MULTINATIONAL BUSINESS RESTRUCTURING: ARE TAX AUTHORITIES TRYING TO HOLD BACK THE TIDE?

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ABSTRACT

Business restructuring by multinationals has become increasingly prevalent as businesses seek to improve their profits through the location of business activities in countries with cheaper distribution, production, administration, or tax costs. This restructuring activity has been subject to increasing scrutiny from the OECD and tax authorities due to its potential impact on domestic tax bases. In particular, when profit-making activities are shifted from one jurisdiction to another, this can significantly alter the tax paid by multinational subsidiaries. Dominating the debate surrounding the tax issues are the transfer pricing implications of these reorganisations. This paper discusses the motivation behind international business restructures, including a review of some recent high profile examples, and considers why transfer pricing issues arise. Responses by the Australian and New Zealand tax authorities are examined, together with the OECD's report on the transfer pricing aspects of business restructuring and recent initiatives aimed at the issue of global profit shifting.

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I INTRODUCTION

Business restructuring and transfer pricing have had a high profile in recent media reports with the spotlight focused on how much or how little tax multinational enterprises pay.[1] Multinationals argue these restructures are legitimate, reflect both the spirit and letter of the law, and are pursued to allow businesses to maximise economies of scale, increase operational efficiencies, develop greater specialisation, and optimise supply chains. Restructures involve the transfer of business functions, assets, and risks between subsidiaries of multinationals. Where the transfers take place cross-border, as is often the case, they have the potential to significantly change the tax paid by multinationals and the countries in which those taxes are paid. In response to the threat to domestic tax bases, a growing number of tax authorities and the Organisation for Economic Co-operation and Development (OECD) have increased their scrutiny of these activities and responded in a variety of ways ranging from providing guidance to multinationals on tax issues to introducing new legislation. However, it is questionable whether these measures are able to cope with either the scale of the restructuring activity or the intangible nature of many of the most valuable transfers.

Business restructuring can take a variety of forms, but underpinning these reorganisations is a profit maximisation objective. Increased profits can arise from operational efficiencies or from tax advantages arising from moving from high tax to low tax jurisdictions.[2] Business restructuring involves multinationals moving single or multiple business functions (e.g., production or distribution facilities) from a subsidiary located in one tax jurisdiction to a subsidiary in a different and often, but not always, lower tax jurisdiction. The transfer of business functions through this restructuring activity can involve the transfer of both tangible and intangible assets, together with associated functions and risks.

Restructuring can have significant and complex outcomes for international tax planning as restructuring can raise transfer pricing and treaty issues. Transfer pricing issues arise

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[1] See, for example, Charles Duhigg and David Kocieniewski, 'How Apple sidesteps billions in taxes', *The New York Times* (New York), 28 April 2012 and Simon Neville and Shiv Malik, 'Starbucks wakes up and smells the stench of tax avoidance controversy', *The Guardian* (London), 12 November 2012.

[2] J Dunning and S Lundan, *Multinational Enterprises and the Global Economy* (Edward Elgar, 2008); J Fraedrich and C Bateman, 'Transfer pricing by multinational marketers: risky business', (1996) *Business Horizons* 17-22.

from the transfers of goods, services, or intangibles between multinational subsidiaries, either as part of the restructure itself, or as part of the resulting network of transfer pricing transactions arising from the new structure. Tax authorities are concerned with whether the transfer prices and the resulting reallocation of profits among subsidiaries of the multinational are consistent with the arm's length principle. Treaty issues arise from the determination of whether restructuring arrangements give rise to income sourced in a particular country or to a permanent establishment in one or more jurisdictions.

This paper discusses the transfer pricing issues arising from business restructuring and considers the motivation behind business restructures. Recent media attention on this issue is discussed, together with the responses to this issue by the OECD and the Australian and New Zealand tax authorities. This analysis identifies the current approach taken to manage the inherent risks associated with unfettered business reorganisations and highlights some of the remaining issues. The paper concludes by considering the future for multinational taxation and assessing whether the current tax authority responses are adequate to address the increasing problem of double non-taxation.

II TRANSFER PRICING AND BUSINESS RESTRUCTURING

The OECD defines business restructures as consisting of:

> internal reallocation of functions, assets and risks within an MNE [multinational enterprise], although relationships with third parties (e.g. suppliers, sub-contractors, customers) may also be a reason for the restructuring and/or be affected by it… [3]

These business reorganisations can involve either primary business functions (e.g., manufacturing or distribution) and/or business support functions (e.g., general management or intangible management). The main types of business restructure that multinationals have pursued include:[4]

1. Conversion of fully-fledged distributors into limited-risk distributors or commissionaires;

[3] OECD, *Transfer Pricing guidelines for Multinational Enterprises and Tax Administrations* (2010) [9.1].
[4] Ibid [9.2] to [9.3].

2. Conversion of fully-fledged manufacturers into contract-manufacturers or toll-manufacturers;
3. Rationalisation and/or specialization of functions (e.g., creation of single manufacturing or research and development sites); and
4. Transfers of intangible property rights to a single entity within a multinational.

Reorganisations involving the conversion of fully-fledged distributors or manufacturers result in a reduction in the level of business functions performed by those subsidiaries. This may involve reductions in the number of physical assets and employees. However, in some conversions the only major changes may relate to contract terms and relationships with suppliers and customers, and/or the location of certain management or administrative functions. In these cases, risks are transferred between legal entities in the multinational by changing the terms of the contractual relationships. Where a multinational can demonstrate that significant profits relate to those risks, it is possible to reallocate large portions of profit between jurisdictions. In such cases it may appear to an observer that little has changed when considering the externally visible operations of the distributor or manufacturer as products continue to be manufactured or sold from the same location. This can create tension, particularly with the media and general public, when these businesses' profits and tax reduce significantly post-restructure.

