. Conversion into limited-risk entities

A conversion into a limited-risk entity entails the transfer of risks. This may have both positive and negative consequences. The company transferring the risk will have its potential losses and liabilities also shifted. On the other hand, the potential returns related to the risk will also be shifted. It should therefore be questioned whether some compensation is to be paid when shifting risks and if so, how an arm's length price can be determined.

A central issue is to assess whether the risk – and thus also the transfer of the risk – is economically significant. If the risk is assessed as being insignificant (although this leads one to ask “What is significant?”), its corresponding value is also likely to be low. The transfer of that risk generally will not lead to a substantial decrease of the entity's profits.

The company to which the risk is allocated should manage and/or mitigate the risk and bear the related costs. In addition, the increase of the risk potential should also increase the expected return of the company.

When determining the market price, it should also be verified whether the company to be stripped previously created some intangibles which are part of the transfer and which should also be compensated.

It can be questioned whether the use of a specific transfer pricing method will create a so-called “low-risk environment”. However, the degree of risk which is inherent to the nature of the business, should be the basis for choosing the transfer pricing method – and not the contrary.

4. Specific Tax Accounting Impacts

Naturally, a business restructuring will have a tax accounting impact, particularly in the case of multi-jurisdiction restructurings, to the extent that pre-tax financial accounting results are affected. For example, shifting operations – and therefore income and expenses – between jurisdictions with different statutory tax rates may increase or decrease the effective tax rate for the overall enterprise. Similarly, establishing a restructuring reserve for wage and lease expenses related to a manufacturing facility closure may result in the need for deferred taxes. These changes first impact the pre-tax financial accounting results, which then drives the need to determine the tax accounting impact. Equally significant, however, are the tax accounting consequences that result from changes in facts and circumstances arising from a reorganization ^[12] that are not directly reflected in the pre-tax financial accounting results or that may not otherwise be evident in the financial statements (e.g. as the result of eliminations accounting in a consolidation). These key tax accounting considerations include:

- accounting for uncertainties in income taxes; and
- deferred tax accounting, including (1) accounting for intercompany asset transfers, (2) assessment of the realizability of deferred tax assets and (3) changes to outside basis differences expected to be distributed or “permanently reinvested”.

12. “Reorganization” and “business restructuring” are used interchangeably throughout this chapter. Both terms are intended to indicate an internal change in business structure/operations that involves only related parties.

These considerations can have a significant impact on the values of the tax accounts, including income tax expense, in the financial statements as well as on the related disclosures and financial metrics (e.g. earnings per share). In addition, the impact often extends beyond the tax and finance departments, and requires decisions to be made by company management regarding management's intended future actions (e.g. the decision to settle or litigate an issue raised by the tax authorities).

The remainder of this chapter will address each of these tax accounting considerations and their pervasive impacts in more depth, and will be followed by a comprehensive example that follows the tax accounting and business impacts of a hypothetical reorganization.

Business restructurings generally come hand-in-hand with new transfer pricing arrangements or changes to existing arrangements. As a consequence, all of the uncertainties and risks inherent in transfer pricing come hand-in-hand, as well. These uncertainties and risks must be evaluated not only from a cash tax and compliance perspective, but also from a tax accounting perspective where the potential exposure to the financial position of the company is appropriately and timely accounted for and disclosed in the financial statements.

4.1. Transfer pricing uncertainties

As discussed in quite some length in previous chapters, business restructurings typically involve the movement of assets (both tangible and intangible), functions and/or risks between related entities and across borders. Such movements are governed by transfer pricing regulations as a means of ensuring that related-party activities are conducted at arm's length pricing, affording each involved tax authority its fair share of the tax base pie. This then begs the question, "Are these related-party activities appropriately conducted at arm's length?"

In practice, the answer is often a range of answers provided by asset valuation reports, benchmark studies, and the like. For example, a manufacturing know-how intangible transferred between entities may be valued from EUR 15 million to EUR 18 million. Or an appropriate markup for a limited-risk distributor may be return-on-sales of 3%, although return-on-sales remuneration for distributors in the same industry with similarly limited risk and performing similar activities may range from 2% to 5%. The difference among the possible correct answers is the underlying estimates, assumptions and varying reasonable (but not always accepted) methodologies used to determine arm's length pricing. Income projections, useful life assumptions and discount rates are among the many moving targets included in transfer pricing calculations, for example in the framework of transfers of intangibles. These factors create the risk that the relevant taxing authorities will arrive at a different answer than the taxpayer – and an answer that is less favourable to the taxpayer.

In fact, the "soft" nature of transfer pricing is increasingly making this area of taxation a prime target for challenge by tax authorities. ^[13] There are grounds to challenge nearly any transfer pricing position, and the tax authorities benefit from the possibility that a company will be more inclined to reach an early settlement rather than pursue lengthy, and likely costly, litigation procedures. While accounting for uncertainties in income taxes under [IFRS](#) and [US GAAP](#) should be based on the technical merits of the tax position rather than the risk that the tax authorities will detect or audit a position (discussed in more detail below), the attention of tax authorities to this area of taxation should motivate companies to carefully consider the tax accounting impact of their transfer pricing positions in order to prevent any surprises in their financial statements resulting from a tax audit. And indeed, it is the soft nature

13. Nick Raby, *International Transfer Pricing 2008* (PricewaterhouseCoopers, 2008), at 1.

of transfer pricing and the possibility of multiple positions having technical merit that should drive the tax accounting analysis in the first place.

4.1.1. ASC 740-10: a further overview

ASC 740-10 was designed to place much more rigour around companies' evaluations and calculations of tax reserves, and as a result provides an almost step-by-step approach.

The first step is the recognition test. For each potential tax exposure, a company must determine if, based on the technical merits of the tax position, it is *more likely than not* that the tax return position can be sustained. ^[14] There are three key points to consider here:

- ASC 740-10 is a tax-benefit-oriented approach. The question is whether or not the tax benefit taken (or to be taken) on the tax return can be sustained. This can be somewhat counter-intuitive in cases where the tax benefit results from non-recognition of income rather than an increased tax deduction. For example, the tax benefit associated with a lower-than-recommended cost-plus markup for the taxpaying entity, is having less pre-tax profits on which to assess tax. There is no deduction that can be pointed to on the tax return to indicate this benefit – it is a function of a lower pre-tax income starting point.
- Determination of the sustainability of a tax return position must be made on technical merits alone and on the basis that the tax authority is aware of all relevant facts, circumstances and information. ASC 740-10 prohibits consideration of detection risk, the risk that an exposure will be identified by the tax authorities under audit, in the recognition step. Even if a company believes there to be only a remote possibility that an issue will be discovered by the tax authorities, such a belief is not necessarily sufficient to bypass the full ASC 740-10 analysis and record no reserve.
- The term “more likely than not” refers to a greater-than-50% probability (i.e. 51%-100%) to have a sustainable tax position.

The determination of whether or not a tax position meets the recognition threshold can be relatively subjective, especially if tax law and related case law are unclear. It is the responsibility of management to analyse the technical basis that supports the position and draw a conclusion regarding its sustainability. In some cases, a “should” or other high level of opinion from tax or accounting advisors may help in management's final determination. If it is ultimately determined that a tax position is *not* more likely than not to be sustained, a ASC 740-10 liability in the full amount of the benefit must be provided for in the financial statements and the next step, the measurement step, is bypassed.

