Business Restructurings
Transfer Pricing Aspects from a Distributor’s Perspective: When Should Shifted Profit Potential Be Remunerated?

Master’s Thesis in Commercial and Tax Law
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Abstract

The OECD Guidelines stipulates that a business restructuring resulting in shifted profit potential not automatically implies that compensation should be paid between the restructuring parties. This thesis examines when shifted profit potential should be remunerated from the perspective of the fictive Swedish distributor Enterprise A which is facing a business restructuring. The arm’s length principle does not require any remuneration for the mere shift of profit potential when applying the principle on business restructurings. Instead, the questions are whether there has been a transfer of something of value; or a termination or significant renegotiation of the current agreement. In the context of remuneration for shifted profit potential the questions can be rephrased to whether considerable assets and/or rights have been transferred which carry considerable profit potential that should be remunerated. And, whether the arm’s length principle requires remuneration to be paid by reference to the concept of “options realistically available”. Enterprise A’s shifted profit potential could be remunerated and thus have tax consequences if there are other options realistically available for the entity apart from entering into the business restructuring. Enterprise A’s bargain power would then have been greater and consequently the chances of being remunerated as well. Further, Enterprise A could be remunerated as a result of the shifted profit potential if the entity takes title to transferred marketing intangibles that can be identified and assessed valuable. The shifted profit potential should as well be remunerated and thus have tax consequences if the parties in Corporate Group C have included a compensation clause in their contract, and the clause can be assessed as at arm’s length when considering what independent parties would have agreed upon.
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<tr>
<td>CCA</td>
<td>Cost Contribution Arrangement</td>
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<td>CFA</td>
<td>Committee on Fiscal Affairs</td>
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<td>C+</td>
<td>Cost Plus</td>
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<td>CUP</td>
<td>Comparable Uncontrolled Pricing</td>
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<td>Etc.</td>
<td>Et cetera</td>
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<td>IBFD</td>
<td>International Bureau of Fiscal Documentation</td>
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<td>IP</td>
<td>Intellectual Property</td>
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<td>HR</td>
<td>Høyesterett</td>
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<td>OECD</td>
<td>Organisation for Economic Co-Operation and Development</td>
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<td>OECD Guidelines</td>
<td>OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations</td>
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<td>OECD Model Tax Convention</td>
<td>OECD Model Tax Convention on Income and on Capital</td>
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<td>PSM</td>
<td>Transactional Profit Split Method</td>
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<td>R&amp;D</td>
<td>Research and Development</td>
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<td>RPM</td>
<td>Resale Price Method</td>
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1 Introduction

1.1 Background

During the last decades, the influence of multinational groups has increased rapidly as well as the international intra-group transactions. For instance, 70 percentage of today’s world trade transactions are made between associated parties and merely in Sweden the transfer pricing regulations concern 22 000 enterprises.¹

Transfer prices should be described as the prices at which associated enterprises transfer physical goods, intangible property or provide services within a multinational group. This area of law is of significant interest for both taxpayers as well as tax authorities worldwide since the transfer prices charged within a multinational group to a considerable extent compose and affect the taxable profits of the enterprises within the group as well as the tax revenue of each enterprise’s country.² The lack of fixed rules regarding how to explicitly determine the correct transfer price has made transfer pricing complex seen from a tax perspective. However, the arm’s length principle which is the international transfer pricing standard, forms a pricing framework which implies that the prices charged within a multinational group should correspond with what would have been agreed between independent parties.³

The financial crisis has affected the tax revenue of countries all over the world and has resulted in many multinational enterprises’ decisions to streamline their businesses in order to stay competitive. The crisis has further carried with tax authorities’ ambition to stimulate the economy but at the same time defend their own tax revenues which possibly are obtained by changing or bending domestic rules. Evidently, the risk of double taxation becomes substantial.⁴


Business restructurings have until now been an uncertain area without any provided guidance from OECD. However, in the last couples of years, tax administrations and OECD have put a lot of attention and focus to the transfer pricing aspects of business restructurings. Business restructurings of multinational groups in general involve cross-border relocation or termination of functions, assets and risks which radically may affect the allocation of profits and thereby the potential tax revenue.\(^5\) OECD’s work regarding the transfer pricing aspects of business restructurings has resulted in a new chapter in the OECD Guidelines where these business restructuring aspects have been incorporated during 2010.\(^6\)

The new chapter considers several different transfer pricing issues related to business restructurings. One central issue concerns whether compensation should be paid for the restructuring itself according to the arm’s length principle.\(^7\) As mentioned earlier, relocation of profit potential is a probable consequence of a business restructuring. However, the new guidelines stipulates that a business restructuring resulting in a relocation of profit potential not automatically implies that compensation should be paid between the restructuring parties.\(^8\) The approach taken by OECD creates considerable uncertainty regarding in what cases profit potential actually should be remunerated; and further forms the basis to examine the business restructuring issue in this thesis.

The examination in this thesis will have a case based approach where the restructuring of the fictive company Enterprise A will be studied and constitute the foundation of the thesis. This approach angle is taken in order to enable a rewarding and interesting scrutiny where certain selected consequences and effects of a business restructuring are thoroughly analyzed. The scenario described below is rather unspecified which has been made deliberately to enable an analysis that examines the different effects depending on the different circumstances.


\(^6\) OECD Guidelines, Forewords, p. 3.

\(^7\) OECD Guidelines, paras. 9.48-9.122.

\(^8\) OECD Guidelines, para. 9.65.
The scenario is that the Swedish fully fledged distributor Enterprise A is part of the multinational Corporate Group C. Enterprise A is owned by the manufacturer Enterprise B which is the parent company within the corporate group located in a foreign country. Additionally, Enterprise B produces the products which Enterprise A sells as well as takes title to the brands and trademarks. Corporate Group C is currently facing a business restructuring in order to streamline the business model and stay competitive on the market. Consequently, the business activities will be centralized and as a result Enterprise A will be stripped of functions. In the restructuring process all inventories will be transferred to Enterprise B at an arm’s length price. It is further assumed that no comparable transactions or entities can be found.

Figure 1-1 The Scenario: Enterprise A

1.2 Purpose

The purpose of this thesis is to examine in which cases Enterprise A’s shifted profit potential should be remunerated and thereby have tax consequences in order to be in accordance with the arm’s length principle. And oppositely, when shifted profit potential should not be remunerated and thus not have tax consequences.

The thesis’ examination is made from a Swedish perspective and is addressed to enterprises concerned with transfer pricing issues, though without having significant or sufficient knowledge in the area of law.

1.3 Methodology

This thesis is formed by mainly using a traditional legal method. This means that existing sources of law are studied to determine which the applying rules are (de lege lata) as well as an estimation of what rules that possibly need to be formed by the legislator (de lege ferenda).²

The sources of law are assessed in the established order of priority which means that laws and other regulations are credited with a supreme value amongst the sources of law, thereafter followed by preparatory work and case law. The last source of law in the established order of priority is legal doctrine. However, the doctrine is of essential value when analyzing complex legal issues since it is in the doctrine primarily that solutions are framed and the further development of the legal issue is made.\textsuperscript{10} To some degree, a comparative method is used to compare the applicable rules with foreign legislation concerning remuneration for shifted profit potential.

As transfer pricing aspects of business restructurings is a complex area of tax law, legal doctrine will be of great importance in this thesis due to the fact that solutions and development most likely will be framed and formed in this source of law. Legal doctrine as books and articles in international tax and transfer pricing journals are attained by mainly using the database IBFD, but also other databases such as Kluwer Law, SpringerLink, Lovdata and Westlaw International have been frequently used.

As mentioned in section 1.2, the thesis intends to make an examination from a Swedish perspective. Sweden is one of the member states of OECD which has established the OECD Guidelines.\textsuperscript{11} These guidelines are generally intended as guidance in transfer pricing issues such as determining the correct transfer price. However, member states of OECD as well as multinational enterprises in their role as taxpayers are encouraged to follow these guidelines.\textsuperscript{12} The vision which implies that the principles in the OECD Guidelines should control the assessment of transfer prices between related parties is a recognized approach among OECD’s member states.\textsuperscript{13} In Sweden, the OECD Guidelines’ recognition has been established by case law and has thereby gained great importance in Swedish tax law.\textsuperscript{14} Moreover, the absence of statutory transfer pricing rules concerning business restructurings

\textsuperscript{10} Bernitz, Ulf et al, 

\textsuperscript{11} OECD Model Tax Convention, IBFD, accessed 7 September 2010 from http://online.ibfd.org.bibl.proxy.hj.se/kbase/.

\textsuperscript{12} OECD Guidelines, Preface, para. 16.

\textsuperscript{13} OECD Guidelines, para. 1.14.

\textsuperscript{14} RÅ 1991 ref. 107, Section 2.8, Transfer Pricing Database, IBFD, accessed 14 September 2010 from http://online.ibfd.org.bibl.proxy.hj.se/kbase/ and Swedish Tax Agency, 
is commonly occurring in the member states.\textsuperscript{15} In the light of this, the OECD Guidelines are an important source of law from a Swedish and a global transfer pricing perspective when determining applicable legal provisions and will consequently be considered and examined thoroughly. Further, OECD is one of the largest publishers in the world in the fields of economics and public policy; thus the global importance of OECD and its materials is not limited to merely the organisation’s member states.\textsuperscript{16}

Most articles in the thesis have been published in the International Transfer Pricing Journal. This journal stands for a global view of transfer pricing issues for corporate tax purposes; and inputs from OECD and worldwide countries ensure that the view presented in the journal actually is global. Due to the journal’s universal approach it has been found to be a credible source and reference to use in this thesis.\textsuperscript{17}

An examination of the German legislation concerning remuneration for shifted profit potential is made in section 4.3. German law has been chosen for two reasons. Firstly, since Germany is a member state of OECD which makes it interesting from the perspective that an OECD member state establishes its own transfer pricing rules in the area of business restructurings.\textsuperscript{18} Secondly, due to the heavy criticism that the original version of the German business restructuring legislation has been subject to.\textsuperscript{19}

The Cytec Norge Case which is reviewed in chapter five has been selected since the case is one of the first court rulings concerning transfer pricing consequences when making a business conversion or restructuring. The case has been noticed in articles in the International Transfer Pricing Journal which indicates that the court ruling most likely is of international interest and possibly can be used as guidance from a Swedish perspective.\textsuperscript{20}


\textsuperscript{16} http://www.oecd.org/pages/0,3417,en_36734052_36734103_1_1_1_1_1,00.html, accessed 25 November 2010.

\textsuperscript{17} http://journalseek.net/cgi-bin/journalseek/journalsearch.cgi?field=issn&query=1385-3074, accessed 3 November 2010.