Manufacturers and distributors can perform a range of functions and the relative level of profitability should reflect the extent of those functions and the level of assets and risks held by the business. For example, a fully-fledged manufacturer performs all aspects of the manufacturing process, including product and process design, inventory management, production planning and scheduling, supply chain management, and quality control. Such businesses are responsible for inventory and liability costs, plant capacity risks, and warranty risks. As a consequence, fully-fledged manufacturers would be expected to earn a significant portion of the total profits generated from the eventual sale of the manufactured product to the end-customer. In contrast, a contract or toll-manufacturer performs only a restricted range of functions such as scheduling day-to-day production, execution of quality procedures, and the manufacture of standard products. Such businesses may not be responsible for holding or managing the finished products and may be indemnified for most or all business risks associated with the manufacture of the products. Accordingly, a toll-manufacturer would be expected to have a significantly lower level of profitability than a full-fledged manufacturer operating in the same industry.

Similarly, a fully-fledged distributor performs all aspects of the distribution process, including the logistics of purchase and supply of products, creation and management of local marketing strategies, performance of all sales functions, and all related customer relationship management. In contrast, a limited-risk distributor or commissionaire may only perform the sales function with products supplied directly by the manufacturer, or other related company, to the end-customer. As a consequence, the limited-risk distributor may have limited or no credit or inventory risk and few assets.

As a result of the conversion of a fully-fledged distributor or manufacturer to a limited-risk business, tax authorities would expect to see costs associated with the restructure (e.g., asset disposal and staff redundancy costs) to support the argument that the business has changed. Contractual terms would be expected to change to reflect changes in the relationships. The sharing of risks and modifications to the supply chain from the manufacturer to the end-customer would be expected to occur to reflect the shift in functional profile of the restructured business. The key transfer pricing issues in the conversion of distributors or manufacturers to a limited-risk arrangement are whether the reduced functionality reflects the economic reality of the underlying transactions and to what extent changes should lead to a reduction in profitability. In addition, if the business has developed valuable intellectual property, such as locally-developed brands or manufacturing know-how, it is likely that the restructure will involve the transfer of this property and the restructured business would be expected to be compensated for such transfers.

Reorganisations involving the centralisation of primary business activities (e.g., the transfer of all or most manufacturing activities to a single location such as Mexico) result in the removal of all or most local business functions. To an observer this type of reorganisation is, generally, the most compelling as it involves the transfer of all or most tangible assets and the transfer or dismissal of many local employees. In these reorganisations the range of manufacturing functions can be reduced in scope, a business or product line can be eliminated, or manufacturing capacity can be shifted from one country to a lower-cost country. For example, the establishment of a Chinese manufacturing hub could result in the removal of manufacturing activities in most or all

other locations. However, while the reduction in profit may seem more explicable to the general public these reorganisations create their own bad press when local jobs are replaced by foreign jobs, particularly in periods of high unemployment.[5]

Centralisation of administration or research functions can involve the establishment of regional offices that provide back-office support and/or regional research and development centres. Tax authorities would expect businesses that had previously performed these functions to reduce their own functions and costs as part of these new structures. For example, if a regional accounting centre was established, in the local subsidiaries served by that centre the number of accounting staff would be expected to reduce as a result of the transfer of accounting functions. Of particular interest to tax authorities is whether any costs that relate to services that are of no value to the subsidiaries are on-charged to local subsidiaries. For example, a regional accounting centre could perform work related to compliance with the legislative requirements applying to the parent company only. Local tax authorities would expect such costs to be charged to the parent and not to the local subsidiary.[6]

Restructuring activities that involve the rationalisation of management, other support activities, and/or the ownership and management of intangible property into a specialised regional or global entity may result in the removal of only a limited scope of activities from the local jurisdiction. Rationalisation may involve only the movement of intangible property and/or the transfer of risks through the modification of contracts between subsidiaries or between the multinational and its suppliers or customers. The centralisation of intellectual property ownership to a newly created subsidiary presents particular challenges to tax authorities due to the unique nature of these assets and the difficulty in determining their profit potential. Issues arise in relation to the valuation of the transfer of the intellectual property to the new company and to the subsequent charging of royalties and research and development costs. These types of arrangements can be contentious, particularly where intellectual property is well-known and feted in the local jurisdiction. Parochial considerations can cloud determinations of whether the

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[5] The recent US presidential elections provided numerous examples of this type of media scrutiny, see, for example, Ewen MacAskill, 'Obama repeats claim that Romney outsourced jobs to China and India', *The Guardian* (London), 5 July 2012.

[6] The treatment of these "shareholder activities" is discussed further in the OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010), Chapter VII.

arrangements are arm's length. Tax authorities, as a result, are concerned both with valuation issues and also the capacity of the newly created intellectual property-company to manage the property i.e., whether the restructure has any economic reality. These arrangements can be complicated where the intellectual property-owning subsidiary does not employ staff and is reliant on other related companies to further develop and manage the intellectual property. The creation of intellectual property owning companies can be particularly troublesome for tax authorities in the digital-age where software and internet businesses can conduct huge volumes of business in countries while maintaining limited or no physical presence that gives rise to a tax liability.[7]

Regardless of the type of reorganisation the resulting structure is designed to be beneficial to the multinational by creating increased profits through increased efficiencies driven by the centralisation of particular functions. In addition, if high-value business activities, such as the ownership of intangible property, are located in low tax jurisdictions then this can result in substantially reduced tax obligations. However, expected benefits, whether tax-related or otherwise, do not always arise and the OECD recognises that the implementation of a restructure could result in increased costs and less efficiency, which may explain changes in the tax paid by the restructured multinational.[8]

The transfer pricing issues for tax authorities in relation to business restructuring are related to, first, whether the restructure and sale of property is arm's length and, second, whether the resulting transfer pricing arrangements (e.g., sale of goods and royalty payments) are arm's length. A more fundamental problem is whether, if these arrangements are at arm's length and legitimate under current legislation, the current basis for taxation and network of tax agreements provides the best approach for allocating the tax payable between competing tax jurisdictions.[9]

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[7] See, for example, Ben Chapman-Smith, 'Facebook NZ's $14k tax bill a 'rort'- Labour', *New Zealand Herald* (Auckland) 29 November 2012 and Rosamund Urwin, 'Facebook, Amazon, Google, Starbucks: you owe us £900,000,000', *Evening Standard* (London), 13 November 2012.

