Business Restructuring
The applicability of the arm’s length principle for intangibles with an uncertain value at the time of the restructuring

Master Thesis in Commercial and Tax Law
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Abstract

This thesis is based on the regulations found in the OECD model and the OECD TP guidelines concerning the arm’s length principle. The core of the arm’s length principle is that transactions between associated enterprises should be treated the same as transactions between independent enterprises. This principle can be found in Article 9 of the OECD model. One transaction that may fall within the scope of Article 9 of the OECD model is business restructuring. Business restructuring was previously an unregulated TP area but with the new OECD TP guidelines, from 2010, regulations have been formulated. The aim with the thesis is therefore to examine how the arm’s length principle should be applied to the new guidelines for business restructurings of intangibles with an uncertain value at the time of the restructuring.

In order to answer the question set out in this thesis some of the factors that affect the application of the arm’s length principle have been examined separately. Firstly the arm’s length principle that is the generally accepted TP method used by both taxpayers and tax administrations in order to find a fair price for transactions between associated enterprises. The principle seeks to identify the controlled transaction and thereafter find a comparable uncontrolled transaction that is similar to the transaction performed between the associated enterprises. The second part examined the meaning of the term business restructuring according to the new guidelines since there is no other legal or general definition. Business restructurings are defined as cross-border redeployments of functions assets and risks, performed by MNEs. As long as a transaction falls within this definition it will be subjected to the arm’s length principle for tax purposes. The third part examined intangibles since that also lack a general definition. The identification and valuation of intangibles is a complex and uncertain thing to do for both taxpayers and tax administrations. When applying the arm’s length principle it is however found that the issue of identification of what consti-
The applicability of the arm’s length principle to business restructurings of intangibles with an uncertain value at the time of the restructuring should be found by performing a comparability analysis. In order to perform a comparability analysis, the controlled transaction firstly has to be identified. Thereafter, a comparable uncontrolled transaction needs to be found. An equivalent uncontrolled transaction may not be found in all cases and it should in those cases be examined what independent enterprises would have done if they had been in a comparable situation.

The arm’s length principle should be applied to business restructurings of intangibles with an uncertain value in the same manner as for any other uncontrolled transaction. The issues for this type of a transaction become the identification of what constitutes a business restructuring and also how to determine a fair value for the intangibles. The OECD TP guidelines lack some guidance as to the issues that can occur when a comparable uncontrolled transaction cannot be found. This creates an unsatisfactory guesswork for both taxpayers and tax administrations when trying to determine what independent enterprises would have done if they had been in a similar situation. This creates an unnecessary uncertainty when trying to apply the arm’s length principle.
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## Abbreviations

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<th>Full Form</th>
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<tbody>
<tr>
<td>CFA</td>
<td>Committee on Fiscal Affairs</td>
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<td>CTPA</td>
<td>Development Center for Tax Policy and Administration</td>
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<td>DTC</td>
<td>Double Taxation Conventions</td>
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<td>EU</td>
<td>European Union</td>
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<td>MNE</td>
<td>Multinational Enterprises</td>
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<td>MS</td>
<td>Member States</td>
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<td>OECD</td>
<td>Organisation for Economic Co-operation and Development</td>
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<td>OECD model</td>
<td>The OECD Model Tax Convention on Income and Capital</td>
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<td>OECD TP guidelines</td>
<td>OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations</td>
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<td>OEEC</td>
<td>Organisation for European Economic Co-operation</td>
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I Introduction

I.1 Background

In today’s global economy, it is crucial for multinational enterprises (MNE’s) survival to be able to compete with other businesses on the market. The effectiveness of the business strategies of an MNE is therefore vital to an MNE’s survival and an MNE need to constantly improve its structure to optimize its competitiveness. For this part, business restructuring has become an important tool for a MNE to get a competitive advantage.¹

Transfer pricing (TP) have become one of the most important tax issues in an ever growing global economy, especially for taxpayers and tax authorities. Not only for the apparent amount of tax that can be affected but also because of the complexity of the TP issues in itself.² Business restructuring is one area that can lead to great TP issues since it involves allocation of taxable profits for MNEs and the countries in which the MNE has its enterprises.³

The area of business restructuring was previously not regulated by the Organisation for Economic Co-operation (the OECD) and this created some concerns for the OECD member states (MS). The concern expressed was that taxable profits initially belonging to one MS would be transferred to another MS when a MNE decided to do a business restructuring that shifted the profits to “low-tax jurisdictions”, hence creating a taxable profit loss for that country.⁴

In January 2005, the OECD and the Development Center for Tax Policy and Administration (the CTPA) stated that business restructuring had become a more commonly used business strategy that was not sufficiently regulated in the current OECD Model Tax Convention on Income and Capital (the OECD model) or the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the OECD TP Guidelines). They continued stating that this could possibly lead to both issues of double taxation and

¹ Bakker, Anuschka. Transfer Pricing and Business Restructurings Streamlining all the way, IBFD, 2009 Amsterdam, The Netherlands, p.3.
³ The 2010 OECD Updates, p.154.
double non-taxation. To come to terms with this gap in regulations regarding business restructuring, for TP purposes, the Committee on Fiscal Affairs (the CFA) began developing new guidelines for the TP issues that was attached to business restructuring.\textsuperscript{5} This lead to the 2010 update of the OECO TP guidelines with, among others, the new chapter IX of the OECD TP guidelines concerning TP aspects of business restructuring.\textsuperscript{6} The update was approved on 22 July 2010 by the Council of the OECD, marking the first update since 1995.\textsuperscript{7}

Even with the new chapter IX of the OECD TP guidelines, there is no legal or general definition of what is to be regarded as a business restructuring. The OECD has in the OECD TP guidelines only defined it “as the cross-border redeployment by a multinational enterprise of functions, assets and risks.” Furthermore it is uncertain how business restructuring of intangible assets (hereby referred to as intangibles) should be dealt with even though intangibles are included in the scope of the new chapter IX of the OECD TP guidelines.\textsuperscript{8}

Intangibles have become the leading asset for MNE and within some business areas; intangibles stand for up to 90\% of the market value for that MNE. With intangibles growing in importance for MNEs, the TP issues grows as well.\textsuperscript{9} With the new chapter IX regarding business restructuring it is uncertain if the OECD has been able to satisfactory give guidance on the applicability of the arm’s length principle. Particularly for business restructurings of intangibles that has an uncertain value at the time of the business restructuring.

\section*{1.2 Purpose and delimitations}

The new chapter IX of the OECD TP guidelines deals with business restructuring and how to determine if a certain transaction in a business restructuring is at arm’s length. Business

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\textsuperscript{5} OECD Transfer Pricing Aspects of Business Restructurings: Discussion Draft for Public Comment 19 September 2008 to 19 February 2009.


\textsuperscript{7} The 2010 OECD Updates, p.147.

\textsuperscript{8} OECD TP Guidelines, Chapter IX, p.235.

\end{flushleft}
restructurings may concern intangibles but the new chapter IX of the OECD TP guidelines lacks clear and precise guidance in this area.

The purpose with this master thesis is to determine how the arm’s length principle should be applied for business restructurings of intangibles that have an uncertain value at the time of the business restructuring according to the updated OECD TP guidelines.

This thesis is based on the OECD model and the OECD TP guidelines and no national legislation has therefore been examined. The thesis does not take into consideration the different versions of double taxation conventions (DTC) that can be entered and this means that the conclusions made only applies to the original OECD model and original OECD TP guideline. Case law has been excluded from this thesis since the aim is to examine the application of the arm’s length principle for business restructurings according to the new chapter IX. Case law that discusses the arm’s length principle or business restructuring previously to the new chapter has therefore been exempted from. This thesis only applies to business restructurings between countries that are OECD MS and third countries are therefore exempted from this thesis. Business restructurings that are done in the intent of tax fraud or tax avoidance are exempted from this thesis and only business restructurings performed with valid business reasons are discussed. This thesis will only examine the applicability of the arm’s length principle for business restructurings of intangibles with an uncertain value at the time of the restructuring. Factors other than the tax consideration connected to TP issues and the arm’s length principle will be exempted. Documentation as such will not be examined in this thesis. Post-restructuring controlled transactions as such are also exempted from this thesis. Only one type of business model has been examined closer and all other types of business models are exempted from in this thesis.

1.3 Method and materials

This thesis uses a traditional legal method that aims to analyse the material in their hierarchical order. This method is used in order to correctly establish the legal position of the question asked in the purpose. The thesis is based on the OECD model and the OECD TP guidelines and these two legal sources have therefore been given the highest legal value in this thesis even though they are only models and guidelines. In order to use them as legal sources, their legal value has firstly been established. Case law is a valuable legal source when examining the applicability of the arm’s length principle but since this thesis aims to examine the new chapter IX of the OECD TP guidelines, from 2010, case law has not
been used. In order to, with more certainty, determine the applicability of the arm’s length principle for the issue at hand, articles from different legal journals has been used as a basis for the analysis. These articles have given a clearer and more certain usage of the arm’s length principle. They have also been used when examining certain terms that have been the necessary to understand in order to answer the purpose with this thesis. They have been used as a secondary source when the OECD model or the OECD TP guidelines have not clearly expressed the meaning of the terms, such as business restructuring and intangibles. The thesis has a problem oriented approach with descriptive elements. All chapters begin with a descriptive examination of the subject at hand in the chapter and thereafter develop into a problem oriented approach for the same subject using the legal journals as a basis. All chapters end with an analysis where the author expresses her view on the matter at hand. In order to clearly answer the purpose with the thesis, the thesis ends with a concluding chapter that aims to sum up the different analysis sections in the previous chapters.

1.4 Disposition

This thesis aims to answer the question of how the arm’s length principle should be applied to business restructurings of intangibles with an uncertain value. In order to find a satisfactory answer the thesis begins by descriptively and generally examine some of the term used in this thesis.

Chapter 2 begins by examining the legality of the OECD model and the OECD TP guidelines. Secondly, the implications of the arm’s length principle found in Article 9 of the OECD model are discussed. Thirdly, the regulations for business restructurings according to chapter IX of the OECD TP guidelines are discussed. The last part of the first chapter shortly examines business models according to the OECD. This chapter ends with an analysis where the author summaries the chapter and analyses the implications of the parts examined.

The aim with chapter 3 is to examine how the valuation of intangibles should be done when intangibles have an uncertain value at the time of the business restructuring. This chapter begins with the difficulties of identifying what is considered an intangible. The chapter then continues with the OECDs standpoint on the valuation issue. After examining the standpoint of the OECD, the standpoint of the literature is examined. This chapter ends with an analysis where the author summaries the chapter and analyses the implications of the parts examined.
Chapter 4 examines the applicability of the arm’s length principle for business restructurings of intangibles with an uncertain value at the time of the restructuring. This chapter begins by establishing how the ownership of intangibles should be made. The second part gives an introduction to the comparability analysis used for business restructuring of intangibles. The third part of this chapter examines the actual transaction undertaken in order to understand the factors of the business restructuring that should be part of the comparability analysis. The chapter moves on to the comparability factors and examines what they are and how they should be used. The last part examines the comparable uncontrolled transaction and what that transaction has to fulfill in order to help find an arm’s length price. The chapter ends with an analysis where the author summaries the chapter and analyses the implications of the parts examined.

