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**TRANSFER PRICING & BUSINESS RESTRUCTURINGS—  
INTANGIBLES  
SYNERGIES AND SHELTERS**

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# TRANSFER PRICING & BUSINESS RESTRUCTURINGS – INTANGIBLES SYNERGIES AND SHELTERS

Richard T. Ainsworth & Andrew B. Shact

## Introduction

Transfer pricing in business restructuring is attracting global attention. In the past two years two key policy making groups have released three substantive documents on this topic. The Organization of Economic Cooperation and Development (OECD) issued two position statements while the Joint Committee on Taxation (JCT) issued one. While restructurings are a very common commercial practice,<sup>1</sup> until recently it has been uncommon to apply transfer pricing criteria when examining them in detail.

## OECD v. JCT Perspective

Although differing in apparent focus, the OECD and the JCT documents fit well together. They approach the same problem from different directions. Where the OECD is concerned that a *restructured entity*, commonly a manufacturing or a distribution subsidiary, is adequately compensated for the assets, risks, and functions transferred to related parties the JCT is concerned about a *domestic parent entity* reducing its taxable income after a restructuring. The argument presented in this paper is that there are critical aspects to multinational enterprise (MNEs) restructuring that the OECD misses because its focus is too narrow. The JCT's assessment provides an important balance to the OECD's perspective but misses some of the same points.

## OECD and JCT

Essentially, the OECD has overlooked that a unique and valuable intangible is *created* during the restructuring process. By not acknowledging this intangible in the mix, the OECD fails to see the whole picture. In addition, the OECD is overly fixed on the MNE shifting profits when the truth is that most restructurings result in no net improvement in productivity. In fact, many restructurings cause financial harm, including reductions in net enterprise value.

The JCT has the same blind spot. Even though the JCT is far more focused on intangible assets, it too overlooks the restructuring's *intangible asset creating* function because it is primarily concerned with identifying profits that are shifted from its taxing jurisdiction via the restructuring. The critical point that both the OECD and JCT fail to understand is that a restructuring's core activity is not *asset movement*; it is fundamentally changing the enterprise's *decision-making*.<sup>2</sup>

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<sup>1</sup> Restructurings are the norm, not the exception for MNEs. In fact, "... nearly half of all CEOs launch a reorg[anization] during their first two years on the job ..." Marcia W. Blenko, Michael C. Mankins & Paul Rogers, *The Decision-Driven Organization*, HARVARD BUSINESS REVIEW 56 (June 2010).

<sup>2</sup> Assuming that a restructuring is about structures not decisions is a common misunderstanding. Blenko, Mankins & Rogers further indicate, *Id.*, at 56:

Many CEOs assume that organizational structure, the boxes and lines on a company's organizational chart – is a key determinant of financial performance. ... We believe that this

## **Restructuring v. Tax Motivated Transaction**

During a restructuring, critical decision-making changes coalesce within the MNEs parent company. They almost always directly result from a CEO's personal engagement with enterprise-wide performance objectives. These objectives center on the endless corporate search for more and deeper profit-enhancing synergies. When this CEO commitment is in play, an intangible is created and a new decision-matrix is visible to anyone in the enterprise.

A primarily tax motivated transaction may be in play when the CEO's involvement and commitment are missing or when assets, risks and functions are moved independently from a central business purpose / new decision-matrix. In these restructurings it is often the tax department or an external tax advisor who plays the dominant role. The CEO's involvement is peripheral and there is doubt as to whether the structural changes reflect real changes in the way business is done.

### **Part II of Chapter IX Guidelines**

This paper largely follows the OECD argument in Part II – *Arm's length compensation for the restructuring itself* within Chapter IX of the OECD's *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (the *Guidelines*). The OECD's work in this area represents a multi-year dialogue among governments and with business and represents a consensus. It is a consensus that misses something important.

### **Article Outline**

There are six parts to this paper: (1) a short introduction (2) a summary regarding the shortcomings in the OECD and JCT approaches to business restructurings, (3) the main argument, part (4) concrete examples involving two very different business restructurings in Xerox, (5) how the OECD's position developed between the *Discussion Draft* and Chapter IX, and (6) a short concluding section that contrast the JCT approach to the same issues.

### **(1) Introduction**

On July 22, 2010 the OECD's Committee on Fiscal Affairs (CFA) amended the *Guidelines* by adding a new chapter on the *Transfer Pricing Aspects of Business Restructurings* (Chapter IX).<sup>3</sup> The OECD approaches transfer pricing in business restructuring with a wide-angle lens that is narrowed to the entity level. It is concerned with risk transfers, the restructuring itself, post-restructuring transactions and tax treatments associated with the actual transactions undertaken. *All* cross-border business restructurings are swept up in this analysis.

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failure [in reorganizations – a reference to their own empirical work that “most reorganizations fall flat”] is rooted in a profound misunderstanding about the link between structure and performance. Contrary to popular belief, performance is not determined solely by the nature, scale, and disposition of resources, important though they may be. An army's success depends at least as much on the quality of the decisions its officers and soldiers make and execute on the ground as it does on actual fighting power. A corporation's structure, similarly, will produce better performance if and only if it improves the organization's ability to make key decisions better and faster than competitors.

<sup>3</sup> OECD, *Report on the Transfer Pricing Aspects of Business Restructurings – Chapter IX of the Transfer Pricing Guidelines* (July 22, 2010) available at: <http://www.oecd.org/dataoecd/22/54/45690216.pdf> (at the same time the OECD revise Chapters I-III of the *Guidelines*).

This article's intent is to consider Part II *Arm's length compensation for the restructuring itself* in detail but not the other three parts.<sup>4</sup>

### Timing

Just two days prior to the OECD releasing Chapter IX, the JCT published a companion study on the same topic.<sup>5</sup> Rather than looking at *all* restructurings, the JCT only considers *tax abusive* restructurings. There are six case studies involving US-based MNEs that undergo a restructuring that reduces the US income tax base. The JCT does not, however, consider all the transfer pricing issues involved in the restructuring process. Unlike the OECD, the JCT does not consider the transfer pricing aspects inherent in the restructuring itself nor does it isolate risk transfers or consider non-recognition treatments. The JCT offers no solutions, although solutions can be inferred. Its direct focus is the problems and the tax losses that result from these restructurings. Its major concern is intangible asset transfers.

### Link between OECD and JCT Timing

The JCT study was prepared for hearings before the House Ways and Means Committee. It was drafted before Chapter IX was released but the JCT was not acting fully independently. The OECD is always in the background. The JCT specifically references the earlier OECD documents and activities, notably the 2008 *Discussion Draft on Transfer Pricing Aspects of Business Restructurings (Discussion Draft)*<sup>6</sup> and the 2005 OECD Roundtable on Business Restructurings.<sup>7</sup> Thus, a clear line is drawn from the 2005 Roundtable, through the 2008 *Discussion Draft*, and onward through the near simultaneous release of the JCT study and Chapter IX.

### (2) Shortfalls

Chapter IX misses its mark, not because it misstates the problem but because it overstates its accomplishments. Chapter IX is supposed to set out the way transfer pricing applies in *all business restructurings* but in fact it casts a much narrower net. For example Chapter IX has a very limited discussion and no examples on how to handle restructuring losses; particularly at the group level. Given that most restructurings fail in their effort to improve fiscal performance,<sup>8</sup>

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<sup>4</sup> There is not enough space in this paper to consider the other three Chapter IX parts in detail: Part I – *Special considerations for risks*; Part III – *Remuneration of post-restructuring controlled transactions*; and Part IV – *Recognition of the actual transactions undertaken*.

<sup>5</sup> Joint Committee on Taxation, *Present Law and Background related to Possible Income Shifting and Transfer Pricing*, JCX-37-10 (July 20, 2010), available at: <http://www.jct.gov/publications.html?func=startdown&id=3692>

<sup>6</sup> OECD, *Transfer Pricing Aspects of Business Restructurings: Discussion Draft for Public Comment – 19 September 2008 to 19 February 2009* (Sept. 19, 2008) available at: <http://www.oecd.org/dataoecd/59/40/41346644.pdf> (hereinafter *Discussion Draft*).

<sup>7</sup> OECD, *Second Annual Center for Tax Policy and Administration Roundtable: Business Restructurings* (Roundtable, summary) (it was a project that began soon after the January 2005 OECD Center for Tax Policy and Administration (CTPA) roundtable that first brought this topic to light) available at: [http://www.oecd.org/document/20/0,3343,en\\_2649\\_37989760\\_34535252\\_1\\_1\\_1\\_1.00.html](http://www.oecd.org/document/20/0,3343,en_2649_37989760_34535252_1_1_1_1.00.html)

<sup>8</sup> Marcia W. Blenko, Michael C. Mankins & Paul Rogers, *The Decision-Driven Organization*, HARVARD BUSINESS REVIEW 56 (June 2010). See also: Marcia W. Blenko, Michael C. Mankins & Paul Rogers, *DECIDE AND DELIVER – 5 STEPS TO BREAKTHROUGH PERFORMANCE IN YOUR ORGANIZATION* (2010). Blenko, Mankins and Rogers performed empirical studies indicating that that *most* business restructurings have "... no effect – and some actually destroy value [and that] ... fewer than one-third [of all business restructurings] produce any meaningful improvement in performance." The studies themselves are examined in the book. Blenko, Mankins and Rogers

one would expect Chapter IX to consider in some detail those restructurings that fall short and not focus so fully on restructurings that achieve anticipated results. Losses do not seem to interest the OECD.

### **What is missing in the OECD Assessment?**

Something even more fundamental is missing in the OECD assessment. It fails to consider changes in MNE decision-making. Successful restructurings are predominantly about decision-making. Functions, risks, and assets are moved among related parties *to support* changes in the decision matrix rather than *independent* from them.<sup>9</sup> Chapter IX looks in great detail at a restructuring's secondary effects (moving functions, risks, and assets) at an entity level, but it avoids the core matter – what is the tax impact the new decision structures have on the MNE as a whole.

### **Decision Making**

A restructuring does not make a *meaningful change in a MNE's economic position* without making changes in the way decisions are carried out.<sup>10</sup> For example, consider a restructuring that involves shutting down national call centers, eliminating local sales teams and moving assets and functions to a single internet-based regional facility. Changing the internal management hierarchy and re-tooling the decision-making processes will unquestionably be the most demanding aspect in this restructuring. Having sales calls re-routed to a new facility is the easy part as is securing a new facility and closing down the old ones. Getting the decision-making wrong, however, will most likely doom the restructuring.<sup>11</sup> The OECD unfortunately ignores this element in the restructuring dynamic.

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further indicate that fiscal performance (profit/loss) is far more closely associated with the way business decisions are made than it is with the way a MNE is structured. At 57 in *The Decision-Driven Organization* they indicate:

“Our research and experience confirm the tight link between [fiscal] performance and [enterprise] decisions. In 2008, we ... surveyed executives worldwide from 760 companies, most with revenues exceeding \$1 billion, to understand how effective those companies were at making and executing decisions. ... We found that decision effectiveness correlated at a 95% confidence level or higher for every country, industry, and company size in our sample. Indeed, the companies in our sample that were the most effective in decision making and execution generated average total shareholder returns nearly six percentage points higher than those of other firms. ... What's more, the research revealed no strong statistical relationship between structure and performance.”

<sup>9</sup> Jeffrey A. Oxman & Brian D. Smith, *The Limits of Structural Change*, MIT SLOAN MANAGEMENT REVIEW 77 (Fall 2003) (discussing the shortcomings of restructurings focused on structural change alone).

<sup>10</sup> The tax impact of “significant people functions” is becoming increasingly important in determining income allocations to a permanent establishment (Articles 7 and 9 of the OECD Model Treaty). In the financial services industry the companion concept is “key entrepreneurial risk-taking functions.” By moving these functions profit shifts among entities. See: Danny Oosterhoff, *The True Importance of Significant People Functions*, INTERNATIONAL TRANSFER PRICING JOURNAL 68 (March/April 2008).