[8] OECD, above n 3, [9.58].

[9] Tim Worstall, 'Facebook, Apple, Google, Amazon: Why cannot France understand that they already do pay taxes?', (*Forbes)* 27 November 2012 <http://www.forbes.com/sites/timworstall/2012/11/27/facebook-apple-google-amazon-why-cannot-france-understand-that-they-already-do-pay-taxes/>.

The OECD has identified three core issues[10] arising from business restructures that can potentially threaten the tax base of the country in which restructured multinational subsidiaries are located. The first core issue relates to the impact of any risk transfer that occurs as part of a restructure. These transfers often lead to an effective change in the operational profile of a subsidiary due to the transfer of risks. The Australian Tax Office (ATO) identifies business risks arising in reorganisations as related to either the transfer of assets (either their use or ownership) or the transfer of functions (described in terms of the decision-making related to those functions). The most common types of risks are operational, marketing, credit, inventory, foreign exchange, and risks relating to the management and ownership of intangibles.[11] At issue is the degree to which the functionality of a subsidiary has changed and its impact on the profit that should be attributed to it. As part of the restructure, assets, risks or functions could be transferred from subsidiaries in high tax jurisdictions to subsidiaries in low tax jurisdictions with a resulting reduction in the overall tax paid by the multinational and the amount of tax collected in the home countries of the subsidiaries subject to the restructure. Further, the multinational is likely to attribute high levels of profitability to the risks and other assets transferred. Whether this attribution is arm's length may be almost impossible to determine using the existing transfer pricing methods because similar transfers almost never occur between independent entities. In addition, whether the transfer has any economic substance will depend on the ability of the restructured entities to assume the risks transferred. Determining the economic substance of the arrangement is a particular concern for tax authorities given the types of arrangements seen in multinational business reorganisations seldom arise between unrelated parties (e.g., the sale and lease-back of valuable intellectual property). The OECD has highlighted the potential problems with determining the economic substance and, in particular, determining whether the legal entity the risk is transferred to has the capacity to manage that risk.[12] Such capacity would include having sufficient financial resources to cover the risks transferred and sufficient appropriately trained staff to manage those risks.

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[10] OECD, above n 3.
[11] ATO, Taxation Ruling 2011/1 *Income Tax: application of the transfer pricing provisions to business restructuring by multinational enterprise,* [103].
[12] OECD, above n 3, [9.23].

The second core issue identified by the OECD relates to the determination of the appropriate arm's length price for the transactions arising from the restructure itself. Where assets, risks or functions are transferred under a restructure, this can require remuneration to be paid to the transferor. This compensation could include payment related to the termination or substantial renegotiation of existing valuable contracts or payment related to the surrender of profit potential. The arm's length principle requires related parties to behave in a manner consistent with how independent parties would behave in similar circumstances. However, in the case of a multinational business restructure there may be no comparable transactions between independent parties to use as a basis for applying the transfer pricing methods. Accordingly, the valuation of the compensation for such transfers or for the termination or renegotiation of the existing contractual arrangements between parties can be complex. For example, an intangible asset transferred under a restructure may not have an established value at the time of the transfer (e.g., where it relates to newly developed technology). This could result in a significant difference arising between the level of expected future profits used to calculate the transfer value of the technology at the time of the sale transaction and the actual profit subsequently derived by the transferee from that technology. Such discrepancies can call into question the arm's length nature of the transfer value.

The third core issue identified by the OECD is related to the determination of the appropriate treatment for the post-restructuring arrangements. As a general proposition, the application of the transfer pricing rules to the post-restructure transactions should be no different to their application to any transfer pricing arrangement. However, the application may not be straight forward, particularly in relation to the treatment of location savings arising from the restructure. For example, in the case of the manufacture of branded products, if the location savings occur in a market where there are many alternative third parties who could perform the same function (such as in the relocation of the manufacture of clothing to China), then it is likely that the location savings would be allocated to the owner of the brand. Alternatively, if the location savings occur in a market where there are few competitors (such as the relocation of the manufacture of complex engineering products to

Singapore), then it is more likely the location savings would be allocated to the manufacturer.

While the focus of this paper is on transfer pricing issues arising from business restructures, there are also a wide range of other direct and indirect tax consequences arising out of business restructures. These include issues related to identifying the source of income under the restructured arrangements; the creation of permanent establishments; value added tax issues arising from transfers of assets and changes to the supply chain; allocations and deductibility of restructuring expenses; the creation of deemed dividends from the transfers of assets; and the potential exposure to capital gains tax and other property-related taxes.

III RECENT EXAMPLES OF RESTRUCTURING

A number of high profile business restructures have attracted media attention in recent years. Key features of these cases include the transfer of locally developed intellectual property to low tax jurisdictions and the transfer of risks between legal entities to reduce the profit attributable to operations in high tax jurisdictions. Much of the attention has focused on the apparently artificial nature of these transfers, but increasingly the media and public have linked the low effective tax rates of multinationals to the corporate citizenship of these enterprises. This media attention has steadily grown in response to pressures on government spending with many linking the low tax rates of multinationals to decreases in public spending forced on many governments following the global financial crisis. While some of the cases reported in the media relate to general tax avoidance and value added tax, many highlight the tax planning and transfer pricing activities of multinationals. Generally, multinationals do not comment on their tax affairs publicly and it can be difficult to determine tax positions in relation to particular arrangements from published annual accounts. However, it is noteworthy that in relation to the cases detailed below there has been no tax litigation or similar action reported. This suggests that these arrangements are compliant with the applicable tax legislation and that the media attention reflects either the general public's lack of understanding of current international tax rules or their dissatisfaction with these rules.

The Guardian newspaper ran a series of reports in 2009 that detailed a number of well-known UK companies that reportedly transferred valuable intellectual property overseas. These transactions attracted attention because they involved high profile brands, such as Walker potato crisps and Johnnie Walker scotch, and the reduction in UK taxable income was reported to be material. These brands were developed over a long period of time in the UK and after the reported restructure many of the products continued to be manufactured in the UK. By transferring the intellectual property, and related contractual risks, a portion of the profits of these companies were reported to be transferred to other tax jurisdictions and the local manufacturing operations converted to contract manufacturers.[13] However, from the perspective of the consumer, it appeared little had changed. The products were still manufactured in the UK, the branding still emphasised the UK-history and location of the manufacture of the products, and there was no mention of the new foreign ownership in the advertising of the brand.

