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Företagsomstruktureringar och internprissättning i Tyskland och Sverige

Begreppen potentiell framtida vinst och skadeersättning.

Filosofie magisteruppsats inom skatterätt

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Business Restructurings and Transfer Pricing in Germany and Sweden

The concepts of profit/loss potential and indemnification.

Master's thesis within Tax Law

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Sammanfattning

Företagsomstruktureringar inom multinationella koncerner är vanligt förekommande. Syftet med omstruktureringarna är ofta att göra företagen mer konkurrenskraftiga genom att bland annat effektivisera logistik, ledning och därigenom uppnå stordriftsfördelar. Vid gränsöverskridande omstruktureringar finns det en risk att potentiella vinstmöjligheter på risker, tillgångar och funktioner överförs, flyttas till lågskatteländer i syfte att minska koncernens effektiva skattebelastning. Tyskland har infört skattelagstiftning för att förhindra att sådana vinstmöjligheter flyttas ur landet. Dessa regler trädde i kraft den 1 januari 2008. OECD, som är det normgivande organet inom området för internationell beskattning, gav under september 2008 ut ett diskussionsunderlag på grund av den problematik som finns kring företagsomstruktureringar ur internprissättningssynpunkt. Diskussionsunderlaget utgör även en tolkning av tillämpningen av OECDs Transfer Pricing Guidelines.

I denna uppsats analyseras termerna framtida potentiell vinst och skadeersättning som de har presenterats i OECDs diskussionsunderlag. OECDs tolkning av termerna ställs sedan i relation till den tyska och svenska regleringen av samma termer.

I diskussionsunderlaget definieras en företagsomstrukturering som en sammansättning av tillgångar, risker och/eller funktioner som flyttas över landsgränser inom en koncern. Vid värderingen av denna sammansättning skall potentiell framtida vinst inkluderas om den kan identifieras tillhöra en av tillgångarna, riskerna eller funktionerna. Den svenska lagstiftningen innehåller en generell regel kring transaktioner mellan parter i intressegemenskap och träffar således inte enbart företagsomstruktureringar utan all internprissättning. Sverige har traditionellt sett följt OECD:s riktlinjer.

Den tyska lagstiftaren ser en omstrukturering som ett paket av tillgångar, risker och/eller funktioner som flyttas utanför landsgränserna inom en koncern. Att beskatta konceptet affärsmöjligheter, framtida vinst av paketets sammanlagda potentiella värden, skall tas med i värderingen av detta paket. I denna värdering skall synergieffekter för koncernen som en helhet samt besparingar på grund av lägre kostnader i det nya landet ingå. Här skiljer sig den tyska synen från OECD:s. OECD anser att endast lokala synergieffekter och kostnadsbesparingar skall ingå i värderingen. De flesta tecken tyder på att den svenska domstolen och skattemyndigheten kommer att fortsätta att följa OECD:s vägledning även vad gäller värdering av företagsomstruktureringar. Det tyska sättet

att värdera en företagsomstrukturering innebär en överhängande risk av övervärdering av paketet som överförs. Värderingsmetoden som används i Tyskland kan leda till beskattning av vinster som inte realiserats, eller någonsin skulle kunna ha realiserats i Tyskland vilket strider mot realisationsprincipen.

Vidare har OECD i diskussionsunderlaget redogjort för möjligheterna för eventuell skadeersättning för det överförande företaget. En företagsomstrukturering kan i vissa fall liknas med en situation där ett kontrakt mellan två parter bryts. I en sådan situation bör relaterade parter ha rätt till skadeersättning om oberoende parter hade krävt detsamma. Dock får ett sådant tillvägagångssätt praktiska problem då skadeersättningen är så nära kopplat till den civilrättsliga lagstiftningen i varje land. Frågan är situationsspecifik och därmed komplicerad att reglera generellt. Vidare uppstår problemet om vilken myndighet som skall vara kompetent att avgöra frågorna rörande sådan skadeersättning.

Master's Thesis in Tax Law

Title:	Business Restructurings and Transfer Pricing in Germany and Sweden – The concepts of profit/loss potential and indemnification
Author:	Björn Godring and Lisa Wåhlin
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Date:	2009-01-15
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Abstract

Business restructurings within multinational enterprises (MNEs) are regular occurrences. Such restructurings are often carried out in order to increase the MNE's competitiveness on the market by making the supply chain and management more efficient in order to acquire benefits due to economies of scale. There is a risk that such cross-border business restructurings will transfer the profit/loss potential that is associated with the assets, risks and/or functions that are transferred, to low-tax jurisdictions in order to minimize the MNEs tax burden. Germany amended its tax act in order to prevent such profit potential from being transferred out of the country. This amendment came into effect on the 1st of January 2008. The OECD, which is the normative body on the international tax arena, released a Discussion Draft for the public in September 2008 with the purpose to highlight the transfer pricing aspects of business restructurings and to serve as an interpretation of the application of the Transfer Pricing Guidelines on business restructurings.

In this thesis, the concepts of profit/loss potential and indemnification, as they are presented in the Discussion Draft, will be analyzed. The interpretation of the OECD will then be contrasted with the German and Swedish regulation of these concepts.

The OECD defines a business restructuring as a transfer including a bundle of assets, risks and/or functions which are transferred across borders within a MNE. If this transfer involves the shift of profit/loss potential it shall be included in the valuation of the transfer price of the transactions. The profit/loss potential shall only be included if it can be identified as belonging to a specific asset, risk or function of the bundle. In Swedish legislation there is only one rule which tax authorities can use in order to adjust the income of related parties. This regulation is not a specific rule for business restructurings as such but a general rule for all transfer pricing matters. Sweden has traditionally followed the OECD guidelines and the Swedish courts and tax authorities will most likely apply the guidance set out by the OECD on business restructurings as well.

Germany views a business restructuring as a transfer package which consist of assets, risks and/or functions which are transferred a cross borders within a MNE. The concept of business opportunities, i.e. the profit potential of the combined assets, risks and/or functions of the transfer package, shall be included in the valuation of the transfer package. In the valuation of the transfer package synergy effects for the MNE and location savings as a whole shall be included. This concept deviates from the view of the OECD. The OECD states that only local synergy effects and location savings shall be included in the valuation of the transfer package. The German approach leads to an inherent risk of overvaluation of the transfer package. The way of valuing the transfer package in Germany could lead to

taxation without realization, i.e. profits that would never have been or never could be realized in Germany will be taxed. This contradicts the principle of realization.

The OECD, in the Discussion Draft, gives an account for the possibilities for an indemnification for the transferor. A business restructuring can sometimes be compared with the breach of a contractual relationship. In such a situation, associated parties would be entitled to an indemnity if independent parties would be indemnified. Such an approach will be difficult to apply in practice since indemnification is closely linked to nations national commercial legislation. The matter of indemnifying a party shall be decided on the merits of each case, and it can thereby be complicated to formulate a general regulation. The question regarding which authority shall be competent to govern such a matter must thereby also be resolved.

Contents

List of Abbreviations

art.	article
AStG	Auβensteuergesetz
CFC	Controlled Foreign Corporation
Discussion Draft	Transfer Pricing Aspects of Business Restructurings: Discussion Draft for Public Comment 19 September to 19 February 2009
edn	edition
FVerlV	Funktionsverlagerungsverordnung
IAS	International Accounting Standards
Ibid.	Ibidem
IFRS	International Financial Reporting Standards
IL	Swedish Income Tax Act
Intl	International
J	Journal
L	Law
MNE	Multinational Enterprise
Mng	Management
No	Number
OECD	The Organization for Economic Cooperation and Development
OECD MC	OECD Model Tax Convention on Income and Capital
p.	page
para.	paragraph
Prop.	Swedish Preparatory Act
R&D	Research and Development
Rep	Report
RÅ	Supreme Court of Administrative Appeal
TPG	Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations
US	United States
Working Group	Joint Working group of delegates from Working Party No.1 and Working Party No.6 and Working Group 6 appointed by the OECD Committee on Fiscal Affairs in 2005

ÅRL	Årsredovisningslag

1 Introduction

1.1 Background

In a growing international market, where larger enterprises acting within one jurisdiction are becoming less common, transactions across borders within a MNE[1] have become an issue for tax auditors worldwide. For MNEs, the growing international market poses both difficulties and opportunities. By for example placing production and manufacturing units in nations with low labor costs the MNE can increase its revenue compared to keeping it at its present location. Business restructurings can be performed due to wholly commercial reasons such as maximizing synergies and economies of scale. However, it has been detected that business restructurings are also conducted for tax reasons in order to "locate and relocate profits in the constant effort to lower effective tax rates"[2]. Tax authorities are aware of the risk of tax base erosion due to business restructurings and are focused on preventing its eroding effects.[3]

Associated enterprises[4] (throughout this thesis the terms associated enterprises and related parties will carry the same meaning) have the opportunity to relocate their assets, functions and/or risks within the MNE in order to increase its competitiveness and gain advantages towards their competitors. Independent enterprises (enterprises that are not associated) do not have this opportunity. According to the separate entity approach on which the arm's length principle is based, each company within a MNE shall be treated as if it was an independent one.[5] By applying the arm's length standard which states that

"where 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"[6]

MNE's are to be hindered from transferring hidden profit between states and thereby eroding the tax base of a country. Another aim of the arm's length principle is to avoid double taxation[7]. The principle thereby has two aims and the proper application of it will secure the tax base of the nations and avoid double taxation of the MNE.

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[1] According to the TPG, p. G-6, a MNE is defined as: *A group of associated companies with business establishments in two or more countries.*

[2] Khvat James, Nias Peter & Ross James, 'Current Trends in Transfer Pricing and Business Reorganizations' (2008) [April 21] Tax Notes Intl p. 247.

[3] Ibid.

[4] According to Article 9, 1a) and 1b) of the OECD Model Tax Convention, two enterprises are associated if one of the enterprises participates directly or indirectly in the management, control, or capital of the other or if the same persons participate directly or indirectly in the management, control, or capital of both enterprises.

[5] TPG, Preface, para. 6.

[6] TPG, Glossary.

[7] According to the OECD MC p. 7. Double taxation can generally be defined as: *the imposition of comparable taxes in two (or more) States on the same taxpayer in respect of the same subject matter and for identical periods.*

The principle is included in art. 9 of the OECD MC on which tax treaties are commonly based. The aim of the OECD MC is to eliminate double taxation.[8] There are commentaries to the MC, which are used as guidelines to interpret and resolve matters of double taxation. The commentaries are an important tool for tax administrators, tax payers and national courts in order to interpret the articles set out in the OECD MC although not binding. However, the OECD recognized the need for further guidance within the field of transfer pricing and in 1995 the TPG were published. Since the publication of the TPG they have been used to a great extent and have served as a role model to many countries' legislations. Due to the increased awareness from tax auditors of the possibility to transfer profit between members of a MNE and the complexity within the area of business restructurings, a topic not explicitly covered in the TPG, the OECD assembled a working group[9] to investigate what needed to be done in the field of business restructurings through rules on transfer pricing. The working group published its Discussion Daft on the 19th of September 2008.

Seeing how business restructurings are of such complex nature and can involve a transfer of risks, functions and/or assets; or a combination of these elements. It poses difficulties both for taxpayers and tax administrators in many regards. One of the areas causing special difficulties in order to avoid double taxation is the valuation of profit/loss potential due to a business restructuring.

Profit/loss potential can be compensated by the party which in a restructure gains such potential to the party that surrenders it. However there is neither a uniform definition of what should be included in such potential nor over which time period such profit/loss potential shall be calculated to last. The profit/loss potential is also dependent upon the reasons for the business restructuring as well as what type of restructure it is, if intangibles are transferred and so forth. In the Discussion Draft the working group has tried to initiate an international consensus of what is to be included in the profit potential in order to be able to establish an arm's length compensation. The final determination of the compensation is dependent upon what independent parties would have agreed upon. The separate entity approach is difficult to apply to business restructurings due to the difficulty to find comparables as independent parties would not have the options available to them as members of a MNE have. Irrespective of the complexity of the subject of business restructurings some sort of consensus on profit/loss potential is to strive for, especially since nations are free to legislate as they find suitable on national tax measures. A country that did not await the work done by the OECD on business restructurings is Germany and their valuation of profit/loss potential deviates from that of the Discussion Draft. When determining whether the restructured entity shall be indemnified for its restructuring costs guidance can be found in commercial legislation of the nations involved. The indemnity that is decided to be attributed between the countries shall be included in the transfer price of the restructuring but can be compensated in various ways.

In this thesis the German and Swedish legislations are discussed since the countries take on different approaches of transfer pricing issues regarding business restructurings. Germany has recently amended its tax code and codified their transfer pricing legislation on business restructurings. Sweden on the other hand has no codified legislation on transfer pricing and

[8] OECD MC. p. 7.

[9] A result of the January 2005 CTPA Roundtable the joint WP1-WP6 Working Group on Business Restructurings.

business restructurings. However, this does not mean that practitioners within the two countries value profit/loss potential and indemnification differently.

1.2 Purpose

The purpose of this thesis is to analyze the transfer pricing aspects of profit/loss potential and indemnification in a business restructuring as it is set out in the Discussion Draft.

The thesis will give an account of the approach taken by the OECD. The Discussion Draft will then be viewed against the national legislation of two countries; Germany that has codified its transfer pricing regulations on business restructurings recently and Sweden which uses a rather (compared to Germany) simplistic method to govern transfer pricing issues.

1.3 Method

In order to serve our purpose the traditional legal method will be used throughout this thesis. It will be applied to analyze the current legal position in Germany and Sweden. The Discussion Draft is not a legally binding document and is open for public commentaries until February 2009. In this thesis it will be used to a great extent to determine the interpretation of the application of the TPG on business restructurings. The TPG are not binding but have been acknowledged both by German and Swedish courts to be used as guidance for taxpayers and tax administrations. As the Discussion Draft was recently published there is limited literature on the subject and information has mainly been found in academic articles.

In Germany there is legislation that is binding on courts, tax administrations and tax payers, explanatory decree laws that explain the terms set out in the legislation and administrative principles that are only binding for the tax administration. The legal position in Sweden will be determined by analyzing legislation, preparatory works and case law. Guidelines published by the Swedish tax authority that are not binding for taxpayers are also used since the legislation on transfer pricing is limited in Sweden.

Through the traditional legal method, relevant legal sources are analyzed in their hierarchical order. This is done in order to establish the current legal position to answer the purpose of the thesis. The authors deviate from the traditional legal method in chapter 2, where the Cytec case (a Norwegian case) is described. Since the authors were unable to find a translated version of the case, reference is made to an article where the case is recounted and analyzed in English. This case is included in order to illustrate a recent judgment by a court in a nation that adopts a similar legislation as Sweden on transfer pricing. In order to refer and cite other authors in a proper and consistent manner, the Oxford Standard for Citation of Legal Authorities (OSCOLA) has been used.