<sup>11</sup> This is a common topic in business education. One classic case study involving making fundamental changes in a decision structure within a company-wide restructuring is the British Petroleum restructuring under Lord John Browne (Tony Hayward's predecessor). The process for making this kind of change has been explored at the executive and operational level and in an on-going leadership-training program (the X-Teams). See: Steven E. Prokesch, *Unleashing the Power of Learning: An Interview with British Petroleum's John Browne*, HARVARD BUSINESS REVIEW 1 (September/October 1997); Howard Gardner & Loren Gary, *Changing Minds, Strategy & Innovation – Harvard Business Review Newsletter* 1 (May/June 2004); Deborah Ancona & Henrik Bresman, *Crafting an Infrastructure for Innovation: The X-Team Program* Chapter 8 in X-TEAMS: HOW TO BUILD TEAMS THAT LEAD, INNOVATE AND SUCCEED (2008).

### The JCT Case Studies

The JCT's study has a different limitation. Although the JCT uses real data from specific yet unidentified MNEs from public (annual reports) and private (tax returns) sources, the cases were not randomly selected nor were they intended to be representative.<sup>12</sup> Filters used to focus on MNEs that engaged in an *abusive restructuring*.

To be included, a company had to publicly report an effective tax rate on worldwide income that was less than 25%. Additionally, significant US GAAP basis income needed to be earned offshore in low tax jurisdictions, the taxpayer had to indicate that foreign earnings were permanently reinvested overseas, that US income as a percent of world-wide income needed to be lower than US sales as a percent of world-wide sales, and a major income source for the MNE needed to be exploiting US developed intangible property rights overseas.<sup>13</sup> The JCT does not represent that it has a balanced representation for all business restructurings. It does suggest that it can distill some abusive restructurings elements.

### (3) The Argument

What's missing from both the OECD and JCT analyses is recognition that the restructuring itself *creates* a unique intangible asset that is entitled to a rate of return equal to the net present value for the *synergistic gains* (if any) accruing to the MNE (as a whole) from the restructuring. These gains are distinguishable from any inherent *profit potential* embedded in transferred functions, assets, or risks for which compensation is due at the time they are transferred among related parties in a restructuring. The intangible is located at the head office.

### Telecom Restructuring Example

For example, assume a telecommunications MNE has both a traditional land-line and mobile communications firm A (in country A) and a cloud computing firm B (in country B). Both businesses have large server farms but the traditional business's farm is underutilized by half while the cloud computing business' farm is operating at maximum capacity and needs more server time. Three options are considered: (1) firm A could simply lease excess computing time to firm B at an arm's length price; (2) firm B could build-out additional capacity over the next two years; and (3) all computing capacity could be transferred to a new firm (firm C in country C) that would lease back capacity to firms A and B as needed. Firm C is then free to build-out capacity, maybe in a fourth country, if and when it is needed.

### Synergies

Assume additionally that the CEO believes that if server usage *decisions* are centralized, then efficiencies and natural synergies will develop<sup>14</sup> so a dedicated computing subsidiary (firm

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<sup>12</sup> Two JCT case studies involve consumer products (Alpha and Foxtrot); two involve technology-based consumer products (Delta and Echo); one involves industrial products (Charlie); and the sixth involves technology products and services (Bravo).

<sup>13</sup> Thomas A. Barthold, *Ways and Means Hearing on Possible Income Shifting and Transfer Pricing* 3 powerpoint slides (July 22, 2010), available at:

[http://waysandmeans.house.gov/media/pdf/111/2010Jul22\\_JCT\\_Powerpoint.pdf](http://waysandmeans.house.gov/media/pdf/111/2010Jul22_JCT_Powerpoint.pdf).

<sup>14</sup> It is important to note that option (3) is no more than the combination of options (1) and (2). However, the CEO believes that there is more to be gained in option (3), because the whole is more than the sum of its parts. There is a cost to selecting option (3) that is more than the sum of the costs in options (1) and (2), but there are also savings – elimination of positions, duplications of functions – that are not present in options (1) and (2). Unless the MNE was

C) is established. C's first rate, business savvy technology staff is assembled from the best employees currently working at firms A and B.

### **Synergy Results**

When the restructuring is implemented, all server farms are transferred to firm C. This occurs without equipment physically leaving country A and B. Farm management is consolidated (streamlined), and computing time is leased back to firms A and B at an arm's length price. The MNE's profits surge. The surge is attributable primarily to *synergies* – new products, new business opportunities, and adopting more efficient processes.

### **Transfer Pricing Issues**

The transfer pricing issues in this hypothetical are relatively simple. Server time is a commodity and an arm's length price is easily determined. *Profit potential* attributable to unused server capacity is transferred from firm A to C.

### **Synergies**

Synergy gains are not attributable to the server farm assets. Synergy gains are attributable to the executive vision and its implementation. Synergy gains result from (a) the new management structure and centralized decision-making, (b) the technology's quality and management / decision-makers selected, (c) the decision-makers ability implement their plans to motivate the workforce, and most importantly to (d) the CEO's insight or ability to anticipate how these pieces will fit together. Thus, firm C should achieve a normal rate of return as a server farm proprietor engaged in leasing computing time. Firms A and B should see an increase in profits, based on higher sales and lower operating costs. Extraordinary synergy gains, however, are attributable to the parent (firm X) and should be reflected in a royalty.

### **Symmetry**

In effect, the restructuring is an inward-looking R&D effort. Synergy gains produce a royalty to the parent (firm X). If, however, the CEO's insight is mistaken, the restructuring has no effect, or worse, integrating firms A and B's server farms produces a dysfunctional business unit (firm C), then the parent (firm X) will bear the cost attributable to this failure. This treatment is fully symmetrical. Firm X (the parent) is responsible for the restructuring, directing its implementation, and empowering its officers and entities to engage in the restructuring process. Firm X has accepted the restructuring risks so the synergy gains are fully attributable to it.

## **(4) Business Restructuring at Xerox** *Mulcahy and Thoman*

A close look at two Xerox restructurings helps to further illustrate the points made above. Anne Mulcahy's restructuring in 2001 and Richard Thoman's restructuring in 1999 are contrasted.

### **Pre-Restructuring**

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exceptionally inefficient, it is unlikely that these "linear efficiencies of scale" would be sufficient to make option (3) the CEO's choice. The key to a restructuring is that the CEO sees something more – business synergies are anticipated that will multiply profitability and dramatically accelerate performance.

Until the Federal Trade Commission in 1975 forced Xerox to license its technology to competitors, it enjoyed a near monopoly position in the plain-paper copier market.<sup>15</sup> During this time it developed an obsession with quality and was the first company to win the quality triple crown: the Deming prize in Japan in 1980, the Baldrige award in the US in 1989, and the European Foundation for Quality award in Europe in 1992.<sup>16</sup>

### History

Xerox, however, was unprepared for price competition and successive CEOs began restructuring as it lost market share. David Kearns restructured the company twice in the 1980's<sup>17</sup> while his successor Paul Allaire<sup>18</sup> arrived in 1992 and restructured four more times.<sup>19</sup> Richard Thoman was brought in from IBM in 1999 and began the seventh restructuring. Mulcahy replaced him in 13 months and restructured yet again.

Mulcahy's 2001 restructuring created an extremely valuable intangible and the company realized significant synergy gains. Mulcahy was highly focused on improving the way Xerox made decisions. The Thoman restructuring in 1999 was a very different matter. It focused on structural rather than decisional change. It tried to *copy* rather than *create* a unique intangible. Thoman's restructuring was in large measure about asset relocation. Bottom line improvements were forecast based on synergy gains and tax benefits that never materialized.

### Mulcahy

Xerox's 2001 restructuring was a success but it did not come overnight. It took seven years before the restructuring synergies took hold.<sup>20</sup> When Anne Mulcahy replaced Thoman in 2001, Xerox was close to bankruptcy<sup>21</sup> and under an SEC investigation. Share prices were in freefall. The stock dropped from \$65 in 1999 to \$27 when Mulcahy took over as COO and fell further to a \$4.44 low when she became CEO.

Mulcahy's restructuring was *decision-driven* not *structure-driven*. She began by examining every critical decision Xerox needed to make and execute to fend off bankruptcy. Decisions were carefully assessed, clearly articulated, and efficiently executed. She raised

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<sup>15</sup> Bill George, *Anne Mulcahy: Leading Xerox through the Perfect Storm (A)* 2 (HBS No. 5-405-050) (Jan. 26, 2005) (indicating that by 1970 Xerox held a 90% share of the market with gross margins on key products ranging from 70% to 80%).

<sup>16</sup> David E. Hussey, STRATEGIC MANAGEMENT – FROM THEORY TO IMPLEMENTATION, 671 (1988).

<sup>17</sup> In 1982 David Kearns became CEO and in 1983 he led a restructuring effort based on quality benchmarks, and Japanese manufacturing methods. In 1988 he led a second effort whereby Xerox underwent a \$275 million restructuring that also cut 2,000 jobs.

<sup>18</sup> Bill George, *Anne Mulcahy: Leading Xerox through the Perfect Storm (A) and (B)* (Teaching Note) (HBS No. 5-408-101) (Feb. 21, 2008) (indicating that Paul Allaire's tenure was "marked by continuous reorganization").

<sup>19</sup> Allaire created three geographically defined sales areas that sold products from nine divisions organized around market segments. Each division had end-to-end responsibility for a set of products and related services. Each division had its own manufacturing, income statements and balance sheets. In subsequent restructurings the nine divisions are reduced to four, but company-wide management was reintroduced. Bill George, *Anne Mulcahy: Leading Xerox through the Perfect Storm (A)* 2-3 (HBS No. 5-405-050) (Jan. 26, 2005)

<sup>20</sup> Ruthie Ackerman, *Xerox's Nifty Turnaround*, Forbes.com (Jan. 24, 2008) (indicating that Xerox's profits had "skyrocketed" 79%) available at: <http://www.forbes.com/2008/01/24/xerox-office-closer-markets-equity-cx-ra-0124markets30.html>

<sup>21</sup> Harvard Business School teaches the Xerox restructuring in conjunction with bankruptcy strategy. Bill George & Andrew N. McLean, *A Strategic Perspective on Bankruptcy* (Technical Note) (HBS No. 406-080) (Jan. 30, 2006).

cash,<sup>22</sup> preserved R&D, and enhanced customer relationships by moving risk and authority to make sales-critical decisions down the supply chain – closer to the customer.

... Xerox moved from a global customer structure, in which sales and pricing decisions were made by global teams organized around industry verticals, to a simpler country structure, where those decisions rested with local sales teams. The new structure enabled Xerox to eliminate several layers of middle management, increase local accountability, and take nearly \$1 billion out of the company's cost structure in just two years. The simpler structure also concentrated decisions related to the shift from analog to digital technology – critical to Xerox's success in office products at the time – within the senior leadership of the Product organization, which helped accelerate the pace of new product introductions in this vital segment. The explicit focus on where decisions should be made was critical to the successful turnaround at Xerox.<sup>23</sup>

### **Executive Leadership**

In executing the turnaround, much of Mulcahy's success came from her direct engagement with both employees and customers. Substantial structural adjustments were one thing but the restructuring only worked because Mulcahy was not just moving assets around.<sup>24</sup> She molded structure to fit decisions, she built an intangible that changed how Xerox did business. She re-crafted the structure to “fit” the new decision-making. She demonstrated and demanded decisiveness and customer commitment. Her style is classically illustrated in her reputation for cancelling shareholder meetings but making it clear that she would fly anywhere to save a valued customer relationship.<sup>25</sup>

Mulcahy recognized that the only way to rebuild the value of the Xerox franchise was by trying to save or restore customer relationships, rebuild employee morale, and inspire creative people.<sup>26</sup>

### **Thoman**

The Richard Thoman's 1999 restructuring results could not have been more different. Thoman's restructuring had classic tax elements, but tax savings were not the only or even the dominant reason for the restructuring. Thoman, like Mulcahy was intent on capturing the enterprise-wide synergies that would turn Xerox around. The problem was that he did not understand the company.