More recent media focus has concentrated on high profile US multinationals and, in particular, technology companies. Starbucks,[14] Apple,[15] Facebook,[16] Google,[17] and Amazon[18] have all been the subject of intense media scrutiny. This attention is likely the result of their high profile and the large numbers of customers they have outside the US. The general public, and many politicians, struggle to understand how such visible businesses used by so many people can have no or very limited taxable presence in the countries where those people live. In response, some locally-based competitors of these firms have reportedly started using this negative media to encourage customers to shop locally rather than electronically to ensure tax is paid locally.[19] Further, the reports of

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[13] Tax Gap Reporting Team, 'How to save a packet: The transfer of Walkers crisps to a foreign subsidiary has cost UK millions', *The Guardian* (London), 5 February 2009 and Tax Gap Reporting Team, 'Going Dutch: How drinks giants spirited away Johnnie Walker label from UK tax liabilities by a technique known as outward domestication', *The Guardian* (London), 2 February 2009.

[14] BBC News UK, 'UK Uncut protests over Starbucks 'tax avoidance'', 8 December 2012, <http://www.bbc.co.uk/news/uk-20650945>.

[15] Charles Duhigg and David Kocieniewski, 'How Apple sidesteps billions in taxes', *The New York Times* (New York), 28 April 2012.

[16] Chapman-Smith, above n 7.

[17] Louise Armistead, 'Bermuda shelter helps Google duck $2bn tax bill', *The Age* (Melbourne), 11 December 2012.

[18] Juliette Garside, 'How Amazon finds tax loopholes', *The Guardian* (London), 4 April 2012.

[19] Sainsbury and John Lewis are reported to have encouraged customers to shop with them to ensure the resulting income is reported in the UK and UK corporate tax paid, see Ian Griffiths, 'VAT loophole on digital sales 'costs UK more than Olympics'', *The Guardian* (London), 3 December 2012.

low tax paid by these companies have spurred protests by politicians and even, in the case of Starbucks, protests in the street.[20]

Starbucks recently attracted public scrutiny in the UK (and elsewhere) because of its ubiquitous high street presence and the low level of tax reported to be paid by some of its foreign subsidiaries.[21] The profitability of its overseas subsidiaries that operate coffee shops is reported to be affected by payments of royalties for the use of its marketing intangibles and payments for the purchase of the coffee beans from related foreign subsidiaries. The adverse publicity in the UK was followed by a report that the company is to make a 'voluntary' additional payment of £20 million to HM Revenue & Customs over the next two years; this additional payment is to be generated by Starbucks UK voluntarily not claiming deductions related to royalties, inter-company loans, and coffee purchases. [22] However, this raises the question of what treatment will be made by the counter-party to the transactions. If the foreign counter-party returns the income on the basis that it is the arm's length value of the transfers then double taxation will arise.

While the reduction in domestic profits related to transfers of intellectual property for businesses selling physical products or services (such as crisps, scotch, or coffee) are important, a potentially more significant problem is the taxation treatment of digital commerce. Amazon is reported to have transformed local supply operations into low-risk delivery centres that do not create a significant local tax presence, thus, ensuring that most of the profits related to local sales are attributed to offshore subsidiaries located in lower tax jurisdictions.[23] Google, which generates much of its revenue from services such as the sale of advertising, is reported to have introduced tax structures that allow it to attribute revenue arising from customers located in a variety of high tax jurisdictions to subsidiaries located in countries with favourable tax regimes.[24] The intangible nature of the services provided, the electronic transmission of those services,

[20] BBC News, above n 14.
[21] In the UK the tax paid by Starbucks is reported to be less than one percent of its UK sales over the last 14 years. See Louise Armistead, 'Starbucks' £20m gift 'makes joke' of tax system', *The Telegraph* (London), 6 December 2012.
[22] Armistead, above n 21.
[23] Ian Griffiths, 'How one word change lets Amazon pay less tax on its UK activities: The word 'fulfilment' introduced in 2006 marked new role for Amazon.co.uk after ownership moved to Luxembourg', *The Guardian* (London), 4 April 2006.
[24] Jesse Drucker, 'Google revenues sheltered in no-tax Bermuda soar to $10 billion', *Bloomberg* (New York), 10 December 2012.

and the electronic nature of the transactions themselves, have allowed technology companies to structure arrangements so that they limit their taxable presence in the countries where customers reside.

Here the issues are more fundamental than simply whether multinationals are complying with existing legislation and/or creating artificial tax structures; instead they represent a rapidly emerging problem of so-called double non-taxation where current source-based taxation systems, designed for the conduct of business through a physical presence with employees using tangible assets, are failing to deal with the new electronic business model. Under this new model billions of dollars of transactions can occur with limited or no local physical presence in any country. These cases do not represent a failure of tax authorities to apply the transfer pricing rules, nor are they a failure of the existing transfer pricing rules in their role of eliminating double taxation, but rather a failure of the system to allocate taxable profits in a way that continues to be acceptable to governments and the general public.

IV Tax Authority Responses to Business Restructuring

In response to these high profile business restructurings tax authorities, governments, and quasi-governmental bodies are currently addressing a variety of issues related to these activities. These include issues related to tax policy, source rules, the treatment of permanent establishments, tax avoidance, and transfer pricing. The purpose of this paper is to examine some of the responses directly related to the application of the transfer pricing rules. In this respect, the OECD was among the first to respond to this issue.

The OECD established a working party (Working Party No. 6) to examine business restructuring and released a draft discussion document for public consultation in 2008.[25] Responses[26] to this discussion document were subsequently incorporated into the new chapter on business restructuring contained in the latest update of the OECD's

[25] OECD, *Transfer Pricing Aspects of Business Restructurings: Discussion Draft for Public Comment 19 September 2008 to 19 February 2009* (2008).
[26] OECD, *Response to the Committee on Fiscal Affairs to the Comments Received on the September 2008 Discussion Draft on the Transfer Pricing Aspects of Business Restructuring* (2010).