1.4 Delimitations

This thesis does not aim to go beyond the scope of its purpose which is limited to the concept of profit/loss potential and indemnification as set out in the OECD Discussion draft and its relation to German and Swedish interpretations of those terms. There will be no in depth description or analysis of intangibles in general or transfer pricing methods. The discussion draft consists of four issues notes and although all four are shortly described, the first, third and forth are not included in the discussion or analysis. Domestic anti-abuse rules such as CFC regulations and exit taxation are not included in the thesis in order to focus on the concepts of profit/loss potential and indemnification. Such anti-abuse rules are also excluded from the Discussion Draft. Due to the absence of case law and codified leg-

islation on the topic of transfer pricing and business restructurings in Sweden, the thesis is limited to the interpretation of the general statute on transfer pricing in Swedish legislation. Rules on documentation requirements are not included in the thesis.

The new German legislation includes many controversial aspects. Focus will be on the profit/loss potential that arises from the transfer of a transfer package and how a restructure should be indemnified. Other aspects of the German legislation will only be briefly described in order to give an appropriate picture of the regulation of transfer pricing in Germany.

1.5 Outline

This master thesis includes 7 chapters of which the first five are descriptive and the last two consists of a discussion, analysis and a conclusion. The aim of chapter 2 is to describe business and tax implications of a business restructuring.

In chapter 3 OECDs standpoint on business restructurings is discussed. The OECD MC and TPG will be described. The newly released Discussion Draft will be discussed in detail.

In chapter 4 and 5 the German and Swedish transfer pricing legislation in regard to business restructurings are described respectively. Chapter 6 is discussional in nature and the differences and similarities between the German and Swedish legislations with the view of the OECD will be presented. Within the scope of chapter six the problems with indemnifying a business restructuring will also be discussed. The analysis and conclusion of this thesis are in chapter 7. In this chapter the topics of profit/loss potential and indemnification are analyzed in order to reach a conclusion.

2 Business Restructurings and Tax Implications

The aim of this chapter is to shortly illustrate and describe the incentives (commercial and tax driven) for a MNE to restructure its organization and to provide guidance to the reader on the basic reasons for complex restructurings to take place. There is no unified definition of business restructurings which further highlights the difficulties of the subject. The OECD Discussion Draft for example excludes mergers and acquisitions from its scope of application. The difference between a business relocation and a business restructuring is that a business relocation includes transfers of fixed assets and personnel.

The business models of enterprises have developed since the early 90's and it is no longer the norm that entities within a MNE perform a single production phase of an integrated business.[10] MNEs are restructuring their business models due to aspects such as; competition, savings from economies of scale, need for specialization, increase efficiency and reductions of costs.[11] Restructurings can involve stripping out functions, intangible assets and risks that were previously integrated into local operations and transferring them to more specialized globalized units.[12] Even though such a restructure might not be motivated by tax purposes, tax administrations will see reduced profits in their jurisdictions.[13] According to the head of the tax treaty and transfer pricing division at the OECD Centre for Tax Policy and Administration, Mary C. Bennett, the restructurings that have evolved are situations such as the conversion of full-risk distributors into stripped-risk, or situations in which intellectual property or research and development activities are centralized.[14] These restructurings can cause a significant shift of profits from one country to another and lead to tax base erosion.[15]

The situation of business restructurings can be compared to a situation where the parties are in a contractual relationship with each other. Within a MNE, a fully fledged manufacturer produces, distributes and sells the manufactured product to associated parties as well as to independent parties. The ownership structure within the MNE provides a guarantee to a certain extent that the manufacturer will continue to supply the associated parties with the goods they produce.

An example of a business restructuring that is conducted to increase MNEs competitiveness, improve efficiency and so forth is when manufacturing operations have been restructured to contract manufacturers to limit the risk of MNE's manufacturing.[16] A contract

[10] Musselli Andrea & Musselli Alberto, 'Stripping the Function of Producing Affiliates of a Multinational Group, Addressing Tax Implications via Economics of Contracts' (2008) [January/February] Intl Transfer Pricing J, p. 15.

[11] Ibid.

[12] Ibid.

[13] Ibid.

[14] Elliot, Amy S, 'OECD Official Highlights Business Restructurings' (2008) [October 27] Tax Notes Intl, p. 286.

[15] Ibid.

[16] Khvat et al, 'Current Trends in Transfer Pricing and Business Reorganizations' (2008) [April 21] Tax Notes Intl p. 247.

manufacturer bears low risks, receives extensive instruction about what to produce, in what quantity, of what quality and is certain that its entire output will be purchased.[17]

Another example is where fully fledged distributors in different jurisdictions concentrate their operations in a single jurisdiction and the local operations are converted to limited risk distributors.[18] In such a restructure there is a shift of risks from the local enterprises to the centralized unit. Two important questions that arise in restructurings are whether the allocation of risks[19] has changed due to the business restructuring and whether intangibles are transferred[20] between the entities. If any of the above has been transferred, the chance that profits and/or profit potential are also relocated is apparent. A restructuring in this context involves the transfer of functions, assets and/or risks and these elements are often bundled together. It is therefore difficult to assess exactly which part of the 'package' that causes the reallocation of profits.

As different governments take on different views on regulating cross border business restructurings the risk of double taxation causes tax payers worry. The current trend on business restructurings has led to an increased global awareness on this issue from courts and legislators. Two main areas of concern are the valuation and definition of profit/loss potential and whether the restructured entity should be compensated for its restructuring costs.

Profit/loss potential includes not only profits but also losses and potential liabilities as well as expected return attached to the risk that is transferred.[21] In some jurisdictions the exit charge that is to be paid by the transferee depends on the transfer of an intangible, where this is the key value driver (US), in other jurisdictions the transfer of business opportunity is to determine the profit/loss potential (Germany).[22] Since the value of the profit potential is an amount that exceeds the value of the tangible and intangible property in the restructuring, it will be characterized as goodwill[23] for the recipient in the transaction. According to Swedish accounting standards, goodwill shall be depreciated during its economical life time.[24] However, most countries do not allow depreciation on goodwill, only a write-down if the value of the goodwill has been impaired. IAS states that an impairment test must be run once a year, in which goodwill is checked to see if it was impaired.[25] As there in many

[17] TPG, para. 7.40.

[18] Khvat et al, 'Current Trends in Transfer Pricing and Business Reorganizations' p. 247.

[19] TPG, para. 1.27.

[20] Musselli Andrea & Musselli Alberto, 'Stripping the Function of Producing Affiliates of a Multinational Group, Addressing Tax Implications via Economics of Contracts' p. 15.

[21] Discussion Draft, para. 63.

[22] Vollebregt, Hugo, Business Restructuring, PricewaterhouseCoopers, April (2008) Institutet för Utländsk Rätt, slide 28.

[23] According to IFRS 3, 32nd point, Jan 2008, goodwill is defined as *'an asset representing the future economic benefits arising from other assets acquired in business combinations that are not individually identified and separately recognized*.'

[24] ÅRL chapter 4 para. 4, 2nd sentence.

[25] IAS 36.

accounting standards is no depreciation on goodwill, this increased value of the transfer package will result in a situation of economic double taxation for the MNE.[26]

Whether or not the restructured party shall be indemnified for its restructuring costs can also be discussed. Contracts between unrelated parties can include an indemnification clause. Indemnity is the "compensation for a wrong done, or trouble, expense or loss incurred".[27]

Business restructurings are in focus on the international arena. The first case involving an exit charge due to a business restructuring in Norway was ruled by the court of Appeal of Eidsivating in 2007, the Cytec case[28]. In the Cytec case the Norwegian entity was restructured from a full-fledged manufacturer and seller of goods into a toll manufacturer[29].[30] The major issue before the court was to what extent there was a basis for a taxable exit payment upon conversion from a manufacturer to a toll manufacturer.[31] The court did to a large extent base its decision on an interpretation of the contracts the parties had entered into as well as the various agreements created in connection with the new structure.[32] The court further stated that a decrease in income is not enough to confirm that an intangible asset has been transferred. The asset must be identified before it can be established whether a transfer has taken place.[33] The conclusions of the case are that written documentation on intracompany dealings are important and that at arm's length parties would have required a compensation for the transfer of intangibles through a restructuring.

Regulating business restructurings through rules on transfer pricing is an area that will most likely continue to expand. Taxpayers will increase their efforts to try to decrease its effective tax rates whilst tax authorities will continue to increase its efforts in order to avoid tax base erosion.[34] OECD will continue its work to harmonize the international tax arena and its discussion draft and effects will be described in section 3.3.

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[26] Ihli, Uwe, 'Transfer Pricing, Restructuring, Apportionment and Other Challenges for Tax Directors' (2008) [Vol. 36 (Issue 8/9)] Kluwer L Intl p.356.

[27] Penner, J.E. (ed), *Mozely & Whiteley's Law Dictionary* (12th edn, Butterworth's, London 2001) p. 178.

[28] Decision of the Court of Appeal of Eidsivating (26 September 2007), Cytec Norge GP AS and Cytec Overseas Corporation Filial v. Utenlandsk Foretak, 2006-180819. Appealed to the decision of the Norwegian Supreme Court, the court dismissed the appeal Decision of the Norwegian Supreme Court (11 January 2008), Cytec Overseas Corporation Inc, Cytec Overseas Corporation NUF and Cytec Norge GP AS, HR-2008-50-U.

[29] According to Hugo Vollebregt, '*A toll manufacturer holds limited risk, no inventory, charges conversion fees and produces finished goods according to orders from the principal*'. From Seminar on Business Restructuring in Gothenburg, April (2008) Institutet för Utländsk Rätt, slide 11.

[30] Flood Hanne, 'Business Restructuring: The Question of the Transfer of Intangible Assets' (2008) [July/August] Intl Transfer Pricing J p. 175.

[31] Flood Hanne, 'Business Restructuring: The Question of the Transfer of Intangible Assets' p. 178.

[32] Ibid.

[33] Flood Hanne, 'Business Restructuring: The Question of the Transfer of Intangible Assets' p. 179.

[34] Khvat et al, 'Current Trends in Transfer Pricing and Business Reorganizations' p. 247.

3 OECD and Business Restructurings

The purpose of this chapter is to describe the guidance set out by the OECD on transfer pricing of business restructurings. The OECD's standpoint will be presented by giving an account of Article 9 of the OECD MC and the guidance given in the TPG. Finally the Discussion Draft will be described. The view of the OECD will then be used in chapters 6 and 7 to discuss and analyze the German and Swedish legislations accordance with the OECD.

3.1 Model Convention

Article 9 of the OECD MC deals with adjustments of income due to setting transfer prices that are at arm's length. According to article 9 of the OECD MC the transfer price between associated enterprises shall be set as had the transaction been undertaken between independent enterprises, the article states that;

> 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. (emphasis added)

Article 9 shall only be applied when conditions have been used between associated enterprises that differ from the conditions that independent parties would have agreed upon.[35] Article 9 does not have a self-executing effect and can only limit the application of domestic law.[36] Tax jurisdictions can thereby never extend their taxing rights by referring to article 9. The methods on how to reach an arm's length price can be found in the TPG.[37] A primary adjustment due to increased profits in the receiving state should only be made if the

[35] OECD MC, commentary on article 9, para. 1, 2nd point.

[36] 'Country analysis Germany', Section 2.1.2. IBFD Database accessed October 6th 2008. http://online2.ibfd.org.bibl.proxy.hj.se/tp/.

[37] OECD MC, commentary on article 9, para. 1.

transaction was not at arm's length when it was performed.[38] The method to adjust the profit is left to the parties to agree upon according to tax treaties or so forth.[39] Germany has raised an observation[40] to paragraph 2[41] of the article and has reserved[42] the right not to insert that paragraph in its bilateral tax treaties.

3.2 Transfer Pricing Guidelines

The purpose of the TPG is of dual character; to secure an appropriate tax base and to avoid double taxation.[43] Through the proper application of the arm's length principle the tax base is to be secured and double taxation avoided.

Transfer prices are defined as "the prices at which an enterprise transfers physical goods and intangible property or provides services to associated enterprises"[44]. This definition does not cover cross border business restructurings and foremost profit/loss potential arising from such a restructure explicitly, which is why the application of the TPG on business restructurings has been questioned. This uncertainty with the application of the TPG on business restructurings was removed by the working group in the Discussion Draft where they asserted that the TPG are to be applied to business restructurings.[45] Seeing how the guidelines are to contribute in reaching an arm's length price to a transaction, the TPG require a functional analysis[46] of the enterprises to be conducted. The allocation of functions, risks and assets determines to some extent the transfer price of the transaction and are included in the functional analysis. [47] As a business restructuring per definition involves a transfer of at least one of these elements i.e. transfer of the framework within which the transaction is to be set at arm's length, the TPG's applicability to business restructurings has been questioned.[48]

3.2.1 TPG and Profit/Loss Potential

Profit/loss potential as a result of a business restructuring is (as mentioned in section 3.2) not included in the TPG. There is guidance on how to value transfers of intangibles and adopting business strategies[49] that do not have an established value at the time of the trans-

[38] OECD MC, commentary on art. 9, para. 2, 6th point.

[39] OECD MC, commentary on art. 9, para. 2, 7th point.

[40] According to OECD MC, para. 30. 'Observations have been inserted to enable countries that do not concur the interpretation given in the commentaries. Observations do not mean that the country disagrees with the text of the convention'.

[41] Germany does not agree with the use of the term 'arm's length profits'.

[42] According to OECD MC, para. 31. 'A reservation is aimed at the text of the convention'.

[43] TPG, preface, para. 7.

[44] TPG, preface, para. 11.

[45] Discussion Draft, p. 2.

[46] TPG, para. 1.20.

[47] TPG, para. 1.17.

[48] Ihli, Uwe, 'Transfer Pricing, Restructuring, Apportionment and Other Challenges for Tax Directors' p.348.

[49] TPG, para. 1.35.

fer. These cases are somewhat similar to the transfer of a bundle of assets as is the case in a business restructuring. However, since a business restructuring in many cases involve both transfers of intangibles and adopting new business strategies they require more complex assessments in order to determine an accurate arm's length price than is given in the TPG.