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<sup>22</sup> Xerox' China operation was sold for \$550 million, half of its 50% stake in Fuji Xerox was sold to Fuji Film for \$1.28 billion. Half of the office-copier manufacturing operations were sold to Flextronics for \$229 million. The financing business was sold to GE Capital. The low end “Single Office/ Home Office” was closed down.

<sup>23</sup> Marcia W. Blenko, Michael C. Mankins & Paul Rogers, *The Decision-Driven Organization*, HARVARD BUSINESS REVIEW 59 (June 2010).

<sup>24</sup> She reduced Xerox's 96,000 employees by 30,000, and restated profitability from 1997 – 2001 by \$1.9 billion.

<sup>25</sup> Bill George, *Anne Mulcahy: Leading Xerox through the Perfect Storm (A)* 9 (HBS No. 5-405-050) (Jan. 26, 2005).

<sup>26</sup> Bill George, *Anne Mulcahy: Leading Xerox through the Perfect Storm (A) and (B)* 12 (Teaching Note) (HBS No. 5-408-101) (Feb. 21, 2008).

Thoman was a Xerox “outsider.” He was a Lou Gerstner, IBM CEO protégé. As IBM’s CFO, he oversaw its very successful restructuring. Not surprisingly he borrowed heavily from this experience when he went to Xerox. As the Teaching Notes to the Harvard Business School case study on Xerox underscore, Thoman attempted

... to implement IBM’s sales and service approach by converting Xerox from a hardware company into a systems supplier. His approach is directly contrary to industry trends at the time, as customers were becoming more comfortable with hardware-only purchases from Japanese competitors Canon and Ricoh.<sup>27</sup>

Thoman’s plan was to cut 9,000 jobs and a billion dollars in costs.<sup>28</sup> The sales force was transformed into system consultants and reorganized according to industry rather than geographic area. As the Harvard case study explains:

- (a) The sales reorganization so disrupted customer relationships that revenues and profits suffered. Sales team members lost client relationships they had cultivated over the years and many used the strong job market to leave the company.
- (b) Xerox customers not only lost their sales contact but also began to experience increased billing issues due in part to customer administration charges and more complicated pricing plans.
- (c) With the two strong customer ties to Xerox broken, competitors exploited the opening for new business and stole market share from Xerox.
- (d) As the Xerox sales team scrambled to find new business, it cut prices sharply and wound up closing fewer and fewer profitable contracts.<sup>29</sup>

### **Failure Illustration in Europe**

A specific example of how Thoman’s failed restructuring played out can be seen in the establishing the Irish center for Xerox (Europe). Thoman closed fifty separate customer-call centers across Europe and built a giant multi-lingual center in Ireland. A large manufacturing complex to make ink-jet cartridges, print heads, color toner, and power supplies was also constructed. Xerox’s equipment leasing portfolio was transferred and important intellectual property rights were moved to Ireland through cost-sharing arrangements.

### **Tax Motivated Restructuring**

Dubbed “Project Global,” the tax goal was to reduce the worldwide tax rate below 30%. Restructuring synergies were relied upon to increase profits but the synergies were ephemeral in large part because they were tax-based.

Project Global hinged on an assumption that Xerox would show 15% annual growth in pretax profit according to the documents and people familiar with the plan. It was assumed that a big chunk of that expected growing profit would be

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<sup>27</sup> Bill George, *Anne Mulcahy: Leading Xerox through the Perfect Storm (A) and (B) 5* (Teaching Note) (HBS No. 5-408-101) (Feb. 21, 2008).

<sup>28</sup> Vara Vasanthi & Sauvik Dhar, *Xerox’s Turnaround: Anne Mulcahy’s “Organizational Change,”* India Business School, Case Development Center 2 (Ref. No. OB0023) 2009.

<sup>29</sup> Bill George, *Anne Mulcahy: Leading Xerox through the Perfect Storm (A) 4* (HBS No. 5-405-050) (Jan. 26, 2005).

shifted from high-tax countries such as Britain and the U.S. where statutory rates for big companies are as high as 35% to Ireland where its profits would be taxed at between 10% and 12.5%.<sup>30</sup>

### **Unanticipated Consequences**

Xerox fell deeply into losses. Xerox reported its first-ever net loss in 2000, losing \$384 million in stark contrast to a \$1.42 billion profit one year earlier. The out-of-pocket restructuring costs exceeded \$600 million and Thoman was forced to resign. But what really hurt Xerox was that these losses were suffered in low tax jurisdictions so tax benefits were substantially reduced. As a result, instead of lowering Xerox's worldwide tax rate, the restructuring increased the effective tax rate from 31% to 38%.

Project Global was a "big mistake," says John Hodges, the former deputy treasurer for Xerox's European operations who was familiar with the tax shift. "The whole thing was based on increasing revenue and profits, but no one looked at what would happen if these increased revenues and profits did not occur," says Mr. Hodges, who retired last year.<sup>31</sup>

### **Movement between Affiliates**

In hindsight it is clear that significant risks were being transferred among Xerox affiliates that were either not recognized as risks or if recognized then were not appropriately measured. Sizeable tangible and intangible assets including manufacturing facilities, employee contracts, customer relationships, critical intellectual property, ongoing concerns, and local business reputations were transferred.

The difference between Mulcahy's and Thoman's restructurings is not that one moved and sold assets and the other did not. It is not that one tried to create enterprise-wide intangibles and the other did not. Both sold and move asserts; both tried to create enterprise-wide intangibles. The difference is simply that Mulcahy succeeded where Thoman failed. Mulcahy produced a return for the value invested in the restructuring where Thoman did not. If we want a *balanced* assessment of the transfer pricing impact involving a business restructuring, we need to understand that restructurings end in losses as well as in gains and that both come home to roost with the CEO at the parent company.

## **(5) Guidelines, CHAPTER IX, PART II**

### ***Arm's length compensation for the restructuring itself***

Part II of Chapter IX in the *Guidelines* closely follows Issue Note No. 2 in the *Discussion Draft*. At seventy-two paragraphs, Issue Note No. 2 is the largest section in the *Discussion Draft*. With some notable exceptions, most analysis in the *Discussion Draft* carries over to the final document.

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<sup>30</sup> James Bandler & Mark Maremount, *How a Xerox Plan to Reduce Taxes and Boost Profits Backfired*, WALL STREET JOURNAL C-1 (April 17, 2001).

<sup>31</sup> James Bandler & Mark Maremount, *How a Xerox Plan to Reduce Taxes and Boost Profits Backfired*, WALL STREET JOURNAL C-1 (April 17, 2001).

There are five major sections in Part II. Some minor modifications have been made in the *Discussion Draft* topical headings but the essential structure is the same. The sections are:

- (A) Introduction
- (B) Understanding the restructuring itself
- (C) Reallocation of profit potential as a result of a business restructuring
- (D) Transfer of something of value (e.g. an asset or an ongoing concern)
- (E) Indemnification of the restructured entity for the termination or substantial renegotiation of existing arrangements.

Chapter IX Part II sections (A), (B), and (C) set out basic rules while sections (D) and (E) apply the basic rules to specific fact patterns. The applications in (D) are transactional while in (E) they are entity-based.

### (A) Introduction

Generally speaking, the three paragraphs in the *Discussion Draft*'s "Introduction" are reduced to two short paragraphs. Most editing is not significant. There is simply a less detailed summary as to how things will proceed.<sup>32</sup> One difference, however, is significant. The *Discussion Draft* uses the phrase "associated profit / loss potential," and that expression is eliminated in the "Introduction." The opening sentences in the *Discussion Draft* are:

Business restructurings involve transfers of functions, assets and / or risks with *associated profit / loss potential* between associated enterprises, for instance from a restructured operation to a foreign related principal. Restructurings can also involve the termination (including non-renewal) or substantial renegotiation of existing arrangements (whether or not formalized in writing), e.g. manufacturing arrangements, distribution arrangements, licenses, service agreements, etc.<sup>33</sup>

The shorter section in the "Introduction" of Part II reads:

A business restructuring may involve cross-border transfers of something of value, e.g. of valuable intangibles, although this is not always the case. It may also or alternatively involve the termination or substantial renegotiation of existing arrangements, e.g. manufacturing arrangements, distribution arrangements, licenses, service agreements, etc.<sup>34</sup>

What makes this omission important is a premise in the *Discussion Draft* that related parties do not just transfer functions, assets, and / or risks in a restructuring. The OECD presumes that companies transfer functions, assets, and / or risks *together with associated profit / loss potential*.<sup>35</sup> Several commentators have asked for clarification about this. Unfortunately, problems arise without further clarification, including:

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<sup>32</sup> For example where the *Discussion Draft* lists items that are transferred (transfers of functions, assets and / or risks) Part II simply says "something of value," and specifies "valuable intangibles" (something that was not mentioned in the *Discussion Draft* list, but which is central to the whole JCT study).

<sup>33</sup> *Discussion Draft*, *supra* note 6, at ¶ 46 (emphasis added).

<sup>34</sup> *Guidelines*, Chapter IX, *supra* note 3, at ¶ 9.48.

<sup>35</sup> "Associated profit/ loss potential" appears three times in the *Discussion Draft*. It does not appear at all Chapter II. It is always connected with Issue Note No. 2. [*Discussion Draft*, *supra* note 6, at ¶¶ 18.2; 46; 70.] The term "associated profit" is used once [*Discussion Draft*, *supra* note 6, at ¶ 149]. It does not appear in Issue Note No. 2.

- *Associated*. How much or how little profit / loss does this term encompass? Do the associated profits / losses include group or entity level synergies that *might be* achieved with these assets in *any* enterprise or is it limited to just those profits or losses inherent to the asset, functions, or risks as they are used in *this* business?
- *Profit / loss*. This binary profit / loss expression indicates that the *Discussion Draft* is interested in all restructurings. Mulcahy’s success and Thoman’s failure at Xerox are equally relevant. The expression “profit / loss” appears throughout the *Discussion Draft*<sup>36</sup> and its elimination from the “Introduction”<sup>37</sup> anticipates its removal throughout Chapter IX. Chapter IX only uses the term “profit potential”<sup>38</sup> in these contexts and this suggests a major change in focus.
- *Potential*. How is potential measured? Consider the assets transferred in Thoman’s restructuring at Xerox. Is *actual* used to measure *potential*, or is something else used? In Thoman’s hands the same assets that produced losses would in Mulcahy’s hands produce profits. Where is the proper measure for potential and how does it relate to actual results?

Rather than clarifying these points, the expression (*with associated profit / loss potential*) is eliminated here and throughout the text. The “Introduction” therefore sets the stage for a subtle but important change in focus. Chapter IX will be directed more at recovering profits that *may be shifted* from a jurisdiction than it will be about a *balanced* discussion about associated profits and losses in a restructuring context.

### **(B) Understanding the restructuring itself**

Section (B) closely follows its predecessor in the *Discussion Draft*. It is divided into three subsections and contains fifteen paragraphs. The subsections are:

- (B.1) *Identifying the restructuring transactions: functions, assets and risks before and after the restructuring*
- (B.2) *Understanding the business reasons for and the expected benefits from the restructuring, including the role of synergies*
- (B.3) *Other options realistically available to the parties*

Both documents work at an entity level discussing the functions, assets, risks identified and the locating comparables. If comparables are inexact, adjustments are made. If no comparables are found, then hypothetical transactions are constructed based on what “... parties might be expected to have agreed ...”<sup>39</sup>, constrained by options realistically available to the parties.

