Transfer Pricing in Business Restructurings – Reasoning from Implausible Assumptions Issue Note 2 – (OECD, Discussion Draft)

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Richard T. Ainsworth
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The OECD’s Center for Tax Policy and Administration (CTPA) roundtable on business restructurings in January 2005\(^1\) was a considerable success. It led to a Joint Working Group (JWG) project later that year.\(^2\) After two years the JWG project was divided so that permanent establishment threshold issues were handled by Working Party No. 1 (a report was issued on July 17, 2008)\(^3\) and transfer pricing aspects of business restructurings were handled by Working Party No. 6 (WP-6). The *Discussion Draft on Transfer Pricing Aspects of Business Restructurings* (the *Discussion Draft*)\(^4\) is the first product from WP-6 on this matter. It was available for public comment between September 19, 2008 and February 19, 2009,\(^5\) and it attracted over 500 pages of commentary from 36 sources.\(^6\)

FOCUS ON ABUSIVE TRANSACTIONS

If the WP-6 work-product follows through to a conclusion it will (of necessity) be broadly applicable to all cross-border restructurings (under Articles 5, 7 and 9 of the Model Tax Convention) and not just to a small subset of tax abusive restructurings. The *Discussion Draft* states that it is not concerned with domestic anti-abuse rules, even though the selective (one-sided) application of anti-abuse rules may be the true source of business concerns in this area.\(^7\)

\(^1\) OECD, *Second Annual Center for Tax Policy and Administration Roundtable: Business Restructurings* (Roundtable, summary) available at: http://www.oecd.org/document/20/0,3343_en_2649_37989760_34535252_1_1_1_1,00.html

\(^2\) OECD, Approval of the Mandate, available at: http://www.oecd.org/document/11/0,3343_en_2649_37989760_38087051_1_1_1_1,00.html


\(^5\) Available at: http://www.oecd.org/dataoecd/59/40/41346644.pdf

\(^6\) OECD, Public Comments on the Transfer Pricing Aspects of Business Restructurings, available at: http://www.oecd.org/document/25/0,3343_en_2649_37989760_42155737_1_1_1_1,00.html

\(^7\) Article 1 of the OECD Model states that the benefits of a tax treaty should not be available to a taxpayer where the main purpose for entering into a transaction is to secure a more favorable tax treatment. Issue Note No. 4 of the Discussion Draft come the closest to explaining how business restructurings and anti-abuse rules relate. See Anuschka J. Bakker & Giammarco Cottani, *Fourth Issue Note: Sting in the Tail*, INTERNATIONAL TRANSFER PRICING JOURNAL 81 (March/April 2009). Few jurisdictions conduct audits, and make adjustments based on a business restructuring that placed more (not less) income within local entities. However, if the other jurisdiction seeks to prevent this income loss through the application of anti-abuse rules (rather than transfer pricing rules), then there may not be an effective mechanism to secure corresponding adjustments. Placing the entire cross-border (business restructuring) fact pattern within the ambit of the transfer pricing provisions of the Model Tax Convention (where there are clear mechanisms for achieving parity) makes a lot of sense. *Discussion Draft*, supra note 4, at ¶¶ 8, 18.4, 195, & 196.
That being said, when considered broadly, the Discussion Draft appears to narrowly focus on just such abusive restructurings. For example, illustrations in the Discussion Draft only examine profit allocations (there are no loss patterns considered). In addition, the Discussion Draft selects its illustrations from a limited number of transaction-types that are commonly associated with abusive restructurings: (a) the conversion of a fully-fledged manufacturer to a contract manufacturer (or toll manufacturer), (b) the conversion of a fully-fledged distributor to a stripped distributor (commission agent, commissionaire, or classic buy-sell distributor) with some additional (but limited) illustrations drawn from (c) the development of shared service centers and contract service providers, as well as (d) the transfer of intangible assets to off-shore holding companies. This paper will rely on additional illustrations drawn from well known business restructurings to try to bring out the full impact of the Discussion Draft.

THE ESSENCE OF THE TRANSFER PRICING PROBLEM

The core transfer pricing problem in a MNE’s business restructuring is the fact that: (a) the decision to reorganize is made centrally but (b) the arm’s length principle mandates that the transfer of functions, assets and/or risks among related parties must be accounted for locally (at the entity level).

This is the case even though entity-to-entity transfers may not be the way anyone understood these transactions in the restructuring plan. In many cases hypothetical arm’s length prices for transfers need to be derived only for tax purposes. Finding these prices can be a difficult if not an impossible task when intangible assets or substantial business risks are involved.

However, to make matters worse, the Discussion Draft adds to the natural difficulties of these tasks by suggesting that not only are assets, rights, and risks transferred in a restructuring, but there is something else of value, something it identifies as “profit/loss potential” (which is not itself an asset) that is “carried” between entities in a restructuring. This too must be valued (when it is found) and considered in the calculus of the arm’s length price.

SOLUTION BY ASSUMPTION
(AND PROBLEMS WITH THIS APPROACH)

The Discussion Draft resolves many of its most difficult problems with assumptions. These assumptions frequently have an intuitive appeal, but are not buttressed empirically, marketplace studies.

This paper considers one of these assumptions. In Issue Note No. 2 (Arm’s Length Compensation for the Restructuring Itself) a central contention is that not only do businesses that restructure have a clear grasp of (and take an accurate measure of) the synergistic value of the restructuring they are engage in, but they also can and do measure alternate courses of action. In other words, specific transfers occur (WP-9 assumes) because these are the best result that could be achieved from among a number of known (or knowable) options. Thus, taxpayers and tax authorities (theoretically) can measure the values being transferred indirectly – by examining the “other options reasonably available.”

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8 Discussion Draft, supra note 4, at ¶ 209 indicates:
But, how good are we at anticipating and then measuring the synergies that are expected to be derived from a restructuring? What if the empirical evidence suggests that most business restructurings have “… no effect – and some actually destroy value?” What if, “… fewer than one-third [of all business restructurings] produce any meaningful improvement in performance?” What if, “… there is a profound misunderstanding about the link between [business] structure and [fiscal] performance?” What if (to take a specific case) a thoroughgoing two-year business restructuring that appeared to everyone to be the poster child of a restructuring success story (Wall Street’s profit expectations were exceeded by 50%), in fact turns out to be nothing short of restructuring “suicide?”

If this is the case, then how do we value entity-level transfers within a MNE restructuring? And then, how do we add to this value the anticipated profit/value that is carried with the transferred assets? Should be draw any comfort when the solution to valuation problems is to value instead the “other options reasonably available” to the entities engaged in the transfer.

THE DECISION-MATRIX INTANGIBLE

Is it possible that even with our best efforts we really do not know (until some time has passed) what values were created (or destroyed) in a restructuring? What if the source of our problem is that successful restructurings are in fact all about creating a new decision-making intangible? What if a successful restructuring is far more that just shuffling assets around that are embedded with potential profits or losses? This is what the empirical evidence suggests. And if this is the case, how do we accurately measure this intangible without using hindsight?

Such an intangible is exceptionally unique – it is the business plan on how to best make decisions that optimize performance. It is a tailor made intangible that fits a specific enterprise. It is an intangible that is difficult to duplicate in any but the most general ways. However, it is an intangible that has huge (potentially enterprise-saving) value if the CEO “gets it right.”

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. … The OECD is of the view that at arm’s length, an independent party would not enter into a restructuring transaction that is expected to be clearly detrimental to it if it has the option realistically available to it not to do so. In evaluating whether a party would at arm’s length have had other options realistically available to it that were clearly more attractive, due regard should be given to all the relevant conditions of the restructuring, to the rights and other assets of the parties, to any compensation or indemnification for the restructuring itself and to the remuneration for the post- restructuring arrangements … as well as to the commercial circumstances arising from participation in an MNE group ….

9 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 (Oct. 2010) (empirical support for the positions taken in the June article are set out in the forthcoming book which the author has received in an “advance reader’s copy” compliments of the publisher).