The disposition used in this thesis aims to give the reader a continuous analysis after each chapter where the facts presented are summarised and thereafter analysed. The last chapter of the thesis is a conclusion of the analyses made in the separate chapters and aims to answer the question set out in the purpose.
2 The arm’s length principle and business restructuring

2.1 Introduction

This thesis aims to determine how the arm’s length principle should be applied to business restructurings of intangibles that have an uncertain value at the time of the restructuring. In order to assess this it is crucial to understand both the arm’s length principle in itself and the meaning of the term business restructuring found in the new chapter IX of the OECD TP guidelines. Before examining this and to understand the implications that the arm’s length principle has for taxpayers and tax administrations it is firstly important to examine the legal value of the OECD. After determining this, the OECD’s definition of the arm’s length principle found in Article 9 of the OECD model will be examined, this in order to give an introduction to the principle used in this thesis. The third part of this chapter examines the general definition of a business restructuring both from the OECD’s perspective and from other views. The fourth part of this chapter examines the business restructuring model where full-fledged manufacturers are restructured into contract-manufacturers or toll-manufacturers. This is the model kept in mind for the application of the arm’s length principle in this thesis. This chapter will end with an analysis of the facts presented in the different parts.

2.2 The legal value of the OECD

This thesis aims to examine the arm’s length principle found in the OECD model and the legal value of the OECD model is therefore important to firstly determine. The OECD was established in 1961 out of the already existing Organisation for European Economic Co-operation (OEEC) and is considered an inter-governmental organization. The initial purpose of the OECD was to support governments in several different cross border issues.\(^\text{10}\) Today, a few of the goals the OECD works towards is to support economic growth, to strengthen employment and to work towards a financial stability.\(^\text{11}\) The OECD consists of 34 MS, not only within the European Union (EU) but worldwide, that together goes

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\(^{10}\) Bakker, A. Transfer Pricing and Business Restructurings – Streamlining all the way, p.49.

\(^{11}\) Article 1 of the Model Tax Convention on Income and on Capital 22 July 2010.
through cross border issues and works to find polices that can be implemented in all the MS.\(^\text{12}\)

There are some risks with MNE and cross border transactions, such as business restructurings and one of the risks is the risk of double taxation. To avoid double taxation on the same income, countries\(^\text{13}\) signs bilateral international tax conventions (DTCs)\(^\text{14}\), that determines which state should exempt from tax and which state may levy tax.\(^\text{15}\)

An international law obligation occurs between the two parties that signing a DTC to which a commitment to partly or wholly give up a tax is imposed.\(^\text{16}\) Since the OECD model was the first model tax convention for income tax, it has not only leaded the way for other model tax conventions but it has also influenced several international tax laws.\(^\text{17}\)

The OECD model is as it sounds only a model but countries are known to look to the context of the OECD model when negotiating a DTC. The reason for this is that countries may not be willing to sign the OECD model as it stands and several OECD MS may therefore want to put in a reservation for some parts of the OECD model when negotiation a DTC.\(^\text{18}\) When two contracting countries have signed the OECD model with or without reservations, a commitment to refrain from or delimit the right to tax occurs and this should prevent double taxation. This commitment falls upon both contracting countries and will thus have an effect on the domestic legal system since it will restrict domestic tax law.\(^\text{19}\)

12 http://www.oecd.org/pages/0,3417,en_36734052_36761863_1_1_1_1_1,00.html 2012-01-27. Also see Appendix I.

13 For this thesis the countries discussed are the countries that are members of the OECD and have signed the OECD Model. See appendix I.

14 So called double taxation conventions (DTCs).


16 Ibid.


18 Lang, M. Introduction to the Law of Double Taxation Conventions, p.28-29.

19 Lang, M. Introduction to the Law of Double Taxation Conventions, p.31.
2.3 The arm’s length principle in Article 9

The arm’s length principle is the TP principle determined, by the OECD MS, as the international TP standard for tax purposes. This principle is to be used both by tax administrations and by taxpayers within MNE groups.\(^{20}\) This principle should be used for associated enterprises that performs a business restructuring and it is therefore of value to firstly examine the meaning of the principle according to the OECD. The arm’s length principle is regulated in Article 9 paragraph 1 of the OECD model and states the following:

“\([W]here\) conditions are made or imposed between the two \(\text{[associated]}\) 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.”\(^{21}\)

The main purpose with the arm’s length principle is to find transactions between independent enterprises so called “\(\text{comparable uncontrolled transactions}\)”\(^{22}\) and determining if they differ from the controlled transactions found between associated enterprises.\(^{23}\)

The different entities of MNE’s should not be regarded as inseparable parts of one single unified business; the MNE should instead be regarded as separate entities. With this approach, the focus becomes the transaction in itself and the nature of that transaction. This approach will then make it easier to determine whether a transaction, and its conditions, within an MNE differ from that of a comparable uncontrolled transaction. This type of an analysis is the core of the arm’s length principle and the OECD refers to is as a “comparability analysis”\(^{24}\) A closer examination of the comparability analysis can be found in chapter four.

Article 9 of the OECD model hold the basis for an arm’s length principle and the comparability analysis by showing a need for two different aspects. The first being a comparison between the conditions laid down for associated enterprises and for independent enterpris-

\(^{20}\) The OECD TP Guidelines, Chapter I, 1.1, p.31.

\(^{21}\) Article 9 of the OECD Model Tax and The OECD TP Guidelines, Chapter I, p.33.

\(^{22}\) The OECD TP Guidelines, Chapter I, 1.6, p.33.

\(^{23}\) Ibid.

\(^{24}\) Ibid.
es. This comparison is done to assess whether the accounts, for tax liability, are to be re-calculated or if they are not in accordance with Article 9 of the OECD model. The second aspect aims towards the determination of the accrued profits that would have occurred if the transaction were at arm’s length. This part is important as to the determination of the amount of any re-calculation and re-writing of the tax accounts.25

There is always a risk of distortion of competition between associated enterprises and independent enterprises if they are treated differently for tax purposes. The arm’s length principle has shown to be a great toll to create equality between associated enterprises and independent enterprises when it comes to tax treatment. The principle creates a more equal playing field for tax purposes and therefore helps avoid emerging tax advantages or disadvantages that can hinder competition between different types of enterprises. This has become one of the main reasons for OECD MS to implement the arm’s length principle.26

When looking at business restructuring, the commercial and financial relation of that business transaction are normally determined by other similar transactions between independent enterprises. This is not the case between associated enterprises since the transactions that occur within associated enterprises may not have any external market force influencing them. The taxpayers within an associated enterprise may therefore have difficulties finding an independent transaction for comparison.27 When this difficulty occurs and the price is no longer guaranteed to follow the arm’s length principle, there is a risk of both tax liabilities and tax revenues being misrepresented.28 This difficulty does not however by itself exclude a transaction from being at arm’s length.29

Even if there is a comparable transaction between associated enterprises and independent enterprises, the comparison can still create an unjustifiable burden for taxpayers and tax administrations. It can become difficult to find the information needed for a comparison of uncontrolled transactions and the task of finding the information needed can in itself be regarded as a burden for both the taxpayers and the tax administrations. Reasons why the information may be hard to find are for example, geographical reasons, lack of existing

25 The OECD TP Guidelines, Chapter I, 1.7, p.33-34.
26 The OECD TP Guidelines, Chapter I, 1.8, p.34.
27 The OECD TP Guidelines, Chapter I, 1.2, p.31.
28 The OECD TP Guidelines, Chapter I, 1.3, p.32.
29 The OECD TP Guidelines, Chapter I, 1.10-1.11, p.34-35.
information or even confidentiality issues preventing an independent enterprise from sharing the information needed to find a comparable independent uncontrolled transaction. The OECD has made it clear that “TP is not an exact science” but is instead something that demands a great deal of knowledge, judgment and time from both the taxpayers and the tax authorities.\textsuperscript{30}

Even though taxpayers and tax authorities are faced with a heavy burden by using the arm’s length principle; it provides income levels that are adequate enough to satisfy tax administrations. The principle is also the closest to estimate a fair value of transactions that are transferred between associated enterprises as to uphold the open market. By not using the arm’s length principle, the risk of double taxations would increase and the OECD MS have therefore shown a continuing support of the principle.\textsuperscript{31}

\section*{2.4 Definition of a business restructuring}

On July 22 2010 the OECD presented an updated version of the OECD TP guidelines that contained the new chapter IX concerning business restructuring.\textsuperscript{32} The two main objectives with the new chapter IX of the OECD TP guidelines was firstly, to determine when an allocation of profits follows the arm’s length principle and secondly, how the business restructuring in a more general matter follows the arm’s length principle.\textsuperscript{33}

The new chapter IX of the OECD TP guidelines is limited to business restructurings that fall within Article 9 of the OECD model.\textsuperscript{34} In accordance with both Article 9 of the OECD model and the arm’s length principle, the conditions of the business restructuring should be examined since the conditions should not differentiates from those between independent enterprises.\textsuperscript{35} Chapter IX is divided in four different parts:

1. Special consideration for risks
2. Arm’s length compensation for the restructuring itself

\textsuperscript{30} The OECD TP Guidelines, Chapter I, 1.13, p.35-36.
\textsuperscript{31} The OECD TP Guidelines, Chapter I, 1.14 – 1.15, p.36.
\textsuperscript{32} The OECD TP Guidelines, Chapter IX.
\textsuperscript{33} The OECD TP Guidelines, Chapter IX, 9.6, p.236.
\textsuperscript{34} Ibid. Which means only transactions that are between associated enterprises are covered by this new Chapter IX of the OECD TP Guidelines.
\textsuperscript{35} The OECD TP Guidelines, Chapter IX, 9.9, p.237.
This chapter will only discuss the general definition of a business restructuring and the different business restructuring models that have been put forward by the OECD. The different part of the new chapter IX mentioned above will therefore be discussed first in chapter four when examining the applicability of the arm’s length principle in the comparability analysis.

The initial thing to examine, for the purpose of a business restructuring according to the OECD TP guidelines, is the meaning of the term business restructuring. This since there is no legal or general definition of what is to be regarded as a business restructuring. The OECD has in its TP guidelines defined it “as the cross-border redeployment by a multinational enterprise of functions, assets and risks.” The OECD TP guidelines do not, when applying the arm’s length principle, distinguish different business transactions from each other as long as they fall within the scope of the definition given.

As mentioned earlier, the new chapter IX in the OECD TP guidelines states that a business restructuring occurs when a MNE redeploy functions, assets or risks. When only using this definition for a business restructuring it becomes a rather wide definition of something that could benefit from a narrower definition. One example, when the wide definition of a business restructuring can create problems, is an insurance contract that in itself transfers risks. This contract could be seen as a business restructuring if the OECDs definitions is followed. Another issue with the definition is the fact that functions in itself cannot be transferred. To transfer a function, the original function in company A needs to cease to exist while a new function is created in company B.

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36 The OECD TP Guidelines, Chapter IX, part 1-4.

37 See chapter 1.2 Purpose and Delimitations.

38 The OECD TP Guidelines, Chapter IX, 9.1, p.235.

39 The OECD TP Guidelines, Chapter IX, 9.3, p.236.

40 Rasch, S and Schmidtke, R. OECD Guidelines on Business Restructuring anf German Transfer of Function Regulation: Do Both Jeopardize the Existing Arm’s Length Principle?.