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<sup>36</sup> “Profit / loss potential” appears 33 times in the *Discussion Draft*, and 22 times in Issue Note No. 2.

<sup>37</sup> “Profit/ loss” appears only once in the *Guidelines*, Chapter IX, *supra* note 3, at ¶ 9.145.

<sup>38</sup> “Profit potential” appears 35 times in Chapter IX, and 24 times in Part II. In the *Discussion Draft* “profit potential” is used more narrowly to refer to identified values embedded in a transferred asset or function. In the *Discussion Draft* “profit potential” is used 15 times, most commonly in an expression like “... rights or other assets that carry profit potential” where the concept is that profit potential is inherent (embedded) in a transferred assets in the manner of an unrealized gain (although there is no companion concept developed whereby a transferred right or asset “carries” loss potential).

<sup>39</sup> *Guidelines*, Chapter IX, *supra* note 3, at ¶ 9.52.

There are five places where important observations can be made. Four concern differences between the *Discussion Draft* and section (B). Two differences are minor,<sup>40</sup> but two others are reasonably significant, dealing with prohibitions on using *hindsight* and the removing references to *local synergies*. The fifth item is an omission. Section (B) continues to resist using complex (multi-entity) examples despite the admission that these are the most frequent reorganization patterns. The sections below consider the *hindsight prohibition*, *synergies (anticipated and local)*, and *multi-party transactions*.

### ***Hindsight***

The *Discussion Draft* has a very limited discussion regarding hindsight. It simply indicates that the "... the TP *Guidelines* recommends that *tax administrations* avoid the use of hindsight."<sup>41</sup> The OECD now recognizes that the issue is broader than tax administrations, and Section (B) corrects this.

Section (B) moves the hindsight discussion three steps further. First, it indicates that the hindsight prohibition is universal and extends it to both *taxpayers* and *tax administrations*.<sup>42</sup> Second, it explains that it is not appropriate to use hindsight to evaluate hypothetical transactions when these are being used to determine arm's length compensation for functions, assets, or risks. Third, it makes clear that neither taxpayers nor tax administrations should use hindsight to determine "anticipated synergies" (see below).<sup>43</sup>

### ***Anticipated and Local Synergies***

The quest for performance enhancing synergies is the major reason that businesses restructure.<sup>44</sup> The *Discussion Draft* clearly made mistakes here and section (B) corrects at least two of them – one dealing with anticipated synergies and the other with local synergies.

The *Discussion Draft* asserts that if anticipated synergies do not materialize then this should be is an important factor in determining "... what party (ies) should at arm's length bear the consequences of the non-realization of the anticipated synergies and in what proportion."<sup>45</sup> This is hindsight. It is clear that hindsight may not be used by taxpayer or tax administration.

The *Discussion Draft* also attempts to distinguish between group-wide and local synergies. This distinction is difficult to sustain. Using a "stripped" manufacturer / "stripped"

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<sup>40</sup> The minor changes are: (1) The *Discussion Draft* mandates [*Discussion Draft*, *supra* note 6, at ¶ 50] a "before and after" functions, assets, and risks analysis; section (B) simply suggests that a "before and after" analysis should be [*Guidelines*, Chapter IX, *supra* note 3, at ¶ 9.53] done. (2) The *Discussion Draft* imposes a reasonableness standard [*Discussion Draft*, *supra* note 6, at ¶ 53] to document synergies (making it "unreasonable" not to do so); section (B) simply calls it a "good practice." [*Guidelines*, Chapter IX, *supra* note 3, at ¶ 9.57 (two references)].

<sup>41</sup> *Discussion Draft*, *supra* note 6, at ¶ 55 (emphasis added).

<sup>42</sup> *Guidelines*, Chapter IX, *supra* note 3, at ¶ 9.56.

<sup>43</sup> *Guidelines*, Chapter IX, *supra* note 3, at ¶ 9.57 (although this might seem obvious from use of the adjective "anticipated" in the "anticipated synergies" expression, section (B) underscores that this means that hindsight is prohibited).

<sup>44</sup> As with the Thoman restructuring at Xerox, both the *Discussion Draft* and section (B) acknowledge that synergies "... do not always materialize ... [and] there can be cases where the implementation of a global business model designed to derive more group synergies in fact leads to additional costs and less efficiency." *Guidelines*, Chapter IX, *supra* note 3, at ¶ 9.58 and *Discussion Draft*, *supra* note 6, at ¶ 55.

<sup>45</sup> *Discussion Draft*, *supra* note 6, at ¶ 56.

distributor example, the *Discussion Draft* hypothesized that creating group-wide synergies in a restructuring can reduce or even eliminate local synergies. The *Discussion Draft* indicates that this “... may need to be taken into account in the analysis of the transfer pricing consequences of the restructuring ...”<sup>46</sup> Section (B) omits this discussion entirely and the term “local synergies” does not appear anywhere else in Chapter IX. It is fair to say that the effort to distinguish between local and group synergies has been abandoned as unworkable.

### ***Multi-party transactions – Part 1***

By far the most important observation comparing the *Discussion Draft* and section (B) is that neither document analyzes reorganizations through multi-entity fact patterns even though these are the patterns that appear frequently in the real world. Every example is binary. Both documents recognize that restructuring transactions “... may involve two or more than two members ... [and that] frequently, the restructuring will be more complicated, with functions performed, assets used and/or risks assumed by either or both parties to a pre-restructuring arrangement shifting to one or more additional members of the group.”<sup>47</sup>

Complex reorganizations lead analysis in an entirely different direction than adjustments in simple (one-off) related party relationships. A complex reorganization requires an expanded analytical vision. Complex reorganizations force the examiner to probe all parties to determine where a gain properly resides. They are more than merely aggregating many simple related party exchanges. Complex reorganizations arise from enterprise-wide quests for performance changing synergies and the CEO almost always plays a major role in making these synergies come about. Complex reorganizations are loaded with risk but rich with potential profits. They require changes in attitude, commitment, and decision-making processes.<sup>48</sup> They have tax impact, but are not primarily tax-driven.

### ***The CEO***

There is a reason that “... nearly half of all CEOs launch a reorganization during their first two years on the job ...”<sup>49</sup> Most new CEOs are brought in to find inherent and often overlooked synergies in the organization that will allow the company to turn a performance corner. The most successful reorganizations find the CEO connecting a profit potential in one entity with an underutilized capacity in another and linking these with talents found in a third.

A detailed numeric example is provided below. Unfortunately, this type of example and analysis are missing from both OECD reports because several things are accomplished via such an example and analysis: First, it makes it clear that the OECD is right – successful restructurings often directly result from multi-party synergy development efforts. Second, it makes it clear that these synergies arise from the insights or opportunities the CEO or his/her reorganization team identified and that these insights constitute new intangible assets for the MNE that deserve a royalty payment from the entities that realize the synergy gains. Third, it demonstrates that there are serious difficulties with the OECD’s effort to *understand the*

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<sup>46</sup> *Discussion Draft*, *supra* note 6, at ¶ 57.

<sup>47</sup> *Guidelines*, Chapter IX, *supra* note 3, at ¶ 9.53 and *Discussion Draft*, *supra* note 6, at ¶ 49.

<sup>48</sup> *Guidelines*, Chapter IX, *supra* note 3, at ¶¶ 9.4 & 9.57 and *Discussion Draft*, *supra* note 6, at ¶¶ 4 & 53.

<sup>49</sup> Marcia W. Blenko, Michael C. Mankins & Paul Rogers, *The Decision-Driven Organization*, HARVARD BUSINESS REVIEW 56 (June 2010).

*restructuring itself* when the preferred measure for the arm's length price involves comparing *other options realistically available* at the *entity level*.<sup>50</sup>

Despite considerable efforts made to keep this example simple, it has unfortunately become complicated. This is largely because the reorganization type it reflects is itself very complicated. These difficulties in draftsmanship may have discouraged the OECD from developing similar examples but it should not have prevented them from offering them.

### **Illustration**

In this paper's third section, THE ARGUMENT, a telecommunications example is used. Once numbers are added to the example, critical points can be made.

The basic example is: Firms A and B are firm X's wholly owned subsidiaries. Firm A is a traditional land / mobile line company that utilizes its server farm at half capacity while firm B is a cloud computing company using its server farm at maximum capacity. Firm B needs at least A's excess capacity and therefore three options are considered: (1) firm A could lease its excess capacity directly to firm B; (2) firm B could build out additional capacity over the next two years; and (3) all computing capacity could be transferred to a new firm C in country C that would lease capacity back to firms A and B as needed. Firm C could build-out capacity, even in a fourth country.

If waiting two years is not possible, then the real choice is between options (1) and (3). Suppose the following figures apply:

- Server farms at firms A and B have 30 in annual fixed costs;<sup>51</sup>
- Firm A
  - Operates at half capacity and has 15 in variable costs;
  - Has 75 in gross receipts and 30 in net profits [ $75 - (30 + 15) = 30$ ];
- Firm B
  - Operates at full capacity and has 30 in variable costs;
  - Has 160 in gross receipts and 100 in net profits [ $160 - (30 + 30) = 100$ ];
- Third parties will sell the extra capacity that Firm A has (or that Firm B needs) for 25;
- Firm C will achieve efficiencies simply by merging A's and B's server capacity.
  - Total fixed costs will fall from 60 [ $30 + 30$ ] to 50 [ $25 + 25$ ]
  - Total variable costs will fall from 45 [ $15 + 30$ ] to 30 [ $10 + 20$ ]
  - New variable costs from full capacity operation are 10

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<sup>50</sup> *Guidelines*, Chapter IX, *supra* note 3, at ¶ 9.59 and *Discussion Draft*, *supra* note 6, at ¶ 58 (emphasis added).

The application of the arm's length principle is based on the notion that independent enterprises, when evaluating the terms of a potential transaction, will compare the transaction to the *other options realistically available* to them, and they will only enter into the transaction if they see no alternative that is clearly more attractive.

<sup>51</sup> All figures are in neutral "currency units."

- Two lease contracts add 10 in administrative costs [5 + 5]
- Exceptional *synergy gains* are thought to be possible, valued at 100
- In addition, C guarantees availability of capacity to A and B

Under option (1) Firm A sells its excess capacity to firm B for 25, incurs 5 in additional administrative costs, and receives 20 in additional profit. A's net profits rise from 30 to 50. Firm B purchases A's excess capacity for 25, resells its cloud computing business services for 80, and incurs 15 in additional variable costs in doing so. B's net profits rise 40 [80 – (25 + 15)] from 100 to 140 [160 + 80 sales less 60 + 25 + 15 in costs]. The MNE's total profits under option (1) increase 60, from 130 to 190

Option (3) involves a more complex restructuring. Firm C is added to the MNE group. Because it will hold both server farms it will achieve cost savings (fixed and variable cost efficiencies, duplicate management elimination, a selection of the best staff from the A and B server farms and the termination of others). Income is limited by 100, the arm's length market prices for server time [50 + 50]. The cost for running both server farms as a consolidated unit falls from 105 to 80. Because, however, C run both farms at full capacity it will incur 10 in additional variable cost while leasing computing capacity adds 10 in administrative costs [5 per leasing contract]. Firm C will therefore break even [100 – (80 + 10 + 10)].

Under Option (3) firm A will purchase just the capacity it needs for its traditional telecommunications business and resell it for 75. Firm A's profit will be 50. This is the same profit it would expect under Option (1) yet reflect a 20 increase in income over the base case [30]. Firm B will also purchase just the server capacity it needs for its cloud computing service at 75 and resell it for 240. Firm B's profit will rise to 165, a 25 increase in income [165 – 140] over Option (1), and a 65 increase over the base case [165 – 100].