\textsuperscript{18} OECD Model Tax Convention, p. 2.


1.4 Delimitations
This thesis intends to cover business restructurings from the perspective of associated enterprises in the light of article 9 in the OECD Model Tax Convention and does not consider any issues from a permanent establishment perspective or any other perspective.

Additionally, this thesis only aims to examine restructurings from a transfer pricing perspective. All other tax related concerns which may arise when performing a restructuring are in this thesis disregarded.

1.5 Outline
The thesis consists of seven chapters. The first five chapters are mainly descriptive while the last two chapters contain the analysis and the conclusions. In the end of each descriptive chapter, with exception of chapter one, there are concluding remarks. The concluding remarks are intended to sum the important facts of each chapter and to constitute brief chapter analyses.

The first chapter is an introduction chapter which briefly explains the background of the selected area of law. Thereafter, the chapter presents an issue which is currently discussed in transfer pricing contexts and specifies the thesis’ purpose. The chapter aims to introduce the thesis’ issues and purpose to the reader. Chapter two contains a general overview of the basic principles of transfer pricing. The aim is to establish a foundation of transfer pricing knowledge from where a more thorough examination can be made. Chapter three concerns business restructurings; firstly by describing how to determine whether a business restructuring is made on arm’s length; and secondly by describing what kinds of transfers that are made in terms of functions performed, assets used and risks assumed depending on the type of distribution model. Chapter four presents the notion of profit potential. The chapter further specifies under what circumstances that shifted profit potential generally should be remunerated as well as the German approach of when shifted profit potential should be remunerated. The fifth chapter deals with rights and assets which are closely connected with the allocation of profit potential and which also have a significant impact

on the shifted profit potential and possible remuneration. This chapter will thereby take the scrutiny to a more detailed level from the perspective of Enterprise A.

Chapter six is the analysis chapter where the facts and remarks from the previous chapters are considered and analyzed. No new facts will occur in this chapter since it only intends to analyze already given facts. The results of the analysis in chapter six is then presented in chapter seven where the conclusions are drawn. The conclusions shall clearly fulfill and connect with the purpose stated in chapter one.
2 The Principles of Transfer Pricing

2.1 Introduction

This chapter aims to provide a fundamental transfer pricing knowledge from a Swedish perspective. The intention is to enable a deeper understanding for the following chapters and the final analysis.

The inter-governmental organisation OECD has at present 30 member states. The organisation aims to support governments in common problems, identifying good practices, comparing policy experiences and harmonize national and international policies.\(^{21}\) OECD’s work in the area of tax is performed by the Committee on Fiscal Affairs (CFA). The CFA relies on its Working Parties which are performing tax work in respective area of competence. Two of the Working Parties are responsible for the OECD Model Tax Convention and the OECD Guidelines which the member states are recommended to follow. The OECD Guidelines provides guidance concerning the transfer pricing principles which are further explained in this chapter.\(^{22}\)

2.2 The Arm’s Length Principle

The arm’s length principle is the transfer pricing standard that has been agreed upon between OECD’s member states and which thereby should be used when determining the correct transfer price, from a tax perspective, within a multinational group.\(^{23}\) The conditions of two independent companies’ commercial and financial relation are generally set by market forces. However, when associated enterprises make a transaction, the market forces may possibly not affect the relation in the same way as between independent companies.\(^{24}\)

The comparison of the controlled transaction made by related parties, and an uncontrolled transaction made by independent parties, is the core of the arm’s length principle.\(^{25}\) The

\(^{21}\) OECD Model Tax Convention, article 1 and Bakker, Anuschka, *Transfer Pricing and Business Restructurings, Streamlining all the way*, IBFD, Amsterdam, 2009, p. 49.

\(^{22}\) Bakker, Anuschka, *Transfer Pricing and Business Restructurings, Streamlining all the way*, IBFD, Amsterdam, 2009, pp. 50-51.

\(^{23}\) OECD Guidelines, para. 1.1.

\(^{24}\) OECD Guidelines, para. 1.2.

\(^{25}\) OECD Guidelines, para. 1.7.
The arm’s length principle implies that transactions made between associated enterprises should result in the same amount of taxable profit as if the transaction was made between independent enterprises. If the conditions in the parties’ commercial or financial relations differ from those which would have been agreed between independent enterprises, the transaction does not reflect the market forces and thus cannot be seen as at arm’s length. In that case, an adjustment of the price can be made and accordingly taxed. That is attained by establishing the conditions that would have been agreed between independent companies’ in a similar transaction under similar circumstances.

In article 9 of the OECD Model Tax Convention, the international consensus of the arm’s length principle can be found. The definition is repeated in at least 2,500 bilateral treaties around the world and has the following wording:

"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."

The arm’s length principle is also expressed in Swedish legislation where the implication is the same as above.
2.3 Pricing Methods

2.3.1 Choice of Method

To establish whether a transaction between associated enterprises are consistent with the arm’s length principle, different methods can be used to determine if the conditions of the commercial and financial relation of the parties are those which would have been agreed between independent enterprises. There are five methods available in order to determine the correct transfer price. Firstly, there are the traditional transaction methods. These are the comparable uncontrolled pricing (CUP) method, the resale price method (RPM) and the cost plus (C+) method. Secondly, there are the transactional profit methods. These are the transactional net margin method (TNMM) and the transactional profit split method (PSM).

The choice of transfer pricing method should at all times be made with the intention to find the most suitable method for the specific transaction in hand. That is done by considering which the strengths and weaknesses of each method are. In the process of determining whether a transaction is at arm’s length, it is not expected that more than one method is used.

2.3.2 Traditional Transaction Methods

The CUP method compares the price of the goods or service transferred in the controlled transaction with the corresponding price in an uncontrolled transaction. If the comparison results in price differences it should be seen as an indication of that the conditions of the financial and commercial relation are not at arm’s length and an adjustment may be necessary. The CUP method is the preferable method in comparison to the other methods; if it is possible to find comparable uncontrolled transactions.

The RPM starts with identifying the price at which a product purchased from an affiliated enterprise has been sold to an independent enterprise. This resale price is then reduced by a

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30 OECD Guidelines, para. 2.1.
31 OECD Guidelines, para. 2.2.
32 OECD Guidelines, para. 2.11.
34 OECD Guidelines, para. 2.14.
suitable gross margin. The resale price margin represents the sum that the reseller needs to cover operation and selling expenses and to make a suitable profit based on functions performed by the reseller. What is left after reducing the resale price margin from the resale price is what can be considered as an appropriate arm’s length price. This arm’s length price can then be compared with the transfer price between the associated parties to ensure that the transaction has been made at arm’s length. The resale price margin should ideally be determined by the margin that the same reseller earns on products that has been purchased from an independent enterprise. However, the resale price margin that an independent enterprise earns could also be used.

The C+ method begins with the costs of a product or a service that a supplier will resell to an associated party. To these costs a proper cost plus mark-up is added to ensure that the supplier makes a suitable profit based on the functions performed and the market conditions. The sum of the supplier’s costs and the added cost plus mark-up should then be considered as an arm’s length price that could be compared with the price charged between the associated enterprises. Preferably, the cost plus mark-up should be determined by the mark-up that the same supplier earns in a comparable transaction with an unrelated enterprise. However, the mark-up that an independent enterprise earns could also be used. The C+ method is a preferable in cases where the provision of services composes the controlled transaction.

2.3.3 Transactional Profit Methods
The TNMM determines whether a controlled transaction is made at arm’s length by examining the net profit relative to a suitable base, such as for example costs, sales or assets. The ratio of net profit to a suitable base as costs, sales, or assets is called the net profit indicator. The TNMM has similarities with the C+ method and the RPM since the taxpayer’s net profit indicator in a transaction between associated enterprises should be determined by reference to the net profit indicator that the same taxpayer earns in an


36 OECD Guidelines, para. 2.22.


38 OECD Guidelines, paras. 2.39-2.40.

39 OECD Guidelines, Glossary, p. 27.
uncontrolled, but still comparable, transaction ("internal comparables"\textsuperscript{40}). Or in case no such transaction can be found, a comparable transaction made by an independent company ("external comparables"\textsuperscript{41}).\textsuperscript{42} The tax liability determined by using the TNMM is completely reliant on the used net profit indicator whereby the allocation of profit may differ depending on which net profit indicator that is used.\textsuperscript{43}

The PSM aims to eliminate conditions that might have been agreed between associated enterprises which may affect the division of profit. That is accomplished by determining the profit division that would have been agreed between independent enterprises. The PSM begins with recognizing the profit that is to be split. This profit is then divided between the associated parties on an economically legitimate basis reflecting what would have been expected in an agreement between independent parties and thereby, the profit split can be considered to be at arm’s length.\textsuperscript{44} The PSM is generally used when both parties make considerable unique contribution to the transaction or performs significant functions.\textsuperscript{45}

2.4 Comparability Analysis

2.4.1 The Analysis in General

When applying the arm’s length principle, a comparability analysis should be made. Which one of the related parties involved in a transfer that should be tested party should be decided in compliance with the functional analysis which is described in section 2.4.2. This means in general that the party that is least complex in regards of functions should be selected one when making the comparison since it is more probable that a transfer pricing method can be applied with certainty upon the least complex party.\textsuperscript{46} The first step to perform such an analysis is to find a comparable transaction. A comparable transaction is a transaction that not differs from the controlled transaction in a way that could materially

\textsuperscript{40} OECD Guidelines, paras. 3.27-3.28.

\textsuperscript{41} OECD Guidelines, paras. 3.29-3.35.

\textsuperscript{42} OECD Guidelines, para. 2.58.


\textsuperscript{45} OECD Guidelines, para. 2.109.

\textsuperscript{46} OECD Guidelines, para. 3.18.
affect for example the price or the margin. If the transaction differs materially, it still can be comparable if realistic adjustments can be made to remove the effects of the differences.\(^{47}\)

There are five considerable factors when determining comparability. These factors are: the characteristics of the transferred goods or service; the functions that each party performs including used assets and assumed risks; the contractual terms; the economic situation of the companies undertaken the transaction; and the performed business strategies of the parties.\(^{48}\) In the comparability analysis, each factor’s effect is examined from the perspectives of both the controlled transaction and the uncontrolled transaction.\(^{49}\) To what extent these factors are significant depends on the selected pricing method as well as the controlled transaction itself.\(^{50}\)

Consequently, the application of the arm’s length principle implies that a party’s anticipated return should reflect the value of the performed functions, used assets and assumed risks contributed by that party. For example, the assumption of increased risks is to be compensated with increased anticipated return.\(^{51}\)

### 2.4.2 The Comparability Factors

In the open market, differences in the characteristics may lead to different values of the transferred goods or service. Therefore, a comparison of the goods’ or services’ features can be useful. When comparing tangible goods, features such as quality, volume of supply, physical aspects and availability can be important to consider. When comparing services, characteristics as the character and scope of the provided service can be useful. And lastly, when comparing intangible goods the following features can be essential to compare. The form of the transaction in terms of for example licensing or sale; and the type of property, for example a patent or a customer list. But also, the expected benefits of using the

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\(^{47}\) OECD Guidelines, para. 1.33.