41 Ibid.
2.5 Business restructuring models

Within the definition given by the OECD TP guidelines there are three types of business arrangements that can be regarded as a business restructuring:

1. “Conversion of full-fledged distributors into limited-risk distributors or commissionaires for a foreign associated enterprise that may operate as a principal,

2. Conversion of full-fledged manufacturers into contract-manufacturers or toll-manufacturers for foreign associated enterprise that may operate as a principal,

3. Transfers of intangible property rights to create central entity (e.g. a so called “IP company”) within the group.”

The second business model found in the OECD TP guidelines will be examined in the following. A business model where full-fledged manufacturers are restructured into contract-manufacturers or toll-manufacturers includes as understood both fully fledged manufacturers and contract manufacturer. A fully fledged manufacturer owns the intangibles and the contract manufacturer only has the right to the know-how that comes with the manufacturing or the service that the MNE performs. Within an MNE that has several fully fledged manufacturing entities it can become necessary to do a business restructuring to centralize the MNE and create a more efficient business strategy. To do this, all the legal ownership of the intangibles are transferred to one entity of the MNE converting all but one of the fully fledged manufacturers into contract manufacturers, see table 1 and 2.

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Before the business restructuring each of the entities within the MNE owns its own intangibles and are considered fully fledged manufacturer.\textsuperscript{45}

The intangibles have in the business restructuring been transferred to one entity (in this case company A) to create a centralization of the ownership of the intangibles. The fully fledged manufacturer therefore has the full ownership of the intangibles and the contract manufacturers only have the right to the know-how that is needed for the manufacturing performed.\textsuperscript{46}


\textsuperscript{46} Ibid.
2.6 Analysis

The legal value of the OECD and its models and guidelines are important to assess before looking into the core issues with this thesis. The OECD model and the OECD TP guidelines are only models and guidelines but have by its MS been appointed as the basis for any DTC. When MS have agreed to enter into a DTC, whether if it fully follows the OECDS or not, it will be legally binding for the countries.

The arm’s length principle is an important tool for MNE and tax administrations when dealing with international taxation issues within the TP area. The principle has been set as an international standard and can be found in Article 9 of the OECD model. The core of the arm’s length principle is to firstly identify the controlled transaction, meaning the transaction between associated enterprises and thereafter find a comparable uncontrolled transaction, meaning a transaction between independent enterprises. After finding a comparable uncontrolled transaction, the conditions set out in this transaction should be compared with those in the controlled transaction. The conditions in both the uncontrolled and the controlled transaction should coincide for the controlled transaction to follow the arm’s length principle. This means that the transaction in itself is the key aspect to examine.

The applicability of the arm’s length principle may not sound that complicated but finding a comparable transaction can in many cases be very hard to accomplish. For business restructurings of intangibles with an uncertain value at the time of the restructuring, it can be deemed very difficult to find a comparable uncontrolled transaction. The taxpaying associated enterprise may not know how to apply the arm’s length principle in order to find an arm’s length price, since they lack the influence of an external market force to follow. This will create an uncertainty as to how this international standard for TP issues should be applied.

If a transaction between associated enterprises does not follow the arm’s length principle, there is a risk that the price or other conditions with the transaction are misrepresented. This misrepresentation can create an uncertainty both for tax liabilities and tax revenues, an unwanted consequence, which should be strived to avoid. An important factor to consider is the fact that the lack of a comparable transaction does not in itself prove that a transaction is not at arm’s length. This means that even if there are no comparable transactions, a comparability analysis still needs to be performed in order to determine what independent enterprises would have done if they had been in a similar situation. This will also create an
uncertainty with the arm’s length principle since a transaction between associated enterprises without a comparable uncontrolled transaction could follow the arm’s length principle without the possibility of fulfilling the conditions found in Article 9 of the OECD model.

Another issue with the arm’s length principle is the burden the comparability analysis poses both for taxpayers and tax administrations. When dealing with transactions that has an uncertain value and also lacks comparable uncontrolled transactions it can become increasingly difficult to find a way in order to show that the transactions still follows the arm’s length principle. This could be seen as an unjustifiable burden. As stated by the OECD “TP is not an exact science” but taxpayers and tax administrations are still demanded to try and understand and follow the principle. With all this in consideration, the arm’s length principle is still considered the best tool to use in order to find income levels that tax administrations find satisfactory. It gives a fair value of transactions between associated enterprises and has proven to help avoid double and non-taxation issues for MS.

This chapter has also examined the general application of the new chapter IX of the OECD TP guidelines regarding business restructuring. The new chapter IX came into place after years of discussions by the OECD MS in regards to the growing usage of business restructurings as a tool in creating a better advantage in the market. This growth of usage had lead to an ever more lack of regulations in the area. The arm’s length principle was still the principle accepted and used by the OECD MS for TS related issues that occurred for MNEs. With the growing usage of business restructurings, regulations concerning the arm’s length principle therefore needed to be updated to be more helpful within the area of business restructuring. This to ensure that the taxpayers and the tax administrations would know which country should exempt from tax according to Article 9 of the OECD model and also to find the right value that should be taxed.

There is no general definition for what constitutes a business restructuring and the definition given by the OECD only states that a business restructuring is a cross border redeployment by an MNE of functions, assets and risks. This is a very wide and somewhat unclear definition that can include both transactions meant as a business restructuring but also transactions or contracts that were not meant to be regarded or treated as a business restructuring for tax purposes. All transactions that fall within the OECDs definition will be regarded as a business restructuring since the OECD states that no distinction should be made between transactions as long as they fall within the definition. This together with the
wide definition in itself can therefore create issues for both taxpayers and tax administrations when trying to find an arm’s length price to be taxed correctly. One example given is the case with the insurance contract that can fall within the definition of a business restructuring simply since it transfers risks from one party to another when a contract is being entered. This contract could therefore, for tax purposes, be regarded as a business restructuring. To have a definition that is this wide and that may include transactions that were not meant as business restructurings will create legal uncertainty for both taxpayers and tax administrations. This since the ability to foresee the tax consequences of a transaction could be jeopardized.

To avoid having transactions that was not meant to be regarded as business restructuring being included in the OECDs definition it is also important to look at the real purpose of the transaction. For associated enterprises this may create some problems since it can be difficult to have the needed insight in an associated enterprise business reasons. Here it will become necessary to use the comparability analysis and seek to find what independent enterprises would have done in a similar situation.

The OECD has three different types of business models that can occur when an associated enterprise performs a business restructuring. This thesis has only examined one of these types, namely the conversion of a full-fledged manufacturer into a contract-manufacturer or toll-manufacturer. In this business model, all the legal ownership of the intangibles is moved to one entity restructuring all but one of the full-fledged manufacturers into contract-manufacturers. When all the legal ownership is transferred but the other entities still helps in the development of the intangibles then issues of who actually owns the intangibles could be brought up. The valuation of the intangibles could also become problematic in this type of a business restructuring. Both these issues will be examined further in chapter four.
3 Intangibles with an uncertain value

3.1 Introduction

Intangible assets bring a separate set of questions within a business restructuring. One question is how to identify the intangibles that were transferred in the business restructuring and another question is how to decide a value for the intangible. Therefore, this chapter will begin by discussing the challenges with identifying what is considered an intangible. Secondly, the issues with valuation of intangibles will be discussed when the intangibles have an uncertain value at the time of the business restructuring. After answering these questions, this chapter will end with an analysis of the facts presented in the different parts.

3.2 Identification of intangibles

When trying to apply the arm’s length principle on a business restructuring of intangibles it is of great value to understand what constitutes as an intangible. As discussed earlier business restructuring lacks a general definition and the same goes for what constitutes intangibles. To identify what may be considered as an intangible, it is important to first examine the standpoint of the OECD. The OECD TP guidelines do not in chapter IX discuss the meaning of intangibles. To identify what is to be regarded as an intangible, chapter VI of the OECD TP guidelines are of importance. This thesis will only use the general definitions of intangibles found in chapter VI.

The definition given in chapter VI of the OECD TP guidelines is that “the term “intangible property” includes rights to use industrial assets such as patents, trademarks, trade names, designs or mod-

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47 The term intangibles includes assets such as patents, trademark, trade names, designs, copyrights (including software) know-how, trade secrets, customer lists, distribution channels, unique names, symbols and pictures.

48 The OECD TP Guidelines, Chapter IX, 9.80, p.262.


50 See chapter two.

51 The OECD states that “Particular attention to intangible property transactions is appropriate because the transactions are often difficult to evaluate for tax purposes.” The OECD TP Guidelines, Chapter VI, 6.1, p.191.


53 The OECD TP Guidelines, Chapter VI, 6.1, p.191.
els. It also includes literary and artistic property rights, and intellectual property such as know-how and trade secrets.54

According to the OECD TP guidelines there are two different types of intangibles, marketing intangibles and trade intangibles. Both of these types of intangibles are considered commercial intangibles and therefore fall within the general definition used for the purpose of this thesis.55 The term marketing intangibles are usually used when discussing trademarks, trade names and other aids used to market a service or a product. For an example unusual name, symbols or pictures used to make the service or product stand out in a way that helps the marketing. Depending on the country in which the marketing intangible exists, it may be protected by that country’s laws. This protection may imply that the owner needs to give its permission for the usage of the marketing intangible.56

Even if there are clearly two different types of commercial intangibles, only marketing intangibles are defined in the OECD TP guidelines. It is stated that all intangibles that does not fall within the definition of marketing intangibles are to be consider as trade intangibles. Trade intangibles are usually developed as the result of both costly and risky research done by the MNE. This costly development can be seen in the end price of the service or product since the developer needs to regain the money that went into developing the trade intangible. This development can occur in one entity of an MNE or in several entities. This can create some difficulties determining which entity of the MNE holds the legal and economic ownership of the trade intangible.57

There are several different approaches when defining what constitutes an intangible. One approach is that intangibles are the same as tangibles, an asset that can give rise to future benefits.58 The clearest differens between intangibles and tangibles are that intangibles lack physical shape.59 An approach that can be used to separate intangibles from tangibles is to examine the economic characteristics of the assets. This approach can be helpful for TP

54 The OECD TP Guidelines, Chapter VI, 6.2, p.191.
55 The OECD TP Guidelines, Chapter VI, 6.3, p.192.
56 The OECD TP Guidelines, Chapter VI, 6.4, p.192.
57 The OECD TP Guidelines, Chapter VI, 6.3, p.192.
58 For instance the brand Coca Cola that has a high value in the name itself.
purposes since knowing the economic characteristics is needed to determine the value of the intangibles.\textsuperscript{60}

Another approach uses the following five features to explain what an intangible is:

“1) non-physical in nature (no physical substance). However there should be tangible documentation of the intangible existence (e.g. a contract or trademark registration);

2) future economic benefits are expected to flow to the owner;

3) the value of the intangible arises from its intangible nature and not from its tangible nature. (for instance the literary or scientific works included in a book, and not the material carrier itself);

4) subject to property rights, legal existence and protection, and private ownership; and

5) separable and identifiable in order to determine value of specific intangible.”\textsuperscript{61}

Another point of view is that the definition of what is considered an intangible is unnecessary for TP purposes. That this part has no impact on the application of the arm’s length principle since it is not the characteristics of the intangible but the value of the intangible that is of importance. The arm’s length principle seeks to find out what an independent enterprise would have paid for the transfer of the intangible and the issue is therefore “what something is worth through the eyes of third parties.”\textsuperscript{62}

This point of view is of importance since there is no general definition what constitutes an intangible but it depends on interpretations and the area and the county where the intangible is located. Since it is difficult to find a general definition, there is an increased risk that tax authorities and taxpayers will use different definitions that will lead to conflicts between the two parties.\textsuperscript{63}

\textsuperscript{60} Lev, B. Intangible Assets: Concepts and Measurements, p.300.


