# Arm’s length treatment of soft-intangibles

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## Comparative Analysis of the Treatment of Soft-Intangibles in Business Restructurings in Germany, the United States and according to the OECD

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Luxembourg, 17.11.2019

# Abbreviations

| | |
|---|---|
| ABA | American Bar Association |
| Abs. | Absatz |
| APA | Advance Pricing Agreement |
| Art. | Article |
| AStG n.F. | Außensteuergesetz – as amended |
| ATB | Active Trade or Business Exception |
| BEPS | Base Erosion and Profit Shifting |
| BNA | Bloomberg BNA |
| CB | Cumulative Bulletin |
| CCA | Cost Contribution Arrangement |
| CCH | Commerce Clearing House |
| CFC | Controlled Foreign Company |
| Cir. | Circuit |
| C.I.R. | Commissioner of Internal Revenue |
| CSA | Cost-Sharing Arrangement |
| Ct. | Court |
| CUT | Comparable Uncontrolled Transaction Medthod |
| CWI | Commensurate with Income |
| DStR | Deutsches Steuerrecht |
| Ed., Eds. | Editor, editors |
| et al. | and others |
| et seq. | and following |
| e.g. | for example |
| EStG | Einkommensteuergesetz |
| EU | European Union |
| FDA | Food and Drug Administration |
| FEC | Forum Européen de la Communication |
| FEMM | Faculty of Economics and Management Magdeburg |
| ff | and following |
| FN | footnote |
| FTA | (German) Foreign Tax Act "Außensteuergesetz" |
| G20 | Group of Twenty |
| GewStG | Gewerbesteuergesetz |
| HR | House of Representatives |
| HTVI | Hard-to-value intangibles |
| IAS | International Accounting Standards |
| IBFD | International Bureau for Fiscal Documentation |
| Ibid. | Ibidum |

| | |
|---|---|
| ICT | Information and Communication Technology |
| i.e. | id est |
| IFA | International Fiscal Association |
| IFST | Institut Finanzen und Steuern |
| IP | Intellectual Property |
| IRB | Internal Revenue Bulletin |
| IRC | Internal Revenue Code |
| IRS | Internal Revenue Service |
| IStR | Internationales Steuerrecht |
| IWB | Internationale Wirtschaftsbriefe |
| JCS | Joint Committee Staff |
| KStG | Körperschaftsteuergesetz |
| LB&I | Large Business & International Division |
| MA | OECD Model Abkommen |
| M&A | Mergers & Acquistions |
| MC | Model & Commentary |
| MN | Marginal Number |
| MNE | Multi-national Enterprise |
| OECD | Organization for Economic Cooperation and Development |
| p. | page |
| para. | paragraph |
| PCA | Printed Circuit Assemblies |
| PCT | Platform Contribution Transaction |
| R&D | Research and Development |
| S. | Seite |
| Sec. | Section |
| SEC | Securities and Exchange Commission |
| sent. | sentence |
| SME | Small- and Medium sized Enterprises |
| TAM | Technical Advice Memorandum |
| TC / T.C. | United States Tax Court |
| TCM | United States Tax Court Memorandum |
| TP | Transfer Pricing |
| Treas. Reg. | Treasury Regulation |
| UntStRefG | Unternehmensteuerreformgesetz |
| US (USA) | United States (of America) |
| v., vs. | versus |
| viz. | namely |
| Vol. | Volume |
| ZEW | Zentrum für Europäische Wirtschaftsforschung |

# Chapter 1. Introduction

Business restructurings, which involve moving IP and business functions within different parts of an MNE, present major transfer pricing issues, which have drawn much attention since the mid 1990s.[1] Business restructuring can be important to an MNE for a number of economic reasons, but they may also result in a number of complex questions about how to allocate taxing rights between the various states in which the MNE is present. For instance, the benefits of group synergies and advantages of scale – which are part of what may be called "soft-intangibles" – enjoyed by an MNE may by themselves result in additional profits for the MNE. The question arises: which part of the MNE is responsible for the realisation of such additional profits, and to which jurisdiction should the taxing rights over these profits be allocated? These issues are only compounded by business restructuring activities within the MNE.

Business restructuring has mainly moved manufacturing and supply functions within a value chain from the west to the east. Although these business functions are not insignificant, a major part of value creation, nowadays, is a result of R&D activities. Different types of soft-intangibles[2] such as group synergies, which are predominantly present in MNEs, form another significant part of value creation. Such soft-intangibles present important transfer pricing issues, which this dissertation tackles. These issues affect the application of the arm's length principle not only to a particular segment of the value chain, but rather the entirety of it.[3]

Transferring R&D functions presents challenges to applying the arm's length principle of a peculiar nature. R&D activities require a greater degree of infrastructural development in a jurisdiction as compared to some other activities, e.g. sourcing of raw materials, contract manufacturing, or distribution. Nevertheless, large developing countries such as China and India are catching up rapidly and have made available within their economies the necessary personnel at rates that are unprecedented for any of the developed countries.[4] Therefore, the R&D centres of the developed world cannot be seen as having an oligopoly over these functions, which can indeed be transferred abroad by

[1] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Paris: OECD, (2017), para 9.2. – it no longer makes reference to the circumstance that since the Mid 90's business restructurings were signified by "(…) *the centralisation of intangible assets and of risks with the profit potential attached to them*"; as previously contained in: OECD, Report on the Transfer Pricing Aspects of Business Restructurings – Chapter IX of the Transfer Pricing Guidelines, Paris: OECD, (2010), p. 4/para. 9.2; retrievable at: https://www.oecd.org/ctp/transfer-pricing/45690216.pdf (22.09.2016).

[2] As defined in the IBFD Glossary: Soft intangible: term that may be used to describe particular types of intangible property, such as goodwill, going concern value, workforce in place, customer lists, etc., as distinguished from hard intangibles, although there is no precise line of division between the two terms.

[3] Porter, M.E., *Competitive Advantage: Creating and Sustaining Superior Performance*, New York: The Free Press, (1985), p. 33ff.

[4] OECD, *International Migration Outlook 2012*, Paris: OECD Publishing, (2012), p. 175; the relevant table can be retrieved at: http://dx.doi.org/10.1787/888932617265.

way of business restructuring. This could lead to the fragmentation of businesses which results in the emergence of more specialized entities within an MNE group. Creating these specializations in some of such non-traditional R&D centres may result in an imbalance between the place at which value generating functions are performed and the jurisdiction to which taxing rights are allocated.

Moreover, developments in communication technologies and transportation have made cross-border business restructuring easier and therefore also more attractive to businesses. Likewise, the focus on intangibles has made the realisation of such transactions easier from a logistical perspective. However, the reliance on intangibles, in particular by companies that are involved in the digitalised economy, leads to the creation of immense tacit values. In particular the values vested in (soft) intangibles can be the basis for disputes about restructuring because of the difficulty of qualifying and quantifying them.

Developing countries are not only getting better at producing the human capital and infrastructure necessary for more advanced tasks, but also becoming more ambitious regarding their share in value-creation. By transferring their business functions to these countries, MNEs enjoy a wide array benefits, including location savings, east of access to their very sizeable markets and the collective spending power of their populations.

It is possible for countries to see these benefits, afforded by their economies to MNEs, as being the prime contributor to a certain amount of additional profits earned by the MNEs, and they may seek to tax them.[5] However, other countries may disagree with such an approach by arguing that it is not consistent with the arm's length principle.[6] Such disagreements may result in the double taxation of income.[7]

Therefore, it can be stated that. due to the ease of moving business functions across borders, the need for countries to protect their tax base has become ever more important. Consequently, the pressure on states in a globalized environment to combat the expatriation of business functions, or at least to ensure that they secure their taxing rights over the value already created within their jurisdiction, is increasing. In the European Union, instruments such as the Parent-Subsidiary Directive,[8] the Interest and Royalties Directive[9] and the Merger Directive[10] have facilitated the reallocation of a number of business functions

[5] This approach has been adopted by China and India.

6Sanghavi, D, IFA 68th Congress in Mumbai – Seminar F: UN Matters – UN and OECD differences in Model, TP, etc. (15 Oct. 2014), News IBFD.

[7] Ghosh, S. et al., Location-specific advantages: India and China, *International Tax Review*, London: Euromoney, [2014]; can be retrieved at: http://www.internationaltaxreview.com/Article/3300894/Location-specific-advantages-India-and-China.html, [04.07.2015]; Bilaney, S., Location-Specific Advantages: When and how they should be allocated, *Bulletin for International Taxation,* Amsterdam: IBFD, Volume 69, No. 8, [2015]; Kane, M.A., Transfer Pricing, Integration and Synergy Intangibles: A Consensus Approach to the Arm's Length Standard, World Tax Journal, Amsterdam: IBFD Volume 6, No. 3, [2014].

[8] Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, [2011], OJ L 345/8.

[9] Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, [2003] OJ L 157/49.

[10] Council Directive 2005/19/EC of 17 February 2005 amending Directive 90/434/EEC 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States, [2005], OJ L 58/19.

amongst member states. All in all, business restructurings can be perceived to be a tool to separate the creation of value in a jurisdiction on the one hand, and the allocation of taxing rights, on the other, amongst the countries in which the MNE is present. A separation of the two could effectively lead to base erosion and profit shifting. After numerous events in which the aggressive tax planning schemes of high-profile MNEs like Google, Starbucks etc. became public, leaving both politicians and society at large with the impression that tax laws are being abused or deficiencies being taken advantage of, the G20 commissioned the OECD to develop counter measures.[11] The acronym for base erosion and profit shifting, *BEPS*, has become ubiquitous, and is currently being implemented within the national tax laws and tax treaties of 129 countries within the inclusive framework.[12] The BEPS project has made it clear to everyone that aggressive tax planning are no longer profitable, and that transfer pricing is now being put in the spotlight. Furthermore, the BEPS project intends to identify and solve issues arising from business restructurings.

Thus, one of the more prominent tools to counter BEPS is transfer pricing legislation. Assets, in particular the intangible assets, have to be correctly valued and the remuneration received/payable has to be in line with the internationally accepted arm's length principle. This principle has at its foundation the requirement of treating related parties in these transactions in the same way as unrelated parties. It has come under pressure from two sides. On the one hand, legislators intend to reap an ever-larger share from transferred assets that they consider to belong to their jurisdiction. This particularly the case for intangibles that carry significant value and that are, at the same time, difficult to value. On the other hand, it can be argued that the arm's length principle is strongly exposed by the shift from a tangible economy into an IP centred and increasingly digitalised one. Being created at the beginning of the 20$^{th}$ century the arm's length principle may no longer be suited to deal with today's economy that is based primarily on intangibles. Nevertheless, today the arm's length principle remains pivotal to transfer pricing legislation and therefore the income/price adjustments that may be necessary.

The United States of America is the pioneer when it comes to specifically laying down income/price adjustment clauses in the case of the transfer of intangibles between related entities. The basis for this adjustment is Sec. 482 of the Internal Revenue Code. With the 1986 update, the effect of Sec. 482 has been extended so as to allow for the so-called *super royalty*.[13] This is the basis for tying the transfer price to the return that can be attributed to the intangible asset in question, which is why it is also referred to as the *commensurate*

[11] OECD/G20, Base Erosion and Profit Shifting Project - 2015 Final Reports, Paris: OECD, (2015), p.5; retrievable at: https://www.oecd.org/ctp/beps-reports-2015-executive-summaries.pdf; 23.09.2016.

[12] As of 23 March 2019.

[13] IBFD Glossary: Super royalty synonymous with the Commensurate with income standard is defined as: A standard applied by the United States in *transfer pricing* cases that requires *royalties* charged for the use or transfer of *intangible property* to be commensurate in each year with the income produced by the intangible property. If the use of the property is transferred for more than 1 year, the commensurate with income standard authorizes the *Internal Revenue Service* to make periodic adjustments to the amount of royalty charged. Any adjustment under the commensurate with income standard must be consistent with the *arm's length principle* and, therefore, based on accepted methods (and not, for example, on the *basic arm's length return method*). The application of this standard is internationally somewhat controversial.

*with income standard*.[14] The idea of a *super royalty* has been criticised as being contrary to the arm's length principle. Despite the contradiction, the 1994 regulations have reinforced the United States' subscription to the idea as belonging to the arm's length principle. The *commensurate with income* standard is still good law in the United States, but questions about its compatibility with the arm's length standard persist. Therefore, the topic is as current as it ever was, being fuelled as it is by developments such as the introduction of the *Hard to Value Intangible* (HTVI) within the framework of the BEPS project.[15] From the perspective of the tax authorities, a case that would actually call for the application of the *commensurate with income* standard is the Google-structure, which has become a tax model applied by a number of (mainly) US-based multinational enterprises.[16] The apparent problems that intangibles pose to Transfer Pricing legislation are not confined to the United States. Rather, these problems are also faced by most industrialized nations that are trying to retain taxing rights in a rapidly changing technological landscape.

Therefore, even before the Google-structure became public, Germany had already implemented legislation that similarly relies on posterior adjustment of certain transactions where functions and intangibles are involved.[17] Additionally, the function that is shifted is, under certain circumstances, valued as a package together with tangible and intangible assets instead of each asset individually, trying to capture profit potential and business opportunities contained therein. Furthermore, the tax claim on aggregated transfer is extended to factors which are based purely on conditions in the receiving country. Such factors can usually be grouped under the heading of soft-intangibles such as synergy effects and location savings.

Germany introduced the aforesaid legislation – Regulation on the Relocation of Functions – which is based on the German Foreign Transaction Tax Act in 2008. The introduction of Article 1 Para. 3, sentence 9 et seq. leads to the codification of the treatment of the shifting of functions abroad to a related party. It targets the shift of intangibles, including the business function itself. However, it is debated whether this could also extend to intangibles that at the time of the transfer did not yet amount to an intangible (asset). The goal is to deter the shift of functions and assets abroad and to allow an intangible, once created in Germany, to be subjected to a posterior valuation, in case its valuation was uncertain at the time when it was shifted abroad. Hence, similar to the *commensurate with income* standard in the United States, the German legislation also prescribes a posterior adjustment in certain situations where the actual performance of the value of the intangible deviates from the projections. Thus, in this situation as well, intangibles are at the forefront of the consideration. But this also creates the issue that the developed

[14] Taic, J., *Die "Super Royalty" und das U.S.-Richtlinienpaket von 1993*, Rechtswissenschaftliche Forschung und Entwicklung, No. 465, München: VVF, 1994, p. 30.

[15] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Paris: OECD, (2017), paras. 6.186-6.195.

[16] The application of the commensurate with income standard has been prevented by having the transaction price fixed through a ruling.

[17] German Foreign Tax Act (Außensteuergesetz), Art. 1 para. 3, sentence 9 et seq., [2007], BGBl. I S. 1912; jo. Function-Shifting Regulation (Funktionsverlagerungsverordnung), [2008], BGBl. I S. 1680.

intangibles should remain subject to German corporate tax for the part of the value which was not determinable at the time of the transfer, after having profited from infrastructure and possibly incentives. This approach, which hampers corporate mobility and the best allocation of resources, needs to be considered in light of a number of international tax law aspects.

The commensurate with income standard and the German Functions Shifting legislation need to be looked at in relation to the internationally prevalent transfer pricing principle – the arm's length principle. Similarly, these laws have to be analysed in light of the BEPS initiative and the changes that it has brought about, which, among many other subjects, is concerned with transfer pricing and intangibles.[18] The particular problem that had to be tackled within the BEPS framework with regards to the transfer of intangibles, is the transfer at values below the arm's length value.[19] The OECD has identified three key reasons which are generally applicable in illustrating the problems that intangibles create, namely: "(i) […] difficulties in valuing transferred intangibles at the time they are transferred; (ii) […] unequal access to information relating to value between taxpayers and tax administrations; and (iii) [….] arrangements result in the transfer of hidden or unidentified intangibles without payment."[20]

It is particularly interesting to see how the OECD, the proponent of the arm's length principal, adds another dimension by requiring that transfer pricing outcomes are aligned with value creation. This alters the principle by introducing "special measures" that fall outside of the arm's length principle.[21] Naturally, adjustments to the transfer price in one country do not necessarily lead to a corresponding adjustment in the other country. Furthermore, as Germany intends to secure the taxation of income attributable to the use of intangible assets which have been developed in Germany, it will inevitably impede their mobility to a certain degree. Considering the progress of the BEPS project, it can also be presumed that a number of OECD member countries will implement similar legislation, making this an issue of relevance for countries other than Germany and the US.

## 1.1 Problem Statement

National tax legislation, which targets the shift of functions and therefore the shift of specific intangibles, is rightfully aimed at preventing BEPS. However, such laws inevitably create impediments against business restructuring. While an optimal tax structure is

[18] OECD/G20, Action 8-10.

[19] OECD/G20, *BEPS Action 1, Address the Tax Challenges of the Digital Economy – Public Discussion Draft*, Paris: OECD, (2014), p. 51; retrievable at: https://www.oecd.org/ctp/tax-challenges-digital-economy-discussion-draft-march-2014.pdf; 14.10.2016.

[20] OECD/G20, *Base Erosion and Profit Shifting Project – Addressing the Tax Challenges of the Digital Economy – Action 1: 2014 Deliverable*, Paris: OECD, (2014), p. 117.

[21] OECD, Public Discussion Draft, BEPS Actions 8, 9 and 10: Discussion Draft on Revisions to Chapter I of The Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures), Paris: OECD, p. 1; retrievable at: https://www.oecd.org/ctp/transfer-pricing/discussion-draft-actions-8-9-10-chapter-1-TP-Guidelines-risk-recharacterisation-special-measures.pdf; 23.09.2016.

usually only the cherry on the cake, MNEs need to ensure optimal conditions to conduct their business. With value chains being international rather than national, shifting functions across borders is a necessity for companies to be able to compete in a globalized environment, thereby realizing group synergies, location savings and additional benefits that can commonly be grouped under the term "soft intangibles".

Impeding the reallocation of business functions to places where they can be put to optimal use comes at a cost to the enterprise itself. But the inefficient allocation of resources is also detrimental to the national and global economy. This is true in particular in cases where a difference in technological development between developed and developing countries creates a new business case for originally superfluous businesses in the latter. Similar examples also exist in cases where the execution of a number of business functions became prohibitively expensive due to high (labour) costs, statutory constraints or state aid in another country. Regardless of these arguments for a business restructuring based on location, countries see themselves placed in an equally competitive tax environment. The focus of developed countries lies on retaining businesses, and therefore the tax base and tax revenue, within their jurisdiction. In order to create more beneficial business environments, the corporate tax rates were generally reduced in most developed countries.[22] In some situations this led to harmful tax competition. Thus, where once the focus was on the countries and their tax systems, this has now switched to the taxpayers trying to engage in aggressive tax planning by shifting profits to low tax jurisdictions. One tool that countries have at their disposal to counter BEPS is transfer pricing legislation. This tool, however, is prone to causing (economic) double taxation in cases in which a corresponding adjustment is not available or is denied.

The introduction of the described legislation clearly leads to the overall problem of hampering business restructuring activities and thereby the most efficient use of resources. However, from a legal point of view, this problem is more nuanced, and different facets of the problem ought to be addressed. The introduction of super royalty legislation as a consequence of the OECD HTVI approach[23] as well as the difficulties of dealing with soft-intangibles can be viewed as being deviations from the arm's length principle. They may also lead to double taxation. These controversies have been key factors for choosing the topic of this dissertations. The three approaches to address these issues – the United States approach, the German approach, and the OECD HTVI approach – will be critically analysed in this dissertation with a view to identifying the best practices therefrom.

Consequently, the analysis of business restructurings needs to be undertaken considering that two factors will drive the world's economies in the years to come: digitalisation and fragmentation of value chains. It is possible to consider these two

[22] OECD. Stat, Table II.1. Corporate Income Tax Rate, 2000-2015 & 1999-1981; to be retrieved at: http://stats.oecd.org//Index.aspx?QueryId=58204 (last visited 30.07.2015); These tables show except for short periods of time a general trend in the reduction of corporate income tax rates.

[23] Countries need to implement the HTVI approach as e.g. witnessed in Japan. See: Hagelin, J., Ex Post Facto Considerations in Transfer Pricing of Hard-to-Value Intangibles: Practical and Methodical Issues with the HTVI Approach, *International Transfer Pricing Journal*, Amsterdam: IBFD, Vol. 26 No. 1, (2019).

factors as being drivers of BEPS. The underlying reason for this can be seen in the fact that companies are being boiled down to their intangible property. Digitalisation and fragmentation will be on the agenda of MNEs also in a post-BEPS tax world. With these changes in mind, business restructurings and the transfer pricing legislation dealing with it need to be considered in light of two predominant issues.

**Firstly**, it can be argued that said national legislation potentially alters or even breaches the internationally recognized arm's length principle. Moreover, the addition of the new objective to align transfer pricing outcomes with value creation as the main target of the relevant BEPS action points further impinges on the arm's length principle.

Exactly this principle is the basis for transfer pricing legislation worldwide. Extending it not only by considering how a transaction among unrelated parties would take place but by including an element in the equation that considers the future development of the value of the function and the intangible adds a new dimension to this principle, and thus makes a unified application on a national level ever less likely. Trying to take into account future developments of an intangible in the hands of a related party situated in another jurisdiction creates the inherent risk of economic double taxation.[24]

Additionally, the BEPS project, which pursues the goal of aligning transfer pricing outcomes with value creation, requires a statement on where value has actually been created. The latter then needs to be transposed into national tax legislation where this dimension has only been considered from a one-sided perspective. Such deviations or alterations of an essential principle can lead to effects beyond the borders of the jurisdictions introducing that particular transfer pricing legislation, especially when value creation is actually a matter of perspective:

> *"(…) a country with strong customer base, value creation will take place in the market jurisdiction (destination principle) and such a country will advocate for principles that will allocate income based on the location of customers. A developing country with low-cost production factors will support value creation in line with production not consumption (origin principle). Every country has an incentive to define "value creation" in a way that will favour its local economy. If more and more countries are able to establish taxing rights based on the vague value creation concept, the risk of double taxation will inevitably increase."*[25]

Moreover, taking into account this sentiment of also considering local market features when referring to value creation,[26] one essentially subjects the arm's length principle to

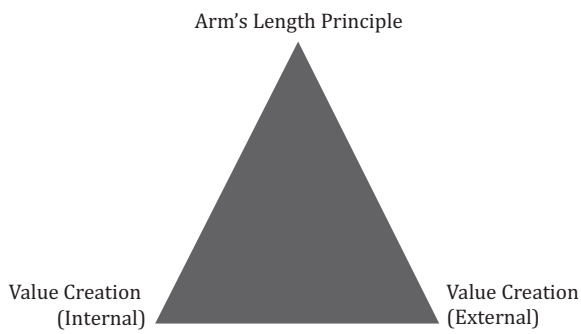
[24] See the example in Fedusiv, O., Transactions with Hard-to-Value Intangibles: Is BEPS Action 8 Based on the Arm's Length Principle?, *International Transfer Pricing Journal*, Amsterdam: IBFD, (Nov/Dec 2016), p. 488 & 489.

[25] Bal, A. (Mis)guided by the Value Creation Principle – Can New Concepts Solve Old Problems?, *Bulletin for International Taxation*, Amsterdam: IBFD, Vol. 72 No 11, (2018), p.

[26] Piltz, D.J., BEPS und das staatliche Interesse, IStR, München: Beck, (2015), p. 531. *"Der Leiter der Steuerabteilung der Volkswagen AG hat kürzlich berichtet, dass VW nur ca. 13 % seiner Autos in Deutschland verkaufe, aber mehr als 50 % seiner Ertragsteuern in Deutschland bezahle. Die Aufforderung an die Importländer dieser Autos ist klar. Wenn das CbCR*

the discussion of the supply approach vs. the supply-demand approach.[27] This becomes an issue where it is not clearly discernible how far the demand of a certain market has contributed to the value creation,[28] which is why the supply-demand approach is considered to be inferior to the supply approach.[29] Therefore, value creation should be independent of a local market feature. However, this does not need to produce the same outcomes as the arm's length principle.

This illustrates that, depending on the exact transaction at stake, the transfer pricing outcomes are now supposed to be aligned with the arm's length principle, value creation (internal) and value creation (external). Considering the different kinds of value creation that are handled in economics, it is questionable in how far these can actually be aligned.[30]




Thus, the way in which such alterations interact with the arm's length principle needs to be analysed. Moreover, the alignment of the German and the US approach of producing transfer pricing outcomes that match value creation needs to be reviewed.

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*ergibt, dass z.B. 80 % des Gewinns von Volkswagen aus dem Autoverkauf in den Importländern erwirtschaftet wird, kann es nur noch Monate dauern, bis diese Länder verlangen, dass die Steuerbemessungsgrundlage in ihrem Land erhöht und die in Deutschland vermindert wird."*

[27] Supply-based approach: Under the supply-based approach, profits originate from where the factors that produce the profits operate and the source of the "normal" return of equity capital should therefore be identified "to the location in which the actual operation of the capital occurs" "[p]ursuant to this approach, the mere consumer market does not represent a factor contributing to the added value of the company." – OECD (Centre for Tax Policy and Administration, Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-Commerce – Final Report, Paris: OECD, (2001), MN40.
Supply-demand based approach: Under the "supply-demand" view, however, the interaction of supply and demand is what creates business profits. This view would therefore require to take account of the fact that the demand of the products arise from the consumer market. – OECD (Centre for Tax Policy and Administration, Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-Commerce – Final Report, Paris: OECD, (2001), MN40.

[28] Schäfer, A. & Spengel, C., *ICT and International Corporate Taxation: Tax Attributes and Scope of Taxation – Discussion Paper No. 02-91*; Mannheim: Centre for European Economic Research (ZEW) and University of Mannheim, (2002), p. 11ff; ftp://ftp.zew.de/pub/zew-docs/dp/dp0281.pdf (03.10.2016).

[29] Ibid.

[30] Oestreicher, A., To see or not to see – das ist keine Frage, *Der Betrieb*, Düsseldorf: Handelsblatt, (2016), No. 20, p. M5; https://recherche.der-betrieb.de/document/zeitschriften/der-betrieb/2016/heft-20/weitere-inhalte/gastkommentar/to-see-or-not-to-see---das-ist-keine-frage?authentication=none (08.08.2016).

**Secondly**, the arm's length principle is based on a feature that tax authorities and treasuries consider to be a gap:[31] in order to conclude transactions at arm's length it is necessary that there is an unrelated party that undertakes such an uncontrolled transaction. However, in particular MNEs exist as a consequence of the synergies within their group and may only exist within such a group.[32] If business restructurings are effected in order to create or exploit these more effectively, then, as a matter of principle, there cannot be an uncontrolled price for such a specific synergy. Synergies can only exist between related parties. Other soft-intangibles pose the exact same problem. A prime example is that of location specific advantages that are to be realized by a restructuring. In some instances, a business restructuring requires the reallocation or the making available of an assembled workforce. Since considering anything related to workforce as an asset, and therefore pricing it, has an aftertaste of slavery, determining an arm's length price is equally difficult.

These soft-intangibles are a problem inasmuch as they do not form part of a transaction between unrelated parties and do not qualify as an asset. One solution being debated is whether some soft-intangibles, in particular synergies[33] and an assembled workforce,[34] should be characterized as intangible assets in their own right – as has been previously discussed in the US and implemented with the US Tax reform of 2017.[35] Moreover, in situations where national transfer pricing legislation is mended in order to fill this void, the question arises how the soft-intangibles are to be attributed between the related parties, and hence taxed.

This particular deviation or alteration of the arm's length principle is also likely to cause double taxation. On the one hand, this can be based on a different treatment of soft-intangibles by the country of the receiving and the ceding entity. On the other hand, double taxation can arise from the different allocation of the benefits from synergy and location savings between ceding and receiving entity. Therefore, it is necessary to analyse such legislation in order to determine whether soft-intangibles are being considered, and if so, to which entity are they attributed.

[31] Ditz, X., Die Grenzen des Fremdvergleichs – Zugleich Plädoyer für ein Festhalten am Fremdvergleichsgrundsatz, *Finanz-Rundschau*, Köln: Verlag Dr. Otto-Schmidt, (2015) No. 03-04.

[32] Li, J., Soft Law, Hard Realities and Pragmatic Suggestions: Critiquing the OECD Transfer Pricing Guidelines, in Schön, W. & Konrad, K.A. (eds.), Fundamentals of International Transfer Pricing in Law and Economics; part of: *MPI Studies in Tax Law and Public Finance*, Vol. 1, Berlin Heidelberg: Springer Verlag, (2012), p. 82.

[33] Kane, M.A., Transfer Pricing, Integration and Synergy Intangibles: A Consensus Approach to the Arm's Length Standard, *World Tax Journal*, Amsterdam: IBFD, (2014), Vol. 3 No. 6.

[34] Panse, A., Workforce in Place: Is It an Intangible to Pay for?, *International Transfer Pricing Journal*, Amsterdam: IBFD, (May June 2014), p. 147ff.

[35] Full title: An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018; 131 Stat. 2054, (2017).

## 1.2 Aim

The aim of this dissertation is to thoroughly consider and evaluate the solutions sought so far. This is done with a view to determining whether it is feasible to deal with the challenges posed by the application of the transfer pricing legislations in the United States and in Germany, or as suggested by the OECD HTVI approach. Thus, this dissertation is a search for best practices derived from the legislations analysed. The best practice can be deduced as a consequence of the solutions found/suggested in the United States and Germany or the OECD HTVI approach respectively. Thereby, the core benchmark is what unrelated parties would in fact agree upon when transferring soft intangibles in business restructurings transactions. The benchmark for the solution to be found is therefore, whether the analysed legislation can model and account for situations as they would arise in an uncontrolled situation. Specifically, the test will be in terms of business restructuring, whether the threshold for aggregation can be considered as being the same where unrelated third parties would also agree to value a business in its entirety as opposed to singular assets transferred. Moreover, whether the price determination in the absence of comparables is sensible – in as much as this is possible for the arm's length principle. Related to this, it will also be evaluated in how far the definition of intangible is sensible for the application of (specific) Transfer Pricing legislation. The foregoing will be specifically elaborated on, on the soft intangibles of workforce in place, synergies and location savings.

Furthermore, the provisions for posterior valuation will be tested on their arm's length compatibility in the categories of scope, time frame, trigger and the envisaged posterior adjustment. Similarly, it is analysed whether the analysed legislation is capable of aligning the produced transfer pricing outcomes with value creation.

While this aim has implications at both the international level and for national transposition of the arm's length principle, only the latter will be regarded in this dissertation.

In order to arrive at a conclusion, the existing legislation in Germany and the US dealing with the transfer of (soft) intangibles in the course of business restructuring is analysed. Furthermore, these approaches are compared and checked for compatibility with the arm's length principle as well as for their alignment with value creation. The solution sought for is naturally placed in-between the needs of the company and the desires of the treasury. On the one hand, the solution needs to give corporations the flexibility they need to not only survive but also excel in highly competitive markets. On the other hand, such a solution needs to respect the legitimate right to tax of the jurisdiction where the intangible or function has been brought about. At the same time, this solution for dealing with cross-border business restructurings has to be compliant with the internationally recognized arm's length principle. Deviating from the arm's length principle on which transfer pricing is based would be contrary to the goal of avoiding double taxation – especially where such deviations are rather unilaterally.

Thus, the focus is on the implementation of the arm's length principle in cases dealing with soft-intangibles and the reconciliation of the newly formed requirement of aligning transfer pricing outcomes with value creation on a national level. However, it is not within the scope of this dissertation to deal with the discussion on the most suitable transfer pricing method. Furthermore, the analysis is limited to outbound restructurings between corporate entities.

Taking the foregoing into account, the target of the research can be further refined into the following research questions:

1. What is the best overall approach to deal with business restructurings and in particular with soft-intangibles involved? For the latter, it is important to specifically consider the performance of an aggregated valuation, the necessary conditions for such a valuation and the compliance with the arm's length principle and value creation.
2. Is it necessary to specifically define the category of soft-intangibles, and if so, how, in terms of the arm's length principle and value creation?
3. In light of the arm's length principle and value creation, how is a workforce in place to be treated best?
4. In light of the arm's length principle and value creation, how are synergies treated best? Given their nature of only existing at the virtue of two related entities, how should a synergistic benefit be allocated?
5. While not a soft-intangible, location savings are subject to the identical issue of allocation. How is this treatment best realised, in light of the arm's length principle and value creation?
6. Considering posterior valuation, an analysis for the best practices is necessary on how this is best achieved considering the underlying arm's length principle and the concept of value creation as a nexus rule? The elements of such a measure are the trigger and its exceptions for an adjustment, the time frame and the basis of such an adjustment.

## 1.3 Current State of the Treatment of Soft-intangibles

This problem analysed and treated in this dissertation essentially deals with a small but important fraction of shortcomings of the arm's length principle as it is exposed in national transfer pricing legislations and in the alterations made by Germany and the USA in order to mend these shortcomings. In the framework of the BEPS project, the OECD also tries to

curb the arm's length principle, by resorting to "special measures".[36] This is exemplified by the HTVI.[37]

While there is an abundance of literature on the broader conceptual flaws of the arm's length principle, only recently has there been (partly in the framework of the BEPS discussion) an academic treatment focusing on the transfer and the allocation of soft-intangibles between related entities across borders.[38]

An assembled workforce, synergies and location savings generally fall outside the intangible asset qualification provided by many jurisdictions. That is why they can be referred to as soft-intangibles.[39] Yet, this lack of categorization by applicable legislations makes it necessary to limit the analysis to a number of soft-intangibles that can be considered key in a business restructuring.

Predominately relevant in a cross-border business restructuring, irrespective of whether it targets manufacturing, distribution or research and development, are synergies and related location savings and workforce in place. These are interrelated inasmuch that a business restructuring aims at capitalizing on synergies and location savings, yet some restructurings make it necessary that e.g. a research and development team, thus a workforce in place, is relied upon after a business restructuring.

In light of the proposed twofold analysis, it can be established from a business perspective that transfer pricing issues which arise in the course of a business restructuring are used to decrease the overall tax rate of the group.[40] Therefore, an allocation of a tax base between group companies to either the one or the other jurisdiction through the application of transfer pricing legislation is essential from a business perspective.[41] Taking into account both the legislation that is to be examined and the BEPS project, in a number of situations this tax base is also made up of these soft-intangibles.[42] Due to the impossibility of fully grasping and allocating soft-intangibles, their attribution to the one or the other

[36] OECD/G20, *BEPS Actions 8, 9 and 10: Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures) – Public Discussion Draft*, Paris: OECD, (2014), p. 2; retrievable at: http://www.oecd.org/ctp/transfer-pricing/discussion-draft-actions-8-9-10-chapter-1-TP-Guidelines-risk-recharacterisation-special-measures.pdf (15.10.2016).

[37] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Paris: OECD, (2017), paras. 6.186-6.195.

[38] Schön, W., Konzerninterne Risikoallokation und internationales Steuerrecht, Steuer und Wirtschaft, Köln: Verlag Dr. Otto Schmidt, (2015), No. 1, p. 69ff; Ditz, X. Die Grenzen des Fremdvergleichs – Zugleich ein Plädoyer für ein Festhalten am Fremdvergleichsgrundsatz, Finanz Rundschau, Köln: Verlag Dr. Otto Schmidt, (2015), No. 3-4, p. 115ff; Hülshorst, J. et al., Berücksichtigung von Standortvorteilen im Rahmen einer fremdvergleichskonformen Vergütung konzerninterner Transaktionen, IStR, München: Beck, p. 33ff.

[39] IBFD, Glossary – IBFD Tax Research Platform, Amsterdam: IBFD; retreivable at: http://online.ibfd.org/kbase/#topic=doc&url=/highlight/collections/itg/html/itg_soft_intangible.html&q=soft+intangibles+intangible&WT.z_nav=Navigation&colid=4949 (15.10.2016).

[40] Schön, W., Transfer Pricing – Business Incentives, International Taxation and Corporate Law; in Schön, W. & Konrad, K.A. (eds.), Fundamentals of International Transfer Pricing in Law and Economics; part of: *MPI Studies in Tax Law and Public Finance*, Vol. 1, Berlin: Springer Verlag, (2012), p. 62 & 63.

[41] Ibid.

[42] See sections 3.7.; 4.3.;

jurisdiction remains vague.[43] However, there seems to be consensus that benefits derived from these soft-intangibles should not be allocated exclusively to the entity receiving them as opposed to the entity lifting them. In line with this, *Schön* goes so far as to demand in the case of synergy rents that:

> *(…) any synergy rents drawn by members of a corporate group from dealings with the local company should be allocated to the country where the synergy is located (e.g. from the use of specific investment in a country) not to the country where the corporation receiving the rent resides.*[44]

This statement is in principle backed by *Wilkie*, who describes the existence of firms as aimed at:

> *(…) avoid(ing) costs and other limitations associated with not being "firms." This is how internal "rents" or synergistic returns are generated. Encasing these sorts of dealings in a "firm" is the valuable benefit from not dealing at arm's length. It is the source of a unique "return" that decidedly is not "transactional". Even in the most "routine" cases, the unavoidable realization is that the TPG as a statement of the arm's length principle necessarily misses the mark, though by how much is hard to tell."*[45]

Since a successful business restructuring hinges on many different factors, including the soft-intangibles that are considered in this thesis, the problem is not confined to synergies but is also present in location savings. While location savings clearly arise in one jurisdiction, the allocation of the advantage possibly generated is equally difficult, since circumstances like competition or location disadvantages beg the question whether the net location savings are to be retained by the related entity newly performing the function or whether they are to be attributed to the parent company.[46]

Another problematic issue is the posterior valuation of intangibles in a number of situations covered by such legislation as analysed in this dissertation. The posterior valuation of intangibles is seen as necessary in the analysed legislation where no reliable comparables exist. It is insofar related to soft intangibles, which are also not transferred among unrelated parties. While there has been an abundance of literature on both the US

[43] Hülshorst, J., Berücksichtigung von Standortvorteilen im Rahmen einer fremdvergleichskonformen Vergütung konzerninterner Transaktionen, IStR, München: Verlag C.H. Beck, p. 377ff.

[44] Schön, W., Transfer Pricing – Business Incentives, International Taxation and Corporate Law; in: Schön, W. & Konrad, K.A. (eds.), Fundamentals of International Transfer Pricing in Law and Economics; part of: *MPI Studies in Tax Law and Public Finance*, Vol. 1, Berlin: Springer Verlag, (2012), p. 66.

[45] Wilkie, J.S., Reflecting on the "Arm's Length Principle": What is the "Principle"? Where Next?, in: Schön, W. & Konrad, K.A. (eds.), Fundamentals of International Transfer Pricing in Law and Economics; part of: *MPI Studies in Tax Law and Public Finance*, Vol. 1, Berlin: Springer Verlag, (2012), p. 143.

[46] Wilkie, J.S., Intangibles and Location Benefits (Customer Base), *Bulletin for International Taxation*, Amsterdam: IBFD, (June/July 2014), p. 355 & 356.

and the German versions of a posterior adjustment, there has not been a comprehensive comparison of the two. Additionally, the comparative analysis of the HTVI approach in light of the two already existing posterior valuation legislations allows for a conclusion which elements of a posterior valuation are regarded as serving the arm's length principle and an allocation in line with value creation.

Both issues have not been touched upon yet in a comparative manner and finding a solution to such problems first requires establishing what the initial features of the legislation in question are. Furthermore, since both issues possibly involve a deviation from the arm's length principle, double taxation is looming for taxpayers undertaking a business restructuring involving either one or even two of the jurisdictions analysed in this thesis. However, double taxation is to be avoided and by analysing the pitfalls of legislation targeting business restructurings, including soft-intangibles and the posterior valuation of intangibles, double taxation can be prevented in particular with a view towards a general trend in transfer pricing to target business restructuring transactions.[47]

## 1.4 Methodology

This dissertation analyses the issues set out in section 1.1 in a comparative manner. Whereas comparative legal research is usually conducted in private law, it can also be useful in other fields of law.

This is in particular the case for tax law. While there are different national tax laws, these have always been partly subject to common financial foundations of businesses and treasuries, which could be considered to operate largely irrespective of national borders.[48] Additionally, in an increasingly globalised world, national tax laws have to compete but also to interact with each other, and have to play their role in the application of double tax conventions.[49] This is especially the case where national tax laws specifically target transactions that have a cross-border element, as can be seen with business restructuring and the relevant provisions contained in the German Foreign Tax Act and the US Internal Revenue Code.[50] Some of these national laws are based on internationally accepted principles, such as, in this case, the arm's length principle. However, the transposition into national law is not always congruent, in part because such transposition is a legal transplant[51] and in part because of a certain number of national policy decisions.

The principle aim of a comparative legal analysis is to gain closer insights into the analysed legislation.[52] In general, this means finding the strengths and weaknesses

[47] Consider e.g. OECD BEPS Action 8.

[48] Reimer, E., Comparative International Tax Law - Issues and Methodology [Der Rechtsvergleich im Internationalen Steuerrecht. Fragestellungen und Methoden], (2010), p. 2; available at SSRN: http://ssrn.com/abstract=1544251 (15.10.2016).

[49] Ibid., pp. 7 & 8.

[50] Ibid., pp. 8 & 9.

[51] Ibid., p. 7.

[52] Zweigert K. & Kötz, H., Einführung in die Rechtsvergleichung: Auf dem Gebiete des Privatrechts, 3rd Edition, Mohr Siebeck, 1996, p. 14.

of legislation as opposed to those of the other laws that are part of the comparison.[53] A comparative analysis can also be used to investigate legislation that is implemented in order to regulate situations which may not yet be an issue in other countries but at some point will also be introduced there.[54] Another function of particular interest for tax law is the coordination function. Only where national tax laws can smoothly interact with other national tax laws can double taxation be avoided, since the reach of double tax conventions and the work provided by the OECD is limited in that regard.[55] Furthermore, analysing legislative solutions to problems that are internationally prevalent can lead to improved legislation at home and abroad. All in all, it can be summarized that:

> *"Comparative Law does not simply criticize what it finds but can claim to show the way to a better mastery of the legal material, to deeper insights into it, and thus, in the end, to better law."*[56]

Comparative law is a legal science that studies the actual problems and the solutions found instead of conceptual constructs.[57] Comparative law is the method of choice particularly for finding the better solution. It is said to be an "école de vérité" which extends and enriches the "supply of solutions".[58] Specifically, this better solution is at the heart of this dissertation.

For a functional micro comparison, which is conducted in this dissertation, *Zweigert & Kötz* name the following five step process,[59] which is adhered to in order to ultimately determine the superior solution:

Firstly, the functional problem needs to be identified. Secondly, the jurisdictions that are to be compared, need to be chosen. Thirdly, the legislation, which forms part of the comparison, is described. Fourthly, the similarities and differences are identified. Finally, the solutions are critically evaluated in order to arrive a comparatively superior solution. The methodological approach chosen in this dissertation has been closely modelled to the aforementioned process. In order to apply comparative law with these aims in mind, one first needs to establish a common basis of the legislation/guidelines under review. Otherwise, without carving out this common basis and the same function that these different instruments fulfil, a meaningful comparison is not possible.[60]

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[53] Reimer, E., Comparative International Tax Law – Issues and Methodology [Der Rechtsvergleich im Internationalen Steuerrecht. Fragestellungen und Methoden], (2010), p. 6; available at SSRN: http://ssrn.com/abstract=1544251 (15.10.2016).

[54] Ibid., p. 7.

[55] Ibid., p. 7.

[56] Zweigert K. & Kötz, H., An Introduction to Comparative Law, Oxford: Clarendon Press, 3rd Edition, 1998, p. 34.

[57] Ibid., 45.

[58] Zitelmann, cited in Zweigert K. & Kötz, H., An Introduction to Comparative Law, Oxford: Clarendon Press, 3rd Edition, 1998, p. 15.

[59] Marian, O.Y., The Discursive Failure in Comparative Tax Law, *American Journal of Comparative Law*, Oxford: Oxford University Press, Vol. 58, No. 2, 2010, p. 19 & 20; Zweigert K. & Kötz, H., An Introduction to Comparative Law, Oxford: Clarendon Press, 3rd Edition, 1998, p. 32-47;

[60] Zweigert K. & Kötz, H., An Introduction to Comparative Law, Oxford: Clarendon Press, 3rd Edition, 1998, p. 34.

A common basis is established by first setting out the key elements of the implementation of the arm's length principle. The more specific legislation in terms of soft intangibles and posterior valuation is then analysed and put into a framework that allows for comparison. This framework looks at the following elements, based on the research questions:

- The overall framework to deal with business restructurings;
- The necessity of a definition of a soft-intangible;
- The treatment of workforce in place;
- The treatment of synergies;
- The treatment of soft-intangibles;
- Posterior valuation and the elements of such legislation.

Subsequently, the comparison is done based on this framework, by describing the legislation and the observed benefits and drawbacks of the solutions that have been found for every criterion of the framework. They are then evaluated based on their features that have been the result of a literature review.

According to Zweigert & Kötz,

> *"[...] when it comes to evaluation, to determining which of the various solutions is the best, the only ultimate criterion is often the practical evidence and the immediate sense of appropriateness."*[61]

The benchmark for one solution being better than the other applying the functional approach is which one is more functional or dysfunctional serving the function that has been identified.[62] The evaluation which allows for the conclusion that the one element of the legislation compared is superior over the other is based on the aims of respecting the arm's length principle and the new aim of aligning transfer pricing outcomes with value creation.

By applying this methodology in order to achieve these aims, the following procedure of analysis has been chosen.

## 1.5 Procedure of the Analysis

In line with the described problems that result from function shifting legislation and legislations mending the shortcomings of the arm's length principle on the national level in the covered jurisdictions, as well as with the desired aim of this dissertation, the following structure has been chosen. Conceptually, this dissertation is divided into four different parts.

[61] Ibid., p. 33.

[62] Michaels, R., The Functional Method of Comparative Law, in Reimann, M. & Zimmermann, R., The Oxford Handbook of Comparative Law, Oxford: Oxford University Press, 2006 p. 375.

The first part beginning directly after this introduction is the main introductory part that puts the focus on the topic. Thus, this introductory part deals, in Chapter 2, with an introduction of the problems faced by businesses and the inherent need to restructure in particular in times of a globalized economy that is based on intangibles instead of tangibles. Therefore, it needs to be determined whether at a time where tangibles are at the centre of attention a concept such as the arm's length principle can still deal with an economy primarily relying on intangibles. This subsequently necessitates an analysis, which is provided in Chapter 3, of the different definitions of intangibles and of the arm's length principle both in general and as applied to soft-intangibles and posterior valuations. This chapter is also used to further direct the focus of attention towards the part of the value chain that is essential for the creation of valuable unique intangibles. Furthermore, the treatment of the arm's length principle as interpreted by the OECD lays the foundation for analysing and comparing the German and the US iteration. This also serves as a benchmark.

The second part introduces and describes the relevant function shifting legislations that are part of the actual comparison that is conducted in the third part. Hence, in Chapter 4 the cornerstone of this dissertation is being introduced, i.e. the German function shifting legislation – known as *Funktionsverlagerungsverordnung*. In Chapter 5 the US Commensurate with Income Standard is dealt with.

The third part is the comparative/analytical part. In Chapter 6, a comparative analysis is conducted of the German Function Shifting legislation and the Commensurate with Income Standard as well as the arm's length principle, which should be their common benchmark, together with the new addition of aligning transfer pricing outcomes with value creation.

Lastly, in the fourth part a solution is sought based on the results of the comparative analysis of the preceding chapter, taking into account the identified flaws and strengths of the legislation considered.

# Chapter 2. Business Restructuring

## 2.1 Introduction

Cross-border business restructuring is strongly connected to the process of globalisation. The reasons that induce companies to alter their current structure are manifold. Just to mention a few examples: an MNE can engage in business restructuring as a result of changing market demands, shifts in production costs or changes in the legal and political framework. Furthermore, the acquisition of a new operation or a merger might necessitate the restructuring of certain parts of the company.[63] This also holds true for other types of networks, such as Joint Ventures.[64] Thus, factors causing such behaviour can be found internally, but external factors contribute to this trend as well.[65]

A similar trend can be observed in SMEs in a number of sectors such as pharmacy, ICT and the automotive industry.[66] This trend may be caused when, these smaller but most of the time still sizeable companies are affected by being the target of acquisitions by MNEs that seek a quick and easy entry into local markets. Another factor can be that SMEs advance onto the global stage either through alliance with other SMEs or as a result of their customers being keen on local sourcing.[67]

The permanent evolution resulting from business restructurings enables companies to make use of the best conditions for their businesses that a jurisdiction has to offer. These favourable conditions can relate to all factors and steps in the conduct of business. This constant alteration of the business structure is not an end in itself, but is ultimately related to the survival of the company.[68] A planned business restructuring affects a company as a whole, and leaves few or no aspects untouched. Especially the value chain of a company will be affected. It commonly starts with the demand chain,[69] continues with the supply chain[70] and ends with the innovation and product lifecycle management.[71] Not only will

[63] Sakai, K., Global Industrial Restructuring: Implications for Small Firms, *OECD Science, Technology and Industry Working Papers*, 2002/4, Paris: OECD, (2002), p. 3.

[64] Ibid.

[65] Stuffer, W. & Hiller, N. in Bakker, A.J. (ed.), *Transfer Pricing and Business Restructurings – Streamlining All the Way,* Amsterdam: IBFD (2009), p. 3.

[66] Sakai, K., Global Industrial Restructuring: Implications for Small Firms, *OECD Science, Technology and Industry Working Papers*, 2002/4, Paris: OECD, (2002), p. 5 & 7.

[67] Ibid., p. 7; This can be due to content requirements of certain government tenders, something that is common especially in the defense sector.

[68] Ibid., p. 9.

[69] Koudal, P. & Engel, D.A., Engel, Building Supply Chain Excellence in Emerging Economies, in Hau L. Lee and Chung-Yee Lee (eds.), *Building Supply Chain Excellence in Emerging Economies*, New York: Springer Science and Business Media, (2007), p. 53.

[70] Ibid.

[71] Ibid.

these changes lead to tax consequences, some of them will have been actively induced by the global tax environment in which the company is operating.

In order to make a company's structure leaner from a tax perspective, generally the tax base is reduced in one jurisdiction. The functions, risks, assets – material or immaterial – as well as business opportunities, which make up the tax base, are moved to a more preferential jurisdiction. However, business restructurings that aim at the improvement of factors unrelated to tax might also result in the reduction of the tax base in one jurisdiction and the subsequent increase in another one. This has implications for the jurisdiction where the tax base of the company is reduced, since a stripped out entity has a reduced profit/loss potential in line with its reduced risk, asset and function profile.[72] Thus, taxing rights are lost in one jurisdiction.

In order to properly deal with the research question set out in Chapter 1, the following sections elaborate on the different causes for business restructuring as well as the main problems associated with the shift of different sorts of intangibles, in particular highly valuable intangibles that are the result of R&D and the group of soft-intangibles attached to tangible and intangible assets.

## 2.2 Reasons for Business Restructuring

In general, business restructurings are effectuated with the following targets in mind:
Centralization of control and management;

- Savings from economies of scale;
- Enable further specialization of the business;
- Increased efficiency at all stages of the value chain;
- Ultimately lowered costs.[73]

One of the underlying causes for business restructuring is globalisation and the competition from around the globe related thereto. However, the large-scale operations built up by MNEs over time, spanning several different jurisdictions, result in organizations with a possibly suboptimal network,[74] either from a tax perspective or from other economic perspectives. All these organizations might have been optimally structured at the time they were put in place, but generally chances are that an optimal structure develops into a suboptimal one within five to ten years.[75]

[72] Cottani, G., OECD Discussion Draft on Transfer Pricing Aspects of Business Restructurings: Summary of Business Comments and Issues for Discussion, *International Transfer Pricing Journal*, Amsterdam: IBFD, (2009), p. 231.

[73] OECD, *Transfer Pricing Aspects of Business Restructurings: Discussion Draft for Public Comment 19 September to 19 February 2009*, Paris: OECD, (2008).

[74] Peter Koudal and Douglas A. Engel, Building Supply Chain Excellence in Emerging Economies, in Hau L. Lee and Chung-Yee Lee (eds.), *Building Supply Chain Excellence in Emerging Economies*, New York: Springer Science and Business Media (2007), p. 45; Bakker, A. J. & Cottani, G., Transfer Pricing and Business Restructuring: The Choice of Hercules before the Tax Authorities, *International Transfer Pricing Journal*, Amsterdam: IBFD, (2008), pp. 272-273.

[75] Ibid., p. 52.

Such structures can be identified as being one reason for a company to restructure its operations.[76] But there may be other reasons as well. With the steady increase of the demand for ever-new products and services,[77] many MNEs have built up plants, warehouses and R&D centres all over the world. This organic growth makes the entire organization prone to logistical drawbacks, a lack of co-ordination, varying legislation as well as a high level of taxation. Similarly, inorganic growth of companies also contributes to sub-optimal structures. Hence, newly acquired entities need to be properly integrated into the value chain of the acquiring entity.

The demand to restructure is not only present in MNEs but also in SMEs. These smaller entities, by varying degree, depending on the sector, are also taking part in the globalisation.

In conclusion, business restructuring is a necessity for a large number of businesses. Especially for those businesses which operate and span their networks across borders, this process has become unavoidable if they wish to successfully compete on the international stage. Thus, taxation can be seen as one of the drivers of business restructurings, but it is certainly not the only one.[78]

In economic literature, these factors are categorized into competitive drivers and compliance drivers.[79] In order to take a holistic approach at business restructuring it is necessary to take into account the competitive drivers which relate to factors inside the company, as well as the compliance drivers which are mainly comprised of external factors.

The different competitive drivers can be examined by applying them to every relevant stage of a value chain. Since expanding the business into new markets is a challenge not limited to the supply chain, it is necessary to take all three parts of the value chain into account. Hence, in the following, all three sub-categories of a value chain are considered. First, the demand chain is analysed, followed by the supply chain and finally the innovation and product life cycle management.

### 2.2.1 Demand Chain

In line with the value chain model developed by Porter, the demand chain is one of the three subcategories.[80] It encompasses the marketing, sales and services of a company.[81] When expanding into new markets, the marketing effort is most likely subject to problems

[76] Ibid., p. 38-66.

[77] Ibid., p. 42.

[78] Bakker, A. J. & Cottani, G., Transfer Pricing and Business Restructuring: The Choice of Hercules before the Tax Authorities, *International Transfer Pricing Journal*, Amsterdam: IBFD, (2008), pp. 272-282.

[79] Peter Koudal and Douglas A. Engel, Building Supply Chain Excellence in Emerging Economies, in Hau L. Lee and Chung-Yee Lee (eds.), *Building Supply Chain Excellence in Emerging Economies*, New York: Springer Science and Business Media (2007), p. 52.

[80] Porter, M.E., *Competitive Advantage: Creating and Sustaining Superior Performance*, New York: The Free Press, (1985), p. 33ff.

[81] Peter Koudal and Douglas A. Engel, Building Supply Chain Excellence in Emerging Economies, in Hau L. Lee and Chung-Yee Lee (eds.), *Building Supply Chain Excellence in Emerging Economies*, New York: Springer Science and Business Media (2007), p. 53.

related to certain tastes and standards of their respective target group.[82] Differences might also occur regarding the brand perception.[83]

One way to address these issues is to acquire a local company to make inroads into the new market. This solves some problems related to the marketing effort of a company newly entering the market, but it also creates the potential for synergies and location savings. Of course, this potential can only be realized through the integration of the newly acquired operation. In effect, this means that the acquired as well as the own operation need to be restructured.

Regarding sales and services, it needs to be kept in mind that certain cultures are used to certain styles of distribution and that the relevant infrastructure requires certain types of distribution. While online sales in Europe and the US are a major distribution channel of products and services, this is not yet so in many South American markets.[84] Consequently, it becomes necessary to rely on more distributors and sales agents, which produces tax consequences due to the higher degree of presence in the particular country. A structure like this is also prone to inefficiencies, which is another reason why it can be considered a target for business restructuring.

### 2.2.2 Supply Chain

As in the case of the demand chain, globalisation offers new opportunities for leverage in operations belonging to the supply chain of a company. The pre-condition to take advantage of such new sourcing and manufacturing opportunities in low cost countries lies in restructuring the existing operations.[85] However, while restructuring takes place, attention needs not only to be paid to the costs of the products used in the production and the manufacturing, but also to logistics and levies. Additionally, varying legislation and import and export duties can turn a promising opportunity into a debacle. Even though there is a high risk that the venture will not turn out to be as successful as projected, these opportunities are not to be ignored. Business restructuring lies at the heart of properly integrating them into the existing structure.[86]

### 2.2.3 Innovation and Product Lifecycle Management

Especially since MNEs as well as SMEs are nowadays embodiments of different kinds of intangibles, a structured approach towards Innovation and Product Lifecycle Management is crucial.[87] This part of the value chain starts off with R&D, continues with design and

[82] Ibid.

[83] Ibid.

[84] Ecommerce Foundation, Global B2C E-commerce Report 2016, Amsterdam, p. 11; https://www.ecommercewiki.org/wikis/www.ecommercewiki.org/images/5/56/Global_B2C_Ecommerce_Report_2016.pdf (19.07.2017).

[85] Peter Koudal and Douglas A. Engel, Building Supply Chain Excellence in Emerging Economies, in Hau L. Lee and Chung-Yee Lee (eds.), *Building Supply Chain Excellence in Emerging Economies*, New York: Springer Science and Business Media, (2007), p. 55.

[86] Ibid.

[87] Stuffer, W. & Hiller, N. in Bakker, A.J. (ed.), *Transfer Pricing and Business Restructurings – Streamlining All the Way*, Amsterdam: IBFD (2009), p. 37.

engineering and ends with the development and launch of the new product.[88] Even though the previous two parts of the value chain are important, the most potential for more leverage is to be found in the Innovation and Product Lifecycle Management.[89]

In most cases this part of the value chain has been scattered worldwide. Restructuring such activities with the aim of centralizing them can lead to synergies with the demand chain and the supply chain. In fact, research has shown that most leverage lies in producing synergies with this particular part of the value chain.[90] However, practice has also shown that in this part of the supply chain the realization of synergies takes the longest, despite it having the biggest potential.[91]

More precisely, these synergies relate to, firstly, the integration of issues regarding the supply chain into the product development. The intended benefit is to make further adaptations to the product or service as easy as possible. Consequently, it becomes cheaper and easier to respond to changing market demands and environments.[92]

Secondly, a supply chain should be designed so as to avoid exposing intellectual property to potential infringement.[93] Moreover, adhering to this strategy means to alleviate issues arising out of the regulatory- or tax framework when restructuring the supply chain of a company.[94]

Thirdly, it is necessary to make use of the values contained in the "intellectual property portfolio" of the company. On the one hand, this can be achieved by streamlining the sale, the acquisition and the licensing process of respectively self-developed or needed intellectual property rights. On the other hand, it is crucial to cut down on the time to market.[95] In order to do so, manufacturing and product development need to be deeply integrated. Only that way is it possible to take the most benefits from R&D expenditure and to maintain or even gain an edge over the competition.[96]

Apart from creating the aforementioned synergies, there are more tax-related matters that can be a reason to restructure this part of the value chain. It can be beneficial to

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[88] Peter Koudal and Douglas A. Engel, Building Supply Chain Excellence in Emerging Economies, in Hau L. Lee and Chung-Yee Lee (eds.), *Building Supply Chain Excellence in Emerging Economies*, New York: Springer Science and Business Media, (2007), p. 53.

[89] Deloitte, Mastering Innovation: Exploiting Ideas for Profitable Growth, *Deloitte Research Global Manufacturing Study*, London: Deloitte Research, (2005), p. 1ff.

[90] Peter Koudal and Douglas A. Engel, Building Supply Chain Excellence in Emerging Economies, in Hau L. Lee and Chung-Yee Lee (eds.), *Building Supply Chain Excellence in Emerging Economies*, New York: Springer Science and Business Media, (2007), p. 55.

[91] Eriksson, M., et al., Post-Merger Integration of R&D – Reaping the full potential of post-merger integration, *Arthur D. Little: Technology & Innovation Management Viewpoint*, (2010), retrievable at https://pdfs.semanticscholar.org/a332/0fad6844ac22ecac7394e0c8ed2ff2f64083.pdf (29.11.2018).

[92] Ibid., p. 56; Deloitte, Mastering Innovation: Exploiting Ideas for Profitable Growth, *Deloitte Research Global Manufacturing Study*, London: Deloitte Research, (2005), p. 4ff.

[93] Ibid., p. 57.

[94] Ibid.

[95] Deloitte, Mastering Innovation: Exploiting Ideas for Profitable Growth, *Deloitte Research Global Manufacturing Study*, London: Deloitte Research, (2005), p. 4.

[96] Herbold, S., Steuerliche Anreize für Forschung und Entwicklung im internationalen Vergleich, *Steuer Wirtschaft und Recht*, Lohmar: EUL Verlag, Vol. 298, (2009), p. 7ff.

move said activities to countries that grant R&D tax incentives and that have a regulatory framework in place that protects intellectual property rights.[97] Depending on the tax incentive applied, this can free up capital and stimulate the company to increase its R&D efforts. In order to successfully restructure from a tax perspective, jurisdictions need to be chosen that do not tax income from foreign licenses and that do not drastically impede the mobility of the intellectual property rights.[98] Therefore, by restructuring this part of the value chain it is not only possible to create potential profits resulting from synergies. It can be used at the same time to make the structure more tax efficient.

### 2.2.4 Compliance Drivers

While the competitive drivers dealt with in the previous paragraphs mainly focus on internal factors, compliance drivers focus on external factors. In particular, this category embodies the regulatory as well as the tax framework in which the company operates. No matter how efficient a structure might be in terms of a value chain, it may fail due to issues arising out of regulations and taxes.

Certain industries are subject to a number of regulations that need to be complied with.[99] Depending on the industry they are operating in, these can touch upon different subjects, such as product liability, safety regulations, environmental regulations and many more.[100] They can be confined to a particular jurisdiction or be applicable on a global scale. Since such regulations are subject to change, previously well-conceived structures might not be feasible anymore, thus necessitating restructuring. However, while operations are being restructured, the regulations that are going to be applicable in the newly entered jurisdictions also play a role. This adds another factor to the equation, which makes business restructuring even more challenging. Another, specific regulatory factor that needs to be accounted for when restructuring a business are local content requirements. If these requirements are not adhered to, companies are barred from entering the relevant market. Such regulations need not be seen as an inevitable burden that will be imposed upon an industry, but may rather be viewed as a challenge.[101]

Similarly, taxation can be considered to be a compliance driver that leads a business to restructure while at the same time it can carry potential for making the structure more tax efficient.