\(^{48}\) OECD Guidelines, para. 1.36.

\(^{49}\) OECD Guidelines, para. 1.38.

\(^{50}\) OECD Guidelines, para. 1.37.

intangible goods. This comparability factor is most significant when applying the CUP method.

The compensation between enterprises on the open market are generally reflected in which functions that the independent parties perform, including used assets and assumed risks. Consequently, a functional analysis is required to determine whether two transactions, or entities, are comparable. The analysis aims to identify what economical important activities and responsibilities that each party performs, the assets that each party uses and which party that assumes the risks. Functions that can be essential to compare and identify are among other research and development, distribution, marketing, design, manufacturing, financing and management. The most important functions are those which have a significant economic value. Assets used refer to for example the use of significant intangible property and equipment. With assumed risks means among other market risk and price fluctuations. The allocation of risks between enterprises within a corporate group is a fundamental component of the functional analysis.

The contractual terms of a transaction usually define how the division of responsibilities, risks and benefits is made. These terms are thus important to consider. The contractual terms made by independent enterprises are generally held by both parties because of the parties different interests. However, between associated enterprises the interests tend to be more similar whereby a comparison between the associated enterprises’ contractual terms and their actual conduct could be necessary.

What can be defined as an arm’s length price may not be the same in different markets. It is thus of relevance to identify the markets and to assess whether the markets that are to be compared are actually comparable. Factors that could be considered when examining the

52 OECD Guidelines, para. 1.39.
53 OECD Guidelines, para. 1.40.
54 OECD Guidelines, paras. 1.42-1.44.
55 OECD Guidelines, para. 1.46.
56 OECD Guidelines, para. 9.10.
57 OECD Guidelines, paras. 1.52-1.53.
economic situations of the companies undertaken the transaction are for example the geographic location of the market, the size of the market and production costs.\textsuperscript{58}

To determine comparability, the performed business strategies of the parties may also be examined. Aspects that could be relevant to compare are for example innovation and product improvements; but also consideration of political changes and labour laws.\textsuperscript{59}

\section{2.5 Concluding Remarks}

The arm’s length principle constitutes the core and foundation of transfer pricing. This pricing standard is reflected in all phases of transfer pricing procedures and all legislative transfer pricing measures are made with the intention to enforce the arm’s length principle.

One may say that the arm’s length principle in theory implies that the commercial or financial relation between related parties should not differ from what would have been the relation between independent enterprises. To determine whether differences exist, pricing methods and comparability factors are used. Further, one may say that the arm’s length principle in practice implies that the value of the assets, functions and risks contributed by one party should be reflected in that party’s anticipated return.

It is easy to decide that all transaction between related parties should be made at arm’s length. However, since the arm’s length principle is a general notion it is hard to define what actually can be considered arm’s length in different situations and under different circumstances. Next chapter concerns business restructurings where restructurings at arm’s length will be considered. The restructurings at arm’s length are thereby a reflection of the arm’s length principle. Moreover, the chapter will declare how a business restructuring of a distributor such as Swedish Enterprise A could be made, as well as a description of which functions, assets and risks that generally are performed, used and assumed by a distributor in different distribution models. Thus, the chapter will explain the extent of Enterprise A’s restructuring depending on the entity’s distribution model after the business restructuring.

\textsuperscript{58} OECD Guidelines, para. 1.55.

\textsuperscript{59} OECD Guidelines, para. 1.59.
3 Business Restructurings

3.1 Introduction

Business restructurings can be defined as cross-border relocation of functions, assets and risks within a multinational corporate group. A restructuring may also involve the transfer of significant intangible assets or the termination or significant renegotiation of the current agreement.\(^{60}\)

Multinational enterprises of today tend to restructure the companies within the group in another way than before. The business models have gone from being “vertically integrated” to “supply chain management” business models. In the “vertically integrated” business models each company within the group assumes risks and performs functions within its area of business activity. For instance, distributors within the corporate group are usually fully fledged. The characteristic of the “supply chain management” business model is the centralization of business activities. The result is that for example distributors and manufacturers perform reduced functions and do not bear any significant risks. From a transfer pricing perspective the “supply chain management” business model creates a system where the routine profits are allocated to the operating companies, while the residual profits are allocated to the company bearing the greatest risks and performing the most functions; generally the principal company.\(^{61}\)

In general, a business restructuring does not involve substantial changes. Instead, business restructurings often involve the shift of risks in combination with a limited reallocation of staff and assets.\(^{62}\)

To determine whether the conditions of a business restructuring transaction are arm’s length, a comparability analysis is generally made. If there is an uncontrolled transaction that possible is comparable with the controlled transaction, the comparability analysis also should estimate the reliability of that comparison between the uncontrolled and the


controlled transaction, as well as what adjustments that may be needed.\textsuperscript{63} If no comparable uncontrolled transaction can be found, the business restructuring transactions between the associated parties still can be at arm’s length. Whether the transactions are at arm’s length, thus whether independent entities could be willing to agree to the same conditions in comparable circumstances, are than assessed by looking at the aspects that are described below in section 3.2.\textsuperscript{64}

3.2 Business Restructurings at Arm’s Length

3.2.1 Risks, Assets and Functions Before and After the Restructuring

A business restructuring can be a complicated reform not merely involving two companies within a corporate group but more.\textsuperscript{65} It is therefore essential to identify the transactions that take place during the restructuring to determine the extent of the compensation as well as which entity that should bear the restructuring compensation. It could additionally be of relevance to recognize the restructured party’s rights and obligations before and after the restructuring by looking at both the contractual arrangement as well as the conduct of the parties.\textsuperscript{66}

3.2.2 Restructuring Motives and Anticipated Gains

The globalization of trade worldwide creates new opportunities in regards of business. However, at the same time the globalization creates new threats in terms of increased competition. As a result, enterprises are under high pressure to stay competitive and be efficient. This is partly the background to many enterprises decisions to restructure their corporate group.\textsuperscript{67}

The motives to restructure are not necessarily tax related. A restructuring can also be made in order to reduce production costs or to get closer to a specific market. It is also possible that an enterprise chose to restructure in order to centralize certain functions of the

\begin{footnotes}
\item[63] OECD Guidelines, paras. 9.50-9.51.
\item[64] OECD Guidelines, para. 9.52.
\item[65] OECD Guidelines, para. 9.53.
\item[66] OECD Guidelines, paras. 9.54-9.55.
\end{footnotes}
multinational group and to streamline the supply chain and the management. However, the fact that there are motives for doing the restructuring not necessarily imply that the anticipated benefits and synergies actually will be realized in practice.

3.2.3 Other Options Realistically Available
When determining whether independent companies would have made a similar restructuring transaction it is important to bear in mind that an independent entity would not have entered into an arrangement if there were other options realistically available which could be considered more attractive and profitable. The concept of “other options realistically available” does not merely imply that a more attractive alternative is available. It could also mean the option to not enter into any agreement at all which possibly could have been an independent entity’s choice.

The concept of “options realistically available” is in general an important part of transfer pricing and is one aspect considered in the arm’s length principle’s comparability analysis. This concept has further gained great importance in business restructurings as well, as being a part of determining whether a restructuring should be considered as at arm’s length as described above.

3.3 Business Restructuring of a Distributor
As previously mentioned in section 3.1 today’s multinational enterprises tend to centralize their business activities. Consequently, a business restructuring could most likely imply the transformation of a fully fledged distributor into a distributor stripped on functions. As a result, the distributor does not assume risks any longer, or perhaps assumes very limited risks. This model of restructuring implies that functions, assets and risks will be transferred.

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69 OECD Guidelines, para. 9.58.

70 OECD Guidelines, para. 9.59.

71 OECD Guidelines, para. 9.61.

72 OECD Guidelines, para. 1.34.
to another associated enterprise; as well as the economic burden of product liability claims, marketing and advertising.\textsuperscript{73}

The extent and consequences of a distributor’s restructuring depends on which distribution model that is converted, as well as which distribution models the distributor is converted into.\textsuperscript{74} The different distribution models will be presented in the next section and the chart in the end of this chapter shows the allocations of functions, assets and risks which in general are performed, used and assumed by the different distribution models.

3.4 Distribution Models

3.4.1 In General

Distribution is the process of getting a product to the final customer. There are different formats of distribution where the degrees of added value, assumed risks, performed functions and used assets differ.\textsuperscript{75} Depending on the level of involvement the reflection in the level of profit will differ. The different formats of distribution are fully fledged distributors, classic buy-sell distributors, commissionaires and commission agents.\textsuperscript{76}

Figure 3-1 Correlation between expected profit rates and assets used, functions performed and risks assumed

\begin{center}
\begin{tabular}{c|c|c|c}
\hline

Expected Profit Rate & Assets used & Functions/Risks & \hline

High & Integrated (High) & Fully fledged distributor & \\
Low & Simple (Low) & Commission agent & Commissionaire Classic buy-sell distributor & \\

\hline
\end{tabular}
\end{center}


\textsuperscript{75} Bakker, Anuschka, \textit{Transfer Pricing and Business Restructurings, Streamlining all the way}, IBFD, Amsterdam, 2009, pp. 24-25.