\textsuperscript{62} Verlinden, I and Mondelaers, Y. Transfer Pricing Aspects of Intangibles: At the Crossroads between Legal, Valuation and Transfer Pricing Issues.

\textsuperscript{63} Ibid.
3.3 Valuation of intangibles

3.3.1 General approach

Valuation of intangibles is a complicated process with or without the involvement of a business restructuring. Business restructuring of intangibles may become even more problematic when the intangibles at the time of restructuring have an uncertain value (pre-exploitation).\textsuperscript{64} According to the OECD TP guidelines this can become problematic since future expected profits are taken into account when determining the value of the intangibles that are transferred. The future expected profits may not conform to the actual future profit that comes from the transferee. A gap between the expected profit and the actual future profit may occur and this change in value affects the application of the arm’s length principle.\textsuperscript{65}

An arm’s length price when the valuation of the transferred intangible is uncertain should be found with the help of both the taxpayers and the tax authorities. Both should seek guidance from what an independent enterprise would have done in a similar situation.\textsuperscript{66}

The OECD TP guidelines give some examples in the annex to chapter VI of the OECD TP guidelines as to how the valuation could be done when a business restructuring of intangibles with an uncertain value has occurred.\textsuperscript{67}

After examining the below mentioned examples, the OECD TP guidelines state that it is important to assess if the valuation was uncertain enough so that independent enterprises would not have accepted the valuation. The question then becomes if the independent enterprise would have demanded a price adjustment mechanism, or would have demanded that the valuation should be renegotiated.\textsuperscript{68} An \textit{ex-post} adjustment should not be done before assessing what independent enterprises would have done in the same situation.\textsuperscript{69}

\begin{itemize}
\item \textsuperscript{64} The OECD TP Guidelines, Chapter IX, 9.87, p.264.
\item \textsuperscript{65} The OECD TP Guidelines, Chapter IX, 9.87, p.264-265. Also see The OECD TP Guidelines, Chapter VI, 6.29, p.201.
\item \textsuperscript{66} The OECD TP Guidelines, Chapter VI, 6.28, p.201.
\item \textsuperscript{67} The OECD TP Guidelines, Chapter IX, 9.87, p.265 and the Annex to Chapter VI, p.365-368.
\item \textsuperscript{68} The OECD TP Guidelines, Chapter IX, 9.88, p.265.
\item \textsuperscript{69} Ibid.
\end{itemize}
Since the tax authorities have the possibility to make adjustments years after a business restructuring of intangibles have occurred, it is important for taxpayers to be open and share the course of actions that were taken to find the arm’s length price. This could lead to great tax consequences for the taxpayers if the tax authorities do not agree that the price paid at the time of the business restructuring of the intangibles were at arm’s length.  

3.3.1.1 Example 1

The first example examines what may happen if the value of intangibles changes and if this change was not anticipated in the original contract between the associated enterprises. The example discusses manufacturing and distribution rights for a drug, where the licensing contract between the associated enterprises runs over a time period of three years. This three year contract regulates the rate of royalty that comes from the manufacturing and distribution of the drug. The future benefits from the agreed upon rate are reasonable for both parties.

The terms of the contract at year one are in accordance with what independent enterprises would have agreed upon in a similar situation, even if the contract lacks an adjustment clause, and therefore follows the arm’s length principle. In the third year, a change of the value occurs when it found that the drug can be used for another purpose. If this new usage of the drug had been known in the first year, then the rate of royalty would have been significantly higher.

If shown that the change of value could not have been anticipated at the first year then and the lack of any price adjustment clauses would be consistent with what independent enterprises would have done. The change in value should therefore not be regarded as fundamental enough to go against the arm’s length principle and demand a renegotiation of the price.  

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70 Mauro, R and Rodrigues, S. Transfer Pricing and Intangibles in the Context of Business Restructurings.

71 The OECD TP Guidelines, Annex to Chapter VI, example 1, p.365-366.
3.3.1.2 Example 2

In the second example follows the same circumstances as the first example and begins at the end of the third year when the royalty value has increased. This time the contract is being re-negotiated at the end of the three year period. Even though the royalty has a higher value now that at the beginning of the contract, it is still highly uncertain how this increased value will affect future benefits. This uncertainty creates an even more difficult re-evaluation process of the royalty.

In this example, the associated enterprise re-negotiates a new long term contract over ten years and this new contract adds on to the previous value for the royalty. The new value of the royalty is speculative and is in the form of a fixed royalty rate. When the value of royalty is expected to be high but has not been correctly established, then it is not customary to enter long term agreements like this one that extends over a period of ten year. An uncertain valuation like this would not be accepted by independent enterprises and a fixed royalty rate would not have been accepted. Independent enterprises would most likely demand some sort of an adjustment clause to protect them from future events that may affect the value of the royalty.

One example of where this adjustment clause could be used is if the sales of the drug initially follow the ten year plan. At year four the royalty rate is in conformity with the arm’s length principle but the year after a new competitor enters the market. This new competitor has a drug that makes the first drugs sales to drastically go down and the royalty rate are no longer in conformity with the arm’s length principle after year five. By the sixth year, tax authorities can go in and demand TP adjustments of the royalty rate since independent en-
terprises would not have entered into a long term agreement without an adjustment clause based on yearly valuations of the royalty, as mentioned earlier.\(^{72}\)

### 3.3.2 Alternative approaches

There are alternative approaches developed when trying to find ways as to how to deal with the issue of an uncertain value at the time of the restructuring. One approach in determining how to value intangibles with an uncertain value at the time of the business restructuring is to include the added risk in the transaction terms. This means that the structure of the business restructuring should include upside- and downside risks that the parties should share. The seller (A) takes the upside risk\(^ {73}\) and the buyer (B) takes on the downside risk\(^ {74}\) and to adjust for the uncertain value of the intangibles in the business restructuring an adjustment mechanism could also be added in the structuring of the business restructuring. Both the risk distribution and the adjustment mechanism will offer the two parties some protection when dealing with intangibles with an uncertain value at the time of the business restructuring.\(^ {75}\)

This means that the business restructuring of the intangible will be done in two steps. The first step being the one-time-sum paid when the business restructuring is done and the second step being the adjustment mechanism. By structuring the business restructuring of intangibles this way, the first one-time-sum will be lower since the seller may receive a positive adjustment in the future and the downside risk that the buyer has overpaid for the intangible will be softened.\(^ {76}\)

As mentioned above chapter VI in the OECD TP guidelines gives some guidance as to how to define what constitutes intangibles. There are some questions as to how this guidance can be helpful when trying to assess the value of intangibles. Instead of seeking guidance in chapter VI for a valuation method for intangibles some taxpayers have sought...
guidance from the valuation ways used for tangibles. The OECD acknowledges that there are some difficulties determining the value for intangibles since intangibles within an MNE may have characteristics that are hard to find between independent enterprises.

The comparability analysis that the OECD uses to find an arm’s length price is a very difficult analysis to use when dealing with intangibles. This since it puts a huge burden on both the taxpayers and the tax administration in finding “sufficiently similar open-market references”. The term “open-market” reference in itself contains difficulties since this rarely can be up filled by the MNE on the market even if they compete on the same market.

Another problem that may occur when trying to value intangibles is the fact that intangibles and tangibles often are bundled together. An example is the business restructuring of a new machine. The machine would not be transferred by itself but the technological process that belongs to the development and usage of the matching would be transferred together with the machine. In a case like this it is not uncommon that the tangible and the intangibles value are tied together in a way that makes it hard to determine the value of intangible in itself. To determine the value of only the intangibles, tax authorities are forced with the demanding task of separate the tangibles from the intangibles.

The fact remains that the only guidance given by the OECD is that in order to finding an arm’s length price is to ask “would independent parties at arm’s length remunerate the element and, if so, how?”. Once again the question does not seem to be the identification of what constitutes an intangible but if an independent enterprise would have paid for the transfer. Meaning, would an independent enterprise have seen the transfer as something valuable for them. If an independent enterprise sees the transfer as something valuable and would pay for it then that may indicate that an intangible exist.

77 This approach will not be further explored in this thesis.
78 Verlinden, I and Mondelaers, Y. Transfer Pricing Aspects of Intangibles: At the Crossroads between Legal, Valuation and Transfer Pricing Issues.
79 Ibid.
80 Ibid.
81 Ibid.
3.4 Analysis

As shown above, there are several factors to consider when talking about intangibles with an uncertain value at the time of the restructuring. All these factors need to be examined to know how a transaction should be regarded when determining an arm’s length price. The OECD TP guidelines do not give an extensive amount of guidance in this matter, which may affect the legal certainty for business restructuring of intangibles.

Before discussing the valuation issues that may occur with a business restructuring of intangibles, the definition of what constitutes an intangible had to be examined. Intangibles lack in a similar way as business restructuring a general definition which in itself can create problems when trying to find an arm’s length price. To begin with, the OECD has not given a separate definition of intangibles in the new chapter IX regarding business restructuring. Guidance therefore has to be taken from the separate chapter VI of the OECD TP guidelines. In this chapter the OECD’s general standpoint is that there are two different types of intangibles, marketing intangibles and trade intangibles. For the application of the arm’s length principle on business restructurings of intangibles with an uncertain value at the time of the restructuring, there is no need to separate intangibles into these two types. In this thesis only a general definition of intangibles has been used. The reasons this thesis still mentions these two different types of intangibles is because trade intangibles often are a result of costly and risky research. This will create a more expensive intangible and this increased price will be seen in the service or product that is tied together with the intangible. This change in price will affect the taxation when the intangible is part of a business restructuring and therefore also the application of the arm’s length principle. When dealing with intangibles with an uncertain value, all factors that can be helpful in determining a fair value is useful. Knowing the type of intangible and the fact that it may have a higher value from the start is something that therefore should be considered when finding an arm’s length price.

There are other approaches that may be used when trying to define what constitutes an intangible. One approach is that intangibles can be defined in the same way as tangibles, namely that intangibles are assets that creates future benefits. The only difference between tangibles and intangibles in this case would be that intangibles lack physical form. To seek to differentiate between tangibles and intangibles, the economic characteristics of the assets could be examined. This is one of the more useful approaches for TP purposes since the economic characteristics will be used later on when trying to determine a value for the in-
tangibles that has been part of a business restructuring and thereafter finding an arm’s length price that should be used for the taxation issues. Other approaches use several features that need to be present for an asset to be regarded as an intangible.

There is one approach that may explain the lack of a definition of what constitute intangibles in a business restructuring. That approach is that it is not necessary to have a definition for TP purposes. This since the arm’s length principle does not require that an asset, that is being transferred, is defined as either a tangible or an intangible. The reason behind this approach is that the characteristic of an asset being transferred is not important but that the value is the aspect that should be examined when applying the arm’s length principle on a business restructuring. This approach further shows the problems that MNEs face when performing a business restructuring with an uncertain value at the time of the restructuring. It puts all focus on the valuation process and with an uncertain value it becomes even more difficult to apply the arm’s length principle and find an arm’s length price for this kind of business restructurings.