10 This is the story of BP. Tony Hayward’s 2007 reorganization of BP had been deemed a success by 2009 (even by Blenko, Mankins & Rogers in both article and text). However, by 2010 the reorganization is considered “suicidal” by Jeffrey Stamps & Jessica Lipnack as a significant cause of the Deepwater Horizon disaster, see infra note 28.
For cross-border tax purposes then, how should the ambiguity in valuing this new intangible inform our analysis? Should a portion of the value of this intangible be imputed to the functions, assets and/or risks that are transferred in the restructuring? Should (or can) a clear distinction be drawn between the potential profit/loss value of the decision-making intangible and the potential profit/loss value that is inherent in the transferred assets themselves?

Does the Discussion Draft get this analysis right? Or, does it simply assume too much and end up being a very unstable text when applied in a real restructuring setting? Does the absence of even a single example dealing with restructuring losses belie a belief by WP-6 that restructurings almost always improve fiscal performance, or that its real concern is with tax abusive restructurings?

Three real world examples will be helpful. The first example, Ford Motor Company, highlights the transfer of intangible assets; the second example, BP, highlights the connection between risk and decision-making; the third example, Xerox, highlights how CEOs frequently “get it all wrong” before the right decision-matrix is found to bring out the synergies in the enterprise. Ford and Xerox seem to be successful reorganizations; BP appears to be a failure.

After these examples the second Issue Notes of the Discussion Draft is examined (section-by-section) in light of the questions posed above. The paper concludes that the Discussion Draft needs to be developed further if the intent is to present a full consideration of transfer pricing in the context of all cross-border business restructurings.

BUSINESS RESTRUCTURING AT FORD (2006) – Transferring Intangibles and a Successful Business Restructuring. By 2006 the Ford Motor Company had been losing market share by a point or more each year since 2000. Alan Mulally, Ford’s new CEO11 began a successful reorganization of the company in 2006. He called it “the way forward” or “Ford fights back,”12 and Ford returned to profitability in 2010.

Structurally, Mulally moved Ford from a regional-business-unit design to a global matrix of complementary functionalities. Characteristic of the new Ford was an increase in the use of global car platforms, and global parts suppliers.13 The Ford Motor Company of Canada (a wholly owned subsidiary of the Ford Motor Company) was directly affected. Ford Canada was required to close its Windsor Castings subsidiary.14 Windsor Castings was a “green” company. At the time of its closing Windsor was producing

11 Prior to 2006 Alan Mulally was the CEO of Boeing’s Commercial Airplanes division.
14 Ford’s decision was to out-source casting operations. Ford generally moved away from in-house casting. Production was also terminated at the Ford casting facility in Cleveland Ohio. See: Production Ends at Historic Windsor Casting Plant, WEBWIRE (May 29, 2009) available at: http://www.webwire.com/ViewPressRel.asp?Id=37549
engine blocks and crankshafts for seven Ford models entirely out of reprocessed steel. This function however, was being outsourced to low cost manufacturers.

Among car enthusiasts Windsor Castings has a different reputation. Rather than being noted as a “green” company, Windsor Castings is noted as the birth place of the exceptionally durable Windsor small-block V-8 engine (first introduced in 1962). Although slated for replacement several times, the Windsor design refused to die. It was simply that good. It outlasted all competitors. Today, Ford’s racing engines are essentially upgrades of the Windsor. Windsor Castings however, was not as fortunate as its engine – the plant was closed; but the engine lives on. The simple transfer pricing question in this pattern is: Who owns the Windsor engine design intangibles today, and what should they have paid for them?

Because the arm’s length principle applies to reorganizations at the entity level, when the Windsor engine intangibles are transferred to a related-party Windsor Castings must be compensated in a manner comparable to how an independent entity would be compensated (operating at arm’s length) under similar circumstances. These valuable intangibles do not just transfer for free, simply because they are going to a related party in the same MNE. The Discussion Draft makes it clear that if this is a cross-border transfer, then Article 9 of the Model Tax Convention applies.

This story presents a simple transfer pricing question because the text narrows the focus to a single intangible asset in an entity that is being terminated. This problem would be far more complex if the focus was Ford more broadly, and if Windsor Castings continued to operate, but under the influence of a new decision matrix. In that case the value of the intangible, its inherent profit/loss potential, and the anticipated impact of the new organizational structure would all need to be measured.

BUSINESS RESTRUCTURING AT BP (2007)

Transferring Risk and a Failed Business Restructuring

When Tony Hayward became CEO of BP in 2007, the company produced 3.8 million barrels per day. ExxonMobile produced slightly more – 4.2 million. The stock market however, “valued” each BP barrel at $59 while a barrel of ExxonMobile was worth $122. Why was there such a difference?

The first Windsor engines (the 221 series) was used in the early Ford Fairlane. The second series (the 260’s) was used in the Ford Falcon, the Mercury Comet, and the 1964 Mustang. A special rally version was used in the AC Cobra sports cars. The Shelby GT-350 used the 289. The Windsor lineage extends to the Racing Boss 351 engine that currently sells for $1,999 at Ford Racing Performance Parts.


These facts are abbreviated. The Windsor engine was not exclusively produced at Windsor Castings, although it was conceived (first design and production) at the Ontario plant. Design modifications to the Windsor engine were made at other Ford facilities. However, the Windsor engine had its genesis at Windsor Castings, and was still being produced there the day it was closed. The Ford plant in Cleveland Ohio was also involved in production of the Windsor engine.

Hayward believed BP’s organizational structure negatively impacted margins. He set out to correct this through a business restructuring. Hayward told shareholders, “Our problem is not about the strategy but about our execution of it … our organization has grown too complex … what [we will be] doing represent[s] a fundamental shift in how BP works.”

Lord John Browne, his predecessor, had also restructured when he became CEO in 1996 and this is what Hayward was going to change.

The BP that Lord Browne inherited had five business units each of which, “… operated with a high degree of independence and intra-group trading [was] carried out strictly on arm’s length terms.” Browne’s restructuring extended the logic of this model by further subdividing “… BP into 150 business units and giv[ing] each manager considerable freedom. The only conditions [imposed on the managers] were that they respect certain “boundaries” – essentially the core values of the company – and deliver on their performance contracts. … Browne downsized or completely eliminated much of the staff-supported, vertical, command-and-control infrastructure, abolishing the offices of country presidents and several functional departments in London.” Browne believed that fully autonomous subunits and empowered managers unleashed entrepreneurial spirits, promoted innovation and made the company more profitable. Browne also recognized that keeping managers accountable according to their performance contracts encouraged cost-cutting. Integration under Browne was horizontal not vertical.

From a transfer pricing perspective Lord Browne’s BP (and the BP before him) is exactly what a tax administration wants to see – a MNE that actually deals with related parties at arm’s length. Corporate policy and tax policy coincide. The problem is – a MNE operating this way does not (according to the next CEO, Tony Hayward) optimize shareholder value.

Hayward attributed BP’s poor margins to the complexity of the horizontal integration in Lord Browne’s system. Hayward therefore, structurally consolidated the 150 units and

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21 The five units were: exploration and production; refining and marketing; chemicals; minerals; and nutrition
25 Hayward’s belief is of course very consistent with an economic understanding of the nature of a MNE. Long established economic theory suggests that the only reason for a MNE to exist is to produce goods or services more efficiently than the marketplace. Thus, if all intercompany transactions are conducted exactly as they would be in the market, then MNEs would not be needed and would be replaced by the market. Ronald H. Coase, The Nature of the Firm, 4 Economica 386 (1937)
eliminated overlapping functions. Hayward did not, however, pull back the decisional independence of the units – and this may have been a mistake.26 Hayward’s BP tended toward vertically integration, but decisions were still made largely by trusted professional staff within each business unit (as they were under Browne).

