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## Company reorganisations analysis - Transfer pricing issues on restructuring

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***Speed Read: With global tax authorities viewing restructuring of multinationals operations as a green light for initiating transfer pricing audits, there are a variety of areas in which taxpayers can both reduce the odds of wide-ranging, potentially costly enquiries, and mitigate the possibility of wholesale adjustments to transfer prices. Tax and fiscal authorities worldwide are routinely releasing more detailed and formulaic guidelines which allow taxpayers to anticipate contentious areas, while transfer pricing litigation in the UK and elsewhere is providing a clear insight into the practical application of transfer pricing structures and the associated legal and contractual issues critical to any reorganisation.***

Corporate reorganisations offer significant opportunity for proactive management of internal transfer pricing and tax structures, but inevitably attract scrutiny from tax authorities. In the current economic climate many multinational companies are seeking either to rationalise or consolidate operational activity with a view to economies of scale and other cost savings: an increasingly important element to such restructuring is post-tax cash results and management of a group's consolidated effective rate of tax, and as such transfer pricing often takes centre stage.

### Risk profiling

Global tax authorities are increasingly undertaking detailed analysis to determine which corporate taxpayers are most likely to have transfer pricing issues, and which are also most vulnerable to adjustment at audit. HMRC cites 'business reorganisation' as a 'complex' issue, categorising such activity as high risk in terms of transfer pricing ('Guidelines for the conduct of transfer pricing queries' HMRC 10 June 2008). Almost by default companies undertaking a reorganisation will therefore be top of a tax inspector's hit list.

In the UK, the taxpayer does benefit from the prescribed format by which HMRC undertakes any transfer pricing risk assessment. The three elements to an assessment are 'quantum risk' (the value of tax at risk), 'behaviour risk' (a review of the systems and processes in place to manage internal pricing), and 'transaction risk' (the nature of the transaction, its complexity and whether points of principle are involved). Of these three, a taxpayer can readily influence behavioural risk, a significant factor directly influencing the potential for a detailed enquiry by HMRC. Incorporating a review of the way a business identifies, captures and deals with transfer pricing compliance and planning, behavioural risk is one area where a taxpayer can clearly demonstrate internal systems and controls that ensure that business units are complying with transfer pricing requirements both locally and globally. There is a very important caveat: many businesses may take the view that an internal reorganisation is an ideal point at which to update or even implement a comprehensive transfer pricing policy. In practice, tax authorities will undertake a detailed 'before and after' analysis of transfer prices following a restructuring exercise, and taxpayers should carefully review existing documentation to ensure that an all-singing, all-dancing TP structure post-reorganisation doesn't merely serve to highlight any previous compliance weaknesses.

Of particular note during the risk analysis is the open format adopted by HMRC with regard to pre-return and pre-enquiry discussions, which falls outside the remit of the statutory enquiry framework. This seemingly innocuous forum for analysis of a corporate's business and tax developments can often be a technical minefield, frequently providing ammunition for HMRC to merit continuing with a detailed transfer pricing enquiry on the basis of a taxpayer demonstrating a limited or incomplete understanding of the full impact of a company reorganisation on existing and ongoing internal pricing.

As a counterpoint however, this discussion process can provide a valuable opportunity to pre-empt any potential enquiry by demonstrating adherence to the prescribed transfer pricing documentation and compliance appropriate to the businesses concerned, as well a clear understanding of the more complex considerations outlined elsewhere in this article and their application to the reorganisation. With HMRC now incorporating interviews and discussion not only with the tax specialists of a company but also with representatives from the businesses being reviewed, a well prepared and informed tax director needs to ensure that the group's transfer pricing policy and compliance is not merely a technical exercise, but is substantiated in practice by the tangible elements of the reorganisation and operational structure that it

represents.

## Form versus substance

Despite being relatively small in terms of tax settlements, the ruling in the landmark transfer pricing case of *DSG Retail Ltd v HMRC* (2009 TC00001) quantified an element that continues to be routinely attacked as a fundamental weakness in many transfer pricing structures – an inter-company legal and contractual structure that is frequently at odds with the economic reality of the day-to-day activities of the parties involved.

