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Transfer Pricing and Business Restructurings

A legal comparison between the OECD Transfer Pricing Guidelines and the German Transfer Pricing Rules

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Foreword

This thesis provided me the opportunity to expand my knowledge about transfer pricing and its implications. It has been an enjoyable learning process through which I discovered the complexity of international taxation as well as many interesting challenges faced in this field nowadays.

This work is the reflection of the hard work I have done through my whole studies. It has been possible to conclude it thanks to the support of many people. First of all, my family and Juliette always supported me. Secondly, my supervisor, Doctor Cees Peters, who helped me throughout the writing process with his expertise in transfer pricing. Last, but not least, the KPMG Meijburg & Co, Eindhoven, who provided me with an insight of practical cases and in particular Maarten Greijn, for facilitating the writing process.

Finally, I would like to show gratitude towards the professors and all my fellow students in the master program International Business Taxation. It was a pleasure and enrichment to work together with people all over the world.

Robert van der Vlies

List of Abbreviations

APA	Advance Pricing Agreement
AStG	Außensteuergesetz (Foreign Tax Act)
BEPS	Base Erosion and Profit Shifting
CUP Method	Comparable Uncontrolled Price Method
CPLM Method	Cost Plus Method
MNE	Multinational Enterprise
OECD	Organisation for Economic Co-operation and Development
OECD TPG	Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations
TNMM	Transactional Net Margin Method
TPSM	Transactional Profit Split Method

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Abstract

This thesis addresses the transfer pricing aspects of business restructurings within a multinational's value chain. While there are business restructurings in different forms and sizes, there is one business restructuring which has been commonly found in practice: the centralization of assets, functions, and risks in a principal company. After such a restructuring, the principal company will start to control the business processes of the other group entities that used to work before independently. With the adjustment of risk profiles, profit potential is allocated from the local group entity to the principal company. This research examines to what extent the local group entity is compensated for the loss of profit potential. In this regard, a legal comparison is conducted between the OECD Transfer Pricing Guidelines and the German tax law. While the current international debate is concentrated on finding an arm's length compensation for the business restructuring itself, this thesis advocates for a solution of the underlying problem, namely that after the business restructuring all the residual profits are allocated to the principal company. This study found that under the current transfer pricing system, MNEs have the incentive to position a principal company in a low-tax jurisdiction. This might result in the erosion of the tax base in the jurisdiction of the stripped group entity. Given the highly integrated and fragmentised value chain of a MNE under the principal company structure, this study recommends to move to a more flexible transfer pricing system which enables the stripped entity to participate in the residual profits or losses of a MNE after the restructuring. In this respect, a two-sided method such as the current profit split method might be a good starting point.

Chapter 1 - Introduction

1.1 Introduction

Over the last decades, under the influence of globalisation and the development of new technologies, the world economy has changed significantly as trade and production became more and more organized in a globalized way.[1] Given the high degree of globalisation and competition, in this day and age, there is a strong pressure on multinational enterprises (MNEs) to optimize their value chain.[2] The concept of value chain can be defined as *"the full range of activities that firms and workers perform to bring a product from its conception to end use and beyond, including design, production, marketing, distribution, and support to the final consumer"*[3]. With the successive development of communication and transportation technologies, businesses have more possibilities to organize their value chain at the global level which is also referred as the global value chain.[4] For instance, the widespread use of web technology, allows a business located in one country to interact with consumers and entities situated in another one against low transaction cost.[5] Taking the current economic situation into account, MNEs are exploring new ways to (re)organize their global value chain in the most efficient way in order to realize operational benefits while keeping the cost as low as possible.[6] In concrete terms, this means notably that MNEs modify their value chain by reallocating tangible and intangible assets, functions such as production or distribution, and risks from a group company in one jurisdiction to a group company in another jurisdiction.[7] This concept is referred as a 'business restructuring'[8] and it has far reaching consequences for the structure of the value chain of the MNE as a whole.

Business restructurings may take different forms but imply often a centralization of functions, risks and/or assets.[9] In this case, traditional country-based organizational structures are replaced by a global

[1] G. Gereffi, J. Humphrey, and T. Sturgeon, "The governance of global value chains", *Review of international political economy*, no. 12(1), 2005, p. 78
[2] S. Kishore Bilaney, "Supply Chain Management Using Alternative Manufacturing Models", *International Transfer Pricing Journal*, no. 21(2), 2014, p. 85; G. Gereffi, "Global value chains and international competition.", *The Antitrust Bulletin*, no. 56(1), 2011, p. 37-56.
[3] G. Gereffi, and K. Fernandez-Stark, "Global Value Chain Analysis: A Primer." *Durham, NC: Center on Globalization, Governance & Competitiveness (CGGC), Duke University*, 2011, p. 7.
[4] R.B. Handfield, and E.L. Nichols, *Introduction to Supply Chain Management*, New Jersey, Prentice-Hall, p. 1
[5] See for instance M. Johnson, and S. Whang, "E-business and supply chain management: an overview and framework.", *Production and Operations management*, no. 11(4), 2002, p. 413; R.A. Lancioni, M.F. Smith, and T.A. Oliva, "The role of the Internet in supply chain management." *Industrial Marketing Management*, no. 29(1), 2000, p. 45-56.
[6] S. Kishore Bilaney, "Supply Chain Management Using Alternative Manufacturing Models", *International Transfer Pricing Journal*, no. 21(2), 2014, p. 85
[7] J. Monsenego, *Introduction to transfer pricing*, Kluwer Law International, 2015, p. 95
[8] The OECD defines business restructurings as 'The cross-border reorganisation of the commercial or financial relations between associated enterprises, including the termination of substantial renegotiation of existing arrangements.'
[9] J. Monsenego, *Introduction to transfer pricing*, Kluwer Law International, 2015, p. 95

organizational or pan-continental structure.[10] A reason for the increase of centralised global business models might be found in the fact that it has become easier and more cost-effective for MNEs to manage their business operations from distance as a consequence of emerging information technologies.[11] A MNE might have several economic reasons to reorganize its value chain in a more central way, including the reduction of operational cost[12], the willingness to reach new markets[13], realization of group synergies[14], exploitation of economies of scale[15], and the need for specialization[16].

In the past, academic literature in the field of supply chain management was primarily concerned with the pre-tax aspects of the value chain, while literature in the field of taxation was primarily concerned with the tax aspects.[17] Notwithstanding, nowadays, studies underpin with more and more emphasis that both disciplines are increasingly linked[18] and that also taxation plays a role in businesses' decisions to restructure the value chain[19]. In particular, since the 90s, the application of a 'principal company structure' has been gaining more popularity among MNEs as a means to decrease the tax burden of the MNE group as a whole.[20] The application of a principal company structure, imposes that the MNE restructures its value chain in such a way that the value drivers, in terms of functions, assets, and/or risks, belonging to a local group company, are transferred to another company within the group, the principal organization.[21] Thus, the principal organization, the transferee, is most of the times organized in a low-tax jurisdiction, such as Luxembourg, Ireland, Switzerland or Singapore, while the local group entity is more likely to be situated in a high-tax jurisdiction.[22] For instance, a local fully-fledged manufacturer might be converted into a low risk entity by reallocating its risks concerning the inventory, market demand, and warehousing to the

[10] A. Chakravarty, and S. Ray, "Is Business Restructuring and Tax-Aligned Supply Chain Planning Still Viable?", *Asia-Pacific Tax Bulletin*, no. 19(6), 2013, p. 415
[11] S. Webber, "The tax-efficient supply chain: Considerations for multinationals.", *Tax Notes International*, no. 61(2), 2011, p. 149
[12] Ibid
[13] J. Monsenego, *Introduction to transfer pricing*, Kluwer Law International, 2015, p. 95
[14] Ibid
[15] Ibid
[16] Ibid
[17] S. Webber, "The tax-efficient supply chain: Considerations for multinationals.", *Tax Notes International*, no. 61(2), 2011, p. 149; A. Casley, S. Pope, and P. Hohtoulas, "Supply chain models: United Kingdom." *International Transfer Pricing Journa*l, no. 13(4), p. 194
[18] Ibid
[19] L. Oster, "How to benefit when the supply chain meets tax." *Supplychainbrain*, no. 13(6), 2009
[20] See for instance L. Yoder, 'Global Services Delivered Through Principal Structures Leads to Business and Tax Efficiencies' Forbes (2012) < https://www.forbes.com/sites/lowellyoder/2012/02/01/global-services-delivered-through-principal-structures-leads-to-business-and-tax-efficiencies/#6666d35b4744> accessed 8 April 2018
[21] S. Kishore Bilaney, "Supply Chain Management Using Alternative Manufacturing Models", *International Transfer Pricing Journal*, no. 21(2), 2014, p. 89; A. Chakravarty, and S. Ray, "Is Business Restructuring and Tax-Aligned Supply Chain Planning Still Viable?", *Asia-Pacific Tax Bulletin*, no. 19(6), 2013, p. 416
[22] L. Yoder, 'Global Services Delivered Through Principal Structures Leads to Business and Tax Efficiencies' Forbes (2012) < https://www.forbes.com/sites/lowellyoder/2012/02/01/global-services-delivered-through-principal-structures-leads-to-business-and-tax-efficiencies/#6666d35b4744> accessed 8 April 2018

principal organization by means of a business restructuring.[23] After the business restructuring, the principal organization will be responsible for the decision-making functions and risk assessment concerning the manufacturing activities, while the manufacturer will be converted into a contract or toll manufacturer with respectively less responsibilities.[24] As a consequence, the stripped-risk manufacturer will lose the entrepreneurial risk and will receive a low but stable profit after the business restructuring.[25] The principal, at the other hand, will bear the 'key entrepreneurial risks'[26] related to the manufacturing and will be entitled to the residual profits of the manufacturing activity after the restructuring.[27] In other words, a business restructuring, encompassing the transfer of assets, risks and/or functions, might involve the reallocation of 'profit potential'[28] from the local group member to the principal organization.[29]

From the perspective of the exit country, the jurisdiction where assets, functions, risks and their underlying profit potential are moved out, the question arises whether and how the local entity should be compensated for the loss of profit potential in line with the arm's length principle. With the outbound transfer of profit potential, the tax base of the exit country will decrease after the business restructuring. At the same time, the opposite will apply to the entry country in which the principal is located. Due to the complexity and the different interests at stake, the Organisation for Economic Co-operation and Development (OECD) dedicated chapter IX of the 'Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations' (hereinafter, OECD TPG) to the transfer pricing aspects of business restructurings. Similar to ordinary transactions between affiliated companies, based on the 'separate entity approach[30]' and the 'arm's length principle', business restructurings between related parties have to be valued as if they had been carried out between unrelated parties, each acting in its own interests. Giving the unique character of business restructuring and the lack of data on comparable transactions between market parties, both MNEs and tax authorities are facing difficulties when determining the arm's length price for a business restructuring which involves the transfer of valuable assets, entrepreneurial risks and value-adding functions from one tax jurisdiction to another.[31] Nevertheless, as laid down in the OECD guidelines, "*every*

[23] C. Rawlings, Mixing Oil with Water or Mixing Gin with Tonic: A tax-aligned approach to supply chain. *Supply chain Asia*, no. May-June, 2009, p. 21-23
[24] S. Kishore Bilaney, "Supply Chain Management Using Alternative Manufacturing Models", *International Transfer Pricing Journal*, no. 21(2), 2014, p. 89
[25] Ibid
[26] United Nations, *Practical Manual on Transfer pricing for Developing Countries*, p. 346, par.7.2.9
[27] Ibid; S. Kishore Bilaney, "Supply Chain Management Using Alternative Manufacturing Models", *International Transfer Pricing Journal*, no. 21(2), 2014, p. 89
[28] The expected future profits
[29] A. Chakravarty, and S. Ray, "Is Business Restructuring and Tax-Aligned Supply Chain Planning Still Viable?", *Asia-Pacific Tax Bulletin*, no. 19(6), 2013, p. 417
[30] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2017, p. 16, par. 5
[31] H. van Dam, J.T. Willem, F. Braken, The Zinc Case – Burden of Proof and Business Restructurings in the Netherlands. *International Transfer Pricing Journal*, 2018, no. 25(2), 2018, p. 3

effort should be made to determine the pricing for the restructured transactions as accurately delineated under the arm's length principle"[32].

Despite the far-reaching consequences of business restructurings for transfer pricing and tax purposes, many countries have not yet introduced domestic regulation regarding transfer pricing aspects dealing with business restructuring issues, and they keep referring to the OECD TPG.[33] One noteworthy example is Germany where already in 2007 as an amendment to the Foreign Tax Act (*Außensteuergesetz*, AStG), extensive legislation was introduced on the determination of the arm's length price for business restructurings. According to the Foreign Tax Act, in case of an outbound transfer of functions from a German group company to a group company in the territory of another country (*grenzüberschreitenden Funktionsverlagerung*), the German entity should be compensated for the loss of profit potential.[34] This shall be done through a hypothetical arm's length test in which the compensation is determined by discounting the value of profit potential from the perspective of both the transferor and the transferee.[35] The German 'hypothetical arm's length test' is unique and has not been adopted by Chapter IX of the OECD TPG on business restructurings.[36]

The main aim of this thesis is to compare the German transfer pricing rules with the OECD TPG in regard to the transfer pricing treatment of business restructurings, and more particularly the way in which a local group company involved in a business restructuring is compensated for the loss of profit potential under both approaches. Eventually, this analysis will be used in order to assess whether improvements can be made to the current guidance given in Chapter IX on business restructurings of the OECD TPG.

1.2 Problem Statement

The following problem statement can be identified:

In the context of business restructurings, how is the arm's length compensation for the transfer of profit potential from a local group company to the principal company determined according to respectively the German transfer pricing rules and the OECD transfer pricing guidelines and what improvements can be made to the latter?

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[32] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2017, p. 378, par. 9.35

[33] H. Kroppen, and J. Silva, *Cross-border business restructuring*, The Hague, Sdu, IFA cahiers de droit fiscal international vol. 96a, 2011, p. 19

[34] See P. Cauwenbergh and M. Mas, "Germany: The new German transfer pricing rules on cross-border relocation of functions: a preliminary analysis", *European taxation*, *no. 48*(10), 2008, p.514-526

[35] R. Eicke, *Tax planning with holding companies-repatriation of US profits from Europe: concepts, strategies, structures*, Kluwer Law international, vol. 22, 2009, p. 285

[36] G. Merkel, *Funktionsverlagerungen nach der Unternehmenssteuerreform 2008-Unter besonderer Berücksichtigung von Forschung und Entwicklung*, Doctoral dissertation, Fachbereich Rechts-und Wirtschaftswissenschaften der Technischen Universität Darmstadt, 2009, p.43

In order to answer the central question appropriately, it will be divided into a number of sub-questions. The following research questions will be discussed in order to define and limit the problem statement:

1. *What are the business reasons for MNEs to centralize assets, functions and risks in a principal company by means of a business restructuring, and how can this be understood in the light of a MNE's global value chain?*
2. *What is the arm's length principle and how has it been implemented in the OECD Transfer Pricing Rules and under German statutory law in the context of transfer pricing?*
3. *To what extent a business restructuring arises a compensation of the local group entity for the transfer of profit potential to the principal company according to respectively the OECD Transfer Pricing Guidelines and German tax law?*
4. *What improvements can be made to the OECD Transfer Pricing Guidelines in respect of business restructurings?*

1.3 Methodology

This research will be conducted in an interdisciplinary way as it will be predominantly based on legal sources, including international and domestic tax law on the one hand, and on the other hand, it will be based on economic sources, including firm theory. It is important to underline that both disciplines complement each other; therefore, they are not applied in isolation. The legal dimension is likely to be affected by the economic dimension and vice versa. A considerable part of this study will be based on a legal comparison between the OECD TPG and the German tax rules regarding transfer pricing. Both the OECD and the German legislator have enacted extensive rules on finding an adequate arm's length price of the outbound transfer of assets, functions and risks as part of a business restructurings. Those two legal frameworks will be analyzed and evaluated in the light of the predominant arm's length principle. In this comparison, it is important to refer to legal pluralism: the existence of multiple legal systems within one population and/or geographic area. While the OECD TPG are international non-binding guidelines, the nature of the German tax rules is compulsory in Germany. Moreover, for an adequate comparison, it is important to underline that transfer pricing is not an exact science. For this reason, a case study will be conducted in Chapter four in order to illustrate how an arm's length price can be found under the OECD TPG and German tax law. In this regard, in order to gain a better understanding of the German legislation, a non-binding English translation has been used as found in: '*Transfer Pricing In Germany: Translation of important law and regulations'* by Kratzer and Blesgen.

1.4 Limitations

In chapter IX of the OECD TPG, four different forms of business restructurings are identified: the conversion of a full-fledged distributor into a limited-risk distributor, the conversion of full-fledged manufacturers into contract manufacturers or toll manufacturers, the transfer of intangibles or rights in intangibles to a central entity within the group, and the concentration of functions, including procurement, sales support, and supply chain logistics, in a regional or central entity. Chapter IX does not distinguish between those different forms of business restructurings and only provides a general guidance to find an arm's length price for the business restructuring itself. The same will be done in this thesis. Nevertheless, the conversion of a full-fledged manufacturer into a low risk entity will be discussed into more detail by drawing more attention to the case study.

This thesis will address foremost the first part of Chapter IX: the determination of an arm's length compensation for the restructuring itself. The second part of Chapter IX concerning the remuneration of post-restructuring controlled transactions will not be dealt with into detail. For now, it is important to underline, that the arm's length principle applies the same to post-restructuring transactions as to the ordinary transactions.[37]

Due to the scope and limitations of this thesis, it is assumed that with the adoption of a principal company, assets, functions and risks are transferred from a profitable local group entity to the principal company located elsewhere. In other words, business restructurings, involving loss-making group entities are not within the scope of this thesis. Moreover, this thesis will be written from the perspective of the exit-country, the country in which the local entity is located which is stripped of its assets, functions, and risks. Thirdly, as this study is concerned with transfer pricing, CFC rules and anti-abuse rules will not be directly addressed in this work.

1.5 Structure

Before dealing with the transfer pricing aspects of business restructurings, the aim of chapter 2 is to examine how MNEs create value in this day and age, and more particularly in the principal company structure. In order to put into place a principal company structure; the assets, functions and risks of the company have to be centralized within a MNE's value chain by means of a business restructuring. The process of this business restructuring will be addressed into more detail. In this analysis, also the role of taxation will be examined.

[37] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2017, p. 401, par. 9.98

Subsequently, in Chapter 3, the origin and practical aspects of the arm's length principle as found in German tax law and the OECD TPG will be discussed. This broad analysis is necessary for understanding how relatively Germany and the OECD applied their conception of the arm's length principle to business restructurings.

Chapter 4 encompasses a legal comparison between Germany and the OECD on finding an arm's length compensation for the local entity in the context of business restructurings in which assets, functions, and risks are centralized in a principal company. As part of this comparison, a case study will be included in which the conversion of a full-fledged manufacturer into a low-risk manufacturer will be examined from the perspective of transfer pricing. Here, the central question is how the manufacturer is compensated for the loss of profit potential under respectively the OECD TPG and German tax law.

Subsequently, the aim of chapter 5 is to analyze the findings of chapter 4, and to identify if possible, alternatives for the current approach of the OECD in regard of the transfer pricing treatment of business restructurings. Once we have provided to the reader with all the necessary analyses and explanations of the cornerstone concepts involved in this thesis, we will be in the position to draw a conclusion in chapter 6.

Chapter 2 –Business restructurings and MNE's global value chains

2.1 Introduction

In order to adapt to the modern business landscape, MNEs are constantly seeking for possibilities to optimize their value chain and in this manner, improve their efficiency. In this regard, centralised business models are becoming increasingly popular as MNEs shift extensively assets, functions, and risks from local group companies to a principal company. The main aim of this chapter is to set the matter of business restructurings in the wider context of the functioning of a MNE. For this purpose, the MNE's global value chain and its value drivers will be addressed in order to understand the economic reasoning behind the decision of a MNE to centralize its businesses model through a business restructuring. Subsequently, the implications of the adoption of a principal company structure will be described into more detail.