The second step of the ASC 740-10 analysis is measurement. In this step, a company must determine the largest amount of tax benefit that has a cumulatively greater than 50% likelihood of being realized. ^[15] This entails identifying the potential sustainable tax benefit outcomes and their relative per cent likelihood of sustainability for a given tax position. The cumulative amount of tax benefit that has a more than 50% likelihood of being sustained is the tax benefit allowed for financial reporting purposes. To the extent that the tax benefit amount calculated is less than the benefit to be reflected on the tax return for that tax position, a ASC 740-10 liability is required for the difference between the calculated benefit and the tax return benefit. The following example illustrates this methodology:

14. Para. 13 ASC 740-10-25.

15. Para. 7 ASC 740-10-30.

Example

Company A, a publicly held kitchen appliance manufacturer, has a foreign subsidiary, Company B, which performs sales and marketing services for Company A in the foreign market. As compensation for these services, Company A ensures that Company B earns an operating margin of 5%. Company A has analysed a benchmark study prepared by its tax advisors regarding this arrangement and determined that while the 5% return-on-sales margin is within an acceptable range, it may be higher than the percentage ultimately accepted by the tax authorities, given the nature of services provided by Company B as compared to similar arrangements among other companies in the same industry. At the end of the fiscal year, Company A management had not finalized a decision to amend the intercompany agreement with Company B to lower the margin, and therefore the 5% rate continued to be used. As part of the year-end tax provision calculation, Company A prepared the following ASC 740-10 measurement analysis for this uncertain tax position, having determined that it met the recognition test:

Assumptions:

- Company B's reimbursable sales for the year were 200,000.
- Company A determined that the tax authorities may apply a 2.5%, 3% or 4% markup percentage, with individual probabilities of acceptance by the tax authorities of 25%, 30% and 35%, respectively. Company management believed the current 5% markup position to have a 10% chance of acceptance.
- Company A's statutory tax rate is 10%.

(Amounts are tax-effected)

Return on sales (%)	Potential benefit	Potential cost	Individual probability	Cumulative probability (%)	
5	1,000	0	10	10	
4	800	200	35	45	
3	600	400	30	75	Probability > 50%
2.5	500	500	25	100	

Benefit to be taken on the tax return = (200,000 × 5% markup × 10% tax rate)	
Benefit allowed in the financial statements = (200,000 × 3% markup × 10% tax rate)	
Required liability for unrecognized tax benefit (ASC 740-10 liability) =	

Company A expects to recognize a 1,000 tax benefit on its tax return, as its total expenses, and therefore tax deductions, will reflect an intercompany charge at the 5% markup percentage related to the remuneration of Company B. However, based on the other possible outcomes and the related individual probabilities of those outcomes determined by Company A, the amount of benefit that has a greater than 50% likelihood of acceptance by the tax authorities is 600, the tax benefit associated with a cost-plus markup of 3%. As a result, a liability for unrecognized tax benefit of 400 is required. This amount may or may not represent the exact amount of additional tax that Company A management expects to ultimately pay to the tax authorities, but it is the amount the Company is obligated to record as a liability in accordance with ASC 740-10.

It should also be noted that the ASC 740-10 liability of 400 is more appropriately known as an unrecognized tax benefit. As its name suggests, an unrecognized tax benefit is the amount of benefit taken on the tax return that is not recognized in the financial statements, which is in line with ASC 740-10's tax-benefit-oriented approach. In practice, the terms "unrecognized tax benefit" and "ASC 740-10 liability" are commonly used interchangeably, as a ASC 740-10 liability is usually the amount of unrecognized tax benefit for a given tax position. However, an unrecognized tax benefit does not always result in an actual liability recorded on the balance sheet. An unrecognized tax benefit may instead result in a reduction to a deferred tax asset. Said another way, an ASC 740-10 liability is an unrecognized tax benefit, but an unrecognized tax benefit is not necessarily a ASC 740-10 liability. The implications of unrecognized tax benefits to deferred tax balance sheet presentation will be discussed in more detail later in this chapter.

The values and percentages included in the example above would have been determined by Company A management based on factors such as its knowledge and experience on the subject matter, and its understanding of the involved tax authority's tendencies and prior determinations on related issues. Accordingly, measurement is often an area of considerable subjectivity and an area that should be thoroughly analysed and documented.

The unrecognized tax benefits have been determined. Now what? In this particular example, an increase of the taxable basis of Company A by the tax authorities may possibly give rise to a decrease (a so-called "correlative adjustment") of the taxable base of Company B. Indeed, depending on the jurisdiction where, respectively, Company B and Company A are tax resident and or the existence of an applicable tax treaty between those countries of residence providing for relief from economic double taxation, the taxpayer may have different legal possibilities to correlatively adjust (i.e. decrease) the taxable base of Company B as a result of the adjustment (i.e. increase) of the taxable base of Company A.

In other cases, an unrecognized tax benefit may, in fact, give rise to a future tax benefit that should also be determined. For example, an unrecognized tax benefit may relate to a temporary difference where a tax deduction is accelerated. There may be some uncertainty as to whether or not all qualifications were met in order to sustain the deduction acceleration. If sufficient uncertainty exists, a ASC 740-10 liability should be established for the amount associated with the accelerated deduction that is expected to be disallowed by the tax authorities. However, if the accelerated deduction is in fact disallowed, the deduction will then be allowed, in most cases, in the future tax year in which all criteria for deductibility are met. A deferred tax asset should therefore be recorded in conjunction with the liability for unrecognized tax benefit to reflect the deduction available in the future year.

Example

XYZ Company recorded a restructuring reserve of 10 million for severance wages at the end of Year 1. XYZ will pay these expenses in Year 2. Normally, reserves are deductible only when paid; however, the tax law allows for a deduction in the year of accrual if certain criteria are met (assuming the years in which the reserve is accrued and paid are different). XYZ intends to fully deduct the reserve on its Year 1 tax return. However, XYZ believes that there is a significant risk that some of the criteria required for accelerated deduction have not in fact been satisfied. XYZ performed a ASC 740-10 analysis and determined that, while the recognition step was met (because the deduction was a temporary difference and would ultimately be allowed). XYZ concluded that the benefit to be allowed in Year 1 based on a cumulative probability analysis was zero. Assuming a statutory tax rate of 30%, XYZ therefore recorded a liability for unrecognized tax benefit (UTB) of 3 million in Year 1 for the restructuring reserve as follows:

	Restructuring reserve	10 million	
	Tax rate	30%	
	Liability for UTB	3 million	
	Current tax exposure	3 million	
	Liability for UTB		3 mill

However, should the tax authorities in fact disallow the deduction for the reserve in Year 1, XYZ may take the deduction in Year 2 after the severance wages are paid. As a result, XYZ should also record a deferred tax asset in Year 1 for the future tax benefit of the tax deduction that can then be taken in Year 2 through the following entry:

	Deferred tax asset	3 million	
	Deferred tax exposure		3 mill

Interest and penalties for underpayment of taxes are also items of consideration that have a direct impact on the financial statements. Typically, interest and penalties are not applicable upon initial establishment of a liability for UTB because financial statements for a given taxable year are often prepared prior to the filing of the applicable tax return at which time penalties would be assessed, and the clock begins ticking on interest obligations. ^[16]

16. Consideration should also be made with regard to a company's accounting policy on how to present interest associated with uncertain tax positions in the financial statements (specifically, whether to present interest "above the line" in the income statement as a component of pre-tax book income or "below the line" in income tax expense). Under both ASC 740 and IAS 12, presentation of interest is an accounting policy to be made by the company and disclosed in the footnotes to the financial statements.