Another difficulty is the fundamental application of the arm's length principle on business restructurings seeing how the arm's length principle is based on the separate entity approach[50] and a business restructuring is based on commercial decisions that could not have been undertaken had the entities been separate. The ability to find comparables is especially limited seeing how every MNE is organized and set up differently. It is stated in the TPG that profits can and shall be adjusted by reference to the conditions which would have been obtained between independent enterprises in comparable transactions and comparable circumstances. Such an approach is in accordance with the separate entity approach.[51]

3.2.2 Recognition of Transaction Undertaken

According to the TPG, tax authorities shall consider the actual transaction undertaken between the parties. The actual transaction shall not be disregarded or substituted if it has been made for wholly commercial reasons.[52] This is where the separate entity approach meets one of its challenges. Associated enterprises are more likely and able to conclude arrangements among each other than separate entities. Not only are associated enterprises more likely to enter into agreements, they are also more likely to alter and terminate contracts in a short period of time.[53] In these cases not only should the value of the transaction be at arm's length but also the contract in itself. In its documentation the tax payer shall be able to show that a contract like the one they have concluded would be signed between independent parties. If not, the contract is not at arm's length and has to be adjusted accordingly. In these cases when the contract might not be of arm's length the guidelines advise the tax authorities to try and not to restructure the transaction[54] but instead try to find a comparable uncontrolled transaction and compare the allocation of risks and so forth. By comparing it to a similar transaction the tax authorities can more easily investigate the actual economic substance of the transaction. An example of a case where the court investigated the economic substance of the transaction is the Cytec case which has been shortly described in chapter 2.

3.2.3 Arm's Length Range

In order to reach an accurate arm's length price each transaction between the parties should be identified and set at an appropriate price. This raises a problem in the pricing of business restructurings. Business restructurings are of complex nature and seldom include easily separable functions, risks and/or assets being transferred. The transferred functions are often linked together and involve changes for the MNE as a whole. Taxpayers are al-

[50] See TPG, preface, para. 6. According to the separate entity approach, enterprises within a MNE are to be viewed as separate entities, with no connections between each other, acting at arm's length.

[51] TPG, para. 1.6.

[52] TPG, para. 1.36.

[53] TPG, para. 1.39.

[54] TPG, para. 1.41.

lowed to use any method[55] required in order to reach a price that complies with the arm's length principle. Regardless if taxpayers value the controlled transaction as a package or separate transactions they have to be able to show that whatever mean of valuation they have used have led them to an appropriate arm's length price.[56]

The use of an arm's length range is acknowledged in the TPG; however, its use is not overly appraised. Just because a range of arm's length prices has been established there might still be important factors that separate them from each other. They may not have had an equal degree of comparability.[57] If the arm's length price of the controlled transaction is within the arm's length range no adjustment shall be made. If the arm's length price of that transaction falls outside that range an adjustment shall be made (if the taxpayer cannot show otherwise) to the point within that "range that best reflects the facts and circumstances of the particular controlled transaction"[58].

3.3 Discussion Draft

Business restructurings that are within the scope of the Discussion Draft are defined as *"*…the cross border redeployment by a multinational enterprise of functions, assets and/or risks"[59]. This transfer may or may not include intangibles. For the purpose of the draft, business restructurings within its scope "…primarily consist of internal reallocation of functions, assets and risks within an MNE"[60].

There is a need for further guidance on the issue of business restructurings since such restructurings are typically accompanied by a reallocation of profits among the members of an MNE group, either immediately after the restructuring or over a few years.[61] One of the main objectives with the Discussion Draft is to see to what extent such a reallocation of profits is consistent with the arm's length principle and more generally how the arm's length principle can be applied to business restructurings.[62]

The Discussion Draft consists of four issues notes; (1) special considerations for risks, (2) arm's length compensation for the restructuring itself, (3) remuneration of post-restructuring controlled transactions and (4) recognition of the actual transactions undertaken. All four notes will be briefly described and issues note two will be more thoroughly examined. It needs to be stressed that the discussion draft is in no sense binding and can be amended to a great extent after the comments from the public[63] are received. However, the Discussion Draft does highlight the importance of the subject of business restructurings;

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[55] OECD recommends traditional transaction methods; the comparable uncontrolled price method, the resale price method and the cost plus method to be used in first hand, followed by transactional profit methods; profit split method and the transactional net margin method.

[56] TPG, para. 1.44.

[57] TPG, para. 1.45.

[58] TPG, para. 1.48.

[59] Discussion Draft, section A.1 para. 2.

[60] Discussion Draft, section A.1 para. 2.

[61] Discussion Draft, section A.2 para. 7.

[62] Ibid.

[63] Comments from the public are welcome until the 19th of February 2009.

recognizes that improvements need to be made and gives a clear view on the working groups view on the matter.

3.3.1 Issues note 1) Allocation of Risks

The first issues note discusses the allocation of risks in a business restructuring[64], the application of article 9 of the OECD MC and paragraphs 1.26 to 1.29 of the TPG. According to these paragraphs the economic substance of the transaction is more important than the contractual allocation of risks between the parties.[65] In order to determine the economic substance of the transaction one should consider;

- Whether the related parties conform to the contractual allocation of risks
- Whether the contractual terms provide for an arm's length allocation of risks
- Whether the risk is economically significant,
- What the transfer pricing consequences of the risk allocation are.[66]

The proper allocation of risks between the related parties is of fundamental importance in business restructurings. The party that bears the risk shall be compensated for the increased risk it carries as a result of the restructuring.[67]

3.3.2 Issues note 2) Arm's Length Compensation for the Restructuring Itself.

It is stated in Article 9 of the OECD MC that *"*where conditions are made or imposed*"*[68] which "differ from those that would be made or imposed 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"*[69]*. A restructure may involve transfers of functions, assets and/or risks with associated profit potential.[70] To be able to understand the restructuring one should identify the transactions that actually have been undertaken, understand the role of synergies and analyze other options realistically available at arm's length.[71] This note will be further analyzed and discussed after issues notes three and four have been presented.

3.3.3 Issues note 3) Remuneration of Post-Restructuring Controlled Transactions

Within issues note 3 the applicable transfer pricing method on post-restructuring transactions is discussed. According to the working group there shall be no difference in regards

[64] Functions are not mentioned in this context.

[65] Discussion Draft, para. 20.

[66] Ibid.

[67] TPG, para. 1.23.

[68] OECD MC, art. 9, 1st point.

[69] OECD MC, art. 9, 2nd point, note that Germany has raised an observation and has reserved the right not to include this in its tax treaties.

[70] Discussion Draft, para. 46.

[71] Discussion Draft, para. 48.

to post-restructuring transactions than the criteria that are set up in the TPG (i.e. arm's length principle and selection of transfer pricing methods). In regards to this thesis the more important elements being discussed in issues note 3 are;

- Relationship between compensation for the restructuring and post-restructuring remuneration,
- Comparison of profits earned before and after restructuring,
- Location savings.

In regards to the relationship between compensation for the restructuring and post-restructuring remuneration the working group concludes that in practice it might be difficult to structure and monitor post-restructuring transactions in regards to the actual restructuring.[72] Taxpayers are free to choose method of compensation payment. They should however be able, on request by the tax administration, to give an account for how/if the compensation for the post-restructuring activity was possibly affected by taking account of the foregone compensation, if any, for the restructuring itself.[73]

When comparing profits earned before and after the restructuring the working group is of the opinion that such a comparison will be helpful when shedding light on the options that would have been realistically available to the restructured entity at arm's length.[74] Such a comparison is also helpful when assessing the actual allocation of risks between the parties in a business restructuring.[75]

As regards to location savings the working group states that such savings can be attained by a MNE group that relocated some of its activities to a place where costs (such as labor costs, real estate costs, etc.) are lower than in the location where the activities were initially performed, account being taken of the possible costs involved in the relocation.[76] The working group further states that where location savings are put forward as one of the main reasons for the restructuring, paragraph 1.31 of the TPG is of relevance and the application of the separate entity approach.

3.3.4 Issues note 4) Recognition of the Actual Transactions Undertaken

The fourth note deals with the circumstances where a tax administration might refuse to acknowledge a transaction having the structure presented by the taxpayer. The working group states that from an article 9 standpoint it is decisive to identify the transactions actually undertaken and profits might be adjusted where the conditions of a controlled transaction differ from the conditions that would be agreed upon between independent unrelated parties.[77] The working group also states that as long as functions, assets and/or risks are actually transferred, it can be commercially rational from an article 9 perspective for a MNE group to restructure in order to obtain tax savings.[78]

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[72] Discussion Draft, para. 180.

[73] Ibid.

[74] Discussion Draft, para. 184.

[75] Discussion Draft, para. 182.

[76] Discussion Draft, para. 188.

[77] Discussion Draft, para. 197-198.

[78] Discussion Draft, para. 212.

3.3.5 Arm's Length Compensation for the Restructuring Itself

The matter of arm's length compensation for the restructuring itself as discussed in issues notes 2 will be given closer attention below. The note states that in order to determine whether the restructuring has carried a profit/loss potential that is to be remunerated, the transactions of the restructuring has to be identified, the role of synergies examined as well as other options available at arm's length. If through this examination it can be determined that a profit/loss potential was reallocated through the restructuring, it shall be valued and the function, risk and/or asset that carried that potential need to be identified. Each of these considerations will be dealt with in the following sections.

3.3.5.1 Identification of Transactions

In order to identify the transactions that have taken place the taxpayer should perform a functional analysis before and after the restructuring. Special consideration should be taken to how the allocation of rights and obligations has changed. This should be analyzed in the long and short term to highlight the reallocation of them.[79] The underlying economic principles[80] of the restructuring should be taken into account in the analysis.

3.3.5.2 Role of Synergies

According to the working group business reasons for restructuring the MNE's current structure are, among others, to get centralized control, increase their competitiveness on the market, acquire savings from economies of scale and lower costs.[81] Acquiring synergy effects is one of the major reasons for MNEs to undergo a business restructure. If the taxpayer motivates their restructure with anticipated synergy gains, these should be documented for non tax purposes.[82] For transfer pricing purposes the analysis shall include the effect the restructuring might have on each taxpayer and other options realistically available to the taxpayer.

Although restructurings of MNEs might be motivated by synergy gains, these gains might not necessarily be to increase profits. The synergy gains can be in the form of maintained competiveness and/or the avoidance of making losses.[83] The working group also acknowledges that expected gains do not always materialize and there should be no use of hindsight from the tax administration.[84]

If anticipated synergy effects are one of the main reasons for the restructure and, there is a significant discrepancy between the actual and the anticipated results from the restructuring, these discrepancies need to be analyzed. The functional analysis shall include which in-

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[79] Discussion Draft, para. 51.

[80] According to para. 51 of the Discussion Draft the analysis shall 'reflect the economic principles that generally govern relationships between independent enterprises' and refers to para.s 1.28-1.29 TPG. In these para.s one of these economic principles are explained as 'In dealings between independent enterprises, the divergence of interests between the parties ensures that they will ordinarily seek to hold each other to the terms of the contract, and that contractual terms will be ignored or modified after the fact generally only if it is in the interest of both parties.'

[81] Discussion Draft, para. 53.

[82] Ibid.

[83] Discussion Draft, para. 54.

[84] Discussion Draft, para. 55.

dependent party, would have borne the consequences of the non-realization and in what way.[85]

Even though a business restructuring might be motivated by business reasons for the MNE as a whole the separate entity approach is not to be neglected. This means that even though the restructuring might lead to positive synergy effects for the MNE as a whole the local synergies might be negative for the parties actually involved in the transfer. It is therefore stressed that a restructure has to be at arm's length between the parties concerned. The fact that the MNE as a whole acquires synergy gains does not make the transfer arm's length.[86]

3.3.5.3 Options Available at Arm's Length

When it comes to examining options available for independent parties it shall be analyzed whether entities at arm's length would have had the option to accept other conditions than those presented to them, including the option not to involve in the restructuring.[87] It is assumed that independent parties would not be involved in a transaction that would not benefit them. If any of these options are more attractive this should be taken into consideration and affect the arm's length price of the transaction. The working group states that a business restructuring can be motivated by sound commercial reasons at MNE level. However it does not mean that the arm's length principle is respected between the actual transferor and transferee.[88]

3.3.5.4 Reallocation of Profit/Loss Potential as a Result of a Business Restructuring

The working group established that the profit/loss potential is not in itself an asset and does not require compensation under the arm's length principle[89]. However a reallocation of profit/loss potential that follows from a reallocation of risks, rights and/or other assets shall be remunerated.[90] Shortly, if there are rights or other assets transferred that carry profit/loss potential they should be identified and remunerated at arm's length.

3.3.5.5 Valuation

In order to determine the arm's length remuneration for the carried profit/loss potential the following should be taken into consideration;

- Whether compensation for the transfer of potential losses and liabilities would be agreed upon between independent parties (e.g. would it be preferable for the transferor to pay the transferee to take over the activity rather than to stop performing it and incur the associated windup costs?

[85] Discussion Draft, para. 56.

[86] Discussion Draft, para., 57.

[87] Discussion Draft, para., 59.

[88] Discussion Draft, para. 61.

[89] Discussion Draft, para. 64.

[90] Ibid.

- Whether compensation for the associated transfer of profit/loss potential would be agreed between independent parties at arm's length.

- Consequences attached to the subsequent exercise of activities by the transferor and the transferee in accordance with their new risk profiles.[91]

If it is determined that the change in allocation of the profit/loss potential shall be remunerated, the compensation shall be at arm's length for both parties. When deciding on an appropriate arm's length compensation one should consider options available to both parties at the time of the restructuring. Reference shall also be made to paragraph 1.23 in the TPG, according to which "the assumption of increased risk will also be compensated by an increase in the expected return". The compensation shall further be appropriate to remunerate the transferor's surrender of profit potential when the transferor has transferred or surrendered rights or other assets that carry profit potential.[92]

When it comes to valuing the compensation, reference shall be made to historical results of e.g. a distribution activity of the transferor. However, relying on historical data is not always sufficient for a determination of the size of the compensation.[93]

3.3.5.6 Transfer of Something of Value in a Business Restructuring

Since the working group established that profit/loss potential does not require compensation under the arm's length principle but the right or asset that carries that potential does, the transfer of those rights or assets will be further described. These assets consist of tangibles, intangibles and ongoing concerns[94].

In cases of a transfer of intangibles, difficulties arise as to identify and value them. As noted above, identifying and valuing the assets transferred in a business restructuring are important elements in order to understand the nature of the business restructuring itself. Efforts shall therefore be made in order to identify and value the transferred intangible/s. It is also emphasized that MNEs may have sound business reasons to centralize ownership and management of intangible property.[95] The arm's length principle still applies at separate level and group level benefits do not make the transaction arm's length.[96]

When determining the arm's length remuneration for the transfer of an intangible as a result of a business restructuring, attention should be taken to the capacity of the transferee to maintain and further develop the asset transferred (risk allocation and control) and whether the transaction was followed by a new arrangement (the entire commercial arrangement should then be examined).[97]

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[91] Discussion Draft, para. 65.

[92] Discussion Draft, para. 66.

[93] Discussion Draft, para. 70.

[94] According to the para. 93 of the Discussion Draft a transfer of an ongoing concern equal the transfer of an activity. Such an activity includes the transfer of a total bundle of assets.

[95] Discussion Draft, para. 81.

[96] Ibid.