2.2 Porters' Value Chain Analysis as a theoretical framework

Before understanding the reasoning behind cross-border business restructurings, it is important to look closer at the way businesses, and in particular MNEs, generate value. In 1985, Michael Porter introduced two economic models related to the maximization of corporate value, namely the '*value chain framework*'[38] and the *'competitive forces model'*[39]. While the competitive forces model deals with the attractiveness of a market or industry as whole, the value chain model approaches competitiveness from the perspective of the firm itself. A firm's value chain can be described as the integrated system of '*value activities'* the firm performs in order to add value for its customers.[40] The firm's value activities, which can be distinguished into primary[41] and supportive[42] activities, are linked to each other and represent as a whole, in addition to the '*margin*', the total value of the firm (see figure 1).[43] The value chain analysis provides a systemic view on the way organizations, including MNEs, are generating value to a firm's products or services, by attributing the value generated to different value activities.[44] At the same time, it is important to mention that 'value activities' which were considered as supportive in Porters model, such as human capital[45] and

[38] See M. E. Porter, *Competitive Advantage: Creating and Sustaining Superior Performance*, New York, Macmillan, 1985

[39] See M.E. Porter, "How Competitive Forces Shape Strategy", *HBR March–April*, 1979

[40] M. E. Porter, *Competitive Advantage: Creating and Sustaining Superior Performance*, New York, Macmillan, 1985, p. 33-40

[41] Inbound logistics, operations, outbound logistics, marketing & sales, and services on the one hand, and secondary activities, including firm infrastructure, human resource management, technology development, and procurement

[42] Firm infrastructure, human resource management, technology development, and procurement

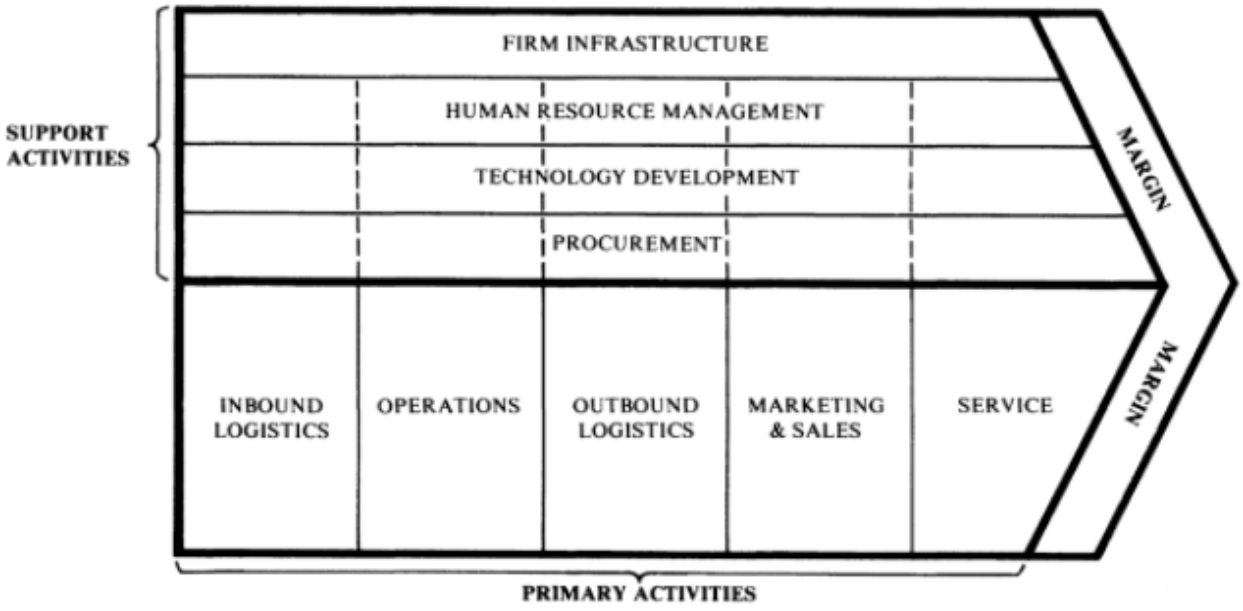
[43] M. E. Porter, *Competitive Advantage: Creating and Sustaining Superior Performance*, New York, Macmillan, 1985, p. 33-40

[44] B. Baumgartner, "Value Creation Analysis for Transfer Pricing Purposes", *International Transfer Pricing Journal*, no. 25 (2), 2018, p. 2

[45] See R.J.S. Tavares and J. Owens, "Human Capital in Value Creation and Post-BEPS Tax Policy: an Outlook", *Bulletin for International Taxation*, no. 69(10), 2015

technology development[46], are seen as the main value drivers of businesses nowadays. This phenomenon can be explained by the fact that the value chain analysis was developed as a model when internet, big data, and artificial intelligence did not exist.

Figure 1: A schematic overview of Porter's value chain framework



Source: copied from M. E. Porter, *Competitive Advantage: Creating and Sustaining Superior Performance,* New York, Macmillan, 1985, p. 33-40

2.3 An analysis of a MNE's Global Value Chain

2.3.1 The Global Value Chain

Globalisation of the world in terms of international trade and industrial organization emerged organisations to innovate their business models and underlying value chains.[47] Nowadays, MNE's value chains are mostly organized in a global way: '*manufacturing or service activities done at home are combined with those performed abroad'*[48]. A value chain which encompasses business activities in several countries is also referred as a 'global value chain'.[49] In general, the decision of companies to shift from a domestic value chain to a global value chain is most of the times motivated by reasons of market efficiency and cost

[46] See P. Petruzzi and S. Buriak, "Addressing the Tax Challenges of the Digitalization of the Economy – A Possible Answer in the Proper Application of the Transfer Pricing Rules", *Bulletin for International Taxation*, no.72(4a), 2018
[47] A. Bakker, (Ed.). *Transfer pricing and business restructurings: streamlining all the way*, IBFD, 2009, p. 11
[48] Park, G. Nayyar, and P. Low, "Supply Chain Perspectives and Issues. A literature review", *WTO and Fung Global Institute*, 2013, p. 29
[49] For an overview on the effects of the global value chains from a worldwide perspective see R. Kaplinsky, "Globalisation and unequalisation: What can be learned from value chain analysis?," *Journal of development studies*, *37*(2), 2000, p. 117-146

effectiveness.[50] The dispersion of value activities across country boundaries enables a company to benefit from the comparative advantages of different countries in terms of low costs, unique assets and specific knowledge.[51] In order to operate globally, companies are faced with the make-or-buy decision[52]: establishing a business activity under full control and ownership in the territory of another country or finding a third party which will carry out the business activity through an arm's length contract in the territory of another country.[53] In the case of the former, a business will relocate its own value chain activities across geographical boundaries which is also referred as '*offshoring*'[54].

Already in the second half of the 20th century, businesses in developed countries started to move their manufacturing activities to developing countries in order to save on production cost since the labour costs in those countries were significant lower.[55] At the same time, the higher value-added business activities, including R&D, design, marketing, and branding remained located in the developed countries[56] Technological innovations and the regulatory environment made that the costs of managing the global value chain remained low and enabled companies to generate a location-based competitive advantage.[57] In line with the value chain framework, it can be explained that the transfer of a value activity, e.g. the relocation of the manufacturing from a high cost country to a cost-efficient country, enables a firm to realize a higher value for that business activity, which increases the total value of an organization and enables the business to realize its competitive advantage.

2.3.2 Fragmentation of a MNE's Global Value Chain

While in the past, an entire value activity could be offshored to another country, nowadays, different tasks of the same value activity may be performed in different countries. Literature indicates that production

[50] A. Bakker, (Ed.). *Transfer pricing and business restructurings: streamlining all the way*, IBFD, 2009, p. 19; Park, G. Nayyar, and P. Low, Supply Chain Perspectives and Issues. A literature review, *WTO and Fung Global Institute*, 2013, p. 12

[51] P.D. Ørberg Jensen and T. Pedersen, "The globalization of high-value activities: Why do firms offshore advanced tasks?", *in* J. Pla- Barber and J. Alegre (ed.), *Reshaping the Boundaries of the Firm in an Era of Global Interdependence*, Emerald Group Publishing Limited, 2010, p. 5

[52] See for instance M. Sako, "Outsourcing and offshoring: implications for productivity of business services", *Oxford Review of Economic Policy, 22*(4), 2006, p. 499-512.

[53] Park, G. Nayyar, and P. Low, "Supply Chain Perspectives and Issues. A literature review", *WTO and Fung Global Institute*, 2013, p. 29

[54] Ibid, p. 56

[55] See J. M. Stopford and L.T. *Wells, Managing the multinational enterprise: Organization of the firm and ownership of the subsidiaries*, Basic Books, vol. 2, 1972

[56] P.D. Ørberg Jensen and T. Pedersen, "The globalization of high-value activities: Why do firms offshore advanced tasks?", *in* J. Pla- Barber and J. Alegre (ed.), *Reshaping the Boundaries of the Firm in an Era of Global Interdependence*, Emerald Group Publishing Limited, 2010, p. 6

[57] Park, G. Nayyar, and P. Low, "Supply Chain Perspectives and Issues. A literature review", *WTO and Fung Global Institute*, 2013, p. 57

processes within Global Value Chains are increasingly fragmented.[58] The process of fragmentation has been described as the "*phenomenon by which reductions in trade barriers and the costs of moving goods and information make it possible to break up an integrated production process, moving separate elements of the process to lower cost locations"*[59]. For instance, with respect to the manufacturing process, a MNE may decide to relocate less advanced tasks such as the large scale routine production to a cost-efficient country, while keeping the more advanced tasks of manufacturing, including the design of a prototype and the start of a niche production, in a high-cost country.

The fragmentation of the value chain and the corresponding high mutual dependency between affiliated entities concerning the creation of value can be read in the light that most of the MNE's are pursuing a '*global strategy*' nowadays. In contrast to a 'multi domestic strategy', MNEs operating under a global strategy are making decisions by taking their worldwide interest into account.[60] In other words, with a global strategy, MNE's try to maximize the after-tax profit of the MNE as a whole rather than the individual after-tax profits of its separate entities.[61] One of the implications of a global strategy is the centralisation of decision-making functions. In this context, MNEs manage their risks as if they are integrated productive and financial entities.[62] Because of the fact that, under such a strategy, subsidiaries are highly interdependent and work tight together[63], a MNE becomes able to maximize synergies and economies of scale.[64] With the rapidly development of information, communication, and other technologies, MNEs face even less barriers in terms of cost and effectiveness to perform a global business strategy.[65]

Following from the analysis above, it is feasible to say that with the interdependency and integration of group entities, it has become more difficult to attribute value to different group entities. This raises the question whether the value chain analysis, as introduced by Porter, is still an adequate instrument for value determination. As advocated by a recent study, the fragmentation of business activities requires a more

[58] Seabrooke and wigan: the governance of global wealth 3
[59] A. J. Venables, "Fragmentation and multinational production.", *European economic review*, no. 43(4-6), 1999, p. 935
[60] D. Rutges, C. Sporken, and J. Dijkman, "The transfer of production, research, development and service activities out of the Netherlands", International Transfer Pricing Journal, 2004, no.11(4), p. 166
[61] J.C. Fleming, R.J. Peroni, and S.E. Shay, "Formulary Apportionment in the US International Income Tax System: Putting Lipstick on a Pig", *Mich. J. Int'l L*., no. *36*(1), 2014, p. 3
[62] Seabrooke and wigan: the governance of global wealth p. 4
[63] D. Rutges, C. Sporken, and J. Dijkman, "The transfer of production, research, development and service activities out of the Netherlands", International Transfer Pricing Journal, 2004, no.11(4), p. 166
[64] A. Bakker, (Ed.). *Transfer pricing and business restructurings: streamlining all the way*, IBFD, 2009, p. 11
[65] Ibid, p. 12; S. Webber, "The tax-efficient supply chain: Considerations for multinationals.", *Tax Notes International*, no. 61(2), 2011, p. 149

disaggregated view on the value chain of an organization.[66] As an alternative, the study proposes that the creation of value should be attributed to tasks rather than to value activities as proposed by Porter.[67] However, in the opinion of this author, Porters' value chain analysis and a more task-approach of value creation should not be seen as mutually exclusive, but as supplementing and supporting each other in order to determine where the value is created.

2.3.3 Coordination of a MNE's Global Value Chain: the principal company model

As illustrated above, value chains have become more and more complex in this day and age. Therefore, the concept of governance is perceived as central in order to understand them. Within the literature, the term governance in the context of value chains has been used in order to *"express that some firms in the chain set and/or enforce the parameters under which others in the chain operate"*[68]. It is important to underline that there are different types of governance in regard of global value chains.[69] For the scope of this study, we will focus on the coordination of a global value chain based on 'hierarchy': "*this governance form is characterized by vertical integration. The dominant form of governance is managerial control, flowing from managers to subordinates, or from headquarters to subsidiaries and affiliates."*[70] An example of a highly integrated and MNE-operated global value chain is the 'principal' or 'entrepreneurial' business model. Since the early 1990s, the 'principal' or 'entrepreneurial' business model has been widespread adopted by MNEs. In this regard, the role of the principal company is to coordinate the value activities and the conditions under which the other group entities participate in the MNE's global value chain.[71]

> *"An effective principal typically assumes responsibility for some of the following tasks: purchases, research & development, planning, production and distribution planning, stock management, logistic planning, marketing strategy development, sales, treasury, intellectual property (IP) management financial and administrative functions."*[72]

The wide range of business aspects as listed above, which fall within the competence of a principal, illustrate the role of the principal as the hub of the MNE: key functions and the decision making processes of the value chain are centralized in the principal company. This is confirmed by the fact that the principal

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[66] P.D. Ørberg Jensen and T. Pedersen, "The globalization of high-value activities: Why do firms offshore advanced tasks?", *in* J. Pla- Barber and J. Alegre (ed.), *Reshaping the Boundaries of the Firm in an Era of Global Interdependence*, Emerald Group Publishing Limited, 2010, p. 7

[67] Ibid

[68] J. Humphrey and H. Schmitz, "Governance in global value chains", *IDS bulletin*, 2001, p. 20

[69] See for an overview G. Gereffi, J. Humphrey, and T. Sturgeon, "The governance of global value chains", *Review of international political economy*, no. 12(1), 2005, p. 83-89

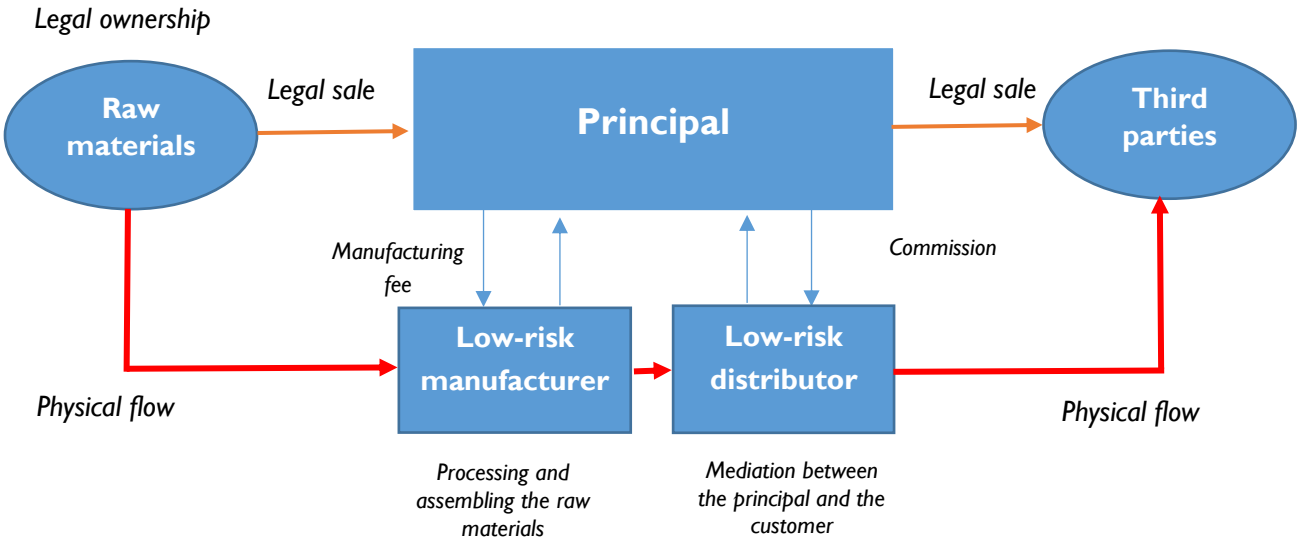
[70] G. Gereffi, J. Humphrey, and T. Sturgeon, "The governance of global value chains", *Review of international political economy*, no. 12(1), 2005, p. 84

[71] The intersection of EU State Aid and US Tax Deferral – p. 181

[72] S. Kersemaekers and B. Piëst, "Management control: benefits of tax effective supply chain restructuring", *MCA*, no.*1*, 2011, p. 34

company instead of the local entities will be responsible for the contractual relations with third parties, including the customers and vendors (see figure 2).[73] It is not uncommon for a MNE to have more than one principal, one for each geographic region.[74] In order to adopt a principal company structure, the value chain has to be restructured in terms of assets, functions, and risks.

Figure 2: A simplified version of the principal company structure: centralization of assets, functions, and risks related to manufacturing and distribution process



Source: made by author

2.4 Business restructurings

2.4.1 Definition of business restructurings

In literature, there is no legal or universal accepted definition of - business restructuring-. As this research assesses business restructuring from the perspective of transfer pricing, it is relevant to assess how both the OECD and the UN, two respected international governmental organisations (IGOs) which have been enacting guidelines on the matter of transfer pricing, have defined the concept of business restructurings in their guidelines (see table 1). Summarizing, a cross-border business restructuring implies a modification of a MNE's value chain as the assets, functions, and/or risks to which profit potential is attached are transferred from one group entity to another. As underlined by the renewed definition of the OECD TPG, a business

[73] Kurtin, O. (2013). A Swiss Principal Model Case Study: Restructuring a multinational corporation to achieve territorial optimization. <http://www.swissprincipal.com/wp-content/uploads/2013/07/KurtinLaw-SwissPrincipalModel.pdf, 18.03.2017> accessed 25 April 2018

[74] See for instance L. Yoder, 'Global Services Delivered Through Principal Structures Leads to Business and Tax Efficiencies' Forbes (2012) < https://www.forbes.com/sites/lowellyoder/2012/02/01/global-services-delivered-through-principal-structures-leads-to-business-and-tax-efficiencies/#6666d35b4744> accessed 8 April 2018

restructuring might result in the termination of substantial renegotiation of existing arrangements between group companies.[75] The group company which losses its entitlement to certain functions, assets, and risks due to a business restructuring can be defined as the transferor.[76] At the other side of the coin, the group company which receives functions, assets, and risks due to the business restructuring, can be referred as the transferee.[77]

Table 1: Legal definitions of business restructurings

Legal source	Definition of business restructurings
OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2010, par. 9.1	The cross-border redeployment by a multinational enterprise of functions, assets and/or risks.
OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2017, par. 9.1	The cross-border reorganisation of the commercial or financial relations between associated enterprises, including the termination of substantial renegotiation of existing arrangements.
UN, *Practical Manual on Transfer pricing for Developing Countries*, 2017, par. B.7.1.2	The cross-border redeployment of functions, assets (tangible and/or intangible) and risks to which a profit/loss potential may be attached.

Source: OECD, UN; made by author

2.4.2 Business restructurings and the principal company structure

Given the broad definition of the term "business restructuring", as listed above, it is significant to emphasize that each business restructuring is unique and requires a case by case analysis of the facts and circumstances. In a similar vein, there is an impact of the business restructuring on the MNE's global value chain which can be of different dimensions. Nonetheless, news reports[78], academic literature[79] and international guidelines on transfer pricing[80], identify one type of business restructuring that is frequently observed in

[75] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2017, par. 9.1
[76] J. Monsenego, *Introduction to transfer pricing*, Kluwer Law International, 2015, p. 97
[77] Ibid
[78] See for instance L. Yoder, 'Global Services Delivered Through Principal Structures Leads to Business and Tax Efficiencies' Forbes (2012) < https://www.forbes.com/sites/lowellyoder/2012/02/01/global-services-delivered-through-principal-structures-leads-to-business-and-tax-efficiencies/#6666d35b4744> accessed 8 April 2018;
[79] See J. Monsenego, *Introduction to transfer pricing*, Kluwer Law International, 2015, p. 97; S. Kersemaekers and B. Piëst, "Management control: benefits of tax effective supply chain restructuring", *MCA*, no.*1*, 2011, p. 34; S. Kishore Bilaney, "Supply Chain Management Using Alternative Manufacturing Models", *International Transfer Pricing Journal*, no. 21(2), 2014, p. 85; G. Cottani, *Transfer Pricing, Topical Analyses IBFD, 2017*, p.174; Kurtin, O. (2013). A Swiss Principal Model Case Study: Restructuring a multinational corporation to achieve territorial optimization. <http://www.swissprincipal.com/wp-content/uploads/2013/07/KurtinLaw-SwissPrincipalModel.pdf, 18.03.2017> accessed 25 April 2018
[80] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2017, p. 365-366, par. 9.2; United Nations, *Practical Manual on Transfer pricing for Developing Countries*, p. 346, par.7.2.9

practice: the transfer of value adding functions, valuable assets and entrepreneurial risks from one or more profit generating entities of a MNE to a 'principal company' - a central entity of the MNE which is located in another country. Subsequently, based on such a risk reallocation, key functions and decision making processes are centralized in a 'principal company' (see also the section above).

A business restructuring that commonly occurs, is the conversion of a full-fledged manufacturer into a low-risk entity being controlled by the principal company. It is true to say that there are manufacturers in all shapes and sizes but all of them fulfill the same functions within a MNE's value chain: the transformation of raw materials into finished goods[81]. In order to allocate the control over the manufacturing process to the principal company; the valuable assets, as well as the value adding functions and the entrepreneurial risks are transferred from the local manufacturer to the principal one. It is of utmost importance to born in mind that in this situation, the local manufacturer does not cease to exist and it will continue to manufacture under another risk profile (see table 2 for an overview). While the transferee or the principal company is given the entrepreneurial functions and risks of its assigned territories, the low-risk entities end up performing limited routine functions, holding minimal assets and bearing low risks, and they have a lower profit potential attached to them.[82] It is feasible to say that such a business restructuring has a fundamental impact on the local group entity, especially when the local group entity used to bear all the risks itself.

With the fragmentation of the manufacturing process, it has become harder to identify the places of value creation. For instance, principal companies do not monitor, but often direct and manage the operations of the controlled group entities.[83] Further, given the strong integration of MNE's global value chains nowadays, it can be argued that also the employees of controlled limited-risk entities, e.g. a contract manufacturer, perform activities under control of the principal company, which are thus for the benefits of the entire global value chain.[84]

[81] A. Bakker, (Ed.). *Transfer pricing and business restructurings: streamlining all the way*, IBFD, 2009, p. 27
[82] G. Cottani, *Transfer Pricing, Topical Analyses IBFD, 2017*, p.174
[83] R. Tavares, "Multinational Firm Theory and International Tax Law: Seeking Coherence", *World Tax Journal*, no. 8(2), p. 265
[84] Ibid

Table 2: Competences of respectively the local manufacturer (M) and the principal company (P) under different company structures

		Fully-fledged manufacturer	*Licensed manufacturer*	*Contract manufacturer*	*Toll manufacturer*
Assets	Current Assets	LM	LM	LM/P*	P
	Fixed Assets	LM	LM	LM	LM
	Intangible Assets	LM	P	P	P
Functions	Procurement of materials	LM	LM	LM	P
	Assemblage of goods	LM	LM	LM	LM
	Production planning	LM	LM	LM	LM
	Research & Development	LM	P	P	P
	Sales of goods	LM	LM	P	P
	Invoicing the customers	LM	LM	P	P
Risks	Inventory risk - raw materials	LM	LM	LM	P
	Inventory risk - finished goods	LM	LM	P	P
	Market risk	LM	LM	P	P
	Business risk	LM	LM	P	P
	R&D risk	LM	P	P	P

Source: own author

2.4.3 Economic reasons for business restructurings

As the competitive landscape is continuously subject to change, there is a strong pressure on MNEs to keep on optimizing their global value chains.[85] A MNE has to change or restructure its value chain frequently in order to secure its continuity or long-term survival.[86]

Once an enterprise has taken the decision of having a business restructuring, the main reason behind might be the aim to realize savings from the synergies and economies of scales.[87] Synergies can be explained as the realization of higher profits for the MNE as a whole as a result of the cooperation between affiliated companies. In this respect, the whole is greater than the sum of its parts.[88] For instance, by centralizing a

[85] A. Bakker, (Ed.). *Transfer pricing and business restructurings: streamlining all the way*, IBFD, 2009, p. 11
[86] Ibid; H. Kroppen, and J. Silva, *Cross-border business restructuring*, The Hague, Sdu, IFA cahiers de droit fiscal international vol. 96a, 2011, p. 19
[87] See A. Bakker, (Ed.). *Transfer pricing and business restructurings: streamlining all the way*, IBFD, 2009, p. 12
[88] A. Navarro, "The Arm's Length Standard and Tax Justice: Reflections on the Present and the Future of Transfer Pricing", *World Tax Journal*, no. 3 (10), 2018, p. 358

business operation which used to be conducted by different group companies at different locations, a higher profit could be realized for the MNE as a whole.[89] Economies of scale, at the other hand, are comprehended as the reduction in unit production costs resulting from an increased level of production.[90] Those costs can be reduced or eliminated by deciding to assemble those services at a central location, i.e. a principal company.[91]

As a conclusion, we can claim that the reallocation of MNE's value, by means of a business restructuring, it is often driven by the attempt of MNEs to be placed in a more favourable position against competitors by realizing a higher return on the market (economic rents).[92]

2.4.4 The role of taxation

The literature is in disagreement about the importance of taxation in business restructurings. On the one hand, a study mentioned the following about the relationship between taxation and business restructurings: *"MNEs carrying out business transformations solely for tax reasons are rare and represent only exceptional cases"*[93]. In harmony, another study mentions: *"More often than not, operational factors drive business restructuring decisions"*[94]. This view might be supported by the idea that, from an economic point of view, a business restructuring enables a MNE to distinguish itself from its competitors by realizing a higher return than that one of its competitors.