Transfer Pricing Guidelines.[27] The underlying philosophy of the discussion document and new chapter is that:

> the arm's length principle and these [transfer pricing] Guidelines do not and should not apply differently to restructurings or post-restructuring transactions than to transactions that were structured as such from the beginning… [28]

Of particular note, the OECD's examination of the transfer pricing issues related to business restructuring specifically do not consider anti-abuse rules. As such, the existence of a tax purpose in a restructure is not sufficient to conclude that an arrangement is not arm's length:

> Under Article 9 of the OECD Model Tax Convention, the fact that a business restructuring arrangement is motivated by a purpose of obtaining tax benefits does not of itself warrant a conclusion that it is a non-arm's length arrangement. The presence of a tax motive or purpose does not of itself justify non-recognition of the parties' characterisation or structuring of the arrangement… [29]

In addition, the scope of the OECD's chapter on business restructuring excludes a consideration of CFC rules, capital gains tax, domestic rules on deductibility of payments, value added taxes and indirect taxes.[30] Similarly, issues arising from permanent establishments are specifically excluded.[31] However, in recognition of these wider problems and their potential impact, in 2012 the OECD commenced a new project, *Base Erosion and Profit Shifting* (BEPS), which has been charged with examining the current rules for allocating taxable profits to locations other than where actual business takes place. This project will look wider than just transfer pricing issues, and will also consider aggressive tax planning, the role of tax treaties, tax policy, and compliance. In the briefing paper on the issue the key problem of multinational tax planning was identified as:

[27] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010), Chapter IX.
[28] Ibid [9.9].
[29] Ibid [9.181].
[30] Ibid [9.8].
[31] Ibid [9.7]. The OECD's definition of permanent establishment is currently under review with the most recent discussion document released in 2012. See OECD, *Model Tax Convention: Revised Proposals Concerning the Interpretation and Application of Article 5 (Permanent Establishment) 19 October 2012 to 31 January 2013* (2012).

> a tendency to associate more profit with legal constructs and intangible rights and obligations, thus reducing the share of profits associated with substantive operations involving the interaction of people with one another.[32]

The BEPS released its first report in 2013.[33] This identified key issues and principles related to the scope of the problem. The fundamental policy issue identified by the report was that changes in international principles on the tax treatment of economic activity have not 'kept pace with the changing business environment'.[34] The report recommends that any action taken should not be unilateral as uncoordinated responses are likely to increase the risk of double taxation. In this regard, the OECD has proposed that an initial comprehensive plan be developed to identify the actions needed, set deadlines to implement actions, and identify the resources and methodology needed to implement changes.

The OECD believes that these wider problems must be addressed by international cooperation and a re-examination of the tax treatment in relation to a number of key areas. These include the international mismatch of the treatment of different corporate entities (particularly hybrid entities); the treatment of the delivery of digital goods and services under double tax treaties; related party financial transactions, such as debt-financing and insurance; shifting of risk and intangibles, and the artificial reorganisation of assets that do not reflect normal business transactions between independent parties; anti-avoidance measures including general anti-avoidance, CFC regimes, and thin capitalisation rules; and the existence of preferential regimes for certain business activities.

In this regard, the transfer pricing rules related to business restructuring can be regarded as only a partial solution to the wider problem of legitimate tax planning that can result in an increasing level of double non-taxation. The OECD's essential approach to the transfer pricing issues arising from business restructuring is to treat them as no different to the issues related to normal transfer pricing arrangements, but with an additional focus on the terms of risk reallocations under restructures, the determination

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[32] OECD (20 November 2012), *The OECD Work on Base Erosion and Profit Shifting*, http://www.oecd.org/ctp/BEPS_Background_Brief.pdf*) p 2.*
[33] OECD, *Addressing Base Erosion and Profit Shifting*, (2013).
[34] Ibid p 5.

of the consideration for the restructure itself, and the remuneration for the post-restructuring arrangements.

The OECD's starting point in the Guidelines is the recognition of the actual transactions that have taken place,[35] and it considers that only in exceptional circumstances should those arrangements be disregarded.[36] Exceptional circumstances can occur either if the economic substance of the arrangements differ from their form or if the arrangements lack 'commercial rationality' (i.e., independent parties in comparable circumstances would not have entered similar arrangements). While the former may be relatively easy to identify based on a comparison of the contractual arrangements to the actions of the related parties, the latter may be difficult to determine. The nature of multinationals is such that many of the arrangements entered into are only possible because of the relationships within the multinational. Accordingly, the likelihood of comparable data existing to support a particular restructure is low. The OECD suggests one approach to this problem is to consider the other options realistically available to the related parties; if more attractive options existed, then this provides evidence that the arrangements were not arm's length and the parties were not acting in a commercially rational way.[37]
In relation to risk allocation, the OECD has stressed the need to examine the contractual terms of the restructure between the related parties. If comparable data exists that shows similar risk allocations would take place between independent parties, then the allocation is regarded as arm's length. If comparable data does not exist, which is usually the case, then it is necessary to consider who has control over the risk, defined as:

> the capacity to make decisions to take on the risk (decision to put capital at risk) and decisions on whether and how to manage the risk, internally or using an external provider…[38]

In the absence of comparable data to support the arrangement, a multinational needs to be able to demonstrate both that the related party has assumed control over the risk and also that they have the financial capacity to assume that risk. Further, it would be

[35] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations,* above n 27, [9.164].
[36] Ibid [9.168].
[37] Ibid [9.175].
[38] Ibid [9.23].

expected that the related party assuming the risk would also assume all the related costs associated with managing and bearing that risk (e.g., in relation to credit risk this would include all costs of credit defaults). If this can be demonstrated, then the transfer of the expected benefit from bearing the risk (i.e., the expected profit) would be considered arm's length. However, for a significant transfer of profit to be associated with the transfer of the risk it is necessary that the risk be economically significant i.e., that the risk is associated with significant expected profit. For example, in relation to credit risk, it would be necessary to demonstrate that there was a history of an economically significant level of default. Conversely, if there was a very low risk of default then no or very little profit would be expected to be associated with the transfer of that risk.