[97] Discussion Draft, para. 85.

If an intangible is transferred at a point when it had no established value, no adjustments shall be made by the tax authorities as long as the tax payer can prove that they were in good faith on the basis of the information that was available to them at the time of the transfer.[98] If the price was not set in good faith the tax authorities can adjust the price on the basis that such an adjustment or renegotiation had been done at arm's length. However, no hindsight shall be used by the tax authorities.[99]

Contractual rights may also be considered as intangibles, if they are valuable and transferred (or surrendered) between related parties and this transaction shall be remunerated under the arm's length principle.[100] The contract is the asset that carries the profit potential which is transferred from one member of the MNE to another.

The transfer of an ongoing concern involves the transfer of a "bundle of assets"[101]. In such a transfer between independent parties goodwill[102] is taken into account and the working group recommends the use of valuation methods used in acquisition deals between independent parties.[103] The working group also recommends transfers of ongoing concerns to be compared to such transfers rather than the transfer of isolated assets.[104]

When a loss-making activity is transferred to a related foreign party the transfer should be compensated if independent parties would have done so. Note that the restructured entity might be saved from future losses through the transfer and that the MNE might benefit from it.[105] However, the separate entity approach still applies and the transfer is to be remunerated at arm's length between the transferring parties. The working group raised the question whether the benefiting party should indemnify the party that suffers from the transfer.[106] This question of indemnification is discussed below.

3.3.5.7 Indemnification

The working group uses the term indemnification for the purpose of the Discussion Draft to mean "any type of compensation that may be paid for detriments suffered by the restructured entity."[107] The indemnification can be in various forms such as an up-front payment, sharing in restructuring costs, lower or higher sale/purchase price for the post-restructuring operations or of any other form.[108] In contract law indemnity refers to, as mentioned in chapter 2, "compensation for a wrong done, or trouble, expense or loss in-

[98] Discussion Draft, para. 88.

[99] Ibid.

[100] Discussion Draft, para. 91.

[101] According to the Discussion Draft, para. 93 'Bundle of assets possibly including contractual rights, workforce in place, goodwill, etc.'

[102] See note IFRS 3 Goodwill.

[103] Discussion Draft, para. 93.

[104] Discussion Draft, para. 94.

[105] Discussion Draft, para. 95.

[106] Discussion Draft, para. 96.

[107] Discussion Draft, para. 100.

[108] Ibid.

curred".[109]It should also be noted that the indemnity is a separate element and is not to be included in the compensation for the transfer of functions, assets and/or risks in a business restructuring. A business restructuring is defined in the discussion draft as "the cross border redeployment of functions, assets and/or risks between associated enterprises, with consequent effects on the profit/loss potential in each country"[110] and that indemnification is not to be understood as part of the loss potential as the costs that are to be indemnified are actual costs for the restructuring and not loss potential.

According to the working group the restructured entity should be compensated for its restructuring costs[111], reconversion costs[112] and loss of profit potential, if independent parties had paid an indemnification to the restructured entity at arm's length. That is, there should be no presumption that all contract terminations or substantial renegotiations should give right to an arm's lengths indemnification.[113] Whether the costs incurred due to the restructuring should be indemnified or not should be decided by considering these four factors;

1. Contract is formalized in writing and provides for an indemnification clause?
2. If the existence or non-existence of such a clause is at arm's length?
3. Is indemnification rights provided for by commercial legislation or case law?
4. Whether at arm's length another party would have been willing to indemnify the one that suffers from the termination or renegotiation of the agreement?[114]

According to the first factor it shall be analysed whether the contractual terms were respected or not. This is in line with the TPG which states that unrelated parties "will seek to hold each other to the terms of the contract and that these terms and conditions would only be ignored or modified between such unrelated parties if it is of the interest of *both* parties."[115] (emphasis added) As noted in paragraph two it is not required under the arm's length principle to include such a clause in contracts. Nevertheless it should be analysed whether the existence or non-existence of such a clause is realistically available to parties at arm's length. In this analysis the allocation of risks stipulated or followed from the contract shall be taken into account. In the determination of whether such an indemnification clause should be included or not in the contract, guidance can be found in the commercial legislation in the country of the transferor.

According to the working group one should see to "information on indemnification rights and terms and conditions that could be expected in case of termination of specific types of agreements, e.g. of a distributorship agreement."[116] In this respect focus should be on

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[109] Penner, J.E. (ed), *Mozely & Whiteley's Law Dictionary* p. 178.

[110] Discussion Draft, p. 2.

[111] According to the Discussion Draft para. 99. Such costs could include 'write-off of assets, termination of employment contracts'.

[112] According to the Discussion Draft para. 99. Such costs could include costs 'in order to adapt its existing operation to other customer needs'.

[113] Discussion Draft, para. 101.

[114] Discussion Draft, para. 102.

[115] TPG, para. 1.29.

[116] Discussion Draft, para. 115.

whether the transferor has the right to claim before the courts an indemnification regardless if such a clause is inserted in the contract or not. It is worth noting that the working group raises a warning since even though the contract might include an indemnification clause the likelihood of members of the same MNE to litigate is slim and the clause might therefore not include the same conditions as an indemnification clause between unrelated parties. The last of the four factors that shall be taken into account is whether the transferee would be willing to indemnify the transferor at arm's length. No single answer can be derived from this question. The facts and circumstances of each individual case have to be examined and whether an unrelated party would be willing to pay for such a termination indemnification.[117]

3.4 Chapter Summary

The inherent problem that arises with the application of the separate entity approach on business restructurings between associated enterprises is apparent due to the community of interest within MNEs. This is reflected upon at numerous times in the discussion draft. However, since the separate entity approach is one of the fundamentals' the arm's length principle rests upon, it is obvious that it is the view of the OECD that business restructurings shall be subject to the arm's length test. Whereby, the discussion draft has been released to shed light on the application of the TPG on such transactions.

In order to reach an arm's length price on business restructurings the true allocation of risks between the parties needs to be determined. Further, it is of utmost importance to understand the underlying reasons (both economical and business related) for the restructuring. The profit/loss potential of the restructuring is not a taxable event itself under the arm's length principle but the asset that carries such a potential is. In the valuation of that transfer, the profit/loss potential shall be included. When determining the value of the indemnification of the transferee to the transferor for the transferor's restructuring costs guidance can be found in national commercial legislation and case law on termination of contracts. The indemnification is per definition not included in the business restructuring but the compensation for it shall also adjust the income of the parties. The compensation can have any form; one example is that the parties share the restructuring costs.

[117] Discussion Draft, para. 118.

4 Germany and Business Restructurings

The aim of this chapter is to give an account for the amendments of the AStG regarding transfer pricing regulations on business restructurings. Special attention will be given to four aspects namely; the standard of a prudent and diligent business manager, the application of the arm's length principle, definition of a transfer of functions and the valuation of business opportunities i.e. profit/loss potential. The German approach on these matters will then be compared and contrasted with the guidance set forth by the OECD and the Swedish way of regulating these terms.

4.1 Amendments to the Foreign Tax Act

The amendments to the AStG came into effect the 1st of January 2008. The legislation has been adopted as part of a package to finance the reduction of the German corporate tax from 25 percent to 15 percent.[118] Motives for the tax cut were among others to make Germany more attractive to both foreign and domestic investors as well as safeguarding that profits realized in Germany stays in Germany.[119] According to the Head of the International Tax for Germany's Federal Ministry of Finance, Manfred Naumann, another aspect of the new legislation was to discourage MNEs from transferring intangibles outside of Germany, due to the difficulties in valuing these intangibles.[120] Seeing how Germany is Europe's largest market[121] it was not unexpected that measures were to be taken by the German government to make the country more attractive for both national and international investors. However, the amendments to the AStG involve some unexpected and far reaching rules.[122]

According to the AStG, section 1, paragraph 1, 1st sentence, a taxpayer's income from business dealings with foreign countries with an associated enterprise shall be based on what would have been agreed upon between unrelated parties under the same or similar circumstances, i.e. the arm's length principle. Should the income not have been agreed upon under such circumstances, then the taxpayer's income shall be determined as if it would have accrued under conditions made between unrelated parties.[123] This provision is the only one in German tax law that explicitly refers to the arm's length principle. It complies with the arm's length principle according to the definition in article 9 of the OECD MC. This was previously only a general rule in relation to the arm's length principle and has only been slightly modified.

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[118] Beck, Karin E.M, 'Business Restructuring in Germany' (2008) [July 21st] Tax Notes Intl p. 271.

[119] Damji Salim, Wollf Ulrike, 'German Business Tax Reform 2008 Transfer Pricing Aspects' (2007) [nr 9] Der Schweizer Treuhänder p.684 and 687.

[120] Bell, Kevin. A, 'Business restructuring, Germany's Price Adjustment Provision "In line with Arm's Length Standard," Official Says' (2008) [Vol. 16, nr 24] BNA Tax Mng p. 928.

[121] Wehnert Oliver, Wolff Cornelia, 'German Transfer Pricing Regulations: Tax Authorities Further Tighten the Belt' (2007) [Nov nr 18] J of Intl Taxation p. 24.

[122] Troping, Mitchell J., 'German Legislature Approves Bill Introducing "Commensurate With Income," Other Changes' (2007) [Vol. 16 No. 7] Tax Mng Transfer Pricing Rep p.22.1 Quoting Alexander Loh and Christian Looks of KPMG in Frankfurt.

[123] AStG, Sec 1, para. 1, 1st sentence.

The most significant change in the legislation is the codification of which method to use when determining the transfer price. A hierarchy of methods has been established which states the order in which to apply transfer pricing methods. According to the new rules, the availability and quality of comparable data is crucial for the acceptance of which transfer pricing method a German taxpayer selects in transactions with associated enterprises.[124] Regulations on the choice of an applicable transfer pricing method were previously stated in the Administrative Principles[125]. These principles are however not binding for taxpayers, only for the tax authorities. Much of what was only stated in the Administrative Principles has now been codified in the AStG. The new legislation is far more detailed and expansive in determining the taxable amount resulting from a business restructuring.

The Federal Ministry of Finance has distributed a decree law FVerlV [126] which contains definitions and explanations to terms in the tax law. A decree law has legal binding effect for tax authorities and taxpayers.

4.1.1 Hierarchy of Methods

Section 1, paragraph 3 AStG establishes a hierarchy between the standard transfer pricing methods. The taxpayer must primarily determine the arm's length price according to comparable prices using the standard transfer pricing methods, comparable uncontrolled price method, resale price method or the cost-plus method.[127] If fully comparable arm's length prices can be determined by applying either of these methods, these prices will then form a range of potential arm's length prices.[128] Within this range the taxpayer has to determine the price which complies with the arm's length principle with the utmost probability.[129] If the price determined by the taxpayer is outside the range, the midpoint value of the range shall be applied, i.e. adjusted to the median.

According to the OECD any price within the arm's length range can satisfy the arm's length principle.[130] However, the comparable transactions within the range must be of high quality and the range shall be narrowed by deducing the least comparable transactions.[131] The facts and circumstances of each individual case must be taken into consideration but there should, according to the OECD be no presumption that an adjustment to the median satisfies the arm's length principle. An adjustment to the median can thereby put the taxpayer in a less beneficial situation than the TPG requires.[132] Prior to this new legislation

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[124] Wehnert Oliver, Wolff Cornelia, 'German Transfer Pricing Regulations: Tax Authorities Further Tighten the Belt' p. 24.

[125] Germany's Transfer Pricing Administrative Principles, IV B 4 - S 1341 - 1/05**,** released by the Ministry of Finance 4th of December 2005.

[126] FVerlV Decree-Law on the Application of the Arm's Length Principle according to sec. 1 para. 1 AStG in the case of cross border relocations of functions. Based on sec. 1 para. 3, sentence 13 AStG, which has been inserted by Art. 9, No. 2 of the law of 14 August 2007 (BGB1. I, at 1912).

[127] AStG, Section 1, para. 3, sentence 1.

[128] Ibid.

[129] AStG, Section 1, para. 3, sentence 7.

[130] TPG art. 1.48.

[131] TPG art. 1.47.

[132] TPG, articles 1.45 to 1.48.

there had been no legislative guidance determining exactly how the tax authorities could adjust a taxpayer's transfer prices. Rulings from the German Supreme Tax Court had established that an adjustment may be made only to the most favorable point for the taxpayer in a price range.[133] It was only where the taxpayer did not comply with its documentation obligations that it had been possible to select a less favorable price point.[134]

It is clearly stated in the provision that the median of the price range shall be used as a basis.[135] The burden of proof is thereby shifted to the taxpayer. The taxpayer has to provide the tax authority with sufficient evidence that the price which is applied to the transaction is in fact the price which complies with the arm's length principle with the utmost probability. In addition, in cases where valuable intangibles are transferred and discrepancies in their valuation are discovered the German tax authority can make a onetime adjustment during a ten year period after the transfer.[136] This use of hindsight introduced by the German legislator clearly deviates from the recommendations of the OECD.[137]

In case a fully comparable arm's length value cannot be determined using the standard methods, then it shall be determined according to limited comparable values after making adjustments using other, appropriate, transfer pricing methods.[138] Data is considered fully comparable when business conditions are identical, or where differences in the business conditions either do not materially affect the pricing, or can be eliminated by sufficient accurate adjustments.[139] With limited comparable data, the taxpayer has to explain the differences of the comparable company, the adjustment calculations that have been made due to these differences and document why limited comparability is assumed.[140]

By stating that an "other appropriate transfer pricing method" shall be used, the German legislator implies that all transfer pricing methods are available for the taxpayer, as long as the method results in a price that is at arm's length.

If only limited comparable data are available, the range in which the taxpayer can determine an arm's length price has to be narrowed.[141] To narrow the range, the inter-quartile range can be used. This measure of variability is the difference between the third quartile, and the first quartile, i.e. the range for the middle 50 per cent of the data.[142] The top and bottom 25

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[133] Eigelshoven, Axel & Stember, Kathrin, 'New Transfer Pricing Rules' (2008) [March/April] Intl Transfer Pricing J, p. 64.

[134] Ibid.

[135] AStG, Section 1, para. 3, sentence 7.

[136] Ihli, Uwe, 'Transfer Pricing, Restructuring, Apportionment and Other Challenges for Tax Directors' p. 349.

[137] See TPG, para. 1.51 and Discussion Draft, para. 88.

[138] AStG, Section 1, para. 3, sentence 2.

[139] Wehnert Oliver, Wolff Cornelia, 'German Transfer Pricing Regulations: Tax Authorities Further Tighten the Belt' p. 26.

[140] Ibid.

[141] AStG, Section 1, para. 3, sentence 3.