In contrast, a large part of literature emphasises the role of taxation in the (re)design process of a MNE's value chain.[95] Indeed, as part of their tax planning, MNEs restructure their value chain in such a way that most of the value is added in the territory of a low-tax jurisdiction.[96] This concept is also referred as 'tax-efficient supply chain' or 'tax aligned supply chain' and it can be defined as the *"the restructuring process of integrating tax planning into the overall management of a company's supply chain, factoring in where*

[89] A. Bakker, (Ed.). *Transfer pricing and business restructurings: streamlining all the way*, IBFD, 2009, p. 11
[90] A. Navarro, "The Arm's Length Standard and Tax Justice: Reflections on the Present and the Future of Transfer Pricing", *World Tax Journal*, no. 3 (10), 2018, p. 358
[91] A. Bakker, (Ed.). *Transfer pricing and business restructurings: streamlining all the way*, IBFD, 2009, p. 11
[92] *The returns over and above the costs of employing a firm's resource in its next best alternative (i.e., opportunity costs). Such rents result from the efficient and effective exchange, allocation, and utilization of firm-specific resources.* See also: A.A. Lado, N.G. Boyd, and S.C. Hanlon, "). Competition, cooperation, and the search for economic rents: a syncretic model", *Academy of management review*, no. *22*(1),1997, p. 111
[93] A. Bakker, (Ed.). *Transfer pricing and business restructurings: streamlining all the way*, IBFD, 2009, p. 17
[94] Ibid., p. 16
[95] For an overview of the role of taxation in the literature on supply chain management see S. Webber, "The tax-efficient supply chain: Considerations for multinationals.", *Tax Notes International*, no. 61(2), 2011, p. 149
[96] D. Irving, G. Kilponen, R. Markarian, and M. Klitgaard, "A tax-aligned approach to SCM.", *Supply Chain Management Review*, p. 58; H. Mies, "Cross-border outsourcing – issues, strategies and solutions", *Bulletin for International Taxation, no. 68*(10), 2014, p. 574; A. Casley and L. Webb-Martin, "Transfer pricing rules for transactions involving low-tax countries: United Kingdom*", International Transfer Pricing Journal*, *no. 6*, 2007, p. 344

to locate functions and assets of the business, centralized management and control over the risks, and which entity will legally and economically assume the risks"[97]. Likewise, the OECD Transfer Pricing Guidelines, acknowledges that taxation may be a factor in restructuring business operations.[98]

In this regard, the predominant design of a tax-effective supply chain restructuring is the principal company structure.[99] As described above, after the restructuring, the principal company will become the primary risk taker, while the stripped local group entity will perform routine activities and will receive a return based on what would be earned by market parties bearing little if any entrepreneurial risk.[100] In chapter 5, an exhaustive study will be conducted concerning the allocation of the residual profits of the MNE to its entities in the principal structure. For now, it is crucial to understand that with the transfer of assets, functions, and risks, the profit potential will be at the same time relocated from one jurisdiction to another. As a consequence, assuming future expectations indicate that profit will be realized, a MNE might be able to reduce its overall tax burden by establishing a principal company in a low-tax jurisdiction (see table 3). While in the case of foreseeable losses, it would be more likely that the assets, functions, and risks remain located in the high-tax jurisdiction due to the more favourable tax loss carry forward. All in all, despite some contradictory views, it would seem that taxation plays an important role in the decision of companies to relocate assets, functions, and risks from one tax jurisdiction to another.

Table 3: The most favourable tax location

	Risks assumed	**Share of profits or losses**	**Favorable tax location based on future expectations**	
			Losses	**Profits**
Stripped local group entity	Low	Low	Low-tax jurisdiction	High-tax jurisdiction
Principal Company	High	High	High-tax jurisdiction	Low-tax jurisdiction

Source: made by author

[97] L. Oster, "How to benefit when the supply chain meets tax." *Supplychainbrain*, no. 13(6), 2009
[98] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2017, p. 378, par. 9.34
[99] S. Kersemaekers and B. Piëst, "Management control: benefits of tax effective supply chain restructuring", *MCA*, no.*1*, 2011, p. 34
[100] Green book 288

2.4.5 Exit country versus the entry country

The adoption of the full principal model by a MNE might has a negative impact on the economic situation of the 'exit country', the country in which the stripped entity is situated. With the outbound transfer of assets, functions and risks, less turnover will be realized in that jurisdiction which has a negative impact on a country's Gross Domestic Product (GDP)[101]. In a similar vein, because of the shift in risks borne from the local entity to the principal company, the first will be presumably entitled to a lower profit.[102] This has a negative impact on the tax base of the exit country.

From the perspective of the entry country, principal companies are more than welcome. The inbound transfer of valuable assets, functions and risks comes along with new business and employment opportunities. Moreover, principal companies are often profitable which is beneficial for the country's tax revenue. For those reasons, some countries introduced special tax regimes for principal companies in order to attract foreign direct investment (hereinafter, FDI).[103] . Moreover, in the context of the EU, residual profit allocation and the principal company model were at stake in the Apple, Starbucks and Amazon cases, where the European Commission investigated whether certain Advance Pricing Agreements (APAs) constituted a form of State Aid.[104]

2.5 Conclusion

The aim of this chapter was to provide an answer to the following research question:

What are the business reasons for MNE's to centralize assets, functions and risks in a principal company by means of a business restructuring, and how can this be understood in the light of a MNE's global value chain?

According to Porter's value chain analysis, an organization adds value through its value activities. In this regard, value activities can be rather primary or supportive, they are mutual dependent on each other and each of them contribute to the total value of the firm. There are value chains in different shapes and sizes, this chapter addressed primary the highly integrated and MNE-operated global value chain.

Since the 90s, MNEs started to implement the principal company structure by restructuring their value chain in such a way that assets, functions, and risks are centralized in one entity, the principal company. After the redeployment of assets, functions, and risks within a MNE, the principal company will start to control the

[101] The total value of goods produced and services provided in a country during one year
[102] H. Kroppen, and J. Silva, *Cross-border business restructuring*, The Hague, Sdu, IFA cahiers de droit fiscal international vol. 96a, 2011, p. 22
[103] H. Kroppen, and J. Silva, *Cross-border business restructuring*, The Hague, Sdu, IFA cahiers de droit fiscal international vol. 96a, 2011, p. 26
[104] See 'the intersection of EU state Aid and U.S. tax deferral

business operations of the other group entities in a certain geographical region. At the other side of the coin, local group entities, including distributors and manufacturers, which used to operate independently, will be converted into low-risk entities. With the adaptation of a principal company structure, the MNE's value chain might be fragmentized: the business process might be split in parts and spread across countries. Moreover, business operations of group entities might become more integrated and it is likely that there will be a strong mutual dependency between group entities. It is feasible to say that with the implementation of such a business model, it will become more difficult to attribute value to the different group entities involved. This can be understood in the light of the value chain analysis. By fragmenting the value chain, a value activity might be exercised by different group entities; therefore, it becomes more complicated to attribute an accurate value to each entity of the group.

It has been found that with the integration and interdependency of group entities, a MNE might be able to maximize synergies and economies of scale. The competitive landscape and new information technologies require that MNEs optimize their value chains in order to gain higher economic rents. Besides operational factors, this study found that taxation also plays a significant role for MNEs to centralize its assets, functions, and risks in a certain tax jurisdiction. It was found that with the adoption of a principal company structure, also profit potential is transferred from the jurisdiction of the local group entity to the jurisdiction of the principal company. By positioning a principal company in a low-tax jurisdiction, a MNE might be able to increase the after-tax profits of the MNE as a whole. Giving the fact that most MNEs are pursuing a global strategy, taxation might be taken into account when determining where to establish a principal company structure.

Chapter 3 – The Arm's Length Principle

3.1 Introduction

Transfer pricing rules are necessary for determining the conditions, including the price, of transactions between affiliated entities for tax purposes.[105] Without a legal framework on transfer pricing, MNEs would enjoy an unfair competitive advantage by shifting their tax base or profit from high-tax jurisdictions to low-tax jurisdictions which would eventually result in a lower tax burden for the MNE as a whole.[106] It is for this reason, and the increased share in intergroup trade[107], that transfer pricing is perceived as one of the most important international tax issues at this moment[108]. The arm's length principle has been adopted by the OECD and many tax authorities as the predominant principle. Based on the 'separate entity approach', the price of intragroup transactions should reflect the price which would have been agreed on by independent parties in a similar transaction under similar conditions.[109] In Germany, member of the OECD, the arm's length principle has been adopted as the predominant concept for transfer pricing. However, even though the OECD TPG have been approved by Germany, the German tax authorities emphasized that the approval of the OECD TPG do not imply a direct obligation of a Member State.[110] Therefore, we have to rely on German transfer pricing rules for the German interpretation of the arm's length principle. The main aim of this chapter is to examine the legal basis of the arm's length principle in the OECD TPG and German transfer pricing rules and its implications for the taxpayers. This analysis is essential before answering how respectively the OECD and Germany deal with the application of the arm's length principle in business restructurings.

3.2 The arm's length principle in the OECD TPG

3.2.1 The theoretical framework of the arm's length principle

In section 2.3.1, we discussed some situations when companies desire to globalize their value chain and decide to establish a business entity abroad or rather enter into a contractual agreement with a third party abroad. In the latter case, market forces, i.e. supply and demand, determine the price of the agreement.[111]

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[105] R. Collier and J. Andrus, *Transfer Pricing and the Arm's Length Principle After BEPS*, Oxford University Press, 2017, p. 1

[106] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2017, p. 34, par. 1.3; In the context of the EU, see also the case law of the European Court of Justice (ECJ): Apple (SA.38373 (2014/C), Starbucks (SA.38374 (2014/C), FIAT (SA.38375 (2014/C), Amazon (SA.38944(2014/C)

[107] Research indicates that about two-thirds of all business transactions takes place within MNEs

[108] D. Oosterhoff, "Global Transfer Pricing Trends", *International Transfer Pricing Journal*, no.318(18), 2011, p. 160

[109] A. Navarro, "The Arm's Length Standard and Tax Justice: Reflections on the Present and the Future of Transfer Pricing", *World Tax Journal*, no. 3 (10), 2018, p. 353

[110] A. Thies, "Germany", in ORG. Duff & Phelps (Ed.), Guide to International Transfer Pricing, Kluwer Law International, 2017, p.503

[111] J. Monsenego, *Introduction to transfer pricing*, Kluwer Law International, 2015, p. 17

In contrast, those market forces are absent in the case of a similar transaction between associated entities which has as result a price which deviates from the market price.[112] Eventually, for tax purposes, this would affect the attribution of profits to different group entities located in different tax jurisdictions. Therefore, as argued by the OECD, in order to establish a level playing field between associated and independent parties[113], the price of an intergroup transaction between associated companies should reflect the price which would have been agreed on by independent parties in a similar transaction and under similar conditions.[114] This approach, the so-called arm's length principle, aims to remove tax considerations from economic decisions.[115]

The legal basis of the arm's length principle is stated under article 9 (1) of the OECD Model Tax Convention on Income and Capital (OECD Model), which has been followed by many tax jurisdictions in their tax treaties:

> *"[Where] conditions are made or imposed between the two [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."*

Based on this article, the tax authorities of the contracting State are entitled to adjust the profit or taxable base of a local group company in case that one or more transactions did not meet the arm's length principle.[116]

3.2.2 The practical implications of the arm's length principle

Both tax authorities and tax payers, foremost MNE's, are facing practical difficulties when applying the arm's length principle to intergroup transactions. The OECD issued non-binding transfer pricing guidelines, the OECD TPG, in order to help tax administrations and tax payers in the application of the arm's length principle. As starting point, local group companies are treated as if they are independent entities, i.e. the so-called separate entity approach.[117] In order to set intercompany transactions at arm's length, the OECD advocates for a comprehensive approach in which controlled and uncontrolled transactions are compared by means of a 'comparability analysis'.[118] The first aspect of the comparability analysis is the delineation

[112] Ibid
[113] The so-called neutrality principle
[114] See H.Hamaekers, "The Arm's Length Principle and the Role of Comparables*", Bulletin for international fiscal documentation*, no.*46* (12), 1992, p.602-605
[115] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2017, p. 36, par. 1.8
[116] A. Bakker, (Ed.). *Transfer pricing and business restructurings: streamlining all the way*, IBFD, 2009, p. 125
[117] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2017, p. 35, par. 1.6
[118] Ibid

of the controlled transaction by identifying the economic circumstances of the transaction and the commercial and financial relation between the associated parties.[119] This part of the analysis encompasses an assessment of the contractual terms of the transaction, a functional analysis, the characteristics of property transferred or services provided, the economic circumstances of the parties and of the market in which the parties operate, and the business strategies pursued by the parties.[120] In particular, the functional analysis is important in order to identify the role of each group company to the controlled transaction in terms of functions performed, assets used, and risks assumed.[121] This analysis helps to understand the actual contributions made by the group parties to the transaction.[122] In particular the role of risk is important, as the OECD TPG recognize a 'risk-return trade-off': a higher exposure to risk means that the party is entitled to a higher return.[123] For instance, a party that has a marginal role in a transaction should be less exposed to the profits or losses arising from that transaction. The second part of the comparability analysis requires a comparison of the conditions and economically relevant circumstances of the controlled transaction as delineated under step one with the conditions and economically relevant circumstances of uncontrolled transactions.[124] It can be argued that the comparability analysis is at the heart of the application of the arm's length principle. Afterwards, an adequate transfer pricing method has to be found.

Transfer pricing methods

Transfer pricing is not an exact science; there is not by definition one 'perfect' price.[125] This means that an appropriate assessment of the circumstances of the individual case is required in order obtain an acceptable transfer price. In order to determine an arm's length price for an intercompany transaction, there are five different transfer pricing methods accepted within the OECD TPG: the comparable uncontrolled price method, the resale rice method, the cost plus method, the transactional net margin method, and the transactional profit split method (see also table 4). In general, taxpayers are free in choosing a transfer pricing method as long as the arm's length principle is met.[126] However, as laid down in article 2.2 of the guidelines: "*the selection of a transfer pricing method always aims at finding the most appropriate method for a particular case*". In this regard, the following factors have to be taken into account by the taxpayer: the respective strengths and weaknesses of the OECD recognized methods, the appropriateness of the

[119] Ibid, p. 43, par. 1.33
[120] Ibid, p. 45, par. 1.36
[121] J. Monsenego, *Introduction to transfer pricing*, Kluwer Law International, 2015, p. 27
[122] A. Cousins, and D. Beeton, "OECD Transfer Pricing Guidelines" in M. Heimert, & T. Michaelson (Eds.), *Guide to International Transfer Pricing*, (7th ed., pp. 69-104). Alphen aan den Rijn, The Netherlands: Kluwer Law International, 7th ed., 2017, p. 78
[123] Ibid
[124] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2017, p. 43, par. 1.33
[125] Ibid, p. 163, par. 3.55
[126] J. Monsenego, *Introduction to transfer pricing*, Kluwer Law International, 2015, p. 39

method while taking the functional analysis into account, the availability of reliable information, and the degree of comparability between controlled and uncontrolled transactions.[127] Moreover, in case both a traditional and a transactional transfer pricing method can be applied in an equally reliable manner, the first method is given preference by the OECD TPG.[128] While finding a comparable transaction, the taxpayer might rely on internal and external comparables.[129] The first class refers to similar transactions that have been carried out between the group company itself and other independent companies.[130] External comparables represent data on similar transactions between two independent market parties who are not related to the taxpayer.[131]

Table 4: an overview of the acknowledged transfer pricing methods under the OECD Transfer Pricing Guidelines

	Transfer Pricing Method	**Description**
Traditional transaction methods	Comparable uncontrolled price method (CUP)	The CUP method compares the **price** for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances.
	Resale Price Method (RPM)	The RPM is based on the price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise. The resale price is reduced by the **resale price margin**.
	Cost Plus Method (CPLM)	The CPLM uses the costs incurred by the supplier of property in a controlled transaction. An appropriate **cost plus mark-up is** added to this cost, to make an appropriate profit in light of the functions performed (taking into account assets used and risks assumed) and the market conditions.
Transactional profit methods	Transactional Net Margin Method (TNMM)	The TNMM examines the **net profit margin** relative to an appropriate base (e.g. costs, sales, assets) that a taxpayer realizes from a controlled transaction
	Transactional Profit Split Method (TPSM)	The TPSM examines the **profits** that arise from particular controlled transactions of one or more of the associated enterprises participating in those transactions.

Source: Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations

[127] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2017, p. 97, par. 2.2
[128] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2017, p. 98, par. 2.3
[129] H. Kroppen, and J. Silva, *Cross-border business restructuring*, The Hague, Sdu, IFA cahiers de droit fiscal international vol. 96a, 2011, p. 23
[130] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2017, p. 106, par. 2.28
[131] Ibid

3.3 The arm's length principle under German Tax law

3.3.1 Theoretical framework for ALP in German Tax Law

Traditionally, Germany has been considered as a high-tax jurisdiction.[132] As a response to the fact that businesses started to be organized in a more and more global way, over the last decades, the German legislature have introduced more and more detailed administrative guidance on the matter of transfer pricing.[133] An important landmark was the German Corporate tax reform in 2008: the German legislator reduced the corporate income tax rate on the one hand and tightened the transfer pricing rules on the other in order to secure the taxable base in Germany.[134] Besides the introduction of stricter transfer pricing rules, the German tax authorities intensified their auditing activities in the field of transfer pricing.[135] Both developments reflect the growing importance of transfer pricing for MNE's operating in Germany.

Germany has been a member of the OECD since the establishment of the inter-governmental organization in 1960. In its signed double tax conventions, Germany relies on the OECD Model Tax Convention on Income and Capital.[136] As discussed above, article 9 is of particular relevance as it establishes the arm's length principle as the leading concept for the valuation of inter-group transactions between two contracting States. Germany adopted the arm's length principle for the determination of appropriate transfer prices.[137] In this regard, the OECD TPG have been acknowledged by Germany.[138] However, as discussed before, the OECD TPG are soft law, these guidelines themselves are not binding in Germany.

The legal basis for the arm's length principle (*Fremdvergleichsgrundsatz*) under German law can be found in section 1 of the Foreign Tax Code (*Außensteuergesetz*, AStG). This provision entails the right of the tax authorities to adjust the taxable income of a taxpayer arising from a business relationship with another foreign group entity in case the price of such a controlled transaction does not correspond to the price that unrelated third parties in the same or similar circumstances would have agreed on.[139] In this respect, the

[132] See A. weichenrieder, "Profit shifting in the EU: Evidence from Germany", *International tax and public finance*, no. 16(3), 2009, p. 281-297
[133] J. Schimmer, "Germany – Transfer Pricing & Customs Valuation", *in* A. Bakker and B. Obuoforibo (Eds.), *Transfer Pricing and Customs Valuation*, IFBD, 2009, p. 2
[134] H. Kroppen and S. Rasch, "Regulation on Business Restructuring: Decree-Law on the Relocation of Functions", *International Transfer Pricing Journal*, no. 16(2), 2009, p. 63
[135] J. Schimmer, "Germany – Transfer Pricing & Customs Valuation", *in* A. Bakker and B. Obuoforibo (Eds.), *Transfer Pricing and Customs Valuation*, IFBD, 2009, p. 2
[136] See X. Ditz and M. Schneider, "Federal Tax Court Ruling on Relationship between Article 9(1) of the OECD Model Convention and National Income Adjustment Provision", *International Transfer Pricing Journal*, no. 20(3), 2013, p. 188-192
[137] A. Thies, "Germany", in ORG. Duff & Phelps (Ed.), Guide to International Transfer Pricing, Kluwer Law International, 2017, p.503
[138] Ibid, p.501
[139] Ibid, p.495

German legislator introduced the concept of the prudent and diligent manager *(ordentliche und gewissenshafte Geschäftsleiter)*:

> *"With regard to the application of the arm's length principle it shall be assumed that unrelated third parties know of all essential circumstances of the business relationship and that they act in accordance with the principles of sound and prudent business managers."*[140]

The assumption implies that market parties have access to the full information while determining the price. This differs from the OECD TPG and has been criticized in the literature.[141] In jurisprudence, it is possible to notice that the Federal Tax Court (*Bundesfinanzhof*) has been providing more guidance on the concept of the principle of the prudent and diligent manager:

> *... a prudent and diligent manager will, for the corporation managed by him, introduce to the market and distribute a new product only if he can expect, based on a prudent and prepared economic forecast, a reasonable overall profit within a foreseeable period of time with due consideration to the foreseeable development of the market.*[142]

In the context of transfer pricing, this implies that transactions between two uncontrolled parties have to be valued as if they were concluded between two prudent and diligent managers representing the interest of their own business.