In determining the compensation for transactions occurring as part of the business restructure, the OECD stresses the importance of examining the contractual agreements between the parties. The OECD does not consider that every transaction will require compensation, rather the facts and circumstances at the time of the restructure should be closely examined to determine the value of the assets, risks and/or functions transferred. Further, the determination of any compensation payable for the transfer must consider the position of each related party independently:

> The arm's length principle requires an evaluation of the conditions made or imposed between associated enterprises, at the level of each of them. The fact that the cross-border redeployment of functions, assets and/or risks may be motivated by sound commercial reasons at the level of the MNE group, e.g. in order to try to derive synergies at a group level, does not answer the question whether it is arm's length from the perspectives of each of the restructured entities... [39]

Compensation may include payment in relation to the loss of future profits, although the OECD considers that future expected profit is not an asset itself but a potential carried by some other rights or assets e.g., the profit potential attached to an intangible asset such as a trademark or patent.[40] Payment may be required if the transferor has surrendered rights or other assets that carry that profit potential. Similarly, there is no presumption that all restructurings should give rise to an indemnification of the restructured entity for any losses it incurs as part of the restructure. Whether a payment

[39] Ibid [9.63].

[40] Ibid [9.65]–[9.68].

should be made should reflect what independent parties would have negotiated in similar circumstances. [41]

In relation to post-restructure transactions, the OECD's view is that it is essential to conduct a detailed functional analysis for both pre-restructuring and post-restructuring arrangements to again ensure that the arm's length principle is applied. However, the application of the transfer pricing rules to the post-restructured arrangements should be the same as if the arrangements had been structured in that way from the beginning of the relationship.

While the OECD's new chapter on business restructuring provides more detailed guidance on aspects of these arrangements, when considering these rules in relation to the real world examples discussed in the previous section, it is unlikely they would have prevented or modified the structures adopted. Assuming that the economic substance of these arrangements is consistent with the form of the relationships and that the prices attached to both the restructure and the post-restructure transactions are determined in accordance with the transfer pricing methods, then each would be considered legitimate from a transfer pricing perspective. Accordingly, the rules do not restrict how multinationals can organise and reorganise their business operations. In particular, the OECD's view expressed in the *Transfer Pricing Guidelines* is that:

> *MNEs are free to organise their business operations as they see fit. Tax administrations do not have the right to dictate to an MNE how to design its structure or where to locate its business operations. MNE groups cannot be forced to have or maintain any particular level of business presence in a country. They are free to act in their own best commercial and economic interests in this regard. In making this decision, tax considerations may be a factor. Tax administrations, however, have the right to determine the tax consequences of the structure put in place by an MNE, subject to the application of treaties and in particular of Article 9 of the OECD Model Tax Convention. This means that tax administrations may perform where appropriate transfer pricing adjustments in accordance with Article 9 of the OECD Model Tax Convention and/or other types of adjustments allowed by their domestic law (e.g. under general or specific anti-abuse rules), to the extent that such adjustments are compatible with their treaty obligations.*[42]

[41] Ibid [9.103].
[42] Ibid [9.163].

In Australasia, both the Australian Tax Office (ATO) and the New Zealand Inland Revenue Department (IRD) have also considered the issue of transfer pricing and business restructuring. In 2011 the ATO released a taxation ruling on business restructuring[43] that sets out the ATO's position on the transfer pricing aspects of business restructuring. As with the OECD *Guidelines*,[44] the ATO ruling is restricted in scope to only transfer pricing issues and specifically excludes issues related to anti-avoidance, capital gains tax, permanent establishments, and the CFC rules.[45] The ATO's approach mirrors the OECD in that it requires taxpayers to apply the standard transfer pricing methods to determine the arm's length price of both the restructure and post-restructure transactions with regard to the 'commercial rationality' of those actions.[46] In particular, the ATO has developed a set of indicators, that it will consider in determining whether the actions of related parties are arm's length, specifically:

(a) an arm's length outcome is one that makes business sense in the circumstances of the particular taxpayer;
(b) an independent party dealing at arm's length would seek to protect its own economic interest;
(c) an independent party dealing at arm's length would compare the options realistically available and seek to maximise the overall value derived from its economic resources;
(d) one option might be not to enter into a transaction because it does not make commercial sense for the particular taxpayer. [47]

The ATO's ruling sets out a three-step process[48] for analysing business restructures based on its earlier ruling on documenting transfer pricing arrangements.[49] First, the taxpayer should describe the international dealings with the related parties in the context of their own business. This characterisation of the arrangements should consider the relationships between the related parties both pre- and post-restructure. Second, the taxpayer should select the most appropriate transfer pricing method. Third, the taxpayer should apply the most appropriate method.

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[43] ATO, Taxation Ruling TR 2011/1, *Income Tax: application of the transfer pricing provisions to business restructuring by multinational enterprise*.
[44] The ATO ruling [21] makes specific mention of the OECD report on business restructuring and states the ATO will have regard to this document in its application of the arm's length standard.
[45] ATO, above n 43, [4]-[6].
[46] Ibid [11].
[47] Ibid [14].
[48] Ibid [19].
[49] ATO Taxation Ruling 98/11, *Income tax: documentation and practical issues associated with setting and reviewing transfer pricing in international dealings.*

Overall, the ATO ruling is relatively limited and does not provide much practical guidance on how multinationals should approach business restructuring. More details on how the ATO is likely to apply the transfer pricing rules are provided in Appendix 2 of the ruling, however, this section is not legally binding on the ATO. This Appendix notes that the arm's length rules will be applied to the entire 'arrangement' and not to isolated transactions and that it is not necessary for there to be a formal agreement in order for an arrangement to exist for the purposes of the transfer pricing legislation. The ATO's focus is on determining whether the arrangement has a commercial basis for all the parties to the business restructure.[50]

