

Introduction to Business Restructuring

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1. Introduction

The changes in economic and social landscapes impact businesses and individuals alike. In order to adapt to fluctuations in the global marketplace, improve operational efficiency, reduce costs, and optimize financial performance, businesses would need to reorganize to create the right structure to meet some of these challenges. From an economic perspective, business restructuring can enable multinational enterprises (MNEs) to realign their operations, assets, and resources to better match changing market conditions and customer needs. The movement of functions, personnel, assets, and risks within an MNE can enhance their flexibility and agility thereby allowing them to respond more quickly and effectively to modifications in the business environment. From a financial perspective, business reorganization can help MNEs optimize their capital structure, reduce costs, and improve profitability. The economic and financial analysis would be factored in even for the purpose of a transfer pricing (TP) analysis.

Regarding TP, business restructuring can be a minefield of complexity and uncertainty. As MNEs reorganize their operations, the application and determination of the arm's length principle (ALP) can have significant tax implications. Even though the number of these types of cases was approximately only 13% of the analysed case laws in 2022,¹ the complexity and amount involved were massive.

The first OECD TP Guidelines of 1995 did not provide a specific chapter on business restructurings, however, the general guidance provided therein applied to the transactions occurring in the processes of reorganizations. However, taking into account the uncertainty surrounding the topic and the unique nature of transactions involved, the OECD worked on the aspects of business restructurings for several years and published a discussion draft on 19 September 2008.² This work and its subsequent inclusion in the OECD TP Guidelines 2010 reiterated the need for applying the ALP equally to transactions involving business restructuring. In the aftermath of the OECD's Base Erosion and Profit Shifting Project (BEPS) in which the focal point was aligning TP outcomes with value creation, the guidance on Chapter IX was further elaborated. Under the UN Transfer Pricing Manual,³ the chapter on business restructuring was added only in 2017 even though the topic's definition had existed since the first edition was published in 2013.⁴ Moreover,

- 1 A. Padwalkar, M.B. Moura & R. Mirembé, *The Transfer Pricing World in 2022*, TPI 6 (Dec. 2022).
- 2 OECD, *Transfer Pricing Aspects of Business Restructuring: Discussion Draft for Public Comment* (Sept. 2008), available at <https://www.oecd.org/tax/transfer-pricing/41346644.pdf>.
- 3 United Nations Practical Manual on Transfer Pricing for Developing Countries 2021 (United Nations Practical Manual on Transfer Pricing for Developing Countries, United Nations 2021) [hereinafter UN TPM], available at <https://www.un.org/development/desa/financing/sites/www.un.org.development.desa.financing/files/2021-10/Transfer%20Pricing%20with%20new%20cover.pdf>.
- 4 United Nations Practical Manual on Transfer Pricing for Developing Countries (United Nations 2013), available at https://www.un.org/development/desa/financing/sites/www.un.org.development.desa.financing/files/2020-03/UN_Manual_TransferPricing.pdf.

various jurisdictions have local legislation on the TP aspects of business restructuring whereas some others directly or indirectly refer to the OECD TP Guidelines for specific guidance.⁵ Even with all of the relevant guidance, the unique nature of these transactions makes the application and determination of the ALP challenging. Furthermore, the tax authorities are increasingly scrutinizing these transactions, and the documentation requirements to support them are becoming even more stringent.

Given the importance and relevance of the topic, the objective of this introductory chapter is to equip the reader with a broad understanding of the topic through examples and case laws and to briefly discuss a number of the potential issues that could arise. Further details on specific issues will be discussed elaborately in the other chapters as follows:

- Chapter 1: Delineating and recognizing business restructuring
- Chapter 2: Remunerating the restructuring itself
- Chapter 3: Remunerating the post-restructuring
- Chapter 4: Other relevant issues

2. What is business restructuring?

Restructuring is the act of organizing a company, business, or system in a new way in order to make it operate more effectively.⁶ It refers to a fundamental change that alters the relationship within a company or with other companies⁷ and occurs when a company significantly alters its financial or operational structure.⁸ Selling business units or making acquisitions, modifying the capital structure by injecting substantial levels of debt, altering the internal structure of the company, changes in functionality, and corporate reconfiguration would generally fall under the umbrella of business restructuring. Depending on the nature of the business activity and the economic conditions surrounding it, the justification for an MNE to undergo it may vary. Factors such as changes in the competitive landscape, shifts in customer demand, technological advancements or financial challenges could be possible stimulators. The rationale behind any business