3.3.2 The practical implications of the arm's length principle

Above, we discussed the legal basis of the arm's length principle in German statutory law, the Foreign Tax Act. In order to provide more guidance and to help interpreting the statutory rules on transfer pricing, the tax authorities issued "Administrative Guidelines on Procedures"[143] in 2005. Those practical guidelines aim to ensure that German tax authorities apply the statutory provisions in a consistent way regardless the fact that they are not binding for the taxpayers and the tax Courts.[144] It is worth noting that those Administrative Guidelines often cross-refer to the OECD TPG of 1995.

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[140] See sec. 1 (1) sentence 2 Foreign Tax Act
[141] P. Cauwenbergh and M. Mas, "Germany: The new German transfer pricing rules on cross-border relocation of functions: a preliminary analysis", *European taxation, no. 48*(10), 2008, p.521
[142] Bundesfinanzhof, judgment of 17 February 1993 (I R 3/92)
[143] Administrative Circular on the Guidelines for the Examination of Income Attribution between Affiliated Parties with Cross-Border Business Transactions Regarding Investigation and Cooperation Duties, Adjustments as well as Mutual Agreement and EU-Arbitration Procedures (Hereinafter, Administrative Guidelines – Procedures), published on 12 April 12, 2005 IV B 4 – S – 1341 – 1/05, Federal Tax Gazette 2005 I, p. 569
[144] J. Schimmer, "Germany – Transfer Pricing & Customs Valuation", *in* A. Bakker and B. Obuoforibo (Eds.), *Transfer Pricing and Customs Valuation*, IFBD, 2009, p. 4

As described before, under the OECD TPG, the comparability analysis is the cornerstone of transfer pricing. In this respect, the German transfer pricing rules follow more or less the guidance of the OECD.[145] While referring to the OECD TPG, the German transfer pricing rules require the taxpayer to examine a functional analysis[146], the contractual terms and conditions[147], the economic circumstances in the relevant market and the business strategy concerning the transaction in question.[148] Also here, the functional analysis is of great importance for determining which party exercise each function and what party bears the risks.[149] While conducting the comparability analysis, the prudent and diligent manager (*ordentliche und gewissenshafte Geschäftsleiter)* concept has to be taken into account.[150]

Transfer pricing methods

Also under the German transfer pricing rules, it has been acknowledged that there is no one single arm's length price. Instead, the rules underline that in most transfer pricing cases, a range of prices may be determined.[151] In this context, as starting point, the German taxpayer is free to choose one of the transfer pricing methods.[152] At the other hand, the Foreign Tax Act indicates that the choice of the transfer pricing method depends on the availability of comparable data.[153] In this respect, three situations are distinguished under the Foreign Tax Act.[154] First of all, in case full comparable data is available[155], the Act requires the taxpayer to apply one of the three transactional methods: Comparable uncontrolled price method (CUP), Resale Price Method (RPM) or the Cost Plus Method (CPLM).[156] The second situation takes effect when there is only restrictedly comparable data available. In that case, the range of derived (limited comparable) arm's length prices has to be narrowed.[157] However, a concrete transfer pricing method in those situations is not mentioned.[158] In the third situation, since the first of January 2008, in absence of any comparable

[145] Transfer Pricing Country Profile Germany. (2017, October 1). Retrieved July 3, 2018, from https://www.oecd.org/tax/transfer-pricing/transfer-pricing-country-profile-germany.pdf
[146] Sec. 3.4.10.2 (c), Administrative Guidelines – Procedures
[147] Sec. 3.4.11.4 Administrative Guidelines – Procedures
[148] Ibid
[149] Sec.3.4.10.2 and 3.4.11.4 Administrative Guidelines – Procedures
[150] Sec. 3.4.10.1 Administrative Guidelines - Procedures
[151] Sec. 3.4.12.5 (a) Administrative Guidelines - Procedures
[152] H. Kroppen and S. Rasch, *Germany - Transfer Pricing.* Retrieved from https://online.ibfd.org/document/tp_de, p. 17
[153] See sec. 1 (3) Foreign Tax Act
[154] See 3.4.12.7 Administrative Guidelines – Procedures
[155] The terms and conditions of the controlled transaction are identical to those of the uncontrolled transaction or differences in terms and conditions have no essential impact on the valuation or the differences in terms and conditions have been eliminated by sufficiently adjustments
[156] Sec. 1 (3) sentence 1 Foreign Tax Act
[157] Sec. 1 (3) sentence 3 Foreign Tax Act
[158] A. Thies, "Germany", in ORG. Duff & Phelps (Ed.), Guide to International Transfer Pricing, Kluwer Law International, 2017, p. 505

data, the Foreign Tax act requires the taxpayer to conduct a hypothetical arm's length test.[159] In that case, based on the concept of the prudent and diligent manager, a minimum and a maximum arm's price has to be calculated based on the respective profit expectations of the hypothetical seller and the hypothetical buyer.[160] The minimum price and the maximum price together are deemed to form the range of mutual consent in which the arm's length price is found.[161] It is within the competence of the taxpayer to proof what price complies the best with the arm's length principle.[162] In absence of such evidence, the mean value of the minimum and maximum price is taken as the arm's length price.[163] At the global level, the hypothetical arm's length test is unique and has not been acknowledged by the OECD TPG.[164] As comparable data for business restructurings is often missing, the hypothetical arm's length test is seen as the standard for business restructurings. Therefore, we will address the hypothetical arm's length test into more detail in chapter 4 in relation to the transfer pricing aspects of business restructuring.

In line with the Foreign Tax Act, it seems that the transactional methods[165] take precedence under German tax law.[166] The transactional net margin method (TNMM) may be only applied by the taxpayer in case the standard methods cannot be applied due to the lack of incompleteness of comparable data.[167] In addition, the TNMM may only be accepted if the business performs solely routine functions.[168] The reluctant position of the German tax authorities with respect to the application of the TNMM is remarkable as this method is considered as the most common transfer pricing method on a global basis.[169] In situations where the TNMM might be applied, the German tax authorities seem to be more in favour of the complex hypothetical arm's length test.[170] Since the publication of the Administrative Guidelines on Procedures in 2005, also the Profit Split Method has been recognized by the German Tax authorities and is regarded as a last resort.[171]

[159] Sec. 1 (3) sentence 5 Foreign Tax Act
[160] Sec. 1 (3) sentence 6 Foreign Tax Act
[161] Ibid
[162] Sec. 1 (3) sentence 7 Foreign Tax Act
[163] Sec. 1 (3) sentence 8 Foreign Tax Act
[164] H. Kroppen and S. Rasch, "Regulation on Business Restructuring: Decree-Law on the Relocation of Functions", *International Transfer Pricing Journal,* no. 16(2), 2009, p. 63
[165] For an overview see section 3.3.2
[166] A. Thies, "Germany", in ORG. Duff & Phelps (Ed.), Guide to International Transfer Pricing, Kluwer Law International, 2017, p. 505
[167] Sec. 3.4.10.3 (b) Administrative Guidelines – Procedures
[168] Ibid
[169] J. Schimmer, "Germany – Transfer Pricing & Customs Valuation", *in* A. Bakker and B. Obuoforibo (Eds.), *Transfer Pricing and Customs Valuation*, IFBD, 2009, p. 11
[170] Ibid
[171] A. Thies, "Germany", in ORG. Duff & Phelps (Ed.), Guide to International Transfer Pricing, Kluwer Law International, 2017, p. 505

3.4 The Arm's length principle under pressure

For at least 75 years, the arm's length principle has been worldwide adopted as the standard system for transfer pricing purposes.[172] As described above, based on a comparability analysis, a price has to be found which reflects the outcome that uncontrolled market parties would have agreed on. As argued by the OECD in its Guidelines, by applying the arm's length principle, members of MNE groups and independent enterprises are put on a more equal footing for tax purposes.[173] The reason for this is that tax considerations are removed from economic decision making of both groups of entities.[174]

In literature, several conceptual problems in applying the arm's length principle have been encountered. Fundamentally, scholars claim that MNEs exist for a reason: the value of a MNE is more than the sum of its parts because of synergies and economies of scale arising from the interdependence between the group entities.[175] The arm's length principle and in particular the underlying separate entity approach do not take into account the benefits of integration in terms of synergies and economies of scale.[176] Moreover, certain transactions conducted by members of a MNE may not be found between market parties which makes it challenging to find either internal or external comparables.[177] This is likely to be the case of business restructurings but also the transfer of intangible assets. Nevertheless, while there are conceptual alternatives[178] for the arm's length principle with each its advantages and disadvantages, scholars seem to agree that also in the nearby future the arm's length principle will remain the international standard.[179] One of the main reasons for this is the fact that the arm's length principle enjoys international consensus[180], something which is unique, especially in the field of taxation. Moreover, despite the fact that an alternative

[172] C. McLure, "Replacing Separate Entity Accounting and the Arm's Length Principle with Formulary Apportionment", *Bulletin for International Fiscal Documentation*, no. 56(12), 2002, p. 588
[173] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2017, p. 36, par. 1.8
[174] Ibid
[175] C. McLure, "Replacing Separate Entity Accounting and the Arm's Length Principle with Formulary Apportionment", *Bulletin for International Fiscal Documentation*, no. 56(12), 2002, p. 586, 587; J. Owens, "Should the arm's length principle retire", *International Transfer Pricing Journal*, no. 12 (3), p. 100
[176] D. Francescucci, "The Arm's Length Principle and Group Dynamics – Part 1: The Conceptual Shortcomings", *ITPJ*, 2004, p.68 – 73.
[177] C. McLure, "Replacing Separate Entity Accounting and the Arm's Length Principle with Formulary Apportionment", *Bulletin for International Fiscal Documentation*, no. 56(12), 2002, p. 587; J. Owens, "Should the arm's length principle retire", *International Transfer Pricing Journal*, no. 12 (3), p. 100
[178] See chapter 5 in which the 'global formulary apportionment' and the 'destination-based cash-flow tax' as alternatives for the current arm's length principle will discussed
[179] R. Collier and J. Andrus, *Transfer Pricing and the Arm's Length Principle After BEPS*, Oxford University Press, 2017, p. 76; J. Owens, "Should the arm's length principle retire", *International Transfer Pricing Journal*, no. 12 (3), p. 102
[180] J. Owens, "Should the arm's length principle retire", *International Transfer Pricing Journal*, no. 12 (3), p. 100

would enjoy consensus, the shift in systems would result in political and administrative problems in the short-term.[181]

3.5 Conclusion

The aim of this chapter was to provide an answer to the following research question:

What is the arm's length principle and how has it been implemented in the OECD Transfer Pricing Rules and under German statutory law in the context of transfer pricing?

Germany acknowledges the OECD Transfer Pricing Guidelines. However, as the OECD TPG are non-binding, we have to rely on German tax law for its interpretation. While there is a lot of overlap between the German transfer pricing rules and the OECD TPG, there are some noteworthy differences identified.

Both the OECD TPG and German tax law follow the arm's length principle and the separate entity approach as the predominant system in transfer pricing. Where the OECD requires that the price of an intergroup transaction should reflect the price which would have been agreed on by independent parties in a similar transaction and under similar conditions, the German legislator introduced the concept of the prudent and diligent manager. This principle entails that an intergroup transaction has to be valued as if it has been concluded between two independent prudent and diligent managers. In this respect, it is assumed that both parties have access to full information in determining the transfer price. Something which is different from the OECD TPG and has been criticized by tax scholars.

With respect to the practical implications of the arm's length principle, the German tax rules follow the guidance of the OECD in which the comparability analysis is seen as the cornerstone in finding an arm's length price. If possible, both the OECD TPG and the German rules seem to favour a transactional transfer pricing method. However, while the OECD TPG require the taxpayer to use the most appropriate transfer pricing method, the German rules identify three different situations which determine the right transfer pricing method: full comparable data is available, restrictedly comparable data is available, and no comparable data is available. In the latter case, in contrast to the OECD TPG, the German transfer pricing rules require the taxpayer to conduct a hypothetical arm's length test. In that case, based on the concept of the prudent and diligent manager, a minimum price has to be calculated from the perspective of the hypothetical seller and a maximum price has to be determined from the perspective of the hypothetical buyer. Moreover, the German tax authorities assume that the tax payer has access to full information which has not been acknowledged by the OECD TPG.

[181] C. McLure, "Replacing Separate Entity Accounting and the Arm's Length Principle with Formulary Apportionment", *Bulletin for International Fiscal Documentation*, no. 56(12), 2002, p. 588

Chapter 4 – In search of an arm's length price for business restructurings, a legal comparison between the OECD and the transfer pricing provisions in Germany

4.1 Introduction

As described in chapter 2, business restructurings, and in particular business restructurings involving the application of a principal company structure or centralized business model enable a MNE to be more efficient and to increase its economic rents. This form of business restructurings are so closely related to the nature of MNEs and their global strategy that they barely or do not exist between independent market parties.[182] As a consequence of the latter, it might be impossible to find comparable uncontrolled transactions to perform the comparability analysis. Nevertheless, both the OECD TPG and the German national transfer rules dated from 2010 and 2008 respectively, provide with detailed provisions to follow in order to determine an arm's length price in the case of business restructurings. As found in last chapter, the German transfer pricing rules require the taxpayer to conduct a hypothetical arm's length test, which we will discuss through the lines of the current chapter. Both legal frameworks attempt to balance the MNE's freedom to adapt their business models to the economic environment with the need for tax administrations to ensure that the tax base is not illegitimately eroded.[183]

The aim of this chapter is to compare how the OECD and Germany address this challenge, and in particular, to what extent a business restructuring gives rise to an arm's length compensation of a local group entity for the loss of profit potential[184]. In a first stage, the legal context of both legal frameworks will be described. Then, the OECD TPG and the German transfer pricing rules will be compared on the basis of the following criteria: the scope of the business restructuring rules, the comparability analysis, the valuation of the business restructuring itself, the compensation for the loss of profit potential, and the role of location savings. In the last phase, a case study will be performed in which the implications of both the OECD and the German rules will be illustrated.

4.2 Legal context

4.2.1 OECD

In response to the increasing presence of business restructurings in the globalized economy and the corresponding challenges in the field of taxation[185], the OECD, and in particular its Working Party No. 6,

[182] H. Kroppen, and J. Silva, *Cross-border business restructuring*, The Hague, Sdu, IFA cahiers de droit fiscal international vol. 96a, 2011, p. 23
[183] See J. Andrus, "Tax Avoidance and Transfer Pricing.", *Asia-Pacific Tax Bulletin*, no. 18(6), p.435-438
[184] As described in chapter 2, after the business restructuring, the principal as primary risk taker will be entitled to receive the residual profits of the business activity. The local group entity at the other hand, will be entitled to receive a low but stable remuneration.
[185] Countries were concerned about the loss of tax revenue due to the implementation of business restructurings in which profits were shifted to low tax jurisdictions

started to work on the development of additional guidance in respect of transfer pricing aspects of business restructurings in 2005.[186] In this process, an ongoing dialogue was established with the business community.[187] With the release of the Discussion Draft on Transfer Pricing Aspects of Business Restructurings in 2008, the public was able to comment on the proposed guidance. In 2010, the work was finalized which resulted in Chapter IX of OECD TPG. This Chapter is divided into two main parts; the first part addresses the arm's length compensation for the restructuring itself and the second part covers the remuneration of post-restructuring controlled transactions. For the scope of this comparison, we will rely foremost on the first part of Chapter IX of the OECD TPG and when necessary also on other parts of the OECD TPG. It is of utmost importance to mention that the work of the OECD in the field of transfer pricing is meant to minimize conflict between tax administrations and promoting international trade and investment.[188]

Recently, in 2017, the OECD TPG were amended in order to align its content with the BEPS project. As a consequence, parts of Chapter IX concerning the allocation of risk, and the recognition of actual transactions were replaced to Chapter I as those aspects were not limited to business restructurings alone.[189] In addition, there were no significant changes with respect to the substance of Chapter IX of this legal framework.

4.2.2 Germany

Already in 2007, before the introduction of Chapter IX of the OECD TPG, as part of the corporate tax reform legislation, the German Parliament included in the Foreign Tax Code (*Außensteuergesetz*, AStG) a provision on the determination of an arm's length price in the case of a relocation of functions (*Funktionsverlagerung*).[190] This provision has been elaborated into detail by means of a special Decree-Law, the "*Funktionsverlagerungsverordnung*", as issued by the Federal Ministery of Finance *(Bundesministerium der Finanzen)*.[191] Both the AStG and the Decree-Law are legally binding for the tax authorities, the taxpayers and the Tax Court.[192] Given the complexity of the matter in practice, in addition to the other two bodies of legislation, the Federal Ministery of Finance published the 'Administrative

[186] G. Cottani, *Transfer Pricing, Topical Analyses IBFD, 2017*, p.173
[187] Ibid
[188] OECD Guidelines 7, page 16
[189] A. Bakker, (Ed.). *Transfer pricing and business restructurings: streamlining all the way*, IBFD, 2009, p. 74
[190] Sec. 1 (3) sentence 9 and sequential Foreign Tax Act
[191] Decree-Law on the Application of the Arm's Length Principle under Sec. 1, Para. 1 of the AStG in the Case of Cross-Border Relocations of Functions, Federal Law Gazette (2008), part I, p. 1680 (hereinafter, Decree-law Relocation of Functions)
[192] S. Rasch, and R. Schmidtke, "OECD Guidelines on Business Restructuring and German Transfer of Function Regulations: Do Both Jeopardize the Existing Arm's Length Principle?", *International Transfer Pricing Journal*, no. *18*(1), 2011, p. 57

Circular on the Guidelines for the Examination of Income Allocation between Affiliated Persons in Cases of Cross-border Relocations of Functions' (*Grundsätze für die Prüfung der Einkunftsabgrenzung zwischen nahe stehenden Personen in Fällen von grenzüberschreitenden Funktionsverlagerungen*).[193] Those Administrative Guidelines are exclusively binding for the tax authorities.[194] Nevertheless, from a practically point of view, the Administrative Guidelines might be also useful for taxpayers in order to obtain an adequate transfer price.[195]

This raises the question why in particular Germany was one of the first OECD countries to introduce extensive legislation on the tax treatment of cross-border business restructurings. Traditionally, Germany is seen as a high-tax jurisdiction with relatively high labour and social security costs.[196] At the eastern border, Germany has to compete with middle and eastern European countries, which have relatively low tax rates and relatively lower costs of labour and social security.[197] The potential movement of functions from Germany to middle and Eastern European countries concerned the German government.[198] In order to improve the German business climate, the German government decided to reform the corporate income tax by means of the Corporate Tax Reform Act in 2008. As part of this reform[199], the German corporate income tax rate was reduced from 25% to 15%.[200] In order to compensate for the loss of tax revenue due to the reduction of the corporate income tax rate[201], more rigid rules on the outbound transfer of business functions to foreign affiliated parties were introduced.[202]

4.3 Scope

First of all, it is important to examine the material scope of both the OECD guidelines and German legislation on business restructurings. It is obvious that the transfer of a single asset is not likely to be considered as a business restructuring. However, in case several assets are transferred in addition to certain

[193] Hereinafter, the 'Administrative Guidelines'
[194] S. Rasch, and R. Schmidtke, "OECD Guidelines on Business Restructuring and German Transfer of Function Regulations: Do Both Jeopardize the Existing Arm's Length Principle?", *International Transfer Pricing Journal*, no.18(1), 2011, p. 57
[195] Ibid
[196] Frotscher, G., & Oestreicher, A. (2009). Comment on the OECD Discussion Draft regarding Transfer Pricing Aspects of Business Restructurings. Retrieved June 10, 2018, from http://www.oecd.org/ctp/transfer-pricing/publiccommentsonthetransferpricingaspectsofbusinessrestructurings.htm
[197] Ibid
[198] Ibid
[199] For more information about the German reform of 2008, see S. Homburg, "Germany's company tax reform act of 2008", *FinanzArchiv: Public Finance Analysis*, no. 63(4), 2007, p. 595
[200] M. Schneider, "Recent Developments Concerning the Rules on the Transfer of Business Functions", *International Transfer Pricing Journal*, no. *18*(2), 2011, p. 114
[201] It is important to underline that besides corporate income tax, German taxpayers are liable for a solidarity surcharge (5.5% of corporation tax) and a trade tax (averaging 14% as of 2008)
[202] Ibid

risks, it becomes already more challenging to determine whether this situation constitutes a business restructuring.

4.3.1 OECD

Under Chapter IX of the OECD TPG, it is stated that there is no legal or universally accepted definition of the term "business restructuring" (see also section 2.4.1).[203] Nonetheless, in the 2010 OECD TPG version, Chapter IX included the following definition: "a *business restructuring is defined as the cross-border redeployment by a multinational enterprise of functions, assets and/or risks"*[204]. One might argue that the definition for business restructurings was extremely broad; for instance, a transfer of a risk (e.g. an insurance contract) itself would be within the scope of this definition but does not per se constitute a business restructuring.[205]

With the amendments of the OECD TPG in 2017, a new definition of business restructuring was introduced: "*business restructuring refers to the cross-border reorganization of the commercial or financial relations between associated enterprises, including the termination or substantial renegotiation of existing arrangements*"[206]. With the new definition, the emphasis is more on the change in commercial or financial relations between associated enterprises following from a redeployment of functions, assets, and/or risks.

A special reference is made to business restructurings involving the centralization of intangibles, risks, or functions with the profit potential attached to them (e.g. the conversion of a local manufacturer or distributor into a low-risk entity).[207] Chapter IX provides four typical examples of business restructurings: the conversion of a full-fledged manufacturer into a low-risk manufacturer, the conversion of a full-fledged distributor into a low-risk distributor, the transfer of intangibles to a central entity, and the concentration of functions in a regional or central entity.[208]

As described in chapter 2, business restructurings aiming at creating a principal company structure, may have harmful economic consequences for the tax base in the exit countries, mostly high-tax jurisdictions.