Presentation and disclosure of unrecognized tax benefits as well as any associated deferred tax assets, interest and penalties on the face of the financial statements and within the footnotes are the next items of consideration. ASC 740 provides specific guidelines for balance sheet presentation of liabilities for UTB in a classified balance sheet. Namely, a liability for UTB should be recorded as a current liability to the extent that payment of cash to the tax authority is expected within 1 year (or the operating cycle, if longer than 1 year), or as a non-current liability if cash payment is not anticipated within this time frame. The liability for UTB should not be netted with current or non-current deferred tax liabilities except in special cases where the liability for UTB arose from an uncertain tax position associated with a deferred tax liability. On 20 November 2015, the FASB issued Accounting Standards Update 2015-17, Balance Sheet Classification of Deferred Taxes (ASU 2015-17). To simplify presentation, the new guidance requires that all deferred tax assets and liabilities, along with any related valuation allowance, be classified as non-current on the balance sheet. The new guidance will be effective for public business entities in fiscal years beginning after 15 December 2016, including interim periods within those years. For entities other than public entities, the amendments are effective for fiscal years beginning after 15 December 2017 and interim periods within fiscal years beginning after 15 December 2018. The guidance may be applied either prospectively, for all deferred tax assets and liabilities, or retrospectively (i.e. by reclassifying the comparative balance sheets). Early adoption is permitted.

An expected tax benefit associated with a liability for UTB, however, should be classified as a deferred tax asset – assuming the tax benefit is not expected within 1 year, and there is no legal right of offset against the related liability for UTB (e.g. the tax benefit is related to a jurisdiction other than that in which the tax associated with the liability for UTB will be assessed, such as federal vs. local, or Country A vs. Country B). If the tax benefit is expected within 1 year, the benefit should be reflected as a current tax receivable and may be netted against any income tax payable, including any current liability for UTB amounts, if legal right of offset exists.

ASC 740 also has specific guidelines regarding disclosure in the footnotes to the financial statements. Perhaps the most significant disclosure requirement introduced by ASC 740-10 is the tabular roll-forward. This roll-forward must reflect increases and decreases to the unrecognized tax benefits related to current period and prior period tax positions taken, tax authority settlements and statute of limitations expirations. Other items required to be disclosed include:

- total amount of unrecognized tax benefits that would impact the effective tax rate if recognized;
- total amount of interest and penalties recognized in the financial statements;
- the nature and estimated amount of tax positions expected to change significantly within the next year, and the reason for the expected change; and
- descriptions of open tax years for significant tax jurisdictions.

Careful consideration of disclosure language should be made regarding the nature of uncertain tax positions. In many cases, especially for publicly held companies, the financial statements are public record and can be viewed by tax authorities in addition to the general public.

It may be evident from this overview that ASC 740 is heavy with definitions and “rules” regarding the recognition and disclosure of uncertainties in income taxes. Until recently, such rigour did not exist under IFRS. However, in its public statement of 28 October 2014,^[17] the ESMA noted that the IFRS

17. See http://www.esma.europa.eu/system/files/2014_1309_esma_public_statement_-_2014_european_common_enforcement_priorities.pdf.

Interpretations Committee discussed the question of recognition and measurement of income taxes in relation to uncertain tax positions. In particular, it referred to the principle in paragraph 46 of IAS 12 and is planning to discuss further the issue of recognition and measurement. In light of these discussions, the ESMA expects issuers to disclose their accounting policy related to material uncertain tax positions in accordance with paragraphs 117 and 122 of IAS 1 “Presentation of Financial Statements”. While the two standards are not drastically different in the overall approach to accounting for tax uncertainties, notable differences still do exist.

4.1.2. IAS 12 versus ASC 740-10: overview and key differences

As alluded to previously, IAS 12 is relatively silent on accounting for tax uncertainties compared to ASC 740-10.^[18] IAS 12 states that current taxes related to prior and current periods which are based on taxable profits and expected to be paid to or received from the tax authorities should be accounted for using enacted or substantively enacted tax rates and laws. There is no defined two-step process (recognition and measurement) as included in ASC 740-10. However, a recognition and measurement process is implicit in the standard. Some insight on the application of IAS 12 with regard to tax reserves may be drawn from IAS 37, the IFRS standard that governs non-income tax provisions (reserves) and loss contingencies. To be clear, this standard specifically does not address income-tax-related reserves and contingencies, although its footnote disclosure requirements should be followed for such contingencies. IAS 37 includes a “probable” threshold for recognition of a non-income tax provision, which is also applied to recognition of a tax reserve under IAS 12. “Probable” as defined in IAS 37 is in fact the same as the “more likely than not” threshold in ASC 740-10 – greater than 50% likelihood.

IAS 37 indicates the “single best estimate” and “weighted-average probability” approaches with regard to measurement, and these are, in principle, also the methods used for the measurement of tax uncertainties under IAS 12. The single best estimate approach utilizes just that – management’s single best estimate of the amount to be assessed by the tax authority for a given tax position. The weighted-average probability method considers all potential assessment outcomes and uses each outcome’s individual probability to determine the weighted-average outcome. These measurement approaches differ to the cumulative probability model used under ASC 740-10, and can result in materially different outcomes between the two standards.

Consider the measurement table in the previous ASC 740-10 benchmarking example, modified to include the probability-weighted cost as shown below. The differences among the ASC 740 and IAS 12 measurement approaches become apparent.

Return on sales (%)	Potential benefit	Potential cost	Individual probability(%)	Probability-weighted cost	
5	1,000	0	10	0	
4	800	200	35	70	← Single best estimate
3	600	400	30	120	← Cumulative probability > 50%
2.5	500	500	25	125	

18. Note, however, that on 21 October 2015, the International Accounting Standards Board’s IFRS Interpretations Committee released a draft Interpretation entitled *Uncertainty over Income Tax Treatments*. The draft Interpretation provides guidance on how to account for uncertain tax positions.

Return on sales (%)	Potential benefit	Potential cost	Individual probability(%)	Probability-weighted cost	
Total probability-weighted cost				315	

Recall that under ASC 740-10, the amount of tax uncertainty liability recorded was 400 (using the required cumulative probability approach). Under the weighted-average probability model used for IAS 12, the amount of liability recorded is 315. Under the single best estimate approach (also currently accepted under IAS 12),^[19] the liability amount recorded is only 200 (highest individual probability of occurrence among all potential outcomes, i.e. the most likely outcome determined by management). Due to the potential for significantly varying outcomes, it is crucial to apply the appropriate methodology depending on the applicable standard and in the case of IAS 12, the methodology that is in line with the current accounting policy of the company. Regarding the treatment of tax benefits associated with uncertain tax positions, IAS 12 is again silent, as is IAS 37. There is diversity in practice in this area, and it is perhaps most important to develop a reasonable accounting policy and use it consistently.