[142] Anderson, David, R., Sweeney, Dennis, J. & Williams, Thomas, A., *Essentials of statistics for business and economics* (2nd edn, South-Western College Publishing, London, 2000) p. 80.

percent of the full range are unaccounted for, thereby closing the possible range of the arm's length price towards the median value. Should the price, which the tax payer has used, according to one of the standard transfer pricing methods be outside of the range or the narrowed range of the arm's length price it shall be adjusted to the median value.[143]

Finally, if no comparisons can be found, the taxpayer is required to perform a hypothetical arm's length test.[144] The test is based on the theoretical calculation of the lowest price (minimum) at which a supplier would be willing to sell and the highest price (maximum) a buyer would be willing to pay.[145] This will then form a range in where a potential agreement between two prudent and diligent business managers might be found. Within this range, the price which complies with the arm's length principle with the utmost probability shall be used.[146] If no other price is substantiated, or if the price is outside the range, the price shall be adjusted to the median.[147] The hypothetical arm's length test is not included in the TPG. As it is to be applied where no comparable data is available the taxpayer may be faced with high legal uncertainty and it might lead to unreasonable results, if the transfer price is to be determined by a purely theoretical approach.[148]

4.1.2 The Standard of the Prudent and Diligent Business Manager

It is stated in the AStG that in order to reach an arm's length price the taxpayer shall act on the principle of a prudent and diligent business manager. The standard of the prudent and diligent business manager has been developed by the Federal Tax Courts[149] in Germany and has now been introduced into German law. The standard has evolved from a one-sided approach. It was then a question whether a prudent and diligent business manager would have agreed to the terms and conditions of the transaction. Today it is a theory of double prudent business manager where there are two business managers facing each other in a transaction.[150] The theory has been developed in order to determine whether an agreement between related parties complies with the arm's-length principle.[151] The theory is based on the notion that all essential facts and circumstances are known to each party, the prudent business managers, of the transaction and that they will undertake the most beneficial alternative for their separate entity within the MNE.

The German Federal Tax Court has stated that the arm's length principle in general matches the prudent and diligent business manager standard.[152] This has been widely criti-

143 AStG, Section 1, para. 3, sentence 4.

144AStG, Section 1, para. 3, sentence 5.

145 AStG, Section 1, para. 3, sentence 6.

146 AStG, Section 1, para. 3, sentence 7.

147 AStG, Section 1, para. 3, sentence 4.

148 Kroppen, Heinz-Klaus, Rasch, Stephan & Eigelshoven, Axel, 'Analysis, Germany's Draft Law on Business Restructurings' (2008) [Vol. 15, No. 22] Tax Mng Transfer Pricing Rep p. 844.

149 Kroppen, Heinz-Klaus & Eigelshoven , Axel, 'Country analysis Germany', Section 2.1.2. IBFD Database accessed October 6th 2008. http://online2.ibfd.org.bibl.proxy.hj.se/tp/.

150 Ibid.

151 Wehnert Oliver, Wolff Cornelia, 'German Transfer Pricing Regulations: Tax Authorities Further Tighten the Belt' p. 24.

152 I R 103/00, published in the Federal Tax Gazette 2004, vol. II p. 171.

cized.[153] Beck claims that the German assumption of total knowledge by the parties in a business transaction is incorrect. She claims that third parties in general do not know all material facts and circumstances regarding a contract since every party conceals its own grounds of calculation regarding costs, purchase price and possible profit.[154] Eigelshoven & Stember are of the opinion that the legal assumption of market participants having full information when setting transfer prices could well lead to prices that are different to market prices.[155] Their claim is that market participants act under incomplete information and agrees on a certain price and that this price, per definition, is an arm's length price.[156] Kroppen, Rasch & Eigelshoven claim that tax authorities will in many cases argue that this standard is somewhat different to the arm's length principle; otherwise the introduction of such a standard would make no sense.[157] They continue stating that since this principle is not in line with the TPG, an area of dispute between tax authorities will arise.[158]

4.1.3 Transfer of Functions

Transfer of functions as part of business restructuring is the main focus of change to the AStG. In order to distinguish what constitutes a transfer of functions, the German legislator has defined the terms regarding such a transaction in the 1st chapter of the FVerlV. A function is defined as a business activity that consists of an aggregation of similar operational tasks which are carried out by certain positions or departments of an enterprise.[159] In the draft executive regulation the term function has a very broad definition.[160] This regulation states that the following are functions: management, research and development, sourcing of material, stock keeping, production, wrapping, distribution, assembling, treatment and cultivation of products, quality control, financing, transportation, organization, administration, marketing and client service.[161] The definition is quite similar to the exemplification of functions that taxpayers and tax administrations have to identify and compare in the TPG.[162]

The relocation of functions[163] is defined in Sec. 1 Para. 3 Sentence 9 AStG as "the transfer of functions including the corresponding chances and risks and the transferred or disposed

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153 See, Beck, Karin E.M, 'Business Restructuring in Germany' p. 272, and Eigelshoven, Axel & Stember, Kathrin, 'New Transfer Pricing Rules' p. 64-65.

154 Beck, Karin E.M, 'Business Restructuring in Germany' p. 272.

155 Eigelshoven, Axel & Stember, Kathrin, 'New Transfer Pricing Rules' p. 64-65.

156 Ibid.

157 Kroppen et al, 'Analysis Germany's, Draft Law on Business Restructurings' p. 844.

158 Ibid.

159 FVerlV, Chapter 1, Sec. 1, Para 1.

160 Beck, Karin E.M, 'Business Restructuring in Germany' p. 273, referring to the Draft of executive regulation, Jan. 19 (2007) 1.1.1, p. 4.

161 Ibid.

162 TPG, art. 1.21.

163 Schnorberger, Stephan, 'Arm's Length Principle, Exit Tax and Commensurate with Income Standard: Some Practical Thoughts on the New German Transfer Pricing Rules' (2008) [Vol. 36, Issue 1] Intertax p. 26. Relocation or transfer of functions is synonymous with business restructuring, using OECD terminology.

assets and other benefits". A relocation of functions shall be deemed to have taken place if a function performed by one entity is transferred to another related entity, even if the transfer is partial or temporary.[164]

4.2 Business Restructuring

Under the German provisions the mere loss of profit potential will give rise to a taxable profit from a shift of functions as part of a business restructuring.[165] A shift of functions and associated risks, opportunities and assets must be compensated under the arm's length principle. In order to assert a profit there is no apparent need in the German legislation to specifically identify an asset or property that was transferred out of Germany as a part of the business restructuring.[166]

The relocation of functions and assets, including the opportunities and risks, shall be understood as a transfer package. The taxpayer has to determine the value shift through the valuation of a transfer package.[167] This means that not only each individual asset transferred in connection with the transfer of functions but also the underlying benefits resulting from the transfer itself, such as business opportunities, synergy effects and location savings shall be considered in the valuation of the transfer package.[168]

A business opportunity is considered a concrete opportunity of a future economic advantage that can be already assessed.[169] Synergy effects within a MNE can be explained as savings from economies of scale, increased competitiveness, improvements in the efficiency of the supply chain, centralized control and lower costs. When referring to location savings, mainly reduced costs obtained by transferring the functions to the new country, such as lower taxes, labor costs and real estate costs are understood to be included in the term. When transferring a transfer package, these underlying benefits or losses are collectively known as profit/loss potential. Transfers of complete functions, where substantial intangibles[170] and advantages are included, should be valued as a transfer package unless the taxpayer can credibly show otherwise.[171] The sum of the individual asset prices shall be accepted as being at arm's length if the taxpayer can credibly show that no such intangibles and advantages has been transferred or that the sum of prices for the individual assets, risks and functions is within the price range.[172] It is assumed that the sum of individual asset prices is below the aggregate value of the transfer package since profit/loss potential is in-

164 Eigelshoven, Axel & Stember, Kathrin, 'New Transfer Pricing Rules' p.66.

165 Beck, Karin E.M, 'Business Restructuring in Germany' p. 274.

166 Ibid.

167 AStG, Sec. 1, para. 3, sentence 9.

168 FVerlV, Chapter 2, Sec. 3, para. 1-2.

169 Beck, Karin E.M, 'Business Restructuring in Germany' p. 275.

170 Substantial intangibles are defined, in Chapter 1, Section 1 Paragraph 5 of the FVerlV, as when their arm's length price amounts to more than 25 percent of the individual price of all assets and advantages in the transfer package.

171 AStG, Sec. 1, para. 3, sentence 10.

172 AStG, Sec. 1, para. 3, sentence 10.

cluded in the transfer package.[173] However, the transfer price for all single assets has to be accepted, if the overall result of the individual price determination complies with the arm's length principle.[174]

4.2.1 Valuation of the Transfer Package

When a taxpayer transfers assets, risks and/or functions to an associated enterprise as part of a business restructuring it is most likely very difficult to find fully comparable or even limited comparable data in order to determine an appropriate transfer pricing method, since every business restructuring is quite unique. Thus it is most likely that the hypothetical arm's length test will be applicable in accordance with sec. 1, para. 3, sentence 5 of the AStG.

When performing a hypothetical arm's length test the taxpayer has to determine the range of the potential agreement based on a relocation of the function, risk and/or assets as a whole, as a transfer package. In order to determine the range of the potential agreement, a value has to be assigned to the transfer package. The valuation of the transfer package shall be made by taking both the receiving and the transferring party into account, thereby providing a range. This approach is in principle in line with the TPG for applying the arm's length principle with regard to intangible property.[175] Paragraph 6.14 of the TPG states that both the perspective of the transferor and the transferee must be taken into account for the purpose of comparability. This approach will however have implications for the taxpayer. It means that the taxpayer must perform at least four business valuations to determine the price range within which the transfer price shall be determined. This includes profit/loss potential.[176] The valuation will also have to take into consideration the minimum price of the buyer and the maximum price of the seller, applying the prudent and diligent business manager standard. The value of the transfer package shall be based on the discounted value of the expected net earnings of the package after tax.[177]

When determining an appropriate discount factor, the discount factor for a risk-free investment shall be used as a starting point. The discounted rate shall be adjusted by a premium in order to correspond to the functions and risks assumed by the parties involved in the transfer of functions.[178] This will then provide a price range within which the taxpayer has to determine the price which has the utmost probability of complying with the arm's length principle.[179] In case a price within the range cannot be determined, or the taxpayer is not able show which price has the utmost probability, the median value shall be chosen as the ascertained transfer price.[180] Kroppen and Eigelshoven[181] claim that there are two prob-

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[173] Schnorberger, Stephan, 'Arm's Length Principle, Exit Tax and Commensurate with Income Standard: Some Practical Thoughts on the New German Transfer Pricing Rules' p. 26.

[174] AStG, Sec. 1, para. 3, sentence 10.

[175] TPG, para. 6.14.

[176] Beck, Karin E.M, 'Business Restructuring in Germany' p. 274.

[177] Ibid.

[178] Eigelshoven, Axel & Stember, Kathrin, 'New Transfer Pricing Rules' p. 66.

[179] Kroppen, Heinz-Klaus & Eigelshoven , Axel, 'Country analysis Germany', Section 2.4. IBFD Database accessed Nov 4th 2008. http://online2.ibfd.org.bibl.proxy.hj.se/tp/.

[180] Ibid.

lems with this approach. Firstly, they state that it is unclear whether third parties would in fact agree on compensation. Such an agreement seems only possible, they claim, if the taxpayer giving up its function loses property rights which are linked to the stream of revenue, namely that intangibles are transferred.[182] Secondly, the approach increases the risk of double taxation as the tax authorities in Germany will only allow one price, the one that is most likely, if no reliable third party evidence is available.[183] Ihli, however, states that valuations based on the net present value are most likely closer to the economic reality of business valuations than the individual valuation.[184] He compares it to the valuation approach in the Merger Directive[185], stating that a combined valuation is more appropriate than a single valuation to reflect market valuation.[186]

A taxpayer is only allowed to value individual assets and services, provided that he can *show credibly* that no substantial intangibles and business opportunities were exchanged or transferred for use with the function, and that the individual asset valuation in comparison to the valuation of the transfer package is at arm's length. [187] Substantial intangibles are defined as assets whose value exceeds 25 per cent of the total value of the transfer package.[188] If the taxpayer can credibly show that the assets transferred should be valued individually, there will be no exit charge on the transfer of functions.[189] This will put a heavy burden of proof on the taxpayer in order for him to show that there are no underlying benefits in connection to the transfer in question. This provision may lead to disputes between tax authorities and taxpayers on whether substantial intangibles were included in the transaction. Such a situation could lead to double taxation for the taxpayer until the matter has been settled.

4.2.2 Business Opportunities

When valuing the transfer package, the taxpayer has to determine the value of the transferred earnings potential. The German provisions focus on the mere loss of profit potential as potentially giving rise to a taxable profit (business opportunity) from a shift of functions, assets and/or risk as a part of a business restructuring.[190] According to the German tax au-

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[181] Ibid.

[182] Ibid.

[183] Ibid.

[184] Ihli, Uwe, 'Transfer Pricing, Restructuring, Apportionment and Other Challenges for Tax Directors' p. 349.

[185] Council Directive 90/434/EEC of 23 July 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States, Official Journal L 225, 20/08/1990 P. 0001 – 0005.

[186] Ihli, Uwe, 'Transfer Pricing, Restructuring, Apportionment and Other Challenges for Tax Directors' p. 349.

[187] AStG, Sec. 1, para. 3, sentence 10.

[188] FVerlV Chapter 1, Sec. 1, para 5.

[189] Schnorberger, Stephan, 'Arm's Length Principle, Exit Tax and Commensurate with Income Standard: Some Practical Thoughts on the New German Transfer Pricing Rules' p. 26.

[190] Beck, Karin E.M, 'Business Restructuring in Germany' p. 274.

thority, a business opportunity falls under this category of taxable profit when a transfer package is transferred.[191]

According to the German regulations a compensation payment has to be made where business functions, assets and/or risks are transferred to an associated party.[192] This compensation is determined by valuing the transfer package. The arm's length value for the transfer of a transfer package is more or less calculated as a whole on the net present values of the profits of the two related parties before and after the transfer of the package.[193] Each individual asset transferred in connection with the transfer of functions will be subject to taxation in Germany. However, the profit/loss potential resulting from the transfer itself, even if gained by the foreign associated party, will also be subject to taxation in Germany.