\textsuperscript{76} See Chart 3-1 in the end of this chapter for an overview.
3.4.2 Commission Agent
A commission agent is an intermediary which searches for sales for a revealed principal. The agent’s function is to arrange sales on behalf of its principal. A commission agent does not take title to the goods and usually does not sign the arrangement with the customers. Instead the principal does that when the agent has arranged a sale. As a result, the commission agent does not have any responsibility towards the costumers and bear no risks. Typically, this kind of distributor is compensated by using the C+ method.\(^77\)

3.4.3 Commissionaire
A commissionaire is very similar to a commission agent with the difference that the principal is not revealed. Instead the commissionaire arranges the sales of products under its own name but for the benefit of the unrevealed principal. The commissionaire does not bear any significant risks but only the market risk. This kind of distributor is commonly compensated on a basis of the RPM or, if not possible, the TNMM.\(^78\)

3.4.4 Classic Buy-Sell Distributor
A stripped buy-sell distributor (a classic buy-sell entity) is very similar to a fully fledged distributor. The difference is that a classic buy-sell distributor is stripped on a number of functions and risks which are reflected in the slightly decreased compensation. For instance, this kind of distributor generally takes title to the products even though some distribution functions may be centralized within the group. For example the warehousing of the products and the after-sales support. The RPM are typically used to compensate a classic buy-sell distributor since no value generally is added to the products by the distributor.\(^79\)

3.4.5 Fully Fledged Distributor
A fully fledged distributor is the kind of a distributor that performs most functions, assumes most risks and uses most assets of the different types of distributors. It is typically responsible for logistics and warehousing, may possess brands and has possibly developed


\(^79\) Bakker, Anuschka, *Transfer Pricing and Business Restructurings, Streamlining all the way*, IBFD, Amsterdam, 2009, p. 29.
its own marketing intangibles to perform its sales. Further, a fully fledged distributor in general performs marketing activities and post-sales services to its customers. The compensation to this type of distributor may be on the basis of the RPM. However, the TNMM or the PSM could in practice be applicable due to benchmarking difficulties if the distributor for example uses valuable intangible assets.\(^8\)

Chart 3-1  Overview of the functions performed, assets used and risks assumed by each distribution model

<table>
<thead>
<tr>
<th></th>
<th>Commission agent</th>
<th>Commissionaire</th>
<th>Classic buy-sell distributor</th>
<th>Fully fledged distributor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Title to goods</td>
<td></td>
<td></td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td>Warehousing and logistics</td>
<td></td>
<td></td>
<td>(x)</td>
<td>x</td>
</tr>
<tr>
<td>Purchase planning</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Marketing and advertising</td>
<td></td>
<td></td>
<td>(x)</td>
<td>x</td>
</tr>
<tr>
<td>Quality control</td>
<td></td>
<td></td>
<td></td>
<td>x</td>
</tr>
<tr>
<td>Price setting</td>
<td></td>
<td></td>
<td></td>
<td>x</td>
</tr>
<tr>
<td>Sales and distribution</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td>After-sales support</td>
<td>x</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Warranty and repairs</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Invoicing and collection</td>
<td></td>
<td>x</td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td>General administrative functions</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td>Inventory risk</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Market risk</td>
<td>(x)</td>
<td>x</td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td>Bad debt risk</td>
<td></td>
<td></td>
<td></td>
<td>x</td>
</tr>
<tr>
<td>(Product) liability risk</td>
<td></td>
<td></td>
<td></td>
<td>x</td>
</tr>
<tr>
<td>Foreign exchange risk</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>


### 3.5 Risks in the Context of Business Restructurings

#### 3.5.1 In General

A common consequence of business restructurings is the reallocation of risks. From a business restructuring perspective, risks are of significant importance since increased risks would usually in the open market be reflected in an increase in the anticipated return. The

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\(^8\) Bakker, Anuschka, *Transfer Pricing and Business Restructurings, Streamlining all the way*, IBFD, Amsterdam, 2009, pp. 30-32.
risk allocation as a consequence of a business restructuring would thereby probably result in the additional consequence of a reallocation of the expected residual profit as seen in Figure 3-1. Consequently, risks constitute a fundamental part of the functional analysis which is described in section 2.4.2.\(^81\)

### 3.5.2 Risk Allocation at Arm’s Length

To determine where the risks are allocated, the parties’ contractual terms should be considered. That is since these terms define how the risks are divided between the parties.\(^82\) However, in contrast to independent parties, associated enterprises tend to have similar interests which make it important to observe the behaviour of the parties to recognize whether or not the contractual terms and the behaviour conform. In other words, if the contractual terms have economic substance.\(^83\) In case that is not the fact, it could indicate that the contractual terms not reflect the real intentions of the parties whereby a further examination might be required to determine the parties' intentions and real terms. However, the behaviour of the associated parties should in general be seen as proof regarding the accurate risk allocation.\(^84\)

When it has been determined where the risks are allocated, it is necessary to further examine whether or not the allocation of the risks is in accordance with the arm’s length principle. In case a comparable transaction regarding the allocations of risks can be find, a comparison between the either internal or external comparable should be made. However, in cases where a comparable transaction cannot be found it is crucial to determine whether or not the allocation of risks in question would have been settled between independent enterprises under comparable circumstances. This assessment can be made by guidance from two relevant but not determinative factors that would have influenced the allocation of the risks in an arm’s length transaction. The first factor is to decide which party that has greater control over the risks. The second factor is to decide whether the risks are allocated to the party which has the financial capacity to assume the risks. However, the assessment

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\(^82\) OECD Guidelines, para. 9.11.

\(^83\) OECD Guidelines, paras. 9.34 and 9.170.

must be made with great care and thorough considerations of the specific facts and circumstances in the particular case.\textsuperscript{85}

It is important to assess which party has the control over the risks since it could be expected that the allocation of the risks should be at the party which has the greater control of the risks in question. In this context, the concept of control should be recognized as the capacity to decide how to handle the risks as well as the capacity to make decisions to take on the risks. However, the fact that the party bearing the risks is hiring another party to, for example, administer the risks on a daily basis is not enough to consider the other party as the one bearing the risks.\textsuperscript{86} Instead, it still is the first party that controls and bears the risks since this party is in control of making the decision to hire the administration party.\textsuperscript{87} As regards this first factor, it should be mentioned that there are risks that no party can control; such as economic conditions and availability of raw materials. In those situations, this factor is not to any guidance in deciding if the allocation of the risks is made in accordance with the arm’s length principle.\textsuperscript{88}

The other factor that could be considered when determining if independent parties would have agreed on the same risk allocation under similar circumstances is whether the party bearing the risks actually has the financial ability to assume the risks. In a situation where the associated enterprise that contractually is bearing the risks not has that ability, the other party may have to bear the risk effectively; regardless of the contractual situation.\textsuperscript{89} Nevertheless, the fact that one of the associated enterprises has a good financial situation not in itself implies that the capitalized party is bearing the risks.\textsuperscript{90}

After having considered the two factors in order to determine whether or not independent enterprises would have been willing to make the same agreement under similar circumstances, it could be found that the risk allocation in the controlled transaction has economic substance and is commercially logical. In that case the risk allocation would be recognised and only adjusted if needed to reduce the effects of material differences, if any.

\textsuperscript{85} OECD Guidelines, paras. 9.18-9.20.
\textsuperscript{86} OECD Guidelines, paras. 9.22-9.23.
\textsuperscript{87} OECD Guidelines, para. 9.25.
\textsuperscript{88} OECD Guidelines, para. 9.28.
\textsuperscript{89} OECD Guidelines, paras. 9.29-9.30.
\textsuperscript{90} OECD Guidelines, para. 9.32.
On the other hand, if it would be found that independent parties would not have allocated the risks in the same way under similar circumstances, the first reasonable solution would be to considerer the possibilities to make a pricing adjustment. However, if a solution can not be reached through a pricing adjustment, the consequences of that particular risk allocation might be redelegated to the other associated party.\textsuperscript{91}

Figure 3-2 How to assess whether the risk allocation in a controlled transaction is at arm's length

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{figure3_2.png}
\caption{How to assess whether the risk allocation in a controlled transaction is at arm's length.}
\end{figure}

3.5.3 Consequences of the Reallocation of Risks

When it has been determined where the risks are allocated and that the allocation is at arm’s length, the consequences of bearing the risks are that this party also bears the costs of handling and minimizing the risks. The risk-bearing party also bear all costs which may arise in case the risks are realized. However, the party bearing the risks is usually remunerated by an increased share of the anticipated profit, as mentioned previously.\textsuperscript{92}

A reallocation of the risks can be seen as both negative and positive in regards of its effects on the parties. For the transferor, it can be positive to not longer bear the risks of the potential losses and liabilities, which can be seen as a negative effect from the transferee’s point of view. Opposite\textsuperscript{9}ly, potential profit connected to the allocation of the risks may be recognised by the transferee rather than by the transferor, which obviously is a negative effect for the transferor.\textsuperscript{93}

When examining the consequences of a risk allocation it is important to assess whether the reallocated risks are economically significant. In case the risks are assessed to be economically significant the extent of the consequences can be seen as more essential for the associated parties involved in the transaction. That is since economically significant risks that are reallocated generally imply reallocation of significant profit potential. To

\textsuperscript{91} OECD Guidelines, paras. 9.37-9.38.

\textsuperscript{92} OECD Guidelines, para. 9.39.

\textsuperscript{93} OECD Guidelines, para. 9.40.
determine whether a risk is economically significant specific aspects have to be considered. These are the risk’s size, how likely it is that the risk will be realized, the risk’s predictability and the mitigation potential of the risk. To assess whether the risks are economically significant is also important from the perspective that an enterprise at arm’s length probably would not have transferred an economically significant risk in exchange for considerably reduced profit potential.94

3.6 Concluding Remarks

The guidance concerning business restructurings at arm’s length is a new set of directions incorporated in 2010. How this guidance actually will clarify business restructurings between related parties is thereby still uncertain. However, the specification of how to assess whether business restructurings are at arm’s length appear necessary since the original arm’s length regulations are difficult to apply on restructurings where both parties are converted during the restructuring process as in Corporate Group C’s case.

As shown in this chapter the different distribution models imply different levels of involvements in regards of assets used, functions performed and risks assumed. The level of involvement further affects the party’s expected return and profit rate whereby a restructuring of a distributor such as Enterprise A most probably will result in a shift in the anticipated return between the restructuring parties. However, that is not an answer to whether the shifted profit potential should be remunerated.

It is also seen that the different levels of involvement are reflected in the different pricing methods used by different distribution models when pricing controlled transactions. For instance, a commission agent’s involvement is low and the agent does not take title to goods whereby the C+ method is preferable since the transactions rather have the characteristics of services. Oppositely, a fully fledged distributor’s involvement is high and the contribution is usually unique; thus the PSM possibly would be applicable.

The fundamental aspects to consider when assessing whether the risk allocation is arm’s length are accordingly which party that has the greater control over the risks as well as which party that has the financial capacity to assume the risks. The party which has the control and the financial capacity should in general be considered as the party which at arm’s length bears the risks. It is also of great interest to evaluate whether the risk

94 OECD Guidelines, para. 9.41.
reallocation is economically significant since that generally implies a reallocation of significant profit potential as a consequence.