5 E.g. under German tax law, cross-border business restructurings are referred to as “relocations of functions” (*Funktionsverlagerungen*). Similarly, in India, Finance Act, 2012 has categorically provided an inclusion of transactions relating to business restructuring or reorganization within the purview of the international transactions irrespective of the fact that it has a bearing on the profit, income, losses, or assets of such an MNE at the time of the transaction or at any future date. In the Netherlands, Dutch tax law does not contain specific transfer pricing rules relating to business restructuring. However, in the 2022 Decree, reference is made to them and to the guidance included in Chapter IX of the OECD Guidelines that is applied by the tax authorities in practice.

6 Cambridge online dictionary.

7 The Law Dictionary, available at <https://thelawdictionary.org/restructuring/>.

8 W.F. Cascio, Corporate Restructuring, in Oxford Research Encyclopedia of Business and Management (Oxford University Press 22 Dec. 2021), available at 10.1093/acrefore/9780190224851.013.348 (accessed 25 Feb. 2023).

restructuring decision entails improving operational or financing structure, transforming the business into one of higher value, or surviving when an MNE's business structure becomes dysfunctional.⁹ To achieve this, MNEs may streamline their operations, reduce costs, expand into new markets, or pursue new business opportunities. Thus, the term restructuring would encompass a wide range of activities undertaken by businesses, and the same would depend on the business facing specific circumstances coupled with their strategic goals and objectives.

2.1. Definition – OECD and UN

Since the ALP applies only between associated enterprises, the scope and understanding of business restructuring under the TP regulations differ from what is commonly understood in a broader business context. Like any other intra-group transaction, TP rules apply when MNEs modify their value chain thereby giving rise to changes in functions, assets, or risks across borders. Thus, under the TP regulations, business restructuring refers to the cross-border redeployment of functions, assets, or risks within an MNE.¹⁰

Since intra-group business restructuring could encompass a wide range of activities, the OECD TPG and the UN Manual acknowledge that there is no legal or universally accepted definition of the term.¹¹ However, the cross-border reorganization of the commercial or financial relations between associated enterprises, including the termination or substantial renegotiation of existing arrangements, could instigate business restructuring according to Chapter IX of the OECD TPG.¹² On the other hand, Chapter 8 of the UN TPM defines it as the cross-border redeployment of functions, assets, and risks to which a profit/loss potential may be attached including the transfer of the ownership and management of intangibles.¹³ A combined reading of these two definitions makes it clear that business restructuring involves not just a bare transfer of assets but also the delegation of a business activity coupled with a relocation of profit/loss potential among an MNE's members.¹⁴

2.2. Types of business restructuring

Broadly speaking, MNEs often rely on two types of models to carry out their business activities, i.e. a centralized and a decentralized business model. MNEs relying

9 R.L. Crum & I. Goldberg, *Restructuring and Managing the Enterprise in Transition* (The World Bank Aug. 1998), available at 10.1596/0-8213-3658-4.

10 J. Monsenego, *Introduction to Transfer Pricing* ch. 4 (2nd ed., Wolters Kluwer 2023).

11 OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022* (hereinafter OECD TPG) ch. 9 (OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, OECD 20 Jan. 2022), available at 10.1787/0e655865-en, Paragraph 9.1.

12 *Id.*

13 Paragraphs 8.1.1.2 and 8.1.1.3, UN TPM.

14 Monsenego, *supra* n. 10, at ch. 4.

on the former consolidate their core business activities and decision making at the top of the organizational structure.¹⁵ Thus, the centralization of management and core business activities makes it easier for these MNEs to coordinate the pool of resources and benefit from economies of scale. It also streamlines the implementation of common business strategies and may simplify entering into new markets.¹⁶ On the other hand, under the latter, the value creating functions relating to strategy and control are dispersed among various entities within the MNE.¹⁷ These MNEs transfer core business operations to various entities in the group thereby diversifying risks and taking advantage of local management.