4.2.3 Indemnification

Regarding indemnification, the German legislator states that the behavior of third parties is decisive. If third parties would contractually regulate claims on indemnification or not should be the basis for the assessment whether related parties should include such claims.[194] The inclusion or exclusion of such claims can be accounted as the basis for taxation of a relocation of functions. However, the burden of proof rests on the taxpayer to make credible that whatever mean of regulating the question on indemnification they have chosen is what third parties would agree upon.[195] The taxpayer must also make certain that no substantial intangible assets or advantages are transferred or provided for use.[196] In a transfer of a transfer package to Germany from a foreign member of the same MNE the German transferee shall indemnify the transferor if such indemnification is required according to the national law of the country of the transferor.[197]

4.3 Chapter Summary

With the amendments to the AStG, the German legislator has established a hierarchy between the standard transfer pricing methods as well as regulations on how business restructuring between associated enterprises should be compensated. Functions, assets and/or risks transferred across borders to another company within a MNE shall be regarded as a transfer package. The value of such a transfer package shall not only entail the individual assets but the profit/loss potential that these combined assets, functions and/or risks carry. The profit/loss potential of the transfer package does not only include the earnings these assets and functions will produce in a future perspective. It also includes the synergy gains, location savings and more that the receiving company might obtain due to the restructuring itself. It can be questioned whether the German approach, with such an expansive view on profit/loss potential is in line with the OECD.

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[191] FVerlV, Sec. 1, para. 4.

[192] AStG, Sec.1, para 3.

[193] Ihli, Uwe, 'Transfer Pricing, Restructuring, Apportionment and Other Challenges for Tax Directors' p. 349.

[194] FVerlV para. 8.

[195] Ibid.

[196] Ibid.

[197] Statement by Dr. Karin Beck, Max-Planck-Institute for Intellectual Property, Competition and Tax Law (Personal email correspondence 12 December 2008).

5 Sweden and Business Restructurings

In this chapter the approach taken by the Swedish legislator on business restructurings and its transfer pricing aspects will be described. Focus will be on the interpretation and application of the concepts of profit/loss potential and indemnification. This is the last chapter where theoretical facts are presented, the following chapters will compare and contrast the facts that have been presented in this and previous chapters.

5.1 Transfer Pricing in Sweden

Transfer pricing is regulated in chapter 14 paragraph 19 in IL. The paragraph states that if the result of a business is reduced because of terms that differ from those that independent enterprises would have agreed upon, the result of that company shall be increased to account for the income that it should otherwise have attributed. In order for an adjustment to be conducted by the Swedish Tax Authority, three criteria are set forward in the above mentioned paragraph:

- The party to whom the income is transferred is not liable to taxation in Sweden on that income;
- They (Swedish Tax Authority) have reason to believe that a community of economic interests exists between the contracting parties;
- It is clear from the circumstances that the contractual conditions have not been agreed upon for reasons other than economic community interest.[198]

There is economic community interest between the parties when a company direct or indirect participates in the management or supervision of another company or if that other company owns part of the other company's share capital.[199] Two additional criteria for adjustments to be conducted by the Swedish Tax Authority have been developed in Swedish case law, namely:

- Facts from one year is not enough to determine whether the arm's length principle has been upheld or not, rather data from a span of years should be used;
- An adjustment can only be made if there has been a significant deviation from the arm's length principle.[200]

The Swedish Tax Authority bears the burden of proof for an adjustment to be made.[201] Documentation requirements were introduced in Swedish legislation in 2007 and the Swedish enforcement activity on Transfer Pricing issues has been described as aggressive.[202] As previously mentioned most of Sweden's tax treaties are based on the OECD MC. Swedish case law has acknowledged that the OECD TPG are not binding on the Swedish Tax Au-

198 IL 14:19.

199 IL 14:20.

200 RÅ 1991 ref 107, The 'Shell case'.

201 Prop. 2005/06:169, p. 102.

202 Tax & Legal Services Transfer Pricing, PricewaterhouseCoopers, *The EU transfer pricing landscape – a review of the regulatory environment, Global Transfer Pricing Perspectives*, (Europe 2007) p. 7.

thority but that relevant aspects of OECD's reports can be used as guidance when applying the Swedish Transfer Pricing rule.[203]

As the Swedish legislation on transfer pricing is not nearly as codified as the German legislation, guidance needs to be sought in fundamental tax principles on which the Swedish tax legislation rests. Two principles that are of such fundamental importance are the principle of realization and the principle of legality.

The principle of realization states that only profits that have been realized are to be taxed for in the same year of assessment.[204] A profit is said to be realized when the asset that carries such a profit has been sold.[205] This principle is applied in order to increase taxpayers' certainty, both in regards to the value of the asset as well as the time of its actual realization.[206] The principle of legality states that taxpayers can never be charged a tax that is not explicitly regulated in law.[207]

5.2 Business Restructurings

When it comes to business restructurings there are neither codified rules in the Swedish legislation nor case law on the matter. However, paragraph 19 in chapter 14 of the Swedish Income Tax Act applies to all types of cross-border related transactions.[208] This rule shall thereby be used on international business restructurings. Seeing how the rule is of general nature tax payers might have problems with foresight and guidance on how business restructurings shall be handled. In the non-binding guidelines on transfer pricing from the Swedish tax authorities, business restructurings and how they are to be valued are not included nor how they should be valued.

5.2.1 Valuation of the Transfer Package

When it comes to the valuation of a transfer package the Swedish tax authorities refer to the TPG and the transfer of a bundle of assets, functions and/or risks shall be valued individually but does not reject a bundled valuation if the taxpayer can show that the value of the package is of arm's length.[209] The starting point for any transfer pricing audit by the Swedish tax authority is however, that all transactions shall be viewed independently but in practice the aggregation of transactions shall not be a problem as long as the package can

[203] RÅ 1991 ref 107.

[204] See for example: IAS 39 and Årsredovisningslagen (1995:1554) Chapter 2, Section 4, 3rd Point.

[205] IL Chapter 41, Section 2.

[206] Lodin, Sven-Olof, Lindencrona, Gustaf, Melz, Peter & Silfverberg, Christer, *Inkomstskatt – en läro- och handbok i skatterätt*. (10th edn Studentlitteratur 2005) p. 30.

[207] Prop. 1993/94:151, p.70.

[208] Branch Reporters: Lars-Eric Ericson and Magnus Grive 'Transfer Pricing and intangibles' (2007) [Volume 92a] International Fiscal Association Kyoto Congress, Cashiers de droit fiscal internation, Off-print, section 1.1.

[209] Handledning för internationell beskattning 2008, SKV 352 12th edn (2008) p. 257.

be verified to be set at arm's length.[210] The Swedish tax authorities refer to the TPG in this aspect.

5.2.2 Profit/Loss Potential

Sweden is a country with relatively high costs in regards to manufacturing and production. The likelihood of a foreign entity restructuring its production or manufacturing to Sweden in order to achieve location savings is therefore remote. However, Swedish MNEs are not unlikely to streamline and centralize their management and production to acquire such savings. This was the case in the late 90's when a number of Swedish MNE's decided to move their production and labor intensive departments to other countries. The Swedish tax authorities aim to prevent this tax base erosion and the likelihood of a Swedish MNE having to prove before the tax authorities that such savings are at arm's length shall be noted.[211]

Location savings, synergy effects and so forth are to be included in the goodwill that arises from a business restructuring according the OECD. The valuation of such profit/loss potential is not noted in Swedish tax legislation nor in the guidelines from the tax authorities. There is however, guidance in the published material from the tax authorities on the valuation on profit/loss potential arising as a result from a transfer of an intangible. In this section the tax authorities continuously refer to the OECD guidelines and how profit/loss potential is valued according to those in order to correspond to the arm's length principle.

The Swedish tax authorities acknowledge that valuation and transfer pricing of intangibles are difficult since they seldom have an established value at the time of the transfer; it is difficult to set an accurate arm's length price. This uncertainty of future profit/loss potential is similar to that which follows from a business restructuring and the potential synergy gains that can be acquired through it.

The VOLVO case[212] is of interest in this area. The case, which was brought before the Swedish Administrative Court of Appeal, dealt with the tax computation of a payment from a Swedish company (VCC) to its American subsidiary (VCNA). The case was never brought before the Supreme Court of Appeal and it shall be noted that it does therefore not constitute case law in Sweden. It is however, the only case that has been brought before a court in Sweden regarding profit/loss potential in a business restructuring between related parties. The case regarded the income taxations of years 1999-2001. The payment was a result of the incorporation of VCNA into the global and homogenous sale structure that had been developed within the MNE. The commercial consequences of the implementation were that VCC acquired a higher degree of risk and profit potential whereas VCNA's degree of risk was reduced along with its profit potential.[213] VCNA was therefore to be compensated for its loss of profit potential due to its incorporation into the existing sale structure of the MNE. The calculation of the payment for the loss of profit from VCC to VCNA was conducted by calculating the expected operational profit had VCNA not adapted to the sale structure compared with its expected operational profit when being im-

[210] Lars-Eric Ericson and Magnus Grive 'Transfer Pricing and intangibles' section 4.3.

[211] Lars-Eric Ericson and Magnus Grive 'Transfer Pricing and intangibles' section 4.4.

[212] Mål nr 3870-3871-03, 6499-03, Administrative Court of Appeal Gothenburg, judgement delivered 2006-03-24.

[213] 'Volvo case' Mål nr 3870-3871-03, 6499-03, p. 2.

plemented into the sale structure. The difference between the two calculations was then distributed over a period of time during which the surplus value was expected to remain.

The plaintiff (VCC) claimed that the payment to VCNA was a cost to acquire future profit and should therefore be deductable according to Swedish tax legislation[214].[215] The court stated that the question at hand was whether the Swedish Tax Administration could show that the conditions between VCC and VCNA differs from those that independent parties would have agreed upon. The court further stated that VCNA could have received a larger part of the profit from the years 1998-2000 had the company's business relations not been amended in 1998. Acting on this background the court ruled that there was cause for the payment from VCC to VCNA. The Swedish tax authorities were thereby unable to prove neither that the companies acted at arm's length nor that the size of the payment was not at arm's length. The verdict was not appealed to the highest instance.

The Administrative Court of Appeal thereby acknowledges that related parties shall be compensated for a loss of profit potential due to a subsidiary's incorporation into the existing sale structure of the MNE. The remuneration from the Swedish company to the US subsidiary was concluded to be a cost to acquire future profits for the Swedish enterprise. It was never determined whether the remuneration was to be characterized as goodwill or an intangible as it was never explicitly tried by the Administrative Court of Appeal.

5.2.3 Indemnification

Swedish regulations on transfer pricing does not contain any provisions regarding indemnification for the transferring party of a business restructuring between associated parties. Where such a compensation payment shall be made, analogies have to be made from Swedish contract law. Indemnification as such is a contractual term that does not have an equivalence in Swedish commercial legislation. In accordance with Swedish contract law, parties are free to regulate the terms of their agreement. This contractual freedom is limited to the extent that such a contract cannot go beyond what is stated in law.[216] Both parties of the contract must be able to depend upon the other party performing in accordance with the terms of the contract. A non-performing party of the contract shall fulfill the economic expectations that where contained in the contract. This means that the parties can regulate indemnification or compensation for potential breaches or other eventualities as they see fit in the contract. Where the parties in a contract has not regulated such terms, the aggrieved party has to turn to commercial legislation and the national courts in order to seek compensation for a breach of contract.

In the case RÅ 1989 not. 506, a contractual relationship between a manufacturer and a distributor was breached by the manufacturer. The manufacturer compensated the aggrieved party for the breach and the matter of the case was whether this compensation was to be treated as a deductible cost, or if the compensation was a compensation for a commercial transaction. The Supreme Administrative Court stated that; where such compensation that is in accordance with the contractual agreement, which is of the nature of contractual damages i.e. indemnification, is in accordance with Swedish commercial legislation. The court

[214] Previous Swedish Tax Act, Kommunskattelagen (1928:370) 43 § 1 mom.

[215] 'Volvo case' Mål nr 3870-3871-03, 6499-03, p. 2.

[216] Taxell, Lars Erik, *Avtalsrätt – Bakgrund Sammanfattning Utblick*, (Norstedts Juridik AB, Stockholm 1997) p.36.

stated that the compensation was a deductable expense, and that no additional assessment should be made.

5.3 Chapter Summary

Transfer pricing aspects of business restructurings have not been highlighted in neither Swedish legislation nor case law. The question if location savings and synergy gains are to be included in the valuation of a business restructuring has not been touched upon by the legislator. However, the Administrative Court of Appeal has recognized that the potential loss of profit due to the implementation to an existing sale structure shall be remunerated. As the development on the international scene seem to focus on business restructurings (German legislation and the Discussion Draft) it seems likely that business restructurings will receive more focus in Sweden in the future. Whether the costs incurred by the transferor in order to adapt its previous organizational structure to the present structure is dependent upon what third parties would agree upon.

6 The Concepts of Profit/Loss Potential and Indemnification – a Discussion

In this chapter the OECDs standpoint on profit/loss potential and indemnification will be compared and contrasted with the legislation of Germany and Sweden. In order to thoroughly compare and contrast the concepts views of scholars and practitioners will be included, the concepts will be exemplified and described continuously. Focus will lie on the concepts, how they shall be interpreted and what they should include rather than as in the previous chapters where the different organs and nations guidelines have been giving account for. The role of OECD as a supranational organ will initially be described in order to emphasize its role on the international tax arena.

6.1 Harmonizing the International Tax Arena

The TPG has during the years since its publication constituted one of the fundamental columns in the international tax regime regarding taxation of MNEs.[217] It is followed by members and non-members of the OECD, and its implementation of different states is a true measure of its applicability. These tasks carried out by the OECD are performed in order to reach an international fiscal harmonization which is distinct from the regulations by the states.[218]

Caldrón states that the best strategy for avoiding double taxation problems that can arise in the area of transfer pricing is to implement a transfer pricing methodology that is in line or consistent with the TPG.[219] It is only when the arm's length principle is understood and applied in a uniform manner on an international level that it will be possible to reduce conflicts of double taxation and other transfer pricing related matters significantly.[220] However, many countries which have followed the TPG have implemented these with a personal interpretation into their national legislation.[221] The interpretation and application of the guidelines by national courts have also impacted the possible differences in the interpretation of them. Nations are free to implement tax law into their national legislation in a manner which is most beneficial for that country and which protects their tax base in the most favorable way. Since national tax bases are the main source of income for countries it is evident why they try their utmost to prevent it from eroding. This is one of the reasons why discrepancies occur with the interpretation of the TPG in national legislation. With regards to business restructurings, tax authorities have become more aware that the possible changes in the way a MNE does business can have a substantially adverse effect on their tax base.

The restructurings at hand, which may risk eroding the tax base of a nation, are those that are within the scope of the Discussion Draft. These have been identified as restructurings including the conversion of full-risk distributors into stripped risk, or situations in which

[217] Caldrón, Jose, 'The OECD TPG as a Source of Tax Law: Is Globalization Reaching the Tax Law?' (2007) [Volume 35, Issue 1] Intertax, Kluwer L Intl p. 5.

[218] Ibid.

[219] Caldrón, Jose, 'The OECD TPG as a Source of Tax Law: Is Globalization Reaching the Tax Law?' p. 5-6.

[220] Caldrón, Jose, 'The OECD TPG as a Source of Tax Law: Is Globalization Reaching the Tax Law?' p. 6.