Presentation and disclosure requirements of tax reserves under IAS 12 are less stringent and may vary among users of IFRS. IAS 12 does not provide specific requirements with regard to balance sheet presentation of tax reserves, and therefore the guidelines for current and non-current tax liabilities within IAS 12 are generally followed. The current vs. non-current liability balance sheet presentation criterion is similar to that in ASC 740-10, i.e. the 1-year threshold. However, in the event that deferred tax assets arise in connection with a tax uncertainty liability, these deferred tax assets should be reflected as non-current assets on the balance sheet consistent with the current IAS 12 presentation rules for all deferred taxes. In addition, the principle of legal right of offset is also applicable under IAS 12 to determine the netting of tax reserves and related tax assets.

The IFRS standards are otherwise silent regarding offset of tax reserves against deferred tax assets and presentation of deferred tax assets associated with tax reserves on the balance sheet. IAS 12 also does not provide any specific disclosure requirements around uncertain tax positions and related tax reserves, other than to refer to IAS 37 in the case of tax contingencies. Both IAS 37 and IAS 1 are looked to for more specific guidance. These standards currently require that the nature and estimated financial effect of the (material) uncertain tax position be disclosed, as well as an indication of the uncertainty that exists that gives rise to a potential future payable amount and the accounting policy applied for measurement. These requirements do not demand the level of detail that ASC 740 requires. In spite of some quite significant differences between ASC 740-10 and IAS 12 regarding accounting for and disclosing income tax uncertainties, the overall process of analysing tax risks is currently largely the same, i.e. determining recognition, an amount to be recognized (measurement), other impacts such as interest and penalties, and presentation and disclosure in the financial statements. Similar considerations specific to transfer-pricing-related uncertain tax positions will apply under either accounting standard.

19. Note that the single best estimate approach is typically less appropriate for non-binary tax positions. The draft Interpretation *Uncertainty over Income Tax Treatments* states that the expected value (the weighted-average probability model) may provide the better prediction if the possible outcomes are widely dispersed. The single best estimate approach, on the other hand, may provide the better prediction if the possible outcomes are binary or are concentrated on one value. The entity shall use the method that it concludes will provide the better prediction of the resolution of the uncertainty.

4.1.3. Accounting for transfer pricing tax uncertainties: specific considerations

From a transfer pricing perspective, determination of whether or not to recognize a tax reserve is often the “easy” part. In most cases, a technical basis or principle on which to calculate an arm’s length price, whether a valuation of an asset or a per-cent-of-sales return, is readily assessable in tax law, regulations, case law and in large part due to the international principles established by the OECD that are followed by many countries. Measurement, however, tends to be a bit trickier as a result of a “range” of potential outcomes. A range of potentially acceptable outcomes may be useful in some circumstances where there are different identifiable points within the range that can be used to build a cumulative probability or weighted-average probability model. Different possible valuations for a buy-in payment, for example, may be based on identical calculations except that one input, such as estimated annual profit growth associated with the use of the intellectual property, is adjusted producing different final valuation results. If a probability of outcome can be reasonably associated with each modified calculation, an analysis can be performed to compare the tax return benefit associated with the buy-in payment made and the appropriate buy-in payment that is most likely to be accepted by the tax authorities based on the cumulative or weighted-average probability outcomes, as appropriate.

A range may be more grey where it is used to validate the acceptance of one particular data point. This is common in return-on-sales or cost-plus markup scenarios where a subsidiary is compensated for sales or services performed based on a per cent margin on sales or markup of certain costs, respectively. The margin or markup percentage is determined based on factors such as the type of services or activities performed and the level of risk assumed, and can vary across industries and companies as the nature of the underlying determining factors may differ slightly or widely. Often, as part of meeting contemporaneous transfer pricing documentation requirements, a company will hire a tax firm to perform a benchmark study that benchmarks the company’s transfer pricing return-on-sales or cost-plus percentage against those of its competitors, those in the same or similar industry or those with similar functional profiles. Based on the results of the benchmark analysis, a range of acceptable percentages is typically provided, within which the return-on-sales or cost-plus percentage used by the requesting company will preferably fall. If the return-on-sales or cost-plus percentage used does in fact fall within the range, the company may feel “safe” that no further analysis of the tax position is required. However, there in fact could be another even more appropriate value within the range that the company should be using based on the facts and circumstances of the arrangement with the subsidiary. Certain tax authorities may also expect the median to be used or referenced. In this case, a UTB/tax uncertainty liability may still be appropriate. Further analysis of the benchmarking study or tax authority practices should be performed to determine exactly which return-on-sales or cost-plus percentages within the range would be relevant. These percentages – or points within the range – may not be as readily apparent as those in the previous asset valuation example, as the criteria to determine the range of potentially acceptable percentages are potentially more subjective.

As transfer pricing continues to grow as a “hot” global taxation issue and receives more scrutiny by tax authorities, tax assessments in this area are likely to increase in both volume and value. Companies hit with a significant tax assessment may be increasingly inclined to pursue compensating adjustments with the jurisdiction in which the other party to the transfer pricing arrangement sits, i.e. where income is increased or expenses decreased by a transfer pricing adjustment in one jurisdiction, an equal and opposite adjustment should be made in the other jurisdiction in order to avoid double taxation. In the United States, companies may choose to pursue relief via competent authority in this situation if there is an applicable income tax treaty with the other involved jurisdiction. Where competent authority is used,

tax authorities from the United States and the other involved jurisdiction will seek to reach an agreement on the adjustments to be made in each jurisdiction such that double taxation is largely avoided.

Similarly, mutual agreement procedures or arbitration may be pursued by European companies, although currently these procedures are not as widely used or available among treaty countries as competent authority is in the United States. The decision to request such proceedings in the event of a tax assessment can have a significant impact on the deferred tax asset implications of uncertain tax positions, and may require company management to make a written representation as part of the financial statement audit regarding its intent to pursue such proceedings. Management may represent, for example, that it would seek mutual agreement procedures or arbitration procedures should a tax assessment be made related to an existing uncertain tax position for which a tax uncertainty liability has been established and the tax assessment exceeds a specified value threshold. If management believes that such proceedings would result in a compensating adjustment and therefore full or partial relief from double taxation, a deferred tax asset may need to be recorded in the amount of the expected relief associated with the tax uncertainty liability established for the uncertain tax position. Due to the potentially significant impact on deferred taxes of such adjustments, these decisions to pursue competent authority or arbitration must be thoroughly documented, and particular attention is often paid to these decisions during a financial statement audit.

4.2. Deferred tax accounting

There are other considerations related to deferred taxes in addition to those that arise from accounting for income tax uncertainties in the context of business restructurings. There are a number of items that originate in the pre-tax accounting that should be analysed from a deferred tax perspective, including intercompany transfers of assets. In addition, particular attention should be paid to the realization of deferred tax assets, as well as changes to foreign earnings and company policy regarding repatriation of those earnings.