To optimize their business potential and maximize profits, MNEs modify their business models. From a TP perspective, changes to these and to their value chains may effectuate business restructuring. Following are some of the common changes undertaken by MNEs to either centralize or decentralize their business operations:¹⁸

- Conversion of full-fledged distributors into limited-risk distributors or commissionaires;
- conversion of full-fledged manufacturers into contract manufacturers or toll manufacturers;
- transfer of intangibles to a central entity, i.e. IP company;
- centralization of functions in a regional or central entity with a corresponding reduction in scope or scale of functions carried out locally;
- allocation of intangibles or risks to operational-related parties; and
- specialization of de-specialization of specific operations including downsizing or closing operations.

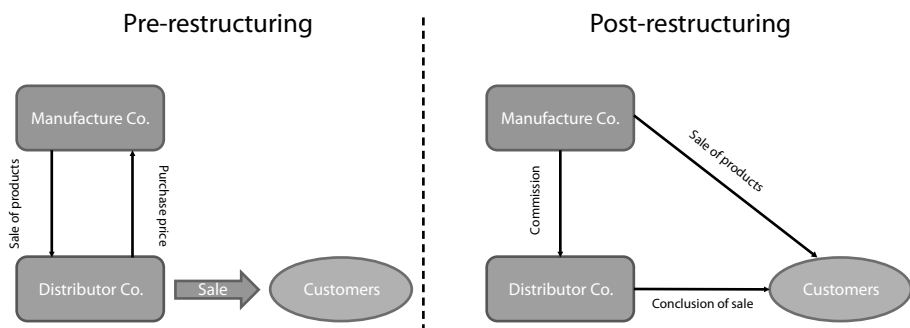


Figure 1: Conversion of full-fledged distributor to commissionaire

15 R.M. Marsh, A Research Note: Centralization of Decision-Making in Japanese Factories, 13 *Organization Studies* 2 (1992).

16 S. Almling & Å. Edesten, Centralized and Decentralized Business Models in a Post-Base Erosion and Profit Shifting World, 44 *Intertax Issue* 10 (1 Oct. 2016), available at 10.54648/TAXI2016066.

17 *Id.*

18 Paragraph 9.2, OECD TPG and Paragraph 8.2.1.1, UN TPM.

Business restructuring may also involve the termination or substantial renegotiation of existing arrangements. The instances listed above affectively result in operational changes, however, not all organizational and structural changes would result in a business restructuring from a TP perspective. Additionally, they may, either positively or negatively, affect the MNE's profit potential, therefore, it is important that there is a relocation of profit potential among members of the MNE.

3. Assessment of the arm's length nature of business restructuring

The ALP applies no differently to restructuring or post-restructuring transactions than to those that were structured as such from the beginning.¹⁹ This means that the four steps of any TP analysis consisting of (i) accurate delineation of the transaction, (ii) recognition of the transaction, (iii) selection of the most appropriate TP method, and (iv) application of the method would apply equally when determining the arm's length compensation for restructuring and post-restructuring transactions.²⁰ In the context of business restructuring, the specificities of accurate delineation would involve the assessment of the following:²¹

- Changes to contractual arrangements arising from the restructuring;
- analysis of functions performed, assets used, and risks assumed pre-restructuring and post-restructuring;
- changes to characteristics of property and services due to the restructuring;
- economic circumstances of the parties and of the market in which the related parties operate; and
- business strategies of the related parties pursuant to the restructurings.

This chapter will discuss some of these elements, however, kindly refer to the specific chapters for a detailed analysis.

3.1. Changes to contractual terms

An analysis of the written contract functions as a commencement for any TP analysis. Contractual terms reflect the intention of the parties at the time the contract was concluded and provide the division of responsibilities, rights and obligations, assumption of identified risks, and pricing arrangements.²² Changes to the function and risk profiles would usually be reflected in the contracts entered into between parties, and the same may give rise to business restructuring. How-

19 Paragraph 9.9, OECD TPG.

20 Fundamentals of Transfer Pricing: General Topics and Specific Transactions (R. Petruzzi et al. eds., Wolters Kluwer 2021) [hereinafter Fundamentals of Transfer Pricing].

21 *Id.*, at ch. 13.