[221] Ibid.

intellectual property or research and development activities are centralized.[222] The draft has affirmed the role of the TPG and the OECD MC on business restructurings and serves as an interpretation of the existing guidelines. Germany did not await the interpretation of the working group and the applicability of Germany's regulations might lead to such discrepancies within the international arena that the OECD aims to prevent.

Khvat et al. states that tax authorities are becoming more focused on business restructurings so as to prevent MNEs from restructuring in order to avoid tax, and thereby preventing an erosion of the national tax base.[223] Such a statement provides that there is an increased awareness of the matter and that it might start a trend in national legislation on the taxation on business restructurings within MNEs. However, many countries will most likely await the commentaries of the Discussion Draft before deciding on whether to legislate in the matter or not. Such a behavior is certainly positive, since it might prevent national legislation from deviating to a greater extent from the consensus of the OECD, thereby keeping harmonization within the matter intact longer.

With the implementation of legislation on business restructurings in Germany, the aim has been to finance the cut in corporate tax and as a consequence, barriers have been raised in order to protect their national tax base.

6.2 Profit/Loss Potential

According to the terminology used by the OECD a business restructuring involves the transfer of a bundle of functions, assets and/or risks. Profit/loss potential shall only be remunerated if the asset, function or risk that carries it can be identified. The German legislators refer to a transfer package instead of a bundle of assets, functions and/or risks. Business opportunities, i.e. profit potential, shall be included in the transfer package.

By deviating from the approach of individual valuation of functions, risks and/or assets and instead valuing them as a package there is an inherent risk of overvaluation. The value of such a package naturally increases with each individual asset, risk and/or function that is added to the package. Each individual asset, risk and/or function including its profit potential shall account for the total value of the package. Since there is no apparent need for the German tax authority to specifically identify an asset or property that was transferred out of its jurisdiction within a business restructuring, the risk of overvaluation of the transfer package is quite apparent. By concluding that the mere loss of profit potential gives rise to a taxable profit from a shift of functions as a part of business restructurings the taxable amount resulting from such a restructuring is expanded. Not only is the profit potential of each individual asset, risk or function subject for taxation but also the combined profit potential of the package as such.

With the introduction of the hypothetical arm's length test, synergy effects for the group and location savings for the transferee shall be taken into account when valuing the profit potential of the transfer package.[224] When applying the hypothetical arm's length test, a price range is established between a prudent and diligent business manager on both sides of

[222] C. Bennet, Mary, head of the tax treaty and transfer pricing division at the OECD Centre for Tax Policy and Administration, at the Boston Conference 2008 October 21st, referred to by Elliot, Amy S, in 'OECD Official Highlights Business Restructurings' (2008) [October 27] Tax Notes Intl, p. 286.

[223] Khvat et al, 'Current Trends in Transfer Pricing and Business Reorganizations' p. 247.

[224] Beck, Karin E.M., 'Business Restructuring in Germany' p. 275.

the transaction. The prudent business managers act on intracompany information, which do not correspond to the information that would be available between unrelated parties. This asymmetry of information which has been used as an argument for the adjustment of income in order to correspond to the arm's length principle and to avoid parties from setting prices below a market price, is now used by the German Tax Authority in order to motivate a higher price on transactions within the MNE as compared to a transaction with an unrelated party. The synergy effects of the transfer package are most likely of a higher value when it is transferred within the MNE than to an unrelated party.

The decision to restructure a business and transfer assets, risks and/or functions is most likely taken on group level and the package which is transferred, is often made by commercial reasons in order to streamline existing supply chains or concentrating the production or distribution.[225] Since the business restructuring often is a part of a group strategy, the transfer package will almost only be beneficial to the receiving company within the MNE, or the MNE as a whole. It is thereby of greater value to the prudent and diligent business manager of that company, which is why the price range according to the hypothetical arm's length test will increase and the taxable gain is thereby higher.

According to the OECD, profit/loss potential is not in itself a taxable gain under the arm's length principle. However should the asset or function carry such a potential, it shall be remunerated and be included in the value of that particular asset or function. The working group has clearly stated that the asset or function that carries such a profit/loss potential shall be identified.[226]

The German and Swedish legislators have taken on different approaches on the regulation of the issue. The German legislator has implemented extensive rules governing the matter in contrast to the Swedish legislator. In Swedish law it is stated that if the income of a Swedish enterprise is decreased due to terms between related parties that differ from those that unrelated parties would have agreed upon, and the decrease of income is due to that community of interest, the income shall be adjusted in Sweden. It is established in Swedish case law that relevant aspects of the OECD reports can be used as guidance when applying Transfer Pricing-rules. [227] The role of OECD reports in Sweden has been further acknowledged as the Swedish tax administration continuously refers to the TPG in their published, for taxpayers non-binding, guidance.

On the question of business restructurings it seems unlikely that the Swedish tax authority would not take reference from the TPG. As the discussion draft is a clarification of the application of those guidelines to business restructurings it is most likely that the Swedish tax authority will not deviate from the view set out by the OECD. This has been further acknowledged by a representative from the Swedish tax authority who stated that "business restructurings will most likely be valued according to paragraph 64 of the discussion draft".[228] Such a view that profit/loss potential shall be remunerated according to the arm's length standard in a business restructuring corresponds to the assessment in the Volvo case. In this case the court stated that the loss of profit potential due to the incorporation

[225] Khvat et al, 'Current Trends in Transfer Pricing and Business Reorganizations' p. 247.

[226] Discussion Draft, para. 64.

[227] RÅ 1991 ref. 107.

[228] Statement by Börje Johansson, Swedish tax administration (Personal email correspondence 2 October 2008).

of a company (VCNA) into the existing sale structure of the MNE was to be remunerated. The VCNA was thereby compensated for their loss of future profit potential. There would have been no justification for compensation in this case if VCC had not taken over the future profit potential. In this case the loss of profit potential constituted a less favorable transfer pricing of ongoing supply of goods.

6.2.1 Risk of Overvaluation

According to paragraph 57 of the Discussion Draft, local synergy gains shall be included in the profit/loss potential and shall be remunerated at arm's length. It is important to emphasize that it is the local synergy gains that shall be included in the profit potential i.e. the synergy effects the transaction has on the transferee and transferor according to the working group. According to the German legislation the synergy gains for the group, i.e. the MNE shall be included in the profit/loss potential.[229] This rule clearly deviates from the view of the working group[230], and can be questioned whether it is in line with the arm's length principle which originates from the separate entity approach. According to that approach each transaction, in this case, including business restructurings, shall be revised/viewed only between the parties actually involved in that transfer, i.e. the transferee and transferor. The restructuring can have group-wide synergy effects; however these are not to be included in the profit/loss potential between the parties of the transaction.

Since a business restructuring can have group-wide synergy effects for the members of the MNE, they might value the transfer package to a higher value than an independent party would have. A business restructure is most often part of a business strategy for the group and is thereby specialized to fulfill the goals of that specific strategy. The probability of such a transfer package being acquired by an independent party is remote. Had an independent enterprise acquired such a transfer package, it would have done so in order to improve the existing operations of that enterprise. Between related parties, a transfer of a package with bundled assets, functions and/or risks could be transferred in order to maintain competitiveness, increase efficiency of the supply chain for the entire MNE, improve economies of scale, centralization of management, IT, R&D and so forth for the MNE as a whole.[231] Naturally the package could also have the same effect for the separate company which is the recipient of the package.

The more assets, functions and/or risks that are added to the package, the less likely it is that there will be more than one purchaser. The package becomes more unique and specialized for the specific recipient by each asset, risk or function that is added. Independent parties would only acquire the package if the economic benefit, or future economic benefit, of this package is worth more to the recipient than the cost of acquiring the package. However, within a MNE a receiving company might actually be willing to suffer detriments by acquiring this package while the MNE as a whole benefits from it. It might not even be the choice of the restructuring parties within a MNE to be involved in the restructuring. The decision might be made on an ownership level and it is not certain that such a decision will have positive effects for the parties actually concerned.

[229] Beck, Karin E.M., 'Business Restructuring in Germany' p. 275.

[230] Joint WP1-WP6 Working Group on Business Restructurings.

[231] Mandate for the Joint WP1-WP6, Working Group on Business Restructuring, p. 2.

6.3 Indemnification

As all restructurings are associated with costs such as; separation packages to employees, equipment write-offs due to the restructuring, for restructuring supply chain and so forth, these are to be attributed between the parties involved in the transaction. As mentioned above, the restructuring can be motivated by group-wide synergy effects that exceed the costs of it; however, it is not certain that these profits will arise in the entity that incurred the costs for the restructuring. Between unrelated parties the transferor would not surrender profit potential and incur costs for surrendering profit potential without making sure that the receiver of that transfer package at least indemnifies them for their costs for the restructure.[232] This party would claim indemnification due to the fact that the relationship between independent parties is based on a contract.

Between independent parties, distribution and manufacturing arrangements are to a great extent regulated in written contracts. The aim of a contract between independent parties is to be as complete as possible. Such a complete contract governs the determination of not only current prices, but also possible prices that would become actual prices if conditions were to arise different to those currently existing. The agreement also covers prices that will be charged upon the occurrence of hypothetical and sometimes future events.[233] In such a complete contract, it is in the interest of all parties to regulate matters of contract termination and indemnification for such a pre-mature termination. Independent parties are dependent on a complete and written contract in order to claim any compensation from the breaching party. A complete contract is essential between independent parties in order for e.g. a manufacturing party to complete the investment it takes to fulfill the agreement. A complete contract is one which governs the rights and obligations of the parties under all possible circumstances.[234] There shall however be no presumption that independent parties conclude perfectly complete contracts between each other however, they will to a greater extent try to include terms and conditions that cover as many scenarios as possible.

In the absence of a complete contract, unrelated parties would periodically renegotiate prices which would increase the costs for both parties. Such costs are particularly evident where one of the parties plans to make a specific investment in relation to the trading relationship. That party might lose bargaining power as a result of the delay due to the renegotiation.[235] Unrelated parties would therefore seek to conclude complete contracts and hold each other to them, as it increases their certainty, bargaining power and reduces risk. Members of a MNE possess opportunities due to their community of interest which make it possible for them to renegotiate and alter contracts.

According to the OECD members of a MNE shall conclude contracts, written or oral, that correspond to those completed by independent parties. In regards to whether the agreement is formalized in writing, it should be examined whether the conditions for termination, non-renewal or re-negotiation of the contract were respected and of whether a guarantee or indemnification clause was provided for in the contract.[236] It is stated in article

[232] Khvat et al, 'Current Trends in Transfer Pricing and Business Reorganizations' p. 247.

[233] Musselli Andrea & Musselli Alberto, 'Stripping the Function of Producing Affiliates of a Multinational Group, Addressing Tax Implications via Economics of Contracts' p. 18.

[234] Ibid.

[235] Ibid.

[236] Discussion Draft, para. 103.

1.29 of the TPG that independent parties will ordinarily seek to hold each other to the terms of the contract and that these will only be ignored or modified if it is in the interest of both parties. Associated enterprises may not apply this type of conduct to the same extent. The question arises whether such a contract is at arm's length, i.e. whether independent parties would have concluded such a contract. In order to determine this, one must examine the substance of the contract, especially the timeframe and the associated risks of it.

A contract that requires a sizable investment by one party will often be concluded for an extended time period, in order for this party to expect an arm's length return.[237] This creates a financial risk for the party making the investment in case the contract is terminated or materially altered before the end of the time frame in the contract. The degree of risk depends on whether the investment was highly specialized or if it could be used for other purposes. The working group states that where such risk is material, it would have been reasonable for independent parties, in comparable circumstances, to take this into account when negotiating the contract.[238] This would most likely be accounted for by providing for a contract duration that matches the return on investment and a right to indemnification in case the contract is terminated early by the party not making the investment. The party making the investment would not, at arm's length, be willing to assume such a risk of termination, which is controlled by the other party, without sufficient guarantees.[239] Another option would be to factor the risk linked with the possible termination of the contract in to the remuneration of the activities covered by the contract. In this case the party making the investment accepts the risk and is rewarded for it. However, such a practice raises the question if the price for the activities covered by the contract would still be acceptable at arm's length.[240]

Between unrelated parties two scenarios are available in order to compare business restructurings of related parties. The first scenario is where a transfer package is acquired. The seller would not sell the transfer package unless he is rightfully compensated for future losses and so forth. The price would include the costs the seller would face in order to adapt its existing operations to the new structure of the company. The second scenario is where a contractual relationship is prematurely terminated. Take the example of a prematurely terminated distribution agreement. In such a case the breaching party would indemnify the other for losses incurred due to the termination. Both scenarios are dependent upon being regulated by complete contracts. Irrespective of which scenario, unrelated parties would be faced with, for the purpose of comparability, they would be compensated for the costs incurred to adapt the existing structure of the company to the post-transfer situation. In a business restructure within a MNE, consideration shall be taken to what independent parties would agree upon. The complex and unique nature of business restructurings makes it difficult to find comparables. However, if it is obvious that, between independent parties there would be a compensation to the restructured entity it would not be in line with the arm's length principle not to compensate such costs between related parties. When a package is transferred between associated parties, an indemnification shall be made by the trans-

[237] Discussion Draft, para. 108.

[238] Ibid.

[239] TPG, para. 1.27.

[240] Discussion Draft, para. 111.

feror to the transferee, if it would have been done so between unrelated parties. This indemnification should cover the costs attained by the transferee due to the restructuring.

National commercial legislation can provide guidance on whether the conditions of termination or material alteration of an existing arrangement are at arm's length. The applicable commercial legislation or case law may provide useful information on indemnification and if the terminated party has the right to claim before the courts an indemnification irrespective of whether it was provided for in the contract.[241] It can however be discussed if the party which belongs to a MNE will take legal action against its associated enterprise in order to seek indemnification. If such an associated party would not claim indemnification before the courts, this matter is solved by default. The question that arises is then whether such an indemnification should be a matter for transfer pricing in order for the entire business restructuring to be at arm's length or whether it should be left to commercial law and the national courts to which such a party has to turn to in order to seek compensation.

6.4 Chapter Summary

The role of the OECD as a harmonizing organ has through Germany's legislation been questioned. The differences in regards to the valuation of profit/loss potential between OECD and Germany are apparent. According to the OECD (and most likely Sweden) profit/loss potential shall only be remunerated where the asset, function and/or risk that carries that potential is identified. There is a risk for overvaluation when adopting the German approach of valuating the transfer package. Due to the unique nature of business restructurings the separate entity approach might not prove the best method to remunerate business restructurings and alternative methods might be needed.

The question of profit/loss potential is however a question of transfer pricing, purely. Whether an indemnification shall be paid between the parties depend to a great extent on national commercial legislation and the terms of the contract. Concluding complete contracts are decisive in the assessment of indemnification. Since business restructurings are specialized and unique in nature it is difficult to make any generalizations regarding when an indemnity shall be paid between the parties. Independent parties are to a greater extent dependent upon complete contracts than related parties.