Exceptional synergy gains [100] are anticipated under Option (3). Business forecasters predict new income streams from breakthroughs believed to reside along the cloud computing and traditional telecommunications interface. It is not clear where the income from these breakthroughs will be reported: firm A (traditional telecommunications), firm B (cloud computing), but it will not be firm C (the server farm subsidiary), because C does not make external sales.

	Base Case			Option (1)			Option (3)		
	<u>Income</u>	<u>Cost</u>	<u>Profit</u>	<u>Income</u>	<u>Cost</u>	<u>Profit</u>	<u>Income</u>	<u>Cost</u>	<u>Profit</u>
Firm A	75			75			75	25	50
- Fixed		30			30				
- Variable		15	30		15	30			
New Activity				25	5	20			
Total	<u>75</u>	<u>45</u>	<u>30</u>	<u>100</u>	<u>50</u>	<u>50</u>	<u>75</u>	<u>25</u>	<u>50</u>
Firm B	160			160			160		
- Fixed		30			30			75	165
- Variable		30	100		30	100			
New Activity				80	40	40	80		
Total	<u>160</u>	<u>60</u>	<u>100</u>	<u>240</u>	<u>100</u>	<u>140</u>	<u>240</u>	<u>75</u>	<u>165</u>
Firm C							100		
- Fixed								50	
- Variable								30	
New Activity								20	
Total	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>100</u>	<u>100</u>	<u>0</u>
Total	235	105	130	340	150	190	415	200	215
IT Synergies							<u>100</u>		<u>100</u>
Grand Total							515		315

### ***Option Comparison***

Option (1) is not a sophisticated restructuring. Profit increases come from firm A's direct leasing of unused computing capacity to firm B followed by firm B reselling that service to its established clientele.

Option (3) is a complex restructuring. Potential profit increases are attributable to *synergies* as well as unused capacity (*profit potentials*). Selecting Option (3) requires an educated business judgment that balances increased risks with increased profits. There is no guarantee that firm C will "work out." Maybe IT employees at firms A and B cannot work together. Maybe management will not "buy into" the restructuring. Maybe the employees will not commit to making the change. Getting all this to work requires the MNE to change the way business *decisions* are made in the aggregate. This is the CEO's mission.

Option (3) will only be the best choice if incremental profits cover the associated incremental costs. In this example, 95 in incremental costs are incurred [200 – 105] along with 85 in incremental gains [225 – 130] without considering 100 in *exceptional synergy gains*. Together, 185 [315 – 130] in gains are achieved once these *synergies* are taken into account.

Under Option (3) firms A and B will be compensated at arm's length for their server farms. The capital for this purchase will be an initial expense in establishing firm C. Even though the firms A and B server farms are otherwise identical, firm A will negotiate to receive *additional compensation over and above the value for its server farm in-place* to compensate for the additional risk that Option (3) imposes.

To firm A there is no income difference between Option (1) and Option (3), however risks are higher. Firm A will no longer control its own server farm. Firm B is in a different position. It will receive 25 in additional income under Option (3). At arm's length, firm A may need to be persuaded to participate in Option (3) while firm B may not need more persuasion.

### ***Profit Potential and Synergies***

There are three restructuring analysis levels in this example. Additional revenue could be realized totaling 185 [315 – 130]. Some represents *profit potential* embedded in firm A and firm B's assets, much being *synergy gains*.

*The first gain* - The first 60 [190 – 130] gain can be secured through a direct lease involving firm A's excess server capacity to firm B at an arm's length price. There is little risk associated with this gain other than the risk that firm B would not pay firm A or that firm B's clients will not purchase additional cloud computing services. This is a reasonable measure for *profit potential* embedded in firm A's server assets.

*The next gain* - The next 25 [215 – 190] gain can *only* be captured in Option (3). It involves additional risk. Establishing firm C, transferring all server capacity to it, and then leasing that capacity back to firms A and B on an as-needed basis is a complex and an inherently risky undertaking. The 25 gain is *reasonably foreseeable*. It is an *anticipated synergy gain* derived from large scale economies rather than derived from hindsight.

Although the entire 25 gain appears in firm B's accounts, the gain is not due to increased sales. Gross receipts are the same at 240 under both Option (1) and Option (3). Profits for the group increase due to efficiencies (all of which are realized through the server consolidation in firm C). It is important to note that great efforts at changing management decision-making, personnel attitudes, and performance commitments will be directed at firm C but the benefits of this effort will be found in firm B.

When Firm A transfers its server farm to firm C, all fixed [30] and variable [15] costs are replaced with a single charge for server capacity [25]. Firm A's profit increases to 50 [75 – 25]. Firm C reduces its fixed and variable costs to perform by 10 [5 + 5]. This is a synergy gain.

When firm B transfers its server farm to firm C much the same occurs. Fixed [30] and variable [30] costs are replaced with a single charge for server capacity [50]. This time, firm C reduces its fixed and variable costs to perform by 15 [5 + 10]. This is also a synergy gain. Firm B also purchases the extra server capacity it needs from C for 25. As a result firm B's profit increases to 165 [240 – 75].

*The final gain* - The final 100 [325 – 225] gain is a *highly speculative synergy gain*. Capturing this gain is what will drive the CEO's decision for Option (3). Profits for the MNE will more than double, going from 130 to 315 under Option (3). This gain will be reflected in increased sales by firm A and firm B. It will be driven by synergies developed in firm C and strongly promoted by the CEO's reorganization team.

Without this extraordinary gain, the incremental efficiency gains in Option (3) [85] are less than the incremental cost [95]. To make Option (3) worth the risk, the CEO needs to believe that he/she can make the synergy happen. Ann Mulcahy's restructuring of Xerox produced these kinds of gains, Richard Thoman's did not. Mulcahy's efforts created intangible values and those values translated into financial gain. Mulcahy created a *unique intangible* at Xerox. She invested time, effort, and capital in the restructuring and took exceptional risks to bring Xerox back to profitability. In such cases the MNE's parent is entitled to a rate of return equal to the net present value for the synergistic gains earned via the restructuring.

#### *Determining the Arm's Length Price*

This illustration has been stripped down to three transaction types:<sup>52</sup> (1) *asset transfer* – firms A and B transfer their server farms to firm C, (2) *service lease-back* – firms A and B purchase computing capacity from firm C at the arm's length market price, and (3) *intangible benefit / royalty* – firms A and B receive the benefits attributable to increased sales through new products or services arising from consolidating the server function.

The price for these transfers should reflect the “other options realistically available standard.” The *Discussion Draft* and section (B) both end their discussion on *understanding the*

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<sup>52</sup> Additional transactions could be considered, notably the transfer of management and staff from firms A and B to firm C. This would add only complexity to the illustration.

*restructuring itself* with analysis drawn from the “investor model” in the US cost-sharing regulations.<sup>53</sup> Both the *Discussion Draft* and section (B) state:

The application of the arm’s length principle is based on the notion that independent enterprises, when evaluating the terms of a potential transaction, will compare the transaction to the other options realistically available to them, and they will only enter into the transaction if they see no alternative that is clearly more attractive.<sup>54</sup>

*Asset transfer* - It is not reasonable to think that firm A would transfer its server farm to firm C only to buy-back the computing capacity at market prices for a 20 gain when it could achieve the same gain without risk by simply selling its excess capacity into the market. Option (1) is the best *other option realistically available*. The lower risks in Option (1) make it *clearly more attractive* than Option (3). Firm A would demand additional compensation.<sup>55</sup>

Would a share in the extraordinary synergy gains potentially realized through the server consolidation be sufficient compensation?

Firm B is in a different situation. Selling its server farm for value to C in exchange for the right to purchase back the computing capacity it needs on a demand basis has value in two respects: (a) firm C can meet and guarantee firm B’s demands at market rates, and (b) firm B will earn 25 more than it would under Option (1). For firm B, the best *other options realistically available* are Option (1) and the open market. Neither offers a better result.<sup>56</sup>

Firm B also stands to receive a share in the extraordinary synergy gains potentially realized through the server consolidation.

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<sup>53</sup> Temp. Treas. Reg. §1.482-7T(j)(1)(i) & -7T(g)(2)(iii) (reciting the *best realistic alternative* principle, holding that an unrelated taxpayer would not enter into a cost-sharing arrangement unless the anticipated value of entering into the arrangement is at least as great as the anticipated value of the alternative arrangement realistically available, taking into account differences in risk).

<sup>54</sup> *Guidelines*, Chapter IX, *supra* note 3, at ¶ 9.59 and *Discussion Draft*, *supra* note 6, at ¶ 58.

<sup>55</sup> There were reservations expressed in the *Discussion Draft* that were not carried over to section (B) suggesting that some jurisdictions might not respect this transaction at any price.

Some countries however consider that the sale of “crown jewels” such as valuable trade names is so detrimental to the seller that it would not be possible to arrive at an appropriate price and that accordingly it would be unlikely to occur at arm’s length, unless it could be demonstrated that a company had decided to exit a particular business or the seller has no option realistically available to it. These countries consider that if the company continues in the business, there is no commercial logic in this divestment which is represented as being driven by the group policy. For these countries, if the arm’s length principle were applied, the group perspective would not feature.

It is not clear that sale of the server farm presents such a “crown jewel” sale. *Discussion Draft*, *supra* note 6, at ¶ 216.

<sup>56</sup> Although Option (1) guarantees availability just as Option (3) does, net costs are higher. Purchasing from the open market will give firm B the same price as Option (1), but availability is not guaranteed. As a result, Option (3) is *clearly more attractive* for firm B. Under Option (1) firm B’s profits are 140 while under Option (3) they are 165. Firm B assumes all variable and fixed costs for server operation under Option (1) and cannot achieve firm C’s economies of scale.

*Service leaseback* - Firms A and B purchase computing capacity from firm C at the market rate. Availability is guaranteed. This price meets the *other options realistically available* standard and the availability guarantee makes it clear that no price is *clearly more attractive*.

*Intangible benefit / royalty* - Extraordinary synergies sufficient to double MNE profits are anticipated from the server consolidation. This benefit, increased profits from sales of new products/ services, will be realized either through firm A or B. Firm C makes no external sales.

The *other options realistically available* standard suggests that the appropriate price for this benefit can be found among third-party suppliers licensing similar technology products. Assume a comparable royalty rate is 20% of sales. If so, then the critical question is who should receive it and which entity owns the intangible? Neither the *Discussion Draft* nor section (B) provides answers. Three results are possible and combinations results are also possible.<sup>57</sup>

- No royalty should be paid (A & B will retain all the gain).<sup>58</sup>
- Royalty should be paid to C.<sup>59</sup>
- Royalty should be paid to Firm X

The norm is that a royalty should be paid to X. Corporate restructurings actively engage the CEO and focus on finding transformative synergies. The CEO's involvement is critical because reorganizations are about alignment. Even though "most reorganizations fall flat"<sup>60</sup> those that are most successful tightly align structure with decision-making.

Ultimately, a company's value is no more (and no less) than the sum of the decisions it makes and executes. Its assets, capabilities, and structure are useless unless executives and managers throughout the organization make the essential decisions and get those decisions right more often than not. Our research [760 companies with revenues in excess of \$1 billion] and experience confirm the tight link between performance and decisions. ... We found that decision effectiveness and financial results correlated at a 95% confidence level or higher for every country, industry, and company size in our sample. ... What's more, the research revealed no strong statistical relationship between structure and performance. ... In reorganizations, decisions rather than structure should be the primary focus.<sup>61</sup>

Table 2 presents results consistent with this analysis:

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<sup>57</sup> For example, if the full royalty rate would be 20% of sales but additional compensation for risks assumed would be demanded like firm A under Option (3), then a portion of the royalty might not held back.