In order to assess the applicability of the arm’s length principle to business restructurings of intangibles with an uncertain value at the time of the restructuring, it is important to find out how the valuation process should be done. The valuation process is known to be a problematic process. One of the reasons is the fact that not only the present value is being considered but also any expected future profits should be taken into consideration. The gap between the actual future profit and the expected profit can create an uncertain situation as to the real value. This uncertainty is not wanted when applying the arm’s length principle.

When this uncertain value occurs, the tax authorities and the taxpayers both have an obligation to help find a price that is in line with the arm’s length principle. As with all considerations where the aim is to find an arm’s length price, independent enterprises should be examined. However it may be more difficult to find transactions between independent enterprises where the valuation before the transaction is uncertain. Independent enterprises would not enter this type of a transaction without compensation that equals the uncertainty, either in the way of a price adjustment mechanism or if the price is too uncertain, a renegotiation of the valuation. This approach from independent enterprises needs to be examined before determining if the uncertain value between the associated enterprises is at arm’s length or not. Since this is a shared burden between taxpayers and tax authorities, and the later has the possibility to demand adjustments years later, it is important for all
parties to openly share information about the intentions and valuation of the business restructuring of intangibles.

This shared burden is positive since it forces both parties to be a part of the application of the arm’s length principle. To only put the burden on one party can create an uneven burden that lead to an even more complex process to determine if a transaction is at arm’s length. The arm’s length principle in itself aim to find comparable situation performed by an independent party and the shared burden between taxpayers and tax administrations is just that, two independent parties. Even though tax administrations do not perform comparable transactions, they are an independent party that can ensure the correct value of the intangibles has been found.

The OECD gives a few examples of business restructurings that have an uncertain value. The examples tries to show the consequences that follows a situation where it is difficult to initially determine a value. Transactions that have an uncertain value are recommended to include an adjustment clause. If it is not know or could have been known at the time of the business restructuring that the value could change and independent enterprises would have done the same, then a business restructuring without an adjustment clause could be accepted as at arm’s length. The change in value would not be regarded as fundamental enough to go against the arm’s length principle.

The second example from the OECD deals with a renegotiation of the agreement set out in example one. The expected future value of the intangibles is still highly uncertain a renegotiation creates a great deal of uncertainty that independent enterprises probably would not agree to. Here the adjustment clause would almost certainly be demanded by independent enterprises and therefore also be demanded for associated enterprises.

Not only is it difficult to find comparable uncontrolled transactions in order to determine if a business restructuring of intangibles with an uncertain value follow the arm’s length principle but here it becomes necessary to find out how independent enterprises may have done. The fact that these examples seeks to find out what independent enterprises may have done if they ever faced this situation is a very difficult approach. It almost becomes guesswork to determine what independent enterprises would have done and the question becomes whose opinion should be followed when the OECD does not go further into the matter. It also becomes difficult to determine in what situations the value is uncertain enough to demand an adjustment clause and in what situations it is not necessary.
The OECD acknowledges that the valuation of intangibles within associated enterprises is a difficult task since comparable intangibles may not be found in independent enterprises. The burden put on both taxpayers and tax administrations can therefore become unrealistic to carry. The demand for comparables from the open market can in itself create issues since there may not be an open market even for MNE within the same field.

An issue that only has been touched upon in this thesis is the issue of business restructurings where the intangibles are bundled together with tangibles. The value of the intangibles may be uncertain because they do not have a value by itself. Here the tax authorities are forced to find a way to separate the intangibles from the tangibles in order to find a certain value. This is for many reasons a difficult matter not only because it creates an even bigger burden but also because it creates an even more uncertain situation as to the application of the arm’s length principle when there is no value at all to examine initially.
4 The applicability of the arm’s length principle

4.1 Introduction

In the previous chapter, the arm’s length principle, business restructurings and intangibles as such have been examined. In order to answer the question raised as the purpose for this thesis, the applicability of the arm’s length principle for business restructurings of intangibles should now be examined. This will be done with the previous chapters in mind. This chapter will firstly try and assess how the ownership of intangibles should be determined in order to perform a comparability analysis. The second part of this chapter will discuss the comparability analysis as such and thereafter go through the five comparability factors. Thirdly the comparable uncontrolled transaction will be examined. This chapter will end with an analysis of the facts presented in the different parts.

4.2 Ownership of intangibles

When trying to determine how to perform a comparability analysis it is important to determine which of the entities in the MNE holds the ownership of the intangibles. This identification may be somewhat problematic since the ownership and the can be divided between several entities or only it can be held by one entity at the same time as other entities contributes to the development of the intangibles. The following example shows a business strategy within an MNE where the legal rights to the intangibles are placed in one singel entity. The other entities still has the responsibility to develop the intangibles and or the ability to use the intangibles.

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82 Cottani, G. Valuation of Intangibles for Direct Tax and Customs Purposes: Is the Convergence the Way Ahead?, p.286.

83 Ibid.
In this type of an MNE there are several entities (company B-D) that contributes to the development of the intangibles but it is only one entity (company A) that holds the legal rights to the intangibles.\textsuperscript{84}

The tax authorities will in a situation like this when several entities contribute to the development of the intangibles ask the taxpayers to clarify how the ownership of the intangibles actually is divided.\textsuperscript{85} When the taxpayers have shown how the ownership of the intangibles were divided both before and after the business restructuring, a comparability analysis should be done.

\section*{4.3 Comparability analysis}

\subsection*{4.3.1 General}

The applicability of the arm’s length principle depends on finding an independent enterprise that has done the same transfer as the one performed with the associated enterprise and compare the conditions of the two. To do this a comparability analysis must be done.\textsuperscript{86}

\begin{table}[h]
\centering
\begin{tabular}{|c|c|c|c|}
\hline
\textbf{Table IV} & \textbf{Company A} & & \\
\hline
 & Legal rights of the intangibles & & \\
\hline
 & & Company B & \\
\hline
 & & Company C & \\
\hline
 & & Company D & \\
\hline
\hline
\end{tabular}
\end{table}

\begin{itemize}
\item \textsuperscript{84} Cottani, G. Valuation of Intangibles for Direct Tax and Customs Purposes: Is the Convergence the Way Ahead?, p.286.
\item \textsuperscript{85} Ibid.
\item \textsuperscript{86} The OECD TP Guidelines, Chapter I, 1.33, p.41 and The OECD TP Guidelines, Chapter III, 3.24, p.115.
\end{itemize}
The comparability analysis is a two-sided analysis which means that consideration needs to be taken to both the transferor and the transferee.\(^{87}\)

Chapter I of the OECD TP guidelines contains general guidance as to how to apply the arm’s length principle and how to do the necessary comparability analysis. The general directions given are that the terms affected in controlled transactions in a business restructuring should be compared with the conditions that an independent enterprise would have agreed upon. A comparability analysis according to the OECD TP guidelines should seek guidance in the economic characteristics of the transactions compared. These economic characteristics need to be “sufficiently comparable”\(^{88}\) for a comparability analysis to be made.\(^{89}\)

The first step in finding a sufficiently comparable independent transaction is to examine and understand how independent enterprises valuate its own transactions. It is unlikely that an independent enterprise would agree to conditions that are unsatisfying if other options are available to them. An independent enterprise would not agree to pay a higher price for intangibles if a cheaper option were available on the market. This is a general stand point when doing a comparability analysis.\(^{90}\)

The reason a comparable transaction is needed is the fact that associated enterprises runs the risk of not being influenced by market conditions or the power of interest that comes from an independent party. This lack of external pressure can create transactions that are not at arm’s length and therefore could lead to a distortion of profit allocation and tax liabilities between countries where the MNE operates.\(^{91}\)

Chapter IX of the OECD TP guidelines discusses arm’s length compensation for the business restructuring in itself. Business restructurings may involve intangibles that are valuable

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\(^{87}\) The OECD TP Guidelines, Chapter I, 1.38, p.43 and Cottani, G. Valuation of Intangibles for Direct Tax and Customs Purposes: Is the Convergence the Way Ahead?, p.287.

\(^{88}\) For the economic characteristics to be comparable “none of the differences (if any) between the situations being compared could materially affect the conditions being examined in the methodology (e.g. price or margin), or that reasonably accurate adjustments can be made to eliminate the effect of the any such differences.”.

\(^{89}\) The OECD TP Guidelines, Chapter I, 1.33, p.41-42.

\(^{90}\) The OECD TP Guidelines, Chapter I, 1.34, p.42.

for an MNE and the consequences of a business restructuring of this sort will therefore be discussed further in this part.\footnote{The OECD TP Guidelines, Chapter IX, 9.48, p.252.}

To understand if a transfer of valuable intangibles are at arm’s length, a comparability analysis should (as mentioned earlier) be done. In a comparability analysis the conditions made for the business restructuring will be examined. There are three parts that will be examined; “the functions performed, assets used and risks assumed by the parties […]”.\footnote{The OECD TP Guidelines, Chapter IX, 9.50, p.252.}

There is a risk that a comparable uncontrolled transaction cannot be found. A transaction like this does not automatically go against the arm’s length principle but instead it becomes important to look at what independent enterprises would have done in a situation like this. Would independent enterprises have agreed upon these same conditions?\footnote{The OECD TP Guidelines, Chapter IX, 9.52, p.252-253.} The first thing to examine in a comparability analysis is the actual transaction undertaken.

### 4.3.2 The actual transaction undertaken

The applicability of the arm’s length principle found in Article 9 of the OECD model firstly requires an identification of the transaction undertaken in the business restructuring. This is a natural first step since Article 9 of the OECD model aims to find a transaction undertaken by an independent enterprise and compare this independent transaction with the transaction in the associated enterprise.\footnote{The OECD TP Guidelines, Chapter I, 1.36, p.43 and Liaugminaite, G. Recognition of the Actual Transaction Undertaken, p.109.} The initial thing to properly examine when performing a comparability analysis is therefore the transaction undertaken by the associated enterprise by using the TP methods given by the OECD.

The OECD uses the term the actual transaction undertaken and it therefore becomes essential to determine the meaning of the term “actual transaction”. Whether this term means the transaction by the associated enterprise as such, the form of the transaction, all of the conditions except the price, the circumstances of the transaction or only the conditions of the transactions is unsure.\footnote{Liaugminaite, G. Recognition of the Actual Transaction Undertaken, p.109-110.}
Taking a step back, the word “actual” is another term for the word real, genuine or a matter of fact. The OECD uses the term in several part of the OECD TP guidelines.\(^97\) When talking about the actual transaction undertaken, the term actual refers to the manner in which the transaction has been structured. This should include all written and verbal communication between the associated enterprises concerning arrangements of the allocation of functions assets and risks.\(^98\)

Tax authorities in a country will look at the actual transaction undertaken when determining if a transaction is at arm’s length or not but this does not mean that they have the authority to control how an MNE structures its business. Nor does it give them the authority to regulate the amount of business presence an MNE has in any given county.\(^99\) This does not take away all the rights for the tax authorities since they still have the ability to determine the tax consequences that follows with the structure set out by the MNE. If the tax authority finds a structure to not follow the provisions found in Article 9 of the OECD model then they can decide that the transaction should be adjusted according to Article 9 of the OECD model.\(^100\)

The price set by the associated enterprise should be a starting point for the tax authorities in finding the actual transaction undertaken.\(^101\) The following example shows the steps that should be taken in order to perform a comparability analysis and find an arm’s length price.\(^102\)

\(^{97}\) Such as for actual transaction, actual profits and price, actual conduct, actual intent and actual allocation.