BP’s 2008 Annual Report states: “From 1 January 2008, BP has two business segments: [1] Exploration and Production and [2] Refining and Marketing.”27 Eleven levels of management were reduced to seven,28 and “[b]y late 2009, BP had eliminated $3 billion in costs and was turning a profit that beat analysts’ expectations by 50%.”29

Was Hayward’s restructuring a success? Early balloting said “yes.” After Deepwater Horizon30 the answer is “no.” Deepwater exposed an aspect of Hayward’s restructuring that was not well considered – in extremely high risk situations the decision-makers were separated from ultimate liability-holders. In other words, managers in the business units were uniformly encouraged to make short-term cost-cutting decisions, but under Hayward they were freed from the cautions of long-term risk assessments (something that had previously come through Browne’s horizontal coordination structure).31

For this reason Stamps and Lipnack consider Hayward’s reorganization “suicidal.” They contend that the Deepwater disaster is “… a massive organizational failure, not [a failure] of people but of [organizational] design.”32 Hayward’s testimony before Congress made this clear. When he explained to Congress that his own reorganization kept him out of the Deepwater

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26 The reason that this may have been a mistake is that Hayward’s consolidation removed the (complex) horizontal integration that Browne relied upon, but did not replace it with a comparably effective vertical integration.


29 Marcia W. Blenko, Michael C. Mankins & Paul Rogers, The Decision-Driven Organization, HARVARD BUSINESS REVIEW 61 (June 2010)

30 The Deepwater Horizon oil spill is a massive (and at the time of the writing an ongoing) spill in the Gulf of Mexico that is considered to be the largest offshore oil spill in US history – some estimates place it as the largest oil spill in the world. The spill stems from the Macondo wellhead on the ocean floor that began gushing oil after the Deepwater Horizon drilling rig exploded. Experts fear that the spill is an environmental disaster. On June 20, 2010 BP agreed to set up a $20 billion spill fund, and pledged US assets worth $20 billion as bond.

31 Liability for the oil spill is with BP plc, not with decision-making subsidiaries. The well is operated by BP Exploration and Production Inc. (BP-E&P) a wholly-owned US subsidiary of another US company, BP America Inc. (BP-A). BP-A is a wholly-owned subsidiary of the UK parent company, BP plc. Profits from the well were to be split along ownership lines: 65% to BP plc; 25% to Anadarko; 10% to MOEX Offshore 2007 (a wholly owned subsidiary of Japan’s Mitsui Oil Exploration Ltd.) According to Anadarko, documents were filed with the US government indicating that the same parties agreed to split liabilities in the same proportion (barring “gross negligence or willful misconduct” by one of the parties). Anadarko’s position is it is not liable for any part of the spill, because BP plc was grossly negligent – most likely because BP plc had designated BP-E&P to be the decision-maker on the rig, knew that BP-E&P was programmed to make cost-minimizing decisions, and did not exercise control over those activities when risk of liabilities were extremely high. From the days of Lord Browne, BP-E&P operated under a short term (cost-saving) decision structure. There is no indication that this operating posture changed under Hayward.

32 Stamps & Lipnack, supra note 28.
Horizon decision-loop the front page of the Wall Street Journal carried his picture with this caption: “I’m not stonewalling. I simply was not involved in the decision making process.”

The transfer pricing question presented by the Deepwater Horizon oil spill concerns the attribution of risk. The proper allocation is to attribute the Deepwater Horizon risk to Tony Hayward’s new decision-making matrix. This intangible was created by the restructuring and is located at the corporate headquarters (BP plc in London). The BP fact pattern is not properly analyzed by only looking at the asset transactions between BP plc and BP-E&P.

From a contract and financial capacity standpoint, the risk of the Macondo Well should rest with BP plc. However, because day-to-day decisions at the Macondo Well are made by BP-E&P without critical oversight by BP plc there is some ambiguity in the fact pattern. Neither BP plc nor BP-E&P carried insurance for blowout losses.

A static analysis would ask (in 2007) whether or not risks associated with the Macondo Well resided with BP-E&P (under Lord Browne), and whether it was transferred to BP plc (under Tony Hayward). If so, BP plc would expect to be compensated by BP-E&P for assuming this risk. A more dynamic analysis however, would consider the restructuring itself as an intangible-creating activity. BP plc possesses Tony Harward’s new decision-matrix for managing BP. Thus, the management risk associated with the Macondo Well resides in London.

Hindsight makes it clear this is where the risk and loss is. BP plc (not BP-E&P) is setting up a $20 billion fund for damaged wildlife, businesses and shorelines. BP plc is expecting to recognize $10 billion in losses on its UK returns (not BP-E&P on its US returns). However, this is not an assessment that would be easily reached, nor is it a risk that would be easily measured with foresight in 2007.

BUSINESS RESTRUCTURING AT XEROX (2001) –

Multiple Restructurings before Success

The 2001 restructuring of Xerox, led by CEO Anne Mulcahy, was a success. Success was not over-night. It was seven years later before the press reported that Xerox profits had “skyrocketed 79%.”

33 Michael M. Phillips & Stephen Power, BP Chief on Hot Seat, WSJ 1 (June 18, 2010). See also: Marty Beckerman, Context-free Highlights from Tony Hayward’s Testimony ESQUIRE (June 17, 2010), available at: http://www.esquire.com/blogs/politics/tony-hayward-quotes-061710

I wasn't part of the decision-making process... I wasn't involved in any of the decision making... I simply was not involved in the decision-making process... I was not part of that decision-making process... I was not involved in that decision... I was not involved in the decision making... That was a decision I was not party to.... I wasn't involved in the decision making on the day... I wasn't involved or aware of any of the decisions... I wasn't involved; I'm sorry.


35 Ed Crooks, Spill Cost to Cut BP Tax Bill by $10bn, FINANCIAL TIMES 1 (July 13, 2010).

36 Success may have been visible as early as 2004:

Note that revenues have not grown, but the company has returned to solid, if not spectacular profitability, debt is down 45%, and cash balances are very healthy. Xerox stock has rebounded from its low of $4.20 on October 20, 2002, to $15.00 as of April 1, 2005. Finally, the product development program is showing results as forty new products have been introduced.
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. It had the success and the financial strength to develop an obsession with quality. It was the first company ever to win the triple crown of quality: the Deming prize in Japan in 1980; the Baldrige award in the US in 1989; the European Foundation for Quality award in Europe in 1992.

Xerox was unprepared for price competition, and as it lost market share its’ CEOs began restructuring. David Kearns restructured the company twice in the 1980’s, his successor Paul Allaire arrived in 1992 and restructured four more times. Richard Thoman was brought in from IBM in 1999, and true to form, Thoman began a seventh (failed) restructuring.

Thoman was quickly replaced by Anne Mulcahy in 2001. None of the seven restructuring efforts before her had been successful. Xerox was close to bankruptcy, and under an SEC investigation that would culminate in a $170 million charge. Share prices were in freefall ($65 share prices in 1999, fell to $27 when Mulcahy took over as COO, and fell further to a low of $4.44 by the time she was CEO). Mulcahy began the eighth restructuring. This time it worked.

Mulcahy’s restructuring was “decision-driven” not structure-driven. She began with an examination of every critical decision Xerox needed to make and execute to fend off bankruptcy. Decisions were carefully assessed, clearly articulated, and efficiently executed. She raised cash, 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.

Bill George, Anne Mulcahy: Leading Xerox through the Perfect Storm (A) and (B) 10 (Teaching Note) (HBS No. 5-408-101) (Feb. 21, 2008).


38 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%).


40 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”).

41 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 ar 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)

42 Paul Thoman was the CFO of IBM prior to coming to Xerox, and had designed the IBM restructuring in the personal computer division. As an outsider he was seen as a change agent, but remained in position for 13 months before he was replaced by Anne Mulcahy.

43 Thoman endeavored to duplicate the IBM restructuring, changing Xerox to a service business in the process. Thoman centralized. Three customer billing centers replaced 30 geographically oriented centers. Two-thousand geographically based sales team members were reassigned to sell tailor-made Xerox solutions to industry groups.


45 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.

Electronic copy available at: https://ssrn.com/abstract=1645404
Richard T. Ainsworth & Andrew Shacht
Business Reorganization
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... 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.46

In executing the turnaround much of Mulcahy’s success derived from her direct engagement with employees and customers. Structural adjustments were one thing (and they were substantial47) but the restructuring only worked because Mulcahy did not spend her time with the numbers at headquarters – she was out building and reinforcing the Xerox intangible. She demonstrated decisiveness and customer commitment.

Mulchahy 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.48 Mulchahy was known for cancelling shareholder meetings, but made it clear that she would fly anywhere to save a valued customer relationship.49

THE DISCUSSION DRAFT

Overview

All business restructurings have two phases: (a) the restructuring itself and (b) the post-restructuring business operations. Transfer pricing issues arise in both phases. The Discussion Draft focuses mostly on the first.