<sup>58</sup> This might be an appropriate result if synergies were entirely unexpected. If, for example, all server functions were transferred to firm C because local telecommunications law required service providers to be independent from the server facilities. In this case, the efficiency-based synergy gains [20 for firm A, and 65 for firm B] would result from a restructuring that was compelled, not planned for.

<sup>59</sup> This might be an appropriate result if the restructuring was internally planned but *only with the* intent to capture the reasonably foreseeable synergies expected from economies of large scale. Once, however, the server farms are consolidated natural (unforeseen and unplanned for) creativity within firm C results in developing new products and services that could be sold through firms A and B. This self-initiated R&D effort in C would produce intangible assets (C owned) that would attract a royalty payment.

<sup>60</sup> Blenko, Mankins & Rogers, HARVARD BUSINESS REVIEW *supra* note 1, at 56.

<sup>61</sup> *Id.*, at 57.

	Base Case			Option (3) No Synergy Gain			Option (3) - IT Synergy Gains		
	Income	Cost	Profit	Income	Cost	Profit	Profit	20% Royalty	Net Profit
Firm A	75	45	30	75	25	50	50		50.0
IT Synergies							24	4.8	19.2
Firm B	160	60	100	240	75	165	165		165.0
IT Synergies							76	15.2	60.8
Firm C	0	0	0	100	100	0	0	0	0.0
								-20.0	20.0
<b>Total</b>	<b>235</b>	<b>105</b>	<b>130</b>	<b>415</b>	<b>200</b>	<b>215</b>	<b>315</b>	<b>0</b>	<b>315</b>
IT Synergies						<u>100</u>			<u>100</u>
Grand Total						315			315

### ***Conclusion – Illustration***

We come to a very unsatisfactory conclusion. If the CEO decides to restructure under Option (3), it is really not possible to *understand the restructuring itself* if we consider it from the firm A or firm B’s perspective. In fact, to understand most restructurings we must at least initially consider it from the CEO’s perspective. The reality is that the parent company dominates restructuring decisions.

For example, we are trying to understand why firm A would sell its server farm under Option (3). The exchange is for fair market value *plus* a 38.4% [ $19.2/50 = 38.4\%$ ] increase in profits that is contingent on firm C developing new marketable services. We are supposed to determine the price based on *options that are realistically available*, but the only way to do this is to first value the central intangible that the reorganization creates, and to do this we need to consider the MNE *as a whole*.

We need this broader perspective. Firm A is really *not* an independent entity and some actions it takes really *cannot* be understood *as if it were a fully independent entity*. In fact, excessive insistence on this kind of theoretical abstraction makes it difficult to identify the intangible the restructuring creates and measure the royalty that is due.

The most realistic reason that firm A as an independent entity would accept Option (3) () is that the CEO persuaded firm A’s management that risks were low and the beneficial synergies were very likely to happen. If this were the case, then the CEO / parent firm may only need to guarantee a profit level equal to *what firm A would have received* net of royalties paid 19.2 [ $24 - 4.8$ ]. This would also be limited to a reasonable commercial time period with a side agreement

that if the synergies do not materialize, then firm C will at firm A's option resell the server farm to firm A.<sup>62</sup> Such an agreement would put firm A into the same position it would be in under Option (1), with a surplus to cover the additional risks assumed during the initial reorganization period.

In firm B's case, the analysis is not much different. Under Option (3), the server farm is exchanged for fair market value *plus* a 36.8% [ $60.8/165 = 36.8\%$ ] increase in profits contingent on firm C developing new marketable services. Firm B also receives access to additional server capacity at market rates. If the parent company were to make the same profit guarantee net of royalties [60.8] for a similar time period, then B would be in the same position it would be in if it had selected Option (1). Of course the CEO would need to persuade firm B that the risks in doing this were manageable and the synergy returns were highly likely.

### (C) Reallocating profit potential resulting from a business restructuring

Section C is a pivotal nine-paragraph section that makes three significant changes to the *Discussion Draft*. A fourth item for concern involves a change that should have been made but was not. Section (C) has two subsections.

- (C.1) Profit potential
- (C.2) Reallocation of risks and profit potential

The most striking aspect in section (C) is that it soon becomes very clear that the OECD does not have an objective view regarding business restructurings. The OECD, like the JCT, very much looks at business restructurings as tax planning tools that may border on tax avoidance.

For example, when Blenko, Mankins and Rogers considered business restructurings in the Harvard Business Review they observed:

A recent Bain & Company study of 57 reogs between 2000 and 2006 found that fewer than one-third produced any meaningful improvement in performance. Most had no effect, and some actually destroyed value.<sup>63</sup>

If most business restructurings are unproductive, then why is there not a significant discussion regarding restructuring losses in section (C)? How do we account for the fact that most restructurings fail to achieve their performance goals even though most CEOs (and those immediately below the CEO) are convinced as to their success? If the rules are focused on allocating profits, what do we do in the far more common case where there are restructuring losses?

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<sup>62</sup> To be fully symmetrical, there is a related problem with firm C. If the CEO (from firm X) is persuading firm A to enter into this agreement, then we need to understand why firm C would be willing to return the server farms it just bought if the extraordinary synergies do not materialize. This may necessitate another agreement between firm X and firm C which is not part of this illustration, but it would be part of the real world fact pattern.

<sup>63</sup> *Id.*, 56.

The three significant changes made to the *Discussion Draft* are: (1) the expression “profit / loss potential” is replaced with “profit potential.”<sup>64</sup> (2) In the *Discussion Draft* the term “profit potential” was treated as something *separable but “related to”* a transferred asset. In section (C) “profit potential” is part (an attribute) of an asset. (3) The concept *understanding the restructuring itself*, developed in section (B), is now incorporated into section (C).

### ***Profit / loss potential v. profit potential***

The *Discussion Draft* frequently uses the expression “profit / loss potential”. This usage was criticized because the expression’s dual nature was never developed. The balance in *expression* was not matched with a similar balance in *conception* – in fact, there was no concept development at all.<sup>65</sup> The implication was that restructuring profits and restructuring losses would be handled by the same rules.<sup>66</sup> The expectation was that this deficiency in the *Discussion Draft* would be remedied in section (C). Instead, the expression was removed from the text and replaced with “profit potential.”

“Profit potential” is simply defined as “expected future profits.” We are told that it “may encompass losses,”<sup>67</sup> but more importantly we are told that profit potential is a familiar concept. It is a standard element in traditional valuation methodologies. As a result, profit potential is not something independent from an asset as it was in the *Discussion Draft*) but rather integral to the asset. Profit potential transfers with an asset that affects the asset’s value.<sup>68</sup>

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<sup>64</sup> “Profit/ loss potential” is used twenty times in this subsection of the *Discussion Draft*, and not at all in the corresponding section of Chapter IX.

<sup>65</sup> The only substantive consideration of losses in the *Discussion Draft*’s Issue Note No. 2 is at ¶¶ 95-97. In the other Issue Notes the situation is much worse – losses are not discussed. See: Baker & McKenzie, *Comments on the OECD Restructuring Discussion Draft*. For example when discussing Issue Note No. 1 Baker & McKenzie observe at 10 that: “... No mention is made of allocation of losses related to the risk. One would think that parity is important.” Available at: <http://www.oecd.org/dataoecd/53/36/42203499.pdf>

<sup>66</sup> The *Discussion Draft* struggles with the relationship between profit / loss potential and transferring assets, functions, or risks. Although it makes it clear that “[p]rofit / loss potential is not an asset, but a potential which is carried by some rights or other assets” [*Discussion Draft*, *supra* note 6, at ¶ 64], it is never clear how this *potential* is supposed to relate to the transferred assets, functions, or risks. In some paragraphs, a causal relationship is implied between the *potential* and the transferred *assets*. In other paragraphs, only an association is indicated. Causality is implied when the *Discussion Draft* says “...profit/ loss potential that *follows from* a reallocation of risks, rights and/ or other assets ...” [*Discussion Draft*, *supra* note 6, at B.1 (heading, emphasis added)]; see the same phrase at *Discussion Draft*, *supra* note 6, at ¶ 65], or “... based on the rights and other assets of each at the outset of the restructuring, that *determine* the profit/ loss potential ...” [*Discussion Draft*, *supra* note 6, at ¶ 66 (emphasis added)]. An association is implied when the *Discussion Draft* says, “[t]ransfers of functions, assets and/ or risks in the context of business restructurings are typically *accompanied by* a reallocation of the profit/ loss potential ...” [*Discussion Draft*, *supra* note 6, at ¶ 62 (emphasis added)] or “... an examination of the transferred profit/ loss potential *associated with* those rights or other assets ...” [*Discussion Draft*, *supra* note 6, at ¶ 65 (emphasis added)]; see the same phrase at *Discussion Draft*, *supra* note 6, at ¶ 68 and ¶ 70] or “... whether there are rights or other assets transferred that *carry* profit/ loss potential ...” [*Discussion Draft*, *supra* note 6, at ¶ 64 (the phrase is used twice in this paragraph) (emphasis added)]; see the same phrase at *Discussion Draft* *supra* note 6, at ¶ 66].

<sup>67</sup> The only significant discussion of losses occurs at *Guidelines*, Chapter IX, *supra* note 3, at ¶¶ 9.96 – 9.98. The presentation involves the transfer of a pre-existing loss-making activity. The question is whether an arm’s length price can be determined using traditional methods. Thus, loss-making is treated as an attribute of an asset.

<sup>68</sup> *Guidelines*, Chapter IX, *supra* note 3, at ¶ 9.66 (emphasis added).

In these *Guidelines*, “profit potential” means “expected future profits.” In some cases it may encompass losses. The notion of “profit potential” is *often used for valuation purposes*, in the determination of an arm’s length compensation for a transfer of intangibles or of an ongoing concern, or in the determination of an arm’s length indemnification for the termination or

This is not an entirely satisfying result. Are all *expected future profits* that follow from the assets transferred in a restructuring *profit potentials* that should be valued along with as part of the assets? Or, stated another way, can an *expectation of future profits* be derived from something other than a profit potential? Should *anticipated* that profits that are *created* from *synergies* that follow from a restructuring be treated differently from a *profit potential* that is inherently part of assets transferred? An important distinction is missing. We need to differentiate between *profit potential* and *profit-making synergies*, both which can be expected and which follow from a restructuring. The following examples are helpful in illustrating this point.

### ***Examples***

Consider the telecommunications example used above. It is relatively easy to see that there is *profit potential* in the unused portion of firm A's server farm. Option (1) measures this value at 20 and firm A expects to receive the fair market value for the server farm *plus* this profit potential if it transfers this asset to firm C under Option (3). The identical server farm firm B transfers to firm C under Option (3) has no profit potential because it is fully utilized.

Firm B's profit potential is in its client base. B's customers are willing and able to purchase 50% more cloud computing services. Option (1) measures this value at 25. Firm B does not transfer this asset and as a result does not transfer (or receive) profit potential. Through its own efforts firm B realizes its profit potential under both Option (1) and Option (3).

What about synergy gains? Firm C *creates* efficiencies and economies of large scale when it consolidates the server farms. Is this a profit potential? Was profit potential transferred to firm C along with the server farms? It does not seem so. Even though the potential for efficiency was technically present when firms A and B owned the farms, neither could realize the synergy gains because neither had sufficient size to do so. This is a very different situation. Firm C has *produced* the synergy gains, and even though these gains were *expected* they are not a profit potential that was embedded in the assets.

The same is true regarding the extraordinary synergy gains. Even though the assets (server farms, critical employees, and management) were transferred from firms A and B to firm C, it is only in a very abstract sense that we can attribute the extraordinary synergy to inherent profit potentials embedded in the assets. It was the CEO in firm X that identified this synergy. If Blenko, Mankins and Rogers are correct that there is a "... tight link between performance and decisions. ... that decision effectiveness and financial results correlated at a 95% confidence level or higher for every country, industry, and company size ...", then it is the CEO that *created* the context for this synergy gain from new products and services. Because this synergy's benefits are realized in firms A and B (not firms X or C) a royalty is due.