In a business that spans across borders and that has grown, either organically or inorganically, the exposure to tax may very well not be optimal. This can be due to simple double taxation, which arises for example in cases where countries lack double tax treaties

[97] Peter Koudal and Douglas A. Engel, 'Building Supply Chain Excellence in Emerging Economies', [why use single quotes here? This isn't done in footnote 73.] in Hau L. Lee and Chung-Yee Lee (eds.), *Building Supply Chain Excellence in Emerging Economies*, New York: Springer Science and Business Media, (2007), p. 56.

[98] Russo, R., *Fundamentals of International Tax Planning*, Amsterdam: IBFD, (2007), p. 171ff.

[99] Peter Koudal and Douglas A. Engel, 'Building Supply Chain Excellence in Emerging Economies', in Hau L. Lee and Chung-Yee Lee (eds.), *Building Supply Chain Excellence in Emerging Economies* (Springer Science and Business Media, LLC, 2007), p. 57ff.

[100] Ibid.

[101] Ibid.

or because there is a conflict of either attribution or qualification.[102] It arises especially when newly acquired operations do not properly fit into the tax structure of the acquiring company. Furthermore, countries are also competing for a business-friendly tax system, which is why some countries might become more interesting over time for the inclusion into a new business structure.

In particular, attention needs to be paid to the full package of taxes to which that a business is exposed. Hence, it is not only the direct corporate tax treatment that matters but also incentives such as R&D tax credits, credits for machinery and equipment or credits fostering sustainable development.[103] For the process of business restructuring itself, *Transfer Pricing* is of importance since substantial values will be shifted from one related entity to the other. It also matters in the normal course of the business due to the aim of most business restructuring strategies, viz. the centralizing of processes, property and thereby profits. Especially when intellectual property and tax are considered together, the latter becomes crucial in cases in which the value of the IP is much higher than the value of the machinery and other tangibles. Notable differences can also arise from the approaches on the valuation and determination of the returns from IP.[104]

Yet, the discussion on IP can also go deeper into which intangible already amounts to an asset and is therefore relevant for the taxation of the transaction. This can also mean that a price tag is put on a function, a function meaning carrying out a business (not considering the assets attached to it) every other third party is free to perform without being remunerated. This sort of taxation looms in particular where the profit potential in the ceding jurisdiction is reduced. A similar approach is perceptible in relation to intangibles that in fact do not yet amount to an asset.

Equally important, but not part of this thesis are deliberations on business restructuring regarding indirect taxes (among others, duties, value-added taxes and stamp taxes). These offer some potential for leverage as can be seen with the VAT on online sales in the EU.

The various reasons for business restructurings mentioned above need to be considered all at the same time. As shown in the chart below, only this way is it possible to make a business restructuring a true success. Considering only one aspect of business restructuring will substantially limit the benefits, as has been shown in a study conducted by *Koudal and Engel*.[105]

[102] Rogers-Glabush, J. (ed), IBFD International Tax Glossary, 6th ed. Amsterdam: IBFD, (2009).

[103] Peter Koudal and Douglas A. Engel, Building Supply Chain Excellence in Emerging Economies, in Hau L. Lee and Chung-Yee Lee (eds.), Building Supply Chain Excellence in Emerging Economies (Springer Science and Business Media, (2007), p. 59ff.

[104] Ibid., p. 60.

[105] Peter Koudal and Douglas A. Engel, Building Supply Chain Excellence in Emerging Economies, in Hau L. Lee and Chung-Yee Lee (eds.), Building Supply Chain Excellence in Emerging Economies (Springer Science and Business Media, (2007).

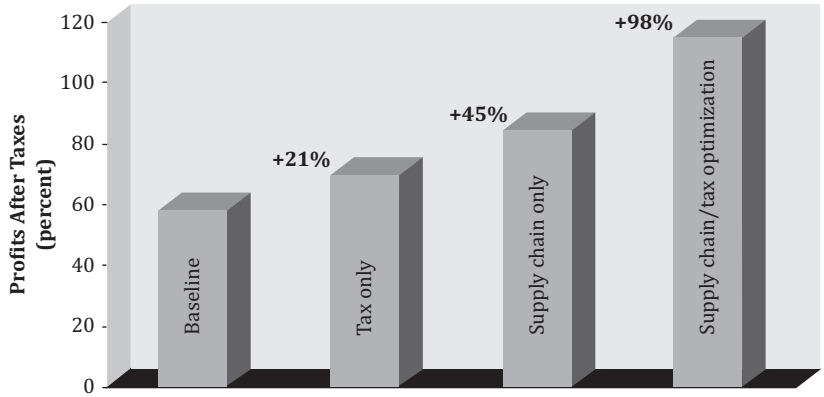


**Figure:** Business Restructuring and Tax Issues.[106]

As depicted in this chart, it is important that a holistic approach is taken when restructuring a business. However, an essential source of leverage as a result of business restructuring is contained in intangibles. These are of particular importance since nowadays the value of a business is mainly a result of its intangible assets. At the same time, they are also a major source for transfer pricing disputes. In particular intangibles in combination with the proper allocation of R&D activities are a major source of profit shifting. Therefore, the remainder of this chapter, within the delimitation of this thesis, deals with a number of aspects stemming from intangible property and Research and Development activity.[107]

## 2.3 The Nexus of Intangibles and Research and Development

There is more of a nexus between intangibles and Research and Development than just one being the origin of the other. In any case, there are many different ways in which intangible property can be brought about, as will be explained below. Moreover, R&D paired with intangible property is recognized to be a major tool of profit shifting, which is not based on the more traditional debt financing methods but which is the result of the sometimes considerable leverage that companies have when assessing transfer prices.[108] Furthermore, room for arbitrage results from the allocation of intangible property as a result of cost-sharing agreements and similar tools.

[106] Peter Koudal and Douglas A. Engel, Building Supply Chain Excellence in Emerging Economies, in Hau L. Lee and Chung-Yee Lee (eds.), *Building Supply Chain Excellence in Emerging Economies* (Springer Science and Business Media, (2007), p. 61.

[107] Overesch, M. & Schreiber, U., R&D intensities, International Profit Shifting, and Investment Decisions, *University of Mannheim Discussion Paper*, Mannheim: University of Mannheim, (2008), p. 3.

[108] Overesch, M. & Schreiber, U., R&D intensities, International Profit Shifting, and Investment Decisions, *University of Mannheim Discussion Paper*, Mannheim: University of Mannheim, (2008), p. 1.

### 2.3.1 Intangibles in the Broadest Sense

Considering intangible property in the broadest sense possible, it encompasses not only clear-cut intangible property such as patents or copyrights but also know-how, goodwill, going-concern value as well as a company's workforce.[109] The latter types of intangibles are generally also referred to as soft intangibles.

| Knowledge-based capital | Type of investment (expenditure) | Stock of competencies (resource) |
|---|---|---|
| ***Computerised information*** | | |
| Computer software | In-house development or acquisition of software | Computerised process, information and knowledge management system |
| Computerised database | In-house development or acquisition of database | Dataset assisting corporate strategy including new product development, marketing |
| ***Innovative property*** | | |
| Scientific R&D | Science and engineering research (measured by in-house or outsourced R&D in manufacturing and selected industries) | Knowledge and intellectual property rights (IPS) leading to new or higher-quality products and production processes (see Box 7.2 for a discussion of innovative property in the pharamceutical value chain) |
| Creative property | Development of entertainment or artistic originals (measured by non-scientific R&D: development cost in entertainment and book publishing industries) | Knowledge and IPR leading to sophisticated artistic and cultural creating |
| Design | Physical appearance, quality and ease of use of products and workspace layout (measured by outsourced architectural and engineering desings, R&D spending in social sciences and humanitites) | Knowledge and IPR leading to better commercial appeal, product differentiation, improved efficiency |
| ***Economic competencies*** | | |
| Brand equity | Spending on advertising and market research (mesured by outsourced advertising and market research) | Reputation, image, cvustomer recognition and relationship |
| Firm-specific human capital | On-the-job training, tuition payment for job-related education | Firm-specific and tacit manufacturing, processing and managerial skill |
| Organisational structure | Spending on organisational change (measured by outsourced management consulting services, etc.) | Flexible and competitive business organisation, network with other firms, universities, government, etc. |

**Table:** Types of Intangible Property.[110]

[109] Rogers-Glabush, J. (ed), *IBFD International Tax Glossary*, 6th ed. Amsterdam: IBFD, (2009).

[110] OECD, *Interconnected Economies: Benefitting from Global Value Chains*, Paris: OECD, (2013), p. 218.

The cross-border transfer of any of the intangible property mentioned above and depicted in the above graphic will almost always result in tax liability due to the loss of taxing rights of one of the jurisdictions involved. Taxation of such events is important inasmuch as they carry tremendous value. More profits can be associated with intangibles and legal constructs than with tangibles.[111] Moreover, the importance of this topic is reflected in the recent legislative development and doctrine in this field of taxation, especially in conjunction with the OECD-led BEPS initiative, that introduced the HTVI standard, among others[112] – a standard which is in the process of being implemented as can be witnessed in e.g. Japan.[113] Earlier, other countries tried to encroach upon the profit shifting potential stemming from intangibles. This can be observed in Germany with the introduction of the function shifting regulation, and in the US with its long standing Commensurate with Income standard as well as the spread of the latter into several other jurisdictions.[114] This needs to be discussed in greater detail since the application of Super Royalties, which is essentially stipulated by the foregoing legislation, is not entirely uncontroversial. Moreover, the Super Royalty is not the only element of the aforementioned legislations considered for taxation. There are several other elements such as location savings or future profit potential of a function that are considered e.g. under the German function shifting legislation. The taxation of these elements of a business restructuring has also been discussed by the OECD.[115] Further on in this thesis, these and several others will be discussed in more depth.[116]

So far, companies that are largely made up of IP have a number of tools at their disposal in order to lower their effective tax rate. Until today this has not changed, despite the early efforts of the USA. Such broad profit shifting capabilities enable MNEs to manipulate the tax rate to which they are subjected. They are also referred to as "Global Tax Rate Makers".[117] Besides their size and organization across borders, these Global Tax Rate Makers have another thing in common: they have a strong focus on R&D. R&D is crucial for the economic prosperity of countries and companies alike, which is why countries are facing the predicament of saving their tax base on the one hand while not hampering the flow of know-how across borders, which is an essential part of today's research and development, on the other. Consequently, the impeded flow of know-how would make a jurisdiction unattractive as a research and development location. Similar

[111] OECD, *Addressing Base Erosion and Profit Shifting*, Paris: OECD, (2013), p. 45.

[112] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Paris: OECD, (2017), paras. 6.186-6.195.

[113] Hagelin, J., Ex Post Facto Considerations in Transfer Pricing of Hard-to-Value Intangibles: Practical and Methodical Issues with the HTVI Approach, International Transfer Pricing Journal, Amsterdam: IBFD, (2019) Volume 26, No. 1.

[114] E.g.: Canada (Indirectly); Wilkie, J.S. & Mihailovich, P., Canada Transfer Pricing – Topical Analysis, Ch. 5.11., Amsterdam: IBFD, (2016) followed by BEPS Action 8.

[115] OECD, Discussion Draft: Transfer Pricing Aspects on Business Restructurings

[116] Levin, C., McCain, J., et al, Memorandum on offshore profit shifting and the US Tax Code, Part 2 (Apple Inc.), Permanent Subcommittee on Investigations of the US Senate Homeland Security and Government Affairs Committee, (2013); to be retrieved from: www.levin.senate.gov/download/exhibit1a_profitshiftingmemo_apple (last visited 16.07.2013).

[117] OECD, *Addressing Base Erosion and Profit Shifting*, Paris: OECD, (2013), p. 61;

results can be expected from legislation that immobilizes and ties intangible property to one jurisdiction.[118]

### 2.3.2 R&D and Business Restructuring[119]



Numerous considerations related to R&D need to be taken into account. One of these is connected to the fact that R&D lies at the heart of the creation of many important intangibles, such as patents. This is why it is important to note that R&D is not only relevant for MNEs but for SMEs as well. An increased level of globalisation and the ease of expanding into new markets thanks to advances in telecommunication technologies also allows SMEs to enter the playing field. Many of them are no longer locally focused and have realized that new opportunities lie beyond national borders. The strength of many SMEs operating internationally stems from sophisticated knowledge and experience in a certain niche. In order to sustain and advance a technological lead in a certain field, it is necessary to conduct R&D. As a side effect of this development, many SMEs that are operating internationally can no longer be called "Domestic Tax Rate takers" as they used to be. Instead, they now have the tools available as well as a business model that enables them to evolve into "Global Tax Rate Makers".

Thus, the second aspect that needs to be considered when dealing with intangibles and business restructuring is R&D, the stage that leads to the creation of some of the most important intangibles: patents, industrial designs and many others that cannot be protected by law. On the one hand, this is interesting from a tax perspective since many countries offer (tax) incentives for research and development. Taking into consideration the incentives that are usually granted in most jurisdictions, there is much left on the table which makes it worthwhile to consider where to allocate the research and development activities of a group. On the other hand, the results of R&D activity lead to the creation of significant value and generally tie the created IP to a certain jurisdiction. Therefore R&D is generally seen as the most valuable but also most the riskiest function performed by an entity.[120] Yet, qualifying it as one of the riskiest functions of a company leads to another problem encountered when engaging into a business restructuring. Since risk in transfer pricing is always linked to profit, shifting the R&D facilities to another jurisdiction will inevitably lead to the migration of profit potential.[121] Furthermore, the performance of R&D functions is equally dependent on local factors such as synergies in the respective country, quality of available workforce or certain tax incentives. Moreover, one of the goals

[118] Overesch, M. & Schreiber, U., R&D intensities, International Profit Shifting, and Investment Decisions, *University of Mannheim Discussion Paper*, Mannheim: University of Mannheim, (2008), p. 27ff.

[119] 2.3.2 – 2.3.2.3 partly derived from: Kipka, T., *The Effectiveness of Fiscal Incentives for Research and Development – A comparative analysis considering the R&D tax incentives of the Netherlands, Luxembourg and India*, Master Thesis, Maastricht University, (2012).

[120] Roberge, C., Transfer Pricing in the pharmaceutical industry: the remuneration of marketing intangibles, *International Transfer Pricing Journal,* Amsterdam: IBFD, Volume 20, (2013), p. 7.

[121] Bakker, A.J. & Cottani, G., Transfer Pricing and Business Restructuring: The Choice of Hercules before the Tax Authorities, *International Transfer Pricing Journal*, Amsterdam: IBFD, (2008), p. 278.

of restructuring a business is to reduce factors that hamper future corporate mobility. Thus, a number of goals are pursued whose effects are directly opposed to each other.



#### *2.3.2.1 Research and Development*

Since R&D can be found in many different shapes, it is first and foremost necessary to define R&D. The most decisive definition that can be given stems from the *Frascati Manual* published and developed by the OECD that it uses in order to statistically analyse and compare the innovativeness of countries. There, R&D is defined as:

> *"[...] creative and systematic work undertaken in order to increase the stock of knowledge – including knowledge of humankind, culture and society – and to devise new applications of available knowledge."*[122]

This definition serves as reference for the EU and its members as well as for a number of other international organizations in matters related to innovation. According to this manual, R&D activity can be further distinguished into basic research, applied research and experimental development.[123]

#### *2.3.2.2 Advantages of R&D*

From a macroeconomic perspective, R&D is a crucial factor for economies at large as well as for any participant in the market. The main reason for companies to invest in R&D is that it will eventually lead to the development of new technologies, which use resources more efficiently.[124] This will result in a competitive advantage for the company and the economy it operates in, thus enabling long-term growth.[125] Such an effect of growth stimulated through technological advances has been observed in the post-war period in the US as well as in Europe.[126] Especially today, where the cost of labour and energy is constantly rising, this will continue to separate companies conducting R&D from other companies that do not.[127]

Furthermore, companies that are engaged in R&D are themselves more competitive, since R&D makes them first movers, meaning that they are able to anticipate trends which competitors will follow. At least it puts them into a position where they can adopt more quickly to a changing market than anyone else.[128] In a mid- and long-term scenario this

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[122] OECD, *Frascati Manual 2015: Guidelines For Collecting and Reporting Data on Research and Experimental development*, Paris: OECD, (2015), p. 44, para. 2.5.

[123] OECD, *Frascati Manual 2015: Guidelines For Collecting and Reporting Data on Research and Experimental development*, Paris: OECD, (2015), p. 45, para. 2.9.

[124] Herbold, S., Steuerliche Anreize für Forschung und Entwicklung im internationalen Vergleich, *Steuer Wirtschaft und Recht*, Lohmar: EUL Verlag, Vol. 298, (2009), p. 7.

[125] Bal, A. & Offermanns, R., R&D Tax Incentives in Europe, *European Taxation*, Amsterdam: IBFD, (2012), p. 167.

[126] Ibid.

[127] Herbold, S., Steuerliche Anreize für Forschung und Entwicklung im internationalen Vergleich, *Steuer Wirtschaft und Recht*, Lohmar: EUL Verlag, Vol. 298, (2009), p. 7.

[128] Ibid., p. 8.

inevitably translates into growth for the entire economy, together with positive spill-over effects such as a stable labour market.

This becomes more apparent considering that a small or medium-sized enterprise (SME) that invests in R&D grows significantly faster, substantially increases its value and creates more jobs than one that does not.[129] Keeping in mind that SMEs form the backbone of almost all economies, it is of the utmost importance to stimulate investments into R&D projects.

Hence, the pursuit of R&D activities should be no more than logical for all companies. Yet, examining it with the phenomenon of business restructuring in mind, it generally leads to opportunities for profit shifting. As research in that field has shown, companies with so called "flexible expenses", a term which also encompasses R&D expenses, in fact shift more profits than those with predominantly less flexible ones.[130] This is not a recent problem. Research into this type of profit shifting has already been done as early as 2003 with the focus on US MNEs using insatiable property in transactions within their group in order to lower their effective tax rate.

At the same time as intangibles are used for profit shifting, the decision on where to conduct R&D activities is influenced by the way profit shifting is hampered by the jurisdiction in question. Furthermore, the location in which R&D is conducted is highly tax sensitive.[131] This is in line with findings that within a group the probability that R&D activities will be located in the one or the other location depends largely on how low the statutory tax rate is in relation to the other members of the group.[132] But the impact of a high statutory tax rate is reduced once there are certain possibilities to shift profits. Likewise, the availability of R&D incentives also plays into these considerations as these can further enhance the effective tax rate for R&D activities.

#### *2.3.2.3 Measures Supporting R&D*

States provide a number of instruments to remedy or at least decrease the adverse effects inherent to R&D like spill overs, information asymmetries and financial risks. These measures supporting R&D activity can be divided into direct measures, indirect measures, adaptation of certain regulations, conduct of public R&D and improvement of the infrastructure needed for R&D activity.[133] Since they are usually all applied at the same time in a certain policy mix, it is necessary to first look quickly into these before focusing on the indirect measure of tax incentives.[134]

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[129] Ibid., p. 7.

[130] Overesch, M. & Schreiber, U., R&D intensities, International Profit Shifting, and Investment Decisions, *University of Mannheim Discussion Paper*, Mannheim: University of Mannheim, (2008), p. 3.

[131] Ibid.

[132] Ibid.

[133] Mohnen, P., *R&D Tax Incentives: Issues and Evidence*, Presentation held in Maastricht 22-26 October 2007 for UNU Merit Programme in Design and Evaluation of Innovation Policy in Developing Countries (DEIP). Slides of that presentation can be retrieved from: http://www.merit.unu.edu/DEIP/Presentations/Pierre%20Mohnen%20-%20R&D%20TAX%20INCENTIVES.pdf (last visited 05.08.2012).

[134] Herbold, S., Steuerliche Anreize für Forschung und Entwicklung im internationalen Vergleich, *Steuer Wirtschaft und Recht*, Lohmar: EUL Verlag, Vol. 298, (2009), p. 51.

Direct support entails that pecuniary aid is directly given to the subject intending to perform a certain R&D project. However, it is not limited to grants. Direct support can also mean that R&D is stimulated by certain public procurement policies or by closer co-operation between state-funded research institutions and private companies.[135] However, this type of support is usually problematic since it needs separate institutions that evaluate the projects and control the use of the funds. It is also considered to be linked to a high administrative burden and to compliance costs. Likewise, issues can arise out of the circumstance that such governmental institutions are not free of political influence that in turn could result in decisions which are not optimal for the economy.[136] In turn, this also means that the budgets of such institutions are subject to political scrutiny, which reduces certainty.[137]

By contrast, R&D can also be stimulated indirectly e.g. through tax incentives, loan guarantees and by allowing R&D co-operations.[138] Especially tax incentives have been the instrument of choice in recent years, even though they also feature some drawbacks such as the lack of an allocative function and a recapture of the loss of revenue through other taxes. Also, they generally only take effect once there has been a successful development that generates income.[139]

Subsidies stimulating the creation of valuable IP through R&D activity matter in two ways. While reallocating certain operations, it can be beneficial to also take the available subsidies for R&D into account. These generally quite costly undertakings can benefit extremely from R&D incentives – of course, only if other conditions such as highly qualified research personal, well suited infrastructure and sufficient legal protection for IP are present in that particular jurisdiction.[140] Yet, by conducting R&D work in one country and receiving incentives for that activity, the resulting IP becomes highly entangled in that particular jurisdiction. Shifting it to a different jurisdiction may lead to the crystallization of contained capital gains, which is generally a taxable event. Similar problems can be encountered when licensing the created IP to group companies as well as third parties. This is particularly problematic in times when business structures and business models are forced to adapt and evolve constantly.

Even though both kinds of the subsidies described above can play a role in the restructuring process, the focus shall lie on indirect measures, specifically those that have an effect on taxation of either the resulting IP or the company that is developing the IP. In

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[135] Mohnen, P., *R&D Tax Incentives: Issues and Evidence*, Presentation held in Maastricht 22-26 October 2007 for UNU Merit Programme in Design and Evaluation of Innovation Policy in Developing Countries (DEIP).
Slides of that presentation can be retrieved from: http://www.merit.unu.edu/DEIP/Presentations/Pierre%20 Mohnen%20-%20R&D%20TAX%20INCENTIVES.pdf (last visited 05.08.2012).

[136] Mohnen, P., *Tax Incentives: Issues and Evidence*, Montreal: Cirano, (1999) p. 3;
to be retrieved from: http://www.cirano.qc.ca/pdf/publication/99s-32.pdf (last visited 26.06.2012).

[137] Ibid.

[138] Ibid.

[139] Ibid.

[140] Verlinden, I. & Smits, A., *Mastering the Intellectual Property Life Cycle – A global perspective on the tax-efficient management of IP rights*, Sint-Stevens-Woluwe: PricewaterhouseCoopers, (2009), p. 193.

the following, the particularities of Research and Development conducted by MNEs and SMEs shall be dealt with. These two types need to be discussed keeping in mind the way they structure their R&D activities and to what extent they could react to R&D incentives.



#### *2.3.2.4 Research and Development Conducted by MNEs and SMEs*

It can be observed that an ever-larger share of R&D activity occurs across borders in many different jurisdictions. This holds true for MNEs but is also more and more the case for SMEs. These different methods, that will be explained in the following, are part of the profit shifting that generally takes place in relation to intangible property.

MNEs traditionally carried out their R&D in large R&D centres and laboratories fixed to a certain jurisdiction. and usually with their own workforce.[141] However, this has changed drastically with the rise of globalisation and innovations in telecommunications, which resulted in globalisation of R&D and at the same time enabled SMEs to drastically expand their activities regarding Research and Development. In particular, SMEs engage in their global venture into co-operations with either MNEs or other SMEs often also located in different jurisdictions. Especially important for SMEs are co-operations in the field of R&D. Due to the increased costs and similarly elevated risk resulting from technological change, only by joining forces can SMEs keep the pace that is required when competing in a globalized market.[142] One result of this more pronounced focus of SMEs on R&D is the fact that the majority of breakthrough innovations stems from exactly these enterprises. Moreover, restructuring a business can mean to terminating that function which was previously performed in one jurisdiction and to rely on different types of research involving contract research and development, cost-sharing agreements and joint ventures partly located in other jurisdictions.

Since this way of conducting R&D involves many different jurisdictions, it is also referred to as Global Development.[143] This includes researchers from related entities collaborating across borders. Since the parties are related, one enters the realms of transfer pricing. The know-how that flows between these researchers sometimes through a separate virtual project room or e-room can be subject to transfer pricing. Yet, this is a stage where generally no third party would ever be involved, making it problematic to stipulate such price.[144] The intangible is also absolutely unique, which makes it almost impossible to find comparables. Furthermore, difficulties arise from the different attribution of resulting intangible property.

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[141] Zhang, J., New Global Pharmaceutical Outsourcing Trends, *Pharmaceutical Online*, Erie, PA: Life Science Connect; https://www.pharmaceuticalonline.com/doc/new-global-pharmaceutical-outsourcing-trends-0001 (19.07.2017).

[142] Sakai, K., Global Industrial Restructuring: Implications for Small Firms, *OECD Science, Technology and Industry Working Papers*, 2002/4, (2002), p. 5 & 7.

[143] Fischer, W.W., Looks, C., Reese, M., Ermittlung von steuerlichen Verrechnungspreisen beim Global Development, *IStR*, München: Beck, (2008), p. 254.

[144] Ibid., p. 256 & 257.

## 2.4 Conclusion

In this chapter, it has been shown why business restructuring is essential for the subsistence and even more for the performance of MNEs as well as SMEs. A major value of the entities participating in the markets is vested in intangibles. Intangibles are present at all stages of the value chain – and that is where part of the problem for the arm's length principle and thus Transfer Pricing lies. Problems arise due to their uniqueness and the difficulty to properly apply the arm's length principle to them. In turn, this enables companies to shift major parts of their profits into low tax jurisdictions, thereby eroding the tax bases of many developed high tax jurisdictions. Measures are being initiated to limit such practices as they can lead to negative effects for such developed economies as they are losing attractiveness for those entities creating values through intangibles.

As many of these issues are the result of the qualities of intangible property, the next chapter deals more thoroughly with this property and how it is entangled in the process of business restructuring.

# Chapter 3. Intangibles, business restructurings and the OECD

The previous chapter focused on introducing the general ideas of the topic that are covered in this dissertation. Dealing with the topic in greater detail necessitates considering the relevant definitions of intangibles, which is the subject of the first part of this chapter. The second part deals with the commonly found models for restructuring a business, especially with the restructuring of R&D activities and with the effects on intangibles involved in these transactions. The combination of business restructuring, intangible assets and international tax laws makes this a highly intriguing topic. In order to subsequently build up the analysis, the two-pronged problem is introduced in the following manner.

Firstly, an intangible, which itself has to be defined, can be further split up into numerous subcategories. The relevant subcategories of intangibles that are of importance for this dissertation will be demarcated marketing and trade intangibles. The category of the commercial intangible has been eliminated in the 2017 Update of the OECD TP Guidelines. Differentiating between the two categories can be of great importance considering the essential differences in the way they are created as well as their tax treatment upon transfer.

However, current developments on the OECD level seem to be no longer in favour of such a differentiation. This has ultimately led to a reduced application of these terms in the 2017 OECD TP Guidelines.[145] Instead, reference can be made to "unique and valuable" intangibles, which according to the OECD groups all those intangibles together that are problematic from a transfer pricing perspective due to their uniqueness and expected significantly higher return.[146]

Furthermore, it is necessary to deal with the intangible asset par excellence – intellectual property. Even though the term intellectual property covers a wide array of intangible assets, it does not cover everything. From a tax perspective it is necessary to consider business opportunities, ongoing concern, contractual arrangements, synergies, location benefits and the workforce that make up a company's intangibles. In other words, a differentiation between so-called soft and hard intangibles is made.

Proceeding in this way it is possible to further elaborate on this topic and, later on in this dissertation, to deal with the different national and international regimes targeting the reallocation of (soft and hard) intangibles as a result of business restructurings. As a benchmark for later comparisons, internationally accepted definitions will be discussed below.

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[145] OECD, *Revised Discussion Draft on Transfer Pricing of Intangibles*, 30 July 2013, p. 16, para. 49; The 2017 OECD TP Guidelines still employ the terms of marketing and trade intangible but this differentiation is no longer made in section *A.3. Categories of Intangibles*.

[146] Ibid., para. 51.

Secondly, having built up the aforementioned intangibles within the value chain can translate to a substantial amount of unrealized taxable profits but also to large future profit potentials. Keeping in mind that it is sometimes necessary to reallocate part of these intangibles in order to unlock their true value, business restructuring is a fundamental necessity.[147],[148] However, this leads to a realization of the profits entangled with the intangible property and therefore the transfer becomes a rather costly transfer pricing issue. Hence, it is the aim of the second part of this chapter to analyse the most common business restructuring operations – with a focus on the intangibles affected by the restructuring, thereby mapping out a framework to which the function shifting regimes treated in this dissertation can be applied.



In the following two parts, intangibles and business restructurings are dealt with from an international perspective in order to enable a comparative analysis in the following chapters. It furthermore makes it possible to consider a number of trends that are visible as a result of BEPS and a more intangible focused approach that can be observed from the position of both businesses and tax authorities.

## 3.1 Intangible Property

Before the end of the 20th century, when the world became more and more interconnected as a result of advances in communication technology, the value of a company was made up of its production process, its skilled employees in the manufacturing as well as its efficient sourcing.[149] This has drastically changed over the past decades. It is now intangibles that are key to a company's success while the production process, manufacturing workforce and efficient sourcing are merely seen as something secondary that can be easily outsourced. However, these value drivers of the past bear a profit potential even if it might be smaller than it used to be. By relocating the more traditional value drivers, the focus now lies on the creation of intangibles, which is done on the one hand through R&D and marketing, but alternatively some are inevitably created in a more subtle way. They can be the result of contractual agreements, a standing well-trained workforce, synergies and the potential for future profit. These can also be referred to as soft intangibles or non-asset values. [150] Furthermore, there is a desire to combine all of these different intangibles, which results in an entire business function that itself can be said to be an intangible asset.[151]

Looking at the following chart it can be observed that the majority of value drivers is contained in intangible property; or more precisely: intellectual property, Technology

[147] Andrews, D. & de Serres, A., "Intangible Assets, Resource Allocation and Growth: A Framework for Analysis", OECD Economics Department Working Papers, No. 989, Paris: OECD Publishing, (2012), p.5; to be retrieved at: http://dx.doi.org/10.1787/5k92s63w14wb-en.

[148] For additional reasons to restructure please see Chapter II.

[149] Verlinden, I. & Smits, A., *Mastering the Intellectual Property Life Cycle – A global perspective on the tax-efficient management of IP rights*, Sint-Stevens-Woluwe: PricewaterhouseCoopers, (2009), p. 22 & 23.

[150] Bakker A. J. & Cottani, G., Transfer Pricing and Business Restructuring: The Choice of Hercules before the Tax Authorities, *International Transfer Pricing Journal*, Amsterdam: IBFD, online edition, (2014), p. 132.

[151] See for example the German Function shifting regime that aims at taxing the transfer of a business unit as a whole.

and other IP, R&D as well as Marketing. The so-called soft intangibles are comprised in the residual functions: sourcing and procurement, manufacturing and services as well as sales and distribution.

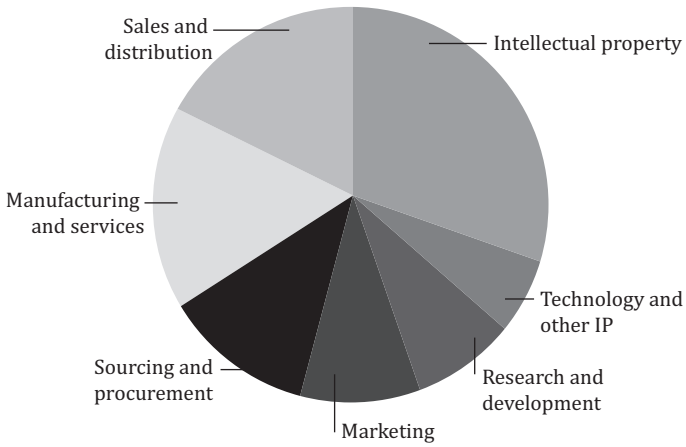


**Chart:** Value Drivers
*Source:* Driscoll, T. et al., 'The Evolution of Business Model Optimisation', in Cunningham, R. et al., 'Intangibles', *Tax Reference Library Series*, International Tax Review, 2013, No. 76, p. 25

Hence, a wide variety of intangibles can be distinguished that are nowadays the main drivers of value creation.

The proper definition of intangibles is relevant not only for tax purposes, but also for accounting, civil law and IP law. These sources of law can be tapped into in order to establish definitions on the relevant groups of intangibles. Even though they have obvious shortcomings, e.g. the definition that is given for accounting purposes is obviously limited to the extent that these intangibles are to be found on the balance sheet, this is not the case with know-how and many other sorts of intangibles. While intangibles such as know-how and goodwill lack a proper definition in civil law, the definitions found there are at least a starting point for a variety of intangibles when applying a broader definition as proposed by e.g. the OECD TP Guidelines. A proper definition is not only of mere academic relevance but also of importance when it comes to the application in practice. On the one hand, a definition can be too limited in its application. This way some of the intangibles that are not covered by the definition will simply not be covered by transfer pricing legislation, which effectively means that they can be transferred disregarding an appropriate compensation.[152] On the other hand, the opposite is likely to happen if the developments culminating in the BEPS project, a project called for by the G20[153] and executed by the

[152] *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* 2017, para. 6.5; originated from: OECD, *Revised Discussion Draft on the Transfer of Intangibles – Public consultation*, OECD: Paris, (2013), p. 14, para. 39.

[153] OECD, *Action Plan on Base Erosion and Profit Shifting*, Paris: OECD, (2013), p. 11; DOI: 10.1787/9789264202719-en.

OECD, do not lead to a harmonized action but to unilateral attempts.[154] Tax authorities are keen to bring even the most routine functions with the slightest economic benefit into the range of taxability.[155] The result of this trend is that even the most routine functions are at risk of being seen as commercially significant and therefore ought to be taxed if moved to another jurisdiction. Such a problem of definition can especially be significant in cases where multiple jurisdictions are involved that at the same time apply different definitions. In that regard, the OECD pointed out in the 2010 OECD TP Guidelines that for example not every marketing activity necessarily leads to the creation of a marketing intangible.[156] The same can be said about many other activities across the entire board of the value chain. The danger lies in the absence of an accurate definition and the subsequent broad application by the tax authorities. Considering this, it is only sensible that one of the actions proposed by the OECD in the Action Plan on Base Erosion and Profit Shifting is the clear and precise definition of the term/concept of an intangible.[157]



Since this dissertation also contains a comparative analysis, it is first necessary to take a look at internationally accepted definitions such as those provided by the OECD and the International Accounting Standards Board responsible for establishing the International Financial Reporting Standards (IFRS). The definitions given by IP law shall also be considered, since decoupling a definition from the actual area of law it belongs to cannot be constructive. After considering and evaluating the different aspects of the respective definitions, the outcomes are discussed and proposals with a view to the following aspects of this dissertation are made.

### 3.1.1 Intangible Property in General

As already pointed out, intangible property makes up an important part of businesses. As intangible property by its nature is not physically present, a large variety of concepts and subcategories of intangible property exists that try to categorize them, as shown in the following chart.

[154] Ibid., p. 10 & 11.

[155] Ackerman, R.E., 'Transfer Pricing and Intangible Planning', *Asia-Pacific Tax Bulletin*, Amsterdam: IBFD, (2008), p. 438.

[156] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD: Paris, (2010), p. 193, para. 6.6; in the 2017 version of the OECD Transfer Pricing Guidelines, this statement has been removed, yet it remains true.

[157] OECD, *Action Plan on Base Erosion and Profit Shifting*, Paris: OECD, (2013), p. 20; DOI: 10.1787/9789264202719-en; however, in the OECD Transfer Pricing Guidelines 2017 it has not been attempted to do just that and it is limited to illustrating the most frequent ones, para. 6.15ff.

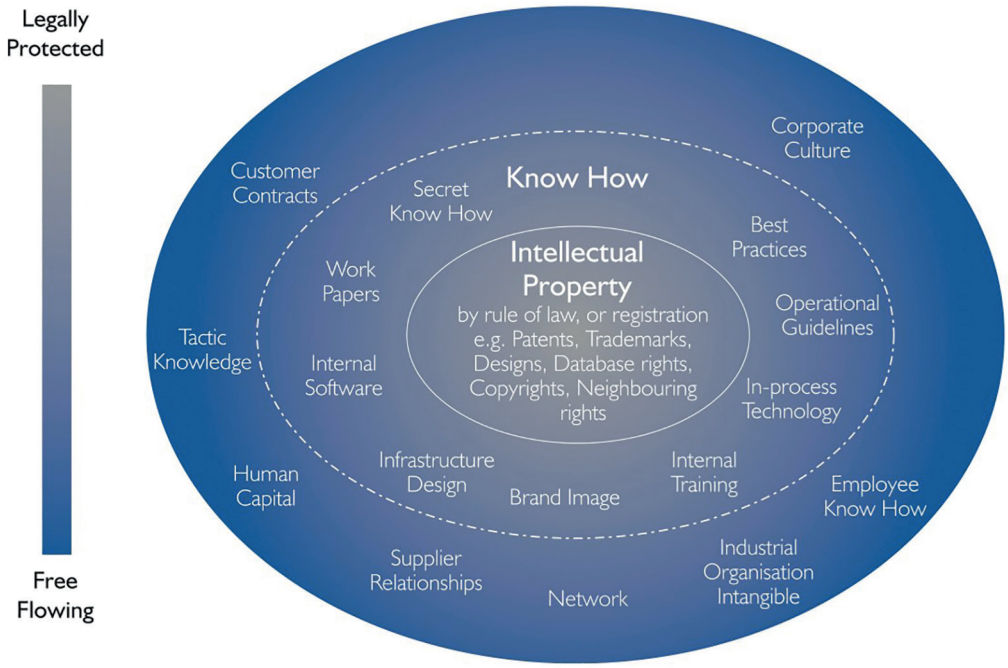


**Chart:** Spheres of Intangibles
Source: Cordova, D. et. al., 'US: Business Restructuring and the Role of Intellectual Property', *International Tax Review*, London: Euromoney Institutional Investor, (2012), p. 47.

These differences, first of all, lead to different levels of legal protection. Those being afforded protection by IP law are generally the best defined. Yet, even more value can be vested in intangible property that is either not protected or only protected to a limited degree by IP law.[158] Carving out these definitions then becomes relevant for transfer pricing purposes since the transfer of these intangibles can lead to taxation and possibly to double taxation.

The need for a proper definition of a number of the most important subcategories of intangibles is thus apparent. The following section focuses on some of the applicable definitions.

### 3.1.2 General Definitions of Intellectual Property

IP is generally the first type of asset which are associated with the term intangible. IP is generally dealt with in the civil laws of the respective country, as well as in international conventions. In particular these assets enjoy a high degree of legal protection and are therefore well defined in civil law and the respective international conventions.

[158] Examples for this can be, on the one hand, so-called soft intangibles like an assembled workforce, that are relevant to the running of the company but that are per se not legally protectable. On the other hand, there are companies that deliberately choose not to legally protect their know-how in order to avoid publication at the cost of a sometimes costly legal protection.

IP can be broadly divided into two categories: copyrights and industrial property. This section, however, shall be limited to industrial property such as patents, trademarks/ brands, trade names and know-how. [159]

A number of distinctive features of intellectual property rights can be pointed out. Firstly, they are generally referred to as creations of the mind or intellect and remain intangible unless they are applied in creating a product or service. Secondly, in order to be afforded legal protection by the relevant civil law, they have to meet a number of conditions. Being awarded such an intellectual property right warrants exclusivity for a creation within a certain territory and a certain period of time. Thirdly, the protection of the creation entails that the owner of it may bar other parties from making use of it; equally, the owner may license or sell the intellectual property right that has been awarded.



### 3.1.3 General Definition of Intangibles for Accounting Purposes

Similarly, to the aforementioned arguments that make intangibles relevant for IP law and transfer pricing, intangibles are important for accounting purposes. In a number of cases there may be intangible assets that are not afforded legal protection through e.g. a patent because a protection through such an instrument is not desirable in that particular case. This is due to the publicity requirements connected to the patent application procedure, allowing competitors to produce products that are similar in how they work but do not fall within the scope of the patent. But even such unpatented know-how needs to be valued for accounting purposes. Hence, the employed definition in this case needs to be broader in order to also cover those kinds of intangible property that are not legally protected. The relevant provisions that need to be considered, when analysing the present subcategories of intangibles, are contained in IAS 38.

Instead of providing a number of examples, as was done by the OECD in the TP Guidelines,[160] or giving a number of provisions to which, a certain rule applies, as occurs in the applicable IP law conventions, the IAS Board has given a general definition and three criteria that need to be fulfilled in order to classify an intangible as an intangible asset.

The following, general definition of an intangible asset has been provided in IAS 38:

> *"An intangible asset is an identifiable non-monetary asset without physical substance."*[161]

Moreover, from the use of the word asset in the definition it follows that it needs to be identifiable and controllable and yield future economic benefits.[162] These conditions

[159] WIPO, *Understanding Industrial Property*, Geneva: WIPO, p. 5; can be retrieved at: http://www.wipo.int/edocs/pubdocs/en/intproperty/895/wipo_pub_895.pdf; last visited on 09.07.2015.

[160] The general definition provided for by the OECD TP Guidelines in para. 6.6 is further illustrated by a number of examples in paras. 6.18-6.31.

[161] IAS 38, para. 8.

[162] IAS 38, para. 8.

will be explained in the following as they will be applied to a number of categories of intangibles and serve as one way to delineate an intangible.

#### *3.1.3.1 Identifiability of the Intangible Asset*

An intangible asset is considered to be identifiable if it is separable. This entails that it can be divided or separated and subsequently be transferred. Such a transfer can be limited to the intangible asset itself or it can take place in connection with a contract, asset or liability.[163] Furthermore, identifiability is a given once it is the result of contractual or legal rights.[164]



Applying this criterion to goodwill, it becomes clear that this does not form part of the intangible assets. Goodwill embodies economic benefits the value of which can be expressed as the difference between the fair market value of a going concern and the value of the net assets of an enterprise. This value can be made up of clearly discernible intangible assets, as well as other soft intangibles.[165] Goodwill is addressed in IFRS 3, which deals with the effects of business combinations entailing mergers and acquisitions where goodwill plays a major role.[166]

#### *3.1.3.2 Control of the Intangible Asset*

The criterion of control entails that the respective entity may obtain the future economic benefits or is able to restrict others from tapping the aforementioned benefits stemming from the intangible asset.

One of the consequences of this criterion is that an assembled workforce cannot be considered to be an intangible asset. Even though it can be presumed that further economic benefit is to be derived from an assembled workforce, it is not entirely certain. Control over individual members of an assembled workforce is very limited. Therefore, it is impossible to control the performance of an assembled workforce.[167] Another example of an intangible that is difficult to bring into the ambit of an intangible asset are customer relationships.[168] Even in cases where substantial efforts have been made in order to bind the customers, control is not a given. Yet, if there are legal rights in place that allow the exercise of control over the customer portfolio, qualification as intangible may well be possible as long as the other requirements are met.[169]

[163] IAS 38, para. 12(a).

[164] IAS 38, para. 12(a).

[165] IAS 38, para. 11.

[166] IAS 38, para. 3(f).

[167] IAS 38, para. 15; However, in situations where the know how vested in these staff members can be subject of a legal right and fulfils the other requirements of future economic benefits and identifiability.

[168] IAS 38, para. 16.

[169] IAS 38, para. 16.

#### *3.1.3.3 Future Economic Benefits*

Future economic benefits mean the realization of revenue as the result of either sale or any other benefit derived from related products, services or cost savings.[170] Such an economic benefit can arise, for instance, by applying an intangible asset to a new product leading to new shares of revenue. An economic benefit is also achieved when the intangible asset contributes to an economic benefit only indirectly, by reducing production costs or making any other step in the value chain more efficient and thereby leading to more revenue.[171] Furthermore, future economic benefits are relevant for the recognition of the intangible, but only when it is probable that the expected future economic benefits stemming from the asset will actually flow to the entity and the costs of the asset can be measured reliably.[172]

### 3.1.4 General Definition of Intangibles According to the OECD

The relevant definition of the OECD that needs to be considered stems from the OECD Transfer Pricing Guidelines. In the current structure of the OECD Transfer Pricing Guidelines, intangibles are mainly dealt with in Chapter VI, which means that the definition(s) given by the OECD has to cover a broad range of intangibles.[173] However, intangibles are also relevant in cases of business restructurings. Therefore, Chapter IX of the OECD Transfer Pricing Guidelines should also be considered when it comes to intangibles. However, no separate definitions are provided for intangibles in that chapter. In particular there is no specific definition for soft-intangibles that can be of major concern in case of a business restructuring.[174]

Chapter VI, it deals with intangible property and has undergone a revision process that started in 2012 culminating in the 2017 OECD TP Guidelines. Before the definition that was first found in the Revised Discussion Draft on the Transfer of Intangibles was introduced in the OECD Transfer Pricing Guidelines, the latter contained the following definition:

> *"[T]he term 'intangible property' includes rights to use industrial assets such as patents, trademarks, trade names, designs or models. It also includes literary and artistic property rights, and intellectual property such as know-how and trade secrets."*[175]

[170] IAS 38, para. 17.

[171] IAS 38, para. 17.

[172] IAS 38, para. 21.

[173] Another chapter of the OECD Transfer Pricing Guidelines dealing with mainly soft intangibles is Chapter IX of the OECD Transfer Pricing Guidelines. The focus there lies among others on the soft intangibles transferred in conjunction with an asset that is commonly observed in cases of mergers and business restructurings. However, this part does not provide a separate definition of "intangibles".

[174] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD: Paris, (2010), p. 252, para. 9.48; OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD: Paris, (2017), p. 251, para. 9.10.

[175] Ibid., p. 191, para. 6.2.

This definition was then refined by stating that the focus was on commercial intangibles.[176] Commercial intangibles are the intangibles used either in the production or supply of services or in the direct supply of intangibles to a customer.[177] Therefore, patents, know-how, designs and models, as well as those intangible assets that are directly transferred to the customer are subsumed into the category of commercial intangibles.[178] [179] Yet, the category of commercial intangibles can be further split up into trade and marketing intangibles.[180] Whether such a fragmentation of the term is useful will form part of the discussion at the end of this chapter.



The OECD defines trade intangibles through an inversion, as being all commercial intangibles that are not marketing intangibles.[181] This means that patents, inventions, formulations, designs or know-how are to be categorized as trade intangibles.[182] These are further described in the following manner:

> *"Trade intangibles often are created through risky and costly research and development (R&D) activities, and the developer generally tries to recover the expenditures on these activities and obtain a return thereon through product sales, service contracts, or licence agreements."*[183]

Their decisive feature is that usually a rather large initial investment is needed in order to create them, whereas sustaining trade intangibles only requires a limited follow-up investment.[184] Since one of the main means of creating this sort of intangibles is through R&D, a high degree of risk is usually involved.[185]

The second group that makes up commercial intangibles is the one of marketing intangibles. The 2010 OECD Transfer Pricing Guidelines contained the following definition:

> *"Marketing intangibles include trademarks and trade names that aid in the commercial exploitation of a product or service, customer lists, distribution*

[176] Ibid., p. 191, para. 6.3.

[177] Ibid., p. 191, para. 6.3.

[178] Ibid., p. 191, para. 6.3.

[179] Miyatake, T., 'IFA General Report', *Cahiers de Droit Fiscal International*, Deventer: Kluwer Law, (2007), p. 23.

[180] Torvik, O., Transfer Pricing and Intangibles – US and OECD arm's length distribution of operating profits from IP value chains, *IBFD Doctoral Series*, Amsterdam: IBFD, Vol. 45, 2019, – online book, Chapter 3, p. 13f.

[181] Ibid., p. 191, para. 6.3.

[182] Miyatake, T., 'IFA General Report', *Cahiers de Droit Fiscal International*, Deventer: Kluwer Law, (2007), p. 23.

[183] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD: Paris, (2010), p. 191, para. 6.3.

[184] Heldermann, L., Sporken, Okten, Kanter, 'A new Era in Determining Arm's length compensation for intangibles? A comparative Overview of Existing and possible future transfer pricing principles', *International Transfer Pricing Journal*, Amsterdam: IBFD, (2013), p. 361; deviating opinion: Miyatake, T., 'IFA General Report', *Cahiers de Droit Fiscal International*, Deventer: Kluwer Law, (2007), p. 23.

[185] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD: Paris, (2010), p. 194; Wittendorff, J., *Transfer Pricing and the Arm's Length Principle in International Tax Law*, Alphen aan de Rijn: Kluwer Law International, (2010), p. 617.

*channels, and unique names, symbols, or pictures that have an important promotional value for the product concerned."*[186]

Hence, the category of marketing intangibles is made up of trademarks, brand names, copyrights, franchises, licences, contracts, methods, systems, studies, forecasts, customer lists and other data related to marketing.[187] Generally, intangible assets in this category also require a larger initial investment but at the same time large continuous investments are needed in order to sustain or even increase their value.[188] Similarly, it is possible that the necessary marketing activities produce high costs but still, due to their short-term impact, do not result in the creation of a marketing intangible.[189] Hence, it is not always clear whether an intangible is to be qualified as the one or the other on the basis of necessary investment. Therefore, one can find a third category that is made up of hybrids of the two groups.[190] This third category is not provided by the OECD but it is proposed by doctrine, which allocates it in-between the two groups currently suggested by the OECD.



However, as the existence of a third category already suggests, a clear differentiation between the two was not always possible. This led to numerous conflicts between tax authorities as well as between tax authorities and taxpayers.[191] These hybrid intangibles combine both features of trade as well as marketing intangibles. It is questionable what exact purpose is served by splitting up intangible assets in this way. However, it has always been argued that the described differentiation is necessary and justified since the two categories are essentially different when it comes to the timing of the investment and the creation of the intangibles.[192,193] Following this line of argumentation, a third category for hybrid intangibles would indeed make sense.

Yet, responding to the arguments calling for a more precise definition the OECD did not suggest a third hybrid-category. Instead, it created a new definition that first appeared in 2012 and was further refined in 2013 in the Revised Discussion Draft on the Transfer

[186] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD: Paris, (2010), p. 192, para. 6.4.

[187] Miyatake, T., 'IFA General Report', *Cahiers de Droit Fiscal International*, Deventer: Kluwer Law, (2007), p. 23; OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD: Paris, (2010), p. 192, para. 6.4. & 6.5.; Wittendorff, J., *Transfer Pricing and the Arm's Length Principle in International Tax Law*, Alphen aan de Rijn: Kluwer Law International, (2010), p. 140.

[188] Heldermann, L., Sporken, Okten, Kanter, 'A new Era in Determining Arm's length compensation for intangibles? A comparative Overview of Existing and possible future transfer pricing principles', *International Transfer Pricing Journal*, (2013), p. 361; OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD: Paris, (2010), p. 194, para. 6.9.

[189] Wittendorff, J., *Transfer Pricing and the Arm's Length Principle in International Tax Law*, Alphen aan de Rijn: Kluwer Law International, (2010), p. 140.

[190] Miyatake, T., 'IFA General Report', *Cahiers de Droit Fiscal International*, Deventer: Kluwer Law, (2007), p. 23.

[191] Wang, J., 'A tentative Improvement: Comments on OECD Discussion Draft on the Transfer Pricing of Intangibles', *International Transfer Pricing Journal*, (May/June 2013), p. 137.

[192] Heldermann, L., Sporken, Okten, Kanter, 'A new Era in Determining Arm's length compensation for intangibles? A comparative Overview of Existing and possible future transfer pricing principles', *International Transfer Pricing Journal*, (2013), p. 361.

[193] Wittendorff, J., *Transfer Pricing and the Arm's Length Principle in International Tax Law*, Alphen aan de Rijn: Kluwer Law International, (2010), p. 617.

of Intangibles. A first apparent change is that it now deals with the broader concept of *intangibles* while the more limited term of *intangible property* has been dropped. This revised definition has ultimately been included in the OECD Transfer Pricing Guidelines 2017. In more general terms than previous definitions the said Discussion Draft states the following:

> *"[T]he word "intangible" is intended to address something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances."*[194]



Essentially this definition then leads to questions that relate to ownership as well as to the transfer of the intangible. Moreover, there are a number of subcategories that can be distinguished and that are equally relevant for insuring that the definition is clearly delineated.

### 3.1.5 Sub-Categories of Intangibles as Proposed in the OECD Revised Discussion Draft and Introduced in the 2017 OECD TP Guidelines

The subcategories that shall be touched upon in the following sections can be considered not to be based on the divide between trade and marketing intangibles, which is rather artificial in comparison to the one, mentioned in the foregoing section.[195] The differentiation previously provided by the OECD in the Transfer Pricing Guidelines 2010 is based on whether the intangibles are market facing or not. Hence it is not necessarily founded on the qualities of the intangible itself but rather on the way the intangibles are used in business. However, the usefulness of any division has been declined.[196] The only one that is still clearly backed by the OECD revised discussion draft and ultimately its implementation in the 2017 OECD TP Guidelines is one of routine intangibles and hard-to-value intangibles. Yet, the enumerated subcategories of the latter document also contain a number of factors relevant to the transfer pricing analysis that are widely considered to be soft-intangibles.

In Chapter VI of the 2017 OECD TP Guidelines these subcategories are framed in a number of different examples. It is not meant to be an exhaustive enumeration of the intangibles relevant for transfer pricing purposes. Similarly, it is also intended to avoid

[194] OECD, *Revised Discussion Draft on the Transfer of Intangibles – Public consultation*, OECD: Paris, (2013), p. 14, para. 40; idem: *OECD, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD: Paris, (2017), p. 249, para. 6.6.

[195] Wang, J., 'A tentative Improvement: Comments on OECD Discussion Draft on the Transfer Pricing of Intangibles', *International Transfer Pricing Journal*, May/June 2013, p. 137.

[196] OECD, *Revised Discussion Draft on the Transfer of Intangibles – Public consultation*, OECD: Paris, (2013), p. 16, para. 13 & para. 49.

other differentiation of routine and non-routine intangible or soft and hard intangible, and any of the other differentiations frequently found in the literature or in other countries.[197] The only separate category that is mentioned is the one of "unique and valuable intangibles".[198] This category of intangibles is important inasmuch as they are not comparable.[199] They are either not used or simply not available to parties in comparable controlled transactions. Furthermore, this sort of intangible can be connected to higher than normal economic benefits compared to situations where such an intangible is absent.[200]



Besides that, the 2017 OECD TP Guidelines, based on the identical revised discussion draft, try to illustrate the different intangible assets that are considered for transfer pricing purposes by giving a number of examples. As will be shown, some of the types of intangibles that are illustrated in the Discussion Draft of Chapter VI and the 2017 OECD TP Guidelines go rather undisputed as they more or less match definitions given by civil law or accounting standards. However, for some of these subcategories the dividing line is more difficult to draw, since a transfer pricing analysis needs to take account not only of the assets that are transferred but also of a number of surrounding circumstances that are neither easy to identify nor to quantify. In the case of business restructurings these are, for example, location savings, available workforce and individual bargaining position. Hence, these definitions need to discern the relevant intangible assets from those circumstances that play into the transfer pricing analysis but are at same time also intangible. Yet, some of the factors that are mentioned could arguably also be intangibles in their own right.

## 3.2 Interim Conclusion

In the foregoing the three overarching definitions that have been considered are those stemming from civil law and accounting as well as those adopted by the OECD. The definitions are limited by their intended field of application. While the term *intellectual property* is the narrow, the definition for intangibles given by the OECD is the broader. This has been further pronounced in the 2017 update of the OECD TP Guidelines, in which the term "property" is eliminated, and which now only talk about intangibles. The meaning of intangible asset for accounting sits in the middle of these two.

The term *intellectual property* can firmly rest on the foundations of property law. Hence, intellectual property that is afforded legal protection and thereby excludes other parties from the use of it, such as a patent, has to be well defined in order to function. Either a right exists by way of intellectual property or it does not. When it comes to accounting,

[197] OECD, Revised Discussion Draft on the Transfer of Intangibles – Public consultation, OECD: Paris, (2013), p. 16, para. 13 & para. 49; OECD, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, OECD: Paris, (2017), p. 252, para. 6.15ff.

[198] Ibid., para. 51; OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD: Paris, (2017), p. 252, para. 6.17.

[199] Torvik, O., Transfer Pricing and Intangibles - US and OECD arm's length distribution of operating profits from IP value chains, *IBFD Doctoral Series*, Amsterdam: IBFD, Vol. 45, 2019, - online book, Chapter 3, p. 16ff.

[200] Ibid.

the definition has to be broader since it is not just about the property but also about the asset that is recognized on the balance sheet. Since accounting is concerned with the in- and outflows of assets and liabilities of the company, it captures only intangibles related to that.[201]

Conversely, the range that needs to be covered by the definition presented by the OECD for transfer pricing purposes has to be even larger. Since the purpose of transfer pricing is to ensure that transactions between related parties are executed at arm's length, it is decisive for such a definition to capture every intangible that can be part of such a transaction. Thus, it does not necessarily correlate with the other two definitions provided. It is questionable whether such an overarching approach is justifiable. This will therefore be covered in the subsequent analysis, in particular regarding cross-border function shifting. More importantly, it is necessary to take a closer look at the different intangibles – in particular at some that are considered to be merely surrounding circumstances to a transfer pricing analysis but could very well be treated as an intangible in their own right.



## 3.3 Different Categories of Intangibles and their Definitions

Given the broad range of intangibles this part looks at the different definitions of a number of subcategories. Since intangibles defined by intellectual property law are not so controversial, the focus is on soft intangibles.

In the absence of a clear definition as to what constitutes a soft-intangible, a number of the most discussed ones have been chosen. The soft-intangibles that are subsequently considered, partially based on the relevance of the legislations looked into, are the following:

- Goodwill & going concern;
- Assembled workforce;
- Group synergies;
- Location savings & location specific advantages.

### 3.3.1 Intangibles not Constituting Rights

While patents, trademarks, licences and other intangibles are backed by established definitions derived from intellectual property law, the following types of intangibles are of relevance since they are not easy to discern and yet play a central role in the case of business restructurings.

The reason for also bringing the intangibles of the following categories in the ambit of intangibles that are relevant for transfer pricing is clear. Goodwill and ongoing concern represents not only the sum of individual, clearly identifiable assets, but also the unity

[201] Cañibano, L., et al., *The Value Relevance and Managerial Implications of Intangibles: A Literature Review*, Madrid: Meritum, (1999), p. 10ff.

of assets which creates an additional value on top of that. Exactly that additional value can be tremendous.[202] In cases of mergers and acquisitions it is necessary to determine the goodwill of the target, while ongoing concern becomes relevant when a business is restructured (internally).[203] Regarding the aims of business restructurings, a certain importance can be attached to group synergies, business opportunities as well as to location savings. Likewise, an assembled workforce can be part of a restructuring; hence it is also dealt with in the following.



#### *3.3.1.1 Goodwill*

Regarding goodwill, there is no explicit definition stipulated by the OECD, neither in Chapter VI nor in Chapter IX of the OECD TP Guidelines.[204] However, in the 2017 OECD TP Guidelines it is stated that, regardless of the absence of a definition, taxpayer and tax authority alike are under the obligation to describe the goodwill transferred in a transaction while also considering how third parties would compensate the goodwill.[205]

#### *3.3.1.2 Ongoing Concern*

For a definition of a going concern in Transfer Pricing it is possible to resort both to Chapter VI of the OECD TP Guidelines, which deals with the specific issues related to intangibles, and to Chapter IX, which applies in cases of business restructures. Without providing a definition itself, the OECD merely states that:

> *"The Term ongoing concern value is sometimes referred to as the value of the assembled assets of an operating business over and above the sum of the separate values of the individual assets."*[206,207]

While refuting the importance of accounting and business valuation methods in the 2017 OECD TP guidelines, Chapter IX describes ongoing concern in the following manner:

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[202] Wang, J. A tentative Improvement: Comments on OECD Discussion Draft on the Transfer Pricing of intangibles, International Transfer Pricing Journal, May/June 2013, p. 138.

[203] Ibid.

[204] Alternatively, however the 2017 OECD TP guidelines offer an overview of the different views on p. 255, para. 6.27: "[…] Depending on the context, the term goodwill can be used to refer to a number of different concepts. In some accounting and business valuation contexts, goodwill reflects the difference between the aggregate value of an operating business and the sum of the values of all separately identifiable tangible and intangible assets. Alternatively, goodwill is sometimes described as a representation of the future economic benefits associated with business assets that are not individually identified and separately recognised. In still other contexts goodwill is referred to as the expectation of future trade from existing customers."

[205] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD: Paris, (2017), p. 256, para. 6.29; OECD, Revised Discussion Draft on Transfer Pricing Aspects of Intangibles, 30 July 2013, para. 62.

[206] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD: Paris, (2017), p. 255, para. 6.27; OECD, *Revised Discussion Draft on the Transfer of Intangibles – Public consultation*, OECD: Paris, (2013), p. 18, para. 60.

[207] Wang, J., A tentative Improvement: Comments on OECD Discussion Draft on the Transfer Pricing of intangibles, International Transfer Pricing Journal, May/June 2013, p. 138.

> *"[…] assets, bundled with the ability to perform certain functions and assume certain risks. Such functions, assets and risks may include, among other things: tangible property and intangibles; liabilities associated with holding certain assets and performing certain functions, such as R&D and manufacturing; the capacity to carry on the activities that the transferor carried on before the transfer; and any resource, capabilities, and rights."*[208,209]



Regarding this particular category of intangible, the OECD pronounces its importance for transfer pricing purposes, acknowledges that there is a variety of definitions but comes to the conclusion that giving a precise definition is actually not relevant. Considering that goodwill and ongoing concern lead to taxation in the framework of transfer pricing, one should expect that the object of taxation is at least somewhat defined.

Taking into account the broad definitions provided for by the OECD of other categories of intangible assets, it can be questioned whether major parts of goodwill and ongoing concern have already been included in these more specific definitions, an example being the reputational value that is connected to a trademark or a brand, which is at the same time also part of the ongoing concern value of an entire company using said trademark or brand.[210]

#### *3.3.1.3 Group Synergies*

Since the revised Discussion draft of 2013, this type of intangible did not qualify as such for means of transfer pricing. Yet, the existence of group synergies can become an issue when conducting the necessary comparability analysis and can subsequently require an adjustment. While incidental benefits that arise from the fact that an entity is a part of the group, it is not relevant for the application of the arm's length principle as such a scenario would not arise in the case of unrelated parties. Unrelated parties would, by definition, not enjoy group synergies since they do not belong to the group. An example would be the increased buying power that comes with the ability to order in higher quantities.[211]

However, if such synergies are a result of deliberate transactions or arrangements between group entities, they materialise into an actual benefit which other market participants do not have by operating outside of a group, and a comparability adjustment is necessary.[212] Thus, incidental benefits stemming from the mere membership of a group

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[208] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD: Paris, (2017), p. 390, para. 9.68.

