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PRACTITIONERS' CORNER

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For most multinational businesses, to say that transfer pricing is their main tax concern is a truism. In an age of maturing globalization, it is perhaps also a truism to say the same of governments and their tax authorities. As the constraints on the movement of people, goods, services, and capital continue to fall away, tax authorities face not only a battle with taxpayers, but also competition with each other as multinationals restructure to locate and relocate profits in the constant effort to lower effective tax rates. It is not surprising to learn that tax authorities are sharpening their favored tools: the arm's-length principle and permanent establishments.

The Vicious Circle

The fiscs' focus on cross-border business restructuring is not new; tax authorities have become acutely aware that changes in the way a multinational does business can have a substantially adverse effect on their tax bases. The idea that a business restructuring could be done for genuine commercial reasons may be difficult to believe for the tax authorities; all the more so because multinationals engage armies of advisers and incur substantial fees to structure and implement the reorganization with tax efficiency very much in mind.

This is a vicious circle; as tax authorities become increasingly focused and determined, both in investigating perceived avoidance and penalizing it, restructurings that result in the achievement of any tax saving become more costly to defend and therefore less attrac-

tive. The more focused the authorities become, the more important it is for taxpayers to consider how they will defend the likely assertion that a restructuring's sole or main purpose is to avoid tax.

It is easy to be trapped in the tax authority mindset that presumes in the absence of any other evidence that all transactions have been undertaken for tax reasons. There have always been (and will doubtless continue to be) business restructurings from which no tax benefit necessarily accrues. One example is a restructuring that takes place wholly within a single tax jurisdiction; profit may move from one company to another within a group, but the overall tax liability of that group within that jurisdiction is essentially unchanged.

For a manufacturing or retail concern, a restructuring typically involves the concentration of production or distribution in a particular site to secure economies of scale. A corollary of this will normally be the removal of some functions (and therefore a degree of risk) from other sites.

On an international scale, a retail or distribution business may switch from having a series of full-fledged distributors in different countries or regions, and instead concentrate its operations in a single jurisdiction, with the local operations acting as limited risk distributors. This may be accompanied by centralizing the physical supply chain (for example, by centralizing the warehousing arrangements).

Also, manufacturing operations may (perfectly legitimately) seek to limit the risk of their manufacturing

function by turning it into a contract manufacturer, which receives a guaranteed market and price for its products. This technique is commonly used by groups to integrate a recently acquired manufacturing business into their existing distribution networks.

Any multinational group will hope to achieve increased profits following the reorganization. However, the profit split among the various jurisdictions is likely to be different from that in place previously, in recognition of the different functions being undertaken in each jurisdiction.

Just as it makes sense for groups to consolidate their tangible operations, it also makes sense for them to consolidate their intangible assets (which are often considerably more valuable) by the establishment of intellectual property (IP) holding companies or by the removal of IP (and thus risk) from the local jurisdictions. In the eyes of tax authorities, this can seem particularly aggressive, because IP is increasingly seen as a tool of avoidance in view of its inherent mobility and its great value. While developing rules to encourage IP to be located in their particular jurisdiction (such as allowing it to be depreciated, as is the case in the Netherlands and the United Kingdom), governments are also increasingly disposed toward antiavoidance legislation to combat the perceived use of IP as a pretext for profit shifting.

Example

Consider a multinational vertically integrated sales entity, which produces and sells goods in several different jurisdictions and restructures its operations to centralize distribution and risk.

While local entities may have bought stock at their own risk and sought their own sales contracts, they may be restructured to operate as limited risk distributors taking a mere flash title in the product and receiving a small but relatively stable profit for the relatively minimal activities.

A common alternative is to transform the local distributor into a commissionaire, or undisclosed agent of the principal, providing support services to the distribution company rather than goods to the ultimate customer.

Until recently, commentators recognized that there was generally a delicate but reasonable balance between the taxpayer and the tax authority. Provided there was an underlying commercial justification to the new arrangements, the tax advantages of those arrangements should be respected.