This chapter has been included to shed light on the differences between the approach taken by a nation with codified legislation and the view of the OECD. Through this chapter the reader has hopefully gained a deeper understanding of the terms and their impact on the nations at hand. In the following chapter the terms will be further analyzed and questioned.

[241] Discussion Draft, para. 115.

7 Analysis

In order to avoid the risk of double taxation it is decisive that a harmonized international tax arena arises above the geographic boundaries of nations. The differences in national legislation and the guidelines from the OECD will affect the MNE's since they will be the ones to suffer from the dissimilarities. The nations involved in a transfer will not surrender their taxation rights due to differences in defining terms such as profit/loss potential and indemnification. Where there are such differences in the definition of these terms, the risk of disputes between tax authorities and double taxation will increase. In this chapter the term profit/loss potential will be analyzed in order to show the consequences of the differences in valuation of the term that has been described in section 6.2. It shall also be analyzed if the consequences of an indemnity can be foreseen and whether it should actually be part of transfer pricing?

7.1 Profit/Loss Potential

The profit/loss potential that is to be compensated is theoretically the profit that the transferor would have earned if it were to continue the operations it had before the restructuring.[242] This was also the view of the Swedish Administrative Court of Appeal in the Volvo case. The restructured entity was compensated for its loss of profit that it would have accrued had its existing sale structure been maintained. The compensation of profit/loss potential shall include in the difference between (past) realized profit at the time of the restructuring and the projected profit that would have been gained under the old characterization.[243] The working group states that compensation may be required to remunerate the transferor's surrender of profit potential, where an identifiable asset, function and/or risk that carries that right is transferred. Another party must take over the profit/loss potential for it to be taxable. In Germany the compensation for loss of future profits shall also include a compensation for potential business opportunities the transferor might lose. According to the AStG profit potential shall be compensated, the term is described in chapter 2, section 3, para. 1 of the FVerlV, as the profits that the enterprises involved in the transfer can expect from the exercise of the function. In the valuation of that particular profit potential geographic location savings (geographic advantages and disadvantages) and synergy effects shall be included according to chapter 2, section 3, para. 2 of the FVerlV. The notion of compensating the loss of business opportunities is not in line with the view of the working group. The correct value for a transfer of functions in Germany is a problematic point since it indirectly taxes synergy effects and location savings in the foreign state.[244]

On the open market, prices are determined by supply and demand and the maximum price a buyer could provide does naturally include all the factors deriving from the actual circumstances provided by that tax territory.[245] The German regulations aim to reconstruct the market price within controlled transactions. The market price is where supply and de-

[242] Musselli Andrea & Musselli Alberto, 'Stripping the Function of Producing Affiliates of a Multinational Group, Addressing Tax Implications via Economics of Contracts' p. 21.

[243] Ibid.

[244] Ihli, Uwe, 'Transfer Pricing, Restructuring, Apportionment and Other Challenges for Tax Directors' p. 350.

[245] Ibid.

mand meet and, if the producer costs are below the market price, a producer surplus will arise. In the opposite situation i.e. when buyers expect a greater benefit than the price paid for the good, a consumer surplus arises. The German approach of applying the hypothetical arm's length test with maximum and minimum prices is an attempt to reconstruct the market price, within controlled transactions. The maximum price in the price range according to the German rules takes into account the maximum price of the buyer i.e. total of the assumed market price including the consumer surplus and the costs the seller incurs. As noted in section 4.1.1 the median value of the price range shall be used if the taxpayer cannot show that another price within the range corresponds to the arm's length principle with the utmost certainty. For the transferor the median price thereby includes half of the combined producer and consumer surplus as well as the transferee's costs.[246] Ihli states that the realized profits in a transaction between unrelated parties are always limited to the producer surplus. The consumer surplus i.e. synergy effects and location savings in the receiving state, which in the case of a transfer of functions is future profit realized in another tax territory cannot be taxed in these circumstances in the first state.[247] A buyer would not have paid for consumer surplus since the benefit the buyer acquires is not dependent on the costs of the seller.

It is unreasonable that the price of the transfer package would differ depending upon the place of residence of the buyer. From a German perspective the same transfer package could be sold to a number of different buyers and each and every one of them would compensate the seller differently due to differences in synergies and location savings. Such synergies and location savings are due exclusively to conditions in the country of the transferee of the transfer package, the compensation that thus arises depend solely on market conditions in each and every one of the receiving nations. There can be commercial reasons for pricing the transfer package at different prices in different markets. These price differences would be as evident for related as unrelated parties due to differences in market conditions. However, the consumer surplus is still not to increase the price on the transfer package. The view that the benefits arising from synergy effects and location savings that are entailed in the term business opportunities should be taxed in Germany would most likely not be agreed upon by tax administrations in the receiving states, as it would lead to taxation without realization. The allocation of taxing rights on profits attributable to location savings and synergy effects to Germany due to the transfer of such a package would probably not pass unnoticed neither by tax authorities nor is it in compliance with the view of the OECD.

In Swedish tax legislation taxation without realization is not allowed (see section 5.1). This is expressed through the principles of realization and legality. The principle of realization is motivated by the need to value profits attributable to the selling of an asset at a correct value. The principle of legality states the need for foresight for tax administrations and tax payers as well as the fact that there can be no taxation without legislation. Taxation of local synergy effects and location savings according to the German legislation had not been realized nor had any profits attributable to them arisen in the country of the transferor had the business restructuring (transfer of a transfer package) not taken place. Taxation of such business opportunities would therefore not correspond to the principles upon which Swedish tax law rests. Baring these principles in mind, it is likely that the Swedish tax authori-

[246] Ihli, , Uwe, 'Transfer Pricing, Restructuring, Apportionment and Other Challenges for Tax Directors' p.350.

[247] Ibid.

ties would value profit/loss potential that can be identified to a specific asset, function and/or risk which is part of a business restructuring in accordance with paragraph 64 of the Discussion Draft. By implementing such an approach taxpayers will incur foresight to the degree that they can, to a certain extent, expect the tax burden that will be borne due to the restructure. The principle of legality is upheld due to the fact that the Swedish Supreme Administrative Court of Appeal has stated that OECD reports can be applied as guidance when interpreting the rule set out in 14:19 IL. With these reports the court referred to the TPG. As the discussion draft is an interpretation of the application of the existing guidelines set out in the TPG on business restructurings, the discussion draft will serve the principle of legality to the same extent as the TPG in Sweden.

According to the Discussion Draft, it is essential to identify the underlying reasons for the restructuring and the distribution of risks before and after the transfer of the package in order to estimate the profit/loss potential of the transfer package.[248] In order to identify and understand the underlying reasons for the restructuring, both the transferee's and the transferor's motives for the restructuring should be analyzed. Such knowledge of both parties of the restructuring does not correspond with the separate entity approach, as unrelated parties often act on asymmetric information. In this respect the German standard of the prudent and diligent business manager where both managers are to be aware of all essential facts and circumstances of the transaction would be applicable to business restructurings. In this case it can be assumed that both parties of the actual transfer are aware of the costs associated with this.

The separate entity approach has weaknesses especially in cases of unique business restructurings where a transfer package with associated profit potential is transferred between related parties. The profit/loss opportunity that is to be included in the transfer package (regardless if it is valued in accordance with the guidance from the Discussion Draft or German legislation) is difficult to assess and compare with the value an independent party might have attributed to it. In these cases the separate entity approach might not be the best way to handle these matters and the principle of the prudent and diligent business manager might lead to a more businesslike valuation of the transfer package.

7.2 Indemnification

Indemnification is recognized by the working group to be compensated between the parties if unrelated parties would have agreed on the same. As the term indemnification is referred to in the discussion draft it is to cover the incurred costs of an aggrieved party of a contractual relationship. Such costs arise due to a breach of a contractual relationship. Independent parties would seek to have a complete contract, governing as many situations as is reasonably possible. Associated enterprises are not dependent on complete contracts to the same extent. In comparing situations, such a contractual relationship can be breached in one of the two scenarios mentioned in section 6.3. When the transfer package is sold, an independent seller would charge a price that would cover the costs for the transfer package as well as the restructuring costs the transferor would incur in such a transfer. An independent party would not sustain costs that would not be compensated in such a transfer.

However, in the second scenario, where the contractual relationship is breached, the aggrieved party has the right to compensation in the form of indemnification, if this right is

[248] Discussion draft, para. 18.2.

included in the contract or national commercial legislation. According to applicable commercial legislation, an aggrieved party may have the right to claim indemnification before the courts irrespective of whether or not such a clause was provided for in the contract. Independent parties would most likely include an indemnification clause in their strive to conclude a complete contract. In theory, the non-performing party shall indemnify the other party in accordance with the terms of the contract. The aggrieved party would theoretically be indemnified without bringing the breaching party to court. If however, the breaching party refuses to align with the terms in the contract, the parties would have to bring the question before court to receive an enforceable title in order to ascertain this amount.

As mentioned in section 3.3.5.7 the indemnification for costs incurred by the restructured entity are not included in the definition of a business restructuring according to the discussion draft. If an indemnification would be available according to either the terms of the contract or national legislation between unrelated parties it should be the same between related parties. The indemnification can be attributed in different ways such as through adjusting the price of the post restructuring transactions or sharing the restructuring costs. Whether such terms would have been agreed upon between independent parties are however questionable. Nevertheless, the appropriate tax base is asserted to the nations involved in the restructuring.

The likelihood of members of the same MNE to bring each other before court in order to seek proper compensation is not apparent. Ownership control and potential badwill for the MNE as a whole make such a claim for compensation unlikely. It can thereby be established that; even though the terms of the contract are at arm's length, it cannot be held that associated parties will act on an arm's length basis. If the non-performing party does not indemnify the aggrieved party in accordance with the terms of the contract, the likelihood of the matter being brought before a court is remote. In such an event, the parties have not acted as independent parties would have in a similar situation. The termination of a contract between associated enterprises may, according to the Working Group, differ from the conditions that would have been concluded between independent enterprises in similar circumstances due to the remote possibility of related parties pursuing such a claim. If an indemnification clause would be included in the contract between associated parties, the conditions between those two enterprises would be in accordance with what independent enterprises have concluded and thus in accordance with the arm's length principle as set out in the OECD MC.

If the terms of the contract are in accordance with the arm's length principle, but the aggrieved party is never indemnified, it should reasonably be a matter for national legislation to settle such a matter. Depending on the parties' national legislation, it would be a matter for either commercial law or tax law. However it is doubtful that a national tax authority is the competent body to decide whether a party shall be indemnified, and if so, to what amount such an indemnification shall be. Indemnity is traditionally within the realms of contract law.

Two questions arises regarding indemnification and business restructurings; Can an indemnification clause be said to be in accordance with the arm's length principle if it is equivalent to what independent parties would include, but is never fulfilled? And which authority should be the competent one to oversee that the indemnity is actually compensated between the parties? Regarding the first question one should be able to see to the economical substance of the contract as is pointed out in the TPG and Discussion Draft when determining the true allocation of risks between related parties. If the included indemnity clause is just fictional and not meant to be rewarded between the related parties it could not be

considered to be at arm's length. The conduct between the parties is according to the TPG the best evidence to determine the true risk allocation between them. A reasonable determination of whether an indemnity clause is at arm's length or not should include the same assessment. One should see to the indemnity clause at hand, what caused the breach of contract or early termination of it, the particular cases and circumstances of each case needs to be thoroughly assessed in order to identify the conduct between the parties. It is difficult to evaluate whether an indemnification is actually rewarded between the parties since it is stated in the discussion draft that it can take any form, such as sharing the restructuring costs or even be part of a post restructuring agreement. The authority that is to resolve such a matter will most certainly have difficulties determining whether it is actually remunerated or not.

Then, what authority shall be deemed competent to oversee that the indemnification is actually executed? If the indemnity is to be part of transfer pricing the tax authorities should be the competent ones. Questions regarding indemnification are closely linked to commercial legislation. The size of the indemnification and whether or not the facts and circumstances of the case allow an indemnification to be rewarded are questions that are normally governed by civil courts. It can be questioned if it is legally accurate for tax authorities to take on such a role that corresponds to civil courts.

7.3 Conclusion

The German legislation includes synergy gains in their valuation of the transfer package for the MNE as a whole, which deviates from the separate entity approach upon which the arm's length principle rests and thereby conflicts with the TPG. This approach could lead to an overvaluation of the profit/loss potential of the package that is transferred. Such an overvaluation will most likely lead to a situation where the German tax authorities will regard potential gains that will only be realized in the country of the transferee as taxable profits, i.e. taxation without realization. It becomes apparent that a practice where one country taxes profits that can only be realized in another country due to the conditions in that other country will lead to conflicts between the tax authorities in these two countries. The OECD has been clear in the Discussion Draft that only profit/loss potential that can be identified as belonging to an asset, risk or function which is part of the transfer package shall be remunerated. There shall be no taxation if the profit potential is not actually transferred to another party. This method of valuating profit/loss potential in a business restructuring is reasonably more closely connected to the true value of the assets, risks and/or functions which are transferred in the business restructuring. Sweden has previously followed the guidance from the OECD on transfer pricing. The TPG have been acknowledged to be used as guidance in Swedish case law. On the question on business restructurings Sweden will most likely value them according to paragraph 64 in Discussion Draft. This has been further clarified by a representative from the Swedish tax authority. Such a valuation will less likely lead to double taxation as it only taxes the future potential earnings and local synergy gains of the transaction. However such a valuation is based on the separate entity approach on which the arm's length principle is based and such an approach can prove to be truly difficult to apply with regards the unique nature of business restructurings.

Regarding indemnification, it should be remunerated for between the parties if independent parties would have agreed on the same. In order for an indemnification clause to be at arm's length, the facts and circumstances of each case need to be assessed individually. In order to comply with the arm's length principle it should first be assessed whether inde-

pendent parties would have included such a clause and whether the terms of such a clause are at arm's length. Where such clauses are deemed to be in line with the arm's length principle, there are numerous factors that have to be taken into account in order to establish whether a party shall indemnify the aggrieved party. The matter of indemnification is furthermore traditionally a matter for national commercial legislation, which will only increase the difficulty of the matter. Issues of indemnification shall be determined on a case to case basis in order to assert that it is commercially rational for the parties to include and hold each other to such a clause. It becomes evident that it will be complicated to conclude a general rule regarding the matter of indemnity in order for it to comply with the arm's length principle. It will be difficult to find a harmonizing platform on the matter of indemnification since it often is a matter for national commercial legislation, where such is applicable. It can further be questioned whether it shall be a matter for transfer pricing and thus the national tax authorities to resolve the matter initially.

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