[209] Wang, J., A tentative Improvement: Comments on OECD Discussion Draft on the Transfer Pricing of intangibles, International Transfer Pricing Journal, May/June 2013, p. 138 – in the version of the 2010 OECD TP Guidelines which has seen the exchange of the word *bear risk* into *assume risk*.

[210] First Mentioned by: OECD, para. 61, revised Discussion Draft Chapter VI, July 2013; introduced into OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD: Paris, (2017), p. 256, para. 6.28.

[211] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, OECD: Paris, (2017), p. 90, para. 1.158; originated from: OECD, Revised Discussion Draft on the Transfer of Intangibles – Public consultation, OECD: Paris, (2013), p. 8, para. 19.

[212] *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD: Paris, (2017), p. 91, para. 1.160; originated from: OECD, *Revised Discussion Draft on the Transfer of Intangibles – Public consultation*, OECD: Paris, (2013),p. 9, para. 21 – revised discussion draft.

do not necessitate an adjustment. Hence, it would also be necessary to define such relevant group synergies and the threshold for a deliberate action.

The revised discussion draft and the 2017 OECD TP guidelines try to achieve this by giving five examples of MNE group synergies. However, group synergies itself are, according to the revised discussion draft, not considered to be intangibles in their own right. Yet, even though examples are given, the discussion draft does not define this category of soft intangible. More importantly, by making it a part of the comparability analysis, the essential question to which entity such synergistic gains are to be allocated remains unanswered.



#### *3.3.1.4 Location Savings and Location Specific Advantages*

This category is covered in the in both Chapter VI and Chapter IX of the OECD TP Guidelines. While Chapter VI only expands on "Market Specific Characteristics",[213] Chapter IX actually considers location savings.[214] Advantages or disadvantages that stem from the market in which a company operates are not considered to be intangibles in the sense of part A1 of the revised discussion draft.[215] It is specifically stated that this category does not qualify as an intangible since it is not possible to own or control them. However, market specific characteristics are to be taken into account when conducting a comparability analysis. They can have an even greater effect in an aggregate analysis capturing more than just the the sum of the values of all separately identifiable tangible and intangible assets of an ongoing business. Therefore, it is still necessary to define them. In the 2017 OECD TP Guidelines, market specific characteristics have been broadly mentioned as entailing:

> *"[…] low prevailing labour costs, proximity to markets, favourable weather conditions and the like may affect the prices paid for specific goods and services in a particular market."*[216]

However, this is only part of what is covered by the broader term of location savings. In that regard, even more is covered under the term location specific advantages. For neither of the two, a comprehensive definition exists in the OECD TP Guidelines. The guidance on Transfer Pricing on intangibles released in the framework of the BEPS Project also considered the issue of location savings and made an addition to Chapter VI of the 2017

[213] *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD: Paris, (2017), p. 257, para. 6.31.

[214] Ibid, p. 411, para. 9.126.

[215] *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD: Paris, (2017), p. 87, para. 1.149; Ibid. p. 6, para. 11 – revised discussion draft.

[216] *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD: Paris, (2017), p. 257, para. 6.31; as first introduced in the revised discussion draft: Ibid., p. 19, para. 64 – revised discussion draft.

OECD TP guidelines.[217] However, it did not further define it nor did it provide a solution for the allocation of location savings.[218]

Location Savings are generally seen as comprising:

> *"[...] any cost advantage that a company involved in any activity in a certain country may benefit from and the impact it should have on the transfer pricing dealings it has entered into with other related companies."* [219]



Location savings are usually seen in a setting where a restructuring takes place in order to make use of low-cost manufacturing.[220] However, there is more that needs to be considered, namely location specific advantages.

When considering the overall location specific advantages, the whole range of factors should be taken into account, unlike what is done currently.[221] In a broader sense, location specific advantages also consider market characteristics. For a more complete definition it is best to side with economists in defining location specific advantages as:[222]

> *"[...] access to factors of production and distribution that can be exploited to produce a particular product or service cheaper, better and/or with less risk, or to increase the ability of a company to sell more products, at a higher price and/or achieve a larger market share."* [223]

Thus, the whole range of advantages offered by one location over another should be considered a location specific advantage, irrespective of savings that only relate to a restructuring but also include the market (the demand as well as the supply side).[224] However, it has to be kept in mind that advantages usually come at the price of disadvantages in other fields, which in turn might lead to the non-crystallization of extra profits. These extra profits that may or may not exist are "location rents", or, put differently, the *net*

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[217] *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD: Paris, (2017), p. 257, para. 6.31; BEPS/G20, Aligning Transfer Pricing Outcomes with Value Creation – Actions 8-10: 2015 Final Reports, Base Erosion and Profit Shifting Project, Paris: OECD, (2015), p. 73, MN 6.31, retrievable at: http://dx.doi.org/10.1787/9789264241244-en (15.10.2016).

[218] *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD: Paris, (2017), p. 84, para. 1.139ff; BEPS/G20, Aligning Transfer Pricing Outcomes with Value Creation – Actions 8-10: 2015 Final Reports, Base Erosion and Profit Shifting Project, Paris: OECD, (2015), p. 43, MN 1.139ff, retrievable at: http://dx.doi.org/10.1787/9789264241244-en (15.10.2016).

[219] Gonnet, S. et al., Location Specific Advantages – Principles, *Transfer Pricing International Journal*, Arlington: BNA, (2011) No. 6, p. 1.

[220] Ibid. p. 2.

[221] Ibid. p. 2.

[222] Ibid. p. 3.

[223] Ibid. p.3, Reference to: Patton and Quick 1991, Ohlin, B., Hesselborn, P.O., and Wijkman, PJ. (ed.), The International Allocation of Economic Activity, London, MacMillan.

[224] Ibid. p. 3.

location specific advantages.[225] The existence of location rents and in particular their size additionally depends on the market situation in which the related parties are operating.

The uncertainty as to the actual existence of location rents after a business restructuring has been undertaken, adds another complication to the allocation of the possible extra remuneration between the related entities.[226] Furthermore, the absence of any definition whatsoever from the OECD is another factor which in the end contributes to two tax authorities claiming location rents in the course of a business restructuring and thereby causing double taxation.



While the OECD also deals with another term, "other local market features", that term should not be differentiated from location savings as it forms part of the analysis of the existence of location savings and the allocation of location rents. In order to answer this crucial question, the OECD merely states that for the transfer pricing analysis, i.e. in cases where no reliable adjustments are available, the question becomes relevant whether these location savings are passed on to the independent customer, and if not fully, to which degree independent entities would pass them on.[227] Furthermore, the effect on revenues and profits is of relevance. Especially the financial effect of the location savings makes it necessary, according to the revised discussion draft, to also investigate which group entity in fact profits from the location savings as a result of a business restructuring.[228] Furthermore, in order to find a solution to the problem how to allocate the benefits generated as a result of location savings and location specific advantages, it can be sensible to distinguish between factors that lead to an advantage are purely external and those that have an internal causal link.

#### *3.3.1.5 Assembled Workforce*

Just as location specific characteristics and group synergies, an assembled workforce does not qualify as an intangible asset in the 2017 OECD TP Guidelines.[229] It has rather been moved to Chapter I in the discussion draft. Hence, till now it is not explicitly considered by the OECD, neither in Chapter VI nor in Chapter IX, to be an individual asset that is relevant for transfer pricing purposes. It has merely been assigned importance in cases where a whole business unit is transferred. This usually occurs as a consequence of a business restructuring which is subject to Chapter IX of the TP Guidelines.

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[225] Ibid. p. 3, Reference to: McKee M. and M. McDonald, ''Location Savings in competitive markets'', Tax Management Transfer Pricing Report, Vol. 9, No. 19, Feb 2001.

[226] See the extensive treatment of this matter and the scenarios that can arise in: Gonnet, S. et al., Location Specific Advantages – Principles, Transfer Pricing International Journal, BNA, 06/11.

[227] Torvik, O., Transfer Pricing and Intangibles – US and OECD arm's length distribution of operating profits from IP value chains, *IBFD Doctoral Series*, Amsterdam: IBFD, Vol. 45, 2019, – online book, Chapter 10, p. 8ff.

[228] *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD: Paris, (2017), p. 86, para. 1.148ff; OECD, *Revised Discussion Draft on the Transfer of Intangibles* – Public consultation, OECD: Paris, (2013), p. 6, para. 10.

[229] *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD: Paris, (2017), p. 88, para. 1.152ff & p. 316, para. 6.208; originated from: OECD, Revised Discussion Draft on the Transfer of Intangibles – Public consultation, OECD: Paris, (2013), p. 7, para. 14ff & p. 51, para. 219.

Thus, while there are many arguments in favour of not considering an assembled workforce as an individual asset, the assembled workforce can nevertheless be crucial in case of a business restructuring.[230] However, in the revised discussion draft it is mentioned that for secondments, where substantial know-how is transferred, a separate compensation on basis of transfer pricing can be necessary.[231] In such a situation the payable compensation is not given for the secondee but for the know-how, thus clearly denying the possibility of qualifying any sort of workforce as an intangible.



### 3.3.2 Conclusion

The different intangibles that are usually relevant when restructuring a business have been covered in the foregoing section. At the outset of this part, the common differentiation of intangibles into marketing, trade and sometimes hybrid intangibles has been discussed. Differentiating intangibles on the basis of these two or, respectively, three groups is not necessarily sensible, as the consequences are limited for TP purposes. In fact, the two categories rather describe the fields of application which does not necessarily translate into qualities relevant for Transfer Pricing. At best it is the different investment cycles for these intangibles that could be of relevance. Likewise, such separation is no longer included in the revised discussion draft for the updated OECD TP Guidelines on the transfer pricing aspects of intangibles.

For Transfer Pricing purposes and specifically for business restructurings the categorization into routine and non-routine intangibles and likewise into soft and hard intangibles is highly relevant.

While routine intangibles are not critical, the lack of comparables for non-routine intangibles poses a challenge to Transfer Pricing and thus to the arm's length principle which is essentially based on the presence of uncontrolled comparables. Some of the latter intangibles are therefore also called *hard-to-value intangibles*.

Furthermore, there are soft and hard intangibles. For this analysis the range has been limited to group synergies, location savings and an assembled workforce as these are, according to the OECD TP Guidelines and the revised discussion draft, taken into consideration as a factor for a TP analysis. However, they are not intangibles in the sense of the general definition provided by the OECD. This stance is not without its controversy, as is further amplified considering the still large value that can be attached to soft-intangibles.

To a large degree, business restructurings are executed for the realisation of group synergies, location savings and other soft intangibles. Similar questions arise for an assembled workforce or the secondment of employees, which can also occur in the process of a business restructuring. Consequently, the question in how far these factors should be qualified and dealt with for TP purposes is a major point for discussion in the following chapters.

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[230] Verlinden, I. & Smits, K., Transfer Pricing Aspects of Business Restructurings, *International Transfer Pricing Journal*, Amsterdam: IBFD, July/August 2009, p. 257.

[231] Personal income tax issues related to secondments are not part of this analysis and strongly depend on the personal circumstances of the individual in question.

## 3.4 Business Restructuring in light of the Arm's Length Principle as Seen by the OECD and the Consequences of BEPS

## Section I: The Arm's Length Principle

### 3.4.1 The Arm's Length Principle



Both the German and the US legislation dealing with the transfer pricing treatment of transferred intangibles, which also in part target business restructurings, should have at their basis, and consequently follow, the arm's length principle.

In order to ascertain the arm's length principle as it has been shaped by the OECD, reference is made to the OECD TP guidelines. These are of relevance in the context of the discussion of what specifically constitutes an intangible, in the OECD TP guidelines; the guidelines are also of relevance for further refining the general OECD position on the qualities of the arm's length principle. By way of the OECD TP guidelines the OECD:

> *"[…] provides a background discussion of the arm's length principle, which is the international transfer pricing standard that OECD member countries have agreed should be used for tax purposes by MNE groups and tax administrations."*[232]

More specifically, Chapter IX is decisive for how, in the opinion of the OECD, the arm's length principle should be applied to business restructurings transactions. This chapter has been subject to alterations within the framework of the BEPS project.[233] Nevertheless, for the treatment of intangibles, also in business restructuring situations, Chapter VI remains decisive.

As a consequence of the BEPS project which, in relation to transfer pricing, set out to not only deal with issues causing BEPS, but also with more fundamental problems of the arm's length principle,[234] a new approach has been developed. This new approach prescribes the alignment of transfer pricing outcomes with value creation.[235,236]

The principle elements for the application of the arm's length principle as it is found in Article 9(1) of the OECD Model are the related party, the reduction of income and the controlled transaction.

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[232] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, Paris: OECD (2017), para. 1.1.

[233] OECD, Conforming Amendments to Chapter IX of the Transfer Pricing Guidelines, *Base Erosion and Profit Shifting Project*, Paris: OECD, (2016).

[234] Schoueri, E., Arm's Length: Beyond the Guidelines of the OECD, *Bulletin for International Taxation*, Amsterdam: IBFD, (2015), Vol. 69 No. 12, p. 711ff.

[235] OECD/G20, Aligning Transfer Pricing Outcomes with Value Creation – ACTIONS 8-10: 2015 Final Reports, *OECD/G20 Base Erosion and Profit Shifting Project*, Paris: OECD.

[236] Brauner, Y., What the BEPS, *Florida Tax Review*, Vol.16, No. 2., (2014), p. 99.

1. *Where*
   a. *an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or*
   b. *the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions have not so accrued, may be included in the profits of that enterprise and taxed accordingly.*[237]



A relation between parties, or, in the wording of Article 9 of the OECD Model, enterprises, is established on the basis of direct or indirect participation.[238] Additionally, a relation can result from common control.[239] Concrete thresholds for the participation that is present in the parties concerned are not provided. Other factors which could influence the decision making of the parties in a way that unrelated parties would not act, are not considered.

The non-arm's length remuneration of a transaction between associated enterprises results in reduced profits for one of the associated enterprises. Article 9(1) of the OECD Model states the arm's length principle, but does not require its application by itself. It is only the national implementation of the arm's length principle which corrects such reduction of profits of its taxpayers by first identifying which one of the associated enterprises has its profits reduced as a result, and secondly by making the necessary adjustments according to the arm's length principle.

Transactions that are of relevance shall relate to *commercial or financial relations* according to Article 9 OECD Model. There is certainty that this encompasses all transactions that are generally exchanged between related entities.[240]

While the three aforementioned elements make up the general scope of the arm's length principle as conceived in Article 9 of the OECD Model, two additional approaches need to be considered regarding business restructurings. These are the principle stances on the aggregation of assets where an ongoing concern is transferred, and what is prescribed in such a case where comparable prices are generally absent.

[237] OECD Model Tax Treaty, Art. 9(1)

[238] OECD MC, Art. 9, MN1 (scope)

[239] OECD MC, Art. 9, MN1 (scope)

[240] Becker, K., in Haase, F., *Außensteuergesetz, Doppelbesteuerungsabkommen*. Heidelberg: C.F. Müller, (2012), Art. 9 OECD MA, MN. 18.

### 3.4.2 Business Restructuring

In situations where an ongoing concern is transferred, the OECD TP Guidelines allow for an aggregation of assets instead of a separate valuation.[241] In order to achieve a valuation that takes into account the ongoing concern which can be more than the sum of values of separate assets, para. 9.69 of the OECD TP guidelines posits the following provision:

> *9.69 The determination of the arm's length compensation for a transfer of an ongoing concern does not necessarily amount to the sum of the separate valuations of each separate element that comprises the aggregate transfer. In particular, if the transfer of an ongoing concern comprises multiple contemporaneous transfers of interrelated assets, risks, or functions, valuation of those transfers on an aggregate basis may be necessary to achieve the most reliable measure of the arm's length price for the ongoing concern. Valuation techniques that are used, in acquisition deals, between independent parties may prove useful to valuing the transfer of an ongoing concern between associated enterprises. The guidance on the use of valuation techniques for transactions involving the transfer of intangibles or rights in intangibles contained in Section D.2.6.3 of Chapter VI should be considered.*[242]

Hence, following through on the approach to make use of the most reliable method, an aggregated valuation can be warranted. The position of this provision within Chapter IX has been altered as a result of the proposed amendments to Chapter IX of the TP Guidelines as a consequence of the BEPS project.[243], What has remained is the inconsistency on the stance as to how such an ongoing concern should be valued. While in this provision a valuation in line with those "used in acquisition deals" is proposed,[244] such a valuation stemming from accounting and business is rejected in other provisions, particularly the one on intangibles.[245],[246]

Another issue that arises in business restructuring transactions, considering that a valuation can be the result of differing Transfer Pricing methods as well as of valuations from different entities' perspectives, is which price that is within the arm's length range

[241] *OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, Paris: OECD, (2017), para. 9.69; already possible according to the 2010 TP guidelines: OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* 2010, Paris: OECD, (2010), para. 9.94.

[242] *OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, Paris: OECD, (2017), para. 9.69; OECD, Conforming Amendments to Chapter IX of the Transfer Pricing Guidelines, *Base Erosion and Profit Shifting Project*, Paris: OECD, (2016), para. 9.69.

[243] OECD, Conforming Amendments to Chapter IX of the Transfer Pricing Guidelines, *Base Erosion and Profit Shifting Project*, Paris: OECD, (2016), para. 9.69

[244] *OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, Paris: OECD, (2017), para. 9.69.

[245] OECD, Discussion Draft: Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions, Paris: OECD, (2012), para. 22; OECD/G20, Guidance on Transfer Pricing Aspects of Intangibles – Action 8, *Base Erosion and Profit Shifting Project* – Deliverables, Paris: OECD, (2014), para. 6.29.

[246] Wang, J., A Tentative Improvement: Comments on OECD Discussion Draft on the Transfer Pricing of Intangibles, *International Transfer Pricing Journal*, Amsterdam: IBFD, (May/Jun 2013), p. 138.

may be chosen in such a controlled transaction.[247] In such a situation the TP Guidelines are explicit in stating that any price within the range may be chosen, and doing so shall not lead to an adjustment.[248] Only in a situation where an adjustment is to be made due to the price being outside the price range, the TP Guidelines suggest the application of e.g. the median or the weighted average.[249]

These general aspects seem not to have been subject to change as a consequence of the BEPS project. However, the alterations that result from the BEPS project are made with the intention of *aligning transfer pricing outcomes with value creation*.[250] The determination of an arm's length price is not necessarily congruent with the creation of value.[251] This is demonstrated in the following example:



> *"[…] in which an intangible is completely designed and perfected in one country but is solely exploited in a second country, where is value created-in the first or second? And if it is created, how should the two jurisdictions split the value creation? Obviously, straightforward arm's length is helpless when this is done within a single firm, and the same problems that exist today are repeated."*[252]

In particular where the arm's length principle fails, as this example demonstrates, the BEPS project should yield changes in the subsequently regarded soft-intangibles by bringing them into the scope of the TP Guidelines.

## Section II: Soft Intangibles

Regarding soft-intangibles, BEPS brought about a number of changes. Some of these soft-intangibles are considered for the first time in a more extensive fashion in the revised section D of Chapter I of the TP guidelines.[253]

### 3.4.3 Workforce in Place

While a workforce in place has only been mentioned as part of the valuation of an ongoing concern, which should also reflect the value of the former,[254] a new sub-section of Chapter I

[247] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, Paris: OECD, (2017), para. 3.58.

[248] Ibid., para. 3.60 & 3.58.

[249] Ibid., para. 3.62.

[250] Brauner, Y., What the BEPS, *Florida Tax Review,* (2014) p. 99; available at http://scholarship.law.ufl.edu/facultypub/642 (30.10.2016).

[251] Ibid.

[252] Ibid.

[253] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, Paris: OECD, (2017), para. 1.139ff; OECD/G20, Aligning Transfer Pricing Outcomes with Value Creation, *Base Erosion and Profit Shifting Project Actions* 8-10: 2015 Final Reports, Paris: OECD.

[254] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, Paris: OECD, (2017), para. 9.68.

now deals separately with a workforce in place.[255] However, the former provision applying to business restructurings mentions explicitly that it is the value of such a workforce in place that is to be taken into account.[256] That there is a value that needs to be attributed to the workforce in place has previously, in the 2010 TP Guidelines, been called into question by the bracketed question: *if any*.[257]

In addition to referring to Section D of Chapter I, the relevant provision in Chapter IX of the 2017 OECD TP Guidelines no longer mentions value, but now makes reference to the *impact* of an assembled workforce in relation to the time and money saved by not assembling a new one.[258] Yet, reference is still made to the value which might have been transferred with the assembled workforce, in a newly added provision of para. 9.86. Furthermore, there it is pointed out that in a situation, where non-compete clauses are in place an indemnification, therefore might become payable.[259]



The newly introduced keynote is reflected in Chapter I section D with the following statement:

> *1.152 Some businesses are successful in assembling a uniquely qualified or experienced cadre of employees. The existence of such an employee group may affect the arm's length price for services provided by the employee group or the efficiency with which services are provided or goods produced by the enterprise. Such factors should ordinarily be taken into account in a transfer pricing comparability analysis. […]* [260]

What can be taken from this is that the additional value that can be generated by a workforce in place for goods and services is the result of the particular composition. By taking this into account, the OECD acknowledges that this (the composition of employees) adds value in the framework of a transfer pricing comparability analysis – something that

[255] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, Paris: OECD, (2017), para. 1.152ff; OECD/G20, Aligning Transfer Pricing Outcomes with Value Creation, Base Erosion and Profit Shifting Project Actions 8-10: 2015 Final Reports, Paris: OECD, (2015), Section D. 7, para. 1.152ff.

[256] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, Paris: OECD, (2017), para. 9.68.: "For example, in the case of a business restructuring that involves the transfer of a business unit that includes, among other things, research facilities staffed with an experienced research team, the valuation of such ongoing concern should reflect, among other things, the value of the facility and the impact (e.g. time and expense savings) of the assembled workforce on the arm's length price."

[257] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010*, Paris: OECD, (2010), para. 9.93.

[258] OECD/G20, Aligning Transfer Pricing Outcomes with Value Creation, *Base Erosion and Profit Shifting Project Actions 8-10*: 2015 Final Reports, Paris: OECD, (2015), para. 1.152; OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, Paris: OECD, (2017), para. 1.152ff.

[259] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, Paris: OECD, (2017), para. 9.86; OECD, Conforming Amendments to Chapter IX of the Transfer Pricing Guidelines, *Base Erosion and Profit Shifting Project*, Paris: OECD, (2016), para. 9.86.

[260] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, Paris: OECD, (2017), para. 1.152; OECD/G20, Aligning Transfer Pricing Outcomes with Value Creation, *Base Erosion and Profit Shifting Project Actions 8-10*: *2015 Final Reports*, Paris: OECD, (2015), para. 1.152.

had been doubted previously.[261] Since the focus is on the particular collection of employees, the individual physical transfer and the secondment are excluded as they are considered to add nothing more than what is already compensated for the services rendered.[262] Should tacit knowledge be transferred in the course of a secondment, this it to be treated according to the transfer of an intangible distinct from the employee.[263]

In line with the assessment of an already assembled workforce saving time and resources for assembling a new one, the physical transfer of a workforce in place is also considered in a comparability analysis, sparing the receiving entity the costs of assembling a new one.[264] This also means taking resulting liabilities into account.[265] However, in order to make use of an assembled workforce, an actual transfer of the latter to the receiving entity is not always necessary. The same can be achieved by making the workforce available to the receiving entity. This can enhance the value of the intangibles or assets transferred.[266]



From an arm's length perspective, it is sensible to include the element of the specifically composed workforce in place since it can add or reduce the arm's length price due to the existing agreements in relation to such a workforce. However, purely making available a workforce in place should not demand a higher remuneration than the services that are rendered in light of the post-restructuring transactions for intangibles or assets transferred. Taking the new aim of value creation into account for evaluating the guidance given, it would be consistent to consider the value that is derived from the composition. However, this should not mean that the value which is potentially created by that workforce in the hands of the receiving entity is also to be accounted for by the tax authorities of the ceding entity. Similarly, value creation is not adequately accounted for where the making available of such a workforce in place should be considered as enhancing the value of intangibles or assets which are transferred. By doing so, one would actually take into account a value that is only created in the hands of the receiving entity, a value which is in fact already separately remunerated on the basis of the services rendered by that workforce in place. Yet, that should not influence the value of the transferred asset or intangible itself if one were to look at the value created. For that, a separate remuneration for the services rendered by that particular workforce in place is to be paid anyway, at arm's length.

[261] Brauner, Y., What the BEPS, *Florida Tax Review,* (2014) p. 99; available at http://scholarship.law.ufl.edu/facultypub/642 (30.10.2016).

[262] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, Paris: OECD, (2017), para. 1.154; OECD/G20, Aligning Transfer Pricing Outcomes with Value Creation, *Base Erosion and Profit Shifting Project Actions 8-10: 2015 Final Reports*, Paris: OECD, (2015), para. 1.154.

[263] Ibid., 1.155.

[264] Ibid., 1.153.

[265] Ibid., 1.153.

[266] Ibid., 1.156.

### 3.4.4 Synergies

In the context of aligning transfer-pricing outcomes with value creation, the OECD has also extended the guidance on synergies, particularly those within MNEs. While synergies have already been touched upon in the TP Guidelines, mainly as a factor inducing a business restructuring, the new section D of Chapter I treats synergies in greater detail. It identifies the issues resulting from synergies that arose as a consequence of deliberate actions of a group, effectively providing:



> *1.161 [...] a member of an MNE group with material advantages or burdens not typical of comparable independent companies, it is necessary to determine (i) the nature of the advantage or disadvantage, (ii) the amount of the benefit or detriment provided, and (iii) how that benefit or detriment should be divided among members of the MNE group.*[267]

Therefore, a first differentiation is made between those synergies that are merely of an incidental nature and those that are the result of deliberate action – like those that result from business restructuring. Those that are merely incidental are not to be compensated.[268]

Synergies that result from deliberate actions, however, are to be compensated for.[269] But it is acknowledged that the realisation of synergies can come at a cost such as record requirements.[270] Furthermore, it is recognized that the realization of synergies in groups is not certain.[271] This, in turn, leads to one of the core issues – namely determining what the synergistic benefit is. This requires a functional and comparability analysis.[272] However, the consideration of synergies is limited to those that arise from within the group.[273] Synergies that result from the interaction with a third party but still produce a benefit for the entire group are excluded.[274] The synergies that remain are to be shared in line with their contribution, which is exemplified by the application of economies of scale resulting in better purchasing conditions.[275] Using the OECD terminology an allocation of these

[267] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, Paris: OECD, (2017), para. 1.161; OECD/G20, Aligning Transfer Pricing Outcomes with Value Creation*, Base Erosion and Profit Shifting Project Actions 8-10: 2015 Final Reports*, Paris: OECD, (2015), para. 1.161.

[268] Ibid., para. 1.158 & 7.13.

[269] Ibid., 1.158.

[270] Ibid., 1.157.

[271] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, Paris: OECD, (2017), para. 9.26; OECD, Conforming Amendments to Chapter IX of the Transfer Pricing Guidelines, *Base Erosion and Profit Shifting Project*, Paris: OECD, (2016), para. 9.26.

[272] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, Paris: OECD, (2017), para. 1.159; OECD/G20, Aligning Transfer Pricing Outcomes with Value Creation, *Base Erosion and Profit Shifting Project Actions 8-10: 2015 Final Reports*, Paris: OECD, (2015), para. 1.159.

[273] Ibid., 1.160.

[274] Ibid., 1.160.

[275] Ibid., 1.162.

purchasing synergies according to the purchase volume should be presumed to be in line with the creation of these synergies.[276]

In an additional five examples the differentiation between deliberate and incidental synergistic benefits as well as the attribution have been further carved out. These examples certainly clarify the position but they are simplified to a degree where it is not possible to derive guidance on how to follow the approach of allocating synergistic benefits according to the contribution made to derive these benefits. One should think of a scenario where substantial efforts are necessary in order to create the synergistic benefit in a first step necessary for pursuing a strategy on carry-over parts[277] and thereby enabling mainly synergies for sourcing and R&D.[278] A subsequent allocation merely based on purchase volume of the group members seems to be contrary to an allocation based on the cause of the synergies. Furthermore, tying the allocation of a synergistic benefit to such a simple indicator might lead to a pragmatic solution, but is certainly not in line with the overarching aim of aligning transfer pricing outcomes with value creation.



Evaluating the general solution proposed for synergies, it is positive from an arm's length perspective to differentiate between those synergies that are merely incidental and those which are the result of deliberate actions. In an arm's length setting remuneration would not take place for synergies that are merely incidental. Once it has been determined whether such deliberate action leads to an advantage or a disadvantage, the crucial question arises as to how such a synergistic benefit or detriment should be allocated. While an allocation based on the parties' contribution does make sense from an arm's length perspective, the example previously mentioned which has been included in the guidelines, splitting the synergistic benefits in line with the purchase volume, suggests otherwise. The same applies when considering the alignment of transfer pricing outcomes with value creation. The determination of kind and size of the synergistic benefit is certainly in line with the aforementioned approach yet as already pointed out, one of the examples deviates from that very approach by relying on a too simplistic indicator for creating a synergistic benefit.

### 3.4.5 Location Savings

While location savings have already been treated extensively in the 2010 TP guidelines, a number of alterations have been made in 2017. Location savings and other local market

[276] Ibid., 1.162.

[277] A Strategy that is pursued by all major car manufactures e.g. Volkswagen AG and PSA Peugeot-Citroën; see: Lampón, J.F., et al., The impact of implementation of a modular platform strategy in automobile manufacturing networks, *Universida de Vigo GEN – Governance and Economics research Network Working Papers* B 2015 – 2, (2015); available at: http://s3.amazonaws.com/academia.edu.documents/37913231/WP1502.pdf?AWSAccessKeyId=AKIAJ56TQJRTWSMTNPEA&Expires=1477841211&Signature=FRJN%2BdshS%2FqmJkfeIzSb5a1u4F4%3D&response-content-disposition=inline%3B%20filename%3DThe_impact_of_implementation_of_a_modula.pdf (30.10.2016).

[278] Ibid., Winterkorn, M. & Pötsch, H.D., *Volkswagen Golf VII: launch of a new era*, Presentation held in Sardinia, (October 8th, 2012); availaible at: http://www.volkswagenag.com/content/vwcorp/info_center/de/talks_and_presentations/2012/10/Volkswagen_Golf7_Launch.bin.html/binarystorageitem/file/2012-10-08%20Golf%20VII_Presentation_Website.pdf (30.10.2016).

features are generally regarded as affecting comparability but also the arm's length price itself.[279]

The essential points for dealing with location savings are now expressed in Chapter I Section D.6.1., which identifies the following issues surrounding the apportionment of location savings by considering:

> *(i) whether location savings exist; (ii) the amount of any location savings; (iii) the extent to which location savings are either retained by a member or members of the MNE group or are passed on to independent customers or suppliers; and (iv) where location savings are not fully passed on to independent customers or suppliers, the manner in which independent enterprises operating under similar circumstances would allocate any retained net location savings.*[280]



While correctly identifying all the relevant issues that need to be taken into account in order to allocate the location savings between the group entities, the guidance provided in the subsequent paragraphs of that section differentiates only between situations where arm's length comparables are available and those where they are not.[281] In the former situation no adjustment is envisaged since an allocation by way of the existing arm's length prices is already made.[282] However, for the latter reference is merely made to an analysis that considers all facts and circumstances deemed of relevance.[283] A solution to how an existing location saving is to be allocated between related parties is not provided.

Additional provisions are to be found in Chapter IX to which only minor changes have been applied after it already dealt with location savings previously. According to these, in the course of a business restructuring the reallocation costs and actual location dissaving are to be taken into account for calculating the net location savings.[284] Also in this section the key question on how to allocate the location savings between the entities is mentioned. One is referred back to section D of Chapter I and its rather disappointing guidance in this matter.[285] But by means of two examples, the difficulties of allocating the location savings

[279] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, Paris: OECD, (2017), para. 1.139; OECD/G20, Aligning Transfer Pricing Outcomes with Value Creation, *Base Erosion and Profit Shifting Project Actions 8-10: 2015 Final Reports*, Paris: OECD, (2015), para. 1.139.

[280] Ibid., para. 1.141.

[281] Ibid., para. 1.142 & 1.143.

[282] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, Paris: OECD, (2017), para. 1.142; OECD/G20, Aligning Transfer Pricing Outcomes with Value Creation, *Base Erosion and Profit Shifting Project Actions 8-10: 2015 Final Reports*, Paris: OECD, (2015), para. 1.142.

[283] Ibid., 1.143.

[284] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, Paris: OECD, (2017), para. 9.126; OECD, Conforming Amendments to Chapter IX of the Transfer Pricing Guidelines, *Base Erosion and Profit Shifting Project*, Paris: OECD, (2016), para. 9.126; OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010*, Paris: OECD, (2010), para. 9.148.

[285] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, Paris: OECD, (2017), para. 9.127; OECD, Conforming Amendments to Chapter IX of the Transfer Pricing Guidelines, *Base Erosion and Profit Shifting Project*, Paris: OECD, (2016), para. 9.127; OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010*, Paris: OECD, (2010), para. 9.149 - stating essentially the same as in Section D.6. of Chapter I.

are demonstrated, contrasting a group that operates in a highly competitive market and one where goods or services offered are rather special as they allow for location savings to be retained by the group/a group entity.[286]

The solutions then presented, therefore, merely differentiate between the passing on of the advantages generated through location savings on the one hand, and retaining them within the entity from which the location savings have originated on the other. While in a highly competitive market prices that result from unrelated transactions are available and the allocation thus will be clear, the guidance in a situation where location savings are not consumed by a competitive market environment is less certain.[287] For the latter situation guidance is limited to the statement that the created location savings should be taken into account for the determination of the remuneration, and that in some instances the use of a transactional profit split method might be warranted.[288]



The relevant issues that arise in relation to location savings have been identified and pointed out. The new section of Chapter I which deals exclusively with location savings has not contributed to determining how a net location saving is to be allocated. Since the overarching principle under which the TP Guidelines have been reviewed is the alignment of transfer pricing outcomes with value creation, a different outcome was expected. However, as the example for the related entities operating in a highly competitive market shows, it is merely the arm's length principle which has been considered but not the actual value creation. Aligning the remuneration with the arm's length price can correlate with value creation but it not a necessity.[289] In that regard, the guidance at paragraph 9.131 of the 2017 OECD TP Guidelines regarding the allocation of location savings is relevant. However, merely accounting for the functions, risks, assets and alternatives realistically available would deficient inasmuch as the application of the transactional profit split method may be warranted in some cases.[290] The deficiency becomes apparent regarding the position taken by emerging markets that generally provide the most substantial location savings and rather sett the focus on *functions, people and physical assets,*[291] and therefore consider that the value has been created within their borders.[292]

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[286] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, Paris: OECD, (2017), para. 9.128; OECD, Conforming Amendments to Chapter IX of the Transfer Pricing Guidelines, *Base Erosion and Profit Shifting Project*, Paris: OECD, (2016), para. 9.128.

[287] Ibid., para. 9.128 -9.131.

[288] Ibid., 9.131.

[289] Such a disparity can result from the difficulty of not only pinpointing the location of value creation but also how value creation is to be defined.

[290] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, Paris: OECD, (2017), para. 9.131; OECD, Conforming Amendments to Chapter IX of the Transfer Pricing Guidelines, *Base Erosion and Profit Shifting Project*, Paris: OECD, (2016), para. 9.131.

[291] Schröger, M., Transfer Pricing: Next Steps in the International Debate; in Petruzzi, R. & Spies, K., *Tax policy challenges in the 21st century*, Wien: Linde, (2014), p. 324.

[292] Bilaney, S., Location-Specific Advantages: When and How They Should Be Allocated, *Bulletin for International Taxation*, Amsterdam IBFD, (August 2015), p. 441.

## Section III: Posterior Adjustment

### 3.4.6 Posterior Adjustment

The keynote described in both the 2010 and the 2017 OECD TP guidelines as well as regarding the guidance on HTVI is that no hindsight may be applied.[293] The approaches adopted are the result of this core principle with the one presented in the HTVI approach being significantly more refined.



In the 2010 version, the benchmark for tax authorities and a posterior valuation is to be set by third parties and their way of dealing with significant uncertainties at the time of the transaction.[294] Thus, where transactions take place that comprise significant uncertainties, a price adjustment clause might be a tool to counter these uncertainties.[295] However, this is only to be applied by the tax authorities if unrelated parties would have hedged the risks in this fashion as well, exclusively on the basis of information reasonably available at the time the transaction in question has been agreed upon.[296]

The rhetoric in that regard has not changed much regarding HTVI and in regard to business restructurings it is no longer dealt with extensively in Chapter IX; rather, reference is made to Chapter VI. However, it has been complemented with a number of factors that indicate the existence of an HTVI, transactions commonly involving HTVI and a number of escape clauses.[297] While more clarity in the application of an ex-post valuation would be desirable, the factors chosen by the OECD fail to provide this.[298]

The guidance presented is intended to identify and handle the situations which are, according to the tax authorities, marked by an information asymmetry to their disadvantage.[299]

An HTVI is deemed to have the following qualities:

> *The term hard-to-value intangibles (HTVI) covers intangibles or rights in intangibles for which, at the time of their transfer between associated enterprises, (i) no reliable comparables exist, and (ii) at the time the transactions [were] entered into, the projections of future cash flows or income expected to be derived*

[293] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, Paris: OECD, (2017), para. 6.188; OECD/G20, Aligning Transfer Pricing Outcomes with Value Creation, *Base Erosion and Profit Shifting Project Actions 8-10: 2015 Final Reports*, Paris: OECD, (2015), para. 6.188; OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010*, Paris: OECD, (2010), para. 6.32.

[294] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010*, Paris: OECD, (2010), para. 6.28 & 9.87.

[295] Ibid., para. 6.33 & 6.34/9.87 & 9.88.

[296] Ibid.

[297] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, Paris: OECD, (2017), para. 6.189ff & 6.193ff; OECD/G20, Aligning Transfer Pricing Outcomes with Value Creation, *Base Erosion and Profit Shifting Project Actions 8-10*: 2015 Final Reports, Paris: OECD, (2015), para. 6.189ff & 6.193ff.

[298] Engelen, C., Ex post Informationen und Preisanpassungsklauseln – kritische Würdigung der OECD Ausführungen zu schwer bewertbaren immateriellen Werten, IStR, München: Beck Verlag, (2016), No. 4., p. 146ff.

[299] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, Paris: OECD, (2017), para. 6.187 & 6.188; OECD/G20, Aligning Transfer Pricing Outcomes with Value Creation, *Base Erosion and Profit Shifting Project Actions 8-10*: 2015 Final Reports, Paris: OECD, (2015), para. 6.187 & 6.188.

*from the transferred intangible, or the assumptions used in valuing the intangible are highly uncertain, making it difficult to predict the level of ultimate success of the intangible at the time of the transfer.*[300]

The described qualities follow the narrative of the tax authorities that there is an information asymmetry which taxpayers take advantage of. While this definition is too broad to create certainty,[301] it is an improvement over the previous guidance, which did not differentiate between the intangibles. Transactions that involve HTVI have been chosen accordingly, exhibiting the following qualities:



- *The intangible is only partially developed at the time of the transfer.*
- *The intangible is not expected to be exploited commercially until several years following the transaction.*
- *The intangible does not itself fall within the definition of HTVI in paragraph 6.189 but is integral to the development or enhancement of other intangibles which fall within that definition of HTVI.*
- *The intangible is expected to be exploited in a manner that is novel at the time of the transfer and the absence of a track record of development or exploitation of similar intangibles makes projections highly uncertain.*
- *The intangible, meeting the definition of HTVI under paragraph 6.189, has been transferred to an associated enterprise for a lump sum payment.*
- *The intangible is either used in connection with or developed under a CCA or similar arrangements.*

In cases where these transactions have been performed, the assessments that are to be undertaken by the tax authorities are met with great difficulty, which is why an ex-post valuation can be required. However, the combination of a very broad definition of what an HTVI is and a list of transactions that e.g. also includes the transfer of an HTVI that is paid by way of a lump sum payment defeats the purpose of narrowing the applicability of an ex-post valuation.[302]

If such an ex-post valuation is made, the taxpayer can rebut the presumption that the agreed ex-ante remuneration has not been at arm's length by meeting one of the following conditions:

[300] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, Paris: OECD, (2017), para. 6.189.

[301] Engelen, C., Ex post Informationen und Preisanpassungsklauseln – kritische Würdigung der OECD Ausführungen zu schwer bewertbaren immateriellen Werten, IStR, München: Beck Verlag, (2016), No. 4., p. 150; Rasch, S. & Greil, E., BEPS Action 8 hard-to-value intangibles: Diskussionsentwurf der OECD vom 4.6.2015 – Überblick und erste Stellungnahme, ISR, Köln: Verlag Dr. Otto Schmidt, (2015), Vol. 7, p. 263.

[302] Engelen, C., Ex post Informationen und Preisanpassungsklauseln – kritische Würdigung der OECD Ausführungen zu schwer bewertbaren immateriellen Werten, IStR, München: Beck Verlag, (2016), No. 4., p. 151.

*i. The taxpayer provides:*
*Details of the ex ante projections used at the time of the transfer to determine the pricing arrangements, including how risks were accounted for in calculations to determine the price (e.g. probability-weighted), and the appropriateness of its consideration of reasonably foreseeable events and other risks, and the probability of occurrence; and,*
*Reliable evidence that any significant difference between the financial projections and actual outcomes is due to: a) unforeseeable developments or events occurring after the determination of the price that could not have been anticipated by the associated enterprises at the time of the transaction; or b) the playing out of probability of occurrence of foreseeable outcomes, and that these probabilities were not significantly overestimated or underestimated at the time of the transaction;*

*ii. The transfer of the HTVI is covered by a bilateral or multilateral advance pricing arrangement in effect for the period in question between the countries of the transferee and the transferor.*

*iii. Any significant difference between the financial projections and actual outcomes mentioned in i)2 above does not have the effect of reducing or increasing the compensation for the HTVI by more than 20% of the compensation determined at the time of the transaction.*

*iv. A commercialisation period of five years has passed following the year in which the HTVI first generated unrelated party revenues for the transferee and in which commercialisation period any significant difference between the financial projections and actual outcomes mentioned in i)2 above was not greater than 20% of the projections for that period.*[303]

In particular the escape clauses make clear that an ex-post valuation is only permissible where the deviations from the projections are significant. Furthermore, it has been clarified that an ex-post valuation undertaken by the tax authorities is merely a measure to analyse whether the ex-ante valuation has been at arm's length.[304] While it is stressed that such an ex-post valuation is not to be confused with an ex-post adjustment relying on hindsight, the ultimate outcome is identical.[305] Should it be determined that unrelated parties had agreed on a price adjustment clause instead of the receiving party taking all the risks as well as the opportunity, the adjustments that were to take place would in the most extreme form be identical to hindsight.

From an arm's length perspective, being guided by what unrelated parties would have done is certainly warranted. Even though the guidance provided only relates to whether an ex-ante price is to be tested by an ex-post valuation, while letting the consequences

[303] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, Paris: OECD, (2017), para. 6.193; OECD/G20, Aligning Transfer Pricing Outcomes with Value Creation, *Base Erosion and Profit Shifting Project Actions 8-10: 2015 Final Reports,* Paris: OECD, (2015), para. 6.193.

[304] Ibid., para. 6.187.

[305] Ibid., para. 6.192 & 6.188.

of a deviation still be determined on the basis of what unrelated parties would have done, there is a certain acceptance of posterior adjustments as compared with the first report of the OECD Task Force on the Commensurate with Income Standard in the US, which found such a posterior adjustment only permissible in situations where abuse was prevalent.[306] Ultimately this approach is problematic because, taking the US and Germany as an example, only 3,9% respectively 3%[307] of the agreements for taking over a business include a price adjustment clause.[308] Instead, risks are reflected in the valuations which are made ex-ante.[309]



Aiming at aligning transfer pricing outcomes with value creation, one has to determine which restrictions are in place that would stop the tax authorities of the ceding entity to consider value that has actually been created in the country of the receiving entity. In that regard, all the elements that would prompt tax authorities to conduct an ex-post valuation fail. Transfers that are remunerated on a lump sum basis are generally considered to be suspicious, as are HTVI developed as part of a CCA. In these two examples the input of the receiving entity can be substantial, so safeguards are needed to ensure that an ex-post adjustment value which has been added by the receiving entity is shielded from the tax authorities of the ceding entity. The escape clauses provided do not take this into account either. Once triggered, one would have to rely on the tax authorities presuming that unrelated parties had accounted for such value creation from the receiving entity in an agreement including a price adjustment clause.

The foregoing concerns in terms of arm's length principle and value creation have been further validated as a result of the examples that the OECD has provided in the Guidance for Tax Administrations on the Application of the Approach to Hard-to-Value Intangibles.[310] This guidance, published in 2018, contains the following example, warranting the application of a posterior adjustment in line with the HTVI approach[311]:

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[306] OECD – The Committee on Fiscal Affairs, *Intercompany Transfer Pricing Regulations under US Section 482 Temporary and Proposed Regulations*, Paris: OECD, (1993), Para. 2.23ff; http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=OCDE/GD(93)131&docLanguage=En (16.11.2016).

[307] Engelen, C., Ex post Informationen und Preisanpassungsklauseln – kritische Würdigung der OECD Ausführungen zu schwer bewertbaren immateriellen Werten, IStR, München: Beck Verlag, (2016), No. 4., p. 149.

[308] In the discussion of price adjustment clauses numerous other studies have been presented disproving the presumption that unrelated entities would resort to the inclusion of a price adjustment clause in order to hedge risks: Taic, J., *Die "Super Royalty" und das U.S.-Richtlinienpaket von 1993, München: VVF, (1995), p. 266ff; Imhof, M., Business Restructuring: Eine Betriebswirtschaftliche und Steuerrechtliche Analyse*, Köln: Eul-Verlag, (2012), p. 63.

[309] Engelen, C., Ex post Informationen und Preisanpassungsklauseln – kritische Würdigung der OECD Ausführungen zu schwer bewertbaren immateriellen Werten, IStR, München: Beck Verlag, (2016), No. 4., p. 150; Cain, D. et al., Earnouts: A study of financial contracting in acquisition agreements, *Journal of Accounting and Economics*, Amsterdam: Elsevier, (2011), Vol. 51, No. 1-2, p.153; Lukas, E. & Heiman, C., Bedingte Kaufpreisanpassungen, Informationsasymmetrien und Shareholder Value: Eine empirische Analyse deutscher Unternehmensübernahmen, *FEMM Working Paper*, Magdeburg: Otto-von-Guericke University, Faculty of Economics and Management, (2010), No. 06, p. 2; retrievable at: http://www.ww.uni-magdeburg.de/fwwdeka/femm/a2010_Dateien/2010_06.pdf (02.10.2016).

[310] OECD, Guidance for Tax Administrations on the Application of the Approach to Hard-to-Value Intangibles, Paris: OECD, 2018.

[311] Conditions applicable: Ibid.; para. 18-20

*21. Company A, a resident of Country A, has patented a pharmaceutical compound. Company A has concluded pre-clinical tests for the compound and has successfully taken the compound through Phases I and II of the clinical trials. Company A transfers in Year 0 the patent rights to an affiliate, Company S, a resident of Country S. Company S will be responsible for the Phase III trials following the transfer. In order to determine the price for the patent on the partially developed drug, the parties made an estimation of expected income or cash flows that will be obtained upon exploitation of the drug once finalised over the remaining life of the patent. Assume the price so derived at the time of the transfer was 700 and that this was paid as a lump sum in Year 0.*

*22. In particular, the taxpayer assumed sales would not exceed 1,000 a year and that commercialisation would not commence until Year 6. The discount rate was determined by referring to external data analysing the risk of failure for drugs in a similar therapeutic category at the same stage of development. Even if the tax administration of Country A had been aware of these facts relating to the transfer of the patent rights in Year 0, it would have had little means of verifying the reasonableness of the taxpayer's assumptions relating to sales.*

***Scenario A***

*23. In Year 4, the tax administration of Country A audits Company A for Years 0–2 and obtains information that commercialisation in fact started during Year 3 since the Phase III trials were completed earlier than projected. Sales in Years 3 and 4 correspond to sales that were projected, at the time of the transfer, to be achieved in Years 6 and 7. The taxpayer cannot demonstrate that its original valuation took into account the possibility that sales would arise in earlier periods, and cannot demonstrate that such a development was unforeseeable.*

*24. The tax administration uses the presumptive evidence provided by the ex post outcome to determine that the valuation made at the time the transaction took place did not consider the possibility of sales occurring in earlier years. The taxpayer's original valuation is revised to include the appropriately risk-adjusted possibility of earlier sales resulting in a revised net present value of the drug in Year 0 of 1,000 instead of 700. The revised net present value also takes into account the functions performed, assets used and risks assumed in relation to the HTVI by each of the parties before the transaction and reasonably anticipated, at the time of the transaction, to be performed, used or assumed by each of the parties after the transaction. Therefore, assume for the purposes of the example that the arm's length price anticipated in Year 0 should have been 1,000. Note that the value of 1,000 is not necessarily the net present value of the transferred rights based solely on the actual outcome (see paragraph 6 of this guidance).*

*25. In accordance with the approach to HTVI, the tax administration is entitled to make an adjustment to assess the additional profits of 300 in Year 0.*[312]

This example contains a number of issues that do not benefit the approach in terms of the arm's length principle and value creation.

The often-cited information asymmetry becomes apparent, yet differently, when the commercialisation of a new drug is described as if it was almost certain after passing Phase II. While in fact the passing rates of Phase III and the Approval state are comparably high, depending on the disease on average only 49,6% arrive at approval and thus can be commercialised.[313] This rate can be as high as 64,5% for infectious diseases and as low as 33% for oncology.[314] Hence, one could think of an information asymmetry in terms of the chances of success in New Drug Development. However, there is none in the question whether a drug is going to succeed up to and including the approval stage. Especially considering these passing rates, it is in fact not much more than a look into the crystal ball for the taxpayer – regardless of how much industry know-how he possesses.



The guidance that is derived from this is quite extreme. Generally, the OECD has used the notion what has been "reasonably foreseeable" at the time of the transaction. In the given example this is, however, turned around and changed to "what has not been unforeseeable". In the example the taxpayer estimated a very reasonable five years until commercialization – taking into account that Phase III can take anything from 1 to 4 years and the subsequent approval by government bodies like the FDA another 6 month to 2 years.[315] Such a timespan is reasonably foreseeable. However, if, as this example suggests, the threshold is what is not unforeseeable, then it becomes a pure ex post assessment since the taxpayer can only demonstrate that something is unforeseeable if it is actually impossible. Thus, in case of the example, it was certainly not reasonably foreseeable but since a small chance exists it cannot be demonstrated that it was unforeseeable.

The foregoing goes directly against the proclaimed goal mentioned in the guidance to apply the HTVI approach "(…) *in a manner that promotes tax certainty for taxpayers (…)".* While taxpayers need to operate based on what can be reasonable foreseen, tax authorities can infer uncertainty into their dealings by applying pure hindsight, as this example suggests.

### 3.4.7 Interim Conclusion

Accepting Article 9(1) in its basic application of the arm's length principle, it has been essential to consider how this principle, together with the newly introduced one of aligning value creation with transfer pricing outcomes, is reflected in case of a business

[312] Ibid., para. 21-25.

[313] Thomas, D.W. et al. for: BIO, Biomedtracker, Amplion, Clinical Development Success Rates 2006-2015, (2016), p. 9; Retrievable at: https://www.bio.org/sites/default/files/Clinical%20Development%20Success%20Rates%202006-2015%20-%20BIO,%20Biomedtracker,%20Amplion%202016.pdf (02.01.2019).

[314] Ibid.

[315] Ibid., p. 12; FDA, *The Drug Development Process*: https://www.fda.gov/forpatients/approvals/drugs/ (02.01.2019).

restructuring, as well as in the soft intangibles that are to be analysed throughout the thesis, and a possible posterior adjustment.

A crucial question in case of a business restructuring is whether assets are to be valued in aggregation. If they are not, it would be impossible to arrive at a residual value. An aggregated valuation is indeed called for where it produces the most accurate result. Such a valuation technique can be based on methods that apply to acquisition deals. It would make sense to rely on proven methods even though valuation techniques that are used in M&A deals need not always be in line with the arm's length principle. There is no consistency on this approach throughout the TP guidelines. Where the application of these methods results in a range of arm's length prices, every price within that range can be chosen by the taxpayer.



The treatment of soft intangibles as part of a business restructuring has been a good indication of how the arm's length principle in light of the newly added principle has been adhered to. The circumstance that some of the soft intangibles have been considered for the first time in an extensive fashion points towards an increased awareness for these soft-intangibles. Likely driven to include these values to conform to the overarching principle of aligning value creation with transfer pricing outcomes, topics which were previously largely avoided, such as workforce in place, synergies and location savings, have now been considered in greater detail.

Regarding a workforce in place it has now been clarified that value is derived from the particular composition of the employees and that the physical transfer as opposed to the making available of a workforce in place needs to be distinguished. While this means a step forward for the adherence to the arm's length principle, the alignment with value creation can be problematic in particular where an assembled workforce in place is being made available to the entity receiving other intangibles or assets and services are rendered in relation thereto.

Equally problematic has been the guidance on synergistic benefits. What stands out as non-conform with either of the two principles is in particular the examples[316] provided as part of the guidance. However, the guidance apart from the example can be considered to be in line. In case of the guidance presented for the net location savings it can be concluded that the issues in relation to this kind of soft-intangible have been correctly identified. However, the guidance presented is not necessarily in line with either of the two principles that should frame the partially renewed guidance. The arm's length principle can still be traced in the guidance. But value creation, not necessarily being in line with the arm's principle itself, is not strictly adhered to. This becomes apparent where one applies the suggested guidance to a situation of different business models where integral parts of the service or good provided rely on location specifics but are at the same time at the heart of the value which is ultimately created. In such a situation one contrasts a function (together with its location savings) that is worthless from an arm's length perspective but that is

[316] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, Paris: OECD, (2017), para. 1.164ff; OECD/G20, Aligning Transfer Pricing Outcomes with Value Creation, *Base Erosion and Profit Shifting Project Actions 8-10: 2015 Final Reports*, Paris: OECD, (2015), para. 1.164ff.

essential for value creation. However, the stance taken in this case appears to be that value creation is only considered from within the entity and thereby falls short of all elements creating value.

The position of posterior adjustments has changed over the course of time to a more permissible stance. While it is pointed out that a posterior adjustment should be applicable where unrelated parties would have hedged risks in this way, thereby taking account of the arm's length principle, the too wide criteria for allowing a posterior adjustment coupled with insufficient escape clauses suggest otherwise. From a perspective of value creation, there is nothing that would stop the tax authorities of the ceding entity to also take into account the value that has been created abroad as a result of the actions undertaken by the receiving entity. The Guidance for Tax Administrations on the Application of the Approach to Hard-to-Value Intangibles unfortunately suggests, specifically in the example provided, an even lower threshold for the application of the HTVI approach, leaving out reasonable foreseeability and replacing it with what is not unforeseeable.



In the following chapters the treatment of the soft-intangibles chosen and the applicable posterior adjustments are considered in the case of Germany and the USA respectively, laying the foundation for a comparison. Since some of the solutions presented by the OECD are modelled on what one can find in the US and Germany on these issues, it can also be seen as an already concluded real-live test of the proposed measures, which makes it possible to also consider the advantages and drawbacks of what has been proposed recently and in how far this has been taken into account.

## 3.5 Conclusion

In the previous section the most relevant concepts of business restructurings have been considered. These concepts are applicable in both directions: as functions, assets and risks are moved out of a jurisdiction, they are then moved into another jurisdiction. However, the main focus is on the jurisdiction where the functionality is reduced as a result of a restructuring.

While shifting tangible and intangible assets leads to the taxation of the hidden profits contained therein, the jurisdiction from which the function is stripped loses more than just that. It is also deprived of future profits which might be inherent in the function, and risks and assets that used to be in that jurisdiction prior to restructuring – in other words: a loss of profit potential and therefore of tax base.

A substantial part of that profit potential is contained in soft intangibles. Even though the OECD renounced such a grouping of intangibles, such a categorization, however, for business restructurings, is reasonable. Furthermore, business restructurings and a possible taxation thereof do not only rely on soft-intangibles that are present in the ceding jurisdiction but similarly in the receiving one.

Next to the group of soft-intangibles there is the group of HTVI. This category if intangibles is still approved by the OECD. These intangibles are equally relevant for both

business restructuring and the performance of an R&D function. In both cases intangibles are involved that are not generally available to third parties and whose future value development is highly uncertain.

In order to also ensure the taxation of soft and hard-to-value intangibles, Germany introduced the *Function Shifting Regulation*. Since however, in business restructurings and R&D intangibles are shifted that are generally not available under arm's length conditions, the scope of this transfer pricing legislation had to be extended to cover soft-intangibles as well. For certain hard-to-value intangibles the possibility of a posterior adjustment by tax authorities has been introduced. Since such alterations of the arm's length principle are at the core of this thesis, the German Function Shifting legislation is subject of the following chapter.

# Chapter 4. German Transfer Pricing Legislation and the Function-Shifting Regime

## 4.1 Introduction

Like many other countries, Germany applies the world income principle to (tax) residents.[317] In case of corporations, the legal entity must either have its effective place of management[318] or its legal seat[319] in Germany in order to be subject to resident taxation. Thus, income is to be allocated according to the relevant German Tax Acts, regardless of whether resident entities in Germany derive their income from domestic sources or from abroad. Relevant for transfer pricing is therefore the element of income allocation rules that relate to the entity to which the income earned has to be attributed. In case of a German resident company, it is prescribed that the respective income has to be allocated to the entity that is generating the income.[320] The aforesaid allocation on the basis of national law translates into effects for the application of international tax law. Relevant in this case is the allocation of income between two related entities. Hence, it becomes a matter of transfer pricing legislation.

In this chapter the German transfer pricing legislation for cross-border transactions is presented and analysed. While the German transfer pricing legislation is spread over a number of different enactments,[321] the core regulation for cross-border transactions is found in the German Foreign Tax Act (hereinafter FTA).[322] For the intended analysis of the transfer pricing treatment of business restructurings as well as associated intangibles, however, this chapter will focus solely on Sec. 1 para. 3 of the FTA. The details of its application to business restructurings and intangibles have been laid out in the function-shifting regulation and the administrative principles belonging thereto. Said regulation has been authored by the German Federal Ministry of Finance. This Regulation has been released on 12 August 2008.[323] After some criticism it was altered by administrative

[317] German Income Tax Act, Sec. 1, para. 1, sen. 1; German Corporate Income Tax Act, Sec.1, para. 2 (corporate entities).

[318] § 10 AO.

[319] § 11 AO.

[320] German CIT Sec. 8 iVm Income Tax Act, Article 2, para. 1.

[321] A number of different Acts also deal with transfer pricing issues like the hidden distribution of profits and constructive equity contribution in Sec,. 8 III 2 Corporate Income Tax Act; c.f.: Zech, T., *Verrechnungspreise und Funktionsverlagerungen 2009: die steuerliche Behandlung von Verrechnungspreisen, insbesondere bei Funktionsverlagerungen, nach der Unternehmensteuerreform 2008*, Baden-Baden: Nomos-Verl.-Ges., (2009), p. 38; Wittendorff, J. (2010). Transfer pricing and the arm's length principle in international tax law. Austin [Tex.]: Wolters Kluwer Law & Business, p. 303.

[322] German Foreign Tax Act, "Außensteuergesetz".

[323] Regulation on the Application of the Arm's Length Principle under § 1 (1) of the Foreign Tax Act in Instances of Cross Border Transfers of Function (Transfer of Function Regulation – FVerlV), Berlin: Ministry of Finance, (12 August 2008); (Function Shifting Regulation).

principles to the function shifting regulation that were released on 13 October 2010[324]. These instruments have been introduced in order to specifically deal with cross border business restructurings.

In order to analyse the function shifting regulation regarding its effects on business restructurings and intangibles it is necessary to consider Sec. 1 para. 3 FTA. Based on this provision, the function shifting regulation has been enacted.[325] Starting with section I of this chapter the equally relevant German implementation of the arm's length principle by Sec. 1 paras. 1 & 2 FTA, forms the basis of this exercise.[326] Thereafter in section II, the actual function shifting regulation is presented and discussed in its working by focusing on the elements of *function*, *shifting* and the *transfer package*. The transfer package is regarded with a particular view to soft-intangibles. Section III considers the posterior valuation which is part of the function shifting legislation.



## Section I: The arm's length principle & Principle working of Sec. 1 FTA

### 4.2 The FTA – Außensteuergesetz

The legal instrument of relevance to cross-border transactions and their transfer pricing implications is the FTA.[327] It is in part intended to avoid tax flight due to the worldwide tax slope.[328] Practises towards unjustifiably shifting the taxable base abroad are tackled in seven different parts of the FTA. The first part of the FTA is put under the headline of "international interconnections", which translates to transfer pricing. This first part comprises Sec. 1, which includes the German implementation of the arm's length principle in cross-border cases.

The other parts of the FTA also deal with issues arising in an international setting such as the German CFC provisions and the transfer of the corporate domicile to low tax jurisdictions. These sections of the FTA do not bear any relevance to this dissertation, as they do not deal with the transfer pricing aspects of international transactions such as business restructurings and the shift of intangibles abroad.[329]

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[324] Principles for the Audit of the Allocation of Income between Related Persons in Cases of Cross-Border Transfers of Business Functions (Administrative Principles – Business Restructurings, (13 October 2010).

[325] However, the basis for the exact embodiment of the Function Shifting Regulation is to be found in the now removed provision of Sec. 1 para. 3 sent. 13 – 2008.

[326] Kasten, C., Die Besteuerung grenzüberschreitender Funktionsverlagerungen – Systematik mit Handlungsalternativen, Hamburg: Verlag Dr. Kovač (2012), p. 20f.

[327] Jacobs, O. H. et al., *Internationale Unternehmensbesteuerung – Deutsche Investitionen im Ausland/Ausländische Investitionen im Inland*, München: Beck (2007), Vol. 6, p. 86.

[328] Ibid.