\(^{98}\) Liaugminaite, G. Recognition of the Actual Transaction Undertaken, p.110.


\(^{100}\) The OECD TP Guidelines, Chapter IX, 9.163, p.290.

\(^{101}\) Liaugminaite, G. Recognition of the Actual Transaction Undertaken, p.109.

\(^{102}\) Ibid.
To find the arm’s length price that should be used for a business restructuring of intangibles with an uncertain value at the time of the restructuring, a comparability analysis should be done. The comparability analysis aims to compare the relevant factors in the transaction within a MNE to a similar transaction between independent enterprises. The initial steps that should be taken to find the arm’s length price are shown in the table above.\textsuperscript{103}

\begin{table}[h]
\centering
\begin{tabular}{|l|}
\hline
Identification of conditions made or imposed \\
Identification of difference (arm’s length principle) \\
Profit adjustment \\
\hline
\end{tabular}
\caption{Comparability analysis}
\end{table}

After identifying the actual controlled transaction undertaken by the associated enterprise, a comparable uncontrolled transaction should be found. This will be done by examining the comparability factors and this will be done in the following.\textsuperscript{104}

4.3.3 \textbf{The five comparability factors}

An examination of how independent enterprises value a transaction should be done and there are five different factors to consider, the “\textit{comparability factors}”.

\begin{enumerate}
    \item The characteristics of the property or services transferred
    \item The functions performed by the parties (taking into account assets used and risks assumed)
    \item The contractual terms
    \item The economic circumstances of the parties
    \item The business strategies pursued by the parties.\textsuperscript{105}
\end{enumerate}

These five factors should be used on a case by case basis, both for the controlled transaction and for the uncontrolled transaction by the independent enterprise.\textsuperscript{106} The following sub-chapters will discuss the implications of the different factors.

\textsuperscript{103} Liaugminaitė, G. Recognition of the Actual Transaction Undertaken, p.109.

\textsuperscript{104} The OECD TP Guidelines, Chapter I, 1.36, p.43.

\textsuperscript{105} Ibid.

\textsuperscript{106} The OECD TP Guidelines, Chapter I, 1.36-1.38, p.43-44.
4.3.3.1 The characteristics of the property or services transferred

The OECD TP guidelines discuss three different types of transactions; tangible property transactions, service transactions and intangible property transactions. For intangibles there are several characteristics that should be considered to determine a comparable independent value for a transaction.

- The form of transaction (e.g. licensing or sale),
- The type of property (e.g. patent, trademark, or know-how),
- The duration and degree of protection, and
- The anticipated benefits from the use of the property.  

The amount of weight these characteristics ought to have depends on the chosen TP method. It may become necessary to include transactions of intangibles from independent enterprises where there is a bigger difference from the transaction in the associated enterprise. This should be done on a case by case basis depending on the circumstances in each case. The difference between the transactions should however not have an effect on the reliability of the comparable factors for it to be acceptable.  

4.3.3.2 The functions performed by the parties (taking into account assets used and risks assumed)

When two independent enterprises try to determine the amount of compensation for a transaction they commonly look at the functions performed, a so called function analysis. A function analysis has as its purpose to find the economic activities that are of importance to the transaction and also to find the responsibilities of the parties. After identifying the economic activities and the responsibilities of the parties the function analysis seeks to compare these two with each other.

There are several functions that both the taxpayers and the tax administrations can take into consideration when doing a function analysis. Out of all the different functions it is “the principal functions performed” that needs to be found. It may be that one independent en-

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107 The OECD TP Guidelines, Chapter I, 1.39, p.44.
108 The OECD TP Guidelines, Chapter I, 1.40, p.44.
109 The OECD TP Guidelines, Chapter I, 1.41, p.44.
110 The OECD TP Guidelines, Chapter I, 1.42, p.45.
111 E.g. design, research, development, purchasing, distribution, marketing, financing and management.
terprise can account for a larger amount of functions than the other independent enterprise that it is being compared with. If this is the case then the economic aspect becomes significant. The value of the functions, the nature of the functions and the frequency of the functions should then be examined from an economic perspective.\textsuperscript{112}

Within the function analysis it is important to consider the risks assumed by the parties and the first part of chapter IX of the OECD TP guidelines examines the special considerations of risks that need to be taken into consideration when performing a business restructuring.\textsuperscript{113}

When independent enterprises transfer something to another enterprise and there is an increased risk attached to the transfer, the price for the transfer should reflect the increased risk by adding compensation for the expected return. It is common for business restructurings to lead to so called “low risk operations”\textsuperscript{114} which makes it even more important for tax administrations to take special considerations for risks in order to assess how the arm’s length principle should be applied.\textsuperscript{115}

When assessing the consideration of risks the OECD states that the first thing that should be examined is the contractual terms agreed upon by the parties involved in the business restructuring. An examination of the contractual terms can be helpful since it can make it easier to determine how the parties intended to divide the risks and which party was supposed to carry the increased risk that came with the business restructuring.\textsuperscript{116}

The OECD advices associated enterprises to document how they intend to allocate or transfer risks before a business restructuring takes place.\textsuperscript{117} But even if an associated enterprise has documentation of the contractual terms, where the allocation of the risks are shown, tax authorities still has the power to question what was really agreed upon. For the

\textsuperscript{112} The OECD TP Guidelines, Chapter I, 1.43, p.45.
\textsuperscript{113} The OECD TP Guidelines, Chapter I, 1.45, p.46.
\textsuperscript{114} A low risk operation is the result of a business restructuring where local operations are being converted and the new operation is allocated rather low. The risks are therein borne by someone else that also gains the right to the residual profit.
\textsuperscript{115} The OECD TP Guidelines, Chapter IX, 9.10, p.239.
\textsuperscript{116} For the purpose of this thesis, the increased risk is the fact that intangibles with an uncertain value at the time of the business restructuring has been transferred.
\textsuperscript{117} The OECD TP Guidelines, Chapter IX, 9.11, p.239.
tax authorities to question this there has to be signs that the content of the contract does not conform to the economic substance of the transaction that has occurred.\textsuperscript{118}

There are three additional questions, beyond only the contractual terms, that should be examined when determining the TP consequences for risk allocation between associated enterprises. The first question is “whether the conduct of the associated enterprises conforms to the contractual allocation of risks”.\textsuperscript{119} Independent enterprises have the advantage that when a contract is being entered, the parties will make sure that the terms of the contract are being followed by the other party. A change in the conditions set down by the contract will only be altered if the parties are in an agreement that it is in the interest of all parties. This level of difference in interest may not be present between associated enterprises, which makes it more important to examine the “true terms” of the contract and therein the business restructuring. The reason to look further into what has actually been agreed upon is to ensure that the conduct of the parties goes in line with the terms of the contract.\textsuperscript{120} If the tax authorities believe that the TP price set does not follow the actual terms of the contract then they may challenge the allocation of risks.\textsuperscript{121}

The second question is “determining whether the allocation of risks in the controlled transaction is arm’s length”.\textsuperscript{122} For a controlled transaction to be at arm’s length the allocation of risks in a similar uncontrolled transaction should be the same.\textsuperscript{123} There are situations where it is difficult to find comparables as to determine if the controlled transaction follows the terms of an uncontrolled transaction. In these cases it should be determined if independent enterprises could be expected to have allocated the risks in the same manner if this type of a transaction had been done. The mere fact that there is no comparable transaction does not mean that the allocation of risks by the associated enterprises is not at arm’s length.\textsuperscript{124} Two factors that can be used in determining if independent enterprises would in fact have allo-

\textsuperscript{118} The OECD TP Guidelines, Chapter IX, 9.12, p.240.
\textsuperscript{119} Ibid.
\textsuperscript{120} The OECD TP Guidelines, Chapter IX, 9.13, p.240.
\textsuperscript{121} The OECD TP Guidelines, Chapter IX, 9.14, p.240-241.
\textsuperscript{122} The OECD TP Guidelines, Chapter IX, 9.17-18, p.241.
\textsuperscript{123} The OECD TP Guidelines, Chapter IX, 9.18, p.241.
\textsuperscript{124} The OECD TP Guidelines, Chapter IX, 9.19, p.242.
icated the risks in the same way is firstly; which party has the control over the risks. Secondly; the independent enterprises financial ability to take on the added risk.\textsuperscript{125}

### Table VI Does the allocation of risks follow the arm’s length principle

<table>
<thead>
<tr>
<th>Is there reliable evidence of a similar allocation of risks in comparable uncontrolled transactions?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
</tr>
<tr>
<td>No</td>
</tr>
</tbody>
</table>

- **The risk allocation in the controlled transaction is arm’s length**
- **Relevant, although not determinative factors:**
  - Which party has greater control over risk?
  - Is the risk allocated to a party which has the financial capacity to assume it?

Search evidence the actual conduct of independent parties

Lacking such evidence, determine whether the risk allocation is one that would have been agreed between independent parties in comparable circumstances

This is an example of how to determine if an allocation of risks within associated enterprises is at arm’s length or not.\textsuperscript{126}

The third question is “what the consequences of the risk allocation are”.\textsuperscript{127} This part aims to find the tax consequences for the allocation of risks for one of the parties in a transaction within an associated enterprise. This is to be done by examining whether the allocation of risks follows the arm’s length principle. For the arm’s length principle to be followed the party to which the risks has been allocated should; bear the costs of managing the risks, bear

\textsuperscript{125} The OECD TP Guidelines, Chapter IX, 9.20, p.242.

\textsuperscript{126} The OECD TP Guidelines, Chapter IX, 9.33, p.246.

\textsuperscript{127} The OECD TP Guidelines, Chapter IX, 9.39, p.248.
costs that could become relevant when the risks are being realized and be compensated for the additional return that are expected to come to the party.\textsuperscript{128}

When associated enterprises relocates risks it can have both a negative and a positive influence for the two parties\textsuperscript{129}. One aspect for the negative and the positive influences is the fact that potential losses and liabilities can be transferred to the transferee. Another aspect is that the transferee will be the one that will have to take the realization of the expected return that comes with the risk. This should belong to the transferor but the restructuring can move it to the transferee instead.\textsuperscript{130}

It is important to determine the economically significant of the risks that are being allocated. Does it have any profit potential? The reason to determine this is to understand if the reallocation of the risks has any basis in the reallocation of profit potential. An allocation of risks in exchange for a lesser profit potential would only occur between independent enterprises if it at arm’s length had an economical value.\textsuperscript{131}

\textbf{4.3.3.3 \quad The contractual terms}

The contractual terms of a business restructuring is of great importance when doing a comparability analysis since the terms agreed upon between the parties can show either explicitly or implicitly how the parties intended to divide the responsibilities, risks and benefits transferred in the business restructuring. Since the contractual terms can show the allocation of these factors, they should be included in the function analysis.\textsuperscript{132}

Not all business restructurings have expressively drawn up contractual terms in advance that can be examined for the comparability analysis. In the absence of contractual terms one can examine any other communication done between the parties that cannot be regarded as a contract. In some cases there is no contractual terms and no other communication done between the parties and when that occurs guidance can be found by examining

\textsuperscript{128} The OECD TP Guidelines, Chapter IX, 9.39, p.248-249.

\textsuperscript{129} Both the transferor and the transferee.

\textsuperscript{130} The OECD TP Guidelines, Chapter IX, 9.40, p.249.