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[203] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2017, p. 365, par. 9.1
[204] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2010, par. 9.1
[205] S. Rasch, and R. Schmidtke, "OECD Guidelines on Business Restructuring and German Transfer of Function Regulations: Do Both Jeopardize the Existing Arm's Length Principle?", *International Transfer Pricing Journal,* no. *18*(1), 2011, p. 58
[206] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2017, p. 365, par. 9.1
[207] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2017, p. 365, par. 9.2
[208] Ibid, p. 365-366, par. 9.2

The OECD seems to address those concerns by explicitly including those business restructurings in the scope of Chapter IX.

4.3.2 Germany

In contrast to the OECD TPG, the German Foreign Tax Act does not address the transfer pricing aspects of a 'business restructuring' but the transfer pricing aspects of the 'relocation of functions' (*Funktionsverlagerung*)[209]:

> *"Where a function is transferred including the corresponding opportunities and risks and including the assets and other advantages transferred or otherwise provided (relocation of function) and sent. 5 shall apply to the transferred function as at least restrictedly comparable arm's length data is not available for the transfer package as a whole, the taxpayer shall determine the range of mutual consent based on the transfer package under consideration of functions and risk adequate capitalization interest rates."*[210]

For a better understanding of the concept of "relocation of functions", a definition of 'function' is provided in section 1, paragraph 1 of the Decree-Law: *"A function is a business activity consisting of an aggregation of similar operational tasks that are performed by certain centers or departments of an enterprise."* In addition, the Decree-Law states that: a function must be an organic part of the business as a whole, whereas it does not have to be a separable part of the business (*Teilbetrieb*).[211] Consequently, the sale of a single asset is excluded from the relocation of a function under German legislation.

A relocation of functions is deemed to occur: "*in case an enterprise transfers or concedes the right of use of assets and other advantages including the corresponding opportunities and risks to another affiliated enterprise to enable the acquiring enterprise to perform a function that thus far been performed by the transferring enterprise and thereby limiting the transferring enterprise in exercising this function."*[212] In other words, also the limitation of a function is within the scope of the German transfer pricing legislation. Similar to the OECD TPG, also in the Administrative Guidelines concrete examples of business restructurings are provided which constitute the implementation of a centralized or principal company

[209] Original: Wird eine Funktion einschließlich der dazugehörigen Chancen und Risiken und der mit übertragenen oder überlassenen Wirtschaftsgüter und sonstigen Vorteile verlagert (Funktionsverlagerung) und ist auf die verlagerte Funktion Satz 5 anzuwenden, weil für das Transferpaket als Ganzes keine zumindest eingeschränkt vergleichbare Fremdvergleichswerte vorliegen, hat der Steuerpflichtige den Einigungsbereich auf der Grundlage des Transferpakets zu bestimmen.
[210] Sec. 1 (3) sentence 9 Foreign Tax Act
[211] Sec. 1 (1) sentence 2 Decree-Law Relocation of Functions
[212] Sec. 1 (2) sentence 1 Decree-Law Relocation of Functions

structure, e.g. the conversion of a full-fledged manufacturer into a toll manufacturer and the conversion of a full-fledged distributor into a commission agent.[213]

Within the literature, the German tax authorities are criticized for the broad and vague meaning of the term "relocation of functions".[214] For instance, in case a MNE expands its activities by establishing a new factory in China in addition to the factory located in its home country, named Germany; this situation might be considered as a relocation of functions even though the Chinese group entity will produce for the Chinese market and the activities of the German manufacturer will not be affected at all.[215] This is remarkable, as the duplication of functions is explicitly excluded from the scope of the Decree-Law Relocations of Functions.[216]

4.4 Arm's length compensation for the restructuring itself chapter IX

4.4.1 OECD

4.4.1.1 Comparability analysis

The guidance of Chapter IX with respect to business restructurings has to be read in the context of Article 9 of the OECD Model Tax Convention.[217] In this regard, the relevant question is whether "*there are conditions made or imposed in a business restructuring that differ from the conditions that would be made between independent enterprises."*[218] Thus, business restructurings are treated in the same manner as other intergroup transactions.[219] However, as discussed before, business restructurings, and in particular those involving the creation of a principal company structure do barely or do not occur between independent enterprises. Nevertheless, Chapter IX states that the lack of comparables does not mean that no arm's length price for business restructuring can be found.[220] It is within this contexts that part I of Chapter IX of the OECD TPG addresses the '*Arm's length compensation for the restructuring itself*'.

[213] Sec. 2.1.2.1 (21) Administrative Guidelines Relocation of Functions
[214] S. Rasch, and R. Schmidtke, "OECD Guidelines on Business Restructuring and German Transfer of Function Regulations: Do Both Jeopardize the Existing Arm's Length Principle?", *International Transfer Pricing Journal,* no. *18*(1), 2011, p. 59
[215] This example is provided in Sec. 2.1.2.2 (23) Administrative Guidelines Relocation of Functions
[216] Sec. 1 (6) sentence 1 Decree-Law Relocation of Functions
[217] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2017, p. 366, par. 9.5
[218] Ibid, p. 366, par. 9.9
[219] J. Monsenego, *Introduction to transfer pricing*, Kluwer Law International, 2015, p. 74; S. Kishore Bilaney, "Supply Chain Management Using Alternative Manufacturing Models", *International Transfer Pricing Journal,* no. 21(2), 2014, p. 99
[220] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2017, p. 378, par. 9.35

According to Section B of Chapter IX, the taxpayer shall conduct an extensive analysis of the companies involved in the business restructuring, both before and after the restructuring.[221] The commercial and financial relations between the parties involved, and the economically relevant circumstances attached to those relations, have to be identified. Moreover, the transactions, comprising the business restructuring have to be delineated.[222] As part of this analysis, in line with the comprehensive approach of the OECD, a functional analysis has to be conducted in order to identify the functional and risk profile of the parties involved before and after the business restructuring.[223] Moreover, the business reasons for and the expected benefits from the restructuring have to be determined.[224] Finally, other options realistically available to the parties have to be identified.[225]

In the context of business restructurings, the allocation of risks between the transferor and transferee is of particular importance as with the transfer of risk from one group entity to another, also profit potential is relocated.[226] This can be explained by the assumption that in the open market, the amount of risk borne by a party is associated with its profit potential.[227] In 2017, with the implementation of the BEPS Final Reports 8-10, the OECD TPG regarding the allocation of risks have been tightened.[228] Most importantly, under the revised rules, in case risks are contractually assumed by a group entity, but the actual control over the risks or the financial capacity to assume the risks are in the hands of another group entity, the risks will be allocated to the latter party.[229] This principle has been transposed into Chapter IX of the OECD TPG with more detailed guidelines on the allocation of risk after the business restructuring. The provisions imply that the 'control over risk' refers to an entity's capability to bear and manage the risk in terms of decision-making and financial capacity.[230] In the context of the principal company structure, this implies that the

[221] M. Cotrut, and L. Ambagtsheer, "Business Restructurings: The Toolkit for Tacking Abusive International Tax Structures", *in* M. Cotrut, *International Tax Structure in the BEPS Era: An analysis of Anti-Abuse Measures*, Amsterdam, The Netherlands, IBFD Tax Research Series, 2015, p.204
[222] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2017, p. 370, par. 9.14
[223] M. Cotrut, and L. Ambagtsheer, "Business Restructurings: The Toolkit for Tacking Abusive International Tax Structures", *in* M. Cotrut, *International Tax Structure in the BEPS Era: An analysis of Anti-Abuse Measures*, Amsterdam, The Netherlands, IBFD Tax Research Series, 2015, p.204
[224] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2017, p. 370, par. 9.14
[225] Ibid
[226] Ibid, p. 372, par. 9.19
[227] A. Cousins, and D. Beeton, "OECD Transfer Pricing Guidelines" in M. Heimert, & T. Michaelson (Eds.), *Guide to International Transfer Pricing*, (7th ed., pp. 69-104). Alphen aan den Rijn, The Netherlands: Kluwer Law International, 7th ed., 2017, p. 78
[228] R. Offermans and R. Botelho Moniz, "Business Restructurings: Options and Practice – Part 2", *Bulletin for International Taxation*, no. 72(9), 2018, p. 2
[229] Ibid
[230] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2017, p. 372, par. 9.20

risks of the local group entity are only transferred to the principal company in case it follows from the transfer pricing documentation that the principal company starts to control the risk after the restructuring.

There are two exceptional cases, based on Chapter I and IX of the OECD TPG, in which tax authorities might decide to disregard the business restructuring as a whole.[231] First of all, the business restructuring can be disregarded if the economic substance of the business restructuring does not comply with its form.[232] For instance, in case a fully-fledged manufacturer is converted into a low-risk entity by means of contractual arrangements, but in reality it keeps controlling the business process, tax authorities of the jurisdiction in which the manufacturer is located, might adjust this transfer pricing event. Secondly, the business restructuring might be disregarded if it lacks commercial rationality that would be agreed between unrelated parties under comparable economic circumstances.[233] However, in practice, business restructurings resulting in the centralization of assets, functions and risks can be easily motivated by economic reasons, i.e. the wish to maximize synergies and economies of scale as demonstrated in Chapter 2.

We could claim that the extensive analysis, as required under Chapter IX, enables the tax authorities to examine the validity of the business restructuring[234], and more particularly the change of the functional and risk profiles of the parties involved in the business restructuring, and secondly, to test whether the business restructuring is substantial. At the same time, it can be argued that the wide range of requirements result in a compliance burden for the taxpayer. However, given the fact that business restructurings are sensitive to certain forms of tax planning, it can be affirmed that this administrative burden can be justified by overriding reasons of public interest.

4.4.1.2 Valuation of a business restructuring based either on an aggregate basis or on a transactional one

After analyzing the role of each party and the business aspects of the business restructuring itself, one has to determine an appropriate transfer price for the business restructuring itself which comprises different transactions. The question may arise as to whether the valuation of the business restructuring should be performed at the transactional level or rather at the level of the business restructuring as a whole – also referred as the aggregate basis.

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[231] R. Offermans and R. Botelho Moniz, "Business Restructurings: Options and Practice – Part 2", *Bulletin for International Taxation*, no. 72(9), 2018, p. 501

[232] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2017, p. 78, par. 1.122

[233] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2017, p. 78, par. 1.122

[234] M. Cotrut, and L. Ambagtsheer, "Business Restructurings: The Toolkit for Tacking Abusive International Tax Structures", *in* M. Cotrut, *International Tax Structure in the BEPS Era: An analysis of Anti-Abuse Measures*, Amsterdam, The Netherlands, IBFD Tax Research Series, 2015, p.204

As laid down in paragraph 9.69 of Chapter IX, in case the business restructuring involves a transfer of an ongoing concern[235], the determination of the arm's length compensation should be based on an aggregate basis as the sum of the separate valuations together might not reflect an arm's length price.[236] The value of a business restructuring based on an aggregate basis is likely to be higher than the sum of individual transactions comprising the restructuring, as synergy gains, business opportunities and other aspects of goodwill and going concern value are taken into account.[237] In the context of the OECD TPG, the transfer of an ongoing concern is described as "*the transfer of assets, bundled with the ability to perform certain functions and assume certain risks*"[238]. In the example of the local manufacturer, a transfer of ongoing concern would mean that the manufacturing activity as a whole is transferred to another country. However, in the case that a restructuring has been put into place in order to set a principal company structure, local entities are stripped off their assets, functions and/or risks. This implies that the activity as such, remains in the same jurisdiction and that there is no transfer of ongoing concern. With respect to business restructurings which do not involve the transfer of an ongoing concern, the guidelines do not take a clear stance whether to determine the value at the aggregate level or at the transactional basis.[239] However, scholars are in agreement that, in overall, Chapter IX seems to be in favour of the valuation based on a transactional basis.[240]

4.4.1.3 Compensation for the loss of profit potential

As described before, with the reallocation of assets, functions, and in particular risks from one affiliated entity to another, also profit potential is reallocated from one party to another. In the transfer pricing analysis, information about the profit potential of the parties involved before and after the business restructuring follows from the functional analysis.[241] Chapter IX describes profit potential as the expected future profits or losses.[242]

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[235] An ongoing concern is defined as a 'functioning, economically integrated business unit'
[236] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2017, p. 78, par. 1.122
[237] P. Blessing, "Business Restructurings", in P. Blessing (Ed.), Tax planning for international mergers, acquisitions, joint ventures and restructurings, Alphen aan den Rijn, The Netherlands, Wolters Kluwer, 4th edition, 2017, p.7
[238] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2017, p. 390, par. 9.68
[239] A. Hanninen, "Transfer pricing of business restructurings from the perspective of Russian, Finnish and US tax law", 2018, p. 176
[240] Ibid, p. 177; S. Rasch, and R. Schmidtke, "OECD Guidelines on Business Restructuring and German Transfer of Function Regulations: Do Both Jeopardize the Existing Arm's Length Principle?", *International Transfer Pricing Journal*, no. *18*(1), 2011, p. 59; P. Blessing, "Business Restructurings", in P. Blessing (Ed.), Tax planning for international mergers, acquisitions, joint ventures and restructurings, Alphen aan den Rijn, The Netherlands, Wolters Kluwer, 4th edition, 2017, p.20
[241] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2017, p. 381, par. 9.42
[242] Ibid, p. 380, par. 9.40

The question being raised is whether the transferor should be compensated for the loss profit potential. In this respect, article 9.39 of Chapter IX explicitly states that "*the arm's length principle does not require compensation for a mere decrease in the expectation of an entity's future profits*"[243]. This implies that the loss of profit potential in the example of the conversion of a fully-fledged manufacturer into a contract manufacturer does not result in a compensation. However, at the same time, another provisions states the following:

> "*… it is not sufficient from a transfer pricing perspective that a restructuring arrangement makes commercial sense for the group as a whole: the arrangement must be arm's length at the level of each individual tax payer, taking into account of its rights and other assets, expected benefits from the arrangement (i.e. any consideration of the post-restructuring arrangement plus, if applicable any compensation payments for the restructuring itself), and realistically available options*."[244]

This statement seems to be contrary to the other, given that it makes a reference to a possible compensation for the restructuring itself to make the arrangement compliant with the arm's length principle. For instance, it can be argued that a profitable uncontrolled manufacturer is not likely to give up its profitable business and to be converted in a low-risk entity without a compensation for the loss of profit potential itself. However, in overall, the first line of reasoning seems to be followed: the transfer of functions and risks, and its underlying profit potential, does not give rise to the payment of a compensation according to Chapter IX.[245]

While the transfer of profit potential itself gives no rise to compensation, Chapter IX requires that a compensation is due in two situations: the business restructuring comprises a transfer of 'something of value' or the restructuring involves termination or substantial renegotiation of existing arrangements between affiliated parties.[246] Literature indicates that the concept of value is a complex concept which requires a deep analysis.[247] Rather than providing a definition of the concept of value, Chapter IX indicates that the transfer of 'something of value' occurs if the restructuring comprises the transfer of an ongoing concern, or the transfer of an intangible or tangible asset.

[243] Ibid, p. 380, par. 9.39
[244] Ibid, p. 379, par. 9.37
[245] J. Monsenego, *Introduction to transfer pricing*, Kluwer Law International, 2015, p. 101; A. Hanninen, "Transfer pricing of business restructurings from the perspective of Russian, Finnish and US tax law", 2018, p. 141
[246] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2017, p. 383, par. 9.39
[247] H. Kroppen, and J. Silva, *Cross-border business restructuring*, The Hague, Sdu, IFA cahiers de droit fiscal international vol. 96a, 2011, p. 32-49

In case the business restructuring involves a transfer of an asset, and thus a transfer of something of value, the transferor is entitled to receive a compensation for that asset.[248] Chapter IX provides little guidance on the determination of an arm's length price. An example is provided in which the inventory is transferred from one affiliated company to another as part of the business restructuring. This inventory has to be valued against an appropriate arm's length price according to one of the acknowledged transfer pricing methods.[249] It can be concluded, that the context of the transaction, namely that the asset is part of a business restructuring, does not require a different transfer pricing method than ordinary transactions of assets between affiliated entities.

Chapter IX acknowledges that the identification[250] and valuation of intangibles, being part of a business restructuring, is a challenging part. In this regard, Chapter IX refers to Chapter VI on the treatment of intangibles for transfer pricing purposes: in order to be considered as the economic owner, the new legal owner has to perform controlling functions related to the development, enhancement, maintenance, protection, or exploitation of the intangible.[251] This legal framework might be useful to test on substance in case intangibles are legally shifted from a local manufacturer to the principal company and afterwards licensed to the local manufacturer. The valuation of intangibles for transfer pricing purposes is a complex matter and not within the scope of this thesis. For this moment, it is important to highlight that the transfer of intangibles, which represent something of value, has to be valued against an arm's length price in the context of business restructurings.[252]

Above, we introduced the concept of a transfer of an ongoing concern. As above mentioned, the transfer pricing treatment of a business restructuring involving the transfer of an ongoing concern is unique for the fact that the price of the business restructuring has to be determined based on the aggregate basis rather than on a transactional basis. In order to determine its value, Chapter IX proposes to make use of 'valuation techniques' that are used in acquisition deals between independent parties.[253] However, besides a reference to those valuation methods, further guidance is missing. As described before, those valuation techniques, e.g. the Discounted Cash Flow Method, take the going concern value and goodwill of a business unit into

[248] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2017, p. 380, par. 9.49
[249] Ibid, p. 385, par. 9.52
[250] A business restructuring might involve the transfer of intangibles which were before not identified by the transferor such as customers lists.
[251] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2017, p. 262, par. 6.42
[252] J. van Egdom, *Verrekenprijzen; de verdeling van de winst van een multinational*, Deventer, The Netherlands, 2017, p.119
[253] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2017, p. 391, par. 9.69

account when evaluating the business restructuring which results in a price which exceeds the sum of the value of individual assets.[254]

Furthermore, under the premise that the termination or change of an existing arrangement between independent parties may result in an indemnification of the aggrieved party, Chapter IX states that the same goes for affiliated enterprises.[255] After the delineation of the business restructuring, the identification of the options realistically available to the parties, the following aspects have to be taken into account in order to assess whether an arm's length compensation is due for the termination or negotiation of contractual agreements: whether commercial law supports a compensation for the aggrieved party, whether an indemnification clause is in place, whether the existence or absence of such an indemnification clause is at arm's length, and finally which party should bear the costs related to the indemnification of the aggrieved party.[256]

All in all, it appears that Chapter IX does not require a compensation for the surrender or loss of profit potential itself. An exception is made for the transfer of an ongoing concern. In that case, an arm's length price should be determined on an aggregate level by means of valuation techniques such as the discounted cash flow model, which gives rise to a compensation for the loss of profit potential. In other cases, when the business restructuring involves a transfer of 'something of value' or implies the termination or negotiation of contractual arrangements, the transferor should receive an arm's length compensation for those transactions themselves. However, it seems clear that the change of a local group entity's risk profile and corresponding profit potential, does not give rise to an arm's length compensation for the restructuring itself.

4.4.1.4 Location savings

MNEs might be able to realize location savings by relocating some of their activities to a jurisdiction where costs, including labour and transportation, are lower as compared to the former location. It seems that location savings are not taken into account for the determination of the arm's length compensation for the restructuring itself.[257]

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[254] P. Blessing, "Business Restructurings", in P. Blessing (Ed.), Tax planning for international mergers, acquisitions, joint ventures and restructurings, Alphen aan den Rijn, The Netherlands, Wolters Kluwer, 4th edition, 2017, p.20

[255] J. Monsenego, *Introduction to transfer pricing*, Kluwer Law International, 2015, p. 104

[256] See OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2017, p. 393, Section F

[257] Chapter I and IX provides purely guidance on the role of the location savings on the remuneration of post-restructuring controlled transactions. In this respect, "*the response will necessarily be based on a comparability analysis and, absent any comparables, what would have been agreed between independent parties based on the functions performed, assets used, risks assumed and the relative bargaining powers of the related parties involved in the business restructuring."*

4.4.2 Germany

4.4.2.1 Comparability analysis

Under German tax law, in order to apply the arm's length principle to business restructurings, it is necessary to understand the material economic reasons behind it[258]. For this purpose, a thoroughly functional and comparability analysis is required.[259] To this end, the German Administrative Guidelines follow and refer explicitly to the provisions of Chapter IX of the OECD TPG.[260] The business relations between the affiliated entities involved, before and after the restructuring, have to be identified.[261] Besides that, the economic reasons for the business restructuring have to be understood both at the level of the MNE[262] and at the level of the individual taxpayer[263]. In regard to the latter, from the perspective of the participating enterprises in the business restructuring, an assessment has to be made in order to determine whether there were more advantageous economic alternatives available to the affiliated parties.[264] Similar to Chapter IX, as part of the functional and comparability analysis, the German transfer pricing rules require to determine the profit potential of the function before and after the business restructurings.[265] Also here, it is assumed that the higher the risks, the higher the profit expectations of a company.[266]

4.4.2.2 Valuation of the business restructuring based on an aggregate basis or on an transactional basis

Before the amendments in 2008, the German Foreign Tax Code provided for a single asset or transactional approach in order to determine the arm's length price of a business restructuring.[267] In other words, tangible and intangible assets, being part of a relocation of functions, were valued against an arm's length price based on a transactional basis and the transfer of risk and functions itself did not give rise to a compensation.

After the amendments of the Foreign Tax Code, business restructurings within the scope of "relocation of functions" *(Funktionsverlagerung)*[268], have to be valued on the aggregate level - the so-called transfer package (*Transferpaket*).[269] Within the meaning of the Foreign Tax Code, a transfer package consists of the

[258] The business relations between the affiliated parties prior the location of functions; the relocation of functions itself; and the business relations after the relocation of functions. See also Sec. 1.3 and sequential Administrative Guidelines – Procedures
[259] Sec. 1.3 par. 11 Administrative Guidelines – Procedures
[260] See also Sec. 1.3 et. seq. Administrative Guidelines – Procedures
[261] Ibid
[262] Sec. 1.3 par.12 Administrative Guidelines – Procedures
[263] Sec. 1.3 par.13 Administrative Guidelines – Procedures
[264] Ibid
[265] Ibid
[266] Ibid
[267] H. Wolter, "Germany", *in* H. Kroppen, and J. Silva, *Cross-border business restructuring*, The Hague, Sdu, IFA cahiers de droit fiscal international vol. 96a, 2011, p. 349
[268] See 4.3.2 of this study
[269] See sec. 1 (3) sentence 9 Foreign Tax Act

function and the opportunities and risks connected to it, as well as the assets and benefits that are transferred with the function from the transferor to the transferee.[270] This is to say that according to German tax law, business restructurings shall be valued based on an aggregate basis rather than on a transactional basis.