[329] The other parts are, next to part one: International Interconnections; part two Transfer of Domicile to Low Tax Jurisdictions; part three: Treatment of an Ownership Interest Within the Meaning of § 17 of the Income Tax Law on Transfer of Domicile to a Foreign Country; part four: Ownership Interests in Foreign Intermediary Companies; part

Thus, Sec. 1 FTA shall be at the centre of attention. This provision is split into six paragraphs. Since Sec. 1 para. 5 is concerned with the Authorized OECD Approach and Sec. 1 para. 6 with the authorisation of the Federal Ministry of Finance to enact regulations further detailing the transfer pricing legislation, these will not be touched upon. The main focus lies on Sec. 1 para. 3 which contains the basis for the function shifting regulation. The remaining paragraphs of this section are also key to its application since they introduce the arm's length principle in general as well as defining the conditions for an entity to be related to a taxpayer.

## 4.3 Principle Working of Sec. 1 FTA



### 4.3.1 Sec. 1. para. 1. – Implementation of the Arm's Length Principle

The arm's length principle is implemented by Sec. 1. para. 1. This section is reproduced below in its translated version.

> *[1]If income derived by a taxpayer from a foreign business relationship with a related party is reduced because the taxpayer has based its determination of income on terms and conditions, in particular on prices (transfer prices) that differ from those on which third parties unrelated to each other would have agreed under the same or similar circumstances (arm's length principle), then – without prejudice to other provisions – the taxpayer's income shall be restated to equal that which would have resulted under the terms and conditions as agreed between third parties unrelated to each other.*
> *(…)*
> *[3]In applying the arm's length principle, the third parties unrelated to each other shall be presumed to know all material circumstances of the business relationship and to act in accordance with the principles of reasonable and conscientious business managers.*
> *[4]Should the application of the arm's length principle result in adjustments that are more extensive than those of other provisions, the more extensive adjustments shall be implemented in addition to the legal consequences of the other provisions.*[330]

#### *4.3.1.1 The First Sentence of Sec. 1 para. 1*

Sec. 1 para. 1 sent. 1 constitutes the transposition of the arm's length principle into German tax law.[331] Hence, it requires the readjustment of the price in a transaction that would not have been charged to a third party while the transaction in question has taken

five: Family Foundations; part six: Compliance and Procedure; part seven: Concluding Provisions (translation prodided by: KPMG/Lenz, M. (ed.), *Deutsches Außensteuerrecht, German International Taxation*, München: Beck (2010), p. 156 ff.

[330] Translation from: KPMG/Lenz, M. (ed.), *Deutsches Außensteuerrecht, German International Taxation*, München: Beck (2010), p. 156 ff.

[331] Kasten, C., *Die Besteuerung grenzüberschreitender Funktionsverlagerungen – Systematik mit Handlungsalternativen,* Hamburg: Verlag Dr. Kovač (2012), p. 20f.

place between related parties and as a consequence has led to a reduction of the taxable income of a domestic taxpayer. Additionally, it is required that it is a transaction between a related party abroad and a domestic taxpayer. This applies to the German entity regardless of whether it is subject to limited or unlimited tax liability in Germany.[332] In case that this provision applies to an entity subject to German non-residence taxation, it is necessary to assess whether the entity is in fact related to a foreign entity and whether it reduces corporate income tax revenues in Germany.[333]

Due to the nature of double tax treaties as instruments that merely distribute taxing rights instead of actually constituting the right to tax, Article 9 of the OECD MC is not self-executing.[334] Thus, a national implementation is necessary. In Germany this has been achieved through Sec. 1 para. 1 FTA. However, it needs to be discussed whether Article 9 OECD MC and the underlying arm's length principle have been correctly implemented by this provision, which is made up of the three sentences quoted above. Considering a potential violation of the arm's length principle its restrictive character also needs to be looked at.



While all three sentences are relevant to its application, the first sentence is key as it embodies the arm's length principle and, by using a conditional clause, also includes the fictional *hypothetical arm's length test*.[335] However, this transposition does not avoid criticism either. While it contains the principal elements, it remains one-sided in its consequences,[336] as prices are only adjusted in case the taxable income of the domestic taxpayer has been reduced as a result of the agreement based on a price with a related party that is not at arm's length.[337] Furthermore, this provision reaches out to income which by way of a double tax treaty has been allocated to the other contracting party.[338] The type of income that is reduced is not specified.[339] Furthermore, Article 9(1) OECD MC has been transposed into German tax law through the first sentence, yet it lacks the basis for a corresponding adjustment as necessitated by Article 9(2) OECD MC.[340]

Considering the peculiarities when transferring anything from tangibles, intangibles, or business units up to entire businesses in the wake of a business restructuring, such transactions bear a high risk of differing opinions regarding the transfer price and other conditions of the transfer. This risk of double taxation is amplified when a domestic German taxpayer would have to suffer when reallocating functions to developing countries that are in some instances similarly overshooting in the application of the arm's length principle in

[332] Hofacker, M., in Haase, F., *Außensteuergesetz, Doppelbesteuerungsabkommen*. Heidelberg: C.F. Müller, (2012), §1 FTA, MN. 67.

[333] Ibid. §1 FTA, MN. 68.

[334] Kraft, G., in Kraft, G., *Außensteuergesetz*, München: Beck, (2009), §1 FTA, MN 44 & 45.

[335] Hofacker, M., in Haase, F., *Außensteuergesetz*, Doppelbesteuerungsabkommen. Heidelberg: C.F. Müller, (2012), §1 FTA MN 181.

[336] Kraft, G., in Kraft, G., *Außensteuergesetz*, München: Beck, (2009), §1 FTA MN 66.

[337] Kraft, G., in Kraft, G., *Außensteuergesetz*, München: Beck, (2009), §1 FTA MN 44 & 45.

[338] Ibid., §1 FTA MN 44 & 45.

[339] Ibid.

[340] Ibid., §1 FTA MN 46.

order to capitalize on some of the features that they have to offer, making for an interesting business climate like location savings and location specific advantages.[341] These countries generally handle different standards to achieve precisely those means.[342] However, as will become more apparent when dealing with the actual function shifting legislation, there are many situations where double taxation can be caused as a result of the rather uncommon approach used by Germany when it comes to the shifting of functions in relation to hard-to-value-intangibles and soft-intangibles.

#### *4.3.1.2 The Third Sentence of Sec. 1 para. 1*

Sec. 1 para. 1 sent. 3 outlines the conditions under which the arm's length principle is determined. In order to fulfil its function to avoid a manipulation of the overall tax rate of a MNE, the price is to be set as if the transaction took place between unrelated parties. Two elements are linked to the arm's length principle by being mentioned in this provision whose accordance with the former principle is to be doubted. These are, on the one hand, the presumption that the fictitious unrelated party that would take part in the transaction at hand is all informed.[343] On the other hand, it is required that the same unrelated party would also behave in line with the standard of the prudent business manager.[344] This is a situation which is prescribed for transactions that require the hypothetical arm's length test, and thus applies to transactions that generally concern intangibles for which no comparables or [only?] comparables that could be adjusted to fit the transaction in question are available. However, considering the placement of this provision within the paragraph generally implementing the arm's length principle, these two factors are presumed by the legislator to be present in all transactions since the comparables are the result of actual transactions.[345] Nevertheless, this can be disputed – among others because of its position within this provision.[346] Instead of placing it in the specific paragraph of sec. 1 FTA that deals with intangibles that are hard-to-value, i.e. sec. 1 para. 3, it has been included in the general sec. 1 para. 1 FTA, suggesting its applicability also to situations where comparables

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[341] E.g. regarding location benefits: Bilaney, S., Location-Specific Advantages: When and how they should be allocated, *Bulletin for International Taxation*, Amsterdam: IBFD, (2015), Volume 69, No. 8, p. 437ff.

[342] Ghosh, S. et al, Location-Specific Advantages: India and China, *International Tax Review*, London: Euromoney, 23 January 2014; retrievable at: http://www.internationaltaxreview.com/Article/3300894/Location-specific-advantages-India-and-China.html; last visited on 19.08.2015.

[343] Kraft, G., in Kraft, G., *Außensteuergesetz*, München: Beck, (2009), § 1 FTA, MN 132. Kraft, § 1 FTA, MN 293; Pohl, C., in: Heuermann, B. & Brandis, P (publ), AStG § 1 Berichtigung von Einkünften, Blümich EStG, KStG, GewStG, München: Verlag Franz Vahlen, (2016; suppl. 133), MN 40; Frischmuth, M., UntStRefG 2008 und Verrechnungspreise nach § 1 AStG n. F., IStR, München: Beck, (2007), p. 486.

[344] Frischmuth, M., UntStRefG 2008 und Verrechnungspreise nach § 1 AStG n. F., IStR, München: Beck, (2007), p. 486; Borstell, T., Chapter C: Grundsätze in: Vögele, A., Borstell, T. & Engler, G., *Verrechnungspreise: Betriebswirtschaft, Steuerrecht.* München: Beck, (2015), MN 41–44.

[345] Whether this provision is confined only to to the hypothetical arm's length price is contested; cf. Hofacker, M., in Haase, F., *Außensteuergesetz, Doppelbesteuerungsabkommen*. Heidelberg: C.F. Müller, (2012), §1 FTA MN 168; Baumhoff, H & Liebchen, D., Chapter 3: Der Fremdvergleich als Instrument internationaler Einkünfteabgrenzung, in: Wassermeyer, F. & Baumhoff (Eds.), *Verrechnungspreise international verbundener Unternehmen*, Köln: Verlag Dr. Otto Schmidt, (2014), para. 3.9.

[346] Kraft, G., in Kraft, G., *Außensteuergesetz*, München: Beck, (2009), § 1 FTA, MN 132. Kraft, § 1 FTA, MN 132

in fact do exist.[347] The latter interpretation, however, can be considered to be internationally unique.[348] Certainty, however, exists in those cases where comparables are not available e.g. because it is a hard-to-value intangible. In such a case, a hypothetical transfer price is to be calculated on the basis of the two mentioned standards of full transparency and the prudent and conscientious business manager.[349]

In essence, both presumptions fit into the theoretical framework of the arm's length principle because they are needed to determine the price agreed upon among third parties.[350] However, certain nuances of these presumptions that are applied by the German version of the arm's length principle can be seen as deviating from the pure arm's length principle.



Another criticism that is generally voiced against the arm's length principle can also be applied to the German transposition of it. It is the practicability of the two conditions of the all informed third party and the prudent business manager which is called into question.[351]

Firstly, there are a number of situations where there simply is no reference price available that could be used to determine the transfer price which would have been handled among unrelated parties.[352] For instance, MNEs are integrated to a degree where a number of dependencies and transactions simply do not exist between unrelated parties.[353] This is also one of the elements which produces the strength of a group of companies that is largely integrated compared to its competitors. These transactions among entities of a well-integrated group can lead to the existence of synergies/integration benefits, a soft-intangible. Furthermore, it is not just that a certain transaction commonly does not take place between unrelated parties: the underlying good or service that is traded can be generally unavailable to an unrelated third party as well. This is the case for business restructurings, in particular those where highly valuable as well as soft intangibles are involved. In cases where data on the price is available for the transaction concerned, the circumstances still have to be comparable; also, the prices have to be the result of a dealing between unrelated parties.[354]

Secondly, there has to be full transparency on all aspects of the transaction.[355] Even though such a requirement is sensible from the perspective of the tax authorities, it is

[347] Kraft, G., in Kraft, G., *Außensteuergesetz*, München: Beck, (2009), §1 FTA MN 132; Hofacker, M., in Haase, F., *Außensteuergesetz, Doppelbesteuerungsabkommen*. Heidelberg: C.F. Müller, (2012), §1 FTA MN 168.

[348] Hofacker, M., in Haase, F., *Außensteuergesetz*, Doppelbesteuerungsabkommen. Heidelberg: C.F. Müller, (2012), §1 FTA MN 168.

[349] Ibid.

[350] Ibid, §1 FTA MN 151ff.

[351] Frischmuth, M., UntStRefG 2008 und Verrechnungspreise nach § 1 AStG n. F., IStR, München: Beck, (2007), p. 486; Borstell, T., Chapter C: Grundsätze in: Vögele, A., Borstell, T. & Engler, G., *Verrechnungspreise: Betriebswirtschaft, Steuerrecht*. München: Beck, (2015), MN 41 – 44.

[352] Hofacker, M., in Haase, F., *Außensteuergesetz*, Doppelbesteuerungsabkommen. Heidelberg: C.F. Müller, (2012), §1 FTA MN 151.

[353] Ibid.

[354] Ibid., §1 FTA MN 155.

[355] §1 FTA para. 1, sent. 2.

contrary to the aim of dealing at arm's length.[356] In a transaction between unrelated parties it cannot be assumed that all circumstances are known, let alone disclosed.[357] Such a requirement runs contrary to the arm's length principle, as it is rather uncommon in a transaction between unrelated parties for all information to be submitted to the other party[358]- considering that a major part of competition consists of an advantage in knowledge. Taking the element of knowledge out of the equation does not result in an arm's length transaction.[359]

This full transparency does not only relate to the qualities of the underlying good or service that is transferred, but also to the future profits that are expected to be derived from it. In cases where this legislation is applied to the transfer of intangibles such as business functions, this particular requirement is of paramount importance, as it will be seen later when this is dealt with more specifically.[360] Requiring this degree of transparency, something that is an element of a market with perfect competition, runs counter to all other elements that are present or rather absent in transactions regarding intangibles.[361] Hence, the degree of fiction that is inherent in applying the arm's length principle in situations where there are no comparables available, is elevated further.



The former requirements are framed by the standard of the prudent business managers. Just like the previous requirement relating to transparency, the standard of the prudent business manager is only applicable in cases where there are no comparables available for that particular transaction.[362] In order to define the necessary standard, recourse can be had to several other German tax provisions aiming at an income adjustment.[363] Thus, it is possible to refine this concept though the respective case law issued in the context of these provisions.[364] However, for the purpose of the functions shifting regulation focus needs to be put on the mode of application. Since the introduction of Sec. 1 FTA, the standard needs to be applied twice for the determination of the hypothetical arm's length price. Hence, it

[356] Hofacker, M., in Haase, F., *Außensteuergesetz*, Doppelbesteuerungsabkommen. Heidelberg: C.F. Müller, (2012), §1 FTA MN 168; Frischmuth, M., UntStRefG 2008 und Verrechnungspreise nach § 1 AStG n. F., IStR, München: Beck, (2007), p. 486; Pohl, C., in: Heuermann, B. & Brandis, P (publ), AStG § 1 Berichtigung von Einkünften, *Blümich EStG, KStG, GewStG*, München: Verlag Franz Vahlen, (2016; suppl. 133), MN 40 - 44.

[357] Ibid.

[358] Hofacker, M., in Haase, F., *Außensteuergesetz*, Doppelbesteuerungsabkommen. Heidelberg: C.F. Müller, (2012), §1 FTA MN 167.

[359] Gosch, D., KStG § 8 Ermittlung des Einkommens; in: *Körperschaftsteuergesetz* (ed. Gosch, D.), München: Beck, (2015), MN 300a.

[360] Hofacker, M., in Haase, F., *Außensteuergesetz*, Doppelbesteuerungsabkommen. Heidelberg: C.F. Müller, (2012), §1 FTA MN 167.

[361] Considering other factors that are prescribed for the determination of a hypothetical arm's length price next to the complete information transparency such as the behaviour of both seller and buyer as a prudent business manager and the complete independence of parties the legislator effectively creates the perfect but virtually non-existent market as described in: Knight, F.H., *Risk, Uncertainty and Profit*, Reprints of economic classics, New York: Augustus M. Kelley, (1964), p. 76 – 80. These conditions are thus alien from a normal market environment in which regular pricing takes place: Hofacker, M., in Haase, F., *Außensteuergesetz, Doppelbesteuerungsabkommen*. Heidelberg: C.F. Müller, (2012), §1 FTA MN 168.

[362] Kraft, G., in Kraft, G., *Außensteuergesetz*, München: Beck, (2009), §1 FTA MN 132.

[363] Hidden Profit Distribution

[364] Kraft, G., in Kraft, G., *Außensteuergesetz*, München: Beck, (2009), §1 FTA MN 132.

is no longer limited in its application to the domestic taxpayer involved in the transaction; the associated entity abroad is also subjected to this standard.[365] The application of such a standard is sensible when establishing the hypothetical arm's length price since the parties involved are related and a decrease in taxable income of one entity ultimately affects the income of the other. However, this peculiar way of applying the said standard is not in conformity with international practice.[366]

It is, however, in line with the OECD TP Guidelines that prescribe, at least for intangibles, the consideration of the perspective of the transferee as well.[367] The OECD thereby focuses on the different benefits for entities, given the fact that for the use of the intangible companies face different challenges to capitalize on the intangible's potential.[368] Therefore, chances are that the hypothetical arm's length price deviates from that at which another country's tax authorities arrive. Thus, at best it leads to a mutual agreement procedure[369] or double taxation.



#### *4.3.1.3 The Fourth Sentence of Sec. 1 para. 1*

Sec. 1 para. 1 sent. 4 deals with the fact that there are a number of different income adjustment provisions in German tax law. Whether an income adjustment according to Sec. 1 FTA could prevail, be the single cause of adjustment or be conducted next to other adjustments, has been a matter of dispute until the update of Sec. 1, para. 1, sentence 3 of the FTA in 2008. This sentence makes clear that an income adjustment according to the provisions of Sec. 1 FTA takes place regardless of the fact that an adjustment was already made on the basis of another income adjustment provision. Furthermore, it entails that the adjustment needs to be made as if no other adjustment had occurred.[370] Even though the full application of the income adjustment of Sec. 1 FTA is guaranteed this way, it is still apparent from the wording of this sentence that this is a lower tier provision. As its scope is limited to cases where a dealing takes place with an associated party abroad, this equally bears the potential for being incompatible with EU law.[371] The reason for this lies in the fact that an adjustment based on the arm's length principle leads to a more severe

[365] Ibid.

[366] Hofacker, M., in Haase, F., *Außensteuergesetz, Doppelbesteuerungsabkommen*. Heidelberg: C.F. Müller, (2012), §1 FTA MN 168, Frischmuth, M., UntStRefG 2008 und Verrechnungspreise nach § 1 AStG n. F., IStR, München: Beck, (2007), p. 485.

[367] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, Paris: OECD, (2017), e.g para. 9.60; originally also included in Chapter VI: OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010*, Paris: OECD, (2010), para. 6.14; Hofacker, M., in Haase, F., *Außensteuergesetz, Doppelbesteuerungsabkommen*. Heidelberg: C.F. Müller, (2012), §1 FTA MN 167.

[368] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, Paris: OECD, (2017), e.g. para. 9.60; originally also included in Chapter VI: OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010*, Paris: OECD, (2010), para. 6.14 & 6.15.

[369] Kraft, G., in Kraft, G., *Außensteuergesetz*, München: Beck, (2009), §1 FTA MN 132; Wassermeyer, F., Modernes Gesetzgebungsniveau am Beispiel des Entwurfs zu § 1 AStG, *Der Betrieb*, Düsseldorf: Handelsblatt, (2007), p. 536.

[370] Hofacker, M., in Haase, F., *Außensteuergesetz*, Doppelbesteuerungsabkommen. Heidelberg: C.F. Müller, (2012), §1 FTA MN 22.

[371] Hofacker, M., in Haase, F., *Außensteuergesetz, Doppelbesteuerungsabkommen*. Heidelberg: C.F. Müller, (2012), §1 FTA MN 31.

income adjustment than prescribed by income adjustment provisions applying to wholly domestic situations.[372]

#### *4.3.1.4 Interim Conclusion*

This section has been concerned with Sec. 1 par. 1 FTA, which is made up of four sentences that entail the core elements of the German transfer pricing legislation and introduce the relevant items for the function shifting legislation. A number of unique features in the transposition of the arm's length principle has become apparent. From an international tax perspective, it is not merely the common criticism against the arm's length principle that has to be voiced against this German version of it. In particular where it is concerned with both hard-to-value intangibles as well as with soft intangibles, the German legislator has introduced new nuances to the arm's length principle. These iterations are prone to cause double taxation if they lead to internationally deviating results. It is necessary to consider the full picture. The next element that is analysed is the definition of the FTA of related party.



### 4.3.2 Sec. 1 para. 2 – Related Party

As mentioned previously, the price of a transaction will only be adjusted if it has been effected with a related party. Thus, the definition of "related party" is essential to the scope of application of the German transfer pricing legislation. Sec. 1 para. 1 sent. 4 of FTA contains the following definition of a related party:

2. *A party is related to the taxpayer where*
    1. *The party holds a direct or indirect ownership interest in the taxpayer of one fourth or more (a substantial ownership interest) or is able to exert direct or indirect control over the taxpayer, or conversely, the taxpayer holds a substantial ownership interest in the party in question or is able to exert direct or indirect control over this party, or*
    2. *a third party holds a substantial ownership interest in both the party in question and the taxpayer or is able to exert direct or indirect control over both, or*
    3. *when agreeing on the terms and conditions of a business relationship, the party in question, or the taxpayer, is able to exert influence extraneous to the business relationship on the taxpayer, or on the party in question; or either of them has an interest of its own in the generation of income by the other.*[373]

The three alternative definitions of a related party are exhaustive examples.[374] The underlying principle in these paragraphs is the exertion of a substantial and effective

[372] Ibid., §1 FTA MN 30 & 31.

[373] Translation originates from: KPMG/Lenz, M. (ed.), Deutsches Außensteuerrecht, German International Taxation, Beck, München: Beck (2010), p. 156 ff.

[374] Hofacker, M., in Haase, F., Außensteuergesetz, Doppelbesteuerungsabkommen. Heidelberg: C.F. Müller, (2012), §1 FTA MN 95.

influence on the terms of the transaction called "*business relationship*" [375] that would not occur in the case of a transaction between unrelated parties.[376] For the application of this provision to a permanent establishment and a parent company, it needs to be considered as a related entity even though it is not legally independent.[377] Nevertheless, transactions between a company and its permanent establishment in another country are considered as a qualifying business relationship to which the arm's length principle applies in line with Sec. 1 para. 1 of the FTA.[378] The entities – in this case either the taxpayer or the other party that takes part in the transaction – are considered to be related in case one of the following three situations.



#### *4.3.2.1 Related Party by Participation (Direct or Indirect)*

Firstly, the relation is established in the case where the entity in question or the taxpayer that takes part in the underlying business relation holds a participation of at least 25% in the other entity, or one of the entities is able to exercise decisive influence on either the taxpayer or the other entity, either directly or indirectly.[379]

Both options equally lead towards the entities being related, i.e. related parties in the meaning of the FTA. While the first option purely looks at the participation and presumes sufficient influence on the transaction, the second option is based on actual influence. Thus, for the latter case it is decisive that one of the parties taking part in the transaction has the ability to influence the terms of the transaction. Yet, the limitation of this definition is that the other party can in fact exert an influence, not in general but on the transaction in question.[380]

By contrast, the participation threshold of 25% looks at the paid up capital of the other entity.[381] Thus the legal form of the entity needs to be such that a participation in the capital is possible.[382] A participation that is merely comprised of voting rights does not suffice.[383] However, the threshold of a participation of 25% can also be reached through an indirect participation in which the ratio of all holdings would be considered.[384] But the spectrum of influence is not limited to a participation in the capital. It also includes other rights that are similar to a participation, such as specific agreements seizing control to

[375] §1 para. 4 sent., FTA Ibid., §1 FTA MN 96.

[376] Ibid.

[377] Pohl, C., in: Heuermann, B. & Brandis, P. (publ), AStG § 1 Berichtigung von Einkünften, *Blümich EStG, KStG, GewStG*, München: Verlag Franz Vahlen, (2016; suppl. 133), MN 177; previously this permanent establishments have not been considered as such: Hofacker, M., in Haase, F., *Außensteuergesetz, Doppelbesteuerungsabkommen*. Heidelberg: C.F. Müller, (2012), §1 FTA MN 94.

[378] § 1 para. 5 sent. 2, FTA.

[379] § 1 para. 2, FTA.

[380] Hofacker, M., in Haase, F., *Außensteuergesetz, Doppelbesteuerungsabkommen*. Heidelberg: C.F. Müller, (2012), §1 FTA MN 97.

[381] Ibid., §1 FTA MN 98.

[382] Ibid., §1 FTA MN 99.

[383] Ibid., §1 FTA MN 99.

[384] Ibid., §1 FTA MN 103.

another party,[385] participation in the management of the other entity, or situations in which both entities are under the control of a third entity, without being affiliated entities.[386]

#### *4.3.2.2 Related Party Through Common Parent*

Secondly, the taxpayer and the other entity taking part in the deal are related entities through a common parent entity that holds a participation of at least 25% in both entities or can exercise control, directly or indirectly, over both entities. Hence, this provision deals with the status of being related as a result of the entities being affiliated entities. However, the participation threshold of 25% stays in place and this also applies to indirect participations.[387]



#### *4.3.2.3 Related Party Through Influence*

Thirdly, the relation between the taxpayer and the other entity taking part in the transaction is the result of the ability to exert influence on the taxpayer or vice versa, apart, that is, from the "business relationship". Also, a relation can be derived from the fact that one of the parties – either the taxpayer or the other entity of the business relationship - has an intrinsic interest in the income generation of the other party. This provision establishes two more circumstances that lead to the existence of a relationship of association. The first option relating to influences apart from the business relationship is disputed since it is questionable if there needs to be a factual influence on the terms and conditions of the transaction or whether the mere ability to exert influence suffices.[388] This needs to be analysed on a case-by-case basis, as the wording of the provision as well as the jurisprudence allow for a very broad application.[389] The second option is also left wide open for interpretation and also includes cases of the shift of income at the expense of the German entity and for the benefit of an entity under direction of a close member of the family. Thus, this applies to both underlying economic intentions just as it does to personal ones.[390] As a consequence of this third manner of establishing a party as a related party, the application of the transfer pricing legislation hinging on there being a transaction between related parties has been extended. Article 9 of the OECD MC only requires that there is a related party on the basis of a relation resulting from company law.[391]

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[385] Ibid., §1 FTA MN 110.

[386] Hofacker, M., in Haase, F., *Außensteuergesetz, Doppelbesteuerungsabkommen*. Heidelberg: C.F. Müller, (2012), §1 FTA MN 108.

[387] Ibid., MN 116.

[388] Hofacker, M., in Haase, F., *Außensteuergesetz, Doppelbesteuerungsabkommen*. Heidelberg: C.F. Müller, (2012), §1 FTA MN 122; Podewills, § 1 Abs. 2 AStG: Keine Einflussnahmemöglichkeit bei entgegenstehender materieller Treubindung!, *IStR*, München: Beck, (2012), p. 133.

[389] Hofacker, M., in Haase, F., *Außensteuergesetz, Doppelbesteuerungsabkommen*. Heidelberg: C.F. Müller, (2012), §1 FTA MN 122 & 123.

[390] Ibid., MN 127.

[391] Eigelshoven, A., Artikel 9, Verbundene Unternehmen, RN 37ff; in Vogel/Lehner, Doppelbesteuerungsabkommen, München: Beck, 6th Ed., (2015).

#### *4.3.2.4 Interim Conclusion*

Sec. 1 para. 2 establishes the thresholds for entities to be considered related parties for German transfer pricing purposes. Except for the threshold relating to the participation in the paid-up capital in the other entity, the elements required for establishing a relation between parties are based on the factual ability to influence the conditions of the transaction. Additionally, transactions of affiliated entities and those relations not brought about by participation that enable one party to influence the terms of the transaction with the other, are covered.

The next element that needs to be considered is the transaction that takes place between the related entities – the business relationship, as it is called in the FTA. Among these business relationships are also business restructurings. Thus, in the following, the fundamental elements are introduced of how the price of such a transaction is to be corrected according to the concept in the FTA. This is followed by an in-depth analysis of the actual German function shifting legislation.



### 4.3.3 Sec. 1 para. 3 – Business Relationship and the Determination of the Price

#### *4.3.3.1 Elements of the Shift of Functions*

Sec. 1 para. 3 FTA is the legal basis of the Function Shifting Regulation. It also codified a hierarchy for the applicable transfer pricing methods,[392] distinguishing the situation where comparable arm's lengths values exist, [393] those where comparable arm's length prices need to be adjusted[394] and those conditions where reliance on a hypothetical arm's length price is necessary.[395] For business restructurings and, thus, business functions, the availability of comparable arm's length prices cannot be presumed. In these cases, it is prescribed to resort to a hypothetical arm's length price, which is the result of a fictitious bargaining between a transferor and an all-informed transferee. This entails that:

> *"[...] the taxpayer must use functional analysis and internal business planning calculations to identify the supplier's minimum price and the recipient's maximum price considering capitalization interest rates that are commensurate with functions and risks (range of agreement); the range of agreement is determined by the respective profit expectations (profit potentials)."*[396]

[392] Kraft, G., in Kraft, G., *Außensteuergesetz*, München: Beck, (2009), §1 FTA MN 207; Baumhoff, H., Ditz, X., Greinert, M., Auswirkungen des Unternehmensteuerreformgesetzes 2008 auf die Ermittlung internationaler Verrechnungspreise, DStR, München: Beck, (2007), p. 1462.

[393] §1 para. 3 s. 1 FTA; In these cases comparable uncontrolled price method, the resale price method, or the cost-plus method have priority.

[394] §1 para. 3. s. 2 FTA.

[395] §1 para. 3. s. 5 FTA.

[396] §1 para. 3 s. 6 FTA; updated translation derived from: KPMG/Lenz, M. (ed.), *Deutsches Außensteuerrecht, German International Taxation*, München: Beck (2010), p. 156 ff.

The resulting price from this fictitious bargaining under conditions that are alien to a perfect market[397] is then to be sought in the middle of the range, unless other causes give reasons for deviating by selecting a price that leans more on either side of the range.[398] A correction of the transfer price that has been agreed upon only occurs in the case where the price range established by the taxpayer is out of the band of prices found to be applicable by the tax authorities.[399]

As this is most likely, but not always, a situation that occurs in business restructurings where intangible assets that are hard-to-value and business functions are shifted, including the respective soft-intangibles, the following provision is applicable:

> *"[…] a function is transferred together with the associated opportunities and risks, and including the assets and other benefits also transferred or otherwise provided (transfer of functions), the taxpayer shall determine the range of agreement on the basis of a transfer of the function as a whole (transfer package), considering capitalization interest rates that are commensurate with functions and risks."*[400]



Thus, the function shifting regulation, which is based on Sec. 1 Para. 3 S. 9ff of the FTA, relies on the presence of two elements. These are the *function* and the *shift* of the latter to a location outside Germany.

#### *4.3.3.2 Function & Shifting*

As has been pointed out, intangibles are at the centre of attention when it comes to business restructuring. The aim of the function shifting legislation is to prevent the shift of the tax base out of Germany through restructurings.[401] This entails making the shift of especially valuable intangibles and profit potential to a different tax jurisdiction less attractive. The desire to restructure across borders can be further explained by not only focusing on the ceding entity but by also taking into account the benefits gained through the receiving entity. These can have their origin in a number of soft-intangibles that are only realized through restructuring.

Specifically, this extension to benefits that only arise as a result of the restructuring in the hands of the receiving company is dealt with in the following. This entails a delimitation

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[397] Knight, F.H., *Risk, Uncertainty and Profit*, Reprints of economic classics, New York: Augustus M. Kelley, (1964), p. 76 -80.

[398] §1 para. 3 s. 7 FTA.

[399] §1 para. 3 s. 8 FTA.

[400] Extract of §1 para. 3 s. 9 FTA; translation taken from: KPMG/Lenz, M. (ed.), *Deutsches Außensteuerrecht, German International Taxation*, München: Beck (2010), p. 156 ff.

[401] The reasoning which has been provided bythe proposed legislation intends to ensure that something which has been brought about in Germany and thereby relied on the conditions and infrastructure in Germany is adequately taxed once it is moved abroad. This has been emphasized in the case of the transfer of intangibles; Parliamentary Groups of CDU/CSU und SPD, *Entwurf eines Unternehmensteuerreformgesetzes 2008, Drucksache 16/4841, (27. 03. 2007), p. 84: "Die Regelungen zu Funktionsverlagerungen sollen dazu beitragen, die Besteuerung in Deutschland geschaffener Werte sicherzustellen, wenn immaterielle Wirtschaftsgüter und Vorteile (Know-how, patentiertes oder nicht patentiertes technisches Wissen, Markenrechte und -namen, Kunden-stamm usw.) ins Ausland verlagert werden."*

of the term *function*, the elements that are taken into account for the valuation of the transfer package, as well as the treatment of highly valuable intangibles.

#### *4.3.3.3 Definition of the Term Function*

The term *function* as it is used in the FTA and therefore also in the accompanying function shifting regulation, which renders it more precisely, is not necessarily comparable with the definition of the term *function* as employed by the OECD TP Guidelines.[402] This distinction is necessary because it is disputed under which conditions such a function could be qualified as an actual intangible (asset).[403]



##### *4.3.3.3.1 The Term Function According to the Function Shifting Regulation*

The first source that can be looked at for distilling the precise range of the term *function* is the Function Shifting Regulation. In Sec. 1 Para. 1, a function is defined as being:

> *"[…] a business activity consisting of an aggregation of operational tasks of the same kind that are performed by certain units or departments of an enterprise. It is an organic part of an enterprise, but need not constitute a branch of activity for tax purposes."*[404]

A number of elements can be derived from these two sentences to lead to the qualification of a function.

According to the definition, a function constitutes a plurality of homogenous business tasks to which opportunities as well as risks can be assigned. Furthermore, these business tasks are concluded within certain positions/distinguishable divisions of a company. Such a function forms an integral part of the company even if the function does not qualify as *business unit*[405] in the meaning of German tax law.[406] In the absence of a statutory definition[407] the following circumstances signify a *business unit*, which*:*

- *is organically complete and separate from other businesses, i.e. conducts its own business life without help from other business parts in essential regards;*

[402] If the term function is used without any further qualification in this section it relates to the term function as it is employed by the FTA.

[403] Dietz, X., Übertragung von Geschäftschancen bei Funktionsverlagerungen ins Ausland Darstellung an ausgewählten Beispielen, *IStR*, München: Beck, (2006), p. 1625ff.; Greil, S., Das Gewinnpotenzial als manifestierte Geschäftschance, IStR, München: Beck, (2009), p. 202.

[404] Translation originates from: KPMG/Lenz, M. (ed.), *Deutsches Außensteuerrecht*, German International Taxation, Beck, München: Beck (2010), p. 156 ff.

[405] Eckl, P., The New Administrative Decree regarding the German Reorganization Tax Act, *European Taxation*, Amsterdam: IBFD, (August 2011), p. 334f.

[406] The term Business Unit refers to *Teilbetrieb*.

[407] Eckl, P., The New Administrative Decree regarding the German Reorganization Tax Act, European Taxation, Amsterdam: IBFD, (August 2011), p. 334f; Kasten, C., *Die Besteuerung grenzüberschreitender Funktionsverlagerungen: Systematik und Handlungsalternativen*, Hamburg: Kovac, (2012), p. 61.

- *is independent from other businesses, i.e. manages its affairs without need for guidance from other parts of the business;*
- *has all the attributes of a business; and*
- *can economically survive on its own.*[408]

The particular information that a function does not necessarily need to be a business unit,[409] does not form a negative delimitation.[410] However, the function is required to amount to at least an organic part of the enterprise.[411] Still, this leaves room for interpretation. The definition of business unit is not to be confused with the definition of business unit given by the EU Merger directive.[412] However, even with the foregoing further limiting the definition, it still requires additional clarification from the Administrative Principles on Business Restructurings, published by the German Ministry of Finance on 13 October 2010. These administrative principles rely heavily on the term "organic part of an enterprise".[413]



*4.3.3.3.2 The Term "Function" According to the Administrative Principles*

Relevant for the definition of the term function is Chapter II of the Administrative Principles. Essentially, a function results from the coordination and combination of similar business tasks within an enterprise.[414] This conglomerate of activities does not, however, need to contain all elements that contribute to value creation.[415] The Administrative Principles merely provide a non-exhaustive list of examples for the clarification of the width of the term function:

> *"(…) business activities that belong to management, research and development, procurement of materials, warehousing, production, packaging, sales, assembly,*

[408] Rasch, S. & Schmidtke, R., OECD Guidelines on Business Restructuring and German Transfer of Function Regulations: Do Both Jeopardize the Existing Arm's Length Principle?, International Transfer Pricing Journal, Amsterdam: IBFD, Volume 18, (2011), p. 61; with reference to: BFH, AZ X R 49/06.

[409] The term Business Unit refers to *Teilbetrieb*.

[410] Zech, T., *Verrechnungspreise und Funktionsverlagerungen 2009: die steuerliche Behandlung von Verrechnungspreisen, insbesondere bei Funktionsverlagerungen, nach der Unternehmensteuerreform 2008*, Baden-Baden: Nomos-Verl.-Ges., (2009), p. 193.

[411] Regulation on the Application of the Arm's Length Principle under § 1 (1) of the Foreign Tax Act in Instances of Cross Border Transfers of Function (Transfer of Function Regulation – FVerlV), Berlin: Ministry of Finance, 12 August 2010, §1 Abs. 1 S2; Kasten, C., *Die Besteuerung grenzüberschreitender Funktionsverlagerungen: Systematik und Handlungsalternativen*, Hamburg: Kovac, (2012), p. 60ff.

[412] Eckl, P., The New Administrative Decree regarding the German Reorganization Tax Act, European Taxation, Amsterdam: IBFD, (August 2011), p. 334 – quoting Art. 2(j) of the Merger Directive (90/434/EC): *"[…] all the assets and liabilities of a division of a company which from an organizational point of view constitute an independent business, that is to say an entity capable of functioning by its own means."*

[413] Principles for the Audit of the Allocation of Income between Related Persons in Cases of Cross-Border Transfers of Business Functions (Administration Principles – Business Restructurings).

[414] Principles for the Audit of the Allocation of Income between Related Persons in Cases of Cross-Border Transfers of Business Functions (Administration Principles – Business Restructurings, MN 14; Imhof, M., *Business Restructuring: Eine Betriebswirtschaftliche und Steuerrechtliche Analyse*, Köln: Eul-Verlag, (2012), p. 161.

[415] Ibid. Translation provided by: Andresen, U., Principles for the Audit of the Allocation of Income between Related Persons in Cases of Cross-Border Transfers of Business Functions (Administration Principles – Business Restructurings) – Federal Ministry of Finance, *International Transfer Pricing Journal*, Amsterdam: IBFD, (2011) Volume 18, No. 1:

*processing and refining of products, quality control, finance, logistics, organization, administration, marketing, customer service, etc."*[416]

This gives an indication of the potential meaning, yet it is not entirely possible to clearly identify the absolute minimum threshold for the presence of a function. This is also one of the main criticisms that the function shifting regulation faced from practitioners and academics alike.[417]

The Administrative Principles merely repeat the wording of the function shifting regulation by stating that it needs to qualify as an organic part of an enterprise. Depending on whether the combination and coordination of similar activities that form an organic part of an enterprise relates to the result thereof or to the process itself, the reliance on the term function could lead to the atomization of activities performed into separate functions.[418]



In the case where an analysis of the function shifts the focus onto the results that are brought about by the pool of activities,[419] it would be possible to imagine a virtually limitless number of functions[420]- simply because the qualities of a product differ marginally. For example, if one were to construe different function to correspond to small differences in products, one would be required to identify a seemingly limitless number of functions corresponding to each difference. For example, producing cars of the same model but with different drive trains could result in to the identification of different functions for the two models.[421] Similarly, different stages in the production process – every definable stage in the process of the making of a product – could amount to considering these activities as being independent functions.[422] This would not just be limited to a differentiation of the three elements of the value chain, but could go as far as perceiving a new function with

[416] Principles for the Audit of the Allocation of Income between Related Persons in Cases of Cross-Border Transfers of Business Functions (Administration Principles – Business Restructurings, MN 15, as translated by: Andresen, U., Principles for the Audit of the Allocation of Income between Related Persons in Cases of Cross-Border Transfers of Business Functions (Administration Principles – Business Restructurings) - Federal Ministry of Finance, *International Transfer Pricing Journal*, Amsterdam: IBFD, (2011) Volume 18, No. 1.

[417] Blumers, W., Funktionsverlagerung und ihre Grenzen, DStR, München: Beck, (2010), p. 20; Hentschel, S. & Kraft, G., Funktionsverlagerungen in anstehenden Außenprüfungen – eine Bestandsaufnahme potenzieller Streitfragen, *IStR*, München: Beck, (2015), p. 194; Borstell, T. & Wehnert, O., Chapter R: *Funktions- und Geschäftsverlagerung*, in: Vögele, A., Borstell, T. & Engler, G.,

[418] Imhof, M., *Business Restructuring: Eine Betriebswirtschaftliche und Steuerrechtliche Analyse*, Köln: Eul-Verlag, (2012), p. 161.

[419] Principles for the Audit of the Allocation of Income between Related Persons in Cases of Cross-Border Transfers of Business Functions (Administration Principles – Business Restructurings, MN 16.

[420] Borstell, T. & Wehnert, O., Chapter R: Funktions- und Geschäftsverlagerung, in: Vögele, A., Borstell, T. & Engler, G., *Verrechnungspreise: Betriebswirtschaft, Steuerrecht*. München: Beck, (2015), MN 65 & 66; Hentschel, S., *Deutsche Regelungen Zur internationalen Funktionsverlagerung: Kritische Analyse unter besonderer Berücksichtigung der Transferpaketbewertung.* Wiesbaden: Springer Gabler, (2015), p. 33.

[421] Hentschel, S., *Deutsche Regelungen Zur internationalen Funktionsverlagerung: Kritische Analyse unter besonderer Berücksichtigung der Transferpaketbewertung.* Wiesbaden: Springer Gabler, (2015), p. 33.

[422] Frischmuth, M., Was bleibt übrig von der Transferpaketbesteuerung nach § 1 Abs. 3 Satz 9 AStG?, *IWB*, Herne: NWB Verlag, (2011) No. 2, pp. 52-54.

every step, no matter how little, in, or leading towards, the development, production or sales process.[423]

This is relativized by the meaning given by jurisprudence to the term "organic part of an enterprise".[424] According to this, it is essential that there is an economic relation among the tasks performed which can be recognized by a third party.[425] Furthermore, in the case where a task is removed from the collection of tasks that make up the entire function, profit potential and the specific character of the function would be lost.[426] And finally, the tasks performed must constitute a certain continuity and thus require recurrence. [427]
The breadth of the term function is limited to some extent by the definition of the organic part of an enterprise. The Administrative Principles do elaborate on another issue that arises when evaluating the presence of a function. While there are already uncertainties about the actual presence of a function of the ceding entity, it is also relevant whether the transfer can result in the receiving entity exercising a function.[428]



Some authors argue that this could be in the interest of the German tax authorities because it could enable them to argue that indeed a function has been transferred. Consequently, they argue, that the goodwill and connected soft-intangibles should be included in determining the arm's length price, in addition to the tangibles and intangibles that are in fact transferred as part of the business reorganisation.[429] However, such atomization of the term function, as it is widely referred to in the literature,[430] does not take place in reality, from the perspective of the party that takes over the alleged function. In the event that an unrelated third party takes over the performance of an activity that might qualify as a function according to the German function shifting regime but barely contains anything other than the tangibles and intangibles necessary for the performance, this party would not be prepared to pay a higher price.[431] Additionally, a function that contains so little of what resembles a business unit cannot yield a certain price from a third party for elements that are either not attached to it or that have their origin within the receiving

[423] Ibid.

[424] Kasten, C., Die *Besteuerung grenzüberschreitender Funktionsverlagerungen: Systematik und Handlungsalternativen*, Hamburg: Kovac, (2012), p. 62.

[425] Ibid.

[426] Ibid.

[427] Ibid.

[428] Principles for the Audit of the Allocation of Income between Related Persons in Cases of Cross-Border Transfers of Business Functions, MN 18; Kasten, C., Die Besteuerung grenzüberschreitender Funktionsverlagerungen: Systematik und Handlungsalternativen, Hamburg: Kovac, (2012), p. 62.

[429] Imhof, M., Business Restructuring: Eine Betriebswirtschaftliche und Steuerrechtliche Analyse, Köln: Eul-Verlag, (2012), p. 161.

[430] Blumers, W., Funktionsverlagerung und ihre Grenzen, DStR, München: Beck, (2010), p. 20; Frischmuth, M., Was bleibt übrig von der Transferpaketbesteuerung nach § 1 Abs. 3 Satz 9 AStG?, IWB, Herne: NWB Verlag, (2011) No. 2, pp. 52-54; Hentschel, S. & Kraft, G., Funktionsverlagerungen in anstehenden Außenprüfungen – eine Bestandsaufnahme potenzieller Streitfragen, IStR, München: Beck, p. 193 & 194.

[431] Imhof, M., Business Restructuring: Eine Betriebswirtschaftliche und Steuerrechtliche Analyse, Köln: Eul-Verlag, (2012), p. 162; Brüninghaus, D. & Bodenmüller, R., Tatbestandsvoraussetzungen der Funktionsverlagerung, DStR, München: Beck, p. 1286; Kasten, C., Die Besteuerung grenzüberschreitender Funktionsverlagerungen: Systematik und Handlungsalternativen, Hamburg: Kovac, (2012), p. 62.

entity, such as synergies, or that are derived from the location in which receiving entity is operating.[432] However, for such a minimum threshold to be derived from the actual market it is necessary that there be a "market" for functions themselves, i.e. functions are actually traded between unrelated parties. Yet, a function in the most extreme sense is merely traded between related parties while an unrelated party can generally pursue a function for free.[433]

Thus, such a minimum threshold for the determination of a function can neither be derived from the actual function shifting regulation nor from the Administrative Principles. Routine functions are in principle also considered, even though they are only relevant in a setting between related entities and therefore miss a number of elements that would enable them to be considered an independent business unit.[434] Accordingly, routine functions form part of an exception brought about by the Administrative Principles.[435] This exception is limited to situations where the function is performed exclusively for a related party and such performance is remunerated on a cost-plus basis.[436] Likewise it is presumed that in such a situation no material intangible assets and advantages are transferred.[437]



Another notion that can be derived from the administrative principles is that the assets, chances and risks can be clearly discerned from either the remaining business operations or within the receiving entity. This leads to further confusion.[438] Nonetheless, such a notion combined with the standard of the prudent business manager means that any part of a business entity that forms a separate unit, by accounting as well as organisation, qualifies as a separate function.[439] Thus, constellations in which there is no separate unit (organic business part) by means of organisation or accounting in the company ceding the activity but which then amount to a function in the receiving entity, are problematic.[440] The condition triggering the function shifting legislation would thus be abroad, and would require the German tax authorities to base a possible adjustment on a condition which is not influenced by the ceding company in Germany but merely by the receiving company abroad.[441]

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[432] Ibid.

[433] Ibid.

[434] Administrative principles, Funktionsverlagerung, 2.1.1.; Imhof, M., *Business Restructuring: Eine Betriebswirtschaftliche und Steuerrechtliche Analyse*, Köln: Eul-Verlag, (2012), p. 162.

[435] Principles for the Audit of the Allocation of Income between Related Persons in Cases of Cross-Border Transfers of Business Functions, MN 66 & 67.

[436] Ibid., MN 66.

[437] Ibid.

[438] Administrative principle 2.1.1.2; Imhof, M., *Business Restructuring: Eine Betriebswirtschaftliche und Steuerrechtliche Analyse*, Köln: Eul-Verlag, (2012), p. 163; Kasten, C., Die *Besteuerung grenzüberschreitender Funktionsverlagerungen: Systematik und Handlungsalternativen*, Hamburg: Kovac, (2012), p. 60.

[439] Imhof, M., *Business Restructuring: Eine Betriebswirtschaftliche und Steuerrechtliche Analyse*, Köln: Eul-Verlag, (2012), p. 163.

[440] Kasten, C., *Die Besteuerung grenzüberschreitender Funktionsverlagerungen: Systematik und Handlungsalternativen*, Hamburg: Kovac, (2012), p. 63.

[441] Ibid.

If there was not the explicit exclusion in Sec. 1 para. 1 Function Shifting Regulation of a business unit (*Teilbetrieb*) it would be possible to construct the minimum by considering every shifted activity as a function that can amount to a business unit – regardless of whoever receives it. However, the minimum is to be sought in the term *organic part* of an enterprise, which is wider and relates to both ceding and receiving company. Such an artificial creation of a function in the hands of the receiving company needs to be rejected.[442]

In order to clarify the scope of application it has also been suggested to abolish the condition of "organic part".[443] Nevertheless, the requirement of it being an organic part of the business unit is sensible as long as it is merely applied to the ceding entity.[444] Otherwise, there would be no minimum threshold for the presence of a function. Additionally, guidance for the minimum threshold for the existence of a function should only be derived by also applying the standard of the prudent business manager from the perspective of the party taking over the function, which would not be inclined to remunerate a stripped out function as if assets, chances and risks were attached to it.[445]



Yet, this still leaves doubt about single intangible assets that are transferred, such as a distribution right.[446] Even though the shift of individual assets has been expressly excluded, [447] it is possible to consider e.g. a distribution right, which is in fact a single intangible asset, as a function.[448] In order for this to happen it is necessary that a certain independence is assigned to this function.[449]

*4.3.3.3.3 Conclusion – Function Terminology*

The term *function* as it is employed by the German Function shifting legislation is in its meaning unrelated to the one referred to in the OECD TP Guidelines. Therefore, the attempt on delineating the term function as employed by the FTA had to be limited to the function shifting regulation, the Administrative Principles as well as other sources in so far as they have been relied upon in the latter.

Controversial as it may be, this definition is more precise. This is because of the fact that tasks need to be performed by either the transferor or transferee in order for them to qualify as *functions*. This two-sided analysis also relates to the application of the test of the prudent business manager. Therefore, the collection of tasks must be more than

[442] Ibid.

[443] Zech, T., *Verrechnungspreise und Funktionsverlagerungen 2009: die steuerliche Behandlung von Verrechnungspreisen, insbesondere bei Funktionsverlagerungen, nach der Unternehmensteuerreform 2008*, Baden-Baden: Nomos-Verl.-Ges., (2009), p. 185.

[444] Kasten, C., *Die Besteuerung grenzüberschreitender Funktionsverlagerungen: Systematik und Handlungsalternativen,* Hamburg: Kovac, (2012), p. 63.

[445] Imhof, M., *Business Restructuring: Eine Betriebswirtschaftliche und Steuerrechtliche Analyse*, Köln: Eul-Verlag, (2012), p. 163.

[446] Kasten, C., *Die Besteuerung grenzüberschreitender Funktionsverlagerungen: Systematik und Handlungsalternativen,* Hamburg: Kovac, (2012), p. 66.

[447] 1 Abs. 7 Function Shifting Regulation.

[448] Kasten, C., *Die Besteuerung grenzüberschreitender Funktionsverlagerungen: Systematik und Handlungsalternativen*, Hamburg: Kovac, (2012), p. 65ff.

[449] Ibid.

just the pursuance of a certain business activity. This is due to the fact that the receiving entity and a prudent business manager would not be willing to pay for a function that has been stripped of the relevant assets. Thus, it ought to encompass more. Yet, it needs to be pointed out that this can lead to a scenario where the transferor cedes a business activity below the threshold that then amounts to a function within the entity of the transferee.

In a subsequent step it has been shown that the collection of tasks needs to form an organic part of the enterprise. It is therefore important to understand the term "*organic enterprise*". This term has been defined by jurisprudence and gives a further indication of the limits of the term function. The required qualities point towards a rather substantial collection of tasks that need to be shifted in order to draw the conclusion that it is an actual function. This result runs counter to the widespread argumentation that the term function is applicable in a fashion that leads to an atomization of functions.



The next issue arising out of the determination of the function itself is the content of the transfer package. This in particular includes a broad range of intangibles that are only meant to come into existence as a result of the business restructuring. The transfer of such a function results in the valuation of the Transfer Package instead of the mere valuation of all the (intangible) assets individually. In the following the exact content of this Transfer Package will be discussed.

### 4.3.4 The Transfer Package and its Valuation

Having dealt with the range of the concept of a function, it is now necessary to analyse how the valuation of a function or that of a highly valuable intangible takes place as part of the valuation of the transfer package. The valuation of the transfer package includes a number of factors that have previously not been considered in the case of a shift of a function and possibly therein contained unique and therefore hard-to-value intangibles. Similarly, a number of soft intangibles makes the complete transfer package more valuable than just the sum of the individual assets, thus forming the basis for taxing the added value.

#### *4.3.4.1 Valuation of the Transfer Package*

The valuation of the effects on the profit potential of the transferor and the transferee can be effected in a direct as well as in an indirect manner.[450] Direct valuation looks at the profit potential of the function in the hands of the transferor and the transferee. This requires the valuation of the actual transfer package becomes necessary. By contrast the valuation can also be effected indirectly by considering the value of the ceding and receiving entities. Both valuations need to be made taking into account the event of transfer as well as the event of the fictitious non-transfer.[451] This results in four different valuations from which it is then possible to deduce a value of the function including the additional content of

[450] Borstell, T. & Wehnert, O., in: Vögele, A., Borstell, T. & Engler, G., *Verrechnungspreise: Betriebswirtschaft, Steuerrecht*. München: Beck, (2015), p. 929.

[451] Ibid.

the transfer package.[452] The valuation is done by applying methods commonly used for business valuation purposes.[453]

The determination of the price is conducted from two opposing points: valuation from the ceding entity on the one hand, and from the receiving entity on the other, each side being subject to the standard of the prudent business manager. Therefore, the two prices result in a price range.[454] The minimum price is thus established by the ceding entity. This has been prescribed by Sec. 7.1. of the function shifting regulation, which already expands on parts of the contents of the transfer package.

> *(1) Where the transferring enterprise can expect profits from the function, the lower limit of the negotiating range (minimum price in the range of agreement) within the meaning of § 1 (3) sent. 6 of the Foreign Transactions Tax Law is equal to the compensation for the loss or reduction of profit potential plus the amount of any closing costs that arise. Courses of action that are available in fact and would be open to the transferring enterprise if it were unrelated to the receiving enterprise must be considered, without however questioning the right of the transferring enterprise to control its business affairs.*[455]



Yet, it is not only important how the minimum price of the transfer package is to be found. One part of the transfer package that is already truncated are alternative options of both ceding and receiving entity. For the ceding entity this translates into considering the costs of continuing and ceasing to exercise the function.[456]

Similarly, the maximum price of the receiving entity is established by considering the alternatives of taking over the function or creating it. Thus, the provision of Sec. 7.2 (4) of the Function Shifting regulation reads as follows:

> *(4) The profit potential of the receiving enterprise from the transferred function is as a rule the upper limit of the negotiating range (maximum price in the range of agreement). Courses of action that are available in fact and would be open to the receiving company if it were unrelated to the transferring company must be considered, without however questioning the right of the receiving enterprise to control its business affairs.*[457]

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[452] Ibid.

[453] Ibid.

[454] §1 Abs. 1 S.2 FTA; Kasten, C., *Die Besteuerung grenzüberschreitender Funktionsverlagerungen: Systematik und Handlungsalternativen*, Hamburg: Kovac, (2012), p. 171.

[455] KPMG/Lenz, M. (ed.), *Deutsches Außensteuerrecht, German International Taxation*, München: Beck (2010), p. 156 ff.

[456] Kasten, C., Die *Besteuerung grenzüberschreitender Funktionsverlagerungen: Systematik und Handlungsalternativen,* Hamburg: Kovac, (2012), p. 172.

[457] KPMG/Lenz, M. (ed.), *Deutsches Außensteuerrecht*, German International Taxation, München: Beck (2010), p. 156 ff.

However, there is more that needs to be considered than just the price of the transfer package. Depending on the particular case, a number of transaction costs need to be taken into consideration as well. These costs are mainly a burden to the ceding entity and are therefore to be taken into account when establishing the minimum price,[458] costs that are not limited to the stopping of the performance of the function in question but also the taxes that are due on the realized gain of that transaction.[459] All in all, the minimum price is made up of the profit potential of the function within the transfer package, the transaction costs and the costs for closing down the operation that exercises said function.[460]

The price range is established as a result of the minimum price (ceding entity) being in fact lower than the maximum price (receiving entity). The price of that function is determined as:



> *[…] the price within the range of agreement that most likely reflects the arm's length principle; if no plausible case is made for another value, the midpoint of the range of ament shall be used.*[461]

Hence, deviation from the midpoint within the price range is only possibly if that other price is likely and can be properly justified by the taxpayer.[462] However, in situations where one needs to rely on the hypothetical arm's length price, information that provides an argument for placing the price on one side or the other of the price range is generally not available.[463] Therefore, prescribing that a price needs to be at the midpoint of the range can be seen as a pragmatic solution,[464] but not necessarily as a correct one, considering the contents that influence the minimum and the maximum price.[465] Yet, requiring the midpoint to be chosen is also problematic when considering that the underlying principle should be the arm's length principle, and therefore, depending on the negotiation, any point within the range is likely to be chosen by independent parties and would thus be at arm's length.

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[458] Kasten, C., D*ie Besteuerung grenzüberschreitender Funktionsverlagerungen: Systematik und Handlungsalternativen*, Hamburg: Kovac, (2012), p. 174.

[459] Administrative principles Function Shifting, MN 118; Kasten, C., *Die Besteuerung grenzüberschreitender Funktionsverlagerungen: Systematik und Handlungsalternativen*, Hamburg: Kovac, (2012), p. 174.

[460] Kasten, C., *Die Besteuerung grenzüberschreitender Funktionsverlagerungen: Systematik und Handlungsalternativen*, Hamburg: Kovac, (2012), p. 173.

[461] FTA 1Abs. 3 S. 7.

[462] Ibid.

[463] Hentschel, S., *Deutsche Regelungen Zur internationalen Funktionsverlagerung: Kritische Analyse unter besonderer Berücksichtigung der Transferpaketbewertung*. Wiesbaden: Springer Gabler, (2015), p. 85; Kraft, G., in Kraft, G., *Außensteuergesetz*, München: Beck, (2009), §1 FTA MN 355; Hofacker, M., in Haase, F., *Außensteuergesetz, Doppelbesteuerungsabkommen*. Heidelberg: C.F. Müller, (2012), §1 FTA MN 223.

[464] Hentschel, S., *Deutsche Regelungen Zur internationalen Funktionsverlagerung: Kritische Analyse unter besonderer Berücksichtigung der Transferpaketbewertung*. Wiesbaden: Springer Gabler, (2015), p. 85. FN 433.

[465] Hentschel, S., *Deutsche Regelungen Zur internationalen Funktionsverlagerung: Kritische Analyse unter besonderer Berücksichtigung der Transferpaketbewertung*. Wiesbaden: Springer Gabler, (2015), p. 85; Borstell, T. & Wehnert, O., Chapter Q: Funktions- und Geschäftsverlagerung, in: Vögele, A., Borstell, T. & Engler, G., *Verrechnungspreise: Betriebswirtschaft, Steuerrecht*. München: Beck, (2015), MN 259.

However, considering what leads to the establishment of the maximum price – namely a broad range of (soft)-intangibles – the precise content of the transfer package plays a vital role. This necessitates further elaboration on the contents of the transfer package as well as additional benefits that are attached to the function and therefore form part of the transfer package.

#### *4.3.4.2 Content of the Transfer Package*

In the case where a function is shifted, and this shift falls within the scope of Section 1 para. 3, S. 9 FTA requires it to be valued as a package instead of all the assets individually. The content of this package has not been clearly defined by the legislator.[466] Even on a superficial level of the meaning of the *transfer package*, different contents can be identified. Yet, the content of the transfer package is crucial for determining the price and the application of the arm's length principle.



According to the pure wording of Section 1 para. 3 of the function shifting regulation which merely outlines the content of the transfer package by stating that it consists of the function itself and thereto-attached opportunities and risks as well as the assets and additional benefits that are transferred.[467] However, reference is made to the transfer of the function from the ceding to the receiving entity. Hence, the definition of the relevant transfer which is defined in Section 1 para. 2 of the same regulation should mention identical contents, if it elaborates on it. In fact, it does mention, in the context of transactions in which the valuation of the entire transfer package is required, as opposed to the valuation of itemised assets, that:

> *"[…] where an enterprise (transferring enterprise) conveys assets and other benefits to a different, related enterprise (receiving enterprise) together with the associated opportunities and risks […]"*[468]

The difference is thus that the provision on the transfer package actually includes the function as something independent,[469] whereas the definition for the actual transfer only mentions the function in a way that the receiving entity needs be able to perform the function as had been performed previously by the ceding entity on account of the assets and other benefits. Yet, the FTA does not mention the function as something independent

[466] Oesterreicher, A. & Hundeshagen, C., Weder Wirtschaftsgut noch Unternehmen, IStR, München: Beck, (2009), 146.

[467] Kasten, C., *Die Besteuerung grenzüberschreitender Funktionsverlagerungen: Systematik und Handlungsalternativen*, Hamburg: Kovac, (2012), p. 146.

[468] Article 1(2) Function Shifting Regulation – KPMG/Lenz, M. (ed.), *Deutsches Außensteuerrecht, German International Taxation*, München: Beck (2010), p. 156 ff.

[469] Kasten, C., Die *Besteuerung grenzüberschreitender Funktionsverlagerungen: Systematik und Handlungsalternativen,* Hamburg: Kovac, (2012), p. 146.

which is transferred. Consequently, it is not possible to clearly deduce the exact content of the transfer package from the function shifting regulation.[470,471]

Leaving the aforementioned issue stemming from the wording aside, what it ultimately results in is that a transfer package entails not only the individual assets but also the profit potential of that function,[472] which is the result of associated chances and risks belonging to the assets that are transferred. This conglomerate is then called "transfer package". Thus, the taxation of this package aims at taking into consideration the added value that can be derived from the combination of the different assets as a whole in the hands of the receiving entity.[473] If the transferred assets were to be taxed individually, the added value of this whole would not be subject to tax.[474] This result is also partly due to the fact that soft-intangibles such as synergies only arise in combination but are not assets by themselves. This adds features to the transfer package, which can only have an effect for something amounting to a business unit. Likewise, location savings are added to the list of (soft)-intangibles that need to be considered in this event.



However, depending on the exact content of the transfer package, such a taxation might overstep internationally accepted boundaries in particular in relation to the nexus of value creation and corresponding taxation. This will be demonstrated in regard to soft intangibles specifically, such as synergies and location savings.[475]

In the following the exact content will be dealt with even though it is not specifically mentioned either in the FTA, the Regulations or the Administrative Principles. It can be presumed as being close to reaching the extent of an ongoing concern if it is about an actual separate business unit taken together.[476]

Yet, as has been shown in the foregoing, this it is not what the function shifting regulation is about. The threshold to trigger the valuation as transfer package instead of individual assets is lower since it does not need to be an actually separate business unit (*Teilbetrieb*).