\textsuperscript{131} The OECD TP Guidelines, Chapter IX, 9.41, p.249.

\textsuperscript{132} The OECD TP Guidelines, Chapter I, 1.52, p.47.
what conduct and economic principles independent enterprises would have used in a similar situation.\textsuperscript{133}

When two independent enterprises transfers intangibles from one enterprise to another, both sides will have different interests and this difference in interests will push the parties to make sure both sides fulfills the terms in the contract. For the contractual terms to be changed or fully overlooked, both parties needed to have an interest in this change otherwise the original terms will stay in place. When associated enterprises transfers intangibles in a business restructuring the same difference in interests that can be found between independent enterprises may not be found. It is therefore important to examine if the contractual terms are being followed by the parties or if the contractual terms merely are a sham. If it is suspected that the contractual terms are not being followed or may only be a sham, then the actual terms that the parties are following needs to be found and analyzed in order to understand the true contractual terms of the business restructuring.\textsuperscript{134}

The importance of finding the true contractual terms behind a business restructuring depends on what has been transferred and also on the choice of TP method used.\textsuperscript{135}

4.3.3.4 \textbf{The economic circumstances of the parties}

The comparability analysis aims to find an arm’s length price for the intangibles transferred in the business restructuring and the economic circumstances needs to be examined since the price for intangibles may differ in the global market. This difference in the price can occur even if the same type of intangibles is examined. This difference can not have a material affect on the price of the intangibles for the comparability analysis to be applicable. If the difference does have a material effect on the price, then an appropriate adjustment of the price needs to be made.\textsuperscript{136}

To determine the economic circumstances needed for the comparability analysis it is important to identify the relevant market/markets where the intangibles are available. There are several economic circumstances that can be examined in order to determine the market comparability of a transfer of intangibles in a business restructuring. Geographic location,

\textsuperscript{133} The OECD TP Guidelines, Chapter I, 1.52, p.47-48.
\textsuperscript{134} The OECD TP Guidelines, Chapter I, 1.53, p.48.
\textsuperscript{135} The OECD TP Guidelines, Chapter I, 1.54, p.48.
\textsuperscript{136} The OECD TP Guidelines, Chapter I, 1.55, p.48.
the size of the market and the extent of competition on the market are some of the eco-
nomic circumstances that can be used.\textsuperscript{137} All factors should initially be taken into consider-
ration to understand the economic circumstance of a transaction but they may not all be
needed to finalize the comparability analysis.\textsuperscript{138} When trying to determine which of the
economic circumstances that is relevant, a case by case determination should be made.

This case by case analysis of the mentioned circumstances should also be done in order to
determine if they have a material effect on the price of the intangibles transferred in the
business restructuring. As mentioned above an adjustment can be made if a material effect
on the price occurs. A case by case analysis also needs to be done here when determining if
an adjustment can be done and in such a case, how.\textsuperscript{139}

\textbf{4.3.3.5 The business strategies pursued by the parties}

The last one of the five comparability factors are business strategies and the reason this is
important as a comparability factor is because it takes into account a different set of aspects
of the enterprise that is an important part of the day to day decisions within a company.\textsuperscript{140}
These factors all help when performing a comparability analysis.\textsuperscript{141}

Business strategies come in many different forms and can affect the applicability of the
arm’s length principle in different ways. One business strategie can be a strategy where the
MNE aims to penetrate a new market. This is a commonly used strategy for MNE that
tries to expand on the market where they operate. When an MNE tries to penetrate a new
market, it may affect both the price for the products (and therein the intangibles) and cre-
ate increased costs for the market shares. The price may be set at a lower range than other
comparable product to give the MNE a better chance to penetrate the market. This lower
price would only be used in the initial phase of the market penetration. The market shares

\textsuperscript{137} Some of the other economic circumstances that can be used when identifying the relevant market are; the
relative competitive positions of the buyers and sellers, the availability (risk) of substitute services, the level
of supply and demand in the market as a whole and in particular regions, consumer purchasing power, the
nature and extent of government regulations on the market, costs of production (land, labour, capital,
transport), level of the market (retail or wholesale), the date and time of the transaction.

\textsuperscript{138} The OECD TP Guidelines, Chapter IX, 9.170, p.293.

\textsuperscript{139} The OECD TP Guidelines, Chapter I, 1.55, p.48-49.

\textsuperscript{140} Some of these different aspects are innovation and new product development, risk assessments, political
changes, labour laws in the different countries that the MNE operates in, the length of the arrangements
and other day to day decisions made in the MNE.

\textsuperscript{141} The OECD TP Guidelines, Chapter I, 1.59, p.49.
may also be affected in a market penetration since there might occur start-up costs that usually is not connected with the new market. Higher costs may lead to lower profits and when an MNE tries to penetrate a new market, its profit may initially be lower than for other companies in a comparable market.\textsuperscript{142}

For tax administrations, a market penetration or expansion can create timing issues, since the profits for the taxpayers, in that MNE can be lower than that for a comparable company while expecting an increase in the future profits. There is no guarantee that the market penetration will, in the future, lead to increased profits since the taxpayer can divert from the business strategy. In the absence of the expected future profits, tax administrations may wish to examine the business strategy. This can become problematic for tax administrations to achieve because of legal constraints that prohibits them from examining past tax years.\textsuperscript{143}

The tax administrations will try to examine if a taxpayer has followed a set business strategy by several different factors. The initial thing to examine is the conduct of the parties, have they acted in a manner that follows the business strategy set forward? Within an associated enterprise that tries to penetrate a new market, a manufacturer may charge the distributor a price that is below the market price and this lower price may follow all the way to the distributor’s customers. It is important to consider the relationship between the parties affected by a business strategy within an MNE and to compare this relationship to those of independent enterprises. This comparison should take notes of which party would bear the costs of the business strategy in an independent enterprise and which party is bearing the costs in the associated enterprise.\textsuperscript{144} An example of this is a company that only should be regarded as a sales agent. In this case the company does not have any commitments to long-term developments on the market and for the business strategy to follow the arm’s length principle; the company should be responsible for any of the costs associated with the business strategy to penetrate a new market.\textsuperscript{145}

\textsuperscript{142} The OECD TP Guidelines Chapter I, 1.60, p.50.

\textsuperscript{143} The OECD TP Guidelines Chapter I, 1.61, p.50.

\textsuperscript{144} The OECD TP Guidelines, Chapter I, 1.62, p.50.

\textsuperscript{145} Ibid.
4.4 The comparable uncontrolled transaction

As mentioned earlier, a comparable uncontrolled transaction is a transaction that takes place between independent enterprises. This transaction should, to be used as a comparable transaction, be similar to the controlled transaction that takes place within associated enterprises. There are two different ways this comparable transaction can occur. Either between two different independent enterprises where there is no connection to the controlled transaction.\textsuperscript{146} Or by looking at a transaction that takes place between an independent enterprise and an associated enterprise.\textsuperscript{147}

<table>
<thead>
<tr>
<th>Table VII</th>
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<tbody>
<tr>
<td><strong>Comparable transaction 1</strong></td>
</tr>
<tr>
<td>Independent enterprise A</td>
</tr>
<tr>
<td>Independent enterprise B</td>
</tr>
</tbody>
</table>

Uncontrolled transactions

In the first comparable transaction, parties of the uncontrolled transaction are two independent enterprises. In the second comparable transaction, the uncontrolled transactions take place between an independent enterprise and an associated enterprise.

It is important to remember that an independent enterprise needs to be present when doing comparability analysis since only controlled transactions will not be useful when determine an arm’s length price.\textsuperscript{148}

The applicability of the arm’s length principle for business restructuring of intangibles with an uncertain value at the time of the restructuring is a challenging matter since it demands a comparability analysis. MS and MNEs continue to welcome new and improved guidance on the matter to try and fill the gaps in the somewhat lacking regulatory framework. To

\textsuperscript{146} An external comparable transaction.

\textsuperscript{147} An internal comparable transaction.

\textsuperscript{148} The OECD TP Guidelines, Chapter III, 3.24-3.25, p.115.
find an arm’s length price a comparison needs to be done and this should be done in two steps as mentioned earlier. The first step is to examine the controlled transaction and the second step is to examine the uncontrolled transaction and thereafter do a comparison of the two.\textsuperscript{149} To do this, comparables should be found but it should be noted that the comparables is only one aspect of the comparability analysis. The search for comparables is not the comparability analysis as such but a part of it. The transaction between associated enterprises should firstly be examined in order to find the parts of the transaction that can be used as comparable factors. It is only after this examination is done as a comparable uncontrolled transaction should be searched for.\textsuperscript{150}

The OECD TP guidelines gives an example for what a typical process should include when doing a comparability analysis. This example entails nine steps;

\begin{itemize}
\item \textbf{Step 1}: Determination of years to be covered.
\item \textbf{Step 2}: Broad-based analysis of the taxpayer’s circumstances.
\item \textbf{Step 3}: Understanding the controlled transaction(s) under examination, based in particular on a functional analysis, in order to choose the tested party (where needed), the most appropriate transfer pricing method to the circumstances of the case, the financial indicator that will be tested (in the case of a transactional profit method), and to identify the significant comparability factors that should be taken into account.
\item \textbf{Step 4}: Review of existing internal comparables, if any.
\item \textbf{Step 5}: Determination of available sources of information on external comparables where such external comparables are needed taking into account their relative reliability.
\item \textbf{Step 6}: Selection of the most appropriate transfer pricing method and, depending on the method, determination of the relevant financial indicator (e.g. determination of the relevant net profit indicator in case of a transactional net margin method).
\item \textbf{Step 7}: Identification of potential comparables: determining the key characteristics to be met by any uncontrolled transaction in order to be regarded as potentially comparable, based on the relevant
\end{itemize}

\textsuperscript{149} Oosterhoff, Danny and Wingerter, Bo. The New OECD Guidelines: The Good, the Bad and the Ugly. International Transfer Pricing Journal, 2011 (Volume 18), No. 2.

\textsuperscript{150} Ibid.
factors identified in Step 3 and in accordance with the comparability factors set forth at paragraphs 1.38-1.63.

**Step 8:** Determination of and making comparability adjustments where appropriate.

**Step 9:** Interpretation and use of data collected, determination of the arm’s length remuneration.

These nine steps are not exhaustive or compulsory and the OECD states that businesses can use other steps in determining if a transaction is at arm’s length or not. The OECD continues on by stating that even if a business chooses to only use the steps provided by the OECD TP guidelines, there is no guarantee that the transaction will be at arm’s length. The OECD finishes by stating that if a business chooses to not use the steps, there is in the same way no guarantee that the transaction is not at arm’s length.  

The updated OECD TP guidelines have many positive new aspects to it in order to help taxpayers and tax administrations understand the application of the arm’s length principle. There are still some improvements that can be made to help reduce the areas where the taxpayers still are required to interpret the guidelines. The nine step “typical process” mentioned earlier is one area that can create interpretation issues. The fourth step entails that taxpayers needs to examine internal comparables in a more serious fashion. This can create an unnecessary anxiety since it changes the way TP previously was practiced. The consequence of this is an added administration burden for the taxpayers that will obstruct the usage of the arm’s length principle.  