The trends within business restructurings tend to be the centralization of business activities and as a result distributors are stripped on functions and become low-risk entities; which is the scenario for Swedish Enterprise A. The anticipated profits of the stripped distributors thereby decrease due to the lower level of involvement. Whether this decreased profit potential should be remunerated since it is transferred to another related party is then the significant issue. Consequently, an examination of when a shift in profit potential between the restructuring parties should be remunerated follows in the next chapter and thus whether Enterprise A may receive remuneration when stripped on functions.
4 Shifted Profit Potential

4.1 Introduction

Profit potential can be defined as expected future profits. However, in the perspective of business restructurings, profit potential should not be defined as just the profit that would have arisen if the structure before the restructuring had remained.95

Business restructurings can be expected to result in a reallocation of profit between the enterprises within a corporate group. As a result, countries involved in transfers of rights and assets due to a business restructuring may be qualified to lower profit potential. This obviously may lead to concurring tax claims from the countries involved. For instance, if profitable functions are transferred, the transferor’s resident country might be tempted to anticipate that the transferor will be compensated and further tax that compensation.96

To decide whether the restructuring itself should be compensated, it is essential to understand the process. Understanding the restructuring itself as discussed in section 3.2 means to consider which restructuring modifications that have been made, how the enterprises’ functional analysis is affected by the changes, the fundamental business reasons, expected benefits and what other options that realistically were available for the parties.97

The concept of profit potential is in many cases used for valuations matters when it is found that compensation would have been paid between independent parties under similar circumstances. Such valuation situations may arise when arm’s length compensation should be paid for a transfer of intangibles, a transfer of an activity, or the termination or significant renegotiation of the current agreement.98

97 OECD Guidelines, para. 9.68.
98 OECD Guidelines, para. 9.66.
4.2 Remuneration for Transferred Profit Potential

4.2.1 The General Approach

It is not certain that an independent enterprise would receive any compensation for the business restructuring itself since the arm’s length principle not oblige any compensation just by reason of an enterprise’s decreased profit potential. Instead, the essential questions when applying the arm’s length principle on business restructurings is whether or not there has been a “transfer of something of value”, or a “termination or significant renegotiation of the current agreement” between the parties. And, whether compensation would have been given under similar circumstances between independent enterprises.\(^9\)

The general approach is found in the OECD Guidelines.\(^10\) The phrasing is as follows:

“… if an entity has no discernable rights and/or other assets at the time of the restructuring, then it has no compensable profit potential. On the other hand, an entity with considerable rights and/or other assets at the time of the restructuring may have considerable profit potential, which must ultimately be appropriately remunerated in order to justify the sacrifice of such profit potential.”\(^11\)

4.2.2 Transfer of Something of Value

When considering transfer of something of value (rights and/or other assets), tangible assets, intangible assets, transfer of activity and outsourcing are included. A transfer of tangible assets does not in general create any difficult transfer pricing issues.\(^12\)

However, when transferring intangible assets, both identification issues as well as valuation issues may arise. That is partly since not all intangible assets are registered or recorded in the accounts. The arm’s length price in regards to intangible assets should be determined by looking at different factors which may affect the value. These factors are particularly the duration, restrictions attached, nature of the assets and the riskiness of the anticipated benefits from using the intangible assets.\(^13\) In addition, the pricing at arm’s length should be determined by taking into consideration the performed functions, used assets and

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9 OECD Guidelines, para. 9.65.
10 OECD Guidelines, para. 9.67.
11 OECD Guidelines, para. 9.67.
13 OECD Guidelines, paras. 9.80-9.81.
assumed risks by each involved party. Another essential valuation aspect regarding intangible assets is when the value is considered highly uncertain at the time when the transaction is made. This is most significant when a considerable gap occurs between the anticipated prospect profits determined at the time when the transfer was made, and the definite profits that the transferee has actually gained by using the intangible assets. In case the valuation is found highly uncertain at the time when the transaction is performed, arm’s length parties probably would have determined the price by using an adjustment clause or would have renegotiated. In case the controlled transaction’s valuation is considered as sufficiently uncertain at the time when the transfer takes place, and not merely uncertain, it could be justified to adjust the price of the intangible assets to what would have been renegotiated or adjusted between independent parties. Regarding the identification issue of intangible assets, such issues may arise when attempting to identify assets as for example marketing intangibles that has been locally developed; or contractual rights that are to be recognized as valuable intangible assets.

A transfer of something of value can as well be the transfer of activity, which means a transfer of assets which are connected with the capability to execute specific functions and to bear specific risks. It could for example be the transfer of assets that enables the transferee to perform research and development (R&D) functions or manufacturing functions. Transfer of an activity must not be a profit-making activity. It can just as well be a loss-making activity where the benefiting party is the transferor since the restructuring results in an elimination of future losses that are greater than the costs of the restructuring. The questions are then whether an independent party would have paid for reducing its loss-making activity through a restructuring and whether an independent party would agree on purchasing such activity. And further, if it rather is an option to terminate the activity. However, it also has to be mentioned that the situation would have been different if the loss-making activity could bring other advantages such as synergies with other activities performed by the same party.

104 OECD Guidelines, para. 9.85.
105 OECD Guidelines, paras. 9.87-9.88.
107 OECD Guidelines, para. 9.93.
108 OECD Guidelines, paras. 9.96-9.98.
At last, a transfer of something of value could also be constructed by an outsourcing arrangement where for example a manufacturing and distributing enterprise decides to outsource the manufacturing function to an associated enterprise in another state resulting in lower costs. If this transaction would have been made at arm’s length, the transferor would not necessarily have claimed any compensation from the transferee; under the circumstances that the expected savings, due to the function restructuring, were larger than the costs of the restructuring.109

4.2.3 Termination or Significant Renegotiation of the Current Agreement

Termination or significant renegotiation of a current agreement can result in disadvantages such as costs for restructurings and possibly shifted profit potential. A renegotiation of an agreement may as well lead to a change in the bearing of risks between associated parties. And by that, a reallocation of the profit potential. It is in this perspective the question arises of whether an independent enterprise possibly would have compensated the restructured party for not bearing the risks anymore. And if so, how the compensation would have been determined.110

To determine whether the agreement’s termination or significant renegotiation at all can be compensated at arm’s length, there are different aspects to consider. These are:

i. Firstly, whether the agreement that is terminated or renegotiated exists in writing and includes a compensation clause;

ii. Secondly, whether the terms of the agreement conform with the arm’s length principle;

iii. Thirdly, whether legislation and case law include rights for compensation; and

iv. Lastly, whether an independent enterprise would have compensated the suffering party in a situation of termination or renegotiation of a current agreement.111

To examine whether the terminated or renegotiated agreement exists in writing is thereby the starting point. If not, the contractual connection between the parties has to be determined by their conduct. However, if a written contract exists, the possible

110 OECD Guidelines, para. 9.100.
111 OECD Guidelines, para. 9.103.
compensation clause has to be identified. The contractual right to compensation could also have the form of for example a guarantee for terminations. However, even if the contract does not include a clause regarding compensation or any other kind of guarantee, compensation could still be in accordance with the arm’s length principle.\textsuperscript{112}

Further as described above, it is useful to decide whether the terms of the agreement are at arm’s length, regardless of if the terms include a compensation clause or not. Especially since the contractual interests between associated enterprises almost certainly are more alike than those between independent enterprises where it is more probable that an interest divergence exists regarding the contractual terms. When comparable terms can be found in a comparable situation, the terms between the associated parties should be considered as at arm’s length. On the other hand, when comparable terms cannot be found, each parties’ rights and assets at both the time when the agreement arose as well as at the time for the termination or renegotiation should be considered in order to decide whether independent parties would have agreed on similar terms. It could also be useful to assess whether there are any options realistically available for the parties. In the process of deciding whether the terms are arm’s length it could further be good to examine both the termination terms as well as the compensation terms since those could be connected. For instance, the existence or non-existence of termination terms could affect the risk-bearing of the parties, which further could affect the compensation in case the agreement has been terminated.\textsuperscript{113}

When examining whether associated parties are at arm’s length, it is always important to consider if independent parties would have been influenced by the present circumstances and terms. Regardless of whether there is a comparable transaction or not. One aspect that would have influenced independent parties’ contractual terms, and therefore is important to consider between associated parties, is the situation where a terminated agreement has required one of the parties to make a considerable investment in exchange of an arm’s length compensation if the agreement continued for a longer time. Those potential terms would create a risk for the investing party from the perspective that the agreement could be terminated before the party is entitled to any compensation. This aspect would have been considered between arm’s length parties and should thus also be considered between

\textsuperscript{112} OECD Guidelines, paras. 9.104-9.105.

\textsuperscript{113} OECD Guidelines, paras. 9.106-9.107.
associated parties, since the risk is significant for the contractual terms.\textsuperscript{114} In the light of risks, it additionally becomes important to decide whether the risk allocation is arm’s length,\textsuperscript{115} which was described in section 3.5.2.

Legislation and case law regarding right to compensation could be useful to examine when determining the potential compensation for the terminated or renegotiated agreement. For instance, it may be the terminated party’s right to claim compensation before a court. However, it is doubtful that associated enterprises would litigate against each other in such an issue.\textsuperscript{116} Since Enterprise A is a Swedish entity, Swedish legislation and case law become significant to the extent such material exists. In regards of a buy-sell distribution agreement, it is generally not possible to terminate a long-term agreement without a notice period due to general Swedish civil law principles. However, there is no mandatory regulations in the area.\textsuperscript{117} Nevertheless, for a commissionaire it is possible to receive remuneration if an agreement is terminated.\textsuperscript{118}

When considering whether an independent party would agree on compensating the suffering party when an agreement either is terminated or significantly renegotiated will in practice result in an indirect consideration of whether compensation could be paid at arm’s length between associated parties. When examining compensation from this point of view it accordingly becomes necessary to identify the contractual terms to find out what independent companies would possibly gain, and thereby would be willing to pay for, in terms of compensation for a termination or a renegotiation.\textsuperscript{119} If the circumstances for instance are that a distributor terminates its manufacturing contract with its contracted associated manufacturer to instead use another associated manufacturer there are several compensation alternatives that could be possible between independent enterprises under similar circumstances. Nevertheless depending on the terms and thereby what the restructuring benefits could be for the independent parties. For example, the terminating distributor might be willing to remunerate its earlier manufacturer if the savings that arise

\textsuperscript{114} OECD Guidelines, para. 9.109.
\textsuperscript{115} OECD Guidelines, para. 9.111.
\textsuperscript{116} OECD Guidelines, para. 9.115.
\textsuperscript{117} Lehrberg, Bert, *Avtalsrättens grundelement*, pp. 62-64.
\textsuperscript{119} OECD Guidelines, para. 9.118.
from the restructuring are greater than the compensation paid to the suffering manufacturer.\textsuperscript{120} Another potential outcome could be that the new contracted manufacturer would be willing to compensate the terminated manufacturer in order to get the contract with the distributor; if the expected benefits in terms of profit from the new agreement are greater than compensation paid to the earlier manufacturer. In this case, the compensation could be seen as an investment from the new manufacturer’s perspective. It could also be the case that the distributor and the new manufacturer would share the costs of the compensation; but also that none of these parties are motivated to compensate the suffering manufacturer. Instead it could be a part of a restructuring between the distributor and the new manufacturing company which would be compensated by these enterprises’ parent company to the independent suffering manufacturer since the corporate group as a whole will gain from the restructuring in terms of synergies, after having terminated the agreement with the independent manufacturer.\textsuperscript{121}

4.3 German Treatment of when Transferred Profit Potential Should Be Remunerated

The German legislation has another approach to remuneration of lost profit potential. The general procedure is accordingly explained hereafter.