Assuming that in case of a business restructuring an arm's length price cannot be achieved through comparable prices nor by adjusting them, the hypothetical arm's length

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[470] Funktionsverlagerungsverordnung §1 para. 2; Kasten, C., Die *Besteuerung grenzüberschreitender Funktionsverlagerungen: Systematik und Handlungsalternativen*, Hamburg: Kovac, (2012), p. 146.

[471] Schabowski, A., *Transferpreise Von Funktionen: Die Deutsche Besteuerung Grenzüberschreitender Funktionsverlagerungen*. Hamburg: Diplomica Verlag, 2012, p. 58.

[472] Kasten, C., *Die Besteuerung grenzüberschreitender Funktionsverlagerungen: Systematik und Handlungsalternativen*, Hamburg: Kovac, (2012), p. 147.

[473] Ibid., p. 145; Baumhoff, H., Ditz, X., Greinert, M., Die Besteuerung von Funktionsverlagerungen nach der Funktionsverlagerungsverordnung vom 12. 8. 2008, DStR, München: Beck, (2008), p. 1948.

[474] Schabowski, A., *Transferpreise Von Funktionen: Die Deutsche Besteuerung Grenzüberschreitender Funktionsverlagerungen*. Hamburg: Diplomica Verlag, 2012, p. 59.

[475] In any case it oversteps national valuation principles that target the value of individual assets – 252 Abs. 1 Nr. 3 (Handelsgesetzbuch) §6 Abs. 1 EStG, c.f. Hentschel, S., *Deutsche Regelungen Zur internationalen Funktionsverlagerung: Kritische Analyse unter besonderer Berücksichtigung der Transferpaketbewertung*. Wiesbaden: Springer Gabler, (2015), p. 44

[476] Kasten, C., *Die Besteuerung grenzüberschreitender Funktionsverlagerungen: Systematik und Handlungsalternativen,* Hamburg: Kovac, (2012), p. 250ff.

price is decisive. This is a two-sided approach.[477] Hence it does not only matter what the transferor would be willing to pay for such a function, but also the transferee.[478] The resulting range of prices includes not only the values of individual assets but also the entirety of the ongoing concern: chances, risks and additional benefits which translate to effects on the earnings potential of the transferor and the transferee. Under this heading it is possible to subsume soft-intangibles such as synergy-benefits, location savings and a transferred workforce in place. This mode of application for the hypothetical bargaining process is also clearly expressed in the Administrative Principles to the Function Shifting Regulation:

> *"The respective capitalized values contain all advantages or disadvantages of the relevant locations and the synergy effects of all enterprises involved. Which enterprise causes the development of these advantages and disadvantages is an indication but not vital. It depends which enterprise could or should use for its benefit or suffer from these advantages/disadvantages in the fictitious price negotiation. This depends on the alternatives of action (recital 96) and the respective negotiating power (No. 9.57, 9.148 et seq. OECD Guidelines) that result from the objective circumstances. Examples for possible advantages or disadvantages of the location of the receiving enterprise can be differences in labour or material costs, financing conditions, the quality of infrastructure or the reliability and qualification of personnel and supply of materials. Differences in the tax burden and investment subsidies that need to be considered for the determination of the price can also constitute advantages or disadvantages of location, without these differences already justifying an assumption of tax abuse (No. 9.181 et seq. OECD Guidelines)."*[479]



Thus, the bargaining position of the receiving entity in relation to the ceding entity is pointed out as being decisive while the causal link between entity and effectively produced benefit is disqualified to a mere indication.[480] Thereby it is effectively proposed to break the nexus between the location of the generation of advantage/disadvantage and its allocation.

The Administrative Principles also shy away from elaborating on synergies, and instead focus on the factors that cause the existence of location savings/location specific advantages.[481]

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[477] Borstell, T. & Wehnert, O., in: Vögele, A., Borstell, T. & Engler, G., *Verrechnungspreise: Betriebswirtschaft, Steuerrecht.* München: Beck, (2015), p. 925ff.

[478] Ibid.

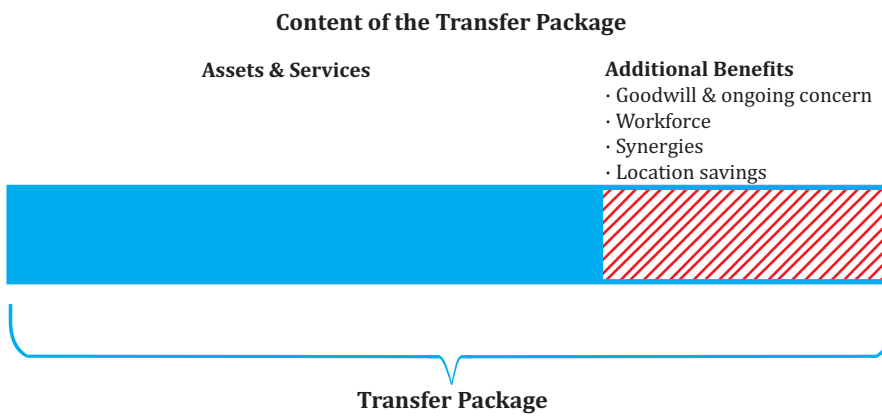
[479] Administrative principles to the function shifting regulation, p. 34, MN. 93 –Translated by Andresen, U., Principles for the Audit of the Allocation of Income between Related Persons in Cases of Cross-Border Transfers of Business Functions (Administration Principles – Business Restructurings, International Transfer pricing Journal, January/February 2011, p. 78 & 79.

[480] Administrative principles to the function shifting regulation, p. 35, MN 93.

[481] Ibid.

Location savings/location specific advantages are further looked into since they are strongly dependent on the jurisdiction of the receiving entity and consist of tax benefits, reduced labour costs and beneficial regulatory climate, among others. Additionally, alternative actions that are available to the parties[482] as well as miscellaneous benefits should be taken into account.

Taking all factors that lead to value creation according to the function shifting regulation into consideration in one chart, one arrives at the following:




Hence, part of the span between the hypothetical bid and ask price essentially relates to elements that are largely dependent on the future place where the assets are transferred to and used. In line with the two-sided approach that applies to the question whether a transaction actually amounts to a shift of a function, the factors influencing the result of the hypothetical arm's length price are equally dependent on both sides.

A detailed discussion of the soft-intangibles that need to be considered in the transfer package follows in Section II. The aggregated valuation of a transfer package can also be avoided on the basis of three available escape clauses.

### 4.3.5 The Escape Clauses

Although there is a broad range of scenarios where the valuation of the transfer package is required, a number of escape clauses exists. As a consequence of the applicability of such a clause, the assets shifted are to be valued separately instead of as a single transfer package.[483]

Originally, at the introduction of the function shifting regulation, there were merely two escape clauses. In 2010 a third one was added with the aim of eliminating possibly

[482] Administrative principles to the function shifting regulation, p. 31, MN 82ff; Borstell, T. & Wehnert, O., in: Vögele, A., Borstell, T. & Engler, G., *Verrechnungspreise: Betriebswirtschaft, Steuerrecht*. München: Beck, (2015), p. 925ff.

[483] Zech, T., *Verrechnungspreise und Funktionsverlagerungen 2009: die steuerliche Behandlung von Verrechnungspreisen, insbesondere bei Funktionsverlagerungen, nach der Unternehmensteuerreform 2008*, Baden-Baden: Nomos-Verl.-Ges., (2009), p. 367.

negative repercussions for Germany as a business location,[484] in particular for the research and development that is undertaken in Germany.[485]

Thus, in total there are three escape clauses which stem directly from the FTA. Section 1 para. 3 s. 10 of the FTA provides that:

> *"In cases to which the ninth sentence applies, the determination of separate transfer prices must be acknowledged for all affected assets and services and after all appropriate adjustments, if the taxpayer substantiates that no significant intangible assets and benefits are exchanged or transferred for use with the function, or that the overall result of the separate price determination, as measured by the price determination for the transfer package as a whole, complies with the arm's length principle; if the taxpayer substantiates that at least one significant intangible asset is subject to the relocation of the function, and if he designates it precisely, then separate transfer prices for the constituent elements of the transfer package must be acknowledged."*[486]



Therefore, applying the escape clauses still made it necessary to determine the value of the transfer package.[487] Otherwise it would not be possible to determine whether one or more intangibles that are shifted make up 25% of the transfer package, there not being a mismatch between the valuation of itemised assets and the valuation as transfer package or there being at least one clearly identifiable intangible passing the threshold of 25%. These escape clauses are available to taxpayers that can substantiate that an escape clause is applicable to their situation, putting the burden of proof on the taxpayer.[488] This is the result of the taxpayer being required to first value the assets involved in the transaction in aggregation only to then be able to conclude that an individual valuation would be possible. Such a substantiation of the circumstances letting the taxpayer believe that an escape clause is applicable to his situation requires the demonstration that the claimed circumstances are more likely to materialize than not.[489] Even though the Administrative

[484] Imhof, M., Business Restructuring: *Eine Betriebswirtschaftliche und Steuerrechtliche Analyse*, Köln: Eul-Verlag, (2012), p. 212.

[485] Ibid; Report of the Finance Commitee; Bericht des Finanzausschusses zu dem Gesetzentwurf der Bundesregierung – Drucksachen 17/506, 17/813 - Entwurf eines Gesetzes zur Umsetzung steuerlicher EU-Vorgaben sowie zur Änderung steuerlicher Vorschriften, p. 8 & 9; http://dip21.bundestag.de/dip21/btd/17/009/1700939.pdf (06.11.2016).

[486] Wittendorff, J. (2010). *Transfer pricing and the arm's length principle in international tax law*. Austin [Tex.]: Wolters Kluwer Law & Business, p. 866 (Table of statutes).

[487] Zech, T., *Verrechnungspreise und Funktionsverlagerungen 2009: die steuerliche Behandlung von Verrechnungspreisen, insbesondere bei Funktionsverlagerungen, nach der Unternehmensteuerreform 2008*, Baden-Baden: Nomos-Verl.-Ges., (2009), p. 368.

[488] Baumhoff, H., Ditz, X., Greinert, M., Auswirkungen des Unternehmensteuerreformgesetzes 2008 auf die Besteuerung grenzüberschreitender Funktionsverlagerungen, DStR, München: Beck, (2007), p. 1653; Principles for the Audit of the Allocation of Income between Related Persons in Cases of Cross-Border Transfers of Business Functions, MN 40.

[489] Borstell, T. & Wehnert, O., Chapter R: Funktions- und Geschäftsverlagerung, in: Vögele, A., Borstell, T. & Engler, G., *Verrechnungspreise: Betriebswirtschaft, Steuerrecht*, München: Beck, (2015), MN. 666.

Principles soften the requirement by stating that a precise calculation of the transfer package was not necessary,[490] there is doubt as to what that means precisely.[491]

#### *4.3.5.1 First Escape Clause*

The first escape clause deals with the situation where the function shifting does not entail the shift of a material intangible asset. The function shifting regime is predominately occupied with intangible assets.[492] It is therefore only logical for the legislator[493] that in a situation in which there is no material intangible shifted, determining individual values would be permissible. However, another opinion holds that in the case where only non-material intangible assets are shifted, no remuneration is required at all.[494]



Thus, the decisive element is whether an intangible asset or benefit is shifted which is considered material. In order for an intangible or benefit to be material in the sense of the FTA a twofold threshold is applicable.

Firstly, it can be material by way of a quality. In the case of a function shifting this means that the intangible asset or benefit is necessary for the function to be shifted at all.[495] Secondly, a quantitative criterion of "materiality" is set of 25% of the value of all assets and additional benefits that are included in the transfer package.


For the application of this escape clause this means that this quantitative threshold may neither be surpassed by a single intangible asset or miscellaneous benefit, nor by

[490] Principles for the Audit of the Allocation of Income between Related Persons in Cases of Cross-Border Transfers of Business Functions, MN 71.

[491] Borstell, T. & Wehnert, O., Chapter R: Funktions- und Geschäftsverlagerung, in: Vögele, A., Borstell, T. & Engler, G., *Verrechnungspreise: Betriebswirtschaft, Steuerrecht*, München: Beck, (2015), MN. 668.

[492] Funktionsverlagerung Verwaltungsgrundsätze, MN 69, Imhof, M., *Business Restructuring: Eine Betriebswirtschaftliche und Steuerrechtliche Analyse*, Köln: Eul-Verlag, (2012), p. 209.

[493] Zech, T., *Verrechnungspreise und Funktionsverlagerungen 2009: die steuerliche Behandlung von Verrechnungspreisen, insbesondere bei Funktionsverlagerungen, nach der Unternehmensteuerreform 2008*, Baden-Baden: Nomos-Verl.-Ges., (2009), p. 371; Parliamentary Groups of CDU/CSU und SPD, *Entwurf eines Unternehmensteuerreformgesetzes 2008*, Drucksache 16/4841, (27. 03. 2007), p. 84ff.

[494] Zech, T., *Verrechnungspreise und Funktionsverlagerungen 2009: die steuerliche Behandlung von Verrechnungspreisen, insbesondere bei Funktionsverlagerungen, nach der Unternehmensteuerreform 2008*, Baden-Baden: Nomos-Verl.-Ges., (2009), p. 371; Kroppen, H.-K., Rasch, S., Eigelshoven, A., Die Behandlung der Funktionsverlagerung im Rahmen der Unternehmenssteuerreform 2008 und der zu erwartenden Verwaltungsgrundsätze Funktionsverlagerung, *IWB* Fach 3, Gruppe 1, Herne: NWB Verlag, (2007), p. 318.

[495] Imhof, M., *Business Restructuring: Eine Betriebswirtschaftliche und Steuerrechtliche Analyse*, Köln: Eul-Verlag, (2012), p. 210, Zech, T., *Verrechnungspreise und Funktionsverlagerungen 2009: die steuerliche Behandlung von Verrechnungspreisen, insbesondere bei Funktionsverlagerungen, nach der Unternehmensteuerreform 2008*, Baden-Baden: Nomos-Verl.-Ges., (2009), p. 369.

multiple intangible assets or miscellaneous benefits taken together.[496] Thus, in order to demonstrate that the quantitative threshold is not surpassed, it would still be necessary to value the transfer package in order to determine whether the quantitative threshold is surpassed.[497] Still, in the Administrative Principles to the Function Shifting Regulation it is merely stated that an exact determination of the value of the transfer package would not be required.[498] Thus, in order for the escape clause to work, the taxpayer has to first value the transfer package, in order to then determine whether the escape clause is in fact applicable.[499] Even though this might be considered as partially defeating the purpose of an escape clause, if successfully applied it does have a beneficial tax consequence for the taxpayer and it does properly operate for situations where the circumstances allow upfront for a precise estimation.



Another notable question regarding this escape clause is the exact scope of the so called miscellaneous benefits. This term generally translates into profit potential. Yet, this is not the case here, in particular since miscellaneous benefits are at best a part of the profit potential.[500] Without doubt it does not mean tangible or intangible asset either. Since the business opportunity is rather subsumed under the header of intangible asset, this similarly cannot be meant by miscellaneous benefits.[501]

Rather, the conclusion that is drawn by Zech in his analysis of the term "benefit" according to the German income tax act is that it must be these benefits that do not amount to intangible assets yet are beneficial to the exercise of the function.[502] According to Zech, these benefits could be know-how regarding the processes in the manufacturing or distribution, knowledge about the industry, or research projects. However, the named "benefits" could in fact amount to intangibles themselves rather than being categorized as something different under the header of additional benefits. Yet, some of the benefits that could be part of a function being shifted do not (yet) amount to an intangible. These are in particular parts of an assembled workforce. The workforce itself is usually not considered an intangible asset because it is not owned. Other soft-intangibles such as synergies and

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[496] Zech, T., *Verrechnungspreise und Funktionsverlagerungen 2009: die steuerliche Behandlung von Verrechnungspreisen, insbesondere bei Funktionsverlagerungen, nach der Unternehmensteuerreform 2008*, Baden-Baden: Nomos-Verl.-Ges., (2009), p. 372; Borstell, T. & Wehnert, O., Chapter R: Funktions- und Geschäftsverlagerung, in: Vögele, A., Borstell, T. & Engler, G., *Verrechnungspreise: Betriebswirtschaft, Steuerrecht*. München: Beck, (2015), MN 665.

[497] Zech, T., *Verrechnungspreise und Funktionsverlagerungen 2009: die steuerliche Behandlung von Verrechnungspreisen, insbesondere bei Funktionsverlagerungen, nach der Unternehmensteuerreform 2008*, Baden-Baden: Nomos-Verl.-Ges., (2009), p. 368. Reference to: Gesetzebegründung zu Satz 10, BR-Drs. 220/07, p. 145.

[498] Imhof, M., *Business Restructuring: Eine Betriebswirtschaftliche und Steuerrechtliche Analyse*, Köln: Eul-Verlag, (2012), p. 210; Administrative principles to the function shifting regulation, p. 29, MN 71.

[499] Imhof, M., *Business Restructuring: Eine Betriebswirtschaftliche und Steuerrechtliche Analyse*, Köln: Eul-Verlag, (2012), p. 210; abweichend – previously Hofacker, M., in Haase, F., *Außensteuergesetz, Doppelbesteuerungsabkommen*. Heidelberg: C.F. Müller, (2012), §1 FTA MN 303.

[500] Zech, T., *Verrechnungspreise und Funktionsverlagerungen 2009: die steuerliche Behandlung von Verrechnungspreisen, insbesondere bei Funktionsverlagerungen, nach der Unternehmensteuerreform 2008*, Baden-Baden: Nomos-Verl.-Ges., (2009), p. 369.

[501] Ibid.

[502] Ibid.

location savings are similarly not to be considered intangible assets, yet are part of the transfer package that needs to be considered at least for the applicability of this exception.

#### *4.3.5.2 Second Escape Clause*

The second escape clause allows for an individual price determination in the case that there is a mismatch between the individual price determination and the price determined for the transfer package while the individual prices are in fact in conformity with an arm's length price. However, this requires credible demonstration by the taxpayer. This means that, unlike in the first alternative, it is imperative for the taxpayer to value the transfer package in addition to the itemised valuations;[503] only then it is possible to analyse a possible difference of the two regarding the question whether it is justified by the arm's length principle.[504]




Therefore, dealing with a transfer package, which requires the valuation in accordance with the hypothetical arm's length test, a complication is added to this escape clause. It is required that the sum of the individual valuations is within the price range of the transfer package which has been determined by the hypothetical arm's length test. According to the pure wording of the function shifting regulation, this would also be the case for situations where comparables or adjustable comparables are available.[505]

Thus, in order to fulfil the requirement of credibly showing that the sum of the individual prices is within the price range of the hypothetical arm's length test, it is necessary for the taxpayer to go through the described procedure in order to determine

[503] Funktionsverlagerungsverordnung, Art. 2 para. 3: (3) Where it is acceptable under § 1 (3) sent. 10 alternative 2 of the Foreign Transactions Tax Law to determine the transfer price for a transfer of function on the basis of the sum of the transfer prices for the individual assets and benefits involved, both the range of agreement and the value for the transfer package as a whole shall be determined under § 1 (3) sent.7 and 9 of the Foreign Transactions Tax Law. The sum of the individual transfer prices for the assets and benefits, which must be included in their entirety, may only be used if it is within the range of agreement and the taxpayer makes a credible showing that this sum reflects the arm's length principle. (KPMG Translation)

[504] Zech, T., *Verrechnungspreise und Funktionsverlagerungen 2009: die steuerliche Behandlung von Verrechnungspreisen, insbesondere bei Funktionsverlagerungen, nach der Unternehmensteuerreform 2008*, Baden-Baden: Nomos-Verl.-Ges., (2009), p. 372; Imhof, M., *Business Restructuring: Eine Betriebswirtschaftliche und Steuerrechtliche Analyse*, Köln: Eul-Verlag, (2012), p. 210.

[505] Zech, T., *Verrechnungspreise und Funktionsverlagerungen 2009: die steuerliche Behandlung von Verrechnungspreisen, insbesondere bei Funktionsverlagerungen, nach der Unternehmensteuerreform 2008*, Baden-Baden: Nomos-Verl.-Ges., (2009), p. 373.

all four different prices. Therefore, the taxpayer has to go to such lengths to make use of this second escape clause that the objective is hardly achieved.[506] By applying this escape clause it is effectively only possible to show that a value other than the mean value needs to be applied.[507] The usefulness of this escape clause to the tax payer is therefore rather limited.

#### *4.3.5.3 Third Escape Clause*

The third escape clause was only introduced in 2010[508] in order to preclude the often voiced fear of repercussions for Germany as a country with a strong basis in research and development.[509] However, the reasoning for how this exception is applied, is rooted in the argument of the information asymmetry by which the tax authorities perceive themselves as being disadvantaged,[510] only discovering later that substantial self-developed intangible assets have been transferred by the ceding entity.[511] Therefore, the tax authorities deviate from the intent of applying the valuation as transfer package where the ceding entity can clearly define and disclose substantial intangibles and therefore subject it at least to an individual valuation.[512]

Thus, the third escape clause applies in circumstances where at least one material intangible asset is part of the function being shifted, meaning that at least one singular intangible asset reaches the quantitative threshold of more than 25%. Separate intangibles can only be accumulated in order to reach the quantitative threshold if this is customary in the industry.[513] Furthermore, this material intangible asset needs to be identified accurately and the taxpayer has to demonstrate it credibly.



[506] Imhof, M., *Business Restructuring: Eine Betriebswirtschaftliche und Steuerrechtliche Analyse*, Köln: Eul-Verlag, (2012), p. 211.

[507] Ibid.

[508] Gesetz zur Umsetzung steuerlicher EU-Vorgaben vom 08.04.2010 (BGBl I 2010, 386).

[509] Imhof, M., *Business Restructuring: Eine Betriebswirtschaftliche und Steuerrechtliche Analyse*, Köln: Eul-Verlag, (2012), p. 210, Eigelshoven, A. & Nientimp, A., Funktionsverlagerungen und kein Ende — Die Änderungen bei der Besteuerung von Funktionsverlagerungen nach dem EU-Umsetzungsgesetz,: Ubg 3, Düsseldorf: IDW, (2010), S. 233.

[510] Report of the Finance Commitee; Bericht des Finanzausschusses zu dem Gesetzentwurf der Bundesregierung – Drucksachen 17/506, 17/813 - Entwurf eines Gesetzes zur Umsetzung steuerlicher EU-Vorgaben sowie zur Änderung steuerlicher Vorschriften, p. 8: *"Gemäß Rechtslage vor der Unternehmensteuerreform 2008 habe sich der Finanzver- waltung vor allem das Problem gestellt, dass die wesentlichen immateriellen Wirtschaftsgüter, insbesondere die selbstgeschaffenen immateriellen Wirtschaftsgüter, vom Betriebsprüfer nicht erkannt und damit von Finanzbeamten nicht bewertet werden konnten. […] Daher plädiere die Bundesregierung dafür, die Transferpaketbetrachtung in den Fällen aufzugeben, bei denen der Steuerpflichtige bereit und in der Lage ist, die wesentlichen immateriellen Wirtschaftsgüter, die Gegenstand der Funktionsverlagerung sind, konkret und genau zu bezeichnen. Auch damit würden die Schwierigkeiten der Nichterkennung selbstgeschaffener immaterieller Wirtschaftsgüter durch die Finanzverwaltung vermieden werden."* http://dip21.bundestag.de/dip21/btd/17/009/1700939.pdf (06.11.2016).

[511] Ibid.

[512] Ibid.

[513] Administrative principles to the function shifting regulation, p. 31, MN 81.


Since this exception mentions that there has to be at least one material intangible, the application of this escape clause can also be sought for multiple[514] material intangibles.[515] However, the burden of proof that at least one material intangible asset is shifted is therefore incumbent on the taxpayer.[516] Therefore, the applied definition for the intangible asset to be qualified as material is identical to the qualitative and quantitative condition imposed for the first escape clause.[517]



However, if there are in fact multiple intangibles that individually do not meet the quantitative and qualitative thresholds of a material intangible, application of this escape clause is not possible.[518] For the latter situation the first escape clause could be applicable. A combination of these intangibles for this purpose is possible as long this is common practice from a business perspective.[519]

Moreover, the existence of the intangible asset needs to be proven and it should be accurately identified. The proof of existence is considered to be a rather low threshold considering that intangible assets of this sort are very likely protected by intellectual property law or entered in the balance sheet. This makes their existence unquestionable.[520] The degree of identification that needs to be reached in order to conform with the requirement of being accurately identified is sensible. It is limited to a degree necessary for the identification of comparables, adjustable comparables or, if applicable, for the conduct of the hypothetical arm's length test.[521]

The requirement of credibly demonstrating that a material intangible asset forms part of the function shifted does not necessitate a valuation of the transfer package.[522] However, once the applicability of this escape clause has been accorded, it is clear from the Administrative Principles that this does not mean that factors (*Geschäftswertbildende Faktoren*) that contribute to the value of the company and location benefits are not taken into account.[523]The basis given for this is para. 9.94 of the OECD TP Guidelines. However,

[514] Due to the quantitative threshold of more than 25% this is in any case limited to three material intangibles.

[515] Administrative principles to the function shifting regulation, p. 30, MN 77.

[516] Administrative principles to the function shifting regulation, p. 30, MN 74.

[517] Administrative principles to the function shifting regulation, p. 30, MN 75; deviating: Imhof, M., *Business Restructuring: Eine Betriebswirtschaftliche und Steuerrechtliche Analyse*, Köln: Eul-Verlag, (2012), p. 212.

[518] Administrative principles to the function shifting regulation, p. 31, MN 80.

[519] Administrative principles to the function shifting regulation, p. 31, MN 81.

[520] Imhof, M., *Business Restructuring: Eine Betriebswirtschaftliche und Steuerrechtliche Analyse*, Köln: Eul-Verlag, (2012), p. 212.

[521] Administrative principles to the function shifting regulation, p. 30, MN 78.

[522] Administrative principles to the function shifting regulation, p. 30, MN 75.

[523] Administrative principles to the function shifting regulation, p. 30, MN 76.

this provision is limited to an on-going concern and not to any intangible assets in general. Furthermore, the Guidelines mention that the valuation of an aggregated transfer can be necessary. Consequently, this is targeted at the transfer of an on-going concern and not at a mere (material) intangible.

The consequence of this is that next to the individual valuation of the material intangible asset the other factors (*geschäftswertbildende Faktoren*: e.g. *Standortvorteile*) would have to be valued individually.[524] Since this is not possible, the valuation of the transfer package is still required.[525] However, this would be contradictory to the intention of easing the impact of the function shifting regulation for the taxpayer.[526] Since such an extensive, all-encompassing valuation is deemed by the Administrative Principles not to be the common practice, the tendency, despite of the vague formulation in the function shifting regulation, is clear.[527]



But the individual pricing does not stop at this escape clause. Rather, it is believed that it leads to the individual pricing becoming the standard rather than the exception.[528] This is the consequence of introducing an escape clause for function shifts that do not contain material intangibles (1st escape clause) and those with a material intangible (3rd escape clause).[529] Nevertheless, according to the legislator, the introduction of this escape clause is capable of preserving the German tax base.[530]

### 4.3.6 Conclusion – Escape Clauses

The escape clauses show the intention to only target the shift of functions that involve material intangibles. Furthermore, they have to be seen in light of the aim of having transactions such as business restructurings generally valued in aggregation of the transfer package.

Based on this is the first escape clause for situations that do not involve material intangibles. Due to the quantitative criterion of no material intangible being shifted, it is still very likely that the taxpayer first has to value the transfer package before being able to credibly show that he can rely on this escape clause. Similarly plagued by the need of valuing the transfer package before being able to assess the viability of relying on it, is the second escape clause. The meagre result of applying the second escape clause is that a price other than the mean can be chosen within the price range of the hypothetical arm's

[524] Imhof, M., *Business Restructuring: Eine Betriebswirtschaftliche und Steuerrechtliche Analyse*, Köln: Eul-Verlag, (2012), p. 213.

[525] Ibid., p. 213 & 214.

[526] Ibid., p. 214.

[527] Administrative principles to the function shifting regulation, p. 30, MN 76; Imhof, M., *Business Restructuring: Eine Betriebswirtschaftliche und Steuerrechtliche Analyse*, Köln: Eul-Verlag, (2012), p. 215.

[528] Imhof, M., *Business Restructuring: Eine Betriebswirtschaftliche und Steuerrechtliche Analyse*, Köln: Eul-Verlag, (2012), p. 216.

[529] Ibid.

[530] Report of the Finance Commitee; Bericht des Finanzausschusses zu dem Gesetzentwurf der Bundesregierung – Drucksachen 17/506, 17/813 - Entwurf eines Gesetzes zur Umsetzung steuerlicher EU-Vorgaben sowie zur Änderung steuerlicher Vorschriften, p. 8; http://dip21.bundestag.de/dip21/btd/17/009/1700939.pdf (06.11.2016).

length test. Thus, both escape clauses require an aggregated valuation up front, putting a large burden on the taxpayer.

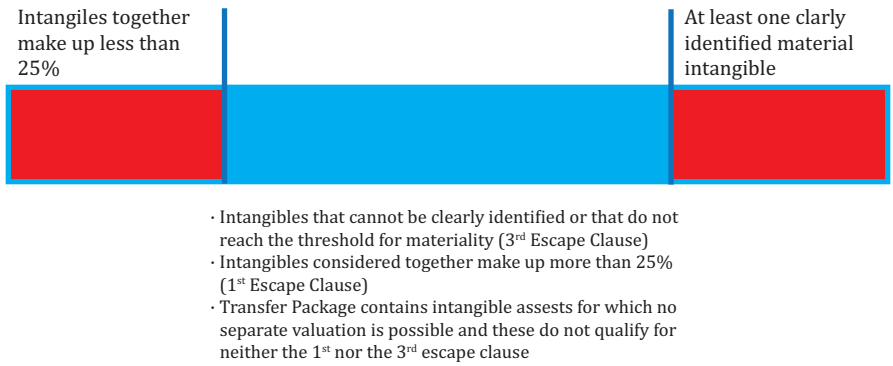
Furthermore, with the first escape clause being applicable to situations where, in line with the intention of the legislator, the risk of eroding the tax base is small and the clause would be rendered superfluous since in this case very likely routine functions are shifted for which comparables generally exist and a hypothetical arm's length test is out of the question., The second escape clause being equally of minimal relevance, one cannot consider these two as true escape clauses. This is why the function shifting regulation was subject to a fair amount of criticism, among others that it would endanger Germany as a place to perform R&D.



Hence, the legislature reacted by introducing the 3rd escape clause. This clause in itself is not necessarily practical in its application, as has been shown in the above, in particular considering that it is usually not a single intangible that is shifted in the course of a business restructuring but a collection of function, assets and risks. This circumstance reduces the chance that the arbitrary threshold of 25% is in fact surpassed by a single intangible.

Therefore, taking into consideration how the three escape clauses interact and how the thresholds are determined, the applicability of an aggregated valuation remains intact where all intangibles never reach 25% and none of the intangibles individually surpasses 25%.

**Applications left for the valuation of the Transfer Package**




Considering the rather limited field of application that is left after the introduction of the 3rd escape clause, it can be concluded that it paved the way for making the valuation at the level of the transfer package an exception rather than the standard.

The application of an escape clause can in some circumstances also yield effects on the application of the price adjustment clause that is applicable for some function shifts, particularly for material intangibles whose valuation is highly uncertain. Price adjustment

clauses as applicable under the FTA and in particular the function shifting regulation are subject of section III.

## 4.4 Interim Conclusion

With respect to business restructuring it needs to be kept in mind that these transactions are usually not primarily effected in order to realize tax savings. The purpose rather lies in exploiting and optimizing existing business models,[531] thereby unlocking synergies and location savings as well as other potentials derived from the new location. However, the aim is to execute business restructurings in a tax efficient way; tax savings are a welcome by-product. For a country like Germany that provides the necessary infrastructure and skilled labour allowing for the creation and continuance of innovative businesses, the approach taken in order to safeguard the tax base that is present in Germany is understandable.



Yet, it is counterproductive if such measures by themselves have the potential of diminishing the attractiveness of Germany as a location for business, by creating uncertainty, inflexibility and double taxation. While the controversy of section 1 para. 1 & 2 FTA, as far as it is relevant to this thesis is limited, para. 3 holds a number of unique approaches which have been analysed. These are related in particular to the "function" terminology, the hypothetical arm's length pricing that is applicable for transfer packages and the three escape clauses.

All of these features put a tremendous burden on the taxpayer, particularly in a situation where an escape clause is potentially applicable but a transfer package valuation is in any case required to prove the fulfilment of one of the escape clauses. While some of the escape clauses can avoid negative implications for companies in Germany, the third one, which is specifically intended to safeguard the interest of companies conducting R&D in Germany, went so far as to reverse the principled valuation in aggregation while adding a certain degree of arbitrariness. The intention to also capture soft-intangibles therefore went largely astray. But the requirement for an individual valuation in order to make use of the escape clauses solves the biggest concern of the legislator – namely that the tax auditor would not be capable of detecting the material intangibles.

However, there are issues that arise independently of the applicability of an escape clause in respect to the taxation caused by the function shifting legislation. Soft-intangibles whose status as a compensable asset in such a transaction is less than certain are still considered for the valuation of a transfer package. The specificities of these soft-intangibles are subject of the next section.

[531] Imhof, M., *Business Restructuring: Eine Betriebswirtschaftliche und Steuerrechtliche Analyse*, Köln: Eul-Verlag, (2012), p. 221.

## Section II: Soft-Intangibles

### 4.5 Intangibles

A function is considered to be shifted if a myriad intangible (assets) are shifted in addition to the function to the receiving entity. Otherwise no function is shifted. This can be derived from the function shifting regulation in Sec. 1 para. 2 where it is stated that:

> *Except as otherwise provided in paragraphs 6 and 7, a transfer of function within the meaning of § 1 (3) sent. 9 of the Foreign Transactions Tax Law occurs where an enterprise (ceding enterprise) conveys assets and other benefits to a different, related enterprise (receiving enterprise) together with the associated opportunities and risks, or provides these for use by the receiving enterprise, so that the receiving enterprise can exercise a function that was previously exercised by the transferring enterprise, thereby restricting the transferring enterprise's exercise of the function in question.*[532]



Therefore, a function is only shifted when an asset to which it can be attached is also shifted. Intangible assets are of particular relevance, because these are the assets that potentially produce the most profit, and at the same time they are the elements which the legislature considered the tax authorities at a disadvantage since they are not necessarily detectable.[533]

### 4.6 Intangibles Considered for the Transfer Package

Within the German function shifting legislation, intangibles are at the centre of attention. In the framework of that legislation, a shift of a function is fictitiously extended to chances and risks but also to assets to which it is attached.[534] Some of these assets can be (soft)-intangibles, which lead to value creation and thus form a large tax base.

In order to not only deter the shift of already existing functions abroad it is necessary to specifically target intangibles, namely those intangibles that cannot yet support a function on its own or that fall short of being considered intangibles. In a scenario where a newly developed intangible is shifted abroad, a legislation only targeting the function itself will not be effective in achieving the legislators' intended goal. The same applies in situations where only clearly defined intangible assets are considered while soft-intangibles are kept out of the picture. Hence, in order to achieve that goal, it is necessary

[532] Translation provided by KPMG Deutsches Außensteuerrecht, German International Taxation, Regulation on the Application of the Arm's Length Principle under § 1 (1) of the Foreign Transactions Tax Law in Instances of CrossBorder Transfers of Function, 1st ed. 2010.

[533] Report of the Finance Commitee; Bericht des Finanzausschusses zu dem Gesetzentwurf der Bundesregierung – Drucksachen 17/506, 17/813 - Entwurf eines Gesetzes zur Umsetzung steuerlicher EU-Vorgaben sowie zur Änderung steuerlicher Vorschriften, p. 8; http://dip21.bundestag.de/dip21/btd/17/009/1700939.pdf (06.11.2016).

[534] Kraft, G., in Kraft, G., *Außensteuergesetz*, München: Beck, (2009), §1 FTA MN 400.

to lay claim to an intangible that will only develop into an intangible and therefore form the basis for a function once shifted abroad. Thereby, possibly existing soft-intangibles need to be taken into account as well. By introducing its function shifting regime, Germany tries to achieve exactly that by capturing a broad range of intangibles that add to and make up the function.

On the one hand there is the presumed transfer package, which catches a multitude of assets that can be associated with the function shifted. On the other hand, future price adjustments are envisaged in case of a shift of *material intangible assets* and *opportunities*.[535]

## 4.7 Intangible Elements of a Function



In view of this piece of legislation the chances and risks that can be attached to the function translate to the profit potential of the function. However, this begs the question whether the chances and risks are not actually intrinsic to the assets that are supposedly making up the function, which is fictitiously shifted with them,[536] while a stand-alone function can be considered to be available for free to anyone.

In the foregoing, an additional consideration for the profit potential that is merely derived from the individual assets could be considered to be too far-reaching and leading to economic double taxation. The general presumption of such an all-embracing taxation being too broad finds further support in the fact that an individual transfer of chances and risks without the actual assets is not possible.[537]

Thus, it matters what these elements are that make up the profit potential, and whether these are intrinsic to the assets that are being shifted. This pertains to business opportunities and (soft)-intangibles which make up the profit potential of a function. These elements are considered individually below.

### 4.7.1 Location Savings

Some of the most important elements that can make a business restructuring a success can be grouped together under location savings.[538] These location savings are taken into account for the valuation of the transfer package, presuming that the shift of function amounts to a function shifting in the sense of Sec. 1 para. 3 FTA.[539] This is the result of including location savings in the transfer package and thus making them part of the virtual bargaining between ceding and receiving entity. Inevitably those location savings that the

[535] Beck, K.E.M., Business Restructuring in Germany, *Tax Notes International*, Falls Church, VA: Tax Analysts, Vol. 51 No. 3, (2008), p. 276.

[536] Kasten, C., *Die Besteuerung grenzüberschreitender Funktionsverlagerungen: Systematik und Handlungsalternativen*, Hamburg: Kovac, (2012), p. 147.

[537] Imhof, M., *Business Restructuring: Eine Betriebswirtschaftliche und Steuerrechtliche Analyse*, Köln: Eul-Verlag, (2012), p. 181.

[538] Described as "being closer to the markets" but can encompass also factors such as a cheap, more readily available labour force, better supply of raw materials, etc. - IFA Report, Germany, Volume 99A, p. 338.

[539] Since location savings can also be realised by having a certain function fulfilled by a contract manufacturer, hence a low risk entity, which merely gets a license to the intangibles that it barely needs to produce the agreed product, it has originally been disputed whether this in fact amounts to an event in the sense of Sec. 1 para. 3 FTA.

receiving entity can rely on increase the price of the transfer package which is not based on the current situation but merely on an assumption of location savings that are to be obtained by exercising the function in the receiving entity.[540]

As large as potential location savings might appear at the outset of a planned restructuring, there are also location dissavings. Whether the business restructuring results in overall net location savings is also largely dependent on the market situation in which either the product or the receiving entity are going to operate. This also affects the answer to the question whether location savings accrue to the ceding or rather to the receiving entity. While it is dependent on several factors to which the advantages accrue, the solution found by the German legislator is rather a one-way street.



The asking price for the transfer package in this process is by default always higher than the bidding price.[541] Hence, the role that negative factors present in the country of the receiving entity can have is limited. Thus, there is an inherent presumption that the overall effects of the restructuring are going to be positive. While this has been considered in section 4.3.4, another issue arises in regard of location savings, viz. the allocation of the presumptive future advantage that is derived from location savings.

By including location savings in the price determination of the transfer package, those advantages are considered before they accrue, but after the business restructuring has been completed.[542] This would also be compliant with the OECD TP Guidelines, although the guidelines mainly relate to the transfer of a routine activities.[543] The valuation of a transfer package in the hands of the receiving entity leads to a different outcome.

The result from considering the location savings for the German tax base by relying on the midpoint is somewhat controversial. Case law only exists for the relocation of a routine function that predates the introduction of the function shifting legislation of Sec. 1 para. 3 S. 9 FTA. However, in that particular case it has been decided that the benefits derived of the location savings may be divided equally between Germany and the country where the manufacturing entity actually realized these benefits.[544] Furthermore, it is worth pointing out that the full allocation of location savings to the ceding entity, in Germany, has been denied for not being in conformity with the arm's length principle.[545] This in fact concerns all benefits that have an effect on the profit potential shifted. This becomes particularly apparent with location savings, which affect the value of a transfer package tremendously due to tax benefits, infrastructure, market and many other features

[540] Kasten, C., *Die Besteuerung grenzüberschreitender Funktionsverlagerungen: Systematik und Handlungsalternativen*, Hamburg: Kovac, (2012), p. 158.

[541] Kasten, C., *Die Besteuerung grenzüberschreitender Funktionsverlagerungen: Systematik und Handlungsalternativen*, Hamburg: Kovac, (2012), p. 182.

[542] Ibid., p. 158.

[543] Ibid.

[544] FG Münster v. 16.3.2006 – 8 K 2348/02 E, IStR 2006, 794.

[545] Ibid.

that affect the maximum price. Presuming that these are in fact net-location savings, the German treasury always participates, yet not in full.[546]

Applying a clear cut solution such as splitting the benefits derived of the location equally or relying on the midpoint is questionable from a number of perspectives.[547] Given the uncertainties of the realization of location savings, the timing of taxing these is critical. As envisaged by the function shifting regulation, such a presumed location saving would already be accounted for in the valuation of the transfer package despite its realization. Therefore, the additional value is only created after the transfer and on basis of external factors (which location savings are). Due to this circumstance it is only logical and appropriate that any benefits that are derived from these location savings are allocated to the state that provides them.[548] This perspective would certainly be supported by the tax authorities of the country providing substantial direct benefits such as R&D tax incentives.[549] The arm's length principle, however, can yield a different result, since there is no direct correlation between the source of location savings and the price agreed by independent parties that furthermore consider prices and market for products and services originating from the function transferred. A clear split in half of the location savings between the states involved is furthermore not in line with the arm's length principle, since the differences resulting from location savings are reflected in the price range which can e.g. be established within the framework of the hypothetical arm's length test.[550] Prices that are within such a price range are theoretically prices that unrelated entities could charge. This is why any price, and not just the median, needs to be considered as conforming with the arm's length principle.



Therefore, a broad range of location savings are considered in the transfer package since it matters how they affect the value of the function in the hands of the receiving entity. This includes, firstly, and obviously, the availability of a cheaper and maybe even better qualified workforce. Furthermore, a broad range of features that is specific to the new market where the function is shifted to, is also taken into account. These include features such as purchasing power, competition, infrastructure and the like that are intrinsically connected to the local market. However, this could be so far ranging as to include location savings that relate to the sourcing, e.g. easier access to the (raw) materials for manufacturing or, similarly, distribution through e.g. easier access to the local market.

Additionally, location savings can take the shape of tax savings or subsidies, since the profit potential of the function shifted is measured according to the possible after-tax

[546] Schreiber, U., *Besteuerung der Unternehmen – Eine Einführung in Steuerrecht und Steuerwirkung*, Wiesbaden: Springer Gabler, (2012), 3rd. Ed., pp. 483 & 484.

[547] Baumhoff, H. & Greinert, M., "Aufteilung von Standortvorteilen bei der Verrechnungspreisermittlung gegenüber Lohnfertigern – Anmerkungen zum Urteil des FG Münster vom 16. 3. 2006, IStR, München: Beck Verlag, (2006) Nr. 22, p. 791; Kasten, C., *Die Besteuerung grenzüberschreitender Funktionsverlagerungen: Systematik und Handlungsalternativen*, Hamburg: Kovac, (2012), p. 158ff.

[548] Baumhoff, H. & Greinert, M., "Aufteilung von Standortvorteilen bei der Verrechnungspreisermittlung gegenüber Lohnfertigern – Anmerkungen zum Urteil des FG Münster vom 16. 3. 2006, IStR, München: Beck Verlag, (2006) Nr. 22, p. 791.

[549] Ibid., p. 791 & 792.

[550] Ibid., p. 792.

return.[551] Thus specific tax incentives such as those for Research and Development have an effect on the valuation of the transfer package, regardless of whether they are designed to have an impact during the stage of actual research and development or later on when being sold or employed in a marketable product. The same applies to direct subsidies that are granted for the conduct of research and development. Yet it is not only those special features of a tax system that need to be taken into consideration. The net-profit from a function is also positively influenced by an overall lower income tax burden.[552] Effects for the ultimate beneficial shareholder can be neglected as they are presumed to remain unchanged.[553] Furthermore, other non-tax incentives such as incentives granted by the receiving government or the market environment itself could be considered to be location savings.[554]



### 4.7.2 Synergies/Integration Benefits

On top of location savings and tax incentives, the transfer package also expands to include something intrinsic to related parties and thereby MNEs – synergies and the benefits of integration.[555] The arm's length standard itself cannot, as a matter of principle, take account of synergies as it relies on how unrelated parties would behave and therefore excludes any consideration of synergistic benefits.[556] Furthermore, synergistic benefits are difficult to qualify since they are not individually transferable and thus generally do not qualify as an intangible asset in their own right. Moreover, the attribution of the synergy effects between related parties is difficult as no criteria exist to determine which party is eligible to profit from the location saving.[557] [558]

The function shifting regulation has nevertheless attempted to find a pragmatic solution, controversial as it may be, by including it in the transfer package valuation. Intrinsic problems such as synergies only existing between related entities have been rejected by reasoning that synergies would nevertheless affect the behaviour of third parties and therefore taking them it into consideration is justifiable.[559] Yet, in none of the legal instruments that establish the function shifting regulation has it been explained more

[551] Sec 1 para. 4 FVerlV; Vögele, A. & Raab, J., Chapter O: Nationales Recht, in: Vögele, A., Borstell, T. & Engler, G., *Verrechnungspreise: Betriebswirtschaft, Steuerrecht*. München: Beck, (2015), MN 239.

[552] Kasten, C., *Die Besteuerung grenzüberschreitender Funktionsverlagerungen: Systematik und Handlungsalternativen*, Hamburg: Kovac, (2012), p. 153 & 158.

[553] Admin. Principles Funktionsverlagerungsverordnung, p. 16, para. 34; Differently for partnerships – These are given the option to calculate it as if the entities that took part in the function shifting were corporations. Principles Funktionsverlagerungsverordnung p. 17. MN 35.

[554] Kasten, C., *Die Besteuerung grenzüberschreitender Funktionsverlagerungen: Systematik und Handlungsalternativen*, Hamburg: Kovac, (2012), p. 158.

[555] Ibid., p. 155.

[556] Ibid., p. 156.

[557] Ibid.

[558] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010*, Paris: OECD, (2010), para. 1.9; Kasten, C., *Die Besteuerung grenzüberschreitender Funktionsverlagerungen: Systematik und Handlungsalternativen*, Hamburg: Kovac, (2012), p. 156.

[559] Ibid., p. 155.

precisely how these synergy effects need to be taken into account. This has, nonetheless, been achieved in the Administrative Principles to the Function Shifting regulation which state that the only thing that is relevant is which party can effectively make use of them in terms of the imaginary bargaining leading up to the hypothetical arm's length price.[560]
The benefit from the synergy needs to be apprehensible and realisable by the party taking over the function. Considering that this discussion is about the application of the arm's length principle it needs to be a synergy benefit that can be realized by a third party regardless of the transaction undertaken.[561] However, in such an imaginary bargaining process it is also entirely possible that there are other options open to the prudent business manager which will minimize the influence of synergistic benefits.



### 4.7.3 Alternatives

Alternatives that ought to be considered by the prudent business manager in his decision making are not part of the soft-intangibles considered. Yet they are an integral part of the determination of the hypothetical arm's length price. Particularly, a possible synergistic benefit in the hands of the receiving entity can be influenced by it.

The virtual bargaining that is conducted in order to arrive at an hypothetical arm's length price is, however, not limited to that particular transaction. In line with the standard of the double sound prudent business manager feasible alternatives need to be considered.[562]

In case that there are alternatives that are more suitable to one of the parties or to the contrary only those that are worse, these alternatives may have the effect of widening or narrowing the price range. This effect needs to be considered while determining the arm's length price between the ceding and the receiving entity.

When applying the German standard of the *doppelt gewissenhafter Geschäftsleiter*[563] to the determination of alternatives, it is first of all necessary to differentiate between ceding and receiving entity. Secondly, it is also important to check if any functions transferred are loss making or profitable functions. However, the alternatives to be considered are limited to actions that are within the framework of the arm's length principle.[564]

This means for the ceding entity that it first of all has to consider whether it must shift a function abroad to a related entity. Naturally, there is the option to continue performing this function, in this case in Germany.[565] The difference between shifting that function abroad and continuing to exercise it results in the minimum price of the price range.[566]

[560] Admin. Principles Funktionsverlagerungsverordnung, p. 34, para. 93.

[561] Kasten, C., *Die Besteuerung grenzüberschreitender Funktionsverlagerungen: Systematik und Handlungsalternativen*, Hamburg: Kovac, (2012), p. 158.

[562] Ibid., p. 154.

[563] Literally, this translates to "double sound prudent business manager", which implies a very cautious business manager.

[564] Bodenmüller R. & Hülster, T., Handlungsalternativen bei der Bewertung von Transferpaketen – Besonderheiten bei erzwungenen Funktionsverlagerungen und bei der Verlagerung von Verlustfunktionen, *IStR*, München: Beck, (2010), p. 652.

[565] Ibid.

[566] Ibid.

Better options as well as circumstances that strengthen the bargaining position of the ceding entity increase the minimum price.

For the receiving entity, there are in principle three options to be considered in place of taking over the function.[567] While it can decide to continue not to exercise the function in question, it can also decide to develop that function together with all the necessary tangibles and intangibles by itself.[568] Furthermore, the receiving entity could decide to acquire it from a third party instead.[569] On this side of the virtual bargaining, a better alternative to taking over the function leads to a decrease of the maximum price.

Having determined the maximum and minimum price then leads to the possible establishment of a price within that range. However, there are situations where such a range might not be workable. This is in particular the case where the function is shifted not merely for reasons of optimization. It would also be the case if it is no longer profitable to continue fulfilling a function in the jurisdiction of the ceding entity (which is a resident of Germany) while due to locations savings or different market circumstances the performance of the functions could still be profitable. A similar situation arises in cases in which a customer demands the shift of a function to a different location or where due to impediments in transportation shifting the function becomes necessary. Shifting of functions, for factual or legal reasons stated above are considered to be in accordance with the Administrative Principles to the Function Shifting Regulation.[570] For this situation Art. 7(2) of the Functions Shifting Regulation provides:

> *Where for legal, factual, or economic reasons the transferring enterprise is no longer able to exercise the function itself using its own resources, its minimum price is equal to the liquidation value.*[571]

The prescribed minimum price is the liquidation value, which consists of the net proceeds of all assets minus debt and liquidation costs.[572]

A more specific regulation has been introduced for the case where the fulfilment of a function produces persistent losses. For this subcase of a "forced" shift of a function abroad, Art. 7(3) states that:

> *Where an enterprise transfers a function from which it can anticipate sustained losses, the negotiating range for the transferring enterprise is limited by the anticipated losses or by any closing costs that arise, whichever is lower in absolute*

[567] Ibid.

[568] Ibid.

[569] Ibid.

[570] Principles for the Audit of the Allocation of Income between Related Persons in Cases of Cross-Border Transfers of Business Functions, MN 120.

[571] KPMG/Lenz, M. (ed.), *Deutsches Außensteuerrecht, German International Taxation*, München: Beck (2010), p. 156 ff.

[572] Kasten, C., *Die Besteuerung grenzüberschreitender Funktionsverlagerungen: Systematik und Handlungsalternativen*, Hamburg: Kovac, (2012), p. 176.

> *value. In such cases it may, for loss limitation reasons, be consistent with the conduct of a reasonable and conscientious business manager to agree on consideration for the transfer of function that only partially covers the closing costs that arise or to make a compensatory payment to the receiving enterprise in return for accepting transfer of the source of losses.*[573]

A multitude of reasons can be found for this situation where a MNE prefers to continue fulfilling a loss-making function but rather prefers to do so outside Germany. A restructuring in this sense enables the group as a whole to still carry out that function while making use of a number of possibilities to alter the value chain. In turn, this can lead to a loss bearing function becoming a profitable function. In any case, the continuation of the function within Germany would not be feasible from an economic perspective.



The particular alternatives available to the ceding entity can be extended in the case of a loss-making function. Thus, there is not just the choice between shifting and continuing to fulfil the function but also the third choice of closing the part that is performing the function.[574] While shifting the function entails more than just the cost related to ceasing the existing function in Germany, the prescribed minimum price of the function for the ceasing entity are the costs of closing or the expected losses from the continuation. The lower absolute value is decisive.[575] The determination of alternatives is not limited to the perspective of the ceding party receiving a compensation for the function from the receiving entity. It also leaves room for payments to the receiving entity for taking over that function, as long as these, added to the closing costs, do not surmount the projected losses.[576]

Rightfully, this particular provision has been criticized for not making any reference to the liquidation value that could also realistically serve as minimum price.[577] By contrast, Sec. 7 para. 2 of the function shifting regulation to which this is a lex specialis since it also deals with the necessity of shifting a function for economic reasons, makes exactly that reference.[578] Furthermore, it can be debated whether the costs of closing the operation performing the function should be considered for establishing the minimum price. It can be argued that the costs of closing would in any case arise in the case of a function shifting

[573] KPMG/Lenz, M. (ed.), *Deutsches Außensteuerrecht, German International Taxation*, München: Beck (2010), p. 156 ff.

[574] Bodenmüller R. & Hülster, T., Handlungsalternativen bei der Bewertung von Transferpaketen – Besonderheiten bei erzwungenen Funktionsverlagerungen und bei der Verlagerung von Verlustfunktionen, *IStR*, München: Beck, (2010), p. 652.

[575] Sec. 7. Para. 3 Function Shifting Regulation.

[576] Kasten, C., *Die Besteuerung grenzüberschreitender Funktionsverlagerungen: Systematik und Handlungsalternativen*, Hamburg: Kovac, (2012), p. 178.

[577] Ibid., p. 180.

[578] Ibid., p. 180.

and are therefore to be disregarded.[579] Another point of view is that these costs are in fact to be considered, thus making it possible to substantially change the minimum price.[580] The approach to be embraced in this case is rather to subsume this particular scenario of a function shifting under Sec. 7.2. of the function shifting regulation that deals with function shifts that are driven by legal factual and economic reasons. Interestingly enough, this provision makes reference to the liquidation value of the function, which should indeed be considered for finding the minimum price.

### 4.7.4 Miscellaneous Benefits – Workforce in Place



Another category that is part of the transfer package are so called miscellaneous benefits. Basis for this is Art. 1 Abs. 2 of the function shifting regulation. However, what this term includes can only be deduced from the Administrative Principles to Function Shifting Regulation. The explanation provided there is based on para. 9.93 of the OECD TP Guidelines, which states that all valuable elements should be remunerated.[581] Therefore, an assembled, experienced workforce and reputation as well as certain sequences of operation are collected under this heading. This means that also those elements are included that do not yet qualify as an intangible asset, for instance, an yet-to-be-realised business opportunity.

In principle, a workforce in place does not constitute a separate intangible. Still, it can be of relevance where a transaction requires a valuation under the hypothetical arm's length test or where an employee by him- or herself embodies a function.

It could happen that together with a distribution right or any other asset – in particular machinery – related workforce is shifted.[582] Taking the qualities attributed to a function by the administrative principles to the function shifting regulation into consideration, a central element is the workforce that is shifted together with the business unit.[583]

Therefore, a situation in relation to a secondment could arise that is considered to be a shift of a function – regardless of whether an actual business restructuring and therefore function shifting has been intended.[584] While the common secondment is expressly excluded by the Administrative Principles, the combination of a secondment and the shift of an intangible or tangible asset with the employee is not.[585] Thus, if the

[579] Ibid., p. 179.

[580] Bodenmüller R. & Hülster, T., Handlungsalternativen bei der Bewertung von Transferpaketen – Besonderheiten bei erzwungenen Funktionsverlagerungen und bei der Verlagerung von Verlustfunktionen, *IStR*, München: Beck, (2010), p. 652.

[581] Principles for the Audit of the Allocation of Income between Related Persons in Cases of Cross-Border Transfers of Business Functions, MN 29.

[582] Kasten, C., *Die Besteuerung grenzüberschreitender Funktionsverlagerungen: Systematik und Handlungsalternativen*, Hamburg: Kovac, (2012), p. 66 & 67.

[583] Principles for the Audit of the Allocation of Income between Related Persons in Cases of Cross-Border Transfers of Business Functions, MN 14.

[584] Kasten, C., *Die Besteuerung grenzüberschreitender Funktionsverlagerungen: Systematik und Handlungsalternativen*, Hamburg: Kovac, (2012), p. 134.

[585] Principles for the Audit of the Allocation of Income between Related Persons in Cases of Cross-Border Transfers of Business Functions, MN 54.

conditions previously elaborated on are fulfilled, a function could be considered shifted if only two things are shifted: the employee and a tangible or intangible asset.[586] More precisely: with the seconded employee know-how and therefore an intangible could have been transferred, thus, potentially fulfilling the requirement of transferring a function together with an intangible.[587]

Another situation that could lead to a function being shifted is when it can be presumed that know-how is transferred together with the seconded employee who fulfils a range of tasks that amount to a function for the receiving entity. Should the secondment then result in the performance of the function for the receiving entity, it could indeed be considered a case of function shifting.[588] In both situations the fact that control over an employee is limited (i.e., he may leave at any given moment), and no third party would be willing to pay a consideration for the employee's abilities to its former employer over and above the consideration paid for his services.[589] This may not be common in traditional employer-employee relationships and outside the realm of professional sports. This argument is a rather weak one since it has also not been uncommon for temporary work agencies demanding a fee from their client to take over and formally employ a previously leased labourer.[590] Whether this is reminiscent of "slavery", as one author put it, is a different discussion.[591]

However, it is also possible to take the stance that an employee may not have all the know-how to surpass the threshold for considering it an asset, nor have such a complete portfolio of tasks that it amounts to an organic part of the company.[592] It is argued that an unrelated party would not be willing to pay a transfer fee in order to hire that employee.[593]

Even though the described situation could occur without an actual business restructuring and therefore the function shifting being intended, the risk that a secondment comes in the ambit of the German function shifting legislation is small but immanent.



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[586] Kasten, C., *Die Besteuerung grenzüberschreitender Funktionsverlagerungen: Systematik und Handlungsalternativen*, Hamburg: Kovac, (2012), p. 67.

[587] Kasten, C., *Die Besteuerung grenzüberschreitender Funktionsverlagerungen: Systematik und Handlungsalternativen*, Hamburg: Kovac, (2012), p. 134ff.

[588] See the discussion of the example of Endres and Oestreicher where the bookkeeping is shifted from Germany to the Netherlands and employees are seconded – Endres, D. & Oestreicher A., Die Besteuerung von Funktionsverlagerungen in zehn Fällen - Zugleich eine Stellungnahme zum Entwurf der Verwaltungsgrundsätze-Funktionsverlagerung; *IStR-Beihefter*, 2009, Nr. 20, p. 5ff.

[589] Beck, K.E.M., Business Restructuring in Germany, *Tax Notes International*, Falls Church, VA: Tax Analysts, Vol. 51 No. 3, (2008), p. 276.

[590] Küpperfahrenberg, J. & Lagardère, P., Vermittlungsprovisionen für Zeitarbeitsfirmen – „Jobwechsel schwer gemacht?", *Betriebs-Berater*, Frankfurt am Main: Deutscher Fachverlag, p. 2952.

[591] Beck, K.E.M., Business Restructuring in Germany, *Tax Notes International*, Falls Church, VA: Tax Analysts, Vol. 51 No. 3, (2008), p. 276; Frotscher, G., Handout Funktionsverlagerung, *Berliner Steuergespräche.* (19.11.2007), p. 7:
*"Kein Arbeitgeber wird für das Wissen, die Erfahrungen und das Können der Arbeitnehmer an den bisherigen Arbeitgeber einen „Kaufpreis" zahlen. Es fragt sich, was für einen „Drittvergleichsfall" den Erlassverfasser vorgeschwebt hat – Sklavenhandel?";* http://www.berlinersteuergespraeche.de/25BSG_Frotscher_Handout.pdf (06.11.2016).

[592] Franke, R. & Kügler, K., Steuerliche Behandlung Grenzüberschreitender Funktionsverlagerungen, IFSt-Schrift Nr. 463, Bonn: Institut „Finanzen und Steuern" e.V., 2010, p. 22 & 23.

[593] Ibid.

## 4.8 Interim Conclusion

In the foregoing the treatment of location savings, synergistic benefits and miscellaneous benefits, representing something of value which, although not yet an asset , unrelated parties would be willing to pay remuneration for , which in the situation of Germany represents a workforce in place, has been analysed. Furthermore, in light of the specific requirements for determining the hypothetical arm's length test, the alternatives that a prudent business manager has at his disposal and their influences have been examined.

By including synergies and location savings into the transfer package and subsequently arriving at the result of splitting the benefit gained from it? them? evenly between ceding and receiving entity can be seen as a pragmatic solution. Yet, it neither conforms with the arm's length principle nor with the actual creation of the benefits derived. While these two types of soft-intangibles are conceptually difficult territory for the arm's length principle, the solution presented by the German legislator is particularly problematic in case of transfers to developing countries. This is due to the way location savings and synergistic benefits whose realization and timing are highly uncertain are accounted for in the hypothetical arm's length price, resulting in a skewed price which does not account for the actual effects in the hands of the receiving entity.



The topic of a workforce in place needs to be considered in a more nuanced way since it involves not only the question how it is accounted for within a transfer package, but also because it triggers the function shifting regulations autonomously e.g. as part of a secondment. By including it in the *miscellaneous benefits* it is clear that a workforce in place does not amount to an intangible by itself yet represents something for which third parties are rightfully willing to pay as it can indeed be an advantage for exercising the received function. Yet, valuing a workforce in place is still met with an outcry because of it being reminiscent of *slavery*. There may be scenarios in which a (seconded) employee exercises such a breadth of tasks combined with know-how that one could conclude that it is actually a function being shifted. While the possibility has been specifically excluded for secondments, scenarios where a transfer of an employee to the receiving entity trigger the function shifting legislation subsist.

All in all, the treatment proposed for soft-intangibles presents a pragmatic solution for dealing with the core problem of allocation taxing rights on account of synergies and location savings where the arm's length principle leaves a partial void. It appears as if this solution lacks the objective of conforming to the arm's length principle as well as to the principle of value creation. Regarding a workforce in place, taking it into account for the valuation is correct as it can indeed present both an advantage and a disadvantage. The possibility of a single employee triggering the function shifting legislation should be clearly excluded. To what extent these solutions conform to the OECD TP Guidelines and how they compare to the US treatment is the subject of Chapter 6. There, the solutions are also evaluated regarding their conformity with either the arm's length principle or to the principle of value creation.