### ***Valuation of Profit Potential Based on "understanding the restructuring itself"***

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substantial renegotiation of existing arrangements, once it is found that such compensation or indemnification would have taken place between independent parties in comparable circumstances.

It is difficult enough to value *profit potential* when section (C) does not distinguish between *expected profit potential* and *anticipated synergy gains*. Things become even more difficult when the *understanding the restructuring itself* standard is deemed *essential* to the valuation. Paragraph 9.68 states:

In order to determine whether at arm's length the restructuring itself would give rise to a form of compensation, *it is essential to understand the restructuring*, including the changes that have taken place, how they have affected the functional analysis of the parties, what the business reasons for and the anticipated benefits from the restructuring were, and what options would have been realistically available to the parties, *as discussed in Section B*.<sup>69</sup>

Two examples are provided in section (C) presenting a business restructuring where *profit potential* needs to be valued. Both examples are binary transfers and both appear to be transfers between wholly owned subsidiaries. There is no discussion as to what the CEO was attempting to accomplish with the restructuring, the performance objectives, or whether synergy gains were anticipated. The second example is followed by three numeric permutations, all replicating without change the *Discussion Draft examples*.<sup>70</sup>

*Example 1* - Paragraph 9.70 considers converting a full-fledged manufacturer into a contract manufacturer and a cost-plus method is suggested to determine arm's length price. The example, however, asks if an amount should be considered for indemnification. Although it will have higher risks, a full-fledged manufacturer is expected to earn higher profits than a contract manufacturer. The higher profit potential is attributed to the higher risk burden. When the risk is transferred, so too is the profit potential and the question is – should there be compensation for this value?

*Example 2* - Paragraph 9.71 considers converting a full-fledged distributor into a low-risk distributor. Presuming the distributor has the right to reject the conversion, the choice in this example is between a +2% stable profit per year and potentially higher profits as a full-fledged distributor. The example is nearly the same as the previous example, but in this case the entire transaction is a contract modification – no tangible or intangible assets are transferred. The example does not indicate whether this contract modification is good or bad for the distributor. The point is, however, if the potential for higher profits are being sacrificed then this is a profit potential that needs to be compensated.

Three numeric permutations for this final example are offered. In each case the other party is a foreign associated enterprise (principal), not the MNE parent entity. Three measures are offered: a five year historical average, three year projected future average, and 2+% guaranteed low-risk distributor's profit. There is no mentioning the CEO, why the reorganization is undertaken, or if any synergy gains are anticipated.

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<sup>69</sup> *Guidelines*, Chapter IX, *supra* note 3, at ¶ 9.68 (emphasis added).

<sup>70</sup> *Guidelines*, Chapter IX, *supra* note 3, at ¶ 9.71 to 9.73 and *Discussion Draft*, *supra* note 6, at ¶ 68 to 70.

*Example 2 – Permutation (a).* In the first permutation all three measures (historical average,<sup>71</sup> projected future average,<sup>72</sup> and guaranteed return for a low-risk distributor) result in a 2% average rate of return. The example does not make sense. If there is “significant uncertainty”<sup>73</sup> regarding expected profitability and the average expected profit is 2%, why would a restructuring *guarantee* the same rate of return? It is axiomatic that low risks return low profits so maybe a 1% return would be appropriate in this example?

If the example is accurate, then there is something we do not understand. Maybe we are missing some information at the group level? If it seems that a 1% guaranteed profit would be appropriate but 2% is guaranteed, then is there an additional compensatory payment being made? In a MNE the source for this payment could several different entities, including the parent company. Perhaps the CEO anticipates synergy gains and is allocating a portion to the distributor? We just do not know because our vision is too narrow. One thing, however, does seem clear. We do not *understand the restructuring itself*.

*Example 2 – Permutation (b).* In the second permutation the historical average profit is 7%,<sup>74</sup> the projected future average is 7%<sup>75</sup>, and the guaranteed post-conversion profits are 2%. The text says, “... it is unlikely that independent parties in the distributor’s situation would agree to relocate the risks and associated profit potential for no additional compensation if they had the option to do otherwise.”<sup>76</sup>

Once again there seems to be something missing. The facts are very unrealistic. If for five years the distributor has never shown a profit below five percent and if the minimum expected profit for the next three years is also five percent, a conversion with a 2% guarantee makes no sense at all. This kind of restructuring would appear to be wrong on its face unless there is something in the wider fact pattern that we are not being told. Are there external market events pushing down profitability in the industry or critical intangible assets that are about to expire? But if so, why is this not reflected in the profit projections? Do we *understand the restructuring itself*?

*Example 2 – Permutation (c).* In the third permutation five-year historical average shows a 7% profit, the projected future average is 2%, and the guaranteed post-conversion profits are 2%. This permutation shows a distributor responding to a falling market due to “new competitive pressures.” The high point for the expected future profits (4%) is lower than historical profit reported in any prior years.

Historical profits were at their highest three years ago (10%) and immediately began to fall – first to 7%, then to 5%, and if we are optimistic the best we should expect to see next year is 4%. Even lower profit margins might well occur, perhaps even 0%. Thus a guaranteed, low

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<sup>71</sup> For the past 5 years the net profit margin/ sales = -2%; +4%; +2%; 0; +6% [average = 2%].

<sup>72</sup> The 3-year projection of net profit margin/ sales is a range of -2% to +6% [average = 2%]. Note the high and low points of the projection match the high and low points of the 5-year historical data.

<sup>73</sup> *Guidelines*, Chapter IX, *supra* note 3, at ¶ 9.73 (indicating “... the distributor is surrendering a profit potential with significant uncertainties for a relatively low but stable profit.”)

<sup>74</sup> For the past 5 years the net profit margin/ sales = 5%, 10%, 5%, 5%, and 10% [average = 7%].

<sup>75</sup> The 3-year projection of net profit margin/ sales is a range of 5% to 10% [average = 7%].

<sup>76</sup> *Guidelines*, Chapter IX, *supra* note 3, at ¶ 9.73.

risk 2% profit appears too high. But a critical element is missing. How long is this guarantee in place (three years, five years, for the relationship's duration)?

The distributor appears headed for losses in the not too distant future *if the business remains unchanged*, and this is most likely the reason for the restructuring. But we are not told this. Has the MNE's CEO entered into this restructuring to address this problem? We do not know. Are synergies anticipated based on the distributor's expertise that would support potentially turn things around? We are told nothing about synergies, nothing about the reasons for or the expected benefits from the restructuring. The text indicates that this case "... illustrates the fact that the analysis should take into account the profit potential going forward and that, where there is a significant change in commercial or economic environment, relying on historical data alone will not be sufficient."<sup>77</sup> But a careful reading indicates that we do not *understand the restructuring itself*.

#### **(D) Transfer of something of value (e.g. an asset or an ongoing concern)**

Chapter IX Part II concludes with matched sections (D) and (E) which apply the principles developed in sections (A), (B), and (C). Section (D) focuses on asset transactions in a restructuring whereas section (E) focuses on transactions that involve transferring an entire entity. What is missing is the MNE and the CEO. There is no effort to set out rules or provide analysis for a restructuring that examines the whole MNE's position.

The twenty-six paragraphs in section (D) closely replicate corresponding paragraphs from the *Discussion Draft*.<sup>78</sup> Only two paragraphs are omitted<sup>79</sup> and one paragraph is added.<sup>80</sup> Section (D) applies the principles developed earlier to the specific asset transfers. The assets considered are:

- (D.1) tangible assets,
- (D.2) intangible assets,
- (D.3) transfer of an activity (ongoing concern), and
- (D.4) outsourcing.

#### ***Tangible asset transfers***

Tangible asset transfers are not considered problematic.<sup>81</sup> The discussion is dominated by an inventory example presented within a restructuring that transforms a full-fledged manufacturer into a toll manufacturer. Section (D) simply explains how the comparable uncontrolled price, resale price, and cost-plus methods are applied to value the finished inventory and the raw materials that are transferred.<sup>82</sup>

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<sup>77</sup> *Guidelines*, Chapter IX, *supra* note 3, at ¶ 9.73.

<sup>78</sup> *Discussion Draft*, *supra* note 6, at ¶¶ 71 – 98.

<sup>79</sup> Paragraphs 84 and 86 of the *Discussion Draft* are omitted from section D. Paragraph 84 applied the "other options realistically available" standard to intangibles and paragraph 86 suggested that the transferee's capacity to maintain and develop transferred intangibles should be considered when valuing intangibles. These topics were considered elsewhere in the *Guidelines*.

<sup>80</sup> *Guidelines*, Chapter IX, *supra* note 3, at ¶ 9.94 has no antecedent in the *Discussion Draft* (indicating that in the transfer of a going concern the value of the whole may be more than the value of the parts).

<sup>81</sup> *Guidelines*, Chapter IX, *supra* note 3, at ¶ 9.75 and *Discussion Draft*, *supra* note 6, at ¶ 72 (indicating, "...it is generally considered that transfers of tangible assets do not raise any significant transfer pricing difficulty, ...")

<sup>82</sup> *Guidelines*, Chapter IX, *supra* note 3, at ¶ 9.78 and *Discussion Draft*, *supra* note 6, at ¶ 76.

### ***Intangible assets***

Intangible asset transfers are considered more difficult. Section (D), however, simply applies standard transfer pricing analysis. It indicates that to determine an arm's length price it is necessary to consider the entire commercial arrangement between the parties.<sup>83</sup> If assets are transferred when values are entirely speculative, section D assumes that a price adjustment mechanism would normally be found in the contract.<sup>84</sup>

### ***Transferring Activities or an Ongoing Concern***

When an activity or a complete going concern is transferred in a restructuring the critical element is recognizing that this asset type frequently includes *profit potential* and its value needs to be included in the transferred asset's value. This subsection includes the added paragraph that indicates that the *whole* value for an ongoing concern may not necessarily equal the sum for the separate parts.<sup>85</sup>

### ***Outsourcing***

Outsourcing is recognized as a common practice. The section states that comparables should be readily available.<sup>86</sup> It observes that “[i]n outsourcing cases ... [one related] party [may] voluntarily decide to undergo a restructuring and bear the associated restructuring costs in exchange for anticipated cost savings.” A hypothetical is presented where a manufacturing entity outsources its manufacturing function to a related party in a low cost jurisdiction. There is no discussion of *profit potential* being transferred.

Independent parties at arm's length do implement this type of outsourcing arrangement and do not necessarily require explicit compensation from the transferee if the anticipated cost savings for the transferor are greater than its restructuring costs.<sup>87</sup>

### **(E) Indemnifying restructured entity for terminating / renegotiating existing arrangements**

Section E considers whether or not compensation is due when an old agreement is terminated or substantially renegotiated. Section (E) does not vary much from the *Discussion Draft*. Four additions are made, but they mostly are clarifications. Transitional language is added in two places,<sup>88</sup> and in two other places using comparables is reinforced.<sup>89</sup> Section E contains twenty-three paragraphs that are divided into four self-explanatory subsections:

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<sup>83</sup> *Guidelines*, Chapter IX, *supra* note 3, at ¶ 9.86 and *Discussion Draft*, *supra* note 6, at ¶¶ 85-86.

<sup>84</sup> *Guidelines*, Chapter IX, *supra* note 3, at ¶ 9.88 and *Discussion Draft*, *supra* note 6, at ¶ 88.

<sup>85</sup> *Guidelines*, Chapter IX, *supra* note 3, at ¶ 9.94 has no antecedent in the *Discussion Draft*.