A restructuring can involve a reallocation of functions if a function and its associated chances, risks, assets and other benefits (the transfer package), are reallocated to a foreign associated enterprise. When a business restructuring results in this kind of a situation, the transferring entity must receive remuneration from the receiving entity according to German legislation.\textsuperscript{122}

The remuneration should be decided by making a comparison with a comparable transaction. However, when a comparable transaction cannot be found, the remuneration should be decided by applying a hypothetical arm’s length test which is done by analyzing changes in the profit potential of both the transferring and the receiving enterprise. The change in profit potential of the transferring party should be regarded as the minimum

\textsuperscript{120} OECD Guidelines, para. 9.119.

\textsuperscript{121} OECD Guidelines, paras. 9.120-9.122.

remuneration for the restructuring while the change in profit potential of the receiving party should be regarded as the maximum remuneration for the restructuring.\footnote{The German Foreign Tax Code, In German: Aussensteuergesetz, Sec. 1, para. 3 and The German Decree-Law on the relocation of functions, In German: Funktionsverlagerungsverordnung, Sec. 7, Sec. 1, para. 4 and Sec. 3, para. 2.} 

The original German business restructuring legislation explained above has been widely criticized and amendments have been made which came into force in April 2010. The implication of the rules after the changes is still that the hypothetical arm’s length test and the transfer package should be the general procedure if no comparable transaction can be found. However, the two previous escape clauses to avoid this general procedure have been supplemented with an additional third escape clause. In practice the application of the escape clauses imply the avoidance of the procedure of evaluating the transfer package as whole and instead individual evaluations of the items within the transfer package are made. The two original escape clauses imply that a transfer package evaluation is avoided if the taxpayer convincingly proves that no significant intangible assets have been transferred due to the restructuring or that the sum of the individual transfer prices is corresponding with the arm’s length price which is determined by considering the transfer package. The new third escape clause implies that evaluation of the transfer package as a whole can be avoided if the taxpayer convincingly proves and accurately describes that at least one material intangible is subject to the restructuring. In that case, this or these material intangibles can be priced individually.\footnote{The German Foreign Tax Code, In German: Aussensteuergesetz, Sec. 1, para. 3, sentence 10 and Lindholm, Pernille & Richter, Christoph, Transfer Pricing Treatment of a Business Restructuring from a Danish and German Perspective, IBFD, International Transfer Pricing Journal, Issue 5, September/October 2010, p. 342.}

### 4.4 Concluding Remarks

The general approach in regards of remuneration for shifted profit potential is consequently that profit potential not constitutes an asset in itself that can be remunerated. Thus, the question is rather whether there are considerable rights and/or other assets transferred that carry considerable profit potential which should possibly be arm’s length remunerated.

To find out whether a transfer of considerable rights or assets has been made the question can be rephrased to whether there has been a “transfer of something of value” or a
“termination or significant renegotiation of the current agreement”. And obviously, whether independent parties would have been willing to compensate the suffering party.

From Enterprise A’s perspective in regards of transfer of something of value, intangible property and transfer of activity are of relevance. That is since a restructuring of the fully fledged distributor Enterprise A probably not would result in a transfer of considerable tangible assets as mentioned in section 3.1 and as seen in chart 3-1. And further, since outsourcing does not correspond with the restructuring case of Enterprise A. Moreover, when restructuring Enterprise A from a fully fledged distributor to a stripped distributor assuming lower or none risks, a termination or significant renegotiation of the entity’s current agreement is doubtlessly made. In this part, it is rather a question of whether the termination or renegotiation would have been compensated at arm’s length. This issue is crucial since a renegotiation generally leads to a shift in the bearing of risks and thereby a shift in the allocation of profit potential.

The German treatment of transferred profit potential is interesting when comparing it to OECD’s and Sweden’s treatment of shifted profit potential. As seen, OECD’s standpoint is much more precautious and vague which in my opinion seems more realistic due to the large differences that occur in each separate transaction and restructuring. The German treatment is thereby an interesting approach in comparison to the general approach of OECD’s member states. However, in cases where a restructuring should be compensated according to the OECD Guidelines, the German treatment and OECD’s treatment are not that much different. Nevertheless, in theory the German treatment seems rather unbalanced due to the fact that every restructuring is unique and that a case-by-case procedure seems necessary.

As seen above, intangible property can possibly be considered as falling within the scope of “significant rights and assets which carry considerable profit potential”. Hence, the next chapter will further examine this kind of property in its different forms.
5 Considerable Rights and Assets Carrying Considerable Profit Potential

5.1 Introduction
The uniqueness and nature of intangible property makes it especially difficult to recognize these assets in transactions between associated parties. However, to recognize the transfer and the allocation of intangible property is of great importance since intangible property is nearly connected with the allocation of profit. Consequently, intangible property may be regarded as a considerable right or asset which carries considerable profit potential that should be remunerated.\(^{125}\)

This chapter aims to examine some considerable rights and assets which possibly carry considerable profit potential that may be remunerable when restructuring a fully fledged distributor such as Swedish Enterprise A. Consequently, intangible property will be scrutinized below.

5.2 Intangible Property

5.2.1 Intangible Property Transfers at Arm’s Length
The reason to give intangible property and especially transfers of intangible property, particular attention depends on the difficulties in evaluating intangible property transactions for tax purposes.\(^ {126}\) Intangible property means the rights to use industrial assets as for example patents, trademarks, trade names, designs and models. The notion also includes intellectual property (IP) such as trade secrets and know-how. Intangible property associated with commercial activity, including marketing activities, may have considerable value even though they may not have any book value in an entity’s balance sheet. There may also be significant risks associated with intangible property such as product liability and environmental damages.\(^ {127}\) Commercial intangibles should be divided in trade intangibles and marketing intangibles due to the different nature of the property. Trade intangibles, such as patents, are generally developed through R&D which is risky and


\(^{126}\) OECD Guidelines, para. 6.1.

Marketing intangibles include for example trademarks, trade names, distribution channels and customer lists. Know-how and trade secrets can also constitute marketing intangibles, but also trade intangibles. The value of marketing intangibles is affected by different factors such as the reputation and credibility of a trade name as well as the distribution and availability of the marketed goods or services. Regarding both trade and marketing intangibles, the actual existence of the property should be determined with caution. That is since not all R&D or marketing activities actually result in valuable intangibles.129

Applying the arm’s length principle on intangible property can be complicated due to the difficulties that may arise when trying to determine the property’s value as well as when trying to find comparable transactions. To a large extent that depends on the special character of intangible property. When applying the arm’s length principle on transactions of intangibles, the transfer has to be considered in the perspective of both the transferor and the receiver. This means that the pricing has to be made so that an independent transferor would be willing to transfer the intangibles, but also so that an independent receiver would be willing to pay the price set.130

When applying the arm’s length principle on transfers of intangible property there are special comparability factors of relevance. These are, among other, the expected benefits from the intangible property; limitations on the geographic area where the rights can used; export restrictions on goods produced by using the transferred intangibles; the exclusive or non-exclusive character of the transferred rights; the capital investment; the possibility of sub-licensing; and whether the licensee has the right to participate in further developments of the property by the licensor.131 When marketing intangibles, such as a trademarks, are involved the comparability analysis should consider the value added by the trademark, taking into account consumer acceptability, geographical significance, market shares and sales volume, among other. Moreover, when trade intangibles are involved, the

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128 OECD Guidelines, para. 6.3.
129 OECD Guidelines, paras. 6.4-6.6.
131 OECD Guidelines, para. 6.20.
comparability analysis should consider the value attributable to such intangibles, as for example protected patents, and the importance of the current R&D functions.\textsuperscript{132}

Due to the special character of intangible property, the valuation can be very uncertain at the time when the transaction is made. As always when applying the arm’s length principle, the fundamental is what independent parties would have done under comparable circumstances. One way that independent enterprises possibly could have handled the uncertainty, is by using the anticipated benefits as a way to determining the price. That would then be done by considering the degree of predictability of the subsequent development. Under certain circumstances, an independent enterprise might find the estimations reliable enough to fix the transfer price on the basis of these estimations without any later possibility to make future adjustments. However, it could also be the case that such estimations are not reliable enough to fix the price according to an independent enterprise. Then an adjustment clause could be included in the arrangement or the enterprises might agree on an arrangement with shorter terms.\textsuperscript{133}

5.2.2 \hspace{1em} \textit{Forms of Transferring Intangible Property}

Due to the uniqueness and nature of intangible property, it is especially difficult to recognize intangibles in transactions between associated enterprises, as mentioned above. A transfer of intangible property can be made in different ways where three main approaches can be recognized. These three ways of transferring intangible property are by a sale arrangement, by a licensing arrangement and by a cost contribution arrangement (CCA).\textsuperscript{134}

When a transfer is made due to a sale, the legal ownership and the control of the assets are transferred to the transferee. This alternative may be useful when the intangible property is not entirely developed yet and thereby does not carry significant profit potential. If the intangible property is transferred by a licensing arrangement, the transfer does not involve any transfer of legal ownership. Instead the transferee receives the right to use the assets for a specific period of time generally in exchange of royalty to the transferor. The third way of transferring intangibles is by a CCA which means that the associated enterprises

\textsuperscript{132} OECD Guidelines, para. 6.24.

\textsuperscript{133} OECD Guidelines, paras. 6.28-6.30.