In January 2005, however, when the OECD Centre for Tax Policy and Administration convened a roundtable on business restructurings and other issues, a warning was sounded that tax authorities may no longer be prepared to countenance this position. The OECD's summary reported that restructuring activity

had become too widespread for tax authorities' liking and that profit would be clawed back to shore up dwindling tax bases.

Lines of Attack

A reorganization such as the one outlined above will normally result in a reduced measure of taxable profit in the local jurisdictions. The first type of challenge by tax authorities is likely to be a forensic investigation into the reality of a new group structure — what is being done, where, and for whom?

The approach of the U.K.'s HM Revenue & Customs has often been to look at local employees' activities when investigating reorganizations involving the transfer of functions out of the United Kingdom. If, despite the new contractual arrangements, it appears that the same individuals are carrying out similar functions in much the same manner as before, HMRC may argue that nothing has really changed and that the local entity should be taxed on a similar measure of profit to that it received previously.

To successfully resist any challenge, a move to a limited-risk local operation will need more substantive measures.

To successfully resist any challenge, a move to a limited-risk local operation will need more substantive measures; for example, stripping out of extraneous functions such as marketing, sales forecasting, and senior managerial functions, and centralizing those functions in the hands of the entity that is now bearing the relevant risk.

'Marketing Intangible' Argument

Newer lines of attack, however, go beyond the reach of this argument and can be used when the purported reorganization was effectively implemented and resulted in genuine changes to the risk/profit profile in the local jurisdiction. The approach seeks to tax value (in the form of goodwill) transferred from the reorganization by the local operator. This goodwill can be variously described as a "marketing intangible" or "loss of profit potential."

The argument is that on an arm's-length basis, an independent distributor would expect to receive compensation for his loss if his contract were to be terminated or amended in this fashion. This approach has not been successfully applied in the United Kingdom yet, but it is now explicitly recognized in German law and has been argued in France, the Netherlands, and

the United States. In other jurisdictions such as Belgium and Greece, a tax charge has not been levied in these circumstances but advisers warn that existing legislation could support the necessary interpretation to tax a restructuring in this way.

European Community law¹ provides for commercial agents to have some rights of compensation on termination of their agency arrangements, which are intended to compensate agents for goodwill they have developed during the course of their agency. Any tax authority in the Community could argue that, on restructuring the supply chain, the protections afforded to commercial agents would have applied, requiring the agent to be suitably compensated.

The compensation argument should not be accepted without question. Consider businesses such as fast food outlets and minimarts, which are not commercial agents but franchisee traders in their own names. In these businesses, there is typically a contract between the owner of the trading and marketing intangibles and a third-party franchisee, which takes a license to use the manufacturer's branding and other intellectual property.

Over time, the brand owner may decide that this structure no longer suits its needs. The brand owner wants to take ownership of the whole supply chain and determines that it can achieve significant cost savings by centralizing functions currently performed by individual franchisees. The franchise contracts have been concluded on an arm's-length basis, but it is unlikely that the franchisees have any rights other than to a few months' notice of termination. It is precisely the function of European Community law on commercial agency to displace the contractual relationship that would otherwise have existed under a pure arm's-length relationship.

Even if the brand owner did not wish to take control of the entire supply chain, who is to say that a franchisee would not accept the payment of a higher franchise fee in return for handing over of risks such as stock oversupply and obsolescence, just as it would expect a lower franchise fee if it were to take on more risk? In other words, the arm's-length standard should not be applied without regard to the realities of bargaining strength.

'Industrial Organization' Intangible

A separate but related tax authority argument is that the restructuring would involve the transfer of "industrial organization" intangibles, which are the savings accruing to the group as a whole from the reorganiza-

tion. This is a concept that has been developed largely by the OECD and has yet to gain wider acceptance or application among tax authorities, possibly because there is no "transfer" of any "intangible." It is also hard to distinguish any value that might be transferred from the local operator from the concept of the marketing intangible described above.

Existing definitions of intangible may hinder recognizing an industrial organization intangible.