The ATO requires that all benefits expected to arise from the business restructuring for all parties to the arrangement be identified. This information should consider the nature and value of the benefits, an explanation of why the restructure is needed to derive the benefits, which related parties contribute to those benefits and how they will be shared among members of the multinational.[51] The ATO approach requires a detailed cost/benefit analysis to be prepared to support the rationale for the business restructure. One of the ATO's goals is to determine exactly what has changed as a result of the restructure and what difference this will make to both the Australian subsidiary's business and profits and the value chain of the multinational as a whole. However, the existence of a tax benefit from the restructure is not considered conclusive that an arrangement is not arm's length, rather the ATO will examine whether the pricing of the restructuring and post-restructuring transactions is arm's length under the transfer pricing rules.[52] Similarly, just because an arrangement is not one typically entered into by independent entities, the ATO accepts that this is not sufficient to conclude that the arrangement is not arm's length.[53]

The ATO acknowledges the risk-reward trade-off and accepts that an entity may accept a lower reward in exchange for lower risk (e.g., when converting to a low-risk distributor).[54] However, the related party to whom any risk is transferred must have the capacity and capability to bear such risk. For example, if the credit risk functions of a

[50] ATO, Taxation Ruling TR 2011/1, above n 43, [54].
[51] Ibid [63].
[52] Ibid [68].
[53] Ibid [78].
[54] Ibid [101].

subsidiary are transferred to another subsidiary and that other subsidiary does not have the staff and/or expertise to manage the risk, the rationale and commerciality of the restructure will be viewed as questionable by the ATO.

In relation to compensation for the restructure itself, the ATO's view is that under the arm's length principle there should be a payment in connection with a business restructuring arrangement if a payment would be expected between independent parties in similar circumstances. The ATO stresses the need for detailed analysis of comparable data to determine whether compensation is needed and the value of that compensation. However, it considers compensation will not be required, generally, unless there has been a transfer of property. Specifically, the ATO's view is that no compensation is likely to be required for the loss of profit potential, for the transfer of a function or risk, or for the termination of contractual rights.[55]

The ATO's documentation requirements under the ruling are likely to be onerous for multinationals. It expects such analysis to include, as a minimum, details of the multinationals internal analysis of the restructuring decision, documentation describing the business context of the restructure including detailing the costs and benefits for the restructure from the perspective of the multinational as a whole and for each of the participating subsidiaries, all relevant contracts for the restructure and post-restructure transactions, detailed functional analyses for all business activities both pre- and post-restructure, and details of the comparability analyses performed and transfer pricing methods applied to determine the arm's length prices for the arrangement.[56]

In addition to the ATO ruling on business restructuring, in recent developments the Australian government has amended its transfer pricing legislation to address deficiencies in the transfer pricing and general anti-avoidance regimes and further amendments are expected. These amendments were designed, at least in part, to address problems identified with the regulation of multinational structuring. Further, the federal government recently announced the formation of a special taskforce to

[55] Ibid [116].
[56] Ibid [150].

examine tax minimisation by multinationals.[57] The assistant treasurer, the Hon. David Bradbury, specifically identified technology companies and the problems they create for the future sustainability of corporate taxation as issues that need to be examined by the task force.[58]

In New Zealand, the IRD generally endorses the approach detailed in the OECD *Transfer Pricing Guidelines,*[59] including its guidance on the treatment of business restructuring. The IRD has not issued its own taxation ruling on this issue, but it has identified business restructuring as an important tax risk issue[60] and has developed a set of questions it considers multinationals need to document in relation to their business restructures. The IRD's list of questions has an underlying assumption that the acquirer of the assets, risks and functions will be the overseas entity. This reflects the IRD's primary concern, which is reductions in the profitability of New Zealand taxpayers rather than increases in profitability where the New Zealand related party is the acquirer of assets. This focus is also reflected in the IRD's standard transfer pricing questionnaires used for audits, where information is only required from foreign-owned subsidiaries of multinationals in relation to structural changes made to their business, as follows:

> 'Have there been any material structural changes in the last five years which have resulted in a reduction of business functions, assets held and risks borne by the New Zealand operations? If so, please provide full details.' [61]

The questions detailed on the IRD's website[62] include information related to whether a functional analysis has been performed at appropriate stages of the restructure; whether there has been any consideration of the value of transferred assets, risks and

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[57] Hon. David Bradbury, 'Specialist reference group on ways to address tax minimisation of multinational enterprises', *Office for the Assistant Treasurer Media Release No. 162*, 10 December 2012.
[58] Adele Ferguson, 'Taxing time for tech giants as war is declared', *Sydney Morning Herald* (Sydney), 23 November 2012.
[59] The IRD released its own transfer pricing guidelines in October 2000. These do not specifically cover the issue of restructuring. Further, these guidelines have not subsequently been updated and the IRD's website notes that the IRD uses the OECD's 2010 *Transfer Pricing Guidelines* (<http://www.ird.govt.nz/forms-guides/title/forms-t/guide-transfer-pricing.html> retrieved 12 December 2012).
[60] IRD, *Restructuring* (18 January 2011) < http://www.ird.govt.nz/transfer-pricing/practice/transfer-pricing-practice-restructuring.html>.
[61] IRD, *Transfer Pricing Questionnaire: Foreign-Owned Multinationals,* question 46 (available from <http://www.ird.govt.nz/resources/d/b/db25cf004bbe4a589cb6dcbc87554a30/tp-questionnaire-foreign-owned.pdf>.
[62] IRD, *Restructuring,* above n 60.

functions; whether the acquirer has the capability to manage the transferred functions, assets, and risks; whether the post-restructuring transactions are arm's length; whether the acquirer has any taxable presence in New Zealand; whether there are any restructuring costs and who has borne those costs; whether valuations of transferred assets have been prepared; and the extent of the documentation. The IRD considers that preparing and maintaining contemporaneous documentation will support the transfer prices adopted by the New Zealand taxpayer in the restructure and reduces the risk of the IRD re-characterising the nature of the arrangements.