In this initial phase two critical transfer pricing events occur. First, a new decision-matrix (the set of decision about how decisions are made) is established. Secondly, a series of related party transfers are carried out. Functions, assets and risks are transferred (all in accordance with the restructuring plan) to facilitate efficient management by the decision-makers.

The Discussion Draft does not acknowledge the first of these events. More importantly, the Discussion Draft does not recognize that this event constitutes the creation of a valuable, unique intangible. The implementation of a new enterprise level decision-matrix is no different than any other corporate R&D effort, except in this instance the effort is directed inward at the corporate decision structure instead of outward at a new consumer product or commercial design.

46 Marcia W. Blenko, Michael C. Mankins & Paul Rogers, The Decision-Driven Organization, HARVARD BUSINESS REVIEW 59 (June 2010).
47 She reduced Xerox’s 96,000 employees by 30,000, and restated profitability from 1997 – 2001 by $1.9 billion.
48 Bill George, Anne Mulcahy: Leading Xerox through the Perfect Storm (A) and (B) 12 (Teaching Note) (HBS No. 5-408-101) (Feb. 21, 2008).
49 Bill George, Anne Mulcahy: Leading Xerox through the Perfect Storm (A) 9 (HBS No. 5-405-050) (Jan. 26, 2005)
Establishing a present value for the new decision-matrix intangible is an entirely speculative endeavor at the initial phase of a restructuring. At this point everything is potential. The new system could work spectacularly, or it could fail miserably. Xerox is a notable example of this. Nothing is known about the actual values that will be returned to the enterprise until well into the post-restructuring phase. The only way that returns (profit or loss) attributed to this intangible becomes a transfer pricing concern is when they get mixed up with the inherent profit/loss potentials that are embedded in various assets, right or risks that are being transferred.

The Discussion Draft misanalyses this point. Using the expression “profit/loss potential” broadly, the Discussion Draft associates all improvements in enterprise performance with structural changes. It allows no room for decision-based improvements. The Discussion Draft considers all “profit/loss potential” to be fully derivative of asset transfers. It theorizes that pre-existing rights, functions or assets “carry” these “potentials” from one related party to another in the restructuring. The way the Discussion Draft sees things,

The question is whether there are rights or other assets transferred that carry profit/loss potential, and should [there] be remuneration at arm’s length.\(^{50}\)

The difficulty with the Discussion Draft’s approach is that its assertions do not square with the research. 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. Blenko, Mankins and Rogers 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.\(^{51}\)

**ISSUE NOTE No. 2**

**ARM’S LENGTH COMPENSATION FOR THE RESTRUCTURING ITSELF**

*Introduction*

At seventy-six paragraphs Issue Note No. 2 is the largest of the four Issue Notes in the Discussion Draft. It sets out the analysis for determining the arm’s length price for transfers that occur as part of a business restructuring. From the opening sentences of the introduction this Issue Note ignores the fact that successful business restructurings are far more about establishing effective decision structures than they are about moving assets around within the multinational enterprise itself. It states:

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\(^{50}\) *Discussion Draft, supra note 4, at ¶ 18.2.* The workability of this approach seems to be doubt even by the OECD. WP-6 specifically invites comments from the public on this point. *Discussion Draft, supra note 4, at ¶ 66.*

\(^{51}\) Marcia W. Blenko, Michael C. Mankins & Paul Rogers, *The Decision-Driven Organization*, HARVARD BUSINESS REVIEW 57 (June 2010)
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.52

The Discussion Draft is very clear that amounts for “associated profit / loss potential” need to be added to (or subtracted from) the value of functions, assets or risks transferred among related parties to arrive at the arm’s length price. There is only limited analysis of losses (subtractions), even though failure is just as likely as success in a business restructuring.53 Issue Note No. 2 is broken down into four sections with (B) being the most important:

(A) Understanding the restructuring itself.
(B) Reallocation of profit/ loss potential as a result of a business restructuring.
(C) Transfer of something of value (e.g. an asset or an ongoing concern).
(D) Indemnification of the restructured entity for the detriments suffered as a consequence of the restructuring.

(A) Understanding the restructuring itself

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 …”54 As a result the Discussion Draft has far reaching implications for MNE tax compliance. Section (A) is on understanding the restructuring and considers three sub-topics: (A.1) identification of related party transactions; (A.2) reasons for restructuring and the synergistic benefits; and (A.3) assessment of entity-level options available.

(A.1) Identification of Related Party Transactions

The first step is to identify related party transactions within the restructuring. A functional analysis is needed and a search for comparables is required. The Discussion Draft recognizes that transfers of tangible assets are easier to identify than are transfers of rights and risks. A before-and-after functional analysis is required:

This [functional] analysis must include an identification of the functions before and after the restructuring, and an evaluation of the rights and obligations of the restructured entity under the pre-restructuring arrangement (including those existing under contract and commercial law) and of the manner and extent to which those rights and obligations change as a result of the restructuring.55

52 Discussion Draft, supra note 4, at ¶ 46 (emphasis added).
53 The omission of losses from the Discussion Draft is a common occurrence. In Issue Note No. 2 that are only substantively considered at ¶¶ 95-97. In other Issue Notes the situation is much worse. See: Baker & McKenzie, Comments on the OECD Restructuring Discussion Draft10 (discussing Issue Note No. 1 Baker & McKenzie observe 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
54 Marcia W. Blenko, Michael C. Mankins & Paul Rogers, The Decision-Driven Organization, HARVARD BUSINESS REVIEW 56 (June 2010).
55 Discussion Draft, supra note 4, at ¶ 50 (emphasis added).
Comparables are needed. The Discussion Draft is not put off by evidentiary difficulties. When evidence is lacking the Discussion Draft authorizes the use of hypothetical comparables: In the absence of evidence of rights and obligations in a comparable situation, it may be necessary to determine what rights and obligations would have been put in place had the parties transacted with each other at arm’s length.56

(A.2) Reasons for Restructuring and the Synergistic Benefits

Business representatives at the 2005 CTPA Roundtable explained and the Discussion Draft reiterates a standard list of reasons for restructuring.57 Blenko, Mankins and Rogers do the same, but draw it all together in a simple conclusion – restructurings are undertaken to improve financial performance. They state:

Some [CEOs] preside over repeated restructurings. The immediate motives vary. Some are about cutting costs; others are about promoting growth. Some are about shaking up a culture; others are about shifting strategic focus. Whatever the specifics, though, reorg[anization]s almost always involve making major structural changes in pursuit of better [financial] performance.58

“Better [financial] performance” is a synonym for what the Discussion Draft calls “synergistic gains.” Documentation for “anticipate synergy gains” (or documentation of anticipated financial improvement) is required by the Discussion Draft. In a very interesting section the Draft explains that this documentation can most likely be found in support of “non-tax” changes to the “decision-making process” of the enterprise.

This is a type of documentation that is likely to be produced for non-tax purposes, to support the decision-making process of the restructuring. For transfer pricing reasons, it would also be reasonable to expect such documentation to provide an analysis of the effects of the restructuring on each affiliate or taxpayer (costs and anticipated benefits) as well as an assessment of the other options realistically available to it.59

This is where the Discussion Draft begins to go astray. The decision-making process is not peripheral to the restructuring; it is central to it. It is not just the place to find data and analysis about assets being transferred; it is the place to find data about the unique intangible (the new decision-matrix) that is being created through the restructuring. This intangible is the reason for the entity-level transfers.