22 Paragraph 1.42, OECD TPG.

ever, contractual terms are simply incipient to a TP analysis. There could be situations in which some of the terms are ambiguous or are simply missing from a contract. The “real deal” of the transaction could be scrutinized further by analysing the factual circumstances and the conduct of the parties.

3.1.1. Termination or substantial renegotiation of contracts

Terminations and substantial renegotiations of contractual arrangements generally involve changes in the risk and functional profiles of the parties accompanied by the allocation of profit potential.²³ This may feasibly lead one of the parties to the transaction to incur the costs relating to write-offs, termination of contracts, reconversion costs, and other costs or loss of profit potential. It must be assessed whether any indemnification is due to the parties suffering such costs because of the termination or substantial renegotiation. Various aspects would need to be considered in order to determine whether any arm’s length indemnification is due to any party to the transaction. First, it must be assessed whether the commercial law of the restructured entity jurisdiction supports the right to indemnification. The legal provisions and jurisprudence would help to determine the terms and conditions under which this could be expected in the event of termination or substantial renegotiation. The party experiencing this has a right to seek indemnification even if the same is not provided in the contract. However, it is unlikely that the entities belonging to the same group will litigate in court against each other for indemnification, and the conditions for it may differ from those that would be made between independent enterprises in similar circumstances.

Second, it needs to be verified whether an indemnification clause is part of the contract. Its existence (or non-existence) would help to determine the conditions governing it. However, in the absence of such a clause, its existence or non-existence should be determined by the parties’ conduct. Using comparable data, it also has to be assessed whether the conditions of indemnification are at arm’s length. Finally, it needs to be evaluated which party shall bear the costs related to it. Such an analysis should be made taking into account all of the relevant facts and circumstances and the options available to the parties. Consider a situation wherein A Co. provides certain IT related services under a long term contract to its associated enterprise, B Co., in another jurisdiction. The contract between A Co. and B Co. is terminated. A similar contract is entered into between B Co. and another associated enterprise, C Co., which provides the IT services. Depending on the terms of the contract and the domestic legislation, A Co. would be eligible for a compensation for termination of the contract. Accurate delineation of the transaction would help to identify whether this is payable by B Co. for terminating the

²³ *Id.* at Paragraph 9.76.

contract or by C Co. as a pay-in for having the opportunity to enter into the contract with B Co.

In the case of *Fortis Petroleum Norway AS (FPN)*,²⁴ its parent, Fortis Petroleum Company AS (FPC), entered into a framework agreement with an associated enterprise Consema wherein the latter agreed to provide integrated administrative services to FPC and its subsidiaries (including FPN). The agreement was for a period of three years and could be renewed for a further three years by mutual agreement. After a period of two years, a termination agreement was entered into between Consema and FPC, and a substantial termination fee was paid by FPN and FPC for which the tax authorities denied the deduction of it. The Norwegian Court of Appeal held that, under private law, the deduction can only be claimed by the person entering into a contract. FPN was neither a party to the framework agreement nor the termination agreement. Moreover, there was no agreement on rebilling from FPC to FPN and no evidence explaining this. The court further held that the transaction itself was commercially irrational as FPC and FPN did not have the capacity to finance the framework agreement.

3.2. Changes in functions, assets, and risks

Business restructuring would generally involve changes in the functions performed, assets used, and risks assumed between the parties.²⁵ However, a mere change in these would not necessarily effectuate business restructuring under arm's length. For an arm's length analysis, there has to be a transfer of something of value or profit potential along with the change in the functional profile. Consider a situation whereby a company, A Co., manufactures electrical appliances. It purchases the raw material, manufactures the appliances, and sells them to related party distributors. A Co. also performs research and development (R&D) and possesses unique intangibles that it uses to manufacture its products. Thus, A Co. has a function and risk profile of a full-fledged manufacturer. Pursuant to a business restructuring, it is converted to a contract manufacturer and performs its activities with substantially low function and risk profile. Following are the changes in the functions, assets, and risks of A Co.:

24 NW: Borgarting Court of Appeal, 25 March 2022, Case No. LB-2021-26379, *Fortis Petroleum Norway AS v. Skatteetaten*.

25 Fundamentals of transfer pricing, supra n. 20, at ch. 13.