**4.5 Analysis**

After examining the general aspects of the arm’s length principle, the meaning of a business restructuring and the implications of intangibles, it is now time to examine the applicability of the arm’s length principle. A controlled transaction that falls within Article 9 of the OECD model should be examined in the light of the arm’s length principle in order to, as mentioned earlier, find an arm’s length price for taxation purposes. The comparability analysis aims to find a comparable uncontrolled transaction that has been performed in a similar matter as the one between the associated enterprises, in order to find this

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151 The OECD TP Guidelines, Chapter III, 3.4, p.108.

152 The OECD TP Guidelines, Chapter III, 3.4, p.108.

153 Oosterhoff, D and Wingerter, B. The New OECD Guidelines: The Good, the Bad and the Ugly.
comparable, several factors has to be considered. The first thing to establish is which entity of an MNE that hold the legal ownership of the intangible. If several entities share the ownership or the ownership is not clearly divided between the entities, then the tax authorities has the ability to ask the MNE to clarify this. This may not be one of the more complex issues in the comparability analysis but the burden it put on both the tax authorities and the taxpayers should be noted. It may be the case that it becomes impossible to identify one entity as the owner of the intangibles and it is not clear how this issue affect the comparability analysis or how it should be solved. This is an issue that has not been further examined in this thesis.

The core of the arm’s length principle is as mentions several times in this thesis, the comparability analysis. The reason a comparability analysis should be made and an arm’s length price should be found for controlled transactions is because of their lack of external influences which can lead to a distortion of profit allocation and tax liabilities. This is a two-sided analysis that should take into account both the transferor and the transferee. A comparability analysis compares the conditions agreed upon by the associated enterprises with the conditions agreed upon by independent enterprises in a similar situation. The OECD states that it is the economic characteristics of the transaction that should be found and examined. In order for the economic characteristics or any other comparables to be able to be used for a comparability analysis, they have to be sufficiently comparable.

A business restructuring of intangibles with an uncertain value at the time of the restructuring is a transaction that brings a level of uncertainty for the parties and finding a sufficiently comparable independent transaction is not always that easy. In order to find a comparable transaction it is important to firstly examine how the independent enterprise would have tried to value a similar transaction. The reason for finding this out is that independent enterprises would not agree to conditions that were unfavorable to them if there were better options available to them. A sufficiently comparable transaction may not be found for several reasons, the transaction is too specific to the business performed in the associated enterprise or it is hard get sufficiently enough information about the transaction. These transactions do not automatically go against the arm’s length principle, as mentioned earlier, and it becomes even more important to examine what independent enterprises may have done in a similar situation. The risk is that this becomes guesswork since there is no actual transaction to compare with, only the speculation of what independent enterprises may have done if they were ever in a similar situation. This creates an uncertainty as for the
application of the arm’s length principle for transactions that has no sufficiently comparable factor. The term sufficiently comparable in itself is not always easy to understand but there are three different parts that should be examined for both the controlled transaction and the uncontrolled namely; the functions performed, assets used and risks assumed.

To examine these different parts the actual transaction undertaken should be identified and examined. The term actual in itself can create some confusion since the OECD has given it different meanings depending on where in the OECD TP guidelines it is found. This confusion is unwanted since it requires an examination of the term actual before going forward with finding the actual transaction undertaken. For this part of the OECD TP guidelines, the term actual means the manner in which the transaction is structured. All communication connected to the transaction, written or verbal that discusses the allocation of functions, assets and risks should be included. For this examination to be possible tax authorities’ needs to be able to access this communication. Within associated enterprises this may not be that well documented and verbal communication is even more difficult to show for.

Even if the tax authorities examines the actual transaction undertaken in order to determine if it follows the arm’s length principle or not, they do not have the authority to tell an MNE how to structure its business. An MNE has the control to restructure its business as they please and, on their own, determine how much business presence should be found in a country. This is a fundamental freedom that MNE have and it is important that this freedom is not restricted by the application of the arm’s length principle. This does not take away all the authority from tax authorities since they still has the authority to determine the tax consequences for the structure that the MNE has chosen and whether it follows the arm’s length principle. This is a good point to make since tax authorities should only be involved with tax issues and not get involved with the MNE’s way of structuring its business.

The comparable uncontrolled transaction should be determined, on a case by case basis, with the help of five comparability factors. The first factor is the characteristic of the intangible transferred and for business restructurings of intangibles there are four aspects to consider assessing this the characteristics; the form, the type, the duration and the anticipated benefits. This thesis do not examine the different TP methods and since the amount of weight put on the characteristics of the transferred intangible depends on the TP method used, this factor is not further analysed. The only aspect of this factor to still keep in mind is that it may become necessary to use transactions with characteristics that differs a
bit more from the controlled transaction. If that becomes the case then it is important that the difference is not bigger then that the reliability of the comparison is still intact.

The second factor is the functions analysis performed in order to assess the amount of compensation that should be paid for the transaction. The function analysis aim to examine the economic factors that are of importance for the transaction and to assess the responsibilities set out for the different parties. These factors will thereafter be compared to each other. The principal function performed is the one that needs to be identified with the help of the economic aspect of the functions. The function analysis was previously called the FAR analysis since it focused on the function, assets and risks. In the updated OECD TP guidelines this analysis is only called the function analysis but it still considers the assets and the risks. The risks assumed by the parties have by the OECD been given separate considerations in the OCED TP guidelines.

A business restructuring of intangibles with an uncertain value at the time of the restructuring creates the issue of the assessment of the price that should be paid for the transaction. This uncertainty of the price can be regarded as an increased risk that should be considered in the function analysis. The higher uncertainty of the value of the intangible the higher the compensation should be. MNEs may decide to perform a business restructuring that leads to parts of the business to be transferred to a low risk operation and in these types of restructurings tax authorities will demand that the restructuring follows the arm’s length principle so that this option is not used in a wrongful manner.

The third factor, the contractual terms, should be examined in order to determine how parties intended to divide the risks. The OECD advises MNEs to document what has been agreed upon in a business restructuring but as mentioned earlier, it may be difficult to find contractual terms determining which party should take what risks within associated enterprises. The OECD can only advice MNEs to uphold the documentation but even if there is a contractual agreement of how the risks should be divided, the tax authorities can come to the conclusion that the economic substance of the transaction is not in conformity with the contractual terms and then the contractual terms could be disregarded. This again can create an uncertainty for the application of the arm’s length principle if contractual terms cannot be found at all or if the tax authorities choose to disregard them.

If the contractual terms do not give satisfactory guidance then there are three additional question that can be asked; whether the conduct of the associated enterprises conforms to
the contractual allocation of risks, determining whether the allocation of risks in the controlled transaction is arm’s length and what the consequences of the risk allocation are. It is important to find the true terms for the business restructuring between associated enterprises since they lack the influence from independent parties. Independent parties will only agree to the terms of a transaction or any changes of that agreement if it benefits them. This difference between associated enterprises and independent enterprises is as mentioned earlier the core reason for finding an arm’s length price.

The allocation of risk in the controlled transaction may not be possible to compare with uncontrolled transactions and in those cases it should be determined what independent enterprises would be expected to do, which again becoming guesswork. This lack of clear guidance makes it difficult to determine the tax consequences of the allocation of risks, namely the application of the arm’s length principle. One thing to keep in mind is the fact that risk allocation only will occur between independent enterprises if it has an economic value. This therefore has to be the same for associated enterprises for the risk allocation to be at arm’s length.

The fourth factor is the economic circumstances and this should be examined since MNEs acts on a global market where the same intangible may have a different price depending on where it is located. In order to use the price set by independent enterprises for an intangible, the difference in price cannot have a material effect. The economic circumstances are determined by examining the relevant market by looking at geographical location, the market size and competition on the market. One aspect that is somewhat unclear is that all these aspects, in finding a relevant market, needs to initially be taken into consideration but are not all needed for the comparability analysis. A case by case determination should be used to determine which of the aspects are relevant but it is not clear what criteria should be used when determining this.

The fifth factor is situations where the business restructuring is performed as a business strategy to either penetrate a new market or expanded in an already existing market. This type of business strategies can affect the application of the arm’s length principle since it may demand a short term adjustment of the price for the intangibles. The price for the intangibles in the targeted market, for independent enterprises, may differ from that of the associated enterprise. This difference does not necessary mean that the price within the associated enterprise goes against the arm’s length principle. Once again a comparison should
be done, keeping in mind what independent enterprises would have done in a similar situation even if there is no comparable transaction available.

After determining the characteristics and the factors of the controlled transaction an uncontrolled transaction needs to be identified. As mention several times in this analysis, this can be a difficult task since associated enterprises may perform transactions that would not normally exist between independent enterprises. For a transaction to be used as a comparable uncontrolled transaction it needs to be performed between either two independent enterprises or one independent enterprise and an entity of an associated enterprise. Only using controlled transactions will prevent the meaning of the arm’s length principle and will therefore not be useful.
5 Conclusion

The new OECD TP guidelines have tried to in a clearer way help taxpayers and tax administrations interpret the application of the arm’s length principle. There is however still some areas where the OECD TP guidelines leave room for interpretations that can create an uncertainty in the application of the arm’s length principle. The core of the arm’s length principle aims to find a comparable uncontrolled transaction and compare it with the controlled transaction from the business restructuring.

There are many factors to consider when applying the arm’s length principle on business restructurings with an uncertain value at the time of the restructuring. The initial thing to examine is the meaning of the term business restructuring in the new chapter IX of the OECD TP guidelines in order to know what transactions will fall within Article 9 of the OECD model and therefore should be at arm’s length. The definition given by the OECD leaves some room for clarification since the current meaning is rather wide and may include transactions that are not meant to be regarded as business restructurings for tax purposes.

The second thing to examine is the implications intangibles can have in a business restructuring. Intangibles also lack a satisfactory definition but as pointed out previously, a definition may not be needed for the application of the arm’s length principle. The value of the intangibles is a more important aspect; however it can be challenging to find a satisfactory value especially for transactions that initially has an uncertain value. It therefore becomes even more important to perform a comparability analysis and seek to find out how independent enterprises would have valued a transaction under similar circumstances.

The comparability analysis uses different factors to firstly identify the controlled transaction and thereafter tries to find an uncontrolled transaction with the same comparables in order to determine if they conform to each other. There are five comparability factors that can be used when trying to find the comparables. The characteristics of the intangible transferred, the functions performed, the contractual terms, the economic circumstances and the business strategies. These factors should be used on a case by case basis and may be more or less useful depending on the formation of the business restructuring of the intangibles.

It is important that the uncontrolled transaction, that is to be compared with the controlled, is not a transaction from within the associated enterprise. An independent enter-
prise needs to be present for the comparison to fulfill its purpose and give an arm’s length price in accordance to Article 9 of the OECD model.

To conclude this thesis, the core issue when applying the arm’s length principle for business restructurings with an uncertain value at the time of the restructuring is the comparability analysis. There is a greater risk for this type of transactions to lack comparable factors and therefore create an unclear position for both taxpayers and tax administrations when trying to find an arm’s length price. The OECDs guidelines does not in a clear way help taxpayers or tax administrations in finding an arm’s length price for business restructuring with an uncertain value at the time of the restructuring. The general guidance is there but there are many factors that are not clearly regulated and needs to be interpreted by both the taxpayer and the tax administrations. There is a risk that the room for interpretations can create an unwanted uncertainty for the parties but the fact remains that this still is the accepted and best principle for TP issues for business restructurings of intangibles with an uncertain value at the time of the restructuring.
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(2012-01-27)
## Appendix

### Countries that are members of the OECD

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Appendix