## Section III: Posterior Valuation

### 4.9 Price Adjustment Clause

The German function shifting legislation is aimed in particular at the transfer abroad of intangibles. One of the presumed qualities of an intangible asset is the high uncertainty about its future valuation.[594] In order to prevent unforeseeable, extreme changes in valuation after a transaction has been concluded, it is possible to rely on a price adjustment clause.[595] Instead of using such a clause, uncertainties about the future development of the value of the intangible can also be represented in the price that the parties agreed upon. It is the latter method that businesses mainly rely on today.[596]

Regardless of business reality, the function shifting regulation introduced the previously frowned upon price adjustment clauses with sentence 11 and 12 of Art 1. (3) of the FTA. This functions primarily as an anti-abuse provision in order to avoid that a too low price is agreed upon in situations where the return can be much higher than previously thought.[597]



> *[11]Where, in situations covered by sentences 5 and 9, a business relationship involves material intangible assets and benefits and the subsequent actual profit performance diverges substantially from the profit performance on which the transfer price determination was based, a rebuttable presumption arises that uncertainties regarding the price agreement existed at the time of conclusion of the business transaction and that independent third parties would have agreed on an appropriate adjustment clause. [12]If no such clause was agreed and a substantial difference of the sort described in sentence 11 occurs in the first ten years after conclusion of the business transaction, taxation in the fiscal year following that in which the difference arose shall, for purposes of an adjustment indicated by reason thereof under paragraph 1 sent. 1, be based on one-time application of an appropriate adjustment amount to the original transfer price.*[598]

Thus, the presumption of a price adjustment clause is not a general one but is coupled with a number of conditions. These conditions are listed in sentence 11 while sentence 12 determines the consequences.

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[594] Kraft, G., in Kraft, G., *Außensteuergesetz*, München: Beck, (2009), §1 FTA MN 452.

[595] Kasten, C., *Die Besteuerung grenzüberschreitender Funktionsverlagerungen: Systematik und Handlungsalternativen*, Hamburg: Kovac, (2012), p. 186.

[596] Beck, K.E.M., Business Restructuring in Germany, *Tax Notes International*, Falls Church, VA: Tax Analysts, Vol. 51 No. 3, (2008), p. 276.

[597] Zech, T., *Verrechnungspreise und Funktionsverlagerungen 2009: die steuerliche Behandlung von Verrechnungspreisen, insbesondere bei Funktionsverlagerungen, nach der Unternehmensteuerreform 2008*, Baden-Baden: Nomos-Verl.-Ges., (2009), p. 81.

[598] KPMG/Lenz, M. (ed.), *Deutsches Außensteuerrecht, German International Taxation*, München: Beck (2010), p. 156 ff.

As a first step, the following cumulative requirements need to be analysed whose presence leads to a rebuttable presumption that uncertainties regarding the valuation existed:[599]

1. The price agreed upon at the time of the transaction was the result of a hypothetical arm's length comparison;
2. The underlying business relationship involved the transfer (and not the mere cession) of a material intangible assets or benefits;
3. Substantial discrepancy of the actual and presumed profit performance at the time of the realisation of the business relationship.



The condition of a transaction having been valued by way of a hypothetical arm's length test is clear. Applying the 2nd requirement to a business relationship that involves a *material* intangible is similarly clear since the identical definition of *material* as employed in the 3rd escape clause applies.[600] However, what requires further treatment is the *substantial discrepancy* in the profit performance of the transfer package shifted. A substantial discrepancy of the price is present as soon as the price of the function deviates from the originally agreed price range.[601]

Consequently, if these three cumulative conditions are fulfilled, the next presumption is prescribed by this provision, namely that third parties would have agreed in such a situation to include an appropriate price adjustment clause.

However, this is a rebuttable presumption. Taxpayers can rebut such a presumption on essentially two grounds. On the one hand, the taxpayer could demonstrate that the substantial difference in profit performance did not arise as a result of uncertainties inherent in the transaction at the time of conclusion.[602] The foundation of such a claim could be previously experienced price developments which make the inclusion of a price adjustment clause superfluous.[603] On the other hand, the presumption is refuted in case it can be demonstrated that independent third parties would not have agreed on a price adjustment clause.[604]

Yet it is unlikely, considering the presumption need to be rebutted on the grounds stated above.[605] The basis for the argumentation could not only be made based on one's own experience but would most likely involve the completion as well. Even if these

[599] Peter, M., Spohn, P. & Hogg, R., Preisanpassungsklauseln bei Funktionsverlagerungen nach deutschem sowie US-amerikanischem Steuerrecht, *IStR*, München: Beck, (2008), p. 865.

[600] Sec. 1 para. 5 FVerlV.

[601] Sec. 10 s. FVerlV. Principles for the Audit of the Allocation of Income between Related Persons in Cases of Cross-Border Transfers of Business Functions, MN 138.

[602] Kasten, C., *Die Besteuerung grenzüberschreitender Funktionsverlagerungen: Systematik und Handlungsalternativen*, Hamburg: Kovac, (2012), p. 187.

[603] Principles for the Audit of the Allocation of Income between Related Persons in Cases of Cross-Border Transfers of Business Functions, MN 141.

[604] Kasten, C., *Die Besteuerung grenzüberschreitender Funktionsverlagerungen: Systematik und Handlungsalternativen*, Hamburg: Kovac, (2012), p. 187.

[605] Hofacker, M., in Haase, F., *Außensteuergesetz, Doppelbesteuerungsabkommen*. Heidelberg: C.F. Müller, (2012), §1 FTA MN 348.

other transactions that are undertaken among participants of the same industry were comparable, it is questionable whether this information is accessible.[606]

## 4.10 Consequences of Triggering the Implied Price Adjustment Clause

In case an appropriate price adjustment clause, a term that has not been further defined, neither by the legislator nor by the subsequent Administrative Principles, is absent, sentence 12 envisages the following actions:[607]

1. A one-time adjustment that is based on the originally agreed price needs to be made;
2. The one-time adjustment needs to be in accordance with Sec. 1(1) of the FTA;
3. The adjustment needs to be effected in the fiscal year after the substantial difference arose, but not later than 10 years after the transaction has been concluded.



Thus, the adjustment is limited by these three different factors. This translates into a price adjustment that reconsiders the maximum price of the price range, while the minimum price of the transferor (*verlagerndes Unternehmen*) remains in place for the purpose of the adjustment. A change in that price is deemed not to be possible.[608] Only the maximum price of the transferee is reconsidered. Similarly, Art. 10 sentence 3 of the function shifting regulation also allows for an adjustment should the new maximum price lie below the originally determined one. Thus, the price adjustment clause works both ways.

The adjustment takes effect the year after the discrepancy arose. With a maximum timeframe of ten years where a single adjustment is allowed to be made, uncertainty about the exact fiscal consequences of the transfer of the function persists for up to eleven years.

Such an uncertainty is not desirable in practice and, as mentioned above, deviates from the agreements that are usually concluded in business, generally not including price adjustment clauses.[609] Instead uncertainty is accounted for in the lump sum price agreed upon. Even if there is a logical case to be made for a price adjustment clause, it is generally concluded for a timespan of one to three years.[610]

[606] Ibid.

[607] Peter, M., Spohn, P. & Hogg, R., Preisanpassungsklauseln bei Funktionsverlagerungen nach deutschem sowie US-amerikanischem Steuerrecht, *IStR*, München: Beck, (2008), p. 865.

[608] Principles for the Audit of the Allocation of Income between Related Persons in Cases of Cross-Border Transfers of Business Functions, MN 139.

[609] Piehler, M., *Kontraktgestaltung bei M&A Transaktionen – Bedingte Zahlungsstrukturen zur Verbesserung des Einigungsbereiches*, Wiesbaden: DUV Gabler Edition Wissenschaft, 2007, p. 203.

[610] Kasten, C., *Die Besteuerung grenzüberschreitender Funktionsverlagerungen: Systematik und Handlungsalternativen*, Hamburg: Kovac, (2012), p. 189; Peter, M., Spohn, P. & Hogg, R., Preisanpassungsklauseln bei Funktionsverlagerungen nach deutschem sowie US-amerikanischem Steuerrecht, *IStR*, München: Beck, (2008), p. 865.

### 5.4.11 Overall Conclusion

Having considered the German implementation of the arm's length principle and the function shifting regulation in so far as it is relevant to the treatment of (soft)-intangibles and the posterior valuation, the following can be pointed out.

Regarding the general implementation of the arm's length principle it stands out that a threshold qualifying a related party has been set. Further specificities are mainly attributable to the function shifting regulation, which is of course based on sec. 1 FTA.

This tool, specifically aimed at business restructurings, further introduced aggregation. However, as has been demonstrated, the aggregation as implemented in the transfer package became rather an exception due to the 3rd escape clause that was added. Yet, in the situations where a function is shifted and a valuation of the transfer package takes place, the implications for the probed soft-intangibles are far-reaching. Due to the uniqueness of a transfer package a valuation of [?] the application of the hypothetical arm's length method is prescribed, which subjects so far unrealized but anticipated location savings and synergies to a partial taxation in Germany. In fact, half of the advantage is taxed in Germany. It has been seen that this allocation and anticipation of highly uncertain advantages is problematic, not only from an arm's length perspective but also because of the difficulty in determining which jurisdiction provided the advantages and which one should be allowed to tax the latter. The treatment of a workforce in place is, however, characterized by a clear statement that it is not an intangible. At the same time, it is acknowledged that a workforce in place can add value to the transfer package and can therefore be subjected to taxation. However, uncertainties in relation to a workforce in place remain which are inherent to this particular soft-intangible.

According to the function shifting legislation, uncertainties are hedged by relying on a price adjustment clause. Under certain conditions this adjustment clause is presumed to have been included by taxpayers. This allows for a one-time adjustment within ten years, only to be imitated by the tax authorities. Even though this presumption should only be made in a limited number of situations, it leads to uncertainties and one-sided adjustments.

Subsequently the actual inspiration of several parts of the function shifting regulation are analysed under Secs. 367 & 482 which have introduced the posterior adjustment, or in this case the super royalty, first and also have relevant approaches for the treatment of soft-intangibles.

# Chapter 5. US Taxation of Business Restructurings

## 5.1 Introduction

In order to put the previously treated German function shifting legislation into perspective, this chapter deals with its US counterpart. To be more precise: the US legislation governing the tax implications of business restructurings can be considered to be the blueprint of the German function shifting legislation.[611] The two laws have been enacted over 20 years apart. Amongst other things, this lapse of time necessitates the identification of the differences between the two laws by way of a comparative study. Similarities between the two approaches are in that regard equally important.

The IRS has a number of tools at its disposal to deal with business restructurings, especially circumstances in which intangibles are shifted abroad and the case might necessitate an aggregated valuation. On top of this, in 1986 the USA introduced the Commensurate with Income standard (CWI) to respond with tax legislation to the trend towards business restructuring.[612] In particular since it was not in a way that foreign business was restructured and functions were consequently shifted towards the USA. It was rather the other way around, necessitating legislation that would protect the US tax base,[613] or, in other words, aimed at outbound transactions from a US point of view involving corporate reorganizations. Such corporate transactions are subject to the provisions of Sec. 367 IRC, causing either the immediate taxation of not yet taxed gains and earnings (Sec. 367(a) IRC) or the taxation of a deemed annual revenue stream over the useful life in case of the transfer of intangible property (Sec. 367(d)). Due to the dependency of this provision on a definition of "intangible" Sec. 936 IRC is also examined with the intention of identifying the intended breadth of the term intangible. The latter is of particular relevance for the analysis of the treatment of soft-intangibles,[614] even though the extent of the definition has been widened by the Tax Cuts and Jobs Act of 2017.[615] Moreover, Sec. 482 IRC embodying the main US transfer pricing provision comes into play,

[611] Pinkernell, R., Internationale Steuergestaltung im Electronic Commerce, *Schriftenreihe IFST*, Berlin: Institut Finanz und Steuern, Nr. 494, (Jan. 2014), p. 121; https://www.ifst.de/images/schriften/2014/494/494.pdf (16.11.2016).

[612] Taic, J., *Die "Super Royalty" und das U.S.-Richtlinienpaket von 1993*, München: VVF, (1995), p. 8.

[613] Zollo, T.M., USA Branch Report on Cross-Border Business Restructuring, IFA Cahier, No 96A, 2011, p. 757.

[614] The issues concerning soft-intangibles is considered to be one of growing importance, which has led to an heightened focus on the delineation of goodwill and going concern; Lowell, C.H. & Briger, P.L., *US International Transfer Pricing*, Thomson Reuters Tax and Accounting, 2017, ¶5.03 & 5.04; Torvik, O., Transfer Pricing and Intangibles - US and OECD arm's length distribution of operating profits from IP value chains, *IBFD Doctoral Series*, Amsterdam: IBFD, Vol. 45, 2019, – online book, Chapter 3, p. 3ff.

[615] Hereinafter: Tax Cuts and Jobs Act; Official designation: An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018; 131 Stat. 2054, (2017).

particularly the Commensurate with Income standard which immediately faced criticism for being incompatible with the arm's length principle.[616]

These legislations and their application by the IRS have been subjected to a number of reforms and alterations, including specifically the Commensurate with Income standard as well as the scope of the US transfer pricing legislation regarding intangibles. Most recent and most noteworthy is the Tax Cuts and Jobs Act of 2017 which brought about alterations in terms of intangibles, aggregated valuation and the repeal of exceptions applicable in some cross-border business restructurings.[617] Additionally, there have been a number of cases which have further shaped the specific interpretation. Therefore, the analysis will include, where necessary, key cases such as Veritas, Compaq and Sundstrand Corporation, among others. The Amazon case which has recently been decided, however, only repeats positions of the judiciary previously taken.[618] The decision has been appealed by Amazon.[619]



Thus, as a result of the US legislation possibly being considered the blueprint of the German function shifting legislation, the comparison is particularly interesting. In light of the proposals made in the final BEPS deliverables that are setting the standard for other nations to adopt, it is particularly relevant to analyse how the predecessor, the CWI standard, of these proposals functions and compares to it.

Therefore, this chapter commences by outlining the US transfer pricing legislation implementing the arm's length principle and the legislation applicable to corporate outbound transactions as it stood until 2018. Separately added to that are the changes stemming from the Tax Cuts and Jobs Act of 2017 (section 1). This is followed by an analysis of the application to business restructurings and the intangibles involved; specifically, the three types of soft-intangibles that are central to this dissertation (section 2). This includes a discussion of the qualification of some of the soft-intangibles dealing with the consequences that result from that particular qualification. The question of how a soft-intangible is qualified, is one prior to the Tax Cuts and Jobs Act of 2017 that came into force on 1 January 2018. In order to also cover the changes that resulted from this and to offer the complete perspective for the comparative analysis, an additional section is devoted to the consequences (section 3). In the final part of the chapter the Commensurate with Income standard – thus an ex-post valuation of the transaction and its peculiarities – is dealt with (section 3). The latter has not been affected by the Tax Cuts and Jobs Act of 2017.

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[616] OECD - The Committee on Fiscal Affairs, *Intercompany Transfer Pricing Regulations under US Section 482 Temporary and Proposed Regulations*, Paris: OECD, (1993), Para. 2.23ff; http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=OCDE/GD(93)131&docLanguage=En (16.11.2016).

[617] US Congress – House of Representatives, Conference Report on H.R. 1, Tax Cuts And Jobs Act, Vol. 163 No. 205, (15.12.2017), H10109 & H10126; Torvik, O., Transfer Pricing and Intangibles – US and OECD arm's length distribution of operating profits from IP value chains, *IBFD Doctoral Series*, Amsterdam: IBFD, Vol. 45, 2019, – online book, Chapter 3, p. 5ff.

[618] Diehl, K., Amazon.com, Inc.: Effect of Tax Court Decision on Buy-In Payments and Cost Sharing, *Journal of International Taxation*, Thomson Reuters Tax and Accounting, Vol 28. No. 61, September 2017, p. 1ff.; Rosenbloom, D., speaking at Seminar C – Cost-sharing and Cost contribution arrangements, *IFA 71st Congress* in Rio de Janeiro, 29.08.2017.

[619] Appeal has been lodged on 29. September 2017.

# Section I: The Arm's Length Principle

## 5.2 The Arm's Length Principle in the US and Legislation Relevant to Business Restructuring

### 5.2.1 Section 482 IRC – Pre 2018

#### *5.2.1.1 Section 482 IRC; The Core of the Arm's Length Principle in the US*

The foundation for the arm's length principle in the US is to be found in Sec. 482 of the Internal Revenue Code (IRC) where it has been introduced in 1954:[620]

> *"In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.*[621]



The following sentence, establishing the Commensurate with Income standard, was added on to Sec. 482 in the Tax Reform Act of 1986 :[622]

> *In the case of any transfer (or license) of intangible property (within the meaning of section 936 (h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible."*[623]

This is not just aimed at transactions that are being undertaken with controlled entities abroad but also domestically. This provision does not contain or make reference to the arm's length principle. Since its inception, Sec. 482 IRC has been refined by way of treasury regulations and only in 1994[624] has it been introduced by the added regulations that it seeks to determine the arm's length amount.[625] Furthermore, the Commensurate with

[620] Imhof, M., *Business Restructuring: Eine Betriebswirtschaftliche und Steuerrechtliche Analyse*, Köln: Eul-Verlag, (2012), p. 337.

[621] Sec. 482 IRC.

[622] Jacob, F. et al., Commentary on US-German Income Tax Convention - Article 9: Associated enterprises, Amsterdam: IBFD, (2010), MN. 62.

[623] Sec. 482 IRC.

[624] Treas. Reg. § 1.482-4(a).

[625] Imhof, M., *Business Restructuring: Eine Betriebswirtschaftliche und Steuerrechtliche Analyse*, Köln: Eul-Verlag, (2012), p. 337; Kuntz, J.D. & Peroni, R.J., *US International Taxation*, 2017, Part A3.07(2)(a).

Income standard, which is essential for this comparative analysis, has only been added later on in the year 1986 by way of the Tax Reform Act 1986.[626]

The essential condition for a (price) adjustment clause is contained in this provision, namely that there are two entities (organizations, trades, or businesses), affiliated or not, that are controlled, directly or indirectly, by a common parent. However, no connection is made between the income and a specific transaction between the related entities.[627] Likewise, no further provisions are made on which thresholds to participation or conditions are in place for entities to be considered to be related by way of direct or indirect ownership, control or common interest.[628] By contrast, the fact that this provision serves as an anti-abuse measure is made clear already in the statute itself. All the other specificities regarding the scope of this provision, however, are to be found in the treasury regulations to Sec. 482.

#### *5.2.1.2 Section 482 IRC and the Applicable Treasury Regulations*



Even though already mentioned in Sec. 482 itself, the meaning of organizations, trades, or businesses is further defined in the treasury regulations by referring to an **organization** as "*any kind, whether a sole proprietorship, a partnership, a trust, an estate, an association, or a corporation (…), irrespective of the place of organization, operation, or conduct of the trade or business, and regardless of whether it is a domestic or foreign organization, […].*"[629] Thus the full range of possible entities is covered. The **trade or business** definition is phrased in a similar all-embracing fashion, as including *"trade or business activity of any kind, regardless of whether or where organized, whether owned individually or otherwise […]*"[630]

Furthermore, **income** that can be subject to an adjustment, relates to **a controlled transaction**,[631] i.e., transactions effected between taxpayers that belong to the same group of controlled tax payers.[632] The requirements for an entity being related as the result of **control, ownership or same interest** are somewhat refined by the regulations in order to prevent abuse.[633] Instead of determining a related entity as the result of a clear-cut threshold of participation in the capital of the entity or ownership interest, it is merely stipulated that actual or factual control over the entity, whether directly or indirectly,

[626] Peter, M., Spohn, P. & Hogg, R., Preisanpassungsklauseln bei Funktionsverlagerungen nach deutschem sowie US-amerikanischem Steuerrecht, *IStR*, München: Beck, (2008), p. 866

[627] Treasury Regulations § 1.482-1(a)-(1).

[628] Postlewaite, P. F., *International Taxation: Corporate and Individual – Vol. I*, Durham, North Carolina : Carolina Academic Press, (2014), 9th ed., p. 355.

[629] Treasury Regulations § 1.482-1(i)-(1).

[630] Treasury Regulations § 1.482-1(i)-(2).

[631] Treasury Regulations § 1.482-1(a)-(1); Treasury Regulations § 1.482-1(i)-(8).

[632] Postlewaite, P. F., *International Taxation: Corporate and Individual – Vol. I*, Durham, North Carolina : Carolina Academic Press, (2014), 9th ed., p. 355.

[633] Ibid.

suffices for it to be a related entity.[634] Furthermore, it does not matter whether such control is legally enforceable or how it is to be exercised.[635] Additionally, the concerted pursuance of a common goal or interest can constitute control even without a particular requirement towards ownership.[636] Additionally, control is presumed to be present once it comes to transactions that lead to an arbitrary shift of income or deductions.[637]

Regarding the **underlying transaction**, it is defined as to mean: "*[…] any sale, assignment, lease, license, loan, advance, contribution, or any other transfer of any interest in or a right to use any property (whether tangible or intangible, real or personal) or money […]. A transaction also includes the performance of any services for the benefit of, or on behalf of, another taxpayer.*"[638] The definition thus includes every sort of transaction which could be of relevance for a business restructuring transaction.

Such a transaction should then produce an **income**, which is at **arm's length**. Unlike the provision in the internal revenue code, the treasury regulation makes specific reference to the arm's length principle.[639] In fact, the arm's length principle then leads to the *true taxable income* as it is referred to in the IRC regulations. While also providing for the different methods that ought to be used, in particular it outlines what needs to be understood by the **true taxable income**:



> *"(…) in the case of a controlled taxpayer, the taxable income that would have resulted had it dealt with the other member or members of the group at arm's length. It does not mean the taxable income resulting to the controlled taxpayer by reason of the particular contract, transaction, or arrangement the controlled taxpayer chose to make (even though such contract, transaction, or arrangement is legally binding upon the parties thereto)."*[640]

In line with this transposition of the arm's length principle, a transaction can not only lead to a correction of the income in a situation of abuse but also where another controlled entity has not been compensated, such as an uncontrolled entity in a comparable situation, regardless of whether it was intended to be abusive or not.

However, this is merely the core of the relevant legislation. Especially with regard to business restructurings there is still Section 367(a), which deals with the shift of assets abroad to a related corporation in general, as well as Section 367(d), which specifically covers intangible assets. This relationship can be demonstrated by the following example:

[634] Ibid.

[635] Ibid.; Treasury Regulations § 1.482-1(a)-(1)i-4.

[636] Ibid.

[637] Treasury Regulations §1.482-1(i)(4), Postlewaite, P. F., *International Taxation: Corporate and Individual – Vol. I*, Durham, North Carolina : Carolina Academic Press, (2014), 9th ed., p. 355.

[638] Treasury Regulations §1.482-1(i)(7).

[639] Treasury Regulations § 1.482-1(b)(1).

[640] Treasury Regulations § 1.482-1(i)(9).

> *DC, a domestic corporation, transfers intangible property to FS, a wholly owned foreign corporation. DC receives nothing in return.*
> *DC must report income annually under the rules of Section 367(d). The Service will make adjustments under Section 367(d) (and will not invoke Section 482). Section 482 would have been the applicable Code section, however, if had chosen the form of an actual sale or a license.*[641]

The necessary definition of intangibles in relation to the mentioned provisions is found primarily in Section 936.[642] Yet, that section being an exhaustive list, questions arise in particular when it comes to soft-intangibles.

Since the aforementioned provisions of Section 367 are essential to the tax treatment of a business restructuring, they need to be examined more closely.[643]

### 5.2.2 Section 367 IRC – Pre-2018



Section 482 embodies the arm's length principle but for its application in case of an international business restructuring, it is necessary to consider Section 367.[644] Section 367 can come into play in situations where property is transferred in outbound and inbound transactions as well as in transactions taking place between foreign (related) entities.[645]

In such a situation, Sections 367(a) and 367(d) are decisive. When dealing with intangibles Section 367(d) is the primary provision for the treatment of intangibles. But Section 367(a) can become similarly relevant in the event of a business restructuring. By relying on the definition of an intangible given by Section 936, Section 367(d) cannot apply in all situations. As will be seen in section 5.2.3.1, the definition of intangibles provided by Section 936 is shy of a number of intangibles, particularly soft-intangibles. However, in such a situation Section 367(a) serves as a fall-back provision, which is why its application should also be considered. Section 367, however, also provides for two noteworthy exceptions.

Firstly, in relation to the taxation of the outbound transfer of assets in line with Section 367(a): by way of this exception the outbound transfer of assets that serve an active trade or business is exempted. This is the so called "active trade or business exception" which has been made use of frequently in international business restructurings outside

[641] Kuntz, J.D. & Peroni, R.J., *US International Taxation*, 2017, Part A3.07.

[642] Armitage, J.C., et al., *United States - Transfer Pricing - Topical Analyses*, Amsterdam: IBFD, (2016), p. 35.

[643] Castro, L.F.M. Treatment of Business Synergy for Transfer Pricing Purposes: Critical Analysis of Sections 367(d), 482 and 936 of the Internal Revenue Code and Government Proposals, *International Transfer Pricing Journal*, Amsterdam: IBFD, (March/April 2012), p. 108ff.

[644] Imhof, M., *Business Restructuring: Eine Betriebswirtschaftliche und Steuerrechtliche Analyse*, Köln: Eul-Verlag, (2012), p. 356.

[645] Koenig, J. C., An Analysis of the Section 367(a)(3)(C) Temporary Regulations, Berkeley Journal of International Law, (1987), Vol. 5, Nr. 2, p. 333f.

the US. Depending on the particular situation, this exception can also be invoked for soft-intangibles relative to the qualification desired by the taxpayer.[646]

Secondly, Section 367(d) offers an exception for a specific kind of intangible. It is an exception for foreign goodwill and going concern value. This exception is relevant inasmuch as soft-intangibles are at the intersection of several elements that are part of either the rule of Section 367 or the corresponding exception. Some soft-intangibles could in fact be considered to be part of foreign goodwill and going concern. However, the difficulty lies on both sides – on the one hand the definition of intangibles and on the other hand the definition of foreign goodwill and going concern. The treatment of foreign goodwill and going concern as originally intended has been reasoned according to the proposed 2015 regulations by stating that:[647]

> *"The favorable treatment of [Foreign Goodwill] available under existing law is premised on statements in the legislative history of section 367(d). "The committee contemplates that, ordinarily, no gain will be recognized on the transfer of goodwill or going concern value for use in an active trade or business.".... The Senate Finance Committee and the House Committee on Ways and Means each noted, without explanation, that it "does not anticipate that the transfer of goodwill or going concern value developed by a foreign branch to a newly organized foreign corporation will result in abuse of the U.S. tax system.".... However, neither Section 367 nor its legislative history defines goodwill or going concern value of a foreign branch or discusses how goodwill or going concern value is attributed to a foreign branch."*[648]

Analysing how they are dealt with is a necessity in both cases in the absence of a legal provision that determines the treatment – considering that soft intangibles are not included in Section 936.

Therefore, this analysis is still relevant, even though the width of the active trade or business exception has been reduced and the exception for foreign goodwill and going concern value has been removed in its entirety as of 15 September 2015 by way of a proposed regulation that became final on 3 January 2017.[649] Yet even this needs to be questioned since it has been identified as: "(…) *imposing an undue financial burden on U.S. taxpayers and adding undue complexity to the Federal tax laws*".[650] A review initiated by way

[646] Castro, L.F.M., Treatment of Business Synergy for Transfer Pricing Purposes: Critical Analysis of Sections 367(d), 482 and 936 of the Internal Revenue Code and Government Proposals, *International Transfer Pricing Journal*, Amsterdam: IBFD, (March/April 2012), p. 117.

[647] Lowell, C.H. & Briger, P.L., US International Transfer Pricing, Thomson Reuters Tax and Accounting, 2017, ¶5.04[2][e][i][A].

[648] Ibid.: quoting IRB 2015-40, p. 477.

[649] IRB 2015-40, p. 453 T.D. 9738 (proposed regulation) & IRB 2017-3, p. 384 T.D. 9803(final regulation).

[650] Calianno, J & Dokko S., Foreign Goodwill and Going-Concern Value: IRS and Treasury Draw a Line in The Sand in Section 367 Final Regs, *Journal of International Taxation*, Vol. 28, Sept. 2017, p. 5.

of Executive order 13789 by President Trump has led to the treasury inquiring from the IRS whether this regulation needs to be altered or rescinded.[651]

#### *5.2.2.1 Section 367(a) IRC*

The general provision of section 367(a) entails that gains on assets that are transferred to foreign corporations need to be recognized; thus, be taxed. This is achieved by denying the otherwise applicable non-recognition by way of a deemed transfer to a new corporate entity.[652]

#### *5.2.2.2 Section 367(d) IRC*

This section determines whether a transfer of intangibles abroad can be executed tax free or whether an exit tax needs is to be levied.[653]

*(d) Special rules relating to transfers of intangibles*



1. *In general*
   *Except as provided in regulations prescribed by the Secretary, if a United States person transfers any intangible property (within the meaning of section 936 (h)(3)(B)) to a foreign corporation in an exchange described in section 351 or 361 –*
   *(A) subsection (a) shall not apply to the transfer of such property, and*
   *(B) the provisions of this subsection shall apply to such transfer.*
2. *Transfer of intangibles treated as transfer pursuant to sale of contingent payments*
   *(A) In general*
   *If paragraph (1) applies to any transfer, the United States person transferring such property shall be treated as –*
   *(i) having sold such property in exchange for payments which are contingent upon the productivity, use, or disposition of such property, and*
   *(ii) receiving amounts which reasonably reflect the amounts which would have been received –*
   *(I) annually in the form of such payments over the useful life of such property, or*
   *(II) in the case of a disposition following such transfer (whether direct or indirect), at the time of the disposition.*
   *The amounts taken into account under clause (ii) shall be commensurate with the income attributable to the intangible.*

[651] Ibid.

[652] Sec. 367(a)(1) IRC.

[653] Castro, L.F.M. Treatment of Business Synergy for Transfer Pricing Purposes: Critical Analysis of Sections 367(d), 482 and 936 of the Internal Revenue Code and Government Proposals, *International Transfer Pricing Journal*, Amsterdam: IBFD, (March/April 2012), p. 108.

The particular transfers that are subject to this provision are those provided by sections 351 and 361 of the IRC.[654] [655] In the context of these transfers, it is presumed that there is a taxable transfer of an intangible asset. This occurs in situations where the transfer takes place from an entity taxable in the US to a related entity abroad and vice versa, as well as in transactions from one foreign jurisdiction to another.[656] An actual sale or lease of the intangible property is not subject to this provision.[657] Thus, it is transfers of the intangible without consideration or when it is conducted for the exchange of rights to participate in the transferee that fall within the scope of section 367.[658]

As a consequence of the application of Section 367(d) this transfer is to be seen as a deemed sale, which in turn triggers a deemed annual payment of royalties to the transferor, which is limited by the useful life of the intangible asset, which is deemed to be up to 20 years.[659] Resulting from the final regulations of 15 December 2016 is an option for the taxpayer to either determine this based on the useful life of the intangible asset or, if the latter were to exceed 20 years or be indefinite, to stick with a period of 20 years.[660] The useful life would be confined solely to the timeframe in which the exploitation of the intangible is reasonably anticipated at the time of the transfer.[661] These royalties are subject to Section 482 of the IRC. Hence, the arm's length principle as well as the Commensurate with Income standard come into play.[662]

The intangible that is transferred needs to qualify as such by law in order for Section 367(d) to apply. Therefore, in case of a business restructuring, the determination of which assets are in fact exempt as foreign goodwill and going concern value is crucial – as is the question whether the asset in fact qualifies as an intangible. However, in principle the



[654] Ibid. p. 108.

[655] Sec. 351 IRC:
"**(a) General Rule**
No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation."
Sec. 361 IRC:
"**(a) General Rule**
No gain or loss shall be recognized to a corporation if such corporation is a party to a reorganization and exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization."

[656] Rienstra, J.G., United States – Corporate Taxation, *IBFD Country Analysis*, Amsterdam: IBFD, (October 2016), para. 7.2.5.2.

[657] Terr, L.B., Outbound Transfers under the new Regulations for Sections 367(a) and 367(d), *The International Tax Journal*, Chicago: CCH, (1987) Vol. 13 No. 1, p. 31.

[658] Ibid., p. 31.

[659] Castro, L.F.M. Treatment of Business Synergy for Transfer Pricing Purposes: Critical Analysis of Sections 367(d), 482 and 936 of the Internal Revenue Code and Government Proposals, *International Transfer Pricing Journal*, Amsterdam: IBFD, (March/April 2012), p. 108.

[660] IRB 2017-3, p. 404 T.D. 9803.

[661] Ibid., p. 478.

[662] IRS – LB&I International Practice Service Transaction Unit, *Deemed Annual Royalty Income Inclusion Under IRC 367(d)*, (28.07.2015), p. 3; https://www.irs.gov/pub/int_practice_units/ISO9411_02_01.pdf (02.12.2016):
Castro, L.F.M. Treatment of Business Synergy for Transfer Pricing Purposes: Critical Analysis of Sections 367(d), 482 and 936 of the Internal Revenue Code and Government Proposals, *International Transfer Pricing Journal*, Amsterdam: IBFD, (March/April 2012), p. 108.

definition is also in this case confined to what has been defined as an intangible by Section 936(h)(3)(B).

Considering these two elements, qualification as intangible and scope of the exception, that determine the applicability of the provision of Section 367(d) and in particular the recent legislative changes, the following part looks into the qualification of intangibles and in particular into a set of soft-intangibles.

### 5.2.3 Definition of an Intangible for Purposes of Sections 367(d) and 482 – Pre 2018

The Internal Revenue Code provides a definition of intangibles in Section 936(h)(3)(B) to which Sections 482 and 367(d) make reference for the definition of an intangible. However, slightly deviating from it is the Treasury Regulation for Section 482 for that very definition which is crucial for the application of Section 482 and consequently for theCommensurate with Income standard.[663]



#### *5.2.31 Intangibles Definition – Section 936 IRC*

Section 936 of the Internal Revenue Code defines intangible property in general by listing the following six groups of intangibles:

*(B) Intangible property*

> *The term "intangible property" means any –*
> *(i) patent, invention, formula, process, design, pattern, or know-how;*
> *(ii) copyright, literary, musical, or artistic composition;*
> *(iii) trademark, trade name, or brand name;*
> *(iv) franchise, license, or contract;*
> *(v) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data; or*
> *(vi) any similar item, which has substantial value independent of the services of any individual*[664]

While there is no doubt about the intangibles covered in paragraphs (i)-(v), paragraph (vi) leaves room for interpretation. The only limitation that is provided for "any similar item" is that it has to have substantial value without the additional service of any individual.[665] It does not require legal protection.[666]

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[663] Treasury Regulations § 1.482-4.

[664] Sec. 936(h)(3)(B) IRC.

[665] Sec. 936(h)(3)(B) IRC.

[666] Wittendorff, J. (2010). *Transfer pricing and the arm's length principle in international tax law*. Austin [Tex.]: Wolters Kluwer Law & Business, p. 597; Technical Advice Memorandum 200907024, (Released 13.02.2009), p. 11; https://www.irs.gov/pub/irs-wd/0907024.pdf (02.12.2016).

Considering that goodwill, workforce in place or any other intangible would, if at all, fall in the category of "any similar item", this category needs further consideration.

#### *5.2.3.2 Intangibles Definition – Treasury Regulations § 1.482-4*

The definition of **§ 1.482-4** is almost identical to the one of section 936(h)(3)(B).[667]This definition, which is necessary for the subsequent application of the Commensurate with Income standard, thus serves a more nuanced purpose compared to the general definition of intangibles of section 936(h)(3)(B). Most striking is the inclusion of the criterion of value. It is stipulated that:

> *(f)or purposes of section 482, an intangible is an asset that comprises any of the following items and has substantial value independent of the services of any individual –*
>
> ***(1)*** *Patents, inventions, formulae, processes, designs, patterns, or know-how;*
> ***(2)*** *Copyrights and literary, musical, or artistic compositions;*
> ***(3)*** *Trademarks, trade names, or brand names;*
> ***(4)*** *Franchises, licenses, or contracts;*
> ***(5)*** *Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data; and*
> ***(6)*** *Other similar items. For purposes of section 482, an item is considered similar to those listed in paragraph (b)(1) through (5) of this section if it derives its value not from its physical attributes but from its intellectual content or other intangible properties.*[668]

Thus, this definition emphasizes the requirement that it is an asset and that the value of the mentioned intangible asset does not rely on the service of any individual.[669] While it is identical to a large degree to the definition of an intangible of section 936(h)(3)(B), sentence 6 deviates by stipulating additional requirements for an intangible asset to be qualified as "*other similar items*". In other words, it is required that other similar items derive their value from intellectual content or other intangible properties.[670] Physical qualities may not be the value driver in this case.[671] According to the default condition of

[667] The first five groups listed in section 936(h)(3)(B) IRC are identical to those in Treasury Regulation §1.482-4 except for the one enumeration of the intangibles being done in singular and the other one in plural.

[668] Treasury Regulations §1.482-4.

[669] Wittendorff, J. (2010). *Transfer pricing and the arm's length principle in international tax law*. Austin [Tex.]: Wolters Kluwer Law & Business, p. 596.

[670] Wells, B., Revisiting Section 367(D): How Treasury Took the Bite out of Section 367(D) and What Should Be Done About It, *Florida Tax Review*, Gainesville, FL: University of Florida Levin College of Law, (2014), Vol. 16 No. 10, p. 525; Armitage, J.C., et al., *United States - Transfer Pricing - Topical Analyses*, Amsterdam: IBFD, (2016), p. 35; Wittendorff, J. (2010). *Transfer pricing and the arm's length principle in international tax law*. Austin [Tex.]: Wolters Kluwer Law & Business, p. 596.

[671] Ibid.

the value not being derived as a consequence of the service of an individual, circumstances where above normal value is derived by such an involvement, such as workforce or management, are in principle excluded from being considered as "other similar items".[672] Legal protection for the intangible in question is not a prerequisite for it being qualified as an intangible for Section 482.[673]

Additionally, by jurisprudence, namely *Merck & Co. v. United States*, the condition of the intangible to be transferable in a commercial transaction has been added.[674] Therefore, this condition is still relevant, despite being introduced by way of Temporary Regulations in 1993,[675] and being dropped in 1994.[676] The reason for dropping the regulations was not rescind the condition, but rather because the condition was thought to be self-evident.[677] Thus, something that is not commercially transferrable cannot be a matter of a controlled transaction.[678] However, the current IRS standpoint can also be construed as no longer adhering to the requirement of an intangible to be commercially transferable in order to be subject of a controlled transaction.[679]



The vague definition of "other similar items" raises questions in particular where transactions also involve foreign goodwill and going concern as well as soft (intangibles) and workforce in place.[680]

#### *5.2.3.3 Conclusion on the Interaction of Sections 367(d), 482 & 936 IRC*

Thus, neither the clearly formulated list of Section 936, paragraphs (i)-(v) nor paragraph (vi) and likewise Treasury regulation **§ 1.482-4** allow for an answer for cases such as going concern value and soft (intangibles). The provisions that deal with the transfer of intangibles in case of a business restructuring hinge on the definition given in Section 936. Therefore, not only the scope of Section 367(d), which specifically deals with intangibles, is of interest, but also the general provision, Section 367(a).

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[672] Wittendorff, J. (2010). *Transfer pricing and the arm's length principle in international tax law*. Austin [Tex.]: Wolters Kluwer Law & Business, p. 597.

[673] Armitage, J.C., et al., *United States – Transfer Pricing – Topical Analyses*, Amsterdam: IBFD, (2016), p. 35; Wittendorff, J. (2010). *Transfer pricing and the arm's length principle in international tax law*. Austin [Tex.]: Wolters Kluwer Law & Business, p. 597; Technical Advice Memorandum 200907024, (Released 13.02.2009), p. 11; https://www.irs.gov/pub/irs-wd/0907024.pdf (02.12.2016).

[674] Merck & Co. v. US, 24 Cl. Ct. 73 (1991); Wittendorff, J. (2010). *Transfer pricing and the arm's length principle in international tax law*. Austin [Tex.]: Wolters Kluwer Law & Business, p. 598.

[675] IRB 1993-10; Kuntz, J.D. & Peroni, R.J., *US International Taxation*, 2017, Part A3.07[2][b].

[676] IRB 1994-31.

[677] Wittendorff, J. (2010). *Transfer pricing and the arm's length principle in international tax law*. Austin [Tex.]: Wolters Kluwer Law & Business, p. 598 & 599.

[678] Ibid., p. 599.

[679] Ibid., p. 599; which is based on the commercial transferability being mentioned as a mere example in the coordinated issue paper of 2007 (Coordinated Issue Paper, Sec. 482 CSA Buy-In Adjustments, (27.09.2007).).

[680] Torvik, O., Transfer Pricing and Intangibles - US and OECD arm's length distribution of operating profits from IP value chains, *IBFD Doctoral Series*, Amsterdam: IBFD, Vol. 45, 2019, - online book, Chapter 3, p. 6.

### 5.2.4 The Exceptions – Active Trade or Business Exception & Foreign Goodwill Exception – Pre 2018

#### *5.2.4.1 Section 367(a) IRC – Active Trade or Business Exception*

In addition to the tax charge that section 367(a) envisages for the transfer of assets in a cross-border business restructuring, the provision also entails an exception for the transfer of assets that are necessary for the conduct of active trade or business in the foreign corporation.

It is furthermore of relevance since intangibles that are not within the purview of Section 936 and should therefore be taxable as a result of Section 367(a), can nevertheless fall within the scope of the active trade or business exception under certain conditions, which are to be discussed.[681]

The Active Trade or Business Exception is subject to a number of limitations. First the question of whether an asset is actually transferred for its use in an Active Trade or Business[682] is to be answered. Secondly, the rules for specific transfers like property which is to be leased out to the foreign entity is to be determined.[683]

However, more important for outlining the scope of this exception is Section 367(a)(3)(B)/1.367(a)–5 and 1.367(a)–5T which lists five different categories of property that are not covered by the Active Trade or Business Exception.[684] Most notably intangible property as it is defined by Section 936(h)(3)(B) is explicitly excluded.[685]



#### *5.2.4.2 Section 367(d) IRC – Foreign Goodwill or Going Concern Value Exception*

An exception to the prescribed tax charge of section 367(d) applies to the transfer of foreign goodwill and going concern value. The scope of this exception which is frequently used when MNEs restructure can, just like the scope of the active trade or business exception, be another indication for the treatment of the transfer of soft-intangibles in case of a cross-border business restructuring.

Section 367(d) provides an exception for the transfer of foreign goodwill and going concern value.[686] This is excluded by way of Treas. Reg. 1.367(d)-1T(b).[687] Yet, in a proposal for new regulations addressing outbound transfers and transfer pricing this

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[681] IRB 2015-40, p. 477.

[682] Treasury Regulations §1.367(a)–2 and 1.367(a)–2T; IRB 2015-40, p. 475 & 476; Terr, L.B., Outbound Transfers under the new Regulations for Sections 367(a) and 367(d), *The International Tax Journal*, Chicago: CCH, (1987) Vol. 13 No. 1, p. 14ff.

[683] Treasury Regulations §1.367(a)–4 and 1.367(a)–4T; IRB 2015-40, p. 475 & 476; Terr, L.B., Outbound Transfers under the new Regulations for Sections 367(a) and 367(d), *The International Tax Journal*, Chicago: CCH, (1987) Vol. 13 No. 1, p. 14ff.

[684] IRB 2015-40, p. 476 T.D. 9738.

[685] Section 367(a)(3)(B)(iv) IRC.

[686] Wells, B., Revisiting Section 367(D): How Treasury Took the Bite out of Section 367(D) and What Should Be Done About It, *Florida Tax Review*, Gainesville, FL: University of Florida Levin College of Law, (2014), Vol. 16 No. 10, p. 523ff.

[687] Treas. Reg. 1.367(d)-1T(b); IRS – LB&I International Practice Service Transaction Unit, *Deemed Annual Royalty Income Inclusion Under IRC 367(d)*, (28.07.2015), p. 3; https://www.irs.gov/pub/int_practice_units/ISO9411_02_01.pdf (02.12.2016). Yodder, L., Disputed Issues with the Application of Code Sec. 367 to Intangibles, *The International Tax Journal*, Chicago: CCH, (2012) Vol. 38 No. 3, p. 3.

very exception is called into question and is to be removed.[688] Taxpayers are keen on this exception being as broad as possible.[689] Analysing the reach of this exception serves this research, regardless of the proposed regulation by the IRS dated 15 September 2015, which abolishes this exception in its entirety, due to the fact that the applicability of this exception hinges on the qualification of the soft-intangibles that have been chosen for analysis.

The definition provided in the regulations to Section 367(d) until it is abolished reads as follows:

> ***(iii) Foreign goodwill or going concern value.*** *Foreign goodwill or going concern value is the residual value of a business operation conducted outside of the United States after all other tangible and intangible assets have been identified and valued. For purposes of section 367 and regulations thereunder the value of the right to use a corporate name in a foreign country shall be treated as foreign goodwill or going concern value.*[690]



Taking into account the possible tax consequence and how businesses relied on this exception, the definition of what actually constitutes foreign goodwill and going concern is quite a decisive one. This exception also extends to intangibles that are similar to goodwill and going concern value.[691] Since a more extensive definition is lacking, it was frequently applied by taxpayers to maintain a low singular valuation of the majority of tangibles and intangibles in a transaction while the actually valuable goodwill was excluded in line with this exception.[692] Thus, the definition remained vague, which was one of the reasons why it was scratched by the proposed and now final regulation. According to the reasoning offered for the alteration, this uncertainty has been used by taxpayers to fit a broad range of intangibles into this exception.[693]

**The US Tax Cuts and Jobs Act**

On 22 December 2017 the US Tax Cuts and Jobs Act was signed into law. This tax reform has also touched the provisions underlying this thesis. While a number of alterations are rather essential, some are merely affirmatory of existing IRC regulations, thus elevating these to the status of statute. This is the case particularly for the aggregated valuation of intangibles that had already been provided for by 1.482-1T(a)(i)(B). Consequently, this

[688] IRB 2015-40, p. 475ff & IRB 2017-3, p. 384ff T.D. 9803.

[689] IRB 2015-40, p. 477.

[690] Treasury regulations §1.367(a)-1T(d)(5)(iii) (Removed in line with the final regulations – IRB 2017-3, p. 384 T.D. 9803).

[691] Castro, L.F.M. Treatment of Business Synergy for Transfer Pricing Purposes: Critical Analysis of Sections 367(d), 482 and 936 of the Internal Revenue Code and Government Proposals, *International Transfer Pricing Journal*, Amsterdam: IBFD, (March/April 2012), p. 111.

[692] An Example of this is strategy can be observed in the discussion: Technical Advice Memorandum 200907024, (Released 13.02.2009); https://www.irs.gov/pub/irs-wd/0907024.pdf (02.12.2016).

[693] IRB 2015-40, T.D. 9738, p. 453ff.

elevated status bars taxpayers from claiming that the IRS overstepped the boundaries of issuing the regulation.[694]

**Section 482**

The core section implementing the arm's length principle in the US has been changed in so far as a third sentence has been added in order to expressly allow for an aggerated valuation:

> *(…) shall require the valuation of transfers of intangible property (including intangible property transferred with other property or services) on an aggregate basis or the valuation of such a transfer on the basis of the realistic alternatives to such a transfer, if the Secretary determines that such basis is the most reliable means of valuation of such transfers.*[695]

Including the possibility to value transfers of intangible property on an aggregated basis includes IRS practice T.D. 9738[696] now in the statute which eliminates the possibility of tax payers claiming that the IRS has overstepped the boundaries set by the statute with the specific regulation. The condition of aggregation being the most reliable means of valuation, as it is also contained in the temporary regulations, that as soon as in an uncontrolled transaction parties would not aggregate and reliable comparables are available, then by default the aggregation would not be the most reliable method. In order to accommodate for an aggregate valuation, section 367 has also been altered accordingly.



**Section 367**

Section 367 comes into play once intangibles are transferred abroad to related entities. It has been altered in two ways. The possibility of an aggregated valuation has been introduced, and the active trade or business exception has been eliminated.

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[694] In general agencies are limited in the regulations that they issue and only so much deference is afforded to agencies by courts. These limits have in general been developed in the case Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984) and more specifically for taxes and the IRS in Mayo Foundation v. United States, 562 U.S. 44 (2011).

[695] The complete statute as of 2018:
*In any case of two or more **organizations**, trades, or businesses (whether or not incorporated, whether or not organized in the **United States**, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of **intangible property** (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible. For purposes of this section, the Secretary shall require the valuation of transfers of **intangible property** (including **intangible property** transferred with other property or services) on an aggregate basis or the valuation of such a transfer on the basis of the realistic alternatives to such a transfer, if the Secretary determines that such basis is the most reliable means of valuation of such transfers.*

[696] See e.g. in relation to synergies: 5.4.3.2., *T.D. 9738*, *Clarification of the Coordination of the Transfer Pricing Rules with Other Code Provisions*, IRB 2015-40, p. 453ff.

The possibility of aggregated valuation has been achieved in the same fashion as with section 482, viz. by explicitly introducing it into the statute. The following paragraph has been added:

> *(D) Regulatory authority For purposes of the last sentence of subparagraph (A), the Secretary shall require–*
> *(i) the valuation of transfers of intangible property, including intangible property transferred with other property or services, on an aggregate basis, or*
> *(ii) the valuation of such a transfer on the basis of the realistic alternatives to such a transfer, if the Secretary determines that such basis is the most reliable means of valuation of such transfers.*[697]

For effecting this aggregation, the same limitations as prescribed in section 482 are applicable: it needs to be the most reliable method, and aggregation is not warranted where there are comparable uncontrolled prices available and thus unrelated parties would not aggregate. This amendment also serves as an elevation of the currently applicable regulations.



Furthermore, the active trade and business exemption of section 367(a) has been repealed, as a consequence of the strong limitation of that exception undertaken in temporary regulations.[698] The foreign goodwill and going concern exception of section 367(d) has been eliminated as a consequence of the extension of the intangibles that are enumerated in section 936.[699]

**Section 936**

The definition of intangible property provided by section 936(h)(3)(B) has been extended and therefore also the scope of sections 482 and 367. This subparagraph has been extended in order to now also include:

> ***(vi)*** *any goodwill, going concern value, or workforce in place (including its composition and terms and conditions (contractual or otherwise) of its* ***employment****); or*
> ***(vii)*** *any other item the value or potential value of which is not attributable to tangible* ***property*** *or the services of any individual.*[700]

[697] IRC, Sec. 367(d)(2)(D).

[698] IRB 2015-40, p. 453 T.D. 9738 (proposed regulation) & IRB 2017-3, p. 384 T.D. 9803(final regulation).

[699] US Congress – Joint Committee on Taxation, *General Explanation of Public Law 115-97(JCS-1-18)*, (20 December 2018), p. 331 & p. 387.

[700] The full section as of 1 January 2018:
***(B) Intangible property***
*The term "**intangible property**" means any –*
***(i)*** *patent, invention, formula, process, design, pattern, or know-how;*
***(ii)*** *copyright, literary, musical, or artistic composition;*
***(iii)*** *trademark, trade name, or brand name;*
***(iv)*** *franchise, license, or contract;*

While it has previously been disputed what "(…) *any similar item, which has substantial value independent of the services of any individual"* encompasses, this has now been stipulated to include goodwill and going concern as well as workforce in place. The previously applicable limitation for a "similar item" has been maintained and thus it is still necessary that the value of the intangible is derived independently from the services of an individual. Moreover, this value is not to be derived from a tangible. Consequently, arguments on the breadth of the definition of the term intangible as they have been an issue in the Veritas case are no longer relevant.

As a consequence of the alteration of these core provisions for the treatment of (soft) intangibles in business restructurings, the taxation of such transactions has been changed quite severely.

## Section II: Soft-Intangibles



### 5.3 Soft Intangibles in the Framework of a Business Restructuring According to 367(d) & 482 IRC – Pre 2018

Looking at the tax consequences stemming from the three main soft intangibles that are concerned in a business restructuring, it needs to be kept in mind that the goal of sections 367(d) and 482 IRC is to not merely tax the intangibles transferred but also the residual value contained therein, which at times take the shape of soft-intangibles.[701] Furthermore, these provisions, entailing two super royalty rules, also aim at considering future price developments. Subsequently, these two aspects, (1) the tax consequences of 367(d) and 482 IRC at transfer and (2) the taking into account of future price developments by way of super royalties, are considered first in general and then per soft-intangible.

#### 5.3.1 General Application and Tax Consequences

Section 367(d) IRC is only relevant in some, not all situations where the restructuring involves soft-intangibles. Section 482 IRC, however, is of overarching importance for the

***(v)*** *method, program, system, procedure, campaign, survey, study, forecast, estimate,* ***customer l****ist, or technical data;*

***(vi)*** *any goodwill, going concern value, or workforce in place (including its composition and terms and conditions (contractual or otherwise) of its* ***employment****); or*

***(vii)*** *any other item the value or potential value of which is not attributable to tangible* ***property*** *or the services of any individual.*

***(C) Exclusion of reasonable profit***

The term "intangible property income" shall not include any portion of the income from the sale, exchange or other disposition of any product, or from the rendering of services, by a corporation electing the application of this section which is determined by the Secretary to be a reasonable profit on the direct and indirect costs incurred by such electing corporation which are attributable to such income.

[701] Silverman, M. J. et al., Considering Veritas and Future Transfer Pricing Litigation, *Tax Notes*, Falls Church, VA: Tax Analysts (13 October 2014), p. 225.

evaluation of the tax consequences since a deemed royalty payment of Section 367(d) needs to be in line with the CWI standard.[702]

Where a soft-intangible can indeed be considered to have been shifted, taxpayers take two stances. This should also be the procedure for determining the tax consequences, as it covers all the relevant issues that can arise. The pivotal point in determining the tax consequences is the position taken on whether the intangible in question is a 936(h)(3)(b) intangible or not.

The first approach generally taken by taxpayers aims at denying the status of 936(h)(3)(b) intangible to the soft-intangible in question. The motive there is to avoid the application of section 367(d) and thereby the deemed royalty payments that are to be made in line with the CWI standard.[703] However, the soft-intangible is then subjected to section 367(a), which requires the immediate recognition of gains. But depending on the precise qualification of the intangible it might be possible to rely on the active trade and business exception and thereby avoid the immediate recognition of gains. Since the active trade or business exception is not necessarily broad in its application,[704] taxpayers tend to also consider a second, alternative, option.



The second option is based on the stance that the intangible is in fact a section 936(h)(3)(b) intangible. As a consequence, the applicability of section 367(a) is excluded. Instead it is subject to section 367(d). By way of the foreign goodwill and going concern value exception, taxation can be avoided altogether. Even though this exception is limited, it is said to cover nearly all outbound transfers of intangible property to foreign entities that fall within the scope of section 367 IRC.[705]

Additionally, it is possible to consider the intangible neither as a section 936(h)(3)(b) intangible nor as goodwill or going concern value, making it a "unique quasi kind of asset".[706] In this situation section 367(d) would be entirely out of the picture. The tax consequences would need to be determined solely on the basis of section 482.

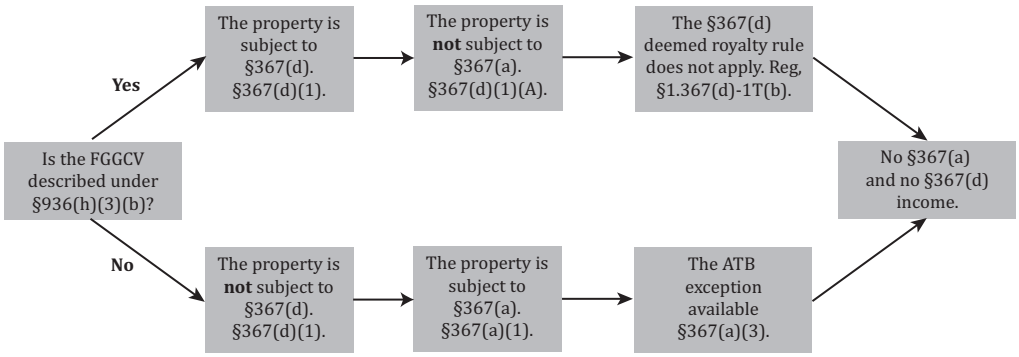
[702] Mishik, M.G., Tax-Free Incorporation of a Foreign Business Enterprise, Part Deux: The Killer Rabbit of Code Sec. 367(d), *The International Tax Journal*, Chicago: CCH, (March 2005), p. 27 & 29.

[703] Ibid.

[704] See section 5.2.4.

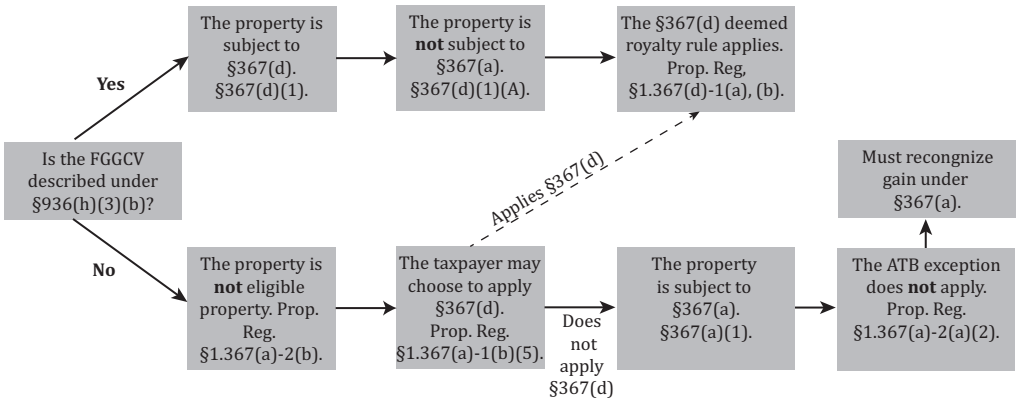
[705] Mishik, M.G., Tax-Free Incorporation of a Foreign Business Enterprise, Part Deux: The Killer Rabbit of Code Sec. 367(d), *The International Tax Journal*, Chicago: CCH, (March 2005), p. 27.

[706] Castro, L.F.M. Treatment of Business Synergy for Transfer Pricing Purposes: Critical Analysis of Sections 367(d), 482 and 936 of the Internal Revenue Code and Government Proposals, *International Transfer Pricing Journal*, Amsterdam: IBFD, (March/April 2012), p. 121.




Current application[707]

Now that the regulations became final there is still a certain relevance to determining the tax consequences this way, since essentially the foreign goodwill and going concern has been removed and the active trade or business exception has been further narrowed.[708] Following from the proposed regulations the application of either section 367(a) or section 367(d) would always take place. In particular, for intangible property that is not considered to be covered by section 936(h)(3)(b), the taxpayer would have to elect whether to apply section 367(a) or section 367(d).




Possible future application[709]

However, some of the soft intangibles that have been considered are not transferred in the course of a business restructuring but are already present in the country abroad. Therefore, tax consequences for the soft-intangibles that are transferred need to be

[707] ABA Tax Section Midyear Meeting Corporate Tax Committee, *Tightening the Noose: IRS Proposes Regulations on Outbound Transfers of Foreign Goodwill and Workforce in Place,* January 30 2016, Los Angeles: http://apps.americanbar.org/dch/thedl.cfm?filename=/TX312000/newsletterpubs/IRSREGS13016.ppt (15.10.2017).

[708] IRB 2017-3, p. 384 T.D. 9803.

[709] ABA Tax Section Midyear Meeting Corporate Tax Committee, *Tightening the Noose: IRS Proposes Regulations on Outbound Transfers of Foreign Goodwill and Workforce in Place*, January 30 2016, Los Angeles: http://apps.americanbar.org/dch/thedl.cfm?filename=/TX312000/newsletterpubs/IRSREGS13016.ppt (15.10.2017).

determined in line with section 367(a) or section 367(d). Those intangibles that are not shifted either because they are already present in the country abroad or because they are made available in the framework of a Cost Sharing agreement need to be considered for section 482.

### 5.3.2 Interaction of Sections 482, 367(a), 367(d) & 936 IRC

Section 367 plays a pivotal role in particular for the outbound business restructuring of companies. It aims at capturing the transfer of a number of assets abroad. However, at the time it has been introduced, the main concerns were the tangible and intangible assets which had previously been developed in the US and for which deductions had been claimed. The foreign goodwill and ongoing concern is nothing for which a deduction has been claimed which explains the particular exception for that particular category, whose elimination has only recently been completed.[710] This is ultimately the consequence of the increased importance of soft-intangibles and the presence of this lacuna.[711]



Thus, assets that do not fall within the scope of Section 367(d) and neither of the exceptions are then dealt with by Section 367(a), causing an immediate taxation of the assets transferred. On the contrary, intangible assets that are indeed subject to Section 367(d) by being transferred to a related entity are subjected to a deemed licensing. Section 367(d) is, coupled with the super royalty of section 482, the former which exists independently and results in an annual imputed royalty payment for the useful life of the intangible (or up to 20 years). In particular Section 367(d) hinges on two other sections, namely 936(h)(3)(B) and 482, making it a cornerstone for the subsequent analysis. The former provision for the definition of intangible, even though the regulations provide for a similar definition of its own, and the former provision for the deemed royalty payments which need to be at arm's length and commensurate with income.

This section has dealt with the core elements of an outbound business restructuring, namely sections 482 encompassing the arm's length principle, section 367 demanding a super-royalty for the transfer of an intangible, which is defined by section 936. All three contain issues that are essential for the further analysis, which is aimed at analysing the treatment of soft-intangibles and the super royalty, which is the product of the CWI standard. In the foregoing discussion of section 367 and its particular exceptions, the problems in relation to soft-intangibles were already mentioned because of the reliance on a limited yet exhaustive list of intangibles almost identical to the one provided in section 936 prior to 2018. However, section 367 also asks for the payment of a deemed annual royalty, commensurate with the income that the intangible in question produces.

Thus, the focus in the next section is on the treatment of the outbound transfer of soft-intangibles to a related party. Essentially, this is dependent on the definition of intangible for situations prior to 2018.

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[710] IRB 2015-40, T.D. 9738, p. 475ff.

[711] Lowell, C.H. & Briger, P.L., US International Transfer Pricing, Thomson Reuters Tax and Accounting, 2017, ¶ 5.03.