Existing definitions of intangible may also hinder recognizing an industrial organization intangible. In the United States, it would be difficult or impossible to ascertain any value in that concept that is "independent of the services of any individual," and thus any transfer of value is unlikely to be recognized for tax purposes. However, in the United Kingdom, the tax authorities have sought to deny expenses connected with reorganization to the local entity if they take the view that benefits of the reorganization accrue to the group as a whole rather than to the entity in particular.

PE Arguments

Commissionaire structures bring up particular concerns in common-law jurisdictions, which do not recognize the civil-law concept of commissionaires, but instead treat them as undisclosed agents of the principal.

A typical restructuring will involve a centralized distribution company with commissionaires in each local jurisdiction through which sales are concluded. Most continental European legal systems will view the ultimate customer as having a contractual relationship with the commissionaire, but common-law jurisdictions will view the ultimate customer's contractual relationship as being with the central distributor. The risk is that the distributor will be regarded as trading in the common-law jurisdiction and that the commissionaire will be its PE. This approach has been used in the United Kingdom and South Korea.

The risk-stripping exercise may be potentially ineffective from a tax perspective if a PE results in broadly the same measure of profit being taxable in the common-law jurisdiction as was the case under a full-risk distributorship.

Possible Solutions

Companies find themselves subject to attack from both directions. They face the danger that a transfer of risk will be viewed as being done in form but not substance, and will be essentially ineffective. However, there is the danger that the transfer of risk has been

¹Council Directive 86/653/EEC of December 18, 1986, on the coordination of the laws of member states relating to self-employed commercial agents.

too effective and that the local entity deserves some form of compensation for the rights it has lost or given up. Even if both of these dangers are avoided, the risks of there being a PE and the potential attribution of profits to that PE remain.

At the heart of these sensitivities is the position of the group's intangible assets. Increasingly, tax authorities will argue for the existence of intangible assets to which value can be attributed, permitting the tax authority to impute a tax charge on the disposal of the intangible, or a royalty for its ongoing use. At the same time, tax authorities are reluctant to accept this principle when it is argued against them, and increasingly they tend to assume that restructurings of IP holdings are done primarily for tax avoidance purposes.

So how does a multinational defend itself from attack? As with any transfer pricing issue, the group should prepare a suitable functional analysis to show how the post-restructuring supply chain differs from that in place beforehand, buttressed with a suitable array of comparables. This may help repel any assertion that nothing in substance has changed.

It may be that the greater risk is of the tax authority asserting that the reorganization involves the transfer of some form of intangible. In this case, the group should consider what that intangible is and what it is worth. The best time to consider this is at the start of the planning process.

Any marketing intangible consists of many different assets — registered and unregistered trade names, the look and feel of a product, a product's branding, design rights, customer lists, and other forms of goodwill. Value normally derives from these being held together by a single entity and exploited in a uniform and consistent manner.

Any split in the development, exploitation, or ownership of assets between different entities is likely to erode the value of the whole, because it will prevent the individual elements being exploited to their optimum ability.

For this reason, intangibles need careful management: A subsidiary using a parent's registered trademark on an unlicensed basis may develop passing-off rights for that trademark, which will effectively prevent the parent from fully exploiting the mark. The subsidiary can still be restrained from exploiting its goodwill by reason of the existence of the registered mark.

This is an issue that receives little attention in some groups, even from those responsible for managing the group's IP. It merits attention simply as a matter of good corporate housekeeping, but also merits consideration from tax managers because of the opportunities for the creation and management of the value of intangibles on group reorganizations. A tax authority will be constrained from attaching value to a marketing intangible that has been transferred if the taxpayer can argue, with justification, that the intangible has little value.

Can this be characterized as aggressive? Superficially, perhaps, but it is no more than the corollary of the provisions many tax authorities have introduced to encourage IP to be held in their jurisdiction. If a group has recognized the value that attaches to IP — a value that can only accrue with careful management — it is important (and legitimate) for taxpayers to give careful thought to the tax consequences of a reorganization involving its intangibles. It also follows that a reorganization can have legitimate business objectives. As a result, a group can find legitimate planning opportunities in a transaction that might otherwise give rise to tax sensitivities and exposure, but only if it asks the right questions early enough. ♦