Changes to the decision-making process are the heart of any successful business restructuring. Decision-making changes empirically correlate with performance improvements. Blenko, Mankins and Rogers indicate that: “[D]ecision effectiveness and financial results correlate at a 95% confidence level or higher for every country, industry, and company size in our sample of 760 companies.”60

56 Discussion Draft, supra note 4, at ¶ 52 (emphasis added).
57 Discussion Draft, supra note 4, at ¶ 52.
59 Discussion Draft, supra note 4, at ¶ 53 (emphasis added).
60 Supra note 51
The Discussion Draft completes this subsection with a number of standard observations:
(a) “…anticipated synergy gains do not necessarily mean that the profits of the MNE group will
effectively increase after the restructuring …”\(^{61}\) (b) “…synergy gains do not always materialize…"\(^{62}\) and (c) “…group-wide synergies … [can be offset by] … local synergies … [or visa-versa]"\(^{63}\)

(A.3) Assessment of Entity-level Options Available

This section underscores that the arm’s length principle applies at the entity level, not the
group level.\(^{64}\) Comparable transaction need to be identified to determine an arm’s length price.
If it turns out that comparable transactions are difficult to find (externally), then it is assumed
that the arm’s length price can be indirectly inferred. It is slightly greater than the next-best
option realistically available.\(^{65}\) In other words, the Discussion Draft presumes the availability
of internal comparables (theoretically available and analyzed as part of the process of setting the
transfer price). The Discussion Draft does recognize that it is always possible that there may not
be such next-best options.\(^{66}\)

The Discussion Draft relies on an unrealistic assumption. A MNE’s restructuring is
conducted at the group-level. It attempts to produce group-level synergy gains. It is simply not
realistic to expect that restructuring documentation contains contemporaneous analytics of entity-
level options that would produce entity-level synergy gains. Why would a CEO seeking to
change the decision-matrix for the MNE be concerned with entity-level alternate courses of
action? Nevertheless, the Draft states:
… it would also be reasonable to expect such [enterprise-level] documentation to
provide an analysis of the effects of the restructuring on each affiliate or taxpayer
(costs and anticipated benefits) as well as an assessment of the other options
realistically available to [the affiliate].\(^{67}\)

This is not very satisfying. It is however, a very common approach in the Discussion
Draft – Assumptions offer answers to many critical questions.

A concrete example is helpful. Tony Hayward restructured BP in 2007 when he replaced
Lord Browne as CEO. Lord Browne had also restructured BP when he became CEO in 1996.
Most observers expect that soon after the Macondo Well is capped Tony Hayward will be
replaced with a new CEO,\(^{68}\) and this person is likely to restructure BP yet again. This
restructuring will feature a new decision-matrix. The objective will be to make BP more
sensitive to risks at the highest levels of the company. BP will invariably forecast that this
restructuring will cure lagging performance.

\(^{61}\) Discussion Draft, supra note 4, at ¶ 54.
\(^{62}\) Discussion Draft, supra note 4, at ¶ 55.
\(^{63}\) Discussion Draft, supra note 4, at ¶ 57.
\(^{64}\) Discussion Draft, supra note 4, at ¶ 58.
\(^{65}\) Discussion Draft, supra note 4, at ¶ 59.
\(^{66}\) Discussion Draft, supra note 4, at ¶ 60.
\(^{67}\) Supra note 59; Discussion Draft, supra note 4, at ¶ 53.
\(^{68}\) Edward Luce, Anna Fifield, Sheila McNulty & Kate Burgess, Anatomy of a Disaster, FINANCIAL TIMES 2 (July 3, 2010) (indicating that the most likely candidates are Robert Dudley, BP’s Managing Director for the Americas and Asia, or Iain Conn, Chief Executive, Refining and Marketing).
To support the new decision-matrix there will be transfers of functions, assets, risks or rights among BP plc, BP-E&P and other related entities. At a minimum the new decision-matrix and asset transfers will guarantee that the CEO is no longer out of the loop on high risk drilling decisions. To accomplish this, risks will be transferred from BP-E&P and other subsidiaries to BP plc. Under the Decision Draft BP plc will need to be compensated at arm’s length for assuming additional risks.

The Discussion Draft unrealistically assumes that documentation supporting entity-level asset transfers will provide an “… assessment of the other options realistically available to …” BP plc, BP-E&P and other entities. In other words, the Discussion Draft assumes that there will be a “what if” exposition on what BP-E&P would likely receive from ExxonMobile if it were to transfer risks, assets, or functions to ExxonMobile instead of BP plc. This would seem to be a bit far from the mark of what the new BP CEO would be looking at.

(B) Reallocation of profit/loss potential as a result of a business restructuring

Section (B) of Issue Note No. 2 is the smallest of the four sections, but it is easily the most important. It is however, is critically deficient. Section (B) confuses an association (transferred assets are accompanied by a reallocation of profit/loss potential), with causality (reallocations of profit/loss potential follows from an asset transfer).

These concepts are not the same. The transfer price for an asset should not be affected by changes in expected profits or losses if those changes are not caused by the asset transfer. If (at an entity-level) profits or losses are expected to change because of a restructuring, it does not necessarily follow that the assets transferred are the cause of these changes. Thus, it does not follow that the full scope of entity-level profit/loss changes should be reflected in the arm’s length price for a transferred asset.

Stated another way, it is entirely possible that entity-level profit or loss may change after a business restructuring, but the cause of the change is not an inherent attribute of the transferred asset – even though the profit/loss change is strongly associated with the transfer.

This paper argues that (a) because a successful business restructuring is largely the result of a newly created intangible asset – the new decision-matrix of the MNE – and (b) because this intangible plays the most significant role in overall profit/loss of the MNE after the restructuring, and thus in the reallocation of profit/loss potential among the entities within the MNE, then (c) the arm’s length price for the transfer of functions, assets, and/or risks in a restructuring should not include the full value of the profit/loss potential associated with the transfer. The arm’s length price should only reflect the profit/loss potential that is causally related to the asset that is transferred.

69 “… transfers of functions, assets and / or risks in the context of a business reorganization are typically accompanied by a reallocation of the profit/loss potential among members of a MNE group…” Discussion Draft, supra note 4, at ¶ 62 (emphasis added).

70 “Transfer pricing consequences of a reallocation of profit/loss potential that follows from a reallocation of risks, rights and / or other assets.” Discussion Draft, supra note 4, at ¶ 63 (heading) (emphasis added).
For example, assume entity (X) has a $100 million certificate of deposit returning 10% annually for five years, and this asset is transferred to related party (Y) pursuant to a business restructuring. Assume further that this asset is transferred after year 2, and the interest rate is exceptionally favorable. There is an inherent profit/loss potential embedded in the asset, and (X) should receive compensation for the asset and this potential at arm’s length. The marketplace solves the transfer pricing problem by using the present value of the stream of income that the asset will accrue in years three through five.

However, what if the CEO determines (as part of the restructuring) that (Y) will use the $100 million to invest in a high risk/high return start-up venture? What if this venture is expected to return 35% per year over the next 3 years (but could also return losses of 15% over the same period)? Profit/loss potential of (Y) has changed. The change is associated with the asset transfer, but it is not caused by the transfer. The cause of the change is the CEO’s decision in the context of the MNE restructuring effort.71

Thus, entity-level profit/loss potential can change in a business restructuring. All changes in profit/loss potential are associated with asset, risk, or rights transfers. Some changes in profit/loss potential are inherent in the transferred asset; other profit/loss potentials are derived from other aspects of the restructuring decision. Section (B) makes no effort to distinguish among these two distinct sources of change in profit/loss potential.

There are two subsections to Section (B): (B.1) Transfer pricing consequences of a reallocation of profit/loss potential that follows from a reallocation of risks, rights and/or other assets; and (B.2) Compensation as a result of a business restructuring.

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71 This example is simple. It can be re-drawn with facts that are closer to a real world restructuring, as follows. What if instead of transferring a certificate of deposit the restructuring transfers a business function? In this case, suppose the MNE is currently structured functionally (vertical function stovepipes): R&D is performed in a single entity; manufacturing is performed in one or more dedicated manufacturing subsidiaries; all sales personnel are grouped into one or more sales entities; follow-up services are in another group of subsidiaries. Suppose the CEO decides to restructure the MNE into global divisions, so that each division (dedicated to a specific aggregate of products defined by an identified customer base) assumes complete “end-to-end” business capability – business planning, product planning, development, manufacturing, distribution, market, sales, and customer service and support. Each division would be so autonomous that it could produce discrete income statements and balance sheets.