\textsuperscript{134} Bakker, Anuschka, \textit{Transfer Pricing and Business Restructurings, Streamlining all the way}, IBFD, Amsterdam, 2009, pp. 37-38.
agree to share the costs and risks of developing the intangible property, in exchange of becoming joint owners who gain the exclusive rights in their respective country.\textsuperscript{135}

As mentioned, the transfer and allocation of intangible property is nearly connected with the allocation of profit. To obtain recognition of the transfer it is important that the restructuring is real both legally and economically, and in substance.\textsuperscript{136}

5.2.3 Ownership of Intangible Property
The ownership of intangible property is essential in order to determine which party that is entitled to the return deriving from the intangibles. There are three forms of ownerships that can be distinguished. These are legal ownership, economic ownership and ownership by agreement. A legal ownership is when the property is legally protected. Economic ownership occurs when an entity has created the property and has invested in it significantly. Ownership by agreement intends when a partial transfer of property has been made due to for instance a license agreement. Economic ownership is more essential than legal ownership. When no legal ownership exists, the economic ownership overcome; and if the economic ownership and the legal ownership are not consistent, the economic ownership overrides.\textsuperscript{137}

5.2.4 Marketing Intangibles
Marketing intangibles include among others research, sales strategies and public relations. These intangibles are generally the result of the performed marketing research and sales activities.\textsuperscript{138} When market activities are performed by an enterprise which does not take title to the trademark or trade names that it promotes, difficulties may arise regarding how the enterprise should be compensated. One example could be when a distributor is promoting branded goods. Possibly, the marketer could be compensated due to the possible return

\textsuperscript{135} OECD Guidelines, para. 8.3 and Bakker, Anuschka, \textit{Transfer Pricing and Business Restructurings, Streamlining all the way}, IBFD, Amsterdam 2009, p. 39.

\textsuperscript{136} Bakker, Anuschka, \textit{Transfer Pricing and Business Restructurings, Streamlining all the way}, IBFD, Amsterdam, 2009, p. 40.

\textsuperscript{137} Hamaekers, Hubert, \textit{Transfer Pricing}, IBFD, accessed 15 October 2010 from http://online.ibfd.org.bibl.proxy.hj.se/kbase/, Sec. 15.3.

attributable to the marketing intangibles.\textsuperscript{139} Regarding whether the marketing distributor should be compensated depends to a large extent on whether the distributor bears the costs of the marketing activity or if those costs are borne by the owner of the marketing intangibles. If the costs are borne by the marketer itself, it is more likely that this party will be compensated for return attributable to the marketing intangibles.\textsuperscript{140}

It is crucial to determine whether a restructured distributor like Swedish Enterprise A has developed, and thereby takes title to, any marketing intangibles before the restructuring. The importance of establishing whether Enterprise A takes title to any marketing intangibles depends on that if the entity not has developed any marketing intangibles, it is probable that a change in the entity’s functions not involves any transfer of intangible property at all. The marketing intangibles are thus essential and have a clear impact on whether the restructured entity will receive any exit compensation for the shifted profit potential or not.\textsuperscript{141}

5.2.5 Case Law: The Cytec Norge Case

The Cytec Norge Case\textsuperscript{142} was one of the first court rulings concerning transfer pricing consequences of a business conversion or restructuring. The case concerned the fully fledged manufacturer and sell entity Cytec Norge KS which was converted into a toll manufacturer due to a business restructuring. Before the restructuring, Cytec Norge KS had sold goods, while after the restructuring; Cytec Norge KS only provided services to the new principal CIE by means of manufactured goods for CIE. The toll manufacturer Cytec KS received compensation on a cost-plus basis and thereby experienced a considerable reduction of income and profit in comparison to before the restructuring. The changed income and profit could be explained with the changes in the nature of business that was performed. In connection with the restructuring, the principal CIE bought the stock of Cytec Norge KS as well as paid for the manufacturing know-how.


\textsuperscript{140} OECD Guidelines, paras. 6.37-6.38.


\textsuperscript{142} HR-2008-50-U, Cytec Overseas Corporation Inc, Cytec Overseas Corporation NUF and Cytec Norge GP AS, Decision of the Norwegian Supreme Court (11 January 2008).
The issues in the case were whether the conversion had resulted in a transfer of intangible assets from Cytec Norge KS to CIE and whether Cytec Norge KS should receive an arm’s length compensation due to the conversion. The Court held that when a company within a corporate group is converted from a fully fledged manufacturer and selling entity to a contract manufacturer against a cost-plus based compensation, a transfer of significant trade and marketing intangibles occurs in the principal’s favour. Thereby, Cytec Norge KS did not receive sufficient remuneration for the transferred intangible property which the entity took title to and had developed over the years. It was further found by the Court that no independent party would agree on the transfer and the restructuring without being paid an appropriate remuneration.

In the Cytec Norge Case, the Court to large extent based its decision on an interpretation of the contracts which the parties had entered into. What further can be considered established in the case is that a mere (1) transfer of functions and/or risks, (2) loss of profit potential and (3) termination of contractual rights should not necessarily trigger the compensation payment in a business restructuring. However, what should trigger a compensation payment is either a transfer of property due to any of the above mentioned factors or where the converted party does not have any other options realistically available or reason to participate in the restructuring.\(^\text{143}\)

5.3 Concluding Remarks

Intangible property is difficult to value and identify. Not least since activities as for example marketing activities not necessarily result in valuable intangibles and may not have a book value in the balance sheet. The value of intangible assets is influenced by the expected benefits, such as profit potential. From Enterprise A’s point of view it is important to identify marketing intangibles, if any, since these intangibles generally are the only intangible property transfers that may take place in a restructuring where a distributor is stripped on functions; and since marketing intangible can be greatly affected by the distributor’s marketing activities.

When having examined intangible property in this chapter, it seems possible to conclude that marketing intangibles might fall within the scope of considerable assets and right carrying considerable profit potential, not least by reason of the Norwegian case law which potentially can be used as guidance in Swedish Enterprise A’s case. The next chapter is the analysis chapter where all parts presented in this thesis are considered together with the intention to come to a final conclusion.
6 Analysis

6.1 Introduction

This chapter intends to analyze facts and information that have been considered and mentioned in previous chapters and references. No new facts will occur in this chapter since it only intends to analyze already given facts.

The original issue presented in the first chapter concerned when shifted profit potential due to a business restructuring should be remunerated. However, during the study it has become ascertained that it actually is not definite that any remuneration is to be paid. The arm’s length principle does not require any remuneration for the mere shift of profit potential when applying the principle on business restructurings. Instead, the questions are whether there has been a transfer of something of value or a termination or significant renegotiation of the current agreement. In the context of remuneration for shifted profit potential the questions can be rephrased to whether there are considerable assets and/or rights transferred which carry considerable profit potential that should be remunerated. And, whether the arm’s length principle requires compensation to be paid by reference to the concept of “options realistically available”.

Consequently, to assess whether Enterprise A should be remunerated for the shifted profit potential there are three main aspects to consider. These are presented below.

i. Whether the restructuring is at arm’s length in terms of restructuring motives; transfers of functions, assets and risks; and whether Enterprise A could be remunerated in the light of the concept “options realistically available”;

ii. Whether the restructuring of Enterprise A has resulted in any “transfer of something of value” which should be remunerated; and

iii. Whether the termination or significant renegotiation of Enterprise A’s agreement would have been remunerated between independent parties.

6.2 (i) Restructuring at Arm’s Length and Remuneration in the Light of the Concept “Options Realistically Available”

When considering whether the restructuring of Enterprise A is at arm’s length, it is assumed that no comparable uncontrolled transaction or restructuring can be found as stated in the scenario described in section 1.1. Instead, the restructuring has to be evaluated
from the aspects described in section 3.2, in order to determine whether independent parties would have been willing to agree to the same conditions in comparable circumstances. Which risks, assets and functions that have been transferred depend on the extent of the stripping as seen in chart 3-1. However, the restructuring of Enterprise A will probably not imply any substantial changes; instead the restructuring will rather imply changes in the allocation of risks and functions.

In order to determine whether the allocation of functions is at arm’s length the contractual arrangement as well as the conduct of Enterprise A and Enterprise B, before and after the restructuring, should be scrutinized to establish the correct allocation of the functions. The functions that should be reallocated depends on the extent of the restructuring as can be seen in chart 3-1. However, the functions that can be transferred are: taking title to goods; warehousing and logistics; quality control; price setting; after-sales support; warranty and repairs; and invoicing and collection. The essential in terms of arm’s length is accordingly that the actual allocation of the functions, after the stripping, is reflected in Enterprise A’s and Enterprise B’s written agreement as well as derivable from their conduct.

The risks which should be reallocated from the stripped entity Enterprise A to its parent company Enterprise B depend on the extent of the restructuring as can be seen in chart 3-1. The risks that possibly can be transferred are: inventory risk; market risk; bad debt risk; product liability risk and foreign exchange risk. However, to determine whether these risks are allocated at arm’s length the scrutiny should include two supplementary factors than just the contractual arrangement and the conduct of Enterprise A and Enterprise B. It thus has to be seen whether Enterprise B after the restructuring has the greater control over the risks and whether Enterprise B has the financial capacity to assume the risks. If so is the case, the risk allocation should be considered as at arm’s length and no adjustments would be necessary.

Corporate Group C’s restructuring motives are given in section 1.1. The restructuring is done with the intention to streamline the business by centralizing the business activities, though it is not certain that the aim actually will be realized in practice. However, the intention of Corporate Group C could very likely have been independent enterprises’ restructuring motives and as a result the motives and aim should be considered as at arm’s length.
Moreover, the options realistically available has to be considered. That is since independent parties would not enter into a restructuring if there are other options that are more attractive. The bargain position of Enterprise A thereby has to be assessed in the perspective of the concept “options realistically available” to determine whether any remuneration should be paid. The potential options for Enterprise A are considered to be the ones presented below.

1) **Terminate the existing contract with Enterprise B and start to distribute products from third parties.**

This alternative does not seem probable or more attractive for Enterprise A. Firstly because many competitors on Enterprise A’s market probably already have their well established distribution networks. And secondly because the third party companies, whose products Enterprise A possible could distribute, would most likely already have their own production activities, research and design etc. Accordingly Enterprise A would probably only receive compensation for its regular marketing and sales activities anyway which would be the same level of profit as if Enterprise A accepted to be restructured in Sweden. As a result, this option is not to be considered as more attractive.

2) **Terminate the existing contract with Enterprise B and start to manufacture its own products.**

Neither this option seems more attractive. Since Enterprise A at the present is a fully fledged distributor it does not have the competences needed to perform product research and design or production activities. In addition, this alternative would require major investments in technological R&D in order to enable Enterprise A to produce comparable products as the ones it distributes today. To produce comparable products would most likely be necessary for Enterprise A in order to keep and please its own already existing customer network. Consequently, this alternative does not seem more attractive from Enterprise A’s perspective.