Contractual terms and conditions of inter-company transactions inevitably come under the spotlight during a group reorganisation, and inter-company agreements are often used as the internal template for determining transfer pricing for ongoing business. Every global business structure is susceptible to the vagaries of local management and implementation, and this must be carefully considered in determining robust, defensible transfer pricing. For example, if a local sales function is being rationalised on implementation of an offshore distribution hub, what are the demonstrable functional changes that warrant a change in the transfer pricing and a potential reduction in local profitability? There may be a tangible change in the cost profile of the business as a whole, often one of the main commercial drivers of the reorganisation in the first instance. There may be inter-company agreements that detail a reduced risk approach to the new business operations and associated pricing, forming a fundamental construct of the argument for moving profits to the distribution hub. However if to all intents and purposes business continues as usual in the local taxable entity, it is hard to argue that the transfer pricing method applied to that local activity should be substantially changed, even if this is the desired outcome for tax planning purposes.

It is often assumed that production of intercompany agreements and contracts at a tax audit are a deal-breaker in supporting attribution of risks and functions in a post-reorganisation transfer pricing structure. However the reverse is often the case, and legal contracts are now often dismissed as not representative of the true nature of an operational relationship. A rigorous functional analysis is therefore critical not only in complying with documentation procedures, but to demonstrate the validity of any contractual and legal relationships. The hands-on approach that tax authorities are now taking to data gathering on transfer pricing enquiries, together with the vast amount of commercial and operational information on corporates that is now available in the public domain means that artificial legal structures are a thing of the past. Understanding the operational effects of a restructuring exercise and correlation between the subsequent inter-company relationships and the legal paper trail is vital to substantiating the associated transfer pricing, and should be a fundamental part of the tax team's role in implementing any reorganisation. Engaging directly with the business and operations in key jurisdictions is to be encouraged wherever possible to ensure consistency between documentation and practice.

## The trend for flexible profit models

Historically there have been a variety of 'off-the-shelf' transfer pricing models that have been used as templates for corporate reorganisations, separately recognising the key principal activities of full and limited risk distribution, service and support activity, financing, management, and tangible and intangible asset ownership, often pricing each constituent element individually, and usually based on traditional transactional transfer pricing methods (ie Comparable Uncontrolled Price, Resale Price and Cost Plus methods). There is now a growing trend towards adoption of more flexible profit models, as discussed at length in the Discussion Draft on the Transfer Pricing Aspects of Business Restructurings that was issued by the OECD in September 2008 and part of a consultation process during 2009.

Whilst pricing based on net margin was previously considered a 'method of last resort' under OECD guidelines, taxpayers should be aware that tax authorities are now more likely to consider Transactional Profit Methods as potentially appropriate to the pricing of a business undergoing restructuring, particularly where there are valuable intangibles involved. Use of the 'most appropriate method' as described by the OECD is slightly at variance with use of 'best method' prescribed in the US transfer pricing regulations (IRC Section 482), with the latter often resulting in the default application of a profit method by the IRS. Until the position is clarified, it is important to be conscious of alternative allocation models, if for no other reason than to establish the quantum of any potential adjustments made at tax audit.

## Variance in local treatment

Most tax authorities have confirmed that where a reorganisation involves movements of functions, risks and assets from one country to another, this potentially constitutes a chargeable event for tax purposes. The calculation of profit on any such chargeable event has been prescribed in certain tax jurisdictions, Germany being an example, although after originally showing a particularly bullish attitude towards intangible value attribution the German tax authorities have subsequently drafted more relaxed legislation.

However, apparent consistency from one tax jurisdiction to the next in treatment of transfer pricing of restructuring, such as general adherence to OECD principles, hides a variety of subtle difference in the attitudes of the tax authorities concerned. While the OECD paper on the Transfer Pricing Aspects of Business Restructurings does provide a useful analytical basis for identification of potentially contentious areas, care needs to be taken where taxpayers are trying to establish a generic transfer pricing template for entities involved in such a multi-jurisdictional exercise.

Determination of third party benchmarked returns are an example of a routine challenge to establishment of a consistent global pricing model post reorganisation, with taxpayers frequently struggling to find local information to support a global model. Often this is because tax legislation in a particular jurisdiction requires identification of local comparable data which is simply not available, or because an internal operational model is not one which would ordinarily be undertaken between two independent parties, the pre-requisite factor for testing the 'arm's length' return that is the standard principle for transfer pricing. In such instances it is critical that comparable data and any appropriate economic adjustments are comprehensively documented, presentation of the best available underlying analysis to support the transfer pricing method adopted under fundamental OECD principles may in practice be the key to avoiding wholesale rejection of data presented at audit.