<sup>86</sup> Although no examples are mentioned there are firms that specialize in outsourcing. A classic example is Flextronics International Ltd., a Singapore-based outsourcing company with roughly 78,000 employees in 29 countries located on five continents. It is the preferred outsourcer for products as wide ranging as Microsoft's Xbox and Lego's building blocks. Jeffrey T. Polzer & Alison Berkeley Wagonfeld, *Flextronics: Deciding on a Shop-Floor System for Producing the Microsoft Xbox* (HBS No. 9-403-090) (Aug. 23, 2004); Robert S. Huckman & Gary P. Pisano, *Flextronics International Inc.* (HBS No. 9-604-063) (Apr. 13, 2010); David Hoyt & Charles Holloway, *Flextronics: A Focus on Design Leads to India*, (Stanford Business School No. OIT-45) (Jan. 10, 2005).

<sup>87</sup> *Discussion Draft*, *supra* note 6, at ¶ 98.

<sup>88</sup> *Guidelines*, Chapter IX, *supra* note 3, at ¶ 9.100 (at sentence two and three) and ¶ 9.101.

- (E.1) Whether the arrangement that is terminated, non-renewed or substantially re-negotiated is formalized in writing and provides for an indemnification clause;
- (E.2) Whether the terms of the arrangement and the existence or non-existence of an indemnification clause or other type of guarantee (as well as the terms of such a clause where it exists) are arm's length;
- (E.3) Whether indemnification rights are provided for by commercial legislation or case law;
- (E.4) Whether at arm's length another party would have been willing to indemnify the one that suffers from the termination or re-organization of the agreement.

Section E applies numerous well-understood transfer pricing principles to business restructurings. Nothing new is added. For example, it is well understood that there is no presumption that indemnification is due in any transaction. Section E applies this to business restructurings.<sup>90</sup> In addition, it is well understood that written intercompany agreements are used to document transfers and agreements should have termination clauses tested under arm's length criteria. Section E applies this to business restructurings.<sup>91</sup>

There is no sustained discussion regarding how to apply *profit potential* at the entity level.<sup>92</sup> This is somewhat surprising given its importance in section C, but there is no discussion at all about *profit-making synergies*. Thus, other than for the discussion on how to indemnify for terminated or renegotiated related party agreements, there is nothing exceptional in section (E) other than classic applying transfer pricing to business restructurings.

### Conclusions - OECD

The OECD's approach to business restructurings is analytically awkward. The awkwardness stems from the OECD's inability to consider business restructurings from the MNE's perspective.<sup>93</sup> Each example in Chapter IX either presents a two-party *single asset* transfer, or a *single entity's* transfer that is deemed to be independent for this test. There is no consideration of business restructurings from the perspective of the whole MNE, no consideration of the CEO's role, no consideration of the critical role played by a careful realignment of decision-making with physical structures, even though these are the perspectives from which successful restructurings are designed.

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<sup>89</sup> *Guidelines*, Chapter IX, *supra* note 3, at ¶ 9.106 (sentence three) through ¶ 9.108 and ¶ 9.111 through ¶ 9.112 (first two sentences).

<sup>90</sup> *Guidelines*, Chapter IX, *supra* note 3, at ¶ 9.103 and *Discussion Draft*, *supra* note 6, at ¶ 101.

<sup>91</sup> Deloris R. Wright & Harry A. Keates, *Comments on the OECD Discussion Draft on Transfer Pricing Aspects of Business Restructurings*, INTERNATIONAL TRANSFER PRICING JOURNAL 115 (March/April 2009); Giammarco Cottani, *OECD Discussion Draft on Transfer Pricing Aspects of Business Restructurings: Summary of Business Comments and Issues for Discussion*, INTERNATIONAL TRANSFER PRICING JOURNAL 233 (July/August 2009)

<sup>92</sup> "Profit potential" is used only twice. Both times in *Guidelines*, Chapter IX, *supra* note 3, at ¶ 9.100. The *Discussion Draft* used earlier expression "profit/ loss potential" only once. *Discussion Draft*, *supra* note 6, at ¶ 99.

<sup>93</sup> The OECD acknowledges these difficulties at: *Guidelines*, Chapter IX, *supra* note 3, at ¶ 9.6.

The implementation of integrated business models and the development of global organizations, where they are done for bona fide commercial reasons, highlight the difficulty of reasoning in the arm's length theoretical environment which treats members of an MNE group as if they were independent parties. This conceptual difficulty with applying the arm's length principle in practice is acknowledged in these Guidelines (see paragraphs 1.10-1.11).

As a result, when efforts are made to square real world business restructurings with the OECD's abstract views towards business restructurings, things do not "fit" well. Some material obvious problems are:

- Successful business restructurings are more about aligning decision-making processes throughout an MNE with its structure than they are about structural change. The OECD is largely concerned with asset transfers and very little, however, about fundamental changes in decision-making.
- Because the CEO must critically examine an enterprises' decision-making, the CEO frequently is directly involved in successfully restructurings. The OECD, however, does not consider the CEO's involvement in business restructurings.
- Over 70% of all business restructurings fail to achieve performance objectives, and many actually damage productivity. The OECD, however, largely ignores losses in a restructuring, focusing instead only on restructuring gains.
- Business restructurings primarily seek *performance-changing synergies*. The OECD's concern is with transferring *profit potential* that may in fact include losses embedded in assets transferred among related parties.
- Business restructurings invariably involve three or more entities, if not the entire MNE. The OECD only examines binary transactions between two related parties within the MNE.

The OECD recognizes that business restructurings reallocate MNE profits<sup>94</sup> but the OECD's analysis does not look at the whole MNE. Yet, the OECD Member Countries see things differently so they tend to focus on the MNE. Member Countries want to know how to determine if the MNE's profit reallocations are primarily tax motivated. Chapter IX cannot hope to answer this question because it focuses entirely on transactions and entities and never on the MNE itself.

The JCT presents the typical assessment:

An advantage of much of the business restructuring activity and of many of the legal structures highlighted in the case studies is the ability of *taxpayers* to generate income in jurisdictions with low tax rates, or in which they have been able to negotiate favorable tax regimes with the local government. The *taxpayers* in each of the case studies were successful in lowering worldwide average tax rates over the study period as a result of structuring transactions and business operations in a way that allowed them to locate and retain significant business earnings in low-tax jurisdictions.<sup>95</sup>

The JCT views the MNC as the "taxpayer" rather than a legal entity within the MNE's overall structure. From that perspective, the JCT's concern differs from the OECD. The JCT's

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<sup>94</sup> *Guidelines*, Chapter IX, *supra* note 3, at ¶ 9.6.

Business restructurings are typically accompanied by a reallocation of profits among the members of the MNE group, either immediately after a restructuring or over a few years.

<sup>95</sup> JCT, *Present Law and Background related to Possible Income Shifting and Transfer Pricing*, *supra* note 5 at 105.

is concerned that the MNE may be inappropriately structuring transactions to shift profits from the US.<sup>96</sup> The intent is to use these case studies to suggest solutions.

### **Conclusion – Synergies or Shelter**

By not considering the entire MNE, the OECD misses two critical aspects to business restructurings – synergies and shelters. These concepts are diametrically opposite within the business restructuring context. A true business restructuring is an activity highly focused on creating MNE-transforming synergies. It is not likely to be a tax shelter. A restructuring, however, that improves financial performance through tax savings derived from structural changes (asset shuffling) that does not involve changes in the way business decisions are made is likely to be a shelter. Two questions therefore need to be asked:

*Synergies* – Did the CEO re-tool decision-making, aligning it with physical structures to create the context for reasonably anticipated performance-changing synergies through the restructuring? In doing so, did the CEO create an intangible asset that is due a royalty return?

*Shelter* – Was the restructuring primarily an asset-moving exercise, with limited CEO involvement, marginal attention to decision-making, and dominated by efforts to achieve tax savings instead of performance-changing synergies that would benefit the whole MNE?

### **Conclusion – JCT Approach**

The JCT study looks at business restructurings very differently than the OECD. The JCT uses case studies to identify the tax-motivated restructuring's attributes. The primary concern is with moving valuable intangibles offshore. Isolating tax motivated transactions, however, needs more than a business purpose or economic substance test. The classic definition for a *tax abusive restructuring* is: (a) moving functions, risks, and assets, (b) among related parties that is (c) not supported by a meaningful change in economic position other than the receiving (d) a *tax* benefit. This economic substance test is commonly applied when identifying tax motivated transactions.<sup>97</sup>

Through its case studies approach, the JCT points towards a two-step test; an objective measure reinforcing a subjective measure. The JCT case studies suggest that that an objective formula could be applied to source intangible income where intellectual property is owned and fully developed in the US (or at least 90% developed in the US). The formulas suggested in the case

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<sup>96</sup> The point is *not* that a tax motivation automatically taints a transaction. The point is that the JCT considers tax motivation *at the group level* to be a critical question, and the OECD does not. Both the JCT and the OECD would agree with *Guidelines*, Chapter IX, *supra* note 3, at ¶ 9.181:

Under Article 9 of the OECD Model Tax Convention, the fact that a business restructuring arrangement is motivated by a purpose of obtaining tax benefits does not of itself warrant a conclusion that it is a non-arm's length arrangement. The presence of a tax motive or purpose does not of itself justify non-recognition of the parties' characterization or structuring of the arrangement under paragraphs 1.64 to 1.69.

<sup>97</sup> *ACM P'ship v. Commissioner*, 73 T.C.M. (CCH) 2189, 2215 (1997), *aff'd.*, 157 F.3d 231 (3d Cir. 1998); Joseph Bankman, *The Economic Substance Doctrine*, 74 S. CAL. L. REV. 5, 7-11 (2000).

studies are: (1) sales / taxable income;<sup>98</sup> (2) workforce / taxable income;<sup>99</sup> and (3) property / taxable income.<sup>100</sup> Each ratio resembles an element in the traditional three-factor formula US states use to allocate income among jurisdiction.<sup>101</sup> The JCT suggests that applying both objective and subjective tests together would work but it unfortunately does not articulate a statutory or regulatory solution.

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<sup>98</sup> Four JCT case studies suggest that a sales/ taxable income ratio could be useful. Alpha company made 60% of its sales but reported less than 30% of its income in the US. [JCT, *Present Law and Background related to Possible Income Shifting and Transfer Pricing*, *supra* note 5 at 54.] Charlie company made 60% of its sales but reported 10% of its income in the US. [JCT, *Present Law and Background related to Possible Income Shifting and Transfer Pricing*, *supra* note 5 at 73.] Echo company made 66% of its sales and reported 50% of its income in the US when the reporting period began but saw US sales fall to 60% and US income fall to 25% when the reporting period ended. [JCT, *Present Law and Background related to Possible Income Shifting and Transfer Pricing*, *supra* note 5 at 84.]

<sup>99</sup> A workforce/ taxable income ratio is suggested in the Bravo company facts. Bravo has 97% of its workforce and 50% of its sales in the US but reports only 30% of its taxable income in the US. [JCT, *Present Law and Background related to Possible Income Shifting and Transfer Pricing*, *supra* note 5 at 62.]

<sup>100</sup> A property / taxable income ratio is suggested in the Delta company facts. Delta's US-based facilities produce 45 to 55% of company revenue but only 10% of the income is reported in the US. [JCT, *Present Law and Background related to Possible Income Shifting and Transfer Pricing*, *supra* note 5 at 77.]

<sup>101</sup> There have been proposals to adopt formulary apportionment for corporate income tax [Reuven Avi-Yonah, Kim Clausing & Michael Durst, *Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split*, 9 FLORIDA TAX REVIEW 497 (2009) (proposing formulary apportionment for all corporate taxable income); Michael C. Durst, *Congress: Fix Transfer Pricing and Protect US Competitiveness*, TAX NOTES 401 (July 26, 2010)], and for residual amounts in a profit split [Reuven S. Avi-Yonah, *Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation*, University of Michigan Public Law Working paper No. 09-011 (May, 29, 2009) available at: [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1411649](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1411649)].