In this restructuring consider just the transfer of a single manufacturing function for a specific product. Assume the manufacturing facility (X) currently has nine product lines [1 to 9], and it transfers one of them [1] to (Y). How should (X) be compensated at arm’s length? There is certainly a profit/loss potential inherent in the [1] manufacturing function. This amount could be determined based on comparable manufacturers of products similar to [1], or by applying a recognized transfer pricing method [cost plus, or transactional net margin].

However, if the CEO is right, and this restructuring is a success, then the entire MNE could be turned around. The CEO recognized additional potentiality for profit/loss based on synergies coming from the new “end-to-end” division structure. This value must be attributed to the restructuring decision of the CEO. It is a return to the decision-matrix intangible created by the restructuring. It is not a value inherent in the [1] manufacturing process even though this value is associated with the transfer of the [1] manufacturing process.

These are essentially the facts of the 1992 restructuring of Xerox by CEO Paul Allaire [the nine business divisions were: Personal document products; Office document systems; Office document products; X-soft; Advanced office documentation services; Document production systems; Printing systems; Xerox engineering systems; and Xerox business services]. It was ultimately unsuccessful. David E. Hussey, Strategic management – From Theory to Implementation, Xerox: Transforming the Corporation, Chapter 35, 680, 685 (1988); Bill George, Anne Mulcahy: Leading Xerox through the Perfect Storm (A) 2-3 (HBS No. 5-405-050) (Jan. 26, 2005)
(B.1) Transfer Pricing Consequences of a Reallocation of Profit/ Loss Potential that Follows from a Reallocation of Risks, Rights and / or Other Assets

There are three brief paragraphs in this critical section of the Note. Although the heading leads one to believe that this section is about causality (“… potential that follows from a reallocation…”), there is nothing here about causation. \(^{72}\)

The first paragraph makes the straight-forward argument that there are instances where risks, rights and/or other assets are transferred and this transfer leads to changes in profit/loss potential that in turn may need to be considered when determining arm’s length compensation. \(^{73}\)

The second paragraph is definitional and makes two points: (a) that profit/loss potential is not an asset itself; it is just a “potential” which is “carried” by rights or assets, and (b) that profit/loss potential is more than just the profit/loss value of an indefinite continuation of the status quo. The term is more open-ended, more expansive – but its limits are not defined. \(^{74}\)

The third paragraph skips over causation and moves directly to valuation. It indicates that valuing profit/loss potential can stand as a surrogate for directly valuing the transferred risks, rights, or assets. In transfer pricing terminology paragraph three provides a valuation methodology. \(^{75}\) The paragraph indicates that proper account needs to be taken of (1) potential losses as well as potential gains; (2) options that would be available to independent parties, and (3) subsequent (post restructuring) activities of both parties. \(^{76}\)

(B.2) Compensation as a Result of a Business Restructuring

The second section begins with a restatement of the causation statement from (B.1), “… where there is a transfer of profit/loss potential that follows from a business restructuring …” \(^{77}\) and then asks how do we know if the compensation received by the transferor is at arm’s length? Five brief paragraphs follow.

The Discussion Draft first lists three factors to be considered: options realistically available; expected returns to the transferor and transferee; compensation for transferred profit potential. The Draft then provides two descriptive examples and three cases. Each example and each case is highly simplified.

The first example involves the conversion of a full-fledged manufacturer to a contract manufacturer; the second considers the conversion of a full-fledged distributor to a low-risk distributor. The three cases extend the distributor example with numbers.

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\(^{72}\) This omission leads the reader to believe that the Discussion Draft either: (a) equates association with causation, or (b) assumes that a simple association with profit/loss potential is sufficient to include that value in the indirect measure of the transferred assets.

\(^{73}\) Discussion Draft, supra note 4, at ¶ 63.

\(^{74}\) Discussion Draft, supra note 4, at ¶ 64.

\(^{75}\) Direct valuation method would be: comparable uncontrolled price method, the cost-plus method, the resale price method, or perhaps a transactional net margin method.

\(^{76}\) Discussion Draft, supra note 4, at ¶ 65.

\(^{77}\) Discussion Draft, supra note 4, at ¶ 66.
Aside from the fact that each case study seems to reach the wrong conclusion as written, each case is also simplified in a way that assumes away the most difficult issues. The cases use a metric of “net profit margin / sales” to assess change. However, in the words of the cases: how do we know that the change in the “net profit margin / sales” ratio is caused by the transferred assets, and not simply associated with the restructuring? Did the decision matrix change (as normally occurs in a business restructuring)?

What if the restructuring in these cases involved changes in the chain of command? What if each entity is made part of an “end-to-end” business division dedicated to a single product? This was what Paul Allaire did in his restructuring of Xerox in 1992. How much of the change in the “net profit margin / sales” ratio is attributable to this new decision-matrix, and how much is attributable simply to the transfer of assets?

The 1992 Xerox restructuring was a noted failure, however all the contemporaneous expectations for the restructuring were outstanding. What VP of tax would not agree with his new CEO that the turnaround was going to be a great success? The Discussion Draft would (as a result) find that there was significant “potential profit” embedded in the transfers.

The problem is, things got much worse at Xerox. In fact, the company’s slide continued year-by-year until 2001. The Discussion Draft is silent on whether or not adjustments to the 1992 transfer prices would be allowed when it became apparent that the projected gains turned out to be bankruptcy-threatening losses. It took eight reorganizations before Xerox “got it right.”

Similarly, consider the 1996 restructuring of BP by Lord Brown. Even though Browne’s design was (eventually) found to weigh too heavily on BP’s profitability, there were noted predictions of success early on as BP split into 150 autonomous business units.

In BP’s case success was attributed in equal measure to local autonomy and to Browne’s vision for intelligent integration through IT-linked peer groups. Business analysts were uniformly in agreement that profitability was attributable to changes in the way decisions were made – the horizontal integration factor.

For example, when Polly Flinn – then a young manager from Amoco with no experience working outside the United States – became the managing director of BP’s retail business in Poland, she drew on active help from the marketing peer

78 Baker & McKenzie Global Transfer Pricing Steering Committee, Comments on the OECD Restructuring Discussion Draft 15. For example, on the first case Baker & McKenzie indicates:

In case No. 1, the example is misconstrued. The discussion of the example in section 70 invites the question of a compensation for conversion of the full risk distribution. This is just the opposite of the appropriate tax treatment. The average profit margin on historical data is 2%. The midpoint of future profit expectations is also 2%. The guaranteed, stable profit post conversion is also 2%. Given some risk aversion, the general economic principle correctly invoked in section 66 calls for a lower margin than 2% as a guaranteed, stable profit, say for 1%. This is because a higher expected return goes along with higher risk so that a lower risk premium in a stable profit situation implies a lower return. Opposite to what is alleged in section 70, in case No. 1 an independent party would be asked to pay for the conversion rather than being paid one (if at all there should be a payment).

Available at: http://www.oecd.org/dataoecd/53/36/42203499.pdf

Electronic copy available at: https://ssrn.com/abstract=1645404
group and turned her business from a $20 million-per-year loss to a $6 million profit within 18 months.

The combination of empowerment and support improved business performance, producing two main results. First, top-level managers developed growing confidence in the strategy of delegating authority to the business-unit leaders. Second, the company had more resources to invest in developing the integration infrastructure, including IT systems, and in building conversation and communication mechanisms. Those investments further strengthened the mechanisms and the processes of horizontal integration.79

(C) Transfer of something of value (e.g. an asset or an ongoing concern)

This section provides a detailed consideration of a range of business restructuring transfers. One would expect that this section would be a great help to taxpayers seeking to apply the principles developed earlier (in Section B). One would expect that the new concept of profit/loss potential would be high on the list of clarified ideas. The range of transfers considered in Section C is broad – tangible assets, intangible assets, a going concern, and outsourcing.

However, the transfer of profit/loss potential is only considered in the context of a going concern (not with tangible or intangible assets, and not in an outsourcing context). In Section C profit/loss potential is expressly equated with “good will.” There is confusion and significant critical commentary because of the way Section C seems to re-characterize transfers of profit/loss potential.