## 5.4 Treatment of Selected Soft-intangibles Under US Transfer Pricing Legislation – Pre 2018

The transfer of clearly defined tangible and intangible assets poses less of a problem when restructuring a business then do soft-intangibles, in particular under US legislation, since they may or may not be subject to the specific provision of Section 367(d) and therefore to a treatment which is aimed at intangibles proper, while they do not necessarily qualify as such.

In principle, the intangible assets that are subject to a treatment in line with Section 367(d) are clearly defined by the (exhaustive) enumeration in Section 936(h)(3)(B) as listed in 5.2.3.1. However, clarity ends when there are intangibles that are either not listed as such or may need to be subsumed under one particular category of intangibles.

This is the case with soft-intangibles, which are not listed as such in either Section 936(h)(3)(B) or § 1.482-4 of the Treasury Regulations. These soft-intangibles particularly pose an issue where they come into existence as the result of not being part of an exclusive enumeration. Due to the nature of soft-intangibles it is possible to consider them as already forming part of the list of intangibles contained in Section 936(h)(3)(B).[712] However, while the foregoing might hold true in case of goodwill and going concern value which was to be included, together with workforce in place, to the definition in line with the 2010 proposal of the Obama Administration, the issue sits slightly differently with the soft-intangibles under review here.[713] The proposed inclusion of workforce in place is more than a clarification, as became, apparent in the case of *Perkin-Elmer Corporation and Subsidiaries vs. Commissioner*[714] and other cases. A similar situation is present in relation to synergies. While synergies are not specifically included in the exhaustive list of section 936(h)(3)(B) either, the IRS considers this qualification to be the result of a network, as seen in TAM 200907024,[715] thus achieving the desired result by the application of a proxy intangible that already forms part of the list. For location savings the situation is slightly different but this only goes to show how contested the definition is and what it encompasses precisely. Although the aforementioned sections contain a default group for "other similar items", there is still ample room for interpretation. Even in the situation where soft-intangibles are to be seen as "other similar items" the same question arises in relation to the exceptions that are provided by Section 367.

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[712] Lowell, C.H. & Briger, P.L., US International Transfer Pricing, Thomson Reuters Tax and Accounting, 2017, ¶ 5.03[3][g].

[713] Ibid.

[714] US: TC, 1994, TC Memo 1993-414, 66 TCM, Perkin-Elmer Corporation and Subsidiaries vs. Commissioner:
A reasonable value cannot be assigned to an experienced staff, a vertically integrated structure that allows a cost efficient operation, an ability to innovate and respond to market demands for new techniques and an extensive purchasing, production planning and inventory control system. (Panse, A., Workforce in Place: Is It an Intangible to Pay for?, *International Transfer Pricing Journal*, Amsterdam: IBFD, (May June 2014), p. 147.

[715] TAM 200907024

The restructuring models that are applied by MNEs where a large emphasize is put on soft-intangibles,[716] while the rest of the restructured operations value remains miniscule,[717] makes them a particularly contested topic between taxpayer and tax authority.[718] This has generally led to diametrically different perceptions of soft-intangibles between taxpayer and tax authorities which, in turn, has led to the issuance by the IRS[719] of a Technical Advice Memorandum in 2009 and ultimately to the finalized regulation which ends the use of foreign goodwill and going concern as well as the active trade or business exception.[720]

It would be optimal for a taxpayer if soft-intangibles did not fall within the scope of either section 367(a) or section 367(d). This would mean that the soft-intangible would not fall within the definition of an intangible for the purposes of section 936(h)(3)(B), or would qualify as one of the two exceptions.[721] This would imply that the taxpayer could transfer the soft-intangible without any tax consequence.

Taking as an example the group of soft-intangibles that can be considered to be goodwill and ongoing concern, this very line of argumentation put forward by taxpayers can be followed in the background explanation provided by the IRS in the proposed and final regulations on Section 367(d), which abolishes the ATB as well as the foreign goodwill and going concern value exception. The first argument would be:



> *[...] taxpayers take the position that goodwill and going concern value are not section 936(h)(3)(B) intangible property and therefore are not subject to section 367(d) because section 367(d) applies only to section 936(h)(3)(B) intangible property. Under this interpretation, taxpayers assert that the foreign goodwill exception has no application. Furthermore, these taxpayers assert that gain realized with respect to the outbound transfer of goodwill or going concern value is not recognized under the general rule of section 367(a)(1) because the goodwill or going concern value is eligible for, and satisfies, the ATB exception under section 367(a)(3)(A).*[722]

[716] Panse, A., Workforce in Place: Is It an Intangible to Pay for?, *International Transfer Pricing Journal*, Amsterdam: IBFD, (May June 2014), p. 147.

[717] Technical Advice Memorandum 200907024, (Released 13.02.2009); https://www.irs.gov/pub/irs-wd/0907024.pdf (02.12.2016).

[718] A prominent example for this is the issue that has been subject of the Veritas case, where the tax payer valued the Cost Sharing Agreement at 166M USD while the IRS arrived at a valuation of 1675M USD taking into account, among others the access granted to an assembled R&D Team, thus a workforce in place and synergies;
Veritas Software Corp. v. Commissioner, 133 T.C. No. 14 (2009).

[719] Technical Advice Memorandum 200907024, (Released 13.02.2009); https://www.irs.gov/pub/irs-wd/0907024.pdf (02.12.2016).

[720] IRB 2015-40, p. 475ff.

[721] IRB 2015-40, p. 477; Castro, L.F.M. Treatment of Business Synergy for Transfer Pricing Purposes: Critical Analysis of Sections 367(d), 482 and 936 of the Internal Revenue Code and Government Proposals, *International Transfer Pricing Journal*, Amsterdam: IBFD, (March/April 2012), p. 108 & 109.

[722] IRB 2015-40, p. 477.

Whilst the first argument relies on not qualifying goodwill and going concern value as an intangible for the purposes of section 936(h)(3)(B), a contrasting strategy can be observed if the second line of argumentation is adopted. This line of argumentation relies on qualifying the goodwill and going concern as intangibles for the purposes of section 936(h)(3)(B) intangible. As a consequence, the position is taken that:

> *[…], although goodwill and going concern value are section 936(h)(3)(B) intangible property, the foreign goodwill exception applies. These taxpayers also assert that section 367(a)(1) does not apply to foreign goodwill or going concern value, either because of section 367(d)(1)(A) (providing that, except as provided in regulations, section 367(d) and not section 367(a) applies to section 936(h)(3)(B) intangible property) or because of the ATB exception.*[723]

The intent of taxpayers when relying on these two very distinct interpretations is to either fully avoid the applicability of the effects of section 367 and thereby equally section 482, or, alternatively, to rely on one of the two exceptions, either for ATB or foreign goodwill and going concern value.



For those soft-intangibles which can be considered to be shifted in the course of a business restructuring, such as workforce in place or profit potential, the aforementioned line of argumentation can be used to further structure the analysis. For soft-intangibles such as synergies and location savings, that either partly or only arise as a result of the restructuring, the aspects of allocation of those benefits are decisive.

For intangibles like goodwill one must consider the list of intangibles provided for by section 936(h)(3)(B) together with the exemption to Section 367(d) for foreign goodwill and going concern value.[724] Thus, having seen the different positions that taxpayer and IRS tend to take, three different positions are crystallized, and lead to the following questions:

- Does the soft-intangible qualify as an intangible asset for the purpose of section 936 respectively section 367(d)?
- Does it qualify as foreign goodwill or going concern in the sense of the applicable exception of section 367(d)?
- How are the soft-intangibles selected and treated in the framework of a business restructuring 367(d) & 482, considering the necessary qualifications?

For the soft intangibles of workforce in place and, to some degree, synergies, the options are considered per item in the subsequent treatment, which then allows for a conclusion on the nature and the treatment of that type of soft-intangibles according to US legislation.

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[723] IRB 2015-40, p. 477.

[724] Castro, L.F.M. Treatment of Business Synergy for Transfer Pricing Purposes: Critical Analysis of Sections 367(d), 482 and 936 of the Internal Revenue Code and Government Proposals, *International Transfer Pricing Journal*, Amsterdam: IBFD, (March/April 2012), p. 108ff.

Furthermore, all of the mentioned scenarios have implications for the applicability of section 482 and hence the CWI standard. A slightly different treatment applies to location savings, since this is not transferred in the course of a business restructuring, due to the circumstance that these are not shifted and are therefore not subject to section 367 but rather to section 482.

### 5.4.1 Selected Soft-intangibles in Light of their Allocation and Origin in the Course of a Business Restructuring

Looking at the diverse range of what could be considered to be a soft-intangible, the issues that can arise in relation to a cross-border business restructuring are manifold. This necessitates a limitation of the range of soft-intangibles to be looked at.

Taking into account the two aspects of origin and allocation of the derived benefits to one jurisdiction, three types of soft-intangibles stand out in the issues that either become relevant as a result thereof or that are only created in case of a cross-border business restructuring. These are (1) workforce in place, (2) synergies and (3) location savings.



Before the business restructuring is effected, the original entity has assembled a standing workforce, which might also be transferred as part of a restructuring. Even though moving employees across borders together with the operations might be less likely, it is not entirely implausible. Another possibility would be to put that workforce at the disposal of a newly formed foreign entity while the workforce remains in the same location.

This workforce has been assembled in the state from which the outbound restructuring is undertaken. Taking into account in particular US legislation that applies to the transfer of intangibles across borders, a core question is whether an assembled workforce should be qualified as a stand-alone intangible - either enabling taxation of the value that is connected to assembling and contractually binding a capable workforce, or whether this is tax free.

The second kind of soft-intangible which is examined are synergies. Synergies can arise out of two circumstances. After the restructuring, a number of synergies can result from the relationship between the remaining entity in the original state and the newly established one in the other state. Similarly, there can be synergies between an entity that already exists in the target state and the newly established one as a result of the restructuring. Hence, there are two distinct situations where a synergy within an MNE can arise. Thus, the matter of allocating the benefits of such a synergy becomes a decisive issue, as a synergy cannot be said to be rooted in the one or the other state.

The third kind of soft-intangible analysed are location savings. These can take the shape of many different advantages that one country offers over another. Since these advantages are being sought in a business restructuring in the target country, they are intrinsic to the target country. Unlike the other two soft-intangibles, location savings are not moved across borders in the course of a business restructuring. However, they

can greatly influence the benefit that can be derived from the target country. Thus, the allocation of location savings is a controversial issue.

Considering the foregoing, workforce in place and synergy are evaluated on whether they can be intangibles in their own right in line with Section 936. This has consequences for the application of Sections 367 and 482.

Location savings, however, are not intangibles and cannot be shifted in the course of a business restructuring which puts the focus on the allocation of the benefits of it. Seeing the trend of more and more aggressive revenue services in countries like India and China, the perspective of a country like the US which is more likely to be the origin of restructurings trying to obtain a disproportional share of the location savings of developing countries is also important, as this side of the restructuring could just as easily cause double or at least over taxation through its allocation rule.

#### *5.4.1.1 General Requirements for Qualifying as Section 936 Intangible*



The discussion whether the analysed soft-intangibles need to be considered as intangibles of Section 936(h)(3)(B) is centred on the legislative history of Section 936[725] and the requirement of an item to be "similar", as phrased by Section 936(h)(3)(B)(vi).[726] While in earlier iterations the focus was on the differentiation between manufacturing and marketing intangibles, it has now become increasingly important to deal with soft-intangibles.[727] These issues are highly controversial and so far have not been resolved.[728] The controversy is a result of the exhaustive nature of the definition contained in Section 936(h)(3)(B), and could be corrected by expanding it.[729]

Since none of the soft-intangibles under consideration are mentioned in Section 936 specifically as *intangible,* the question arises whether these, also value-carrying intangibles, have been left out intentionally, with all the resulting consequences.[730]

If one were to take the position that the intangibles that have not been enumerated in Section 936 are best subsumed under goodwill and going concern value, it should become clear that these have not been intended to be taxed in a cross-border transaction. Approaching this question by subsuming a number of soft-intangibles under goodwill and going concern, the following position taken by the Joint Committee on Taxation in relation to the application of Section 367(d) is indicative:

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[725] Lowell, C.H. & Briger, P.L., US International Transfer Pricing, Thomson Reuters Tax and Accounting, 2017, 5.03.

[726] Castro, L.F.M. Treatment of Business Synergy for Transfer Pricing Purposes: Critical Analysis of Sections 367(d), 482 and 936 of the Internal Revenue Code and Government Proposals, *International Transfer Pricing Journal*, Amsterdam: IBFD, (March/April 2012), p. 111.

[727] Lowell, C.H. & Briger, P.L., US International Transfer Pricing, Thomson Reuters Tax and Accounting, 2017, 5.03[3]ff.

[728] The most decisive case so far is the Veritas Case: Veritas Software Corp. v. Commissioner, 133 T.C. No. 14 (2009).

[729] As it has been first proposed by the Obama Administration in 2011.

[730] Gomes, T., Defining Goodwill for Transfer Pricing, *Transfer Pricing International Journal 11/12*, Chrystal City, VA: Bloomberg BNA, (2012); http://files.mwe.com/files/Publication/673231ae-b7c8-4cfc-802f-15ac36bf03b8/Presentation/PublicationAttachment/f1f5eae2-9bdf-4536-831c-1c971c029ba2/BNA%20-%20Gomes.pdf? (03.12.2016).

> *Goodwill and certain similar intangibles*
> *Except in the case of an incorporation of a foreign loss branch, the Congress did not believe that transfers of goodwill, going concern value, or certain marketing intangibles should be subject to tax. Goodwill and going concern value are generated by earning income, not by incurring deductions. Thus, ordinarily, the transfer of these (or similar) intangibles does not result in avoidance of Federal income taxes.*[731]

A further indication that the omittance of these particular soft-intangibles for the application of Section 482 and 367(d) was intentional is that Section 197, which also deals with intangibles, does in fact include many of these, either explicitly or under the heading of goodwill and going concern value.[732]

However, this very argument can also be seen from a different angle, taking into account that one can also differentiate between foreign goodwill and going concern value specifically and goodwill and going concern value in general. Had it been the legislator's intent to exclude goodwill and going concern value-like soft-intangibles from the status of intangible altogether, a provision targeted at the exclusion of foreign goodwill and going concern value, as it is part of Section 367(d), would not have been necessary.[733] While it is certain that Congress intended to exclude *something*, it is, however, less clear what sort of goodwill and going concern that was.[734]

Likewise, the IRS considers goodwill and going concern in general as "similar item".[735] This is based on the view that the list of enumerated intangibles needs to be seen merely as an exemplary list which is opened up by Section 936(h)(3)(B)(vi) by referring to "similar other items".[736]

However, in the *Veritas* case, which has effectively dealt with numerous intangibles that have not been listed in Section 936(h)(3)(B), it has been reaffirmed that the framework to qualify an intangible as such has been set rather narrowly.[737] A number of conditions are attached. Specifically, in the case of workforce in place, this argument is

[731] Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, p. 428.

[732] Ibid.

[733] US Congress – Joint Committee on Taxation, Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal – Part Three: Provisions Related to the Taxation of Cross Border Income and Investment (JCS-4-09), September 2009, p. 38 & 39; https://www.jct.gov/publications.html?func=startdown&id=3579 (03.12.2016).

[734] Castro, L.F.M. Treatment of Business Synergy for Transfer Pricing Purposes: Critical Analysis of Sections 367(d), 482 and 936 of the Internal Revenue Code and Government Proposals, *International Transfer Pricing Journal*, Amsterdam: IBFD, (March/April 2012), p. 111.

[735] Gomes, T., Defining Goodwill for Transfer Pricing, *Transfer Pricing International Journal 11/12*, Chrystal City, VA: Bloomberg BNA, (2012); http://files.mwe.com/files/Publication/673231ae-b7c8-4cfc-802f-15ac36bf03b8/Presentation/PublicationAttachment/f1f5eae2-9bdf-4536-831c-1c971c029ba2/BNA%20-%20Gomes.pdf? (03.12.2016).

[736] Technical Advice Memorandum 200907024, (Released 13.02.2009), p. 7; https://www.irs.gov/pub/irs-wd/0907024.pdf (02.12.2016).

[737] Lin, A. & Wright, D.R., The Tax Court Decision in VERITAS: A Comment, International Transfer Pricing Journal, Amsterdam: IBFD, (March/April 2010), p. 149; Postlewaite, P.F. et al., Federal Income Taxation of Intellectual Properties and Intangible Assets, Thomson Reuters, 2017, ¶ 14.13.

further emphasized by the addition that has been made to Section 936(h)(3)(B) in the 1999 amendments to the respective regulations,[738] requiring that it: "*has substantial value independent of the services of any individual*".[739] However, for other soft-intangibles another main factor remains that, in order for it to extend to other, not mentioned items, it still needs to be in line with the other 28 kinds of intangibles that are enumerated in Section 936(h)(3)(B).[740] This view finds its basis in Treasury Regulation §1.482-4(b)(6) which states that:

> *"[…] For purposes of section 482, an item is considered similar to those listed in paragraph (b)(1) through (5) of this section if it derives its value not from its physical attributes but from its intellectual content or other intangible properties."*[741]

The IRS takes the standpoint that the overarching goodwill and going concern value possesses the required qualities and therefore follows the line of the intangibles that have actually been listed in Section 936.[742] However, goodwill and going concern value in general fall short of being commercially transferable.[743] Even though this is no longer a specific requirement, the "commercially transferable" requirement differentiates goodwill and going concern value from other listed items without taking the respective business into account.[744]

Thus, in the absence of case law, administrative regulations or legislation to the contrary, goodwill and going concern value currently do not qualify as intangibles in the sense of Section 936(h)(3)(B).[745]

In order to overcome this unfavourable position the IRS is in, the Obama administration has proposed to clarify the definition of intangible that is handled by Section 936 to include goodwill, going concern value and workforce in place.[746] This proposal is effectively in line



[738] Panse, A., Workforce in Place: Is It an Intangible to Pay for?, *International Transfer Pricing Journal*, Amsterdam: IBFD, (May/June 2014), p. 147.

[739] Sec.: 936(h)(3)(B) IRC.

[740] Castro, L.F.M. Treatment of Business Synergy for Transfer Pricing Purposes: Critical Analysis of Sections 367(d), 482 and 936 of the Internal Revenue Code and Government Proposals, *International Transfer Pricing Journal*, Amsterdam: IBFD, (March/April 2012), p. 111.

[741] Treasury Regulations §1.482-4(b)(6).

[742] US Congress – Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal – Part Three: Provisions Related to the Taxation of Cross Border Income and Investment (JCS-4-09)*, September 2009, p. 38; https://www.jct.gov/publications.html?func=startdown&id=3579 (03.12.2016).

[743] Heriford, B. et al., US Cost Sharing: Current Issues and Court Cases, *International Transfer Pricing Journal*, Amsterdam: IBFD, (July/August 2013), p. 206 & 210; Castro, L.F.M. Treatment of Business Synergy for Transfer Pricing Purposes: Critical Analysis of Sections 367(d), 482 and 936 of the Internal Revenue Code and Government Proposals, *International Transfer Pricing Journal*, Amsterdam: IBFD, (March/April 2012), p. 111.

[744] Castro, L.F.M. Treatment of Business Synergy for Transfer Pricing Purposes: Critical Analysis of Sections 367(d), 482 and 936 of the Internal Revenue Code and Government Proposals, *International Transfer Pricing Journal*, Amsterdam: IBFD, (March/April 2012), p. 111.

[745] Heriford, B. et al., US Cost Sharing: Current Issues and Court Cases, *International Transfer Pricing Journal*, Amsterdam: IBFD, (July/August 2013), p. 206 & 210.

746 Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals*, May 2009, p. 32; https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2010.pdf (03.12.2016).

with the argumentation supported by the IRS based on statutory construction, because otherwise the specific exclusion of foreign goodwill and going concern value from the application of Section 367(d) through regulations[747] would have been superfluous. It is nevertheless contrary to legislative history and to the meaning flowing from the wording of "similar" items.[748] The consequences of something qualifying as intangible or not depend on Section 367(d) and can differ greatly. This highly contested issue can be argued either way due to the consequences that the one or the other interpretation would have. That there is no clarity in this question becomes clear when it is considered that the Obama Administration intended to "clarify" the issue. Additionally, recent legislative initiatives proposed to tackle this problem and clarify it, intend to introduce a reference to sec. 197 IRC mentioned earlier.[749] The latter again points more in the direction of it being a capitulation than a clarification.

#### *5.4.1.2 General Requirements for Qualifying as Goodwill and Ongoing Concern*



Independent of the desire to extend the list of intangible assets as featured in Section 936 with goodwill and going concern, the Treasury Regulations contain the following definitions of goodwill and subsequently of going concern:

> *"Goodwill is the value of a trade or business attributable to the expectancy of continued customer patronage. This expectancy may be due to the name or reputation of a trade or business or any other factor."*[750]

> *"Going concern value is the additional value that attaches to property because of its existence as an integral part of an ongoing business activity. Going concern value includes the value attributable to the ability of a trade or business (or a part of a trade or business) to continue functioning or generating income without interruption notwithstanding a change in ownership."*[751]

[747] Yodder, L., Disputed Issues with the Application of Code Sec. 367 to Intangibles, *The International Tax Journal*, Chicago: CCH, (2012) Vol. 38 No. 3, p. 3.

[748] Ibid., p. 4.

[749] Stop Tax Haven Abuse Act, brought to floor on 05 April 2017, HR 1932, Sec.103.

[750] Treas. Reg. §1.1060-1(b)(2)(ii).

[751] Ibid.

The effective interpretation of these IRS definitions differs however significantly from the taxpayer's point of view, even though the cited definitions are close to identical,[752] inasmuch as the IRS finds these definitions to be too broad and unworkable.[753]

Even though there are strong arguments against the inclusion of goodwill and going concern value and even more so in the case of workforce in place as Section 936 intangible, legislative change to actually achieve this is probable. Consequently, an immediate taxation in line with Section 367(a) would not take place[754] but rather the taxation of a deemed royalty payment in line with Section 367(d).

The follow up question, which arises in particular where a restructuring is undertaken by way of a cost sharing agreement, is whether the workforce in place or profit potential could actually be considered as "foreign" goodwill or going concern. The proposed and now final regulations eliminating the exceptions would make a further investigation into this matter superfluous, if it did not completely change the consequences of a business restructuring, which in fact it does. This issue deals with an interesting situation where a tax claim is potentially levied for a workforce in place, regardless of it crossing the border. Cost sharing agreements also consider the transfer of business opportunities.[755]



Since taxpayers tend to give the term "foreign" a rather broad meaning, the IRS has released a coordinated issue paper in 2007, which, among others, makes its position clear on what it considers to be "foreign" goodwill and ongoing concern value,[756] It is generally aimed at commenting on the treatment of the right to exploit foreign markets which is generally transferred for free within the framework of a buy-in payment under the foreign goodwill and ongoing concern exemption.[757] In this context, the IRS emphasizes that this exception is narrower in reach than considered by taxpayers by stating that assets which can be separately identified may not be considered under the exception.[758]

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[752] Compare: IRS, *Technical Advice Memorandum 200907024*, (Released 13.02.2009); https://www.irs.gov/pub/irs-wd/0907024.pdf (02.12.2016):

Goodwill:

*"(…) that the Network meets the definition of goodwill, defined as "the expectancy of continued patronage" or the expectation that "the old customers will resort to the old place."*

Going concern value:

"(…) *the additional element of value which attaches to property by reason of its existence as an integral part of a going concern," a vital part of which is "the ability of a business to continue to function and generate income without interruption as a consequence of a change in ownership."*

[753] IRS, *Technical Advice Memorandum 200907024*, (Released 13.02.2009); https://www.irs.gov/pub/irs-wd/0907024.pdf (02.12.2016) with reference to: *Newark Morning Ledger v. United States, 507 U.S. 546, 570 (1993).*

[754] Yodder, L., Disputed Issues with the Application of Code Sec. 367 to Intangibles, *The International Tax Journal*, Chicago: CCH, (2012) Vol. 38 No. 3, p. 2.

[755] Heriford, B. et al., US Cost Sharing: Current Issues and Court Cases, *International Transfer Pricing Journal*, Amsterdam: IBFD, (July/August 2013), p. 206.

[756] Coordinated Issue Paper, Sec. 482 CSA Buy-In Adjustments, (27.09.2007).

[757] Castro, L.F.M. Treatment of Business Synergy for Transfer Pricing Purposes: Critical Analysis of Sections 367(d), 482 and 936 of the Internal Revenue Code and Government Proposals, *International Transfer Pricing Journal*, Amsterdam: IBFD, (March/April 2012), p. 113.

[758] Ibid.

### 5.4.2 Workforce in Place

#### *5.4.2.1 Workforce in Place as Intangible under Sec. 936(h)(3)(B) IRC*

Workforce in place can take the shape of a soft-intangible in two distinct situations: *firstly*, when it is actually shifted across borders to a new entity, and *secondly,* when it is placed at the disposal of the entity fulfilling that function after the restructuring has taken place.[759]

Originally, a workforce in place was not considered to be an intangible.[760] However, it has now been included in the list of Section 936.[761] With the 1999 addition that an intangible must exist independently of the services of an individual, the position that a workforce in place is not an intangible had been reaffirmed.[762] In 2007 the IRS issued a directive that specifically calls for the qualification of workforce in place as intangible asset for outbound business restructurings.[763]

Specifically the argument of an intangible existing independent of the services of an individual led to the rejection of the IRS's standpoint in the *Veritas* case of 2009, where it was claimed that the payment was not at arm's length as workforce in place was not taken into account.[764] However, this attitude towards workforce in place is said to have changed after the *Veritas* case.[765] This translates to a diametrically different interpretation of the requirement of an intangible having a value independent of the service of an individual. It insists instead that workforce in place is not to be understood to derive its value from the service of a single (and thereby replaceable) individual, but rather from the plurality of individuals. As a consequence of basing the argument on the number of individuals, a workforce in place is indeed altered from something that is dependent and replaceable to something that exists independent of a certain individual, thereby navigating around this condition, which would otherwise lead to the exclusion of workforce in place from the



[759] These two scenarios are mentioned but not distinctively discussed in the Report produced by the Joint Committee on Taxation, *Description of Revenue Provisions Contained in The President's Fiscal Year 2010 Budget Proposal - Part Three: Provisions Related to The Taxation of Cross-Border Income and Investment*, U.S. Government Printing Office Washington: 2009, p. 40.

[760] Panse, A., Workforce in Place: Is it an Intangible to pay for?, *International Transfer Pricing Journal*, Amsterdam: IBFD, (May/June 2014), p. 147 – quoting US: TC, 1994, TC Memo 1993-414, 66 TCM, Perkin-Elmer Corporation and Subsidiaries vs. Commissioner:

> *"A reasonable value cannot be assigned to an experienced staff, a vertically integrated structure that allows a cost efficient operation, an ability to innovate and respond to market demands for new techniques and an extensive purchasing, production planning and inventory control system."*

[761] Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals*, May 2009, p. 32; https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2010.pdf (03.12.2016).

[762] Panse, A., Workforce in Place: Is It an Intangible to Pay for?, *International Transfer Pricing Journal*, Amsterdam: IBFD, (May/June 2014), p. 147.

[763] Fuller, J.P. et al., IRS Creates a New Category of Intangible Property – Significant Implications for Code Sec. 367, *The International Tax Journal*, Chicago: CCH, (May-June 2007) , p. 15.

[764] Panse, A., Workforce in Place: Is It an Intangible to Pay for?, *International Transfer Pricing Journal*, Amsterdam: IBFD, (May/June 2014), p. 148 – making reference to the decision in Veritas Software Corp. v. Commissioner and quoting Judge Foley, Veritas Software Corp. v. Commissioner, 133 T.C. No. 14 (2009), p. 44.

[765] Ibid., p. 148.

Section 936 intangibles,[766] thereby arguing in favour of the inclusion of workforce in place as *similar item*.

However, according to Section 936(h)(3)(B) prior to 2018 and the regulations, workforce in place is not considered to form a separate intangible, despite the proposal of the Obama Administration to include it in Section 936. Such inclusion can only be achieved by relying on the differentiation, proposed by the Joint Committee on Taxation, on the basis of whether its value is derived from the service of an individual or from a group, the latter being a workforce in place.[767]

Considering that values that existed prior to the restructuring and transfer, bluntly relying on the argument that the requirement of an intangible having a value independent of the service(s) of an individual instead of a group can be followed. Yet it falls short of recognizing the value of the composition of the workforce. Thus, the value is in any case not derived from the services of those individuals but rather from the way the workforce has been composed to function, and the integration of those individuals collectively forming a workforce over the course of time. However, such an argumentation is still not very compelling, since a workforce in place still lacks the feature of being a commercially transferable asset.[768] Furthermore, a workforce in place is only valuable if the business performs well – an indicator for it being goodwill and going concern.[769]



#### *5.4.2.2 Workforce in Place in Relation to Sec. 367(d)*

Considering the *Veritas* decision, the non-compelling argumentation of the IRS of it being a "similar item" and the fact that Section 936(h)(3)(B) IRC still does not list workforce in place as an intangible should allow one to take the stance that workforce in place does not qualify as a Section 936(h)(3)(B) intangible.

Yet, as the IRS observed, some taxpayers take the position that if it in fact does qualify as a 936(h)(3)(B) intangible and one presumes that Section 367(d) is applicable, then workforce in place:

> *"(…) is a component of goodwill and going concern value and, consequently, transfers of a foreign workforce in place is non-compensable under section 367(d)."*[770]

[766] US Congress – Joint Committee on Taxation, Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal – Part Three: Provisions Related to the Taxation of Cross Border Income and Investment (JCS-4-09), September 2009, p. 40. https://www.jct.gov/publications.html?func=startdown&id=3579 (03.12.2016).

[767] Panse, A., Workforce in Place: Is It an Intangible to Pay for?, *International Transfer Pricing Journal*, Amsterdam: IBFD, (May/June 2014), p. 148.

[768] Even though the requirement has been removed for being obvious it nevertheless remains sensible from the perspective of the arm's length principle.

[769] Aksakal, L.J. et al., Section 367(d), Intangibles, and Base Erosion: A Reassessment, BNA Tax Management Memorandum, Chrystal City, VA: Bloomberg BNA, (20.05.2013) Vol. 54 No. 191, p. 11; http://www.millerchevalier.com/portalresource/lookup/poid/Z1tOl9NPl0LTYnMQZ56TfzcRVPMQiLsSw43Cn0ZC/document.name=/Section%20367(d),%20Intangibles,%20and%20Base%20Erosion.pdf (03.12.2016).

[770] US Congress – Joint Committee on Taxation, Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal – Part Three: Provisions Related to the Taxation of Cross Border Income and Investment (JCS-4-09), September 2009, p. 40, FN 110; https://www.jct.gov/publications.html?func=startdown&id=3579 (03.12.2016).

Indeed, considering the scope of Section 367(d), this provision would become applicable if it was a 936(h)(3)(b) intangible. This would lead to the deemed royalty payment for the common life span of the intangible in question. This is commonly referred to as super-royalty, and needs to be adjusted in line with the market value. However, the foreign goodwill and going concern exception on which a taxpayer would want to rely in such a situation is only available in a limited range of situations, apart from the fact that the altered regulations eliminate this very exception.[771]

Yet, if workforce in place is not qualified as an intangible, the application of 367(d) is precluded and a further investigation into the applicability of foreign goodwill and going concern value is not necessary.

#### *5.4.2.3 Physical Transfer of a Workforce in Place*

For the first scenario, the previous observation translates primarily into an issue of taking prior value creation into account of assembling the workforce in place, which would be considered at the time of transfer. If one would merely rely on the argument that employees render a service and that therefore their value creation is not independent of the service of an individual[772], it would only be logical not to attribute the status of intangible to a workforce in place, since in any case no currently existing value is transferred. Only once an actual service is rendered can these individuals create a value. That is why no matter how good a workforce in place there is, value can only be attached to it if the business is actually performing well and produces income.[773] That no value is to be attached to a workforce in place is also in line with cases like *Perkin Elmer Corporation and Subsidiar*ies v Commissioner.[774] Besides the residual value which is inherent in the collection of the workforce, the latter argument further points to it being goodwill and going concern because it is auxiliary to the assets transferred.

However, according to the definition of workforce in place provided by Section 197, it is to be seen as an asset distinct from goodwill and ongoing concern.[775] This line of argumentation has been put forward repeatedly by the IRS[776] and was put to the test in the *Veritas* case, which deals with the making available of a workforce in place.

[771] See section 5.2.4.2.

[772] Fuller, J.P. et al., IRS Creates a New Category of Intangible Property – Significant Implications for Code Sec. 367, *The International Tax Journal*, Chicago: CCH, (May-June 2007), p. 17.

[773] Aksakal, L.J. et al., Section 367(d), Intangibles, and Base Erosion: A Reassessment, BNA Tax Management Memorandum, Chrystal City, VA: Bloomberg BNA, (20.05.2013) Vol. 54 No. 191, p. 11; http://www.millerchevalier.com/portalresource/lookup/poid/Z1tOl9NPl0LTYnMQZ56TfzcRVPMQiLsSw43Cn0ZC/document.name=/Section%20367(d),%20Intangibles,%20and%20Base%20Erosion.pdf (03.12.2016).

[774] Perkin-Elmer Corporation and Subsidiaries v. Commissioner, T.C.M. 1993-414 (1993); Panse, A., Workforce in Place: Is It an Intangible to Pay for?, *International Transfer Pricing Journal*, Amsterdam: IBFD, (May/June 2014), p. 147.

[775] US Congress – Joint Committee on Taxation, Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal – Part Three: Provisions Related to the Taxation of Cross Border Income and Investment (JCS-4-09), September 2009, p. 41. https://www.jct.gov/publications.html?func=startdown&id=3579 (03.12.2016).

[776] Department of the Treasury, *Action on Decision – VERITAS Software Corp. v. Commissioner, 133 T.C. No. 14*, (06.12.2010), p. 4; https://www.irs.gov/pub/irs-aod/aod201005.pdf (03.12.2016).

*"Regarding the R&D and marketing team elements of the intangibles and services package, the Court in a footnote states the view that they do not have substantial value independent of the services of any individual and thus do not come within*

#### *5.4.2.4 Physical Transfer of a Workforce in Place in Relation to 367(d)*

The application of the foreign goodwill and going concern value exceptions in the first scenario appears to be plausible since its features point to foreign goodwill or going concern value.[777] After all, it fulfils the definition of goodwill and going concern value by being the residual value of a business, as it is quantified after every other property has been valued.[778] Thus non-recognition of the transfer under Section 367(d) IRC is possible. However, the foreign goodwill and going concern exception to 367(d) has been eliminated by the newly altered regulations.

Taking the position that it is not to be considered a 936(h)(3)(b) intangible brings Section 367(a) into play. Yet, the ATB exception, limited as it is in line with the altered regulations, would not apply in this situation.[779] The solution to this matter provided by the altered regulations is to rather require the taxpayer to elect a treatment according to either 367(a) or 367(d).[780] Moreover, this eliminates the possibility of considering workforce in place as an "unique quasi kind of asset".



#### *5.4.2.5 Making Available of a Workforce in Place*

In a situation where the workforce in place such as an R&D team is made available to a foreign related entity, the *Veritas* case sets the perfect precedent. More precisely, in the situation of the *Veritas* case a workforce in place has been made available as part of a cost-sharing agreement. Thus, an assembled workforce is placed at the disposal of a receiving entity. Even though this constitutes a platform contribution,[781] which handles a broader definition of intangible property, it is nevertheless decisive for determining the status of workforce in place.[782]

Where a workforce in place is made available to the receiving entity, one is looking at the value created after the restructuring has been effected. Such an issue arises with cost-sharing agreements, where the making available of an R&D team can be considered

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*the intangible definitions of section 936(h)(3)(B) or Treas. Reg. § 1.482-4(b). Id. at 43, n.31.7 The Court ignores that, depending on the facts and circumstances, an experienced and successful team's contribution to value may substantially exceed the total compensation expense to employ the individual team members, and similarly may be independent of the services of any individual team member who may be replaced without materially affecting the team as a whole. This is especially true where the relevant value stems not merely from the R&D and marketing teams in isolation, but from their interrelationship in combination with other important elements in an intangibles and services package such as in this case."*

[777] See Section 5.2.4.2.

[778] Sample, W.J., Revised Comments Re: Proposed regulations under sections 367 and 482 (IRS REG-139483-13), United States Council for International Business (USCIB), (17.12.2015), p. 6; http://www.uscib.org/uscib-content/uploads/2016/01/USCIB_367_482_comments_12_17_2015_final.pdf (03.01.2017).

[779] Since the Active Trade or Business exception applies only to specifically mentioned property, which does not include goodwill and going concern value, it cannot apply.

[780] IRB 2015-40, p. 479f T.D. 9738 (proposed regulation concerning § 1.367(a)-1(b)(5)).

[781] IRS – LB&I International Practice Service Transaction Unit, *Pricing of Platform Contribution Transaction (PCT) in Cost Sharing Arrangements (CSA) Acquisition of Subsequent IP*, (23.12.2015), p. 36; https://www.irs.gov/pub/int_practice_units/ISO9411_01_02.pdf (03.12.2016). Cf.: Treas. Reg. 1.482-7(g)(2)(vii)(B) Example 1.

[782] Wittendorff, J., *Transfer pricing and the arm's length principle in international tax law*. Austin [Tex.]: Wolters Kluwer Law & Business, (2010), p. 558 & 559; Treasury Regulations §1.482-4(b).

as a platform contribution,[783] in particular a contribution of an intangible in line with Sections 936 and 1.482-4(b).[784] This is evidence for the value that can be derived from an assembled R&D team before actual work has been performed.

But the cost-sharing regulations also clarify what the source of value in this case is. According to the latter, it is mentioned that it is not necessarily based solely on the "similar items" of Section 936(h)(3)(B) but specifically the result of qualifying it as know-how or contracts.[785] However, by taking this stance the IRS deviates from the actual wording and legislative history of Section 936, by defining intangibles as well as the official interpretation, and excluding in particular a research operation as intangible.[786]

Additionally, it needs to be pointed out that the foregoing concerned a research and development team, in which the collection of highly qualified individuals and their share in the result can be considered to be of far greater importance than in some other services.

Regardless of the position taken officially by the IRS, the IRS expert witness[787] heard in the *Veritas* case stated that the mere access to such an R&D team has been valued at zero.[788] Likewise, the court came to the conclusion that no intangible has been transferred by granting access to the R&D team, since it does not qualify as an intangible in the sense of Sections 936(h)(3)(B) and § 1.482-4(b).[789]



Based on the argument that the value derived from access to an R&D team is entirely dependent on the services of individuals, the court accordingly stated:

> *The value, if any, of access to VERITAS US' R&D and marketing teams is based primarily on the services of individuals (i.e., the work, knowledge, and skills of team members).*[790]

Thus, in this scenario the argument that the service is rendered by individuals could be applied because by granting access a subsequent service is delivered. However, the issue in question is the valuation of a buy-in payment for which the court limits its analysis to

[783] Ibid.

[784] IRB 2012-12, T.D. 9568, p. 501; Wittendorff, J., *Transfer pricing and the arm's length principle in international tax law*. Austin [Tex.]: Wolters Kluwer Law & Business, (2010), p. 559; Femia, R.V. & Blair, D., Hazards Ahead: The IRS's Coordinated Issue Paper on Cost-Sharing Buy-In Payments, *BNA Tax Management Memorandum*, Chrystal City, VA: Bloomberg BNA, (2008), p. 200.

[785] Wittendorff, J., *Transfer pricing and the arm's length principle in international tax law*. Austin [Tex.]: Wolters Kluwer Law & Business, (2010), p. 559 – including reference to: US Congress – Joint Committee on Taxation, Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal – Part Three: Provisions Related to the Taxation of Cross Border Income and Investment (JCS-4-09), September 2009, p. 38ff; Now finalized: IRB 2012-12, T.D. 9568, p. 499ff.

[786] Ibid., p. 559; Andrus, J.L., USA Branch Report on Transfer Pricing and Intangibles, in: International Fiscal Association, Miyatake, T., Green, R. H., & International Bureau of Fiscal Documentation, Transfer pricing and intangibles (Cahiers de droit fiscal international, v. 92a); Amsterdam: IBFD, (2007), p. 634.

[787] Wittendorff, J., *Transfer pricing and the arm's length principle in international tax law*. Austin [Tex.]: Wolters Kluwer Law & Business, (2010), p. 561.

[788] Ibid., p. 561.

[789] Ibid., p. 561.

[790] Ibid., p. 561. Veritas Software Corp. v. Commissioner, 133 T.C. No. 14 (2009), p. 43 (FN 31).

pre-existing intangibles that have been transferred.[791] Yet, access to an R&D and Marketing team simply has not been transferred; rather, it comes into effect in the course of the cost-sharing agreement, and not before.[792]

The IRS, however, is not merely of the opinion that according to Treas. Reg. § 1.482-7(g)(2)[793] pre-existing intangibles need to be considered too, as well as their effects on the results of the cost-sharing agreement, since:

> *... an experienced and successful team's contribution to value may substantially exceed the total compensation expense to employ the individual team members, and similarly may be independent of the services of any individual team member who may be replaced without materially affecting the team as a whole. This is especially true where the relevant value stems not merely from the R&D and marketing teams in isolation, but from their interrelationship in combination with other important elements in an intangibles and services package such as in this case.*[794]



Following the argumentation of the court, there is no value to be attached to the access to a workforce in place such as an R&D team because the value derived from it is entirely dependent on the services of an individual (or a group). Thus, it does not amount to an intangible of Section 936 even though in principle the issues raised by the IRS responding to the judgement make sense – however not in the particular situation of a platform contribution but rather where either an actual transfer takes place (first scenario) or when pre-existing intangibles are being accounted for.

Even though the court's argumentation has subsequently been rejected by the IRS in an Action on Decision, this memo is particularly interesting as the IRS states that it is actually irrelevant to value the R&D team as an intangible asset since it is rather about the arm's length remuneration of the service that is to be rendered by the team.[795] In this regard the IRS also expands on the valuation of the R&D team together with other assets shifted in aggregation.

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[791] Department of the Treasury, *Action on Decision – VERITAS Software Corp. v. Commissioner, 133 T.C. No. 14*, (06.12.2010), p. 3; https://www.irs.gov/pub/irs-aod/aod201005.pdf (03.12.2016).

[792] Ibid. p. 3.

[793] Ibid. p. 3/Treasury Regulations § 1.482-7(g)(2):
"*[i]f a controlled participant [in a CSA] makes pre-existing intangible property ... available to other controlled participants for purposes of research in the intangible development area ... then each such other controlled participant must make a buy-in payment to the owner.*"

[794] Department of the Treasury, *Action on Decision – VERITAS Software Corp. v. Commissioner, 133 T.C. No. 14*, (06.12.2010), p. 4; https://www.irs.gov/pub/irs-aod/aod201005.pdf (03.12.2016).

[795] IRS, Action on Decision, VERITAS Software Corp. v. Commissioner – 133 T.C. No. 14, IRB No. 2010-49, p. (FN8):
"*In determining the arm's length compensation owing between related parties for furnishing the benefit of the services of a team, the existence or transfer of intangible property as defined in Treas. Reg. § 1.482- 4(b) is irrelevant to valuing the team's services (either separately, or as part of a package in the aggregate along with furnishing the benefit of embedded pre-existing intangibles, as appropriate under the facts and circumstances). See Hospital Corp. of America v. Commissioner, 81 T.C. 520 (1983)(no transfer of intangibles, but compensable services).*"

#### *5.4.2.6 Making Available of a Workforce in Place in Relation to 367(d)*

The making available of a workforce in place is a different matter, however. This would be achieved by way of a Cost Sharing Agreement as seen in *Veritas*. Part of such a Cost Sharing Agreement is an initial platform contribution. Since a platform contribution relates to a multitude of different assets that are required to start the intended operation of the Cost Sharing Agreement, the applicable Cost Sharing regulations prescribe an aggregate valuation for the content of the platform contribution.[796,797]

While the IRS failed to have the making available of a workforce in place considered as part of the platform contribution, the regulations released after that judgement, which focus on "resource capability or right", intend to do so.[798] Even though the exact interaction of Sections 482 and 367(d) in the case of platform contributions was not clear after 2009 and the *Veritas* judgement, the IRS made quite clear that carving goodwill, going concern value, and similarly workforce in place, out of the contract in order is not in line with the arm's length principle of section 482.[799] Therefore, remuneration for the making available of a workforce in place appears to be very likely, considering the position taken by the IRS on this issue.[800] Such a platform contribution is required to be made subject to similar mechanisms as the CWI standard by necessitating periodic adjustments.[801,802]



#### *5.4.2.7 Conclusion*

As described in the previous section dealing with the two possible scenarios that could occur in a business restructuring, there is a crucial difference in the qualification as either an intangible under Section 936 or as goodwill and going concern.

In the first scenario, where a workforce in place is physically shifted across borders, looking at the argument which relies on the circumstances that the value derived is not from a single individual but rather from a group of individuals is most striking and convincing. However, considering that the value of a workforce in place is generally derived from its interaction with the assets that are shifted together with it, the argument of it being goodwill and going concern value can be followed just as well. But in that version of Sec. 936(h)(3)(B) workforce in place is not considered an section 936 intangible.

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[796] Aksakal, L.J. et al., Section 367(d), Intangibles, and Base Erosion: A Reassessment, BNA Tax Management Memorandum, Chrystal City, VA: Bloomberg BNA, (20.05.2013) Vol. 54 No. 191, p. 5; http://www.millerchevalier.com/portalresource/lookup/poid/Z1tOl9NPl0LTYnMQZ56TfzcRVPMQiLsSw43Cn0ZC/document.name=/Section%20367(d),%20Intangibles,%20and%20Base%20Erosion.pdf (03.12.2016).

[797] IRB 2015-40, p. 453ff.

[798] Ibid.

[799] IRS – LB&I International Practice Service Transaction Unit, *Pricing of Platform Contribution Transaction (PCT) in Cost Sharing Arrangements (CSA) Acquisition of Subsequent IP*, (23.12.2015), p. 3; https://www.irs.gov/pub/int_practice_units/ISO9411_01_02.pdf (03.12.2016).

[800] IRB 2015-40, p. 453 T.D. 9738.

[801] Aksakal, L.J. et al., Section 367(d), Intangibles, and Base Erosion: A Reassessment, BNA Tax Management Memorandum, Chrystal City, VA: Bloomberg BNA, (20.05.2013) Vol. 54 No. 191, p. 5; http://www.millerchevalier.com/portalresource/lookup/poid/Z1tOl9NPl0LTYnMQZ56TfzcRVPMQiLsSw43Cn0ZC/document.name=/Section%20367(d),%20Intangibles,%20and%20Base%20Erosion.pdf (03.12.2016).

[802] See Section 5.5.

The same section also determines the status of workforce in place for the second scenario. The *Veritas* Case is decisive. In this judgement, the making available of a work force in place has been clearly pronounced as not to be valued as a Section 936 intangible asset. Following this, the IRS has reiterated its position in an Action on Decision note,[803] i.e. that it considers workforce in place as an intangible, yet agrees with the judgement that not the R&D team is to be valued but rather the service rendered by it. Furthermore, the IRS reinforced its position to consider the aggregate value of the service of a workforce in place and other assets shifted.

Comparing the positions of the IRS taken in both situations, in so far as they are comparable, it is noticeable that there is a contradiction regarding the valuation of a workforce in place when shifted physically and when made available to a foreign related entity. While in the first scenario valuation as intangible asset, thus with its value created prior to the shift, is deemed necessary, in the second scenario the IRS would, in line with its Action on Decision paper, contend itself with valuing future services rendered by the workforce in place. However, there is consistency in the desire to value workforce in place in aggregation with other assets/transactions shifted. With regard, however, to the first scenario in particular, this raises the question whether this should not rather be regarded as an argument for qualifying it as goodwill or ongoing concern.



### 5.4.3 Synergy

Since there is no legal definition of synergy, this analysis shall be confined to the benefit, in the broadest sense, that arises out of the interaction between companies that are under common control. Examples for synergies that can arise in the course of a business restructuring are of operational, managerial or financial nature.[804]

Synergy is not explicitly listed among the intangibles that are considered to qualify as Section 936 intangible. Thus, attributing the status of intangible to synergies by qualifying as *similar items* under 936(h)(3)(B).[805] Alternatively, as can be observed in the TAM dealing with synergies arising from a network of agents, the IRS took the approach of fitting the intangibles causing the synergy into an existing defined category as listed in section 936. However, synergy can also be the result of an interaction of assets with each other. This issue shall be touched upon in the framework of aggregation.

While synergies between related entities arise independently of the service of an individual, the discussion surrounding its inclusion into the laundry list of Section 936 (h)(3)(B) is basically identical to the one on workforce in place and goodwill or going concern in general. This issue has been dealt with in the TAM which aims at the inclusion

[803] Department of the Treasury, *Action on Decision – VERITAS Software Corp. v. Commissioner, 133 T.C. No. 14*, (06.12.2010); https://www.irs.gov/pub/irs-aod/aod201005.pdf (03.12.2016).

[804] Sudarsanam, S. et al., Shareholder Wealth Gains in Mergers: Effect of Synergy and Ownership Structure, *Journal of Business Finance & Accounting*, Hoboken, NJ: John Wiley & Sons, (1996), vol. 23 Iss. 5-6, p. 674ff.

[805] Castro, L.F.M. Treatment of Business Synergy for Transfer Pricing Purposes: Critical Analysis of Sections 367(d), 482 and 936 of the Internal Revenue Code and Government Proposals, *International Transfer Pricing Journal*, Amsterdam: IBFD, (March/April 2012), p. 108.

of synergies into the scope of Section 936(h)(3)(B).[806] However, in that publication the IRS relied on those categories of intangibles already in existence, which it considered to be the cause of synergies, in order to capture the synergistic value instead of solely relying on the heading of *similar items* of 936(h)(3)(B).[807]Additionally, the IRS took the position that the intangible assets which it identified need to be valued on an aggregated basis. For the latter the *Veritas* case once again is decisive, where the IRS argued that:

> *"th[e] assets collectively possess synergies that imbue the whole with greater value than each asset standing alone"*[808]

Even though a TAM does not have the status of law, it nevertheless states the position, which has been and would be taken by the IRS in [?] the situation at hand.[809]

#### *5.4.3.1 Synergy as Intangible under Sec. 936(h)(3)(B) IRC*



Instead of grouping the network of agents that has been the subject of the TAM in question under *similar items*, for which merely the individual identifiability of the intangible is mentioned as a necessary requirement,[810] the IRS mainly considered that such networks of companies produce synergies through the "*collection of contracts, a franchise, a system, a method, a program, or a similar asset.*"[811]

Therefore, the first major part of the analysis conducted in the TAM concerns the question whether any of the aforementioned intangible assets can be considered to have been transferred in the course of the business restructuring. IRS and taxpayer only agree on a collection of contracts being in place between the taxpayer and the agents.[812]

In this case the taxpayer argued, by citing VGS Corp. v. Comm'r, 68 T.C. 563, at 592 (1977), that the network in question does meet the requirements of going concern because the network constitutes additional value that is contained in the property transferred and enables a continued generation of income regardless of a change in ownership.[813]

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[806] IRS, *Technical Advice Memorandum 200907024*, (Released 13.02.2009); https://www.irs.gov/pub/irs-wd/0907024.pdf (02.12.2016).

[807] Ibid.

[808] Veritas Software Corp. v. Commissioner, 133 T.C. No. 14 (2009), p. 39.

[809] IRS, *Understanding IRS Guidance – A Brief Primer*; https://www.irs.gov/uac/understanding-irs-guidance-a-brief-primer (16.12.2016).

[810] IRS, *Technical Advice Memorandum 200907024*, (Released 13.02.2009), p. 7&8; https://www.irs.gov/pub/irs-wd/0907024.pdf (02.12.2016).

[811] Ibid., p. 6.

[812] Considering synergies overall, further focusing on the additional arguments raised in the TAM is not productive as the IRS tries to prove that a network, and thus in part synergies, either fits directly into one of the intangibles provided in section 936 (h)(3)(B) or fulfils the requirement of being sufficiently similar to the intangibles listed in paragraph (i) – (v).; IRS, *Technical Advice Memorandum 200907024*, (Released 13.02.2009), p. 12; https://www.irs.gov/pub/irs-wd/0907024.pdf (02.12.2016).

[813] Ibid., p. 6.

Moreover, the taxpayer sees the qualification of goodwill fulfilled since the network is the basis for sustained and returning customer patronage.[814]

However, the IRS, instead, focused on arguing that the network constitutes a "*collection of contracts, a franchise, a system, a method, a program, or a similar asset.*"[815] As a consequence, the IRS concluded that the network is an intangible asset of Section 936(h)(3)(B) and did not expand on whether it is goodwill or ongoing concern.

The taxpayer's rebuttal of the IRS argumentation, which takes parts of the network and fits them into every one of the existing categories of intangibles of 936(h)(3)(B), cannot be considered persuasive.[816] Instead it is rejected by claiming that the definitions of goodwill and going concern on which, the taxpayer relies are too broad.[817]

Considering that synergies do not exist independently but are rather the result of the interaction of intangibles analysed in the TAM as well as those explicitly named in Section 936(h)(3)(B) makes it possible for the IRS to rely specifically on these intangibles to create a proxy for synergies.[818] However, concluding that the network in question is made up of Section 936 intangibles can only be the first part of the analysis, since the synergistic value arises out of the aggregation of those proxy intangibles. Yet, synergy on its own should be considered as part of goodwill and going concern rather than being a Section 936 intangible.



#### *5.4.3.2 Synergy & Aggregation*

Since the intangibles effectively form the network, the IRS further examines the role of the individual intangibles and contends that these contracts need to be seen as a single aggregated asset.[819] The IRS considers the intangibles on an aggregated basis,[820] as they function in unity, thereby arriving at a far greater value than the sum of individual assets.[821] The IRS subsequently draws an analogy to a car whose value exceeds the sum of its individual parts would not be treated as goodwill by a business.[822] Also, the example is given of a group of patents being applied in the aggregate to one product, from which it is concluded that the value of the patents as a group by far exceeds the sum of the individual values of those patents.[823] While this is correct, the IRS, based on Kraft Foods

[814] Ibid., p. 6. – with reference to: Boe v. Comm'r, 307 F.2d 339, 343 (9th Cir. 1962); Comm'r v. Killian, 314 F.2d 852, 855 (5th Cir. 1963) (quoting Nelson Weaver Royalty Co. v. Comm'r, 307 F.2d 897 (5th Cir. 1962)).

[815] Ibid., p. 6.

[816] Ibid., pp. 10-12.

[817] TAM p. 17.

[818] As devised in the TAM: IRS, *Technical Advice Memorandum 200907024*, (Released 13.02.2009); https://www.irs.gov/pub/irs-wd/0907024.pdf (02.12.2016).

[819] Ibid., p. 7.

[820] According to Sec. 482 IRC and the corresponding (temporary) Regulations the IRS may value a broad range of transactions on an aggregated basis as e.g. outlined in *T.D. 9738*, *Clarification of the Coordination of the Transfer Pricing Rules with Other Code Provisions*, IRB 2015-40, p. 453ff.

[821] IRS, *Technical Advice Memorandum 200907024*, (Released 13.02.2009), p. 7; https://www.irs.gov/pub/irs-wd/0907024.pdf (02.12.2016).

[822] Ibid.

[823] Ibid.

Co. v. Commissioner,[824] argues that the added value is part of the patents themselves and not goodwill or going concern value.[825]

Aggregating the intangibles is based on the application of case law which states that:

> *"(…) it is appropriate to value interrelated assets in the aggregate and that the synergistic value of a collection of assets is attributable to those assets rather than a conceptually distinguishable goodwill or going concern value element."*[826]

Therefore, the synergistic value is contained in the assets that are shifted as a collection.[827] As a consequence of the standpoint that the IRS takes in this matter, aggregation is necessary in order to conform to the requirements imposed by Section 482; specifically, to use the most appropriate and reliable method[828] to determine the appropriate arm's length charge.[829]

However, as has been held in *Veritas*, such an aggregate valuation potentially violates §1.482-1(f)(2)(ii)(A) which provides that the IRS needs to respect the way a transaction has been structured by the taxpayer unless it lacks economic substance.[830] Another potential problem of aggregating a transaction was highlighted in the very same judgement, due to the *akin to a sale* standard which has been applied by the IRS and thereby not recognizing that the actual licensing took place. The court came to the conclusion that doing so:

> *Respondent's "akin" to a sale theory (i.e., a theory which encompasses shortlived intangibles valued as if they have a perpetual life and takes into account intangibles*



[824] Kraft Foods Co. v. Commissioner, 21 T.C. 513 (1954).

[825] IRS, *Technical Advice Memorandum 200907024*, (Released 13.02.2009), p. 7; https://www.irs.gov/pub/irs-wd/0907024.pdf (02.12.2016).

[826] Ibid., p. 13.

[827] Ibid., p. 13.

[828] Treasury Regulation § 1.482-1(c)(1):
*"In general. The arm's length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result. Thus, there is no strict priority of methods, and no method will invariably be considered to be more reliable than others. An arm's length result may be determined under any method without establishing the inapplicability of another method, but if another method subsequently is shown to produce a more reliable measure of an arm's length result, such other method must be used. Similarly, if two or more applications of a single method provide inconsistent results, the arm's length result must be determined under the application that, under the facts and circumstances, provides the most reliable measure of an arm's length result. See §**1.482-8** for examples of the application of the best method rule. See § **1.482-7** for the applicable methods in the case of a cost sharing arrangement."*

[829] TAM, p. 13: Treas. Reg. § 1.482-1(f)(2)(i):
"*The combined effect of two or more separate transactions (whether before, during, or after the taxable year under review) may be considered, if such transactions, taken as a whole, are so interrelated that consideration of multiple transactions is the most reliable means of determining the arm's length consideration for the controlled transactions. Generally, transactions will be aggregated only when they involve related products or services, as defined in Treas. Reg. § 1.6038A-3(c)(7)(vii).*"

[830] Veritas Software Corp. v. Commissioner, 133 T.C. No. 14 (2009), p. 40 & 41; Oates, M.A. & O'Brien, J.M., Tax Court Rejects IRS CIP on Cost Sharing Buy-Ins in VERITAS, *The International Tax Journal*, Chicago: CCH, (January 2010) Vol. 36, p. 21 & 24.

> *that were subsequently developed rather than preexisting) certainly does not produce the most reliable result.*[831]

Even though this stance failed in the *Veritas* case, the IRS has reiterated this position in an Action on Decision.[832]

#### *5.4.3.3 Final Regulations Clarifying Aggregation*

The issues surrounding aggregation and therefore synergies have been further refined and expanded in an Internal Revenue Bulletin, published in October 2015, which explicitly stated that:

> *(…) if consideration of the facts and circumstances reveals synergies among interrelated transactions, an aggregate evaluation under section 482 may provide a more reliable measure of an arm's length result than a separate evaluation of the transactions.*[833]



Evidently, the regulations target synergies. In order to expand on the situations where synergies exist and are best captured by an aggregate valuation, a number of new examples was introduced to *§§ 1.482–1T(f)(2)(i)(E)*. There are now eleven examples in total. The original four examples used in the previous regulation remained largely unchanged. Considering what has been covered already in this thesis, Examples 5 and 10 are worth pointing out.

In both examples P is a domestic company and S1-S3 are foreign, wholly owned companies:

> ***Example 5***
> *Aggregation of interrelated patents. P owns 10 individual patents that, in combination, can be used to manufacture and sell a successful product. P anticipates that it could earn profits of $25x from the patents based on a discounted cash flow analysis that provides a more reliable measure of the value of the patents exploited as a bundle rather than separately. P licenses all 10 patents to S1 to be exploited as a bundle. Evidence of uncontrolled licenses of similar individual patents indicates that, exploited separately, each license of each patent would warrant a price of $1x, implying a total price for the patents of $10x. Under paragraph (f)(2)(i)(B) of this section, in determining the arm's length royalty for the license of the bundle of patents, it would not be appropriate to use the uncontrolled licenses as*

[831] Veritas Software Corp. v. Commissioner, 133 T.C. No. 14 (2009), p. 40 & 41; Oates, M.A. & O'Brien, J.M., Tax Court Rejects IRS CIP on Cost Sharing Buy-Ins in VERITAS, *The International Tax Journal*, Chicago: CCH, (January 2010) Vol. 36, p. 21.

[832] Department of the Treasury, *Action on Decision - VERITAS Software Corp. v. Commissioner, 133 T.C. No. 14*, (06.12.2010), p. 5; https://www.irs.gov/pub/irs-aod/aod201005.pdf (03.12.2016).

[833] IRB 2015-40, T.D. 9738, p. 454.

> *comparables for the license of the bundle of patents, because, unlike the discounted cash flow analysis, the uncontrolled licenses considered separately do not reliably reflect the enhancement to value resulting from the interrelatedness of the 10 patents exploited as a bundle.*[834]

Example 5 demonstrates how synergies are dealt with that are derived from the interaction of assets with each other. In the described situation the IRS would deny the use of separate uncontrolled comparables and would instead resort to valuing them as a bundle, thus aggregating them. Yet, as seen in the *Veritas* judgement, this would still violate §1.482-1(f)(2)(ii)(A).[835]

This example, however, highlights another issue that the IRS has with the outbound transfer of intangibles. It intends to reduce the status of the foreign entity to a contract manufacturer or a similarly low risk entity in the value chain.[836] The example is in line with that, as the intangibles are merely licensed to the foreign entity, but by combining the patents into one product the current residual profits as well as future profits are to be allocated to the domestic entity as if an entire business had been transferred.[837] This practice is continued even though the IRS has suffered major losses on this view in the cases of *Eli Lilly & Co v. Commissioner* and *G.D. Searle & Co. v. Commissioner*.[838] This example steers clear of the complex of problems that could arise in relation to a cost-sharing agreement.



Another relevant situation is where existing intangibles are transferred to a foreign entity, on which basis new intangibles or products in the framework of a cost-sharing agreement are developed. In this regard, example 10 becomes relevant since it also deals with the participation of the domestic entity in the development of the intangible by giving access to a R&D team so that not only services are rendered but possibly intangibles are transferred as well. Thus, it deals with synergies resulting from the access to an R&D team (workforce in place) and a platform.

> ***Example 10***
> *Services provided using intangibles. –(i) P's worldwide group produces and markets Product X and subsequent generations of products, which result from research and development performed by P's R&D Team. Through this collaboration with respect to P's proprietary products, the members of the R&D Team have individually and*

[834] IRB 2015-40, T.D. 9738, p. 457.