There are three escape clauses which give the taxpayer the right to value the business restructuring on an individual basis.[271] First of all, in case intangible assets constitute an essential part of the relocation of functions, the Foreign Tax Act requires a valuation on an individual basis.[272] The Administrative Guidelines specify what can be considered under essential: the arm's length price of the intangibles altogether amounts to more than 25% of the transfer package or the intangibles are required for the function relocated.[273] The main reason for this escape clause is to ensure that intangible assets are valued in line with the German transfer pricing rules on intangible assets which differ from those on relocation of functions.[274] The second escape clause allows the taxpayer to value the transfer of a function on a transactional basis in case the taxpayer can demonstrate that the sum of the arm's length prices of the individual assets falls within the arm's length range (*Einigungsbereich*) of the whole transfer package.[275] The third escape clause indicates that if a taxpayer can demonstrate that the transfer of a function involves at least one significant intangible asset, a value based on a transactional basis might be appropriate.[276] The introduction of the third escape clause is a direct response from the German government to situations in which German-based MNE's started to build Research & Development facilities abroad in order to avoid the German transfer pricing rules on business restructurings.[277]

4.4.2.3 Compensation for the loss of profit potential

As aforementioned, in the event of a relocation of functions, an adequate arm's length price has to be found at the level of the transfer package as a whole. The Foreign Tax Act requires the taxpayer to search for unrestrictedly and restrictedly comparable data[278] in order to determine the value of the transfer package, similarly to the provisions dealing with ordinary inter-group transactions. In case that there is no reachable

[270] Sec. 1 (3) Decree-Law Relocation of Functions
[271] S. Rasch, and R. Schmidtke, "OECD Guidelines on Business Restructuring and German Transfer of Function Regulations: Do Both Jeopardize the Existing Arm's Length Principle?", *International Transfer Pricing Journal,* no. *18*(1), 2011, p. 61
[272] Sec. 1 (3) sentence 10 Foreign Tax Act
[273] Sec. 2.2.3.3 Administrative Guidelines – Procedures Administrative law
[274] M. Schneider, "Recent Developments Concerning the Rules on the Transfer of Business Functions", *International Transfer Pricing Journal,* no. *18*(2), 2011, p. 115
[275] Sec. 1 (3) sentence 9 et seq. Foreign Tax Act
[276] Ibid
[277] M. Schneider, "Recent Developments Concerning the Rules on the Transfer of Business Functions", *International Transfer Pricing Journal,* no. *18*(2), 2011, p. 115
[278] In that case Sec. 1 (3) sentence 1-4 of the Foreign Tax Act apply

comparable data, which is likely to be the case for business restructurings, the Foreign Tax Act provides that taxpayers shall conduct a hypothetical arm's length test (*hypothetischen Fremdvergleich).*[279]

The hypothetical arm's length test implies that based on an adequate functional analysis, a minimum and a maximum price have to be found for the transfer package.[280] For this purpose, the minimum and the maximum price of the transfer package are found by calculating respectively the present value (*Barwertermittlung)* of the transfer package for the transferor and the transferee.[281] To this end, the present value of the transfer package is determined by discounting the respective profit expectations or profit potential (*Gewinnpotenzialen).*[282] The minimum price and the maximum price together, form the range of mutual consent (*Einigungsbereich)* in which the arm's length is found.[283] All in all, it can be concluded that under German tax law, the local group entity is compensated for the loss of profit potential. The main argument for this compensation is that a sound and prudent business manager would not waive positive profit expectations without receiving a compensation.[284]

For a better understanding of the relation between profit potential and the arm's length price for the business restructuring, we will describe the hypothetical arm's length into more detail. As described above, the present value of the transfer package is equal to the present value of its profit potential. In the context of the relocation of a function, profit potential can be described as the net profits after tax expected from the transferred function in line with the concept of the prudent and diligent manager.[285]

Based on a functional analysis, before and after the relocation of the function, the profit potential has to be determined from the perspective of both the transferor and of the transferee.[286] Concretely, this means that the presence of synergy advantages at the side of the transferee (the principal company), after the restructuring, result in a higher profit potential and thus a higher present value of the transfer package. This is embedded in the compensation of transferor (the local group entity). Moreover, the presence of beneficial alternative options at the side of the transferor, the local group entity, will influence the profit potential and thus the value of the transfer package positively.[287]

[279] Sec. 1 (3) sentence 5 Foreign Tax Act
[280] D.Endres and C. Spengel, *International company taxation and tax planning*, Alphen aan Den Rijn: Kluwer Law International, p. 524
[281] Sec. 1 (3) sentence 6 Foreign Tax Act
[282] Ibid
[283] Ibid
[284] Sec. 2.1.4 (30) Administrative Guidelines – Procedures Administrative law
[285] Sec. 1 (4) Decree-Law Relocation of Functions
[286] Sec. 3 (2) Decree-Law Relocation of Functions
[287] Sec. 2.3.2 (85) Administrative Guidelines – Procedures Administrative law

The German transfer pricing rules require the application of the discounted cash flow method in order to calculate the present value of the profit potential. A distinction has to be made between the direct and the indirect method. Under the direct method, the profit potential connected to the affected function itself has to be determined.[288] The second method is referred as the indirect method and implies that the value of the transfer package can be determined by calculating the difference in the enterprise value before and after the activity.[289] The equitation below represents the direct method:

$$PV = \frac{PR_1}{(1+i)^1} + \frac{PR_2}{(1+i)^2} + \frac{PR_3}{(1+i)^3} + \dots + \frac{PR_n}{(1+i)^n}$$

PV	=	present value transfer package
PR	=	profit potential
i	=	discount rate
n	=	time

Therefore, it is crucial to address two other aspects, following to profit potential, the discount rate and the capitalization period. The discount rate is equal to the risk-free interest rate plus an appropriate risk premium based on the opportunities and risks that are connected with the function.[290] In case a function as a whole (*Teilbetrieb*) is transferred from one group entity to another, the Administrative Guidelines require the taxpayer to calculate the profit potential for an indefinite period of time.[291] However, in case only a part of the function is transferred, a shorter capitalization period is more appropriate.[292] After calculating the present value of the profit potential, the price has to be adjusted for the tax effects resulting from the remuneration paid.[293]

The present value as calculated by the transferor on the one hand (the minimum price), and the present value determined by the transferee on the other hand (the maximum price) together, form the range of mutual consent (*Einigungsbereich*) in which the arm's length price is found. The precise arm's length price is the value within the range of mutual consent that with the highest probability complies with the arm's length principle.[294] However, in practice, this value cannot be found and the mean of both values is taken

[288] Sec. 3.4.3.2 (165) Administrative Guidelines – Procedures Administrative law
[289] Sec. 2.1.3 (29) Administrative Guidelines – Procedures Administrative law
[290] Sec. 2.3.2 (84) et 2.5.1-2.5.3 Administrative Guidelines – Procedures Administrative law
[291] Sec. 2.6 Administrative Guidelines – Procedures Administrative law
[292] Sec. 2.6 Administrative Guidelines – Procedures Administrative law
[293] Sec. 2.5.4 Administrative Guidelines – Procedures Administrative law
[294] Sec. 1 (3) sentence 7 Foreign Tax Act

as arm's length price.[295] In case that in the following years after the restructuring, it seems that the actual profits deviate significantly from the profit potential[296], an appropriate adjustment shall be applied in line with the decree-law.[297]

4.4.2.4 Location savings

By discounting the profit potential from the perspective of both the transferor and transferee and taking the mean of both outcomes, synergies and location savings are distributed equally to the transferee and transferor. This means that synergies and location savings which will be realized in the territory of the principal company are embedded in the compensation of the local group company. Especially, the latter raises questions. For instance, in case (a part of) a business function is relocated from Germany to Slovakia where the labour costs are lower, location savings might be derived by the MNE in the last country. Because of the hypothetical arm's length test, by discounting the profit potential of both the transferor and transferee, location savings arising from the investment in Slovakia are taken into account for the compensation of the German entity. In the long-term, the compensation of the German entity will be subject to tax in Germany. Consequently, the location savings derived from investing in Slovakia would be indirectly subject to tax in Germany. This is likely to result in conflicting situations, as the Slovakian authorities are likely to reject this situation as the location savings are realized because of the Slovakian economic environment and policies. While under German tax law, location savings and synergy effects have to be taken into account when determining the arm's length compensation[298], this is not the case for the OECD TPG.

[295] Ibid
[296] Sec. 1 (3) sentence 10 Foreign Tax Act
[297] Sec. 1 (3) sentence 11 Foreign Tax Act
[298] Sec. 2.3.2.2. Administrative Guidelines – Procedures Administrative law

4.5 A case study: the conversion of a local manufacturer

As previously discussed in section 4, the OECD and the German legislator have introduced different approaches in finding an appropriate transfer price for business restructurings. By means of the following case study, we will address the differences and implications of both methods.

Fictitious case study: Ficta MNE

This case study involves a Japanese car manufacturer named '*Ficta MNE'*. The MNE operates worldwide, and has subsidiaries in several European countries, including manufacturer A in Germany. The local manufacturer is a fully-fledged entity as it operates fully independent and assumes the full entrepreneurial risks.

In order to realize tax and supply chain efficiencies, Ficta MNE wants to move to a central business model by establishing a principal company structure as of 1st of January 2018. After a thorough examination, Ficta MNE announces that it will establish a principal company for the European region in Vaud, a Swiss canton. In a press release, the CEO of Ficta states that Vaud has been chosen as location because of its central position in Europe and the presence of an experienced and a high-skilled workforce in this region.

By means of a business restructuring of the MNE's value chain, key functions of Ficta MNE in Europe, including administrative, legal and financial services, marketing, sales, manufacturing and supply chain management, will be shifted to the Swiss principal company. A total of 150 employees, most of them coming from other subsidiaries, will start to work in the Swiss principal.

As part of this business restructuring, Manufacturer A will be converted into a toll manufacturer. A significant amount of functions (such as production planning, procurement, research & development, sales of goods, inventory management, and warehousing), risks (including inventory risk, market risk, and R&D risk) and assets (such as inventory and certain patents) will be transferred from manufacturer A to the Swiss principal company. As a result, after the business restructuring, the residual profits of the manufacturing process will be attributed to the Swiss principal company, while the German manufacturer will receive a low but stable manufacturing fee based on the cost-plus method for the provision of manufacturing services to the principal.

After the business restructuring, the contractual relations between the German manufacturers and vendors and customers will be shifted to the Swiss principal company. Because of special rulings and a low corporate income tax rate, the effective tax rate is significant lower in Switzerland than in Germany. As a result, after the business restructuring, Ficta will be able to realize a higher after-tax profit for its operations in the European region.

4.5.1 Comparability analysis

As part of the comparability analysis, both the OECD TPG and the German transfer pricing rules require a functional analysis of the assets owned, functions performed, and risks assumed by both the manufacturer and the principal company before and after the business restructuring. In this case, the business restructuring involves manufacturer A in Germany and the principal company in Switzerland. Valuable Assets, value-adding functions, and entrepreneurial risks related to the manufacturing process are transferred from the German manufacturer to the principal company.

As described above, in order to calculate the profit potential before and after the business restructuring, the allocation of risks plays a fundamental role. Before the business restructuring, it was the German entity who bore all the significant risks with respect to the production process. Accordingly, the residual profits or losses resulting from the manufacturing activities, were fully attributed to the local manufacturer.[299]

After the conversion into a toll manufacturer, the German manufacturer will perform a significantly different function within the value chain of a MNE, namely that of service provider who has to act in accordance with the specifications of the principal company. We would discuss whether the transfer of risk is substantial. Most importantly, it is relevant to assess whether the principal truly controls the risk in practice. Given the fact that personnel is placed in Switzerland seems to answer this question positive. With the transfer of the risks, after the restructuring, the local manufacturer will receive a lower but stable remuneration in the form of a service fee from the principal for processing and assembling the raw materials into output.[300] In this case, in absence of a CUP, the arm's length price of the service fee can be determined with the cost-plus method.[301] At the other side of the coin, the principal company starts to assume the risks arising from the manufacturing process and will be entitled to receive the residual profits resulting from the production process.

This analysis is a very simplified elaboration of a functional analysis. The aim is to underline, that as part of the transfer pricing analysis, the functional profile of each party involved has to be examined.

4.5.2 Finding an arm's length price

OECD

Now we will assess, how an arm's length price would have been determined under the OECD TPG. First of all, it is important to address whether the situation in the case study is within the scope of business restructurings. The answer to this question is affirmative as the conversion of a fully-fledged manufacturer into a toll manufacturer is explicitly mentioned in art. 9.1 of the OECD TPG.

In order to find an adequate arm's length price for the business restructuring, it is important to decide whether the valuation has to be made based on the aggregate basis or on a transaction-by-transaction. The first method is required in case the business restructuring consists of a transfer of an ongoing concern. In

[299] A. Bakker, (Ed.). *Transfer pricing and business restructurings: streamlining all the way*, IBFD, 2009, p. 29; J. Monsenego, *Introduction to transfer pricing*, Kluwer Law International, 2015, p. 74; S. Kishore Bilaney, "Supply Chain Management Using Alternative Manufacturing Models", *International Transfer Pricing Journal*, no. 21(2), 2014, p. 86; A. Bakker, (Ed.). *Transfer pricing and business restructurings: streamlining all the way*, IBFD, 2009, p. 27

[300] S. Kishore Bilaney, "Supply Chain Management Using Alternative Manufacturing Models", *International Transfer Pricing Journal*, no. 21(2), 2014, p. 87

[301] S. Beaumont, N. del Catillo, J. Gross, and M. Solano, "Supply Chains Create Latin Value", *International Tax Review, no. 11*, 2000, p. 41; J. Monsenego, *Introduction to transfer pricing*, Kluwer Law International, 2015, p. 75

that case, the manufacturing activity as a whole would have been transferred from Germany to Switzerland which is not the case. Therefore, the Guidelines seem to be in favour of a valuation of the business on a transaction-by-transaction basis.

In order to assess whether the business restructuring gives rise to a compensation, we have to determine whether there is a transfer of 'something of value' and/or whether the business restructuring involves the termination or renegotiation of existing contractual arrangements. The business restructuring encompasses the transfer of inventory and the transfer of intangibles. The OECD TPG require the taxpayer to find an arm's length price for those 'individual' transactions.

In addition, the business restructuring in the case study might give rise to a compensation in the form of indemnification of the restructured entity, the German manufacturer, for the termination or substantial renegotiation of existing arrangements. Whether an indemnification is due depends on the fact whether there was an indemnification clause or whether German commercial law support rights to indemnification for the restructured entity.

Germany

Under the German transfer pricing rules, it has to be determined whether the conversion of the fully-fledged manufacturer A into a toll manufacturer is within the scope of the relocation of functions. The definition of 'relocation of functions' is broad and compromises the reorganization of a fully-fledged manufacturer into a toll manufacturer as well. Under the assumption that no escape clause can be applied, the business restructuring has to be valued on an aggregate basis. In absence of comparable data, the German rules require to perform a hypothetical arm's length test, in which the profit potential connected to the function has to be assessed at the level of the German manufacturer and at the level of the principal company in Switzerland. For the calculation of the arm's length price, the following profit expectations connected to the manufacturing activity have been found in a prudent and sound business analysis from the side of both the German and the Swiss entity:

	PROFIT POTENTIAL BEFORE THE RESTRUCTURING (IN MLN.)		**PROFIT POTENTIAL AFTER THE RESTRUCTURING (IN MLN.)**	
	Manufacturer A	**Principal Company B**	**Manufacturer A**	**Principal Company B**
2019	€ 20	0	€ 20	€ 25
2020	€ 40	0	€ 20	€ 45
2021	€ 45	0	€ 20	€ 52
2022	€ 60	0	€ 20	€ 70

The present value of the transfer package is calculated by discounting the profit potential against an adequate discount rate. The discount rate is equal to the risk-free interest rate plus an appropriate risk premium.

Present value of the manufacturing function from the perspective of the German manufacturer before the restructuring in 2018:

	PROFIT POTENTIAL IN MLN. (PR)	DISCOUNT RATE (I)	TIME (N)	$PV = \frac{PR_n}{(1+i)^n}$
2019	€ 20	10%	1	€ 18.18
2020	€ 40	10%	2	€ 33.06
2021	€ 45	10%	3	€ 33.81
2022	€ 60	10%	4	€ 40.98
SUM				**€ 126.03**

With the transfer of risks from manufacturer A to principal company B, the discount rate decreases from 10% to 5% as the discount rate represents the risk-free rate plus a risk premium. Present value of the manufacturing function from the perspective of manufacturer A after the restructuring in 2018:

	PROFIT POTENTIAL IN MLN. (PR)	DISCOUNT RATE (I)	TIME (N)	$PV = \frac{PR_n}{(1+i)^n}$
2019	€ 20	5%	1	€ 19.05
2020	€ 20	5%	2	€ 18.14
2021	€ 20	5%	3	€ 17.28
2022	€ 20	5%	4	€ 16.45
SUM				**€ 70.92**

The minimum price can be found by deducting the present value after the restructuring from the present value before the restructuring which is equal to 55.11 million.

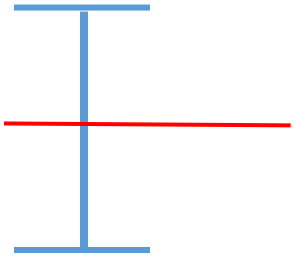
The same test has to be applied from the perspective of the Swiss principal company B. Because of the fact that before the business restructuring, the principal company was not involved in the manufacturing process of A, the present value before the business restructuring is equal to zero.

By means of the business restructuring, assets, functions and risks related to the manufacturing process of A are transferred to the principal company which results in an increase in profit potential. In this case, it is assumed that because of synergies, a higher profit potential is expected.

	PROFIT POTENTIAL IN MLN. (PR)	DISCOUNT RATE (I)	TIME (N)	$PV = \frac{PR_n}{(1+i)^n}$
2019	€ 25	8%	1	€ 23.15
2020	€ 45	8%	2	€ 38.58
2021	€ 52	8%	3	€ 41.28
2022	€ 70	8%	4	€ 51.45
SUM				**€ 154.46**

The present value from the perspective of principal company B, and thus the maximum price, is equal to 154.46 million. Now, the range of mutual consent (*Einigungsbereich)* can be determined:

Maximum price = € 154.46 mln.



Hypothetical arm's length price = 104,79 mln.

Minimum price = € 55.11 mln.

The arithmetic mean of the minimum and maximum price has to be taken as arm's length price which is equal to 105 million. In other words, based on German tax law, local manufacturer is entitled to receive a compensation of 105 million for business restructuring as a whole.

The arm's length price as found under the hypothetical arm's length test is most likely to exceed the value which has been calculated under the valuation of the individual transactions according to the OECD TPG. The main reason for this, relies in the fact that in the process of calculating the arm's length price for the transfer package on an aggregate basis, the local manufacturer A is directly compensated for the loss profit potential. Moreover, aspects such as synergy advantages and location savings realized at the side of the transferee, have an upward effect on the transfer price for the business restructuring as a whole.

4.6 Comparison

4.6.1 Comparison

For an adequate comparison, it is important to underline that the legal context of the OECD TPG and the German Transfer Pricing is slightly different. The OECD, on the one hand, is an intergovernmental organization and has as objective to serve the interest of the international community by minimizing conflicts between tax administrations and promoting international trade and investment. While in Germany, legislators have enacted rules in the aim of German public interest.

The main aim of this chapter was to assess whether the local group entity is compensated for the loss of profit potential to the principal company in the context of business restructurings. Both legislations, the OECD TPG and the German transfer pricing rules, require the taxpayer to conduct a comparability analysis in order to understand the respective positions of the parties involved in the restructuring. As part of this analysis, other options realistically available to the transferor have to be identified. Moreover, a functional analysis shall be performed in order to identify the economically significant activities and responsibilities undertaken, assets used or contributed, and risks assumed before and after the restructuring by the parties involved. In this respect, special attention is given to the allocation of risk because it is connected with the allocation of profit. Whereas companies might find compliance requirements such as the performance of this analysis burdensome, tax authorities are obliged to have the means to test the economic substance reasons of the restructuring.

In a business restructuring, the assets, functions, and risks are transferred from one party to another party. How is the transferor compensated for the 'sale' of assets, functions and risks? In order to answer this question, we can observe the different approaches that have been taken by the OECD and Germany, which differ significantly from each other. According to German tax law, an arm's length price shall be found for the transfer package as a whole. We can observe that unlike the German Foreign Tax Act provisions which require a business restructurings to be valued on an aggregate level, the OECD TPG request such a valuation only in the exceptional case of the transfer of an ongoing concern. Regarding business restructurings not transferring an ongoing concern, the OECD guidelines do not specify clearly whether the value has to be determined at an aggregate or at a transactional level. However, for the author, it seems that the OECD TPG are more in favour of the transactional approach. Indeed, a valuation on a transactional level enables the chances of finding comparable data. For instance, as part of the business restructuring, certain assets might be transferred from one party to another. Those assets have to be valued as if they would have been transferred between uncontrolled parties. In some cases, the value of the transfer package exceeds the sum of the individual transactions. For accountancy purposes, the consideration paid for a business often exceeds the fair value of its assets and liabilities because also goodwill is included. For accountancy purposes,

goodwill is considered as a residual item.[302] It is feasible to say that it is impossible to determine the amount of goodwill if the valuation of the business restructuring is conducted on a transactional level. At the other hand, it would be too shortsighted to conclude that a business restructuring by definition requires the payment of goodwill. The question is whether also in those business restructuring prior to the principal company structure the transferor should be compensated on an aggregate basis. There is no straightforward answer to this question as those kind of transactions strictly occur between controlled entities.

This brings us to the compensation for the loss of profit potential in the context of business restructurings. In case the business restructuring involves the transfer of an ongoing concern. Both the OECD TPG and the German transfer pricing rules require the taxpayer to value business restructurings involving the transfer of an ongoing concern, on an aggregate basis by means of the discounted cash flow method. The going concern value and goodwill of the business are taken into account which results in a compensation which exceeds the aggregate sum of separately valued assets, risks and functions being transferred as part of the business restructuring. In this respect, the additional goodwill paid can be seen as a compensation for the loss of profit potential.