4.2.1. Pre-tax accounting: deferred tax implications

Business restructurings trigger pre-tax accounting events that may give rise to book-tax basis differences and therefore require deferred taxes to be recognized. Restructuring reserves, as mentioned earlier, may be accrued for employee severance, lease terminations and other exit costs associated with a plant closure, movement of operations and similar restructuring activities. The value of tangible and intangible assets may be written down should impairment criteria be met. Deferred tax assets (or decreases to deferred tax liabilities) often arise related to these events in jurisdictions where the income tax base is calculated largely on a cash basis. Restructuring reserves may not be tax deductible until cash payment is actually made on the underlying obligations. Similarly, a loss on the impairment of plant assets, for example, may not be tax deductible until the assets are actually scrapped or otherwise disposed of. Often, the timing of restructuring reserve accruals and asset impairments in the financial statements happen in a different financial reporting/tax year than the actual events that would allow these items to be deducted for tax purposes. In these situations, deferred tax accounting is generally required.

4.2.2. Intercompany asset transfers

ASC 740 includes specific guidance regarding the treatment of intercompany transfers of tangible and intangible assets, which differs notably from the treatment of such transfers prescribed in IAS 12.^[20]

ASC 740-10-25-3(e) prohibits the transferor of the assets from recognizing income taxes for financial reporting purposes that result from a gain on transfer of the assets, even though the transferor may need to report the gain on its tax return and pay tax on the gain in the year of sale.^[21] If the transferor in fact does pay income tax on the gain in the year of sale, such tax payment is considered a prepayment of tax and is recorded on the consolidated balance sheet as an asset with a corresponding credit to current tax expense. This credit to current tax expense negates the debit to current tax expense that would have resulted from a higher income tax payable due to the gain recognition on the tax return. Accordingly, income taxes on such gain are “deferred” in this manner for financial reporting purposes until the assets are transferred outside of the group. ASC 740 further prohibits recognition of a deferred tax asset by the transferee for any book-tax basis differences in the transferred assets that result from gain deferral for consolidated financial reporting purposes.

Example

Assume that Company A located in Country A transfers an R&D IP intangible to Company B, a related party located in Country B, for EUR 1 million. At the time of transfer, the IP is fully expensed/amortized for book and tax purposes, and therefore the basis for both is nil.

In accordance with ASC 740, Company A defers recognition of income tax on the EUR 1 million gain (EUR 1 million sale price less zero basis). However, Company A pays income tax to the Country A tax authorities on the full amount of the gain in the year of transfer to Company B. Company B’s tax basis in the intangible is the EUR 1 million purchase price, and the book basis from a consolidated financial reporting perspective remains zero as a result of the gain deferral via elimination of intercompany transactions. While such temporary book-tax basis differences would typically require a deferred tax asset to be established by Company B, no deferred tax impact is reflected in the US GAAP consolidated financial statements pursuant to ASC 740-10-25-3(e). Instead, the tax paid to the tax authority by Company A is treated as a prepaid tax on the consolidated balance sheet until such time that Company B transfers the intangible outside of the group, thus triggering recognition of the gain (or loss) for financial reporting purposes.

Assuming a 34% statutory tax rate in Country A and total group tax expense of EUR 600,000 before consideration of the gain on the intercompany IP transfer, the journal entries to record the income tax accounting impact on Company A’s books are as follows (all amounts in EUR):

	Income tax expense	940,000	
--	--------------------	---------	--

20. Note, however, that in January 2015, the FASB issued an Exposure Draft, which is expected to simplify accounting for income taxes by (partly) eliminating the prohibition on the recognition of income taxes for transfers of assets from one taxable entity to another. In the Exposure Draft current and deferred income tax consequences of an intra-entity asset transfer, other than an intra-entity asset transfer of inventory, are recognized when the transfer occurs. For an intra-entity transfer of inventory, the current guidance would be retained. The FASB directed the staff to draft an accounting standards update (ASU) which is expected to be issued in late Q3 or early Q4 of 2016. The effective date would be for annual and interim periods beginning after 15 December 2017 for public business entities. For all others, the standard would be effective for annual periods beginning after 15 December 2018 and interim periods in annual periods beginning after 15 December 2019. Early adoption would be allowed for all entities as of the beginning of an annual reporting period beginning after the issuance date of the ASU.

21. In January 2015, the FASB issued an Exposure Draft which is expected to simplify accounting for income taxes by eliminating the requirement for organizations that present a classified statement of financial position to classify deferred tax assets and liabilities as current and non-current, and instead requires that they classify all deferred tax assets and liabilities as non-current.

	Income taxes payable/Cash		940,000
	To record total income tax payable (or payment) and expense including the tax on the gain from the intercompany IP transfer		
	Prepaid asset	340,000	
	Income tax expense		340,000
	To reclassify the tax expense (and payment) associated with the gain as a prepaid asset		
	Total group tax expense =	600,000	

No entries are required for Company *B*. As a result, the tax expense impact for the group associated specifically with the IP transfer transaction is nil.

In contrast to ASC 740, IAS 12 prohibits deferral of recognition of the tax impact of the gain realized by the transferor on an intercompany transfer of assets, and does allow a deferred tax asset to be recorded by the transferee at the transferee's (substantively) enacted tax rate for any initial book-tax basis differences.^[22] If Companies *A* and *B* in the above example reported under IFRS, Company *A* would make no prepaid tax entry to defer the income tax impact of the EUR 1 million gain from the asset transfer, and Company *B* would record a deferred tax asset for the EUR 1 million excess tax-over-book basis in the assets transferred. Assuming Country *B*'s tax rate is 20%, the following entries would be made for Company *A* and Company *B*:

<i>Company A</i>			
	Income tax expense	940,000	
	Income taxes payable/Cash		940,000
	To record total income tax payable (or payment) and expense including the tax on the gain from the intercompany IP transfer		

<i>Company B</i>			
	Deferred tax asset	200,000	
	Income tax expense		200,000
	To record the deferred tax asset associated with the step-up in tax basis in the IP transferred to Company <i>B</i>		
	Total group tax expense =	740,000	

Note that compared to the treatment under ASC 740, the intercompany IP transfer under IFRS may result in an impact to tax expense to the extent the transferor's and transferee's applicable statutory tax rates differ. In this case, Company *A*'s tax rate was 34% whereas Company *B*'s tax rate was 20%. This tax rate differential resulted in additional group tax expense since the current tax expense paid by Company *A* on the gain was more than the deferred tax benefit associated

22. As mentioned before, this US GAAP treatment will be revised (for assets which are not inventory) in the (near) future.

with the deferred tax asset established by Company *B* for the basis difference. If, for example, the tax rates were reversed such that Company *A*'s tax rate was 20% and Company *B*'s tax rate was 34%, a reduction to group tax expense would be the likely outcome, i.e. Company *A*'s current tax expense is less than Company *B*'s deferred tax benefit.