The IRD highlights its three main concerns relating to restructuring as being the economic substance underlying low risk operations such as contract manufacturers, the consistent return of routine profits, and the commercial rational for the restructuring.[63] The IRD's view on the economic substance of the arrangement is similar to the OECD's, and emphasises the need for the structural change to be significant and not simply a restructure of the form of the arrangement only. Further, the terms of contracts and the actions of the related parties must be consistent. For example, the IRD notes that the charging of costs associated with a market penetration strategy to a New Zealand low-risk distributor would not be appropriate, as such a strategy is inconsistent with a low-risk profile.

The IRD's comments highlight that it will consider wider issues than just transfer pricing when reviewing these types of arrangements. Specifically, the IRD will consider whether the reorganisation creates a permanent establishment for one or more overseas parties to the restructure, and whether the general anti-avoidance rules apply. This is particularly relevant where insufficient commercial rationale exists to explain the reorganisation or where there are 'unnecessary steps in the arrangement, circularity of fund-flows or novel instruments exhibiting artificiality'.[64] Given the IRD's recent successes in the courts in relation to anti-avoidance,[65] it is highly likely the IRD would

[63] Ibid.
[64] Ibid.
[65] See, for example, Mark Keating and Craig Elliffe, 'Tax avoidance – Still waiting for Godot' (2009) 23(3) *New Zealand Universities Law Review,* 368, or Julie Harrison and Mark Keating, 'New Zealand's general anti-avoidance provisions: A domestic transfer pricing regime by proxy?' (2011) 17(4) *New Zealand Journal of Taxation Law and Policy* 419.

consider any 'artificiality' under both the general anti-avoidance rules and the specific transfer pricing rules when investigating these types of business restructures.

In December 2012 the New Zealand Minister of Revenue requested the IRD examine the tax treatment of foreign companies and foreshadowed possible changes to tax laws to reflect changes in how these businesses are now operated compared to when applicable tax laws were first drafted.[66] This new focus may have been partly a response to negative media attention focused on the tax paid in New Zealand by a number of internet companies.[67] The IRD report[68] addressing this issue identified the core issue as the increasing problem of non-taxation of multinationals, in particular, in relation to technology companies. However, the IRD acknowledged the international nature of this problem and that it required a global response to deal with issues such as deficiencies in the current source rules and permanent establishment definitions. Accordingly, the main recommendations from the report were that the IRD should actively work with both the OECD's project on base erosion and profit shifting (BEPS) and with the Australian Treasury's taskforce.

V CONCLUSION

Business restructuring has been recognised only recently as a significant issue in transfer pricing. The key transfer pricing issues arising from business restructures relate to the reduced functionality and profits of subsidiaries, the economic substance or commerciality of the arrangements, the valuation of transactions arising from the restructure and post- restructure, the recognition of transactions by tax authorities, and the capacity and capability of acquiring entities to manage risks assumed under the restructure. The tax authority response to these transfer pricing issues has been, typically, to require taxpayers to document and analyse these arrangements in accordance with the general transfer pricing rules. That is, the arm's length nature of these restructures need only be considered using the same approach as if the arrangements had been structured the same way from the beginning. The only caveat to

[66] Hon Peter Dunne 'Taxing multinational companies' (Inland Revenue, Policy Advice Division, 4 December 2012) < http://taxpolicy.ird.govt.nz/news/2012-12-04-taxing-multinational-companies>.
[67] See, for example, Chapman-Smith, above n 7.
[68] IRD, *Taxing multinational companies* (Inland Revenue, Policy Advice Division, 13 December 2012) <http://taxpolicy.ird.govt.nz/sites/default/files/2012-other-taxation-multinational-companies.pdf>.

this is that the commercial rationality of the restructure must be demonstrated. Given many structures are only possible for multinational groups, it may not be necessary to evidence this commerciality by comparison to how independent entities conduct their business. As such, if benefits can be shown to accrue to all parties to the arrangement it is likely commerciality can be demonstrated. However, the inability to evidence any commercial basis for a restructure or the insertion of artificial steps is likely to attract greater scrutiny from tax authorities.

This paper has considered the response of the OECD, ATO, and IRD to these transfer pricing issues. Their approaches reflect varying degrees of specificity in how each approaches the issue. The OECD guidelines provide very detailed discussion of what is likely to be acceptable, the ATO's taxation ruling reflects some of this detail, while focusing on the need for comprehensive documentation. The IRD's approach is more practical and highlights areas of greatest risk and emphasises that transfer pricing is only one aspect of the tax law that will be considered by the IRD in investigating these arrangements.

Similarly, other jurisdictions have attempted to address this problem. For example, Canada and the UK have already adopted the OECD approach.[69] Germany provides an extreme reaction to these restructures with its adoption of an 'exit tax' imposed under laws specifically directed at business restructuring.[70] This approach represents a significant departure from the OECD's as compensation is required for lost business opportunities and profit potential when functions are transferred to another jurisdiction.[71] Arguably, this is contrary to the arm's length principle, where compensation is usually only required where assets are transferred. However, it demonstrates an approach that might be adopted by other countries as a deterrent to a practice that is rapidly reducing the tax paid by multinationals in higher tax jurisdictions.

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[69] K A Bell, 'Canadian, U.K. Tax officials embrace OECD draft on restructurings' (2008) 17(11) *BNA Tax Management*, 460.

[70] Corporate Tax Reform Act 2008.

[71] M Moses, 'U.S. Practitioners compare German, U.S. provisions on restructuring' (2008) 17(1) *BNA Tax Management* 3.

The increasing problem of double non-taxation, particularly in relation to electronic commerce, does not appear to be addressed by simply examining the transfer pricing aspects of business restructures. Tax authorities are rapidly recognising this problem. This is reflected by the number of special task forces that have been appointed in recent months to examine tax minimisation by multinationals. Accordingly, transfer pricing must be regarded as only part of a much wider problem. Multinationals have a long history of complying with transfer pricing rules and have developed strategies for structuring their businesses in ways that meet the requirements of the arm's length standard. The problem is not that many of these restructures are in contravention of the transfer pricing rules; rather the problem is that the restructuring activity can be completed in a way that is arm's length, but increasingly leads to double non-taxation. Accordingly, the regulation of business restructuring must address not only tax issues related to transfer pricing, but also issues related to aggressive tax planning, the application of tax treaties, and tax policy.