In contrast, Germany and the OECD seem to apply a different method concerning the transfer pricing treatment of business restructurings which are outside the scope of 'the transfer of an ongoing concern'. In last section it appeared that the German transfer pricing rules advocate for a compensation of the stripped group entity on an aggregate basis, while the OECD TPG seem to be more in favour of a compensation based on a transactional basis. As clearly demonstrated in the case study, those two different methods result in a different arm's length compensation for the business restructuring itself. Where Chapter IX requires the taxpayer to assess at the transactional level whether there is a transfer of something of value and/or whether the business restructuring involves the termination or renegotiation of existing contractual arrangements in order to determine the compensation of the stripped entity, the German transfer pricing rules require a valuation of the transfer package by discounting the profit potential under the hypothetical arm's length test. By discounting the profit potential of the transfer package from the perspective of both the transferor and the transferee, also location savings and synergies derived in the territory of the acquiring company are embedded in the arm's length compensation of the transferor. This approach has been criticized for the fact that income derived in the country of the transferee is partly allocated to the tax jurisdiction of the transferor: Germany.

As clearly demonstrated in the case study, by applying the hypothetical arm's length test, the stripped entity is compensated for the loss profit potential. Consequently, the compensation paid for the business

[302] See for instance IFRS 3 — Business Combinations in which the rules for goodwill are laid down

restructuring itself under the German transfer pricing rules exceeds the compensation paid under the OECD TPG as the loss of profit potential does not give rise to a compensation under the latter.

4.6.2 An evaluation of both methods

The guidance provided in Chapter IX on the transfer pricing aspects has been criticized for accommodating, rather than targeting the difficulty of applying the arm's length principle to business restructurings which do not occur between uncontrolled parties.[303] In a similar vein, it has been argued that the Chapter leaves some questions open.[304] At the other hand, it was found that the German legislator introduced an advanced system on finding an arm's length price for the business restructuring as a whole. This raises the question whether the German approach, and more particularly, the hypothetical arm's length test, should be followed by the OECD TPG.

The hypothetical arm's length test has been criticized by the tax community for a couple of reasons. As described above, in order to arrive at an arm's length price for the business restructuring, the profit potential or expected profits arising from the transferred function have to be discounted from the perspective of both the transferor and the transferee. Following this reasoning, it is assumed that the taxpayer has access to full information. This assumption has been criticized as it deviates from realistic markets which are not characterized by complete information symmetry.[305] Moreover, the application of the hypothetical arm's length test is seen as costly and burdensome for the taxpayer.[306] Secondly, as the compensation is based on the present value of the expected profits, those profits are indirect subject to tax in the jurisdiction of the transferor at the moment of the restructuring and subject to tax in the jurisdiction of the transferee when they are actually realized.[307] Some authors argue that the approach of the German legislator, in trying to tax a portion of the 'residual profits' realized abroad, is too far-reaching[308] and even a form of protection[309].

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[303] R. Collier and J. Andrus, *Transfer Pricing and the Arm's Length Principle After BEPS*, Oxford University Press, 2017, p. 96

[304] A. Hanninen, "Transfer pricing of business restructurings from the perspective of Russian, Finnish and US tax law", 2018, p. 176; I. Verlinden, D. Ledure and M. Dessy, "The Risky Side of Transfer Pricing: The OECD Base Erosion and Profit Shifting Reports Sharpen the Rules on Risk Allocation under the Arm's Length Standard*",Intl. Transfer Pricing J*, no. 23(2), 2016, p.114

[305] W. Haslehner, "Double Taxation Relief, Transfer Pricing Adjustments and State Aid Law", *in State Aid Law and Business Taxation*, Springer, Berlin, Heidelberg, 2016 p. 155; A. Thies, "Germany", in ORG. Duff & Phelps (Ed.), Guide to International Transfer Pricing, Kluwer Law International, 2017, p.524

[306] H. Baumhoff, X. Ditz, and M. Greinert, "Die Besteuerung von Funktionsverlagerungen nach den Änderungen des § 1 Abs. 3 AStG durch das EU-Umsetzungsgesetz" *DStR–Deutsches Steuerrecht*, no. 48, 2010, p. 1309

[307] A. Thies, "Germany", in ORG. Duff & Phelps (Ed.), Guide to International Transfer Pricing, Kluwer Law International, 2017, p.522

[308] P. Cauwenbergh and M. Mas, "Germany: The new German transfer pricing rules on cross-border relocation of functions: a preliminary analysis", *European taxation, no. 48*(10), 2008, p.520; W. Kessler and R. Eicke, Out of Germany: The New Function Shifting Regime, *Tax Notes International*, no. 48(1), p. 53

[309] P. Zimmermann, *Die Entscheidung zur Funktionsverlagerung im Konzern: Eine Analyse des Zusammenwirkens der Preisgrenzen der beteiligten Entscheider*, Springer-Verlag, 2013, p. 5;

Thirdly, scholars question whether the mean value of the minimum and the maximum price, is by definition the price which two independent market parties under similar circumstances would have agreed upon.[310] Finally, it should be borne in mind that scholars question whether the hypothetical arm's length test is compatible with EU law as those rules do not apply to domestic business restructurings.[311]

From the criticism above, we conclude that the hypothetical arm's length test, as found under German tax law, is not likely to be adopted by the OECD to 'fill in the questions left open' in Chapter IX. From a conceptual point of view, the German method requires a disproportional high compensation for the loss of compensation which favours the exit country. Secondly, from a practical point of view, the assumption that taxpayers have access to full information seems to be contradictory to the economic reality.

4.7 Conclusion

This chapter addressed the following research question:

To what extent a business restructuring arises a compensation of the local group entity for the transfer of profit potential to the principal company according to respectively the OECD Transfer Pricing Guidelines and German tax law?

In short, while under German tax law, the group entity is always compensated for the loss of profit potential in the context of business restructurings, the OECD Transfer Pricing Guidelines seem to imply that only in the case of a transfer of an ongoing concern the business restructuring gives rise to a compensation of the group entity for the loss of profit potential. As clearly illustrated in the case study, in contrast to the German hypothetical arm's length test, the local manufacturer which is stripped off its assets, functions, and risks, does not receive a compensation which exceeds the value of the individual transactions under the OECD TPG. Therefore it can be concluded that business restructurings in which assets, functions and risks are centralized in a principal company do not give rise to a compensation of the local group entity for the loss of profit potential. For a complete overview see table 5.

As Chapter IX has been criticized for leaving questions open, one might wonder whether the hypothetical arm's length test as incorporated under German law might be followed by the OECD. Considering the criticism above, it can be concluded that the hypothetical arm's length test is not likely to be followed by the OECD. It appeared that the hypothetical arm's length test strongly favors the tax jurisdiction of the

[310] H. Kroppen and S. Rasch, "Funktionsverlagerung–der nächste Akt", *Internationale Wirtschaftsbriefe*, 2010, p. 321; P. Cauwenbergh and M. Mas, "Germany: The new German transfer pricing rules on cross-border relocation of functions: a preliminary analysis", *European taxation, no. 48*(10), 2008, p.514-526

[311] Ibid, p.520 et seq.; P. Blessing, "Business Restructurings", in P. Blessing (Ed.), Tax planning for international mergers, acquisitions, joint ventures and restructurings, Alphen aan den Rijn, The Netherlands, Wolters Kluwer, 4th edition, 2017, p.27

transferor, the exit country, while it disfavors the tax jurisdiction of the transferee, the entry country. Therefore, it can be concluded that the hypothetical arm's length is not in line with the more balanced approach of the OECD in which consensus is found by allocating the taxing rights of tax jurisdictions in a fair way. In the same manner, from a practical point of view, the hypothetical arm's length test seems to be problematic. Nevertheless, without doubting this finding, the fact that the German legislator has opted for the implementation strict transfer pricing rules on business restructurings seems to indicate that there is a more fundamental problem, namely that after certain business restructurings, residual profits are allocated to the principal company located in a low-tax jurisdiction. It is reasonable to state that the hypothetical arm's length test attempts to nullify those effects. Consequently, high tax jurisdictions such as Germany find the need to protect their tax base against the (future) consequences of business restructurings. This requires a thorough analysis regarding the effect of the outbound transfer of risk on profit potential, in other words, it is important to discuss why with the outbound transfer of risk, the profit potential results to be relocated to the principal company under the arm's length principle.

Table 5: Summarizing the OECD and German transfer pricing rules on business restructurings

		OECD	Germany
Legal Context		• Working Party No. 6 • Chapter IX in 2010, updated in 2017 • Response to the increasing presence of business restructurings • Minimize conflict between tax administrations and promoting international trade and investment	• Foreign Tax Code (*AStG*) in 2008 • Need for tighter rules on the outbound transfer of business functions in order to secure the German tax base
Scope		• **Business restructurings** • Broad definition • Business restructurings resulting in the creation of a principal business model are explicitly included	• **Relocation of functions** (*Funktionsverlagerung)* • Very broad definition • Business restructurings involving the creation of a centralized business model are explicitly included
Compensation for the business restructuring itself	**Comparability analysis**	• Delineation of the transactions, functional analysis • Business reasons for the restructuring and the expected benefits • Other realistic available options of the transferring party	• German transfer pricing follow the guidance of Chapter IX
	Valuation based on an aggregate basis or an transactional basis	**Transactional basis:** - No clear stance whether to determine the value at a transactional or at an aggregate basis - A valuation based on a transactional basis seems to be preferred in case the business restructuring is not a transfer of an ongoing concern **Aggregate basis:** - Only in case the business restructuring is a transfer of an ongoing concern	**Transactional basis:** - Only for business restructurings which meet one of the escape clauses: 1. Value of intangibles > 25% of the transfer package 2. If proven arm's length price based on transactional basis is within the arm's length range derived on an aggregate basis **3.** The transfer involves at least one significant intangible asset **Aggregate basis:** - The standard for business restructurings (transfer package)
	Compensation for the loss of profit potential	Transfer of ongoing concern: → **Yes** - E.g. discounted cash flow method Other business restructurings: → **No** - Compensation limited to an arm's length price for individual transactions and a potential indemnification for the termination or change of an existing arrangement.	- → **Yes** - Hypothetical arm's length test - Discounted Cash Flow Method - Based on <u>profit potential</u> of both the transferor and transferee arising from the business function
	Location Savings	Location savings in the country of the transferee do **not** affect the compensation of the transferor for the business restructuring itself	By means of the hypothetical arm's length test, location savings in the country of the transferee are embedded in the compensation of the transferor located elsewhere

Chapter 5 – A fundamental analysis and possible alternatives for the current approach of the OECD

5.1 Introduction

Chapter IX of the OECD TPG can be praised for identifying important transfer pricing aspects of business restructurings. In particular, the comprehensive functional analysis can be helpful in order to examine the situation of the parties involved before and after the restructuring and to test whether the restructuring does not lack economic substance. From another perspective, Chapter IX can be criticized for accommodating, rather than targeting, the difficulty of applying the arm's length principle to business restructurings which do not occur between uncontrolled parties.[312] Under the current rules, it is unclear in what circumstances a transfer price for the business restructuring itself has to be determined on an aggregate basis.[313] Furthermore, while Chapter IX explicitly states that the transfer of profit potential itself does not give rise to a compensation, at the same time it requires that the business restructuring makes commercially sense for all the parties involved. In this sense, it is unclear whether the availability of a more favorable alternative option should affect the arm's length price for the restructuring itself.

In some business restructurings, it might be clear that the local group entity is clearly 'disadvantaged' by the business restructuring. This is to say provide that the outbound transfer of assets, functions, and risks, as well as, profit potential are transferred to the principal company, turning in this way the local group entity into a *low-risk entity*. As found in the last chapter, the German transfer pricing rules seem to nullify this effect by demanding a high compensation of the stripped German entity for the loss of profit potential. By requiring a high compensation for the loss of profit potential, the German legislator tries to tax a portion of the residual profits realized abroad. It was observed that such an approach is too far-reaching and would lack consensus among OECD member states.

The main aim of this chapter is to take a step back, and to address the underlying problem, namely why with the transfer of profit potential, also the residual profits are allocated to the principal company after the restructuring. In this respect, the allocation of profit to respectively the principal company and the local entity will be addressed in this chapter.

[312] R. Collier and J. Andrus, *Transfer Pricing and the Arm's Length Principle After BEPS*, Oxford University Press, 2017, p. 96

[313] A. Hanninen, "Transfer pricing of business restructurings from the perspective of Russian, Finnish and US tax law", 2018, p. 176

5.2 A fundamental analysis of the role of residual profits in the context of business restructurings

As explained in Chapter 2, with the implementation of the principal company structure, after the business restructuring, the residual profits of a MNE are allocated to the principal company. This section will discuss the reasons why profit potential and more particularly the residual profits are allocated to the principal company under the current system.

As stated in the OECD TPG: *'Usually in the open market, the assumption of increased risk would also be compensated by an increase in the expected return, although the actual return may or may not increase depending on the degree to which the risks are actually realized'*[314]. Economic theory confirms the correlation between risk assumption and anticipated return: the riskier an operation, the higher the profit premium of a business.[315]

However, while the correlation between risk assumption and expected returns seems to be valid, problems arise when allocating risks to different group entities. The nature of risk makes it difficult to isolate and to measure it. As argued in a recent study: "*there is no such thing as a comparable uncontrolled risk*"[316]. One might consider that the allocation of risk might be even more challenging in the case of a highly integrated global value chain such as the principal company structure (see chapter 2).

Recently, the OECD revised the guidance under BEPS Actions 8-10. Most importantly, in order to avoid based erosion and profit shifting, the BEPS reports require that risk is allocated to the party which exercises the control[317] over the risk and who has the financial capacity to assume that risk.[318] By requiring that a risk is also controlled by a group party, the OECD increased its emphasis on the interrelation between risk allocation and 'human interaction'.[319] The main reason for this revision was to avoid that risk could be simply attributed to a group entity by means of contractual terms. The implications of the new risk allocation

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[314] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2017, p. 53, par. 1.56

[315] C. Heady, The Allocation of Profits and the OECD Approach to Business Restructuring, 2010, p.14; R. Collier and J. Andrus, *Transfer Pricing and the Arm's Length Principle After BEPS*, Oxford University Press, 2017, p. 228

[316] I. Verlinden, D. Ledure and M. Dessy, "The Risky Side of Transfer Pricing: The OECD Base Erosion and Profit Shifting Reports Sharpen the Rules on Risk Allocation under the Arm's Length Standard*",Intl. Transfer Pricing J,* no. 23(2), 2016, p.114

[317] (i) "the capability to make decisions to take on/lay off/decline a risk-bearing opportunity, together with the actual performance of that decision-making function" and (ii) "the capability to make decisions on whether and how to respond to the risks associated with an opportunity, together with the actual performance of that decision-making function". See OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2017, p. 55, par. 1.61

[318] See also 4.4.1.1 of this study; for a complete overview see I. Verlinden, D. Ledure and M. Dessy, "The Risky Side of Transfer Pricing: The OECD Base Erosion and Profit Shifting Reports Sharpen the Rules on Risk Allocation under the Arm's Length Standard*",Intl. Transfer Pricing J*, no. 23(2), 2016, p.109-115

[319] I. Verlinden, D. Ledure and M. Dessy, "The Risky Side of Transfer Pricing: The OECD Base Erosion and Profit Shifting Reports Sharpen the Rules on Risk Allocation under the Arm's Length Standard*",Intl. Transfer Pricing J*, no. 23(2), 2016, p.109

rules mean for the principal company structure, that risks cannot be simply attributed to the principal company through contractual arrangements. Therefore, there has to be human interaction in the principal company, e.g. the key management powers to be able to take strategy decisions for the converted entities and also to assume the related risks[320].

As previously discussed, the transfer of risks from one group entity to the principal company, also profit potential is transferred. After the business restructuring, the stripped entity, the tested party, will receive a stable but low remuneration or routine profit based on what would be earned by third parties with similar risk levels for similar services.[321] After remunerating the affiliated companies in accordance with the arm's length principle, the residual profits, including the economic rents, are allocated to the principal company.[322] This system creates a tax incentive for taxpayers to relocate the 'control over risks' and the corresponding residual profits of the MNE to low tax jurisdictions.[323] This incentive might be even greater when there is a great chance the risk will not come to fruition.[324] Hence, it is not without reason that the risk bearing company, the principal, is often located in an advantageous tax jurisdiction such as Luxembourg, Ireland, Switzerland or Singapore.[325] By placing the principal strategically in one of those tax jurisdictions, also the residual profits of the MNE are attributed to those places which results in a lower tax burden for the MNE as a whole. In a similar vein, governments have the incentive to use taxation as an instrument to attract the principal company. In the context of the EU, this has been demonstrated in the Apple, Starbucks, and Amazon cases, where the European Commission investigated whether certain Advance Pricing Agreements (APAs) granted by respectively the Irish, Dutch, and Luxembourg governments involving a principal company structure and the allocation of residual profits, constituted a form of state aid.[326]

[320] M. Cotrut, and L. Ambagtsheer, "Business Restructurings: The Toolkit for Tacking Abusive International Tax Structures", *in* M. Cotrut, *International Tax Structure in the BEPS Era: An analysis of Anti-Abuse Measures*, Amsterdam, The Netherlands, IBFD Tax Research Series, 2015, p.207

[321] R. Tavares and J. Owens, "The intersection of EU State aid and US tax deferral: A spectacle of fireworks, smoke, and mirrors.", *Florida Tax Review*, no. 19(3), p. 181

[322]Ibid, p. 183; R. Tavares, "Multinational Firm Theory and International Tax Law: Seeking Coherence", *World Tax Journal*, no. 8(2), p. 248

[323] R. Collier and J. Andrus, *Transfer Pricing and the Arm's Length Principle After BEPS*, Oxford University Press, 2017, p. 228; R. Tavares and J. Owens, "The intersection of EU State aid and US tax deferral: A spectacle of fireworks, smoke, and mirrors.", *Florida Tax Review*, no. 19(3), p. 138

[324] R. Collier and J. Andrus, *Transfer Pricing and the Arm's Length Principle After BEPS*, Oxford University Press, 2017, p. 229

[325] L. Yoder, 'Global Services Delivered Through Principal Structures Leads to Business and Tax Efficiencies' Forbes (2012) < https://www.forbes.com/sites/lowellyoder/2012/02/01/global-services-delivered-through-principal-structures-leads-to-business-and-tax-efficiencies/#6666d35b4744> accessed 8 April 2018

[326] See R. Tavares and J. Owens, "The intersection of EU State aid and US tax deferral: A spectacle of fireworks, smoke, and mirrors.", *Florida Tax Review*, no. 19(3), p. 121-188

One might claim that the application of the principal company structure reflects the imperfection of the current system of transfer pricing.[327] While the current arm's length principle as followed by the OECD requires the attribution of risks and profits to the different group entities, the economic reality is that MNEs often operate as if they were a single economic entity (see also chapter 2).[328] In this respect, "*integrated control of risk among multiple group entities is more likely to be the rule than the exception*"[329].For that reason, it is not 'true' and not 'natural' to allocate the risks of a MNE to different group entities.[330]

In a highly integrated value chain, it can be considered that certain risks, such as entrepreneurial risks may affect many of the constituent entities of the group.[331] For instance, if an automotive company develops a vehicle on the market which does not meet the requirements of the customers, then not only the principal company will be affected by the low demand but also the distributing, manufacturing and other group entities. This is confirmed by the findings in Chapter 2, MNE's global value chains, and in particular the principal company structure, are highly integrated and fragmentized which makes it unrealistic to attribute the risks fully to the principal company.

While the OECD TPG have been criticized for left questions open, it is feasible to say that it is impossible to find a satisfying answer to the question whether local group entities should be compensated for the loss of profit potential within the current system of (residual) profit allocation.Therefore, one might consider that the problems encountered above in finding an arm's length compensation for the loss of profit potential seem to have deeper roots, namely that after the business restructuring all the residual profits are allocated to the principal company.

5.3 Possible alternatives for the current allocation of residual profits within a MNE

5.3.1 A radical solution: towards an unitary approach

The implementation of a principal company structure illustrates that different group companies belonging to a MNE are working as if they are a single global organization: operating process are implemented across the group.[332] By treating the group companies as separate and independent entities, conceptual difficulties arise. In a recent study, Chapter IX has been criticized for accommodating, rather than targeting this

[327] R. Tavares and J. Owens, "The intersection of EU State aid and US tax deferral: A spectacle of fireworks, smoke, and mirrors.", *Florida Tax Review*, no. 19(3), p. 121-188; R. Collier and J. Andrus, *Transfer Pricing and the Arm's Length Principle After BEPS*, Oxford University Press, 2017, p. 229
[328] R. Collier and J. Andrus, *Transfer Pricing and the Arm's Length Principle After BEPS*, Oxford University Press, 2017, p. 96 and 229
[329] Ibid, p. 230
[330] W. Schön, "International Tax Coordination for a Second-Best World (Part III)", World Tax J. International Tax Coordination for a Second-Best World (Part III), no. 2(3), 2009, p.243
[331] R. Collier and J. Andrus, Transfer Pricing and the Arm's Length Principle After BEPS, Oxford University Press, 2017, p. 128
[332] Ibid, p. 96

difficulty.[333] One might wonder whether a shift from the separate entity approach to a unitary approach would solve some of the current problems faced. In contrast to the separate entity approach, under the unitary entity approach, as the name suggest, the MNE group is treated for tax purposes on a consolidated basis. Consequently, transactions between entities do not have to be individually valued against the arm's length principle. Given the fact that business restructurings are more or less a bundle of transactions, this would mean that also those transactions do not have to be remunerated in accordance with the arm's length principle.[334] Moreover, '*real unitary taxation would help the task of addressing corporations as centrally coordinated entities'*[335]. Nevertheless, other problems might arise under a unitary approach, significantly, the manner in which the taxing rights should be allocated to the different tax jurisdictions where the MNE is active.