As a practical note to intercompany transfers of assets, it is not uncommon in practice for companies to record intangibles and other assets and liabilities of the group “top-side” at the consolidation level, rather than at the appropriate legal entity level. While this way of accounting is often done for expedience, especially given tight financial reporting deadlines, and may provide the correct financial results from a consolidated perspective, companies should take care to track the book and tax treatment of such assets and liabilities, particularly to the extent that multiple taxable entities are involved. If an asset or liability is not assigned to the appropriate legal entity and the jurisdiction-specific or taxable-entity-specific tax treatments (e.g. applicable statutory tax rate or “realizability test” for deferred tax assets) are not appropriately considered, financial statement errors in current or deferred tax accounting may arise.

4.2.3. Realizability of deferred tax assets

Reorganizations often involve shifting of income streams between entities and jurisdictions to the extent that IP or operations (or other business functions) are moved. An entity that once had taxable income due in large part to licence revenues on IP, for example, may lose that income stream should the IP be moved elsewhere within the group. If such transaction is expected to put the once profitable entity into a taxable loss position following transfer of the IP, any deferred tax assets held on its books should be re-evaluated for realizability.

Under US GAAP, a valuation allowance may be required to reduce the value of total deferred tax assets on the balance sheet in part or in full. Under IFRS, the appropriate net carrying value of total deferred tax assets would need to be determined. ^[23] It may likewise be the case that a once loss-making entity turns profitable as a result of such a transaction (e.g. the entity purchasing/receiving the IP and future licence stream). In this situation, it may be appropriate to increase the value of the net realizable deferred tax asset if that value was previously reduced. This increase would be made directly to the net deferred tax asset under IFRS or via a valuation allowance release under US GAAP.

Other restructuring transactions or activities that would similarly impact the profitability of an entity should prompt re-evaluation of that entity's deferred tax position. For example, if an entity's status changes from an “entrepreneur” the profits of which are determined on sales revenues less costs of sales and operations (in other words, not on a transfer priced basis) to a distributor that is compensated on a return-on-sales basis, this change to the way in which profits are generated may impact realizability of deferred tax assets. The term “may” is used quite frequently in the examples provided because it is important to assess the impact of such changes in entity status or profitability to deferred taxes on a case-by-case basis within the frameworks provided in IAS 12 and ASC 740. It may very well be the case that a status or profitability change does not ultimately impact the deferred tax position of an entity, given a particular set of facts and circumstances. The important take-away is that an assessment should be made.

23. A realizability assessment under US GAAP or IFRS will result in the same or materially similar net deferred tax asset on the balance sheet in most cases. The difference between the two frameworks in this area is primarily terminology – US GAAP requires assessment of the contra-deferred tax asset (i.e. valuation allowance), while IFRS requires assessment of the deferred tax asset itself to arrive at a net realizable value.

An additional consideration with regard to an assessment of deferred tax asset realizability is the timing of such assessment. Generally, business reorganizations are planned and set into motion far before the time that the new structure is in place and final from a legal perspective. Companies that are well down the path of reorganization may be inclined to consider future expected profits that result from the reorganization in their valuation allowance/net deferred tax asset assessment prior to finalization of the reorganization. Both ASC 740 and IAS 12 provide for the use of prudent and feasible tax planning strategies as positive evidence to support recognition of deferred tax assets.

This raises the question of whether or not business reorganizations qualify as a tax planning strategy as defined in these standards. Generally, the answer is that they do not. Business reorganizations are considered to be tax planning “actions” rather than “strategies”. The difference between these two definitions can be a fine line in the case of reorganizations depending on the nature of the restructuring. However, the main principle behind a tax planning action is that an action, such as a reorganization, often has a much broader business purpose and operational impact than a tax planning strategy, and would generally not be implemented for the main purpose of realizing deferred tax assets. A tax planning strategy, on the other hand, would in fact be executed primarily in order to realize deferred tax assets, and its impact on other areas of the company would be minimal. As such, any potential future income from an anticipated tax planning “action” ordinarily would not be included in income projections until the “action” (i.e. reorganization, in this case) is affected because the impacts of the tax planning “action” would not be objectively verifiable. However, in circumstances where effects of the tax planning “action” are objectively verifiable (i.e. no uncertainties or contingencies exist), the anticipated effects of such “action” would be included and incorporated into the overall future income projections. ^[24]

4.2.4. Outside basis differences

The same changes to entity profitability described in the previous section may also prompt review of a company’s deferred tax position with regard to reversal of outside basis differences. “Outside basis” is a term often used by tax professionals to indicate a parent’s basis in the stock of its subsidiary, associate or joint venture. This differs to “inside basis”, which denotes the subsidiary’s, associate’s or joint venture’s own basis in its assets and liabilities. An outside basis difference, as discussed under both US GAAP and IFRS, is then the difference between a parent’s book basis in its investment and tax basis in the stock. To the extent that an outside basis difference exists, the parent must account for the deferred tax impact of such difference unless certain criteria are met. There are a number of items that may give rise to outside basis differences. However, this section will focus on a particular type of outside basis difference that is commonly impacted by restructuring activities – unremitted foreign earnings.

Unremitted earnings of foreign subsidiaries is often the cause or one of the causes of outside basis differences. For US GAAP or IFRS purposes, a subsidiary, associate or joint venture, whether foreign or domestic, is accounted for by its parent via the equity method or consolidated accounting (as appropriate based on the percentage ownership), and as a result, the parent’s investment in the entity (i.e. its book outside basis) is adjusted each reporting period to reflect changes in basis due to income or losses in the entity. Financial accounting is generally not concerned with borders or jurisdictions. From a tax perspective, however, the tax jurisdiction in which a subsidiary is located does impact the parent’s tax outside basis. Earnings made by a foreign subsidiary may not be immediately distributed to the parent, causing the parent’s tax basis in the subsidiary to remain unchanged until the earnings are

24. *Guide to Accounting for Income Taxes 2007* (PricewaterhouseCoopers, 2007), at 108.

repatriated and taxed in the parent's jurisdiction. Delays in actual or deemed distributions or remittances of earnings by a foreign subsidiary give rise to outside basis differences between book and tax.

ASC 740 requires a deferred tax liability to be established for the outside basis difference caused by unremitted foreign earnings, ^[25] to account for the expected tax bill upon repatriation of those foreign earnings. An exception to this rule exists under ASC 740-30-25 (formerly known as Accounting Principles Board (APB) Standard 23), which requires no deferred tax liability to be recorded if the company asserts and can support permanent reinvestment of those earnings in the foreign jurisdiction, i.e. there is no intention of repatriating the foreign earnings in the foreseeable future.

IFRS has a similar view that no deferred tax liability need be recorded so long as the parent company has the ability to control the timing of the repatriation, and it is probable that such repatriation will not happen in the foreseeable future. Should a company's foreign operations (as analysed on a taxable entity basis) become profitable or loss-making as the result of restructuring, its deferred tax position relating to such operations should be re-evaluated. For example, a goal of restructuring is often to move revenue-generating IP or profitable operations to a low-tax foreign jurisdiction. Profits generated in the low-tax jurisdiction post-restructuring must be reviewed by company management to determine whether such profits are to be repatriated or permanently reinvested as a matter of company policy. Such review is particularly important to the extent that operations in that jurisdiction were generating losses prior to reorganization or no prior presences existed in that jurisdiction before the reorganization. If it is the case that management intends to repatriate the profits, a deferred tax liability is likely required. If no repatriation is intended, management should document this policy and, to the best of its ability, track unremitted earnings moving forward for financial statement disclosure purposes. Both US GAAP and IFRS provide guidance regarding financial statement disclosure of unremitted foreign earnings.