To step back a bit, Section B presented the core question of Issue Note No. 2: “The question is whether there are rights or other assets transferred that carry profit / loss potential and should [they] be remunerated at arm’s length?”80 Thus, if Section C (the application section) only considers profit/loss potential when a going concern is transferred, then does Section C mean that profit/loss potential is only carried when there is this kind of aggregate transfers? In other words, is it only when an integrated set of rights, assets, risks and activities are transferred in a going concern that we need to be concerned about the transfer of profit/loss potential?

The Discussion Draft organizes Section C into four parts: (C.1) Tangible assets; (C.2) Intangible assets; (C.3) Transfer of activity (ongoing concern); and (C.4) Outsourcing.

(C.1) Tangible assets

Tangible asset transfers are not presented as problematical in most cases.81 Minor problems can arise. Problem cases arise more from the transfer of a tangible being overlooked, than being difficult to measure.

80 Discussion Draft, supra note 4, at ¶ 18.2; see also ¶¶ 64, 66, & 92.
81 Discussion Draft, supra note 4, at ¶ 72 (indicating, “…it is generally considered that transfers of tangible assets do not raise any significant transfer pricing difficulty, …”)
An inventory example is developed. A full-fledged manufacturer is transformed into a toll manufacturer, and an off shore related party acquires the finished inventory as well as stores of manufacturing supplies. CUP, resale price and cost-plus methods are proposed to measure the value of the transferred property.82

(C.2) Intangible assets

Intangible asset transfers present a more difficult scenario, but once again the Discussion Draft applies standard transfer pricing analysis. Determining if an arm’s length price has been paid requires an assessment of the entire commercial arrangement between the parties.83

If assets are transferred when values are entirely speculative the Discussion Draft assumes that a price adjustment mechanism would normally be found in the contract.84 Only when discussing the transfer of contracts rights [a long-term contract to provide certain goods to customers] does the Draft mention “profit potential.” But this is not profit/loss potential. It is simply profit potential, and the idea at this point is that there will be a known profit component embedded in the long term contract being transferred. The transfer price needs to consider this factor.85

This is not a difficult transfer pricing problem. A known profit element is very different from the much more ambiguous added value derived from a potential for profit or loss as discussed in section B.

This is very much like the case of the Windsor small V-8 engine design intangibles. When these intangibles were transferred from Ford Canada’s subsidiary (Windsor Castings) to a related party, it was not difficult to determine the value of the intangible. The engine casting function was being outsourced to third parties, and as a result there were reliable internal comparables for the Windsor V-8 engine.

(C.3) Transfer of activity (ongoing concern)

There are two parts to (C.3). In the first part the Discussion Draft considers the transfer of ongoing concerns (the transfer of an activity), and it immediately links this discussion with the major concern from section (B), the transfer of profit /loss potential. The third sentence of the opening paragraph literally equates profit/loss potential with the goodwill component in an ongoing concern.86 The second section of (C.3) is also unique. It is one of the few places in the Discussion Draft where loss transfers are specifically considered.87

In the first part, the Discussion Draft asserts that when a business restructuring includes the transfer of a going concern that (a) goodwill is commonly transferred along with the assets,
function, rights and risks as part of the going concern, and (b) that this goodwill represents profit/loss potential. Thus, when an arm’s length price is paid for a going concern it will necessarily include a payment for goodwill and this in turn is the measure of profit/loss potential.

This line of reasoning is problematical for almost all the commentators. Baker and McKenzie’s Treaty Policy Working Group provides a capable summary of the criticism: … good will does not equal profit potential, and both are distinct from going concern value. Good will is the value arising from the expectation that customers will return to the usual place. Going concern value is the residual value of a business after all the other assets have been identified and valued. These assets typically do not transfer in a business restructuring. The going concern value of a collection of business assets located in a country does not move to a different entity if those assets and persons will now be deployed in the same place in a new set of activities. Similarly, good will (as distinct from assets such as trademarks) also normally would not be separated from the functions and assets that remain in place. The value of an intangible normally would not carry with it the value of goodwill that is associated with other business assets that are not transferred. Indeed, goodwill generated through the past activities of a business can disappear in a business restructuring or asset sale, …

The USCIB has similar concerns but phrases them in terms of Discussion Draft paragraphs headings. USCIB asks very specifically: is the profit/loss potential that is carried by transferred assets (as was the case in Section B) a distinct concept, or is it just a component of goodwill only found in the transfer of an ongoing concern (as in Section C) or can it be found in both? USCIB’s commentary on the Discussion Draft states:

Query, is profit potential an asset similar to, or a component of, the good will of a going concern as in ¶93, or is it associated with a transferred asset as in ¶64? This is an important question, as it relates directly to the question of what has been transferred and what needs to be included in the value of the transferred function.

Good will is typically viewed as a residual value …

Going concern is often viewed as the value created by assembling and organizing the myriad of small assets and incremental relationships that are required to start and maintain a business. …

The key question for the authors of the Draft Report is whether the transfer of an intangible asset at arm’s length will be respected as including the profit potential of exploiting the subject intangible (¶64) or whether the profit potential will be classified as a goodwill intangible subject to separate valuation (¶93).89

It is simply not possible to resolve the questions that are raised by the way the Discussion Draft merges the concept of profit/loss potential from Section (B) with the applications in Section (C). Something is amiss. Far too many commentators are having difficulty with exactly the same points.

In the second part of (C.3) the Discussion Draft looks at loss transfers. This is one of the few places where loss transfers are considered. The analysis however is limited to loss transfers associated with the transfer of an ongoing concern. By negative inference then, this analysis suggests that loss transfers either (a) do not arise when tangible or intangible assets are transferred, or (b) if they do occur then normal transfer pricing practices are sufficient to determine the arm’s length price.

As expected, no distinction is drawn between losses that are attributable to decision-based aspects of the restructuring, and losses that are inherent elements of the transferred activity. Because both can be present in any transfer this ambiguity furthers confusion.

For example, assume a loss-making function is performed in a particular entity, but the function is deemed necessary by the MNE as a whole and must be retained. Perhaps the MNE has a reputation as the “go to” place for top quality, historically accurate hardware for doors and windows. Unfortunately, some historically important pintels for exterior window shutters need to be forged by hand. These pintels never return a profit, but it is not entirely clear if the losses are due to the hand forging procedure, or to the business structure.

Assume further that the company is structured according to customer type – homeowners, small independent contractors, major builders – and each business unit provides end-to-end service by customer category.90 Suppose the CEO proposes to move to a product-type structure. In doing so he will: (a) aggregate all pintel fabrication from all business units and place them in one entity, and (b) locate this entity in Eastern Europe where there is an excellent reservoir of hand craft metal forging talent.

There are a lot of questions here that boil down to: (a) should the Eastern European entity be paying, or receiving compensation for the transfer of the pintel fabrication activity, and (b) how much is that arm’s length payment? More specifically we will need to know, how much of the loss (in a specific pintel fabrication function under the old structure) is attributable to the

90 This is the Xerox structure after the 1992 restructuring.
inherent unprofitability of pintel fabrication, and how much of it is attributable to the “defective” end-to-end business structure? The Eastern European entity should not be concerned with losses generated by the old structure.

Will the new structure be a success? If so, is there an off-setting, decision-based profit potential in the new structure that Eastern Europe needs to factor into the arm’s length price? Success cannot be assumed – failures in restructurings run at about a 70% level. Thus, the norm is for double losses to show up in this fact pattern: (a) one loss that is inherent in the activities transferred, and (b) another loss that is caused by the restructuring itself.

Suppose this restructuring follows the normal course: (1) before the restructuring the CEO is fully convinced that this effort will be a great success story, but (2) the outcome is that the restructuring has a negative impact on financial performance. Without using hindsight, how should the related parties value the transfer of pintel fabrication to Eastern Europe? Should the CEO’s expectation of a successful restructuring be factored into the value, or should only the inherent non-profitability of pintel fabrication be considered?

If only the inherent non-profitability of pintel fabrication is considered, how do we peel away the value (the profit/loss potential) that stems from the decision to “correct” the old structure? Will documentation be available to support this kind of value-discrimination? Given the fact that the CEO has made an enterprise-wide decision to engage in this restructuring, what are the chances that most of the available, contemporaneous documentation will point to a positive outcome? If the synergies derived from moving pintel fabrication to Eastern Europe are overstated, can they be subsequently adjusted?