3) **Close down its distribution operations.**

To close down Enterprise A’s distribution operations is clearly not a more favourable option since it would leave Enterprise A with no future income and neither any right to receive remuneration. This option is thereby no option realistically available.
4) **Refuse to enter into the restructuring.**

As mentioned in section 3.2.3, not entering into a restructuring should also be considered as an alternative. However, Corporate Group C’s motive is to streamline the business in order to stay competitive on a fiercely competitive market. Thus refusing the restructuring is not an realistically available option.

5) **Accept the restructuring, become a stripped distributor and as a result receive a reduced profit potential.**

In the light of the options presented above this fifth alternative, Enterprise A does not have any options that are more attractive than to accept the restructuring. To accept the restructuring is thereby the most realistically available option for Enterprise A.

When having examined the possible, and not possible, options for Enterprise A it appears that accepting the business restructuring and becoming a stripped distributor with reduced profit potential is the most attractive option. Consequently, there are no other options realistically available whereby no remuneration should be paid to Enterprise A due to shifted profit potential from the perspective of the concept of “options realistically available”. Oppositely, if there would have been other options realistically available for Enterprise A, its bargain power would have been greater and consequently the chances of being remunerated as well.

The importance of “options realistically available” is evident after having considered when shifted profit potential should be remunerated. However, Enterprise A’s scenario is most likely not an exceptional case with unique circumstances. Thus one get the sense that from a corporate group perspective, the options realistically available is rather limited and consequently the possibilities to be remunerated by reference to the concept of “options realistically available” as well.

6.3 (ii) **Arm’s Length Remuneration due to a Transfer of Something of Value**

To possibly remunerate Enterprise A for a transfer of something of value it firstly has to be examined whether Enterprise A has something of value that at all can be transferred, legally or economically, from Enterprise A to Enterprise B.

In terms of tangible assets, Enterprise A in the present arrangement takes title to the goods. Since that will not be the case in the post-restructuring situation, these assets will be
transferred to Enterprise B. However, as described in section 1.1, the transfer of inventories will be priced at arm’s length and as a result no further compensation is probable for any tangible assets.

In terms of intangible assets, no trademarks or brands will be transferred since Enterprise B already takes title to these. Instead, the question of whether any local marketing intangibles have been transferred has to be assessed since Enterprise A’s possibilities to be remunerated due to a transfer of something of value is critically depending on whether Enterprise A possesses any local marketing intangibles, for example due to intense implementation on the Swedish market.

If taking guidance in the Norwegian Cytec Norge Case, it seems likely that Enterprise A could possess considerable local marketing intangibles that should be remunerated due to a transfer of the property to Enterprise B. However, the major difficulties of identifying and valuing such assets make the remuneration issue concerning the intangibles especially difficult.

What needs to be assessed in regards of marketing intangibles are whether any intangibles at all exists; whether Enterprise A takes title to the intangibles; and whether the intangibles can be considered significant and valuable. Whether Enterprise A takes title to any local marketing intangibles depends on whether the entity has borne the risks and the costs for developing the intangibles; as for example customer lists, distribution channels, know-how and customer relationships. As Enterprise A before the restructuring was a fully fledged distributor it is very likely that the entity has borne the costs and the risks for developing marketing intangibles by performing marketing activities. In terms of risks, the investment risk is probably the greatest risk assumed by Enterprise A when developed the marketing intangibles, given that it is not certain that the investment in marketing activities actually will result in any valuable marketing intangibles. To bear the costs and the risks are thereby closely connected when developing valuable marketing intangibles.

Consequently, the fully fledged distributor Enterprise A most likely takes title to the marketing intangibles if any identified and thereby possesses the economic ownership. When the intangibles have been transferred in the business restructuring, Enterprise B will probably be the owner of the intangibles since the business restructuring is made with the intention to centralize the business activities in order to streamline the business model and stay competitive on the market. Enterprise B should thereby bear the costs and the risks of
the property, after the restructuring, in order for the transaction to be at arm’s length. Regardless of whether Enterprise B is the legal owner after the restructuring it is important that Enterprise B is the economic owner whereby bearing the risks and costs of the transferred intangibles are necessary.

Whether the marketing intangibles are valuable are affected by the trademark’s reputation and credibility as well as the availability of the marketed goods. If Enterprise B's brands and trade names are credible and have a good reputation as well as are highly available on the market, it is likely that the local marketing intangibles are valuable and thus remunerable if existing. However, the valuation and identification should be made with caution whereby a definite answer is hard to provide and is dependent on the circumstances in Corporate Group C’s case. Nevertheless, one must always bear in mind and go back to the arm’s length principle and the question of whether third parties would be willing to pay for the transfer of the intangible assets.

6.4 (iii) Termination or Significant Renegotiation of the Current Agreement Resulting in Arm’s Length Remuneration

Remuneration to Enterprise A could lastly be adequate if the termination or significant renegotiation of Enterprise A’s agreement would have been compensated between independent parties. As described in section 4.2.3 there are four aspects to consider in order to decide whether compensation should be paid between independent entities; and consequently between Enterprise A and Enterprise B. These aspects is therefore assessed below.

1) Whether the agreement that is terminated or renegotiated exists in writing and includes a compensation clause.

The written contract has an essential impact on whether compensation should be paid. As seen in the Cytec Norge Case, the contract is heavily relied upon from an evidence perspective. Consequently, whether Enterprise A and Enterprise B have agreed on a compensation in case of termination is thereby critical. However, regardless of what the contract states, the terms that exist in writing also have to be at arm’s length.

2) Whether the terms of the agreement conform with the arm’s length principle.

To assess whether the contract terms are arm’s length, the essential is what independent parties would have done under similar circumstances. The connection between termination
terms and compensation terms should be examined since short termination notice should be reflected in potential compensation and vice versa; as that would have been the case in an agreement between independent parties. The comparison of the Enterprise A’s situation with independent parties does as well make the concept of “options realistically available” important again; not least in the perspective of bargain power.

In the light of this, if the parties in Corporate Group C would have included an compensation clause in their contract, and the clause was assessed arm’s length when considering what independent parties would have agreed upon (taking “option realistically available” into account); then Enterprise A should be remunerated. Oppositely, if no compensation clause was included in the contract, or was included but not assessed arm’s length; then Enterprise A should not be remunerated due to the termination or significant renegotiation.

3) Whether legislation and case law include rights for compensation.

Whether the contract terms are arm’s length should also be examined from the perspective of applicable legislation and case law which may affect the terms which would have been agreed between independent parties. As seen in section 4.2.3, commercial civil law principles imply that it generally is not possible to terminate a long-term agreement without a notice period. However, the principles do not entail any compensation requirement and are neither binding. Further, the binding regulation regarding compensation in the Commissionaire Act will not affect Enterprise A as a fully fledged distributor since Enterprise A cannot be considered as an commissionaire before the restructuring.

Consequently, no remuneration to Enterprise A can be argued from the perspective of Swedish legislation or case law.

4) Whether an independent enterprise would have compensated the suffering party in a situation of termination or renegotiation of a current agreement.

In the light of this aspects, it yet again becomes a question of what other options that realistically are available for Enterprise A, since it becomes a question of bargain power. As assessed, Enterprise A’s bargain power is significantly limited and thus it is not likely that independent entities would remunerate Enterprise A. If Enterprise A’s bargain power would have been less limited, the potential remuneration would probably have been reflected by the cost savings that the independent enterprise could have gained due to the restructuring.
What has been found in this analysis is the critical impact of the specific circumstances in each separate case; not least Enterprise A’s. The highly individual interpretations and consequences in Enterprise A’s case are not unique; it is rather the norm of transfer pricing where a case-by-case based approach is necessary.
7 Conclusions

7.1 Introduction

The chapter intends to present the final conclusions which are based on the analysis in chapter six as well as on the concluding remarks in previous chapters. The conclusions will fulfill the purpose of this thesis. For the sake of clearness, the purpose stated in section 1.2 is repeated below:

The purpose of this thesis is to examine in which cases Enterprise A’s shifted profit potential should be remunerated and thereby have tax consequences in order to be in accordance with the arm’s length principle. And oppositely, when shifted profit potential should not be remunerated and thus not have tax consequences.

7.2 Conclusions

What has become evident in this thesis, is that a definite answer is very hard to provide due to the case-by-case approach that is necessary when assessing whether profit potential should be remunerated from a transfer pricing perspective. However, the general approach is that considerable assets and/or rights that are transferred may carry considerable profit potential that should be remunerated. How this approach shows itself in Enterprise A’s case and consequently whether Enterprise A’s shifted profit potential should be remunerated has been assessed as concluded below.

Enterprise A’s shifted profit potential could be remunerated and have tax consequences if there are other options realistically available for the entity apart from entering into the restructuring and becoming a stripped distributor. Enterprise A’s bargain power would then be greater and consequently the chances of being remunerated as well. However as assessed in this thesis, no other options are realistically available for Enterprise A and as a result the shifted profit potential should not be remunerated and thus not have tax consequences in order to be in accordance with the arm’s length principle.

Further, Enterprise A could be remunerated as a result of the shifted profit potential if the entity takes title to local marketing intangibles that have been transferred which can be identified and assessed valuable (a transfer of something of value). Nevertheless, if the intangibles are valuable and have been transferred, Enterprise A must have borne the risks and the costs of developing the intangibles before the restructuring in order to be entitled to remuneration as the economic owner. Consequently, if Enterprise A takes title to
significant marketing intangibles before the restructuring, remuneration could be paid and thus have tax consequences. Oppositely, if Enterprise A not takes title to any marketing intangibles, it is not likely that any transfer of value has occurred and accordingly no remuneration should be paid or have tax consequences.

However, whether or not Enterprise A will receive remuneration by reference to “transfer of something of value” depends partly on the extent of the stripping. The more functions, risks and assets that are transferred as a result of the kind of distributor that Enterprise A becomes after the restructuring, the more likely it is that a transfer of something of value will occur which increases the chances of being remunerated due to the shifted profit potential.

Lastly, Enterprise A’s shifted profit potential should be remunerated and thus have tax consequences if the parties in Corporate Group C have included a compensation clause in their contract, and the clause can be assessed as arm’s length when considering what independent parties would have agreed upon. Oppositely, if no compensation clause is included in the contract, or for that matter is included but not assessed arm’s length; then Enterprise A should not be remunerated due to the termination or significant renegotiation of the arrangement.

The guidance given by OECD regarding business restructurings provides room for interpretations in terms of the correct application of the arm’s length principle. However, one may say that what can be considered as an appropriate arm’s length remuneration for shifted profit potential most likely will become clearer as multinational groups and tax authorities strive to comply with the new guidelines.
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