Similarly, if a previously profitable foreign subsidiary became loss-making as the result of a reorganization, the deferred tax liability, if any, associated with those profits that are recorded in the parent may need to be reduced or reversed entirely.

4.3. Comprehensive example

Perhaps the best way to illustrate the tax accounting considerations discussed is through an example. The example below is fictitious, but is intended to mirror fact patterns (to some degree of detail) that may be encountered in practice, and the respective tax accounting implications to be considered.

Lightning Semiconductors (Lightning), a publicly held Country A company, manufactures semiconductors and sells to computer companies throughout Europe. In recent years, Lightning has been profitable, and has been considering reorganizing into a more tax-efficient structure and reducing labour costs. At year-end FY 2014, Lightning formally announced its plans to restructure, and completed the restructuring in 2015. As a result of the reorganization, a Country B principal (BPrincipal) was established to bear the majority of the risk of the operations, and all manufacturing operations were moved to a newly formed subsidiary (of BPrincipal) in Country C (CSub). Lightning was then converted from a fully fledged manufacturer and distributor to a limited-risk distributor, but also retained the R&D function. The new structure is as follows:

Comprehensive example

25. Both standards require deferred tax accounting for all outside basis differences unless certain criteria are met; however, again, only unremitted foreign earnings are addressed in this discussion.

To effectuate this change, Lightning transferred all technology and manufacturing IP intangibles to BPrincipal. Lightning also shut down its two manufacturing plants in Country A, and transferred certain key manufacturing equipment to CSub. An intercompany agreement was put in place between BPrincipal and Lightning which stipulated that BPrincipal would pay Lightning return on sales of 2% for its distribution services and cost-plus 8% for R&D services. CSub was established as a contract manufacturer for BPrincipal and was compensated on a cost-plus 10% basis by BPrincipal per the intercompany agreement. All newly created technology and manufacturing IP that results from the R&D and manufacturing activities is retained by BPrincipal.

In addition:

- Lightning files consolidated financial statements with the Country A National Bank under IFRS;
- at the end of 2013, Lightning was in a small net deferred tax liability position. Lightning had a large deferred tax liability for fixed assets primarily related to accelerated depreciation for tax purposes. This deferred tax liability exceeded the total deferred tax assets, the most significant of which related to a bad debt provision;
- at the end of 2014, Lightning impaired its fixed assets to the expected recoverable amount, ^[26] and the resulting net book value was less than the net tax value. Lightning also established a EUR 16 million restructuring provision for severance wages and the costs to cancel the building leases for its two Country A manufacturing facilities;
- plant equipment transferred had a net book value of EUR 10 million, a net tax value of EUR 6.5 million and a fair market value of EUR 9.5 million on the transfer date;
- the manufacturing know-how transferred from Lightning to BPrincipal was valued at EUR 14 million based on a valuation prepared by a “Big Four” public accounting firm. As discussed in the report, the EUR 14 million value is the weighted-average value of the most likely possible values, which range from EUR 9 million to EUR 17 million. The other possible valuation amounts are the result of different asset life and revenue stream estimates used to value the intangible asset. Similarly, the technology IP transferred from Lightning to BPrincipal was valued at EUR 36 million, which the tax consultants determined to be the most relevant value among possible valuation amounts ranging from EUR 32 million to EUR 38 million;
- the cost-plus and return-on-sales percentages used to determine compensation for manufacturing, R&D and distribution services, as applicable, were all determined to fall within a range of acceptable percentages based on benchmark studies prepared by another “Big Four” public accounting firm. However, the accounting firm discussed with Lightning that the range determined in the study prepared for the limited-risk distributorship, although viewed as acceptable, may be argued by the tax authorities to be too low, and the authorities may therefore view the return-on-sales percentage of 2% as too low; and
- BPrincipal made a one-time “goodwill” payment to Lightning to compensate Lightning for the transfer of its profitable business to BPrincipal upon restructuring.

Based on the information provided, what are key tax accounting considerations for the 2014 and 2015 year-end financial statements? These issues, for 2014 and 2015, are indicated below.

26. The recoverable amount of an asset or a cash-generating unit is the higher of (1) its fair market value less costs to sell or (2) its value in use (paragraph 6 of IAS 36).

2014

- (1) Is there any deferred tax accounting for the asset impairments and restructuring provision? Does Lightning intend to deduct the restructuring provision on its 2014 tax return? If so, is there any risk that the deduction may be disallowed by the tax authorities in 2014?
- (2) If Lightning is in a net deferred tax asset position at the end of 2014, are there any factors that might indicate that a reversal of all or part of the deferred tax assets is required?

2015

- (3) Has Lightning appropriately valued the manufacturing know-how and technology intangibles transferred to BPrincipal? Do these values represent an uncertain tax position?
- (4) What was the book and tax basis in the manufacturing know-how and technology intangibles prior to transfer? Must Lightning recognize any tax gain on the intercompany transfer in the consolidated financial statements? Is there an initial book-tax basis difference that requires deferred tax accounting for BPrincipal?
- (5) Are the cost-plus and return-on-sales percentages between BPrincipal and Lightning as well as CSub appropriate for the activities performed and risks borne by the two subsidiaries? Is the one-time “goodwill” payment from BPrincipal to Lightning adequate to compensate Lightning for the transfer of its profitable business?
- (6) Are there outside basis differences in BPrincipal’s investments in Lightning and CSub at the end of FY15? What is Lightning’s policy for remittance of foreign earnings?

Assume the following additional information:

- Lightning intends to deduct the full restructuring provision amount on its 2014 tax return. A deduction is allowed only if certain criteria are met. Lightning believes that there is some risk that some of the criteria may not have been met in time to allow a full deduction in 2014 from a timing perspective. In addition, Lightning believes that the tax authorities may disallow an amount of the restructuring costs on the basis that one entity should not bear restructuring costs incurred to restructure other entities within the group.
- The book and tax bases in the technology and manufacturing know-how intangibles, which were both internally developed, were zero as the associated costs were expensed and deducted as incurred. The sales price ultimately used for the technology was EUR 32 million – company management reviewed the valuation report and agreed that the EUR 36 million value indicated by the accounting firm was indeed a possible value that the tax authorities would assert. However, Lightning believed that it could reasonably support the use of a lower EUR 32 million value, and therefore priced the transaction accordingly for accounting and tax return purposes. For the manufacturing know-how intangible, Lightning in fact took a more conservative approach and valued the intangible at EUR 17 million. This position is considered to be a certain tax position by Lightning. Lightning’s policy is to litigate tax assessments or proposed settlements (or pursue mutual agreement procedures or arbitration where possible) for additional tax amounts in excess of EUR 1 million.
- Lightning sales were EUR 110 million for 2015, from the date of the reorganization.
- The Country A statutory corporate tax rate is 34%.

- The Country B statutory corporate tax rate is 16%.