Several initiatives dealing with this issue are possible to find in literature. The most known initiative is the 'global formulary apportionment': in that case, the worldwide net income of a MNE group is allocated to its different entities based on a predetermined formula, which might include factors such as costs incurred, assets, workforce, and sales.[336] One of the main advantages of the formulary apportionment is that factors such as assets, workforce, and sales are not affected by the contractual risk shifting within the group.[337] Thus, in the case of the principal company structure, after the restructuring, the residual profits are not simply attributed to the principal company for being the primary risk taker but. However, as the arm's length principle, also the global formulary apportionment has its own weaknesses, e.g. new economic distortions.[338] Another option being considered by tax scholars is the 'destination-based cash-flow tax': based on the destination principle[339], taxation is levied on the net cash flows receipts in a jurisdiction.[340] Such a consumption-type tax system has been praised for its relative simplicity and the potential to solve certain shortcoming and efficiencies associated with the current corporate income tax system.[341] At the same time, the adoption of the destination-based cash-flow tax is conceptually so different from the current system of international taxation, that in the short-term, it is unthinkable that there would be political

[333] Ibid, p. 96
[334] See C. Heady, The Allocation of Profits and the OECD Approach to Business Restructuring, 2010, p.14
[335] M. Ylönen, "Politics of Intra-firm Trade: Corporate Price Planning and the Double Role of the Arm's Length Principle", *New Political Economy*, no.24(4), p. 451
[336] R. Collier and J. Andrus, Transfer Pricing and the Arm's Length Principle After BEPS, Oxford University Press, 2017, p. 284
[337] W. Schön, International Taxation of Risk, "*Bulletin for International Taxation*", no. 68(6/7), 2014, p. 281
[338] R. Franze, "Transfer Pricing and Distribution Arrangements: From Arm's Length to Formulary Apportionment of Income", *Intertax*, no. 33, p. 264
[339] Principle under which tax on cross-border supplies of goods or services is payable in the country of destination of the goods or in the country where the recipient of the goods or services is established
[340] R. Collier and J. Andrus, Transfer Pricing and the Arm's Length Principle After BEPS, Oxford University Press, 2017, p. 292
[341] Ibid

consensus of OECD States to shift to such an approach.[342] Therefore, we will not discuss this model into more detail.

For now, it is valuable to mention that under a unitary approach, some problematic aspects in finding an arm's length price for business restructurings do not exist as the MNE is treated as a single economic entity for tax purposes which do not require the allocation of risk and profit to its different group entities. However, it would be too short-sighted to conclude that the unitary approach would solve the current difficulties in the short-term. This would require a thorough analysis of all strengths and weaknesses, which reach further than the concept of business restructurings alone, which is not within the scope of this thesis. Moreover, as laid down in chapter 3, also in the nearby future, the arm's length principle seems to remain the predominant system for transfer pricing.

5.3.2 A revision of the residual profit allocation

Another solution would be the revision of the allocation of residual profits while respecting the arm's length principle as the predominant system for transfer pricing purposes. As found in section 5.2, given the highly integrated value chains of MNEs nowadays, it seems unrealistic to allocate all the entrepreneurial risks and corresponding residual profits to the principal company after the business restructuring. Therefore, this study explores two alternatives for the current residual profit allocation. The 'residual profit allocation system' as proposed by the Devereux Group and an extension of the profit split method as currently found in the OECD TPG.

5.3.2.1 A residual profit allocation system

A group of international tax experts referred as the Devereux group introduced a proposal for the 'residual profit allocation system'[343]. This system has been designed to reverse the effects of the principal company structure in which the primary risks and the resulting residual profits of the MNE are fully allocated to the principal or entrepreneurial company, while the low-risk entities are compensated with a low but stable profit based on what would be earned by third parties with similar risk levels.[344] As described above, currently, MNEs have the incentive to (re)locate the principal company in a low-tax jurisdiction in order to lower the tax burden of the MNE as a whole which results undesirable.

While under the current system the principal company is considered to bear all the entrepreneurial risks, the residual profit allocation system proposes an allocation of entrepreneurial risks of the MNE to the group

[342] Ibid
[343] Devereux, M. (2016, July 14). A Corporate Tax for the 21st Century. Retrieved August 8, 2018, from https://www.taxpolicycenter.org/event/corporate-tax-21st-century as described in R. Collier and J. Andrus, *Transfer Pricing and the Arm's Length Principle After BEPS*, Oxford University Press, 2017, p. 288
[344] R. Collier and J. Andrus, *Transfer Pricing and the Arm's Length Principle After BEPS*, Oxford University Press, 2017, p. 288

entity in which the sale to the customer takes place.[345] As a consequence, the residual profits are no longer fully attributed to the principal company but to the group entities which are located in the place of consumption. The advantage of such a system is that the residual profits will be allocated based on a relative immobile factor, namely the place of the consumer. Concretely, this would reverse the ability of MNEs to allocate the residual profits to the principal company in a low-tax jurisdiction.

From a practical point of view, the residual profit allocation system makes a distinction between routine and residual profits. Group entities operating in non-market jurisdictions receive a routine profit for the costs incurred based on the current transfer pricing mechanisms.[346] In order to avoid double counting, inter-company purchases of intermediate goods and services do not result in a routine profit. For example, consider a German manufacturer who incurs costs to produce a product and sells the finished product to another group entity in France, then only the German manufacturer will be entitled to receive a routine profit based on the costs incurred.

The residual profits, on the other hand, are determined by taking the revenue to third parties in a market-jurisdiction into account minus the costs of goods sold[347] and minus a share of the MNE's indirect costs which can be allocated to that country, including research and development and other general administrative costs.[348]As an outcome of the residual profit allocation system, local group entities will bear the entrepreneurial risks for the jurisdiction in which they are located and will be rewarded for it. Meaning while, group entities in non-market jurisdictions are remunerated by means of a routine profit in line with the current rules on transfer pricing.

All in all, the main advantage of such a system is that entrepreneurial risk and its underlying profit potential cannot be easily transferred to a low tax jurisdiction.[349] At the same time, in contrast to the current application of the arm's length principle, such an approach would come along with more complexity and other challenges such as the collection of tax in the market country of the consumer. Moreover, one might question whether there would be international consensus for adding a destination-element to the OECD TPG as such an element is fundamentally different from the current dominant approach: the alignment of taxation with value creation.

[345] R. Collier and J. Andrus, *Transfer Pricing and the Arm's Length Principle After BEPS*, Oxford University Press, 2017, p. 288
[346] Ibid
[347] whether or not occurred within the territory of that country
[348] R. Collier and J. Andrus, *Transfer Pricing and the Arm's Length Principle After BEPS*, Oxford University Press, 2017, p. 289
[349] Ibid

5.4.2.2 Extended use of the current Profit Split Method

Already in 1995, the transactional profit split method has been acknowledged by the OECD as one of the transfer pricing methods. Over the last years, more guidance has been issued on the application of the Profit Split Method with most recently an update in July 2018[350]. The profit split method is unique provided that it is the only two-sided transfer pricing method in the OECD TPG of 2017.[351] This means that the determination of a transfer price is based on a two-sided analysis. This is different from the other transfer pricing methods in which a one-sided or unilateral analysis has to be conducted.

Briefly and easily explained, the profit split method implies that the profit arising in a transaction is split between the group parties which contributed to that transaction. In this respect, there are two different approaches to split the combined profits, the contribution profit split and the residual profit split.[352] Similar to the proposal of the Devereux group, also the residual profit split makes a difference between routine profits and the residual profit. Based on a residual analysis, it might be possible to determine first the arm's length price or routine profit for the less complex contributions based on the common transfer pricing methods. Subsequently, the residual profit can be calculated and has to be allocated to the group entities which contributed to the transaction in question. In this regard, the division of profits under the profit split method is based on the relative contribution of each party to the value creation.[353]

> *"… arm's length parties can be assumed to split profits on the basis of their relative contributions to the creation of those profits."*[354]

One might rely on different profit splitting factors including asset-based or cost-based aspects.[355] As proposed by a recent study, in this respect a value chain analysis could be relevant for identifying the contribution of each party to a certain business activity.[356]

One of the main advantages of the profit split method relies on the fact that it provides a solution for cases where different group entities involved in a transaction make unique and valuable contributions to a

[350] OECD, *Revised Guidance on the Application of the Transactional Profit Split Method - INCLUSIVE FRAMEWORK ON BEPS: ACTIONS 10*
[351] C. Ilhan, "The Use of Value Chain Analysis in a Profit Split", *International Transfer Pricing Journal*, no. 25(4), p. 2
[352] OECD, *Revised Guidance on the Application of the Transactional Profit Split Method - INCLUSIVE FRAMEWORK ON BEPS: ACTIONS 10*, p.19-20, par. 2.149 – 2.153,
[353] Ibid; par. 2.169
[354] Ibid
[355] Ibid, p. 26-27, 2.179 – 2.183
[356] See C. Ilhan, "The Use of Value Chain Analysis in a Profit Split", *International Transfer Pricing Journal*, no. 25(4), p. 2

transactions.[357] Another strength of the profit split method is that it provides a solution for highly integrated operations, contrarily to one-sided methods which would not be appropriate. At this moment, a structure, in which both the principal company and local group entity contribute to business activity, is outside the scope of the profit split method, as found in the OECD TPG.[358] In example 8 of the annex of BEPS Action Plan 10, a situation is described in which a parent company controls the group entity which is responsible for the manufacturing process. In this case, the profit split method is rejected as the local manufacturer does not make any unique and valuable contributions in relation to the controlled transactions. Furthermore, the risks assumed by the local manufacturer are not economically significant for the business operations of the group. Therefore, a one-sided transfer pricing method has to be applied under the current framework. By applying a one-sided transfer pricing method, the local manufacturer will receive a routine profit based on what independent entities with similar risk levels would obtain. As a consequence, after remunerating the local manufacturer, the residual profits will be allocated to the parent company. As described above, this creates an incentive for MNE's to establish a principal company in a low-tax jurisdiction.

This raises the question whether the scope of the profit split method could be extended to the principal company structure. Arguments in favour of this extension can be found in the highly integrated and fragmentized character of the MNE's value chain under the principal company structure.[359] As described in Chapter 2, MNEs' global value chains are more and more integrated and fragmentized. As a result, there is a strong interdependence between group entities as value is created across the value chain. For instance, one might consider that not only employees of the principal company perform activities in the interest of the entire MNE, but also workers of low-risk distributors and manufacturers which are managed by the principal company.[360] Moreover, in terms of risks, it has been found that MNEs manage their risks as if they were integrated productive and financial entities. In this regard, also entrepreneurial risks are managed across countries and controlled within a MNE. Therefore, in the opinion of the author, given the economic interdependence and the joint management of integrated entrepreneurial risks[361], it seems inappropriate to compensate the low-risk distributors and manufacturers with a routine profit, leaving the residual profit to the principal company. As an alternative, a more flexible transfer pricing system could be developed in

[357] OECD, *Revised Guidance on the Application of the Transactional Profit Split Method - INCLUSIVE FRAMEWORK ON BEPS: ACTIONS 10*, p.19-20, par. 2.119; R. Tavares, "Multinational Firm Theory and International Tax Law: Seeking Coherence", *World Tax Journal*, no. 8(2), p. 274
[358] See example 8 of the annex in OECD, *Revised Guidance on the Application of the Transactional Profit Split Method - INCLUSIVE FRAMEWORK ON BEPS: ACTIONS 10*
[359] R. Tavares, "Multinational Firm Theory and International Tax Law: Seeking Coherence", *World Tax Journal*, no. 8(2), p. 274; R. Tavares and J. Owens, "The intersection of EU State aid and US tax deferral: A spectacle of fireworks, smoke, and mirrors.", *Florida Tax Review*, no. 19(3), p. 121-188
[360] R. Tavares, "Multinational Firm Theory and International Tax Law: Seeking Coherence", *World Tax Journal*, no. 8(2), p. 264
[361] Ibid

which the low-risk entity does no longer receive a static return but participates in the residual profit or losses as well.

The extension of the profit split for highly integrated value chains is not a new thought. In 2014, the OECD referred to the profit split method as solution for highly integrated value chains as part of a report on the challenges of taxation in the digital economy:

"Attention should therefore be devoted to the implications of this increased integration in MNEs and evaluate the need for greater reliance on value chain analysis and profit split methods".[362]

One of the main advantages of this approach is that it enables to "*identify and reward all contributions to the generation of income and avoid misallocation of profit 'residuals' to low-tax countries without adequate examination."*[363] In the context of business restructurings, the application of a profit split method would imply that also the stripped entity will participate in the residual profits after the restructuring. As a consequence, the tax incentive for MNEs to centralize their value chains in a low-tax jurisdiction will not be as strong as now. It is feasible to say that this will affect the current discussion concerning the compensation of the local group entity for the loss of profit potential. For instance, if we take the case of Germany, with the implementation of a profit split method, after the business restructuring, also the stripped entity will be entitled to a share of the residual profits. As a result, the loss of profit potential due to the restructuring is mitigated and there would be no need for the German legislator to implement strict rules regarding the compensation of the business restructuring itself which are meant to tax indirectly the residual profits 'realized' in the principal company.

While the Devereux group proposal requires a fundamental change of the current system, the profit split method has already been acknowledged by the OECD in other situations which makes it easier to implement it. Nonetheless, it is important to underline that a shift from a static to a more flexible transfer pricing system comes along with more complexity. Future research has to indicate whether such a transition is possible and feasible for the OECD and its Member States.

[362] OECD, Public Discussion Draft - addressing the challenges of the digital economy, p. 53, par. 166 16 (2014), http://www.oecd-ilibrary.org/taxation/addressing-the-tax-challenges-of-thedigital-economy_9789264218789-en

[363] R. Collier and J. Andrus, *Transfer Pricing and the Arm's Length Principle After BEPS*, Oxford University Press, 2017, p. 271

5.4 Conclusion

The following question was central in this chapter:

What improvements can be made to the OECD Transfer Pricing Guidelines in respect of business restructurings?

While the current discussion is concentrated on the arm's length compensation of the local entity for the loss of profit potential, it is feasible to say that the problems encountered above in finding an arm's length compensation for the loss of profit potential have deeper roots, namely that after the business restructuring, all the residual profits are allocated to the principal company.

As demonstrated above, under the current system, MNEs have the incentive to restructure their value chain in such a way that the primary-risk taker, the principal company, is located in a low-tax jurisdiction. After the restructuring, the residual profits of the business activity will be allocated to the principal company. Moreover, from a macro economical point of view, the advent of a principal company comes along with new business opportunities in the entry country. At the same time, at the other side of the coin, the jurisdiction in which the local group entity is located seem to be the 'loser' of the principal company structure in terms of jobs and tax revenue. While Chapter IX has been criticized for its incompleteness, it would be unrealistic to think that there would be an international consensus in respect of the compensation of the transferor for the loss of profit potential given the different interests at stake.

Following the analysis in this chapter, it seems unappropriated to allocate all the residual profits to the principal company. As clearly demonstrated in Chapter 2, principal company structures are characterized by a high level of integration and mutual dependency between group entities. For instance, it can be argued, that a worker of a local group entity contributes to the generation of value at the level of the MNE as a whole rather than that of the local group entity only. Moreover, it was found that risks in a MNE's value chain are often integrated among multiple group entities rather. For instance, in the case of the principal company structure, the MNE acts as it is a single financial entity. It would be unrealistic to conclude that all the entrepreneurial risks are borne by the principal company.

While the adoption of a unitary approach would help the issues identified above, it seems unrealistic that such a reform can be realized in the short-term. Therefore, this thesis advocates for a more flexible transfer pricing system within the current arm's length principle framework. While the local group entity under the current system receives a stable and low remuneration after the restructuring, in the opinion of this author, the low-risk entity should be entitled to a flexible return, which reflects partly the residual profits or losses of the MNE as a whole as well. One of the main arguments for such a system is that with the fragmentation of the value chain, also allocation of the residual profits should also be fragmented. In this regard, an

extension of the current profit split method could be a possible starting point. A more radical alternative would be the Devereux proposal for a residual profit allocation system.

An allocation of residual profits which more aligned with a MNE's value chain would mitigate the loss of profit potential from the perspective of the local group company and places the current discussion about the compensation of the business restructuring in another perspective. The analysis above confirms the complexity of the matter of residual profits in the context of business restructuring. Nevertheless, it can be argued that when this challenge has been overcome, taxation would be more aligned with the place of value creation. Future research has to indicate whether it is practically feasible to attribute the residual profits to the local group entities as well it comes along with more complexity.

Chapter 6 – Conclusion

The main aim of this study was to answer the following problem statement:

In the context of business restructurings, how is the arm's length compensation for the transfer of profit potential from a local group company to the principal company determined according to respectively the German transfer pricing rules and the OECD transfer pricing guidelines and what improvements can be made to the latter?

The value chain of an organization can be described as the integrated set of value activities which represent together the total value of a firm. In this day and age, MNEs have been showing their interest to optimize their global value chain in order to realize operational benefits while keeping the costs as low as possible. It is within this context that MNE's may decide to restructure their value chain. Business restructurings can be described as the modification of a MNE's value chain by relocating assets, functions, and/or risks from one entity to another.

One form of business restructurings which is commonly found in practice is the transfer of assets, functions, and risks from local group entities to one central group entity, the principal company. After such a business restructuring, the principal company will start to control the other local group entities in a certain geographic region. This structure can be understood in the light of a MNE's global strategy: business processes are organised by taking the worldwide interest of the MNE into account rather than that of its separate entities. The implementation of a principal company structure has significant implications for a MNE's value chain: business processes are more integrated and there is a higher mutual dependency between group entities. It has been found that with the increasing integration and interdependency between group entities, MNEs are able to realize synergies and economies of scale. At the same time, it emphasizes that value is created across the different entities of the MNE.

Besides operational factors, this thesis found that there is a strong tax incentive for MNEs to position the primary risk-taker, the principal company in a low-tax jurisdiction. This can be explained by the allocation of residual profits. Before the business restructuring, the local group entity, e.g. a manufacturer or distributor operating as a full-fledged entity, might have assumed the risks for the business activity itself and was entitled to receive the residual profits arising from it. After the restructuring, the local group entity will receive a low but stable remuneration based on what would be earned by third parties with similar low-risk profiles. As after the restructuring, the primary risks are now assumed by the principal company, it will be this group entity which will receive the residual profits of the business activity after remunerating the local group entities. In other words, profit potential is transferred from the local group entity to the principal company. By placing the principal company, strategically in a low-tax jurisdiction, also the residual profits

of the MNE are attributed to this place which results in a lower tax burden for the MNE as a whole. Depending on the profitability of a business activity, this can make a significant impact on the MNE's profits after tax. It has been found that from the country-perspective, it is beneficial to attract a principal company. Besides the fact that the residual profits of the MNE are allocated to this jurisdiction, the establishment of the principal company comes along with new business and employment opportunities. In order to attract principal companies, countries might have the incentive to use taxation as an instrument. In the context of the EU, this has been clearly demonstrated in the Apple, Starbucks, and Amazon cases, where the European Commission investigated whether certain Advance Pricing Agreements (APAs) concerning the residual profit attribution were considered as a form of State aid.

Given the complexity of the matter, and the conflicting interests at stake, the aim of this study was to assess to what extent the local group entity is compensated for the loss of profit potential. In this regard, a comparison has been conducted between the OECD TPG and the German transfer pricing rules. Both approaches attempt to follow the arm's length principle in which a price has to be found for the business restructuring itself which would have been agreed on by independent parties in similar circumstances. This might be very difficult as business restructurings resulting in a principal company structure are not found between uncontrolled parties.

While under German tax law, the business restructuring has to be valued on the aggregate level, the so-called transfer package, the OECD TPG seem to be in favour of a valuation at the transactional level.[364] In this regard, the guidance provided in Chapter IX of the OECD TPG, tends to provide guidance on the determination of an arm's length price at the level of the individual transactions which constitutes the business restructuring. By determining the arm's length compensation for the business restructuring itself at the transactional level, aspects as goodwill and the going-concern value are not taken into account. While the OECD TPG explicitly state that the mere loss of profit potential does not give rise to a compensation, other provisions imply that the business restructuring has to make commercial sense for the group as a whole. Nonetheless, it is feasible to say that by valuing the business restructuring at the transactional level rather than at the aggregate level, the local group entity will not be compensated for the loss of profit potential according to Chapter IX.

In contrast, the German approach introduced the hypothetical arm's length test in which a compensation for the business restructuring, on an aggregate basis, is determined by discounting the profit potential or expected future profits of the transfer package as a whole, from the perspective of both the transferor and

[364] Unless the business restructuring involves the transfer of an ongoing concern

the transferee. The arithmetic of those two prices is considered as the most adequate arm's length price for the business restructuring itself.

While the guidance of the OECD in Chapter IX has been criticized for letting certain questions open, the German approach in which the transferee's future profits are embedded in the arm's length price compensation of the transferor is considered as too far-reaching in securing the German tax base. Therefore, it is most unlikely that wide-spread support could be found for adopting the German hypothetical arm's length test in the OECD TPG. Moreover, from a conceptual point of view, the hypothetical arm's length test has been criticized for assuming that the taxpayer has access to full information and that the mean of the minimum and maximum price is by definition the price market parties would have agreed on.

At the same time, the concern of the German legislator that the German tax base would be eroded through business restructurings seems to be well-founded. It appeared that under the current system, MNE's have the incentive to relocate the control over risks and the corresponding residual profits of the MNE to a principal company located in a low tax jurisdiction. This incentive might be even greater when there is a low chance that the risk comes to fruition. With the establishment of a principal company elsewhere, after the restructuring, the residual profits will be allocated to that jurisdiction rather than to Germany. Germany, traditionally seen as a high-tax jurisdiction, seems to mitigate this incentive by demanding a high compensation or exit charge for the loss of profit potential.

Rather than targeting this problem with the introduction of more rigorous rules on the compensation of the local entity for the loss of profit potential in Chapter IX, this study advocates for a solution of the underlying problem, namely that after the restructuring, the local group entity receives merely a routine profit while all the residual profits are afterwards allocated to the principal company as primary-risk taker. Given the highly integrated and fragmented value chain of MNEs operating with a principal company, it seems unrealistic to attribute all the entrepreneurial risks and more particularly all the residual profits to the principal company. Therefore, this thesis supports the idea of a more flexible transfer pricing system in which also local group entities, who contributed to a certain value activity, participate in the residual profits arising from it. Hence, an extension of the current profit split method as already acknowledged, a two-sided transfer pricing method, might be a possible starting point while respecting the arm's length principle as leading concept. An allocation of residual profits which is more aligned with a MNE's value chain would mitigate the loss of profit potential, from the perspective of the local group company, and it would drive the current discussion in another direction. Future research should indicate whether such a solution would be feasible.

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