[835] Veritas Software Corp. v. Commissioner, 133 T.C. No. 14 (2009), p.41; §1.482-1(f)(2)(ii)(A):
*"The district director will evaluate the results of a transaction as actually structured by the taxpayer unless its structure lacks economic substance."*

[836] Silverman, M. J. et al., Considering Veritas and Future Transfer Pricing Litigation, *Tax Notes*, Falls Church, VA: Tax Analysts (13 October 2014), p. 230.

[837] Ibid.

[838] Ibid.

*as a group acquired specialized knowledge and expertise subject to non-disclosure agreements (collectively, "knowhow").*

*(ii) P arranges for the R&D Team to provide research and development services to create a new line of products, building on the Product X platform, to be owned and exploited by S1 in the overseas market. P asserts that the arm's length charge for the services is only reimbursement to P of its associated R&D Team compensation costs.*[839]

*(iii) Even though P did not transfer the platform or the R&D Team to S1, P is providing value associated with the use of the platform, along with the value associated with the use of the knowhow, to S1 by way of the services performed by the R&D Team for S1 using the platform and the knowhow. The R&D Team's use of intangible property, and any other valuable resources, in P's provision of services (regardless of whether the service effects a transfer of intangible property or valuable resources and regardless of whether the property is relatively high or low value) must be evaluated under the section 482 regulations, including the regulations specifically applicable to controlled services transactions in § 1.482–9, to ensure that P receives arm's length compensation for any value (attributable to such property or services) provided to S1 in a controlled transaction. See §§ 1.482–4 and 1.482–9(m). Under paragraph (f)(2)(i)(A) of this section, the arm's length compensation for the services performed by the R&D Team for S1 must be consistent with the value provided to S1, including the value of the knowhow and any synergies with the platform. Under paragraphs (f)(2)(i)(B) and (C) of this section, the best method analysis may determine that the compensation is most reliably determined on an aggregate basis reflecting the interrelated value of the services and embedded value of the platform and knowhow.*



In the original iteration of the example, the entity abroad develops and subsequently owns and exploits products overseas from a platform which has originally been brought about by its domestic parent.

The IRS asserts that value is not only provided by making available an experienced R&D team but also by the platform. In this situation, the IRS intends to disregard whether intangibles in relation to the platform or merely know-how of the R&D team has been transferred. However, it emphasizes that the remuneration for the domestic entity needs to consider not only know-how which might have been transferred but also any synergies with the platform. The taxpayer considers that the reimbursement for the services of the R&D team must be limited to the compensation costs of the R&D team.

[839] IRB 2015-40, T.D. 9738, p. 458.

Taking into account the stance that the IRS takes in this example by calling for an aggregated approach that also takes synergies into consideration, the extent of these synergies is uncertain. There can be synergies that arise at the moment of transfer since otherwise the entity abroad would not have gained access to the R&D team, and thus the know-how, if it was not part of the group. However, these synergies can also arise in the course of the R&D team rendering its services. While no clear position is taken on how the synergistic gains are to be shared, the fact that the domestic entity has to be remunerated for them shows the agenda of the IRS of attributing only a status of low-risk entity to the related entities abroad.[840] By aggregating transactions this goal is achieved, yet not in line with the actual transaction. However, the aggregation does make sense since only in this way can the transfer of know-how be accounted for.

In order to cover the issues surrounding workforce in place, the example provides an alternative:



> *(iv) In the alternative, the facts are the same as above, except that P assigns to S1 all or a pertinent portion of the R&D Team and the relevant rights in the platform. P takes the position that, although the transferred platform rights must be compensated, the knowhow does not have substantial value independent of the services of any individual on the R&D Team and therefore is not an intangible within the meaning of § 1.482–4(b). In P's view, S1 owes no compensation to P on account of the R&D Team, as S1 will directly bear the cost of the relevant R&D Team compensation. However, in assembling and arranging to assign the relevant R&D Team, and thereby making available the value of the knowhow to S1, rather than other employees without the knowhow, P is performing services for S1 under imputed contractual terms based on the parties' course of conduct. Therefore, even if P's position were correct that the knowhow is not an intangible under § 1.482–4(b), a position that the Commissioner may challenge, arm's length compensation is required for all of the value that P provides to S1 through the interrelated provision of platform rights, knowhow, and services under paragraphs (f)(2)(i)(A), (B), and (C) of this section.*

The alternative also extends to the inclusion of workforce as intangible asset. Thus, regardless of the failed argumentation in terms of aggregation in the *Veritas* case, the IRS maintains its position on aggregation even though there are still a number of caveats, particularly where transactions are economically sound. Some of the present value is thus also derived from future potential.

[840] Silverman, M. J. et al., Considering Veritas and Future Transfer Pricing Litigation, *Tax Notes*, Falls Church, VA: Tax Analysts (13 October 2014), p. 230.

#### *5.4.3.4 Synergies in Relation to 367(d)*

As has been seen in the previous section, different options are to be considered when first dealing with the question whether a synergies ought to be considered to be intangible assets for the purposes of Section 936(h)(3)(b).

The position generally taken by taxpayers is that synergies are not 936(h)(3)(b) intangibles.[841] Consequently, Section 367(d) is not applicable. In line with the final regulations, the ATB exception is no longer available in this case.[842] Consequently, the realization of a taxable gain becomes necessary.

The alternative, i.e. considering synergies as 936(h)(3)(b) intangibles, which is also the line of argumentation followed by the IRS, considering that the TAM, amongst others, makes Section 367(d) applicable. An exception for foreign goodwill and going concern is not available according to the final regulations.[843]

However, synergies arise from the interaction of entities or assets with each other and do not exist by themselves. The best way to take synergies into account, as required by Section 482, is therefore to value them in aggregation.[844] Thus, as has been seen in the TAM, where assets are so interrelated that together they contain a synergistic value, aggregation is warranted.[845]



Even though synergy conceptually rather belongs to goodwill and going concern, a separate valuation would not take place in this case.[846] Thus, the discussion on the no longer existing foreign goodwill and going concern exception of section 367(d) is made redundant. Taxation would therefore ultimately take place by subjecting the synergy to an aggregated valuation.

#### *5.4.3.5 Conclusion*

Individual parts that interact with each other and thereby create synergistic value do so as a result of their relationship with each other, even though such a circumstance rather resembles the definition of goodwill or going concern value,[847] just as has been contended

[841] Castro, L.F.M. Treatment of Business Synergy for Transfer Pricing Purposes: Critical Analysis of Sections 367(d), 482 and 936 of the Internal Revenue Code and Government Proposals, *International Transfer Pricing Journal*, Amsterdam: IBFD, (March/April 2012), p. 113.

[842] IRB 2017-3, p. 384 T.D. 9803.

[843] IRB 2017-3, p. 384 T.D. 9803.

[844] IRB 2015-40, p. 453 T.D. 9738; Aggregation is specifically demanded in the following situations: „[…] situations in which a coordinated best method analysis and evaluation may be necessary include (1) two or more interrelated transactions when either all such transactions are governed by one regulation under section 482 or all such transactions are governed by one subsection of section 367, (2) two or more interrelated transactions governed by two or more regulations under section 482, (3) a transfer of property subject to section 367(a) and an interrelated transfer of property subject to section 367(d), (4) two or more interrelated transactions where section 367 applies to one transaction and the general recognition rules of the Code apply to another interrelated transaction, and (5) other circumstances in which controlled transactions require analysis under multiple Code and regulatory provisions."

[845] IRS, *Technical Advice Memorandum 200907024*, (Released 13.02.2009), p. 13; https://www.irs.gov/pub/irs-wd/0907024.pdf (02.12.2016).

[846] Ibid., p. 13.

[847] Castro, L.F.M. Treatment of Business Synergy for Transfer Pricing Purposes: Critical Analysis of Sections 367(d), 482 and 936 of the Internal Revenue Code and Government Proposals, *International Transfer Pricing Journal*, Amsterdam: IBFD, (March/April 2012), p. 118 & 119.

by the taxpayer. Additionally, in the case depicted in the TAM[848] the IRS seeks valuation on an aggregated basis. The reason for this is the requirement of choosing the most appropriate, the best method. Valuing the contracts on an aggregated basis is deemed necessary by the IRS to reflect the interrelationship between the contracts.[849] Therefore, it can be argued that the IRS contradicts its own position. If the value was in fact embodied in something like the interrelation of the contracts with each other, one would have to consider synergies as goodwill or going concern value instead.

There are a number of good reasons why synergy should not be considered as "other similar item" of Section 936(h)(3)(B). However, as seen in the TAM, there are plenty of different ways to value the intangibles causing the synergy in aggregation instead of the synergy itself. Using this proxy also makes it possible to capture synergies even though they are not mentioned as intangible in the laundry list of Section 936(h)(3)(B).
This forms the second part of the analysis. It does not alleviate the fact that synergies, or those intangibles producing synergies, are not listed in Section 936(h)(3)(B). Additionally, synergies are not individually transferrable nor does a synergy have an independent value. This makes for a rather strong case against the inclusion of synergies in the list of intangibles of Section 936(h)(3)(B).[850]



### 5.4.4 Location Savings

Location savings are not transferred from one country to another in the course of a business restructuring. It is therefore not an issue of Section 367 IRC. Furthermore, location savings are not an intangible by themselves for the application of Section 936. However, there are certain features of a location that can become so intrinsic to the corporation and its policy that it is difficult to determine the actual origin of the resulting advantages.[851]

Thus, the main issue surrounding benefits that are derived from the location is their allocation between the domestic country and the one to which functions are shifted in order to capitalize on them. In the case of the US, location savings have been in focus since "operation bootstrap", as part of a programme to develop the economy of Puerto Rico.[852] This policy relied on the exemption from federal income taxes of income earned in Puerto Rico as well as other possessions.[853] This led to transfer pricing issues which were first considered by Revenue Procedure 63-10[854] and later led to Section 482 IRC.[855] The

[848] Ibid; IRS, *Technical Advice Memorandum 200907024*, (Released 13.02.2009), p. 7; https://www.irs.gov/pub/irs-wd/0907024.pdf (02.12.2016).

[849] Ibid, p. 14.

[850] Ibid; IRS, *Technical Advice Memorandum 200907024*, (Released 13.02.2009), p. 11; https://www.irs.gov/pub/irs-wd/0907024.pdf (02.12.2016).

[851] Wilkie, J.S., Intangibles and Location Benefits (Customer Base), *Bulletin for International Taxation*, Amsterdam: IBFD, (June/July 2014), Vol. 68 No. 6/7, p. 356.

[852] Girish, K.R. & Parrikar, V., Location Savings Depend on Facts of the Case, *International Tax Review*, London: Euromoney Institutional Investor, (October 2007), Vol. 18 No. 19, p. 33.

[853] Ibid.; Sec. 931 IRC.

[854] Ibid. p. 33; Revenue Procedure 63-10, 1969-1 CB 490.

[855] Ibid.

former specifically allocated the income from intangibles to the subsidiary located in the possessions and not the US parent.[856] With the introduction in 1986 of Section 482,which demands an appropriate adjustment for factors such as geographic market in order to increase the comparability of controlled and uncontrolled transactions, the IRS deviated from the clear allocation provided by Revenue Procedure 63-10.[857] Instead, such an adjustment led to a split allocation between the US and the possession, thus allocating the location savings according to the arm's length principle.[858]Section 482 and the respective regulations were further refined in 1994[859] and they now specifically address location saving:

> *If an uncontrolled taxpayer operates in a different geographic market than the controlled taxpayer, adjustments may be necessary to account for significant differences in costs attributable to the geographic markets. These adjustments must be based on the effect such differences would have on the consideration charged or paid in the controlled transaction given the relative competitive positions of buyers and sellers in each market. Thus, for example, the fact that the total costs of operating in a controlled manufacturer's geographic market are less than the total costs of operating in other markets ordinarily justifies higher profits to the manufacturer only if the cost differences would increase the profits of comparable uncontrolled manufacturers operating at arm's length, given the competitive positions of buyers and sellers in that market.*[860]



This approach, which deviates from Revenue Procedure 63-10 and has in essence been part of Section 482 of the IRC since 1968, has been followed by courts even though location savings have not been specifically addressed.[861] Thus, location savings are to be allocated in line with the arm's length principle instead of allocating the income of intangibles entirely to the possession as long as the intangible belonged to the subsidiary located in the possession.[862]

The example provided in the regulations further pronounces the importance of the factor of the market position in which the subsidiary operates:

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[856] Ibid – under the condition that the intangible belongs to the subsidiary under all facts and circumstances.

[857] Ibid.

[858] Ibid. p. 33

[859] Allen, S.N. et al., Location Savings – A US Perspective, *International Transfer pricing Journal*, Amsterdam: IBFD, (July/August 2004), Vol. 11 No.4, p. 4.

[860] Ibid, Treas. Regulations 1.482-(1) (d)(4)(ii)(c)

[861] Girish, K.R. & Parrikar, V., Location Savings Depend on Facts of the Case, *International Tax Review*, London: Euromoney Institutional Investor, (October 2007), Vol. 18 No. 19, p. 33; Tsaneva, E.R., Transfer Pricing in the World of Services and Intangibles – A New Challenge to Preserving the Corporate Tax Base, *UCLA Journal of International Law and Foreign Affairs*, Los Angeles: University of California School of Law, (Fall/Winter 2004), Vol. 9, p. 355; Allen, S.N. et al., Location Savings – A US Perspective, *International Transfer pricing Journal*, Amsterdam: IBFD, (July/August 2004), Vol. 11 No.4, p. 7.

[862] Girish, K.R. & Parrikar, V., Location Savings Depend on Facts of the Case, *International Tax Review*, London: Euromoney Institutional Investor, (October 2007), Vol. 18 No. 19, p. 33.

*Couture, a U.S. apparel design corporation, contracts with Sewco, its wholly owned Country Y subsidiary, to manufacture its clothes. Costs of operating in Country Y are significantly lower than the operating costs in the United States. Although clothes with the Couture label sell for a premium price, the actual production of the clothes does not require significant specialized knowledge that could not be acquired by actual or potential competitors to Sewco at reasonable cost. Thus, Sewco's functions could be performed by several actual or potential competitors to Sewco in geographic markets that are similar to Country Y. Thus, the fact that production is less costly in Country Y will not, in and of itself, justify additional profits derived from lower operating costs in Country Y inuring to Sewco, because the competitive positions of the other actual or potential producers in similar geographic markets capable of performing the same functions at the same low costs indicate that at arm's length such profits would not be retained by Sewco.*



Thus, according to the treasury regulations, the benefits that a related entity has abroad do not justify the allocation of a higher profit resulting in e.g. lower costs, due to the competitive situation the related entity is in.

The application of Section 482 to location savings has been the subject of two significant court cases. The initial situation was vastly different from the example provided above. In order to illustrate these differences and the resulting decisions, the cases are described below.

#### *5.4.4.1 Sundstrand Corporation & Compaq*

##### *5.4.4.1.1 Sundstrand Corporation*

The first case which explicitly considers location savings is *Eli Lilly and Co v. Commissioner*.[863] The location savings were attributed in their entirety to the Puerto Rican Subsidiary of Eli Lilly.[864] However, location savings and their allocation were not substantially discussed in this case.

Only later, in the case of *Sundstrand Corporation v. Commissioner,* have location savings been at the centre of the dispute. The US based Sundstrand Corporation (Sundstrand) had set up a subsidiary in Singapore (SunPac) which manufactured spare parts for products of Sundstrand. The parts were manufactured by SunPac on the basis of a licence agreement for the intangibles required for the manufacturing of the spare parts. Even though intended otherwise, the parts were only sold to Sundstrand and not to third parties. The parts were sold by SunPac to Sundstrand for 15% less than the resale price.[865] This arrangement led to location savings being allocated exclusively to SunPac.

[863] Eli Lilly & Co. v. Commissioner, 84 T.C. 996 (1985); Appealed: Eli Lilly & Co. v. Commissioner, 856 F.2d 855 (1988).

[864] Eli Lilly & Co. v. Commissioner, 84 T.C. 996 (1985), p. 1151; upheld in Eli Lilly & Co. v. Commissioner, 856 F.2d 855 (1988), p. 871-872.

[865] Sundstrand Corporation and Subsidiaries v. Commissioner, 96 T.C. 226 (1991), p. 310.

The IRS, however, did not agree with the arrangement, which essentially made SunPac into a fully-fledged manufacturer, but saw it rather as a contract manufacturer, which was to be remunerated on a cost-plus basis. Therefore, location savings, stemming mainly from lower labour costs after deducting dissavings[866] in Singapore were held to accrue in the hands of Sundstrand. Based on the agreements made between Sundstrand and SunPac the court came to the conclusion that:

> *(…) since SunPac enjoyed a monopolistic position in relation to CSD spare parts, SunPac would not have passed (location savings) on to its customers. Thus, petitioner argues, as an economic matter, the location savings must be allocated solely to SunPac. Petitioner argues further that the record clearly demonstrates that both the form and the substance of the relationship between petitioner and SunPac was not contractor/subcontractor, but licensor/licensee. We agree with petitioner.*[867]



Even though the court concluded in this case that the location savings were to remain with SunPac due to its specific status of a monopolistic supplier of the spare parts in question, it did not render a decision as to the size of the location savings enjoyed. Instead it merely stated that it was:

> *(…) satisfied from the record here that SunPac enjoyed some location savings from operating in Singapore (we are convinced that the substantially lower labor costs in Singapore would eliminate the total dissavings from locating there). Since we find the cost-plus method also inapplicable, see infra, the exact amount of net location savings is immaterial. Consequently we find it unnecessary and unproductive to quantify here those location savings.*[868]

While this case specifically dealt with the issue of location savings and also allocated it exclusively to the country abroad, it has precluded any discussion about a shared allocation of these location savings by its reluctance to quantify them. The question of location savings essentially becomes subordinated to the one of the status of SunPac as either fully-fledged or contract manufacturer. Since the court decided that SunPac is in fact to be seen as a fully-fledged manufacturer, the decision of allocating the location savings to SunPac is plausible.

[866] Sundstrand Corporation and Subsidiaries v. Commissioner, 96 T.C. 226 (1991), p. 319ff.

[867] Sundstrand Corporation and Subsidiaries v. Commissioner, 96 T.C. 226 (1991), p. 369.

[868] Sundstrand Corporation and Subsidiaries v. Commissioner, 96 T.C. 226 (1991), p. 370.

*5.4.4.1.2 Compaq*

The Compaq case dealt with location savings in an even more explicit fashion. Just as in Sundstrand, the location savings to be exploited arose in Singapore. Compaq US had set up a subsidiary, Compaq Asia, to produce so-called Printed Circuit Assemblies (PCA).

The location savings to be exploited in Singapore in order to achieve the overall goal of reducing costs consisted of lower labour costs, a tax holiday as well as the existing high tech infrastructure.[869] However, these location savings were met with a number of location dissavings such as higher shipping costs, lack of infrastructure and duties.[870]

Overall, the IRS claimed on the basis of several expert testimonies that due to the pricing method applied, Compaq Asia operated with significantly higher profit margins than justifiable under the arm's length principle in the years 1991 and 1992 that are in question.[871] Effectively this meant that instead of the mark-up considered reasonable by the IRS Economist:



> *"(...) of 7.5 percent over Compaq Asia's standard costs, petitioner's (Compaq US's) return position resulted in cost plus markups for 1991 and 1992 of 68 percent and 46 percent, respectively."*[872]

Although the fact that location savings can have a serious impact on these figures, there are also other [?] issues such as a broader functional profile taken by Compaq Asia than acknowledged by the IRS.[873] This included the partial responsibility for further developing the PCAs (those used in power supplies).

Compaq US applied a cost plus formula for the prices that were charged in its dealings. Different from the IRS, the cost base chosen was not the cost incurred by Compaq Asia but rather that incurred by Compaq US in Houston as well as later on at trial a CUP based sourcing PCA's from suppliers that were almost exclusively manufacturing in the US.[874] Thus, if there were net location savings, they were attributed to Compaq Asia in consequence of the choice of cost base. This is also the place where the location savings arose.

The court accepted the CUP handled by Compaq at trial which entailed a number of adjustments, yet not for geographical differences.[875] This is the result of the prices of

[869] Compaq Computer Corporation and Subsidiaries, Petitioners, v. Commissioner of Internal Revenue, Respondent., 1998 WL 34069146 (U.S. Tax Ct.), para. 3.

[870] Compaq Computer Corp. and Subsidiaries v. C.I.R., 1999 WL 449958, at *15 (U.S. Tax Ct.,1999), p. 15.

[871] Compaq Computer Corporation and Subsidiaries, Petitioners, v. Commissioner of Internal Revenue, Respondent., 1998 WL 34069146 (U.S. Tax Ct.), para. 122ff.

[872] Compaq Computer Corporation and Subsidiaries, Petitioners, v. Commissioner of Internal Revenue, Respondent., 1998 WL 34069146 (U.S. Tax Ct.), p. 19.

[873] Compaq Computer Corp. and Subsidiaries v. Commissioner of Internal Revenue., 1999 WL 449958, (U.S. Tax Ct.,1999), p. 15.

[874] Allen, S.N. et al., Location Savings – A US Perspective, *International Transfer pricing Journal*, Amsterdam: IBFD, (July/August 2004), Vol. 11 No.4, p. 9.

[875] Compaq Computer Corporation and Subsidiaries v. Commissioner, 78 T.C.M. (CCH) 35 (1999).

Compaq Asia and those CUPs that have been used by Compaq US being applicable to the same market.[876] The competition for this market, considering the lack of capable PCA manufactures in Singapore or even Asia, is to be found [?] in the US.

Overall the allocation of location savings has been obscured by matters relating to IP that were far larger. Thus, it is hardly possible to derive a solution for the proper allocation of location savings from this case. Furthermore, neither in the memorandum submitted by the appellants nor in the judgement has the synergy between Compaq Asia and Compaq US been properly considered for the allocation of location savings. If it was not possible for Compaq Asia to rely on Compaq US for the know-how on setting up and running the factory, including training of staff and other expertise that has been supplied by Compaq US, there simply had not been a Compaq Asia capable of producing PCAs that would meet the requirements of Compaq US and effectively the US/world market. This has been witnessed by Compaq US which, before setting up Compaq Asia, tried to source PCAs from Asian manufactures that did not meet quality standards.[877] Hence, this case addressed the question of allocation of location savings. However, the facts of the case also raised the question of how synergies could be allocated – but unfortunately did not address them.



*5.4.4.1.3 Conclusion – Cases*

According to Sec. 482 location savings are to be allocated in line with the arm's length principle. How such an allocation at arm's length is to be executed needs to be derived from two landmark cases on this issue. Independent of the situation of operation bootstrap, where it was the intention to leave the benefits of realized location savings in the US possessions, the courts reached similar results. However, they did so on different grounds. What can be distilled from the two cases is that the allocation of location savings is in principle dependent on the competitiveness and on the bargaining position of the entity abroad. However, it is not possible to draw any conclusions as to how an actual split would have to be executed since in Sundstrand and Compaq the location savings were allocated entirely to the foreign entity as done by the taxpayer. Furthermore, it appears that the factors of functions performed and the ownership of relevant intangibles relevant are still more prominent than location savings, as has been observed in both cases. Additionally, these cases disregarded synergies and the fact that the competitive position of the entities abroad had been created by the domestic taxpayer as a result of established quality standards and extensive technology transfer.

Ultimately this points in the direction of decoupling the transfer-pricing outcome in terms of location savings from the place where they have their actual origin.

***5.4.4.2 Conclusion on Location Savings***

Different from workforce in place and synergies, location savings are not shifted and therefore subject of neither 367(a) nor 367(d). It does, however, affect the pricing and

[876] Ibid.

[877] Compaq Computer Corporation and Subsidiaries v. Commissioner, 78 T.C.M. (CCH) 25 (1999).

therefore the allocation of the profits resulting from the goods or services that the subsidiary provides to its parent.

What can be deduced from the cases of Sundstrand and Compaq, even though they do not deal directly with the issue of location savings, is that what matters for the determination of an arm's length price, in addition to the usual factors required by Section 482. These are factors such as market position, competition and the actual market targeted. In the two cases considered, this led to an allocation of the location savings to the subsidiary abroad in Singapore. However, given the particularities of these cases, that in fact provided good reasons for allocating the location savings to the subsidiary in Singapore, the pricing applied appeared to be sensible in the light of the relevant, previously mentioned factors. Thus, the allocation of location savings is not merely the result of an arbitrary decision as prescribed in the framework of operation bootstrap.

### 5.4.5 Conclusion



Previously, taxpayers were able to choose an argumentation for their transfers of a wide range of intangibles abroad, coming in the ambit of Section 367 IRC, that would enable them to do so entirely tax free, based on either the foreign goodwill and going concern exception or under the ATB exception. This argumentation was solely focused on whether the transferred intangible property is in fact a 936(h)(3)(b) intangible property. This discussion has relevance for the transfer of workforce in place and synergies. While the IRS has repeatedly (yet never convincingly) taken the position that these are 936(h)(3)(b) intangibles, the proposed changes to the regulations now achieved the intended result. A transfer of workforce in place and synergies will, in line with the proposed regulations, result in either a gain that is to be recognized (Section 367(a)) or a deemed royalty payment (Section 367(d)). This way, the alternative option that considers e.g. synergies to be neither a 936(h)(3)(b) intangible nor goodwill and going concern, effectively lets it fall through the cracks of the law by requiring that always either section 367(a) or 367(d) is applied in situations where the qualification of the item is in question.[878]

The value contained in soft-intangibles potentially not falling within the definition of 936(h)(3)(b) has also been captured for taxation by requiring an aggregated valuation. This is particularly an issue in situations where synergies play a role. The IRS has recognised this in the temporary regulations issued on 5 October [year?] targeting synergies by way of aggregation.

However, the treatment of location savings can only be deduced from case law which was not focused on the issue of location savings itself. It has insofar been a matter of allocating the location savings by way of pricing the products manufactured in the foreign subsidiaries. Yet, different from synergies that are being considered by way of aggregation, the increased profit potential of performing a function in a country offering location

[878] "(5) Treatment of certain property as subject to section 367(d). A U.S. transferor may apply section 367(d) and § 1.367(d)–1, rather than section 367(a) and the regulations thereunder, to a transfer of property to a foreign corporation that otherwise would be subject to section 367(a), provided that the property is not eligible property, as defined in § 1.367(a)–2(b) but determined without regard to § 1.367(a)–2(c). […]" Proposed Regulation *§ 1.367(a)–1 (b)(5)*

savings is not taken into account. What can be deduced, however, is that the allocation is determined on the bargaining position of the parties involved which in a controlled situation is by nature merely artificial.

However, what is accounted for in all of the described situations is a posterior change in value of the property transferred. Effectively two different super royalties are applicable. On the one hand, there are the deemed royalty payments as prescribed by Section 367(d). On the other hand, posterior adjustments are prescribed by Section 482 by the CWI standard. A similar mechanism applies to Cost Sharing Agreements. These mechanisms will be subject of the following section.

## 5.5 General Application and Tax Consequences – Post 2017

While it has previously been necessary to assess whether an intangible that needs to be qualified as such in line with section 936(h)(3)(B) has been shifted, this is no longer necessary for the soft-intangibles dealt with in this thesis. A virtually open-ended definition of what constitutes an intangible leaves no room for a differing treatment.[879] Additionally, the active trade and business exception has been eliminated. Furthermore, the foreign goodwill and going concern exception is no longer an option for avoiding the application of section 367(d).[880] Additionally, the earlier disputed aggregation of separate transactions has been elevated to the level of a statute. This has consequences for synergies in particular.



Thus, what is being shifted is certainly a Section 936(h)(3)(B) intangible for which 367(d) is applicable. Section 936(h)(3)(B)(vi) & (vii) now encompass virtually all (soft)-intangibles. Non-recognition under section 367(a) under the active trade or business exception is no longer possible.[881] The following deemed royalty payment of Section 367(d) cannot be avoided by the foreign goodwill and going concern exception since it has been eliminated.[882] All in all, any non-recognition rule that has previously been available to taxpayers has been suspended.[883]

For the soft-intangibles that are treated in this dissertation it means that workforce in place is now without a doubt an intangible-proper in the sense of section 936(h)(3)(B) and therefore subject to Section 367(d); the resulting deemed royalty payments are taxed. Similarly, synergies, conceptually belonging to goodwill and going concern, are now considered as Section 936(h)(3)(B) intangible and therefore also fall under the scope of Section 367(d) requiring a deemed royalty payment. This result is further underpinned by

[879] Torvik, O., Transfer Pricing and Intangibles – US and OECD arm's length distribution of operating profits from IP value chains, *IBFD Doctoral Series*, Amsterdam: IBFD, Vol. 45, 2019, – online book, Chapter 3, p. 11ff.

[880] US Congress – Joint Committee on Taxation, *General Explanation of Public Law 115-97(JCS-1-18);* p. 331.

[881] IRC 367(a)(3)(A) no longer provides for the ATB exception.

[882] If a transfer of intangible property to a foreign affiliate occurs in connection with certain corporate transactions, nonrecognition rules that may otherwise apply are suspended. US Congress – House of Representatives, Conference Report on H.R. 1, Tax Cuts And Jobs Act, Vol. 163 No. 205, (15.12.2017), H10101, US Congress – Joint Committee on Taxation, *General Explanation of Public Law 115-97(JCS-1-18)*, p. 354

[883] US Congress – Joint Committee on Taxation, *General Explanation of Public Law 115-97(JCS-1-18)*, p. 331.

the circumstance that an aggregated valuation is now mandated, which is the core origin of synergies.[884]

Location savings should, however, remain unaffected since they pose a question of allocation and not of qualification for the applicability of Section 367.

## Section III: Posterior Valuation

### 5.6 Commensurate with Income Standard

#### 5.6.1 Introduction

In an effort to curb tax avoidance of MNEs by moving intangibles that have been developed in the US abroad into low tax jurisdictions, Congress in 1986 introduced the Commensurate with Income standard (CWI) to Section 482.[885] Although subject to a tremendous amount of criticism, in particular regarding its conformity with the arm's length principle, the CWI standard has been adhered to and ultimately implemented through the regulations of 1994.[886]



By requiring that the income that is derived from a transferred intangible be *commensurate* with the income that is derived from the intangible, tax planning that relies on shifting intangibles abroad at an early stage has been hampered. This way it is sought to ensure that either lump sum payment or royalties remain at arm's length also after a transfer has been executed.

Consequently, in situations where a lump sum payment or a royalty are deemed to no longer be in line with the arm's length principle, an adjustment is required. This leads to periodic adjustments.

However, Section 482 is not the only section demanding a remuneration that is commensurate with the income. Section 367(d) does so as well and has been amended accordingly in 1986.[887] Therefore, it now applies not only to actual remuneration but likewise to the fictitious deemed royalty payments that Section 367(d) demands.[888]

Yet, a number of exceptions apply, which are explained in the following, together with the scope and the principle working of the CWI standard.

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[884] Ibid., p. 387 & 388.

[885] Zollo, T.M., USA Branch Report on Cross-Border Business Restructuring, IFA Cahier, Nr. 96A, 2011, p. 757; Postlewaite, P. F., *International Taxation: Corporate and Individual – Vol. I*, Durham, North Carolina: Carolina Academic Press, (2014), 9th ed., p. 384.

[886] Wittendorff, J., *Transfer pricing and the arm's length principle in international tax law*. Austin [Tex.]: Wolters Kluwer Law & Business, (2010), p. 678; Torvik, O., Transfer Pricing and Intangibles – US and OECD arm's length distribution of operating profits from IP value chains, *IBFD Doctoral Series*, Amsterdam: IBFD, Vol. 45, 2019, – online book, Chapter 16, p. 4.

[887] Sensenbrenner, E.B., The Code Sec. 367(d) Paradox: Peering into the Abyss from a Safe Distance, *Taxes – The Tax Magazine*, Chicago: CCH, (March 2015), p. 44.

[888] Imhof, M., *Business Restructuring: Eine Betriebswirtschaftliche und Steuerrechtliche Analyse*, Köln: Eul-Verlag, (2012), p. 374, FN 1493).

### 5.6.2 Scope of the Commensurate with Income Standard

The CWI standard has been introduced by adding the following sentence to Section 482:

> *"In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible."*[889]

Therefore, the CWI standard applies in any case where Section 482 is applicable and where an intangible property in the meaning of Section 936(h)(3)(b) has either been transferred or licensed to a related party. Additionally, it must be an agreement covering more than one year.[890] While the scope appears to be rather broad, the actual application and consequently the periodic adjustment are narrowed down by a number of exceptions found in the respective treasury regulations. These exceptions were introduced in an effort to make the CWI standard somewhat more compatible with the arm's length principle.[891] Furthermore, it needs to be kept in mind that what is ultimately targeted by the CWI standard are intangibles whose valuation is highly uncertain at the time of transfer.[892] Commonly, these are intangibles that lead to higher than normal profits.[893]



### 5.6.3 The Exceptions

Based on the Regulations, there are five exceptions to the application of the CWI standard.[894] In fact these are merely three exceptions that hinge on the application of a particular transfer pricing method.[895] The remaining exceptions that are listed in the Regulations are actually alternative conditions that are imposed in case of either extraordinary events or the lapse of a five year period.[896]

#### (A)

Thus, the first exception from a periodic adjustment applies where the comparable uncontrolled method has been used and therefore the same intangible has already been transferred under circumstances that have been substantially the same as in the

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[889] Sec. 482 IRC.

[890] Treasury Regulations §1.482-4(f)(2)(i).

[891] Wittendorff, J., *Transfer pricing and the arm's length principle in international tax law*. Austin [Tex.]: Wolters Kluwer Law & Business, (2010), p. 678; Treasury Department & IRS, *A Study of Intercompany Pricing – Discussion Draft*, Washington: Department of the Treasury, (18.10.1988), p. 61ff.

[892] Ibid., p. 677.

[893] Ibid., p. 677.

[894] Treasury Regulations §1.482-4(f)(2)(ii); Torvik, O., Transfer Pricing and Intangibles – US and OECD arm's length distribution of operating profits from IP value chains, *IBFD Doctoral Series*, Amsterdam: IBFD, Vol. 45, 2019, – online book, Chapter 16, p. 10.

[895] Treasury Regulations §1.482-4(f)(2)(ii)(A), Treasury Regulations §1.482-4(f)(2)(ii)(B), Treasury Regulations §1.482-4(f)(2)(ii)(C).

[896] Treasury Regulations §1.482-4(f)(2)(ii)(D), Treasury Regulations §1.482-4(f)(2)(ii)(E).

transaction in question.[897] Furthermore, it is necessary that the Comparable Uncontrolled Transaction method has been applied in the first year in which a substantial part of the periodic consideration was due. If the consideration is paid on the basis of the foregoing in the first year, neither subsequent periodic adjustments nor monitoring are necessary.[898]

**(B)**

The second exception also applies in situations where the CUT method is applied but the underlying transaction is merely similar. Thus, a comparable intangible and comparable circumstances suffice to prevent future periodic adjustments if a number of additional conditions have been cumulatively met.

**(B)(1)**

There must be a written agreement, establishing the consideration payable for each taxable year over the time period that it is applicable for. This agreement must be in force in the year of review and the consideration payable in the first taxable year must be at arm's length.



**(B)(2)**

Additionally, a written agreement exists for the comparable uncontrolled transaction that has been relied upon for establishing the arm's length consideration, which does not provide for the possibility of altering the amount of consideration, the terms of the agreement or for the termination. In the case where modifications are permitted by the agreement they may only relate to the amount of the consideration on a periodic and non-contingent basis.[899]

**(B)(3) & (B)(4)**

The requirement of substantial similarity of the agreements also extends to the time period to which they apply[900] and the conditions that are imposed on the usage of the intangible.[901]

**(B)(5)**

Moreover, the set of functions performed by the transferee remains substantially unchanged after the execution of the agreement - unless such a change in the functions occurs due to an unforeseeable event.[902]

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[897] Treasury Regulations §1.482-4(f)(2)(ii)(A); Postlewaite, P. F., *International Taxation: Corporate and Individual – Vol. I*, Durham, North Carolina: Carolina Academic Press, (2014), 9th ed., p. 384.

[898] Ibid., p. 384.

[899] Treasury Regulations §1.482-4(f)(2)(ii)(B)(2).

[900] Treasury Regulations §1.482-4(f)(2)(ii)(B)(3).

[901] Treasury Regulations §1.482-4(f)(2)(ii)(B)(4), Postlewaite, P. F., *International Taxation: Corporate and Individual – Vol. I*, Durham, North Carolina : Carolina Academic Press, (2014), 9th ed., p. 384.

[902] Treasury Regulations §1.482-4(f)(2)(ii)(B)(5).

**(B)(6)**
The final condition imposed concerns the profits that are earned or rather the cost savings that result from the exploitation of the intangible by the transferee. The frame for the year in consideration and all past years is within 80% and 120% of what could have been projected at the moment that the comparability of the controlled agreement and the one under consideration were established.[903]

**(C)**
The third exception applies if a different method has been used. Periodic adjustments can nevertheless be precluded. However, in this case similar yet slightly different requirements have to be met.

**(C)(1)**
There must be a written agreement that determines the amount of consideration payable each year which is still in force in the taxable year under review.[904]



**(C)(2)**
Furthermore, the amount determined in the agreement that is payable in the year where a first substantial amount is due must be at arm's length. In order to demonstrate that the amount agreed upon had been at arm's length, it is necessary that there is documentation that has been prepared at the execution of the agreement, supporting such a claim.[905]

**(C)(3)**
Moreover, just as for the exception where a similar CUT agreement exists, it is required that the functions performed by the transferee remained largely unchanged after the agreement had been executed[906] – unless any change was due to events that were unforeseeable and required according action.[907]

**(C)(4)**
Lastly, it is required that the profits that are earned or rather the cost savings that result from the exploitation of the intangible by the transferee do not deviate by more than ±20% in the year under investigation and over all past years.[908] Benchmark in this case is what was foreseeable at the point in time that the agreement was entered into.[909]

[903] Treasury Regulations §1.482-4(f)(2)(ii)(B)(6).
[904] Treasury Regulations §1.482-4(f)(2)(ii)(C)(1).
[905] Treasury Regulations §1.482-4(f)(2)(ii)(C)(2).
[906] Treasury Regulations §1.482-4(f)(2)(ii)(C)(3).
[907] Treasury Regulations §1.482-4(f)(2)(ii)(C)(3).
[908] Treasury Regulations §1.482-4(f)(2)(ii)(C)(4).
[909] Treasury Regulations §1.482-4(f)(2)(ii)(C)(4).

**(D)**
There is also a separate exception for extraordinary events. Even though it is listed as a separate exception within the regulations, it solely relies on the requirements set out in sections (B) and (C). It can be relied upon if the aggregated profits that are earned or rather the cost savings that result from the exploitation of the intangible deviate in fact by more than ±20% and that this deviation has been caused by events that the taxpayers could neither influence nor reasonably anticipate when entering the agreement.

**(E)**
In cases where the requirements of the exceptions of (B) and (C) have been met in any year of a five year period, a periodic adjustment in year six and subsequent years is precluded. Hence, in this situation it is presumed that an actual arm's length remuneration has been found and a subsequent adjustment is therefore unwarranted.[910]



Considering all three of the exceptions described, it becomes clear what sort of intangibles the CWI standard aims at – namely hard-to-value intangibles. In order for the exceptions to apply, serious safeguards have been introduced, thus ensuring that the anterior valuation was at arm's length. In situations other than where the CUT (unaltered) has been used, the valuation needs to conform to the arm's length standard for the first five years and may not deviate by more than 20% - thus reducing the breadth of the exceptions once again and making transactions susceptible to posterior adjustments. All in all, these exceptions are considered to be so stringent that they are barely applicable.[911] The breadth of application that stems from this observation does not make posterior adjustments relevant only in cases of abuse[912] but something that the taxpayer needs to be aware of even in non-abusive scenarios. Furthermore, these exceptions are only applicable in Section 482. The following evaluates the application of the CWI principle to both Sections 482 and 367(d).

### 5.6.4 Conclusion and Evaluation CWI

The CWI standard as described in the foregoing is applicable to transfers of intangibles that are within the scope of Sections 367(d) and 482 IRC. While applied in line with Section 482 IRC there are three exceptions that are at the first stage of application based on the transfer pricing method which has been chosen, no exceptions exist once it has been determined that royalty payments are deemed to be made in line with Section 367(d).

Yet, regarding the scope of the intangibles covered by the CWI principle by way of Sections 367(d) and 482, both work in unison to cover all sorts of intangibles except for a number of clearly defined exceptions.

[910] Postlewaite, P. F., *International Taxation: Corporate and Individual – Vol. I*, Durham, North Carolina: Carolina Academic Press, (2014), 9th ed., p. 385.

[911] Taic, J., *Die "Super Royalty" und das U.S.-Richtlinienpaket von 1993*, München: VVF, (1995), p. 192.

[912] Ibid., p. 272.

Taking into account the reasons for introducing the CWI standard as enumerated in the house report on the intentions of introducing the super royalty in 1986,[913] it becomes clear that it is meant as a tool to curb abuse. As such it has also been acknowledged by the OECD.[914] Moreover, it fills a void where uncontrolled prices are simply not available, or industry norms insufficiently reflect the value of an intangible.[915]

Yet, the actual implementation of the CWI standard, given the limited scope of exceptions and the recent elimination of the foreign goodwill and going concern valuation transform the standard into all-embracing standard that conforms to the entertained suspicions that it is actually intended to produce prices that are above market and thus contrary to the arm's length principle.[916] Whether the arm's length principle and therefore double taxation is avoided becomes secondary.

Even though the IRS intended to make a case for the conformity of the CWI standard and the arm's length principle, many of the arguments mentioned in the White Paper of 1992 are amiss.[917]

One of the core arguments is that unrelated third parties would include a provision enabling periodical adjustments into their licensing or sales agreements for intangible property.[918] Otherwise unrelated parties would not enter into such agreements. according to the IRS.[919] However, should that not be the case, the licensor would compel the licensee to renegotiate.[920] These presumptions are based on licence agreements filed with the SEC. However, the analysis of these agreements cannot support the claims made by the IRS.[921]

Furthermore, the IRS' sentiment towards periodic adjustments seems to have shifted in light of the circumstance that taxpayers are more inclined to utilize the CWI standard than the IRS itself.[922] While taxpayers supposedly engage in periodic adjustments also in situations where this possibility has not been included in the agreement, the IRS denied such a practice in proposed regulations, released in 2005,[923] relating to the application of



[913] Taic, J., *Die "Super Royalty" und das U.S.-Richtlinienpaket von 1993*, München: VVF, (1995), p. 272.

[914] OECD – The Committee on Fiscal Affairs, *Intercompany Transfer Pricing Regulations under US Section 482 Temporary and Proposed Regulations*, Paris: OECD, (1993), Para. 2.23ff; http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=OCDE/GD(93)131&docLanguage=En (16.11.2016).

[915] Beuchert, T., Entwicklungen im Verrechnungspreissystem der USA am Beispiel der Verfahren DHL, Glaxo und Xilinx – Modell für Deutschland?, *IStR*, München: Beck, (2006), p. 611.

[916] Ibid., p. 611, FN 94.

[917] Oates, M.A. & O'Brien, J.M., Tax Court Rejects IRS CIP on Cost Sharing Buy-Ins in VERITAS, *The International Tax Journal*, Chicago: CCH, (January 2010) Vol. 36, p. 16.

[918] Treasury Department & IRS, *A Study of Intercompany Pricing – Discussion Draft*, Washington: Department of the Treasury, (18.10.1988), p. 63ff.

[919] Taic, J., *Die "Super Royalty" und das U.S.-Richtlinienpaket von 1993*, München: VVF, (1995), p. 265.

[920] Ibid.

[921] Taic, J., *Die "Super Royalty" und das U.S.-Richtlinienpaket von 1993*, München: VVF, (1995), p. 266; Wittendorff, J., *Transfer pricing and the arm's length principle in international tax law*. Austin [Tex.]: Wolters Kluwer Law & Business, (2010), p. 168.

[922] Shapario, A. & Wrappe, S., IRS Comments on Periodic Adjustments for Intangibles: Looking for the Silver Lining, *Tax Notes International*, Falls Church, VA: Tax Analysts, (25 April 2005); http://taxprof.typepad.com/taxprof_blog/files/2005-6378-1.pdf (03.12.2016)

[923] IRB 2005-40. REG-144615-02.

the CWI standard.[924] Therefore, the IRS now takes the position that if a taxpayer wants to make use of periodic adjustments, he should have included a clause to that effect in the agreement and should not have chosen a fixed fee or royalty. Thus, even though CWI adjustments are not a one-way street, it is not possible for a taxpayer to initiate a downward adjustment.[925]

Furthermore, insisting on the CWI implies that industry norms that are generally used to determine future profitability of a licensed or transferred intangible are at odds with the actual development of the intangibles value.[926] From this it follows that the CWI standard does not respect the freedom of companies to conduct their business as they deem fit – licensing vs. sale.[927] The CWI standard disregards the proposition that contracts that have once been at arm's length and been properly concluded between parties should be valid.[928]

Even though the OECD endorses periodic adjustments in situations of abuse, at the heart of all criticism lies that CWI standard does not comply with the arm's length principle because it disrespects that an arm's length remuneration is based on the facts and circumstances that were prevalent at the time the agreement was concluded.[929]
Part of the effort to not only have a transaction that is in line with the arm's length standard but also achieves the arm's length result which is a crucial difference.[930]



## 5.7 Conclusion

The US does not have legislation which specifically targets issues of business restructuring but rather relies on the general transfer pricing legislation. While the general implementation of the arm's length principle does not contain anything extraordinary, the applicable regulations have been specifically tailored to deal with cases of business restructurings. In addition to Sec. 482, Sec. 367(a) and (d) have also been at issue, particularly section 367(d) which is special inasmuch as it deals with the transfer of intangibles. Yet, intangibles also used to be the cornerstone for the application of the other mentioned provisions prior to the Tax Cuts and Jobs Act 2018.

Only where the definition of an intangible has been met, could Sec. 482 or 367(d) actually apply. This became an issue in particular in the case of soft-intangibles which by their general definition did not qualify as a proper intangible asset. Therefore, neither the IRC nor the treasury regulations provided a solution for the treatment of a going concern

[924] Shapario, A. & Wrappe, S., IRS Comments on Periodic Adjustments for Intangibles: Looking for the Silver Lining, *Tax Notes International*, Falls Church, VA: Tax Analysts, (25 April 2005); http://taxprof.typepad.com/taxprof_blog/files/2005-6378-1.pdf (03.12.2016)

[925] Imhof, M., *Business Restructuring: Eine Betriebswirtschaftliche und Steuerrechtliche Analyse*, Köln: Eul-Verlag, (2012), p. 374.

[926] Granwell, A.W., The Super Royalty, *International Business Law Journal*, Paris: FEC, (No. 1 1987), p. 77.

[927] Taic, J., *Die "Super Royalty" und das U.S.-Richtlinienpaket von 1993*, München: VVF, (1995), p. 129.

[928] Ibid., p. 264, FN18.

[929]Granwell, A.W., The Super Royalty, *International Business Law Journal*, Paris: FEC, (No. 1 1987), p. 75.

[930] Treasury Regulations §1.482-1(b).

value and soft intangibles. This problem was apparent throughout the entire treatment of the soft intangibles, leading to a situation where taxpayers applied the definition of intangible at will in order for an "intangible" to be either not captured at all by any of the provisions dealt with, or to make it subject to an exception.

The most significant exception in that regard used to be the foreign goodwill and going concern exception, which is no longer applicable as a result of the now final regulation and the Tax Cuts and Jobs Act of 2018.[931] The ATB exception is insignificant insofar as it specifically excludes intangibles, as defined in the closed list of Sec. 936(h)(3)(B). Driven by matters of qualification of Sec. 936(h)(3)(B) and the subsequent application of Sec. 482, Sec. 367(a) and (d) soft-intangibles have been a major area of dispute.

Workforce in place can be part of a business restructuring by being physically shifted or by being made available to the newly formed entity abroad. In the former situation, the reasoning that was brought forward by the IRS is rather compelling. In the latter case, though, this is different since it is merely a service which is provided and remunerated accordingly. Basing the analysis of these situations and the IRS on an approach hinged on value creation shows the inconsistency and can be considered a main argument against the qualification as an intangible where the workforce is merely made available. This issue has changed as of 2018 since the Tax Cuts and Jobs Act led to the explicit mentioning of workforce in place as a Sec. 936 intangible.



Similarly contested was the qualification of synergies. The argumentation revolves around either using intangibles where there is no doubt about their qualification as a 936(h)(3)(b) intangible as a proxy to also include synergies, or to do so by way of aggregation. Both possibilities described are now available to the IRS due to the Tax Cuts and Jobs Act 2018. Prior to that, aggregation appeared to be the most workable solution for the IRS in order to take synergies into account. Thus, the IRS could disregard economically completely plausible transactions. Furthermore, it can be deduced from the refined regulations concerning aggregation, that the IRS intends to allocate the synergies to the domestic entity and therefore to disregard the very nature of a synergy that is the result of interaction of different assets and entities. The latter issue of allocation still persists even after the clarification brought about by the Tax Cuts and Jobs Act 2018.

Unaffected by the tax reform are the allocation issues of location savings. This matter is driven by two landmark cases resulting in the allocation of location savings to the entity abroad based on competitiveness and bargaining position. Yet, since the allocation of location savings to the entities abroad has been upheld, it is not possible to draw a conclusion on how such an allocation should take place. Furthermore, one needs to recognize that these cases have not been decided on the basis of which country provided the location savings.

It has therefore been exemplified that a closed list of intangibles, as it existed prior to 2018, on whose qualification the subsequent application of Sec. 482, Sec. 367(a) and (d) IRC depends, is not fit to deal with the specific soft-intangibles that ought to be considered

[931] IRB 2017-3, p. 384 T.D. 9803.

in a business restructuring transaction. The then existing exceptions that are available depending on the qualification of the intangible contributed to this uncertainty. While the definitional issues have been largely resolved, there still is major uncertainty about the eventual allocation of the benefits of soft-intangibles, if those were to be shared and the claims of the IRS not dismissed.

In terms of posterior valuation, it has been demonstrated that one deals with an all-embracing provision of Sec. 482 and Sec. 367(d) IRC whose scope has been extended even further with the deletion of the foreign goodwill and going concern value exception. The CWI standard as implemented in Sec. 482 is limited to transactions causing uncertainties in their valuation by way of the transfer pricing method used. It enables the IRS to make adjustments in line with the CWI standard for five years. This is closer to what unrelated parties would have agreed on, if they would resort to such measures at all. Yet, limiting the exceptions to a price development within a bandwidth of ±20% again opens up the scope for posterior adjustment, making the exceptions generally superfluous.



Thus, a recurrent theme when dealing with the application of the analysed provisions is that these have not been specifically tailored for situations of business restructuring nor for the particular soft-intangibles. The resulting shortfalls are further augmented by expanding the definition of Sec. 936 intangibles and the limitation of applicable exceptions. Within this framework, matters of value creation and the investigation of what an uncontrolled situation had demanded become secondary from an arm's length perspective.

# Chapter 6. Comparative Analysis

## Section I: Arm's Length Principle – General Features

### 6.1 Introduction

Having described and analysed the OECD TP Guidelines in their current state under the influence of the BEPS project, as well as the German and the US transfer pricing legislation that affects business restructurings in general and soft-intangibles in particular, this section sets out to compare them. A comparison of the approaches and solutions sought by Germany and the US then lays the foundation for an evaluation in light of possibly different intentions and starting points, and will point out the best solutions.

The comparison considers the three core aspects for which the foundations have been laid in the foregoing, namely the treatment of business restructurings from a transfer pricing perspective in general (Section I), the treatment of soft-intangibles specifically (Section II) and provisions made for posterior valuation of the transferred business (Section III). In the course of comparing and evaluating the provisions, the actual goal pursued is identified and suggestions are made for better, more internationally compliant solutions.



### 6.2 Comparison

Comparing the German and US TP provisions that are applied in business restructuring cases points to a number of inherent differences. It is generally important to transpose the arm's length principle from Art. 9(1) OECD MC into a country's internal tax laws to avoid double taxation. Specifically, for business restructuring, this means that the conditions for aggregation and the perspective which is taken when determining the alleged arm's length price are analysed.

#### 6.2.1 Application to Business Restructuring & Aggregation[932]

Having considered the three versions of the arm's length principle compared to each other in general, the differences regarding business restructurings are subsequently to be carved out.

While Germany introduced Sec. 1 para. 3 s. 9ff FTA in order to specifically target business restructurings and the many transfers that are relevant to transfer pricing, the USA treat business restructurings on the basis of transfer pricing legislation that has been introduced under different circumstances, namely section 482 IRC. Specific provisions on the treatment of business restructurings are contained in the US Treasury regulations.

[932] See sections: OECD: 3.4.1. & 3.4.2; Germany: 4.3; USA: 5.2.

However, in the situation of the US, the particularity of the IRC containing Section 367 and more specifically Section 367(d) as a provision dealing exclusively with the transfer of intangibles is of striking importance in business restructurings scenarios where an aggregated valuation is not required. Furthermore, prior to 2018, the IRC applied a closed list of intangibles for their qualification as such. Everything outside that closed list did not qualify as an intangible unless it shared features with those that are part of the list and can therefore be considered to be "other intangibles". These particularities are the foundation for further discussion in relation to soft-intangibles, as will be seen in section 6.3.

The OECD TP Guidelines deal with business restructurings in general in Chapter IX, and with the crucial specificities of intangibles in Chapter VI. The BEPS project, which among others concentrated on intangibles in Actions 8-10, seems to have partly disregarded the issues arising out of soft-intangibles that are an integral part of a business restructuring. However, some of the soft-intangibles are touched upon in the BEPS project in relation to their qualification as either an intangible proper or a comparability factor.

Thus, these different approaches rely on the qualification of the intangible in question. At first sight, the German approach is not dependent on the question of qualifying something as either intangible or goodwill and going concern as used to be necessary when applying the IRC in order to determine the specific tax treatment. However, these very problems also occur at the crossroads of singular assets and when whole function that is shifted. The problem was far more apparent in the case of the IRC, which contained an exhaustive enumeration of intangibles including one which has lately been interpreted by the IRS as a catch-all clause. This closed list of intangibles has now been extended to achieve that very result and to capture also workforce in place and goodwill and going concern.



The German approach is marked by the pivotal change brought about by the function shifting regulation and thus the introduction of aggregated valuation as soon as a function together with an associated asset is shifted across the border. This is done with the so-called *transfer package*, which includes assets, functions and opportunities as well as risks. This enables the consideration of the whole range of soft-intangibles. However, since the term *function,* just like the relevant threshold, has been left undefined by both the German legislator and the respective regulation and Administrative Principles, uncertainties arise regarding the precise content of a function. Thus, the threshold for triggering a valuation of the transfer package remains unclear. Yet, how a transfer of a function should be equated with the transfer of an ongoing concern.

Similarly, in the US the conditions required for an aggregate valuation remain unclear,. The resultant uncertainty prevails despite a number of decided cases and the elevation of the respective regulations by inclusion into the statute. The guiding principle is that an aggregated valuation is to be chosen where it produces the most accurate valuation. However, this remains vague as synergies, among others, that ought to be captured by aggregating transactions are routinely not transferable and can only vaguely be appropriated, let alone realized. By aggregating transactions, the valuation is certainly going to increase, but whether it is more accurate is doubtful.

An aggregated valuation is also proposed by the OECD TP Guidelines in limited circumstances. Chapter IX proposes an aggregated valuation where it is needed to produce the *most reliable measure of the arm's length price* for the transfer of an ongoing concern.

### 6.2.2 Perspective for Price Determination[933]

Another feature that is relevant for the valuation of a transaction in the course of a business restructuring is the perspective that is being taken regarding the applicable transfer pricing method for determining the arm's length price. In particular, where one deals with unique, generally intangible, assets and no comparables or adjustable comparables are present, the solutions employed in Germany, the US and the OECD TP Guidelines differ.

In Germany one resorts to the determination of a hypothetical arm's length price. This method is employed only at the end, when the common methods fail. The hypothetical arm's length price is the result of fictitious bargaining between the party ceding the function and the receiving party. Thereby the profit potential that the receiving entity determines to be contained in the function is taken into account. In order to conduct such a hypothetical bargaining, it is necessary to operate in full transparency, which is unknown in an arm's length situation. Additionally, it is prescribed that either the price which is most probable within the price range so determined is to be chosen, or the arithmetic mean. Due to the difficulties determining the most probable price, it will generally be the mean that is going to be chosen in these transactions once corrected.



In the case of the IRC the applicable valuation method is not prescribed by a rigid system that is to be followed step by step, with a certain method at the end. The method chosen needs to be the most reliable one considering available data and compared to other methods. Such a method is then applied from the perspective of both the ceding and the receiving entity, as if they were acting independently. Where multiple differing arm's length prices form a price range, the burden of proof is on the taxpayer to show that the price falls within that range. A correction by the IRS will put the price at any point deemed fit within the range. No particular method has been envisaged in a situation where no comparables exist. In such a situation, the range will nevertheless be based on the best method and comparables that are adjusted until the price will fall with a reliability of 75% on either end of the range.

According to the OECD TP Guidelines it is the most reliable method which needs to be chosen. Thus, the perspective taken into consideration is that of both the ceding and the receiving entity, as if they were independent. The OECD TP Guidelines consider a range prices to be at arm's length in a situation where for example different valuation methods are applied that can be considered to be similarly reliable or where comparables have a varying degree of comparability. In the situation that an ongoing concern is being transferred, the TP Guidelines do not prescribe a specific method but make reference to valuation techniques that are commonly used in acquisition deals. This results in a price

[933] See sections: OECD: 3.4.1. & 3.4.2; Germany: 4.3; USA: 5.2.

range. Even though the Guidelines mention that the median can be an appropriate solution, it is not prescribed as *the* solution.

#### *6.2.2.1 Evaluation*

*6.2.2.1.1 Application to Business Restructuring & Aggregation*

When looking at the three iterations of the arm's length principle on how they generally apply to business restructurings, the most important differences for its application need to be pointed out.

The German function shifting regulation has been tailored to specifically deal with business restructurings. This translates to an approach which focuses on the aggregated valuation in the case of a business unit being transferred, as could be observed in an actual acquisition of a business unit by a third party.[934] This works by considering a transfer package whose content also comprises some of the soft-intangibles. In particular synergies and location savings are, in principle, considered by both features, the hypothetical arm's length test and the use of the median within a price range. The result is that not only internal value creation, but also external value creation is considered while trying to strike a balance between the two. At the same time the comprehensive escape clauses also account for the adherence to the arm's length principle by merely requiring an aggregated valuation in limited circumstances where such valuation is plausible. However, this approach is not flawless due to the posterior valuation and because the key element requiring the valuation as a transfer package has been vaguely set below the threshold of a business unit.



By contrast, the IRC is challenged on account of the (almost) exhaustive enumeration of intangibles as provided for by sec. 936(h)(3)(b) on which the other norms that have been discussed in this dissertation rely. Due to the stark difference in treatment based on whether one deals with a sec. 936(h)(3)(b) intangible or not, the discussion is centred on this question, particularly where soft-intangibles are being transferred. Yet, the stronger stance that the IRS takes regarding the qualification of these soft-intangibles as actual sec. 936(h)(3)(b) intangibles together with the repeated but unsuccessful attempt to have location savings allocated to the US in the court cases considered, had as a consequence that the system underwent a stark change. While at the beginning it perfectly complied with an approach of take internal value creation into account as well as the arm's length principle e.g. in the fact that synergies are not targeted by section 482. Yet, parts like the posterior adjustment were inconsistent with the arm's length principle from the beginning. However, now there has been a clear shift regarding soft intangibles, which disregards the arm's length principle and intends to also catch external value creation. The Tax Cuts and Jobs Act 2018, which has opened up the enumeration of sec. 936(h)(3)(B) intangibles, further cemented the approach pursued by the IRS.

[934] Zech, T., *Verrechnungspreise und Funktionsverlagerungen 2009: die steuerliche Behandlung von Verrechnungspreisen, insbesondere bei Funktionsverlagerungen, nach der Unternehmensteuerreform 2008*, Baden-Baden: Nomos-Verl.-Ges., (2009), p. 419.

The OECD/BEPS approach, which is supposedly guided by value creation, hinges on the presence of an ongoing concern being transferred. If so, an aggregated valuation is prescribed in line with methods common to the valuation of businesses. This conforms to the threshold of an ongoing concern, which is less vague than what is being used in the German case. Relying on a valuation as used in business should ensure an adherence to the arm's length principle. However, this does not automatically translate to abiding by value creation. Yet, this general application has not been altered in the framework of the BEPS project either.

*6.2.2.1.2 Perspective for Price Determination*

While the OECD and the US merely prescribe that the most reliable/best method is to be chosen, Germany has implemented a rigid system that needs to be followed, at whose end stands the hypothetical arm's length test for situations where no comparables are available. However, while the German system relies on a sequential order of methods and the OECD TP Guidelines prescribe that the method producing the most reliable result is to be chosen, the outcomes are not greatly different, since in a business-restructuring situation it can be presumed that there are no comparable or adjustable transactions present. Yet, in these circumstances only Germany provides the specific method of the hypothetical arm's length test. By contrast, the US does not provide a particular method and instead tries to statistically adjust potentially unfit comparables. The OECD, in turn, refers to valuation methods which are commonly used for acquisitions of an on-going concern between independent parties. Thus, the German approach is unique in applying the hypothetical arm's length price. Yet the TP Guidelines also make reference to valuation techniques commonly used in acquisition deals, which should be even more in line with commercial reality than the hypothetical arm's length price. Sticking with adjusted comparables as prescribed by the IRC should not yield a reliable result.

Applying the German hypothetical arm's length method essentially leads to four different prices – the maximum and minimum price of the ceding entity and of the receiving entity. This results in a price range of which, in line with the German function shifting regime, the mean is to be picked in the absence of a determination of another more probable price within the range. Essentially it is going to be the mean which is chosen, due to the absence of arguments favouring another point within the range.

The use of price ranges is in line with OECD TP Guidelines. However, the TP Guidelines and the IRC produce them for different reasons. According to the TP Guidelines, the mean can be chosen but other prices within the range can be acceptable as well. The IRC even continues to work with comparables even though they are not fit and have to be altered statistically to attain a reliability of 75% on both ends of the price range.

In the situation of a business restructuring, the commonalities between Germany, USA and OECD also continue in the way the adjustment is made even though the conformity thereof with the arm's length principle remains questionable. In transactions, particularly business restructurings, it is not merely the price that is adjusted but also the type of the

transfer, the inclusion of a posterior adjustment clause and the aggregated valuation of timely and practically separate transactions.

In case of the US, all three alterations can be found. If an intangible is transferred, Section 367(d) applies, resulting in a deemed royalty payment even though the related parties agreed on a one-time payment. Transfers that are subject to Section 367(d) as