The Discussion Draft provides no solutions.

The thrust of the Discussion Draft is to point to a range of possible outcomes based on what an independent party operating at arm’s length would do. The Discussion Draft indicates that compensation could go either way (depending on the facts) and the valuation should be determined by analysis of comparables. This is all well and good, but what we really need is some direction on how to parse out the determinants of value in a restructuring, and the Discussion Draft gives us none.

(C.4) Outsourcing

The last (one paragraph) section of part (C) simply 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/loss potential transferring with the outsourcing. (C.4) concludes that outsourcing is a common practice in the marketplace among independent parties:

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.\textsuperscript{92}

A number of real world examples can be marshaled in support of the Discussion Draft’s observation. For example, outsourcing is the life-blood of Flextronics International Ltd. This Singapore-based company has roughly 78,000 employees in 29 countries on five continents. It is the outsourcing company of choice for products as wide ranging as Microsoft’s Xbox and Lego building blocks. Flextronics is a frequent business school case study on manufacturing efficiency.\textsuperscript{93}

Thus, in 2003 when the Lego Group faced a deficit of DKK 1.4 billion, followed in 2004 by an even larger deficit, and in 2005 by a deficit of DKK 1,931 million, they restructured and looked to Flextronics for an outsourcing solution. In 2006 the world’s fourth largest toy manufacturer laid off most of its employees (employment went from 8,300 to 3,000) and transferred most of its production to Flextronics.\textsuperscript{94} Flextronics paid nothing for the transfer of the ongoing concern. Lego then purchased inventory from Flextronics’ Mexican facility and resold to the public. Profitability returned to Lego Group the next year.

Xerox faced similar difficulties. Beginning in about 1992 Xerox’s downward slide continued until it posted its first ever net loss in 1999, followed by even worse numbers in 2000. Mulcahy’s 2001 restructuring came amid bankruptcy rumors and included the sale of the office products manufacturing operations to Flextronics for $118 million.\textsuperscript{95} As with Lego, Xerox then re-purchased the Flextronics output for resale.

As indicated by the Discussion Draft independent parties outsource production, and on occasion receive compensation (Xerox). At other times an arm’s length exchange will include no compensation (Lego Group).

\textbf{(D) Indemnification of the restructured entity for the detriments suffered as a consequence of the restructuring}

Section (D) of the Discussion Draft considers whether or not an entity within a MNE should be compensated at arm’s length for detriments suffered as a result of a business restructuring. The analysis follows: (a) a standard assessment of the contract, (b) whether there is (or should be) an indemnification clause, and (c) whether the indemnification clause is at arm’s length. Although there is a suggestion that one of the factors considered should be whether there is “a loss of profit potential,” nothing is done to expand on this concept.\textsuperscript{96}

The Discussion Draft considers indemnification in fours subsections:

\begin{itemize}
\item \textsuperscript{92} \textit{Discussion Draft, supra} note 4, at ¶ 98.
\item \textsuperscript{94} Parmy Olsen, \textit{Billionaire’s Lego Outsourceto Flextronics, FORBES.COM} (June 20, 2006) \url{http://www.forbes.com/2006/06/20/lego-group-restructuring-cx_po_0620autofacescan05_print.html}
\item \textsuperscript{95} Xerox, 2001 Annual Report 18 (restated January 27, 2003).
\item \textsuperscript{96} \textit{Discussion Draft, supra} note 4, at ¶ 99.
\end{itemize}
(D.1) Whether the arrangement that is terminated, non-renewed or substantially re-negotiated is formalized in writing and provides for an indemnification clause;
(D.2) Whether the terms of the agreement and the possible 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;
(D.3) Whether indemnification rights are provided for by commercial legislation or case law;
(D.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.

There is no presumption that indemnification is due. If anything, Section (D) makes it clear that intercompany agreements should be put in writing, and (if possible) they should have termination clauses that are tested by the arm’s length and are flexible enough to allow for early termination. Commentators acknowledge this emphasis.

However, this does not mean that contracts without termination clauses will not be respected. The UK case of Baird Textile Holdings Ltd. v. Marks & Spencer plc, concerns the termination of a thirty-year commercial relationship without a termination clause in the supply contract. Baird claimed “lost profits.” Compensation was denied.

In a somewhat unsatisfying ending, Section (D) concludes with an elementary example. Entity A decides to purchase manufactured product from a related party C, and in doing so terminates a similar contract with related party B. The Discussion Draft simply runs through possible compensation permutations:
• A would indemnify B;
• C would indemnify B;
• C would pay A;
• C would meet A’s obligation to indemnify B;
• A and C would share the costs of indemnifying B;
• Neither A nor C would indemnify B, but P [the common parent] would indemnify B.

This is a place where some analysis (rather than a list) would be helpful.

97 Discussion Draft, supra note 4, at ¶ 99.
98 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)
99 2001 EWCA CIV 274.
100 Monica Erasmus-Koen, Art. 9 of the OECD Model Convention, in TRANSFER PRICING AND BUSINESS RESTRUCTURINGS – STREAMLINING ALL THE WAY, Chapter 5 at 130, ed., Anuschka Bakker (2010).
101 Discussion Draft, supra note 4, at ¶ 119.
102 Discussion Draft, supra note 4, at ¶ 120.
103 Discussion Draft, supra note 4, at ¶ 120.
104 Discussion Draft, supra note 4, at ¶ 120.
105 Discussion Draft, supra note 4, at ¶ 121.
106 Discussion Draft, supra note 4, at ¶ 122.
CONCLUSION

Although business restructurings may be abusive, the vast majority of them are not. In addition, even though some business restructurings may involve (a) the conversion of a fully-fledged manufacturer to a contract manufacturer; (b) the conversion of a fully-fledged distributor to a stripped distributor; (c) the development of shared service centers and contract service providers, or (d) the transfer of intangible assets to off-shore holding companies, once again, the vast majority of restructurings are not. A good restructuring is all about changing decisions, not about shuffling assets.

Business restructurings are a very common. Nearly half of all CEOs resort to them within the first or second year of their tenure. However, more than 70% of business restructuring fail to achieve their stated goal of boosting financial results. Those that are the most successful are decision-driven. The empirical evidence is clear. “[D]ecision effectiveness and financial results correlate at a 95% confidence level or higher for every country, industry, and company … What’s more, the research reveal[s] no strong statistical relationship between structure and performance.”

Issue Note No. 2 of the Discussion Draft is deeply flawed. It relies on an unproved correlation between structure and performance (profit/loss potential). The Discussion Draft focuses on transfers of assets, and the profit/loss potential they “carry,” when it really needs to come to grips with the unique, highly valuable intangible that a restructuring creates – the new decision-matrix. A business restructuring is no more than an internally directed R&D effort that goes into production. It should be treated that way.

This is not to say that there are not transfer pricing issues involved in the transfer of assets among related parties. Nor is it to say that there is not a measure of potential profit/loss that should be added to the raw market value of an asset transferred in a restructuring. It is to say that the Discussion Draft is looking in the wrong place, if this is the only place it is looking. It needs to look at decisions.

When transfer pricing problems arise in business restructurings, the current Transfer Pricing Guidelines are reasonably adequate. This appears to be the observation of WP-6 when it discusses the transfer of tangible assets, intangible assets, a going concern, and outsourcing in Section (C) of Issue Note No. 2. The Norwegian government’s successful litigation in Cytec provides reasonably good evidence that the current rules are very workable.

Before we add another analytical structure to the Transfer Pricing Guidelines for all business restructurings, not just a structure for tax abusive restructurings, we need to get the Discussion Draft focused on what business is focused on – the decisions.

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107 Supra note 51
108 Decision of the Court of Appeals of Eidsivating (September 26, 2007), Cytec Norge GPAS and Cytec Overseas Corporation Filial v. Utenlandsk Foretak 2006-180819 (concerning the conversion of a full-fledged manufacturer into a toll manufacturer where valuable intangibles were transferred to a foreign related party at less than an arm’s length price). See also: Hanne Flood, Business Restructuring: The Question of the Transfer of Intangible Assets, INTERNATIONAL TRANSFER PRICING JOURNAL 174 (July/August 2008).