

Transfer Pricing and Business Restructurings

Streamlining all the way

Introduction

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1. Drivers of business restructuring

Regardless of products or sectors, international companies these days face the pressure of competition in a globalized economy. Multinational enterprises (MNEs) experience the necessity to examine the effectiveness of their business structures and adjust their business to the changing conditions on an almost continuous basis. Without constant improvement, an MNE would quickly become uncompetitive, stagnate and ultimately, die.

In general, there are often both external and internal factors which underlie the need for an MNE to change or restructure its business. Decreasing transportation costs and briefer 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. As economic cycles vary internationally, the presence on different global markets is crucial for the economic survival of a company. During the last decade, China, Russia and Turkey became highly attractive investment targets for most companies. The drivers in this context are rapidly increasing demand as well as favourable production conditions. Even the efforts undertaken by the Chinese government to decrease the administrative burdens and the protection of intellectual property increase the attractiveness of the location, especially for research and development (R&D) projects of international MNEs.

Likewise India, Southeast Asia and South Korea enhance their attractiveness by a continuing economic-political reform, an increasing educational level and the expansion of infrastructure.

A classic scenario for business restructuring is the reduction or elimination of a production capacity in one country and the shift to another country. Furthermore, an MNE could structure its business by “stripping out” functions (e.g. production, distribution), tangible and intangible assets and risks which were previously integrated in local operations, and transferring them to more centralized and specialized regional or global units.¹ Under a further scenario, functions could be stripped down or up. By stripping down functions, the functions of a so-called fully-fledged manufacturer could be reduced to a contract or limited risk manufacturer. As the limited risk or contract manufacturer by definition bears only limited risks, excluding amongst others product liability and warranty risk, the manufacturer will earn only a limited return. As the tax authorities in the latter scenario face a drop in profit of the company located in their jurisdiction, the awareness of the tax authorities with regard to business restructuring has increased in recent years.

Although tax considerations are not the drivers of business restructuring, changes in the operational structure often require corresponding changes in the tax and legal structure to align the business and tax models. Some examples of drivers for business restructuring are described in more detail below.

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

Business restructuring is the consequence of decisions related to operational and cost-related factors, e.g. labour costs and energy costs. Further factors are the proximity to the sales market, 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. Competition in the globalized economy forces MNEs to maximize synergies and increase efficiencies

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

associated. Typically, synergy effects could be achieved only among related parties (e.g. MNE, joint ventures, cooperation) which jointly could benefit from the different characteristics of synergy.

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3. Tension between commercial aims and tax environment

As described, taxes are not the predominant motivator for cross-border business restructurings. Nevertheless, the awareness of taxes and especially transfer prices increased significantly in the context of business structuring in past years. One reason is the differences in international tax systems. These differences could lead to discrepancies due to the fact that tax authorities are often interested only in increasing their own tax revenue without taking into consideration that tax authorities in other jurisdictions may not apply the same interpretation. The different and isolated treatment of the tax substrate could lead to double taxation, which could be resolved – if at all – only through a lengthy negotiation or arbitration process between the taxpayer and the tax authorities. Thus, corporate tax departments tend to be involved in business restructurings at a very early stage in order to prevent subsequent disputes with tax authorities.

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Another issue leading to discrepancies in treatment by the tax authorities is the allocation of restructuring costs.² 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 case where a company is converted to a mere low-risk entity that earns a low but stable profit.

² Andrea Musselli and Alberto Musselli, "Stripping the Functions of Producing Affiliates of a Multinational Group: Addressing Tax Implications via Economics of Contracts", 15 *International Transfer Pricing Journal* 1 (2008), at 16 –17.

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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.