Key considerations:

- (1) Yes. The impairment of the net book value of fixed assets to the lower fair market values resulted in a change to the deferred tax position in this case, from a deferred tax liability to a deferred tax asset. As Lightning decided to deduct the restructuring provision in the year of accrual, it may seem that there is no difference between the tax and accounting treatment, and therefore no further tax accounting considerations. However, Lightning analysed the criteria that must be met in order to allow for a deduction in 2014, and concluded that there may be grounds for the tax authorities to argue that such criteria were not in fact met until 2015. As a result, Lightning established a tax uncertainty liability of EUR 5,439,840 (EUR 16 million × 34%) to reflect the additional tax liability owed to the tax authorities for 2014 in the event that the deduction taken in 2014 is not allowed until 2012. As the EUR 16 million deduction would ultimately be allowed on the 2015 tax return, however, Lightning also established a deferred tax asset of EUR 5,439,840 to account for this future benefit should the tax uncertainty liability materialize. Once the 2014 tax return is filed, Lightning should also consider accruals for underpayment penalties and interest. After careful consideration, Lightning determined that the issue regarding full deductibility of the restructuring charges in Country A was a certain tax position, and therefore no tax uncertainty liability was recorded specifically related to this item.
- (2) Yes. Lightning was in a deferred tax asset position at the end of the year due primarily to the impacts of the asset impairment and restructuring provision. Lightning should assess the realizability of these deferred tax assets. Given that the restructuring is a tax planning “action”, Lightning may not consider any tax consequences of the restructuring to support realizability. If Lightning does not have sufficient future income to support realization of the deferred tax asset, a reversal of the deferred tax asset may be required.
- (3) Lightning valued the technology intangibles at EUR 32 million, which was below the weighted-average value indicated in the valuation report prepared by the Big Four accounting firm. Lightning believes this issue to be an uncertain tax position. While Lightning believes its overall methodology used to arrive at the EUR 32 million valuation is sustainable on a “probable” basis, Lightning also recognizes that some of the underlying assumptions used may be aggressive and therefore modified by the tax authorities to arrive at a higher valuation amount if audited. Lightning reviewed the following weighted-average valuation table included in the intangible technology valuation report, and also reviewed the factors and assumptions used to arrive at the different possible values of the intangible. Having agreed with the approach used by the accounting firm for each intangible valuation, the table included in the report was used as the basis of the tax uncertainty liability determination (all amounts in EUR):

Intan	Potei	Potei cost	Indiv	P w
32,00	2,040 M	0	25	0
34,50	1,190	850,0	10	8

* $(38,000,000 - 32,000,000) \times 34\%$

Intan	Potei	Potei cost	Indiv	P w
36,00	680,0	1,360	50	6
38,00	0	2,040	15	3
Total probability-weighted cost				1

$$* (38,000,000 - 32,000,000) \times 34\%$$

Based on this analysis, a tax uncertainty liability of EUR 1,071,000 should be established. In addition, given Lightning's policy to seek compensating adjustments for tax assessments in excess of EUR 1 million, Lightning intends to seek mutual agreement procedures with the Country A and Country B tax authorities, and believes that this process would result in allowed additional expenses in Country B of 80% of the undervalued amount, or EUR 4.8 million. As a result, a deferred tax asset of EUR 768,000 was also established at the Country B statutory tax rate of 16%.

- (4) Given that the book and tax bases for both the manufacturing know-how and technology intangibles are zero, the transfer of these intangibles to BPrincipal results in gains in the hands of Lightning. These gains will be deferred for pre-tax financial accounting purposes until the intangibles are transferred outside of the consolidated group. However, Lightning must pay tax on the gains in the year of transfer, and IAS 12 requires that the impact of such gains be reflected in income tax expense in the year of transfer (rather than deferred as under ASC 740/FAS 109). In addition, BPrincipal's tax basis in the transferred intangibles is the fair market value (i.e. the price paid to Lightning for the intangibles), and therefore, deferred taxes may need to be accounted for, given that the tax basis was stepped-up to fair market value but the book basis remained unchanged.
- (5) Based on a review of the benchmark studies prepared by the accounting firm and review of the assumptions and data points included in those studies, Lightning concluded that the cost-plus arrangements regarding the manufacturing and R&D activities were conservative, and therefore considered these tax positions to be certain. However, in light of the discussion with the accounting firm regarding the 2% return-on-sales percentage, Lightning analysed the potential expected percentage to be accepted by the tax authorities. This resulted in the following weighted-average probability analysis (all amounts in EUR):

Reti on sale (%)	Poter benef	Po cost	Indivi proba (%)	Proi wei cos
2	748,0 [**]	0	30	0
2.5	561,0	187	20	37,4
4	0	748	50	374

** $[(110,000,000 \times 4\%) - (110,000,000 \times 2\%)] \times 34\%$

Return on sale (%)	Potential benefit	Potential cost	Individual probability (%)	Probability-weighted cost
Total probability-weighted cost				411,

$$** \quad [(110,000,000 \times 4\%) - (110,000,000 \times 2\%)] \times 34\%$$

Based on the weighted-average probability analysis, a 4% return-on-sales percentage is the most likely percentage to be accepted by the tax authorities. For 2015, this means that Lightning was potentially undercompensated by EUR 2.2 million, or 2% of sales while under the intercompany contract. As a result, a tax uncertainty liability of EUR 411,400 was established to account for this potential assessment.

With regard to the one-time “goodwill” payment, Lightning determined that the payment received from BPrincipal was a certain tax position based on the multiple-of-earnings calculation used to value the Lightning manufacturing operations and determine the payment. As such, no tax uncertainty liability was recorded related to this issue.

- (6) Yes. Both Lightning and CSub are guaranteed a profit margin, albeit relatively small, for services performed. As a result, both entities will have earnings, which BPrincipal must decide whether or not it will repatriate or reinvest in the local operations. If the decision is made to reinvest and BPrincipal has full ability to do so (e.g. is able to fully control movement or non-movement of cash, does not need the cash to fund its own obligations/activities, etc.), no deferred tax liability would likely be required, as no Country B tax liability is expected associated with the unremitted earnings. Conversely, if the decision is made to repatriate the foreign subsidiaries’ earnings in the future, a deferred tax liability may be required to account for applicable “participation exemptions” and withholding tax on dividends for Country B tax purposes, provided that certain conditions are not met.

5. Conclusion

Income tax accounting in the context of business restructurings, and certainly in general, is an important and often complex area that deserves its fair share of attention. While cash may be king, especially in recent economic times, accounting for income taxes can have a significant impact on the financial statements and therefore influence the way in which a company is evaluated in the financial markets. And again, the devil is often in the detail! It is important to analyse every significant transaction and event of a business restructuring for income tax accounting consequences, and to understand the transactions and events in both substance and form. Communication internally within a company regarding income tax accounting impacts is also crucial, as management may be required to make representations as part of financial statement audits indicating management’s intentions regarding such issues as litigation and investment of unremitted foreign earnings. And as [IFRS](#) continues to grow as the premier global financial reporting framework, the need to understand the implications of the standard for accounting for income taxes (currently [IAS 12](#)) and related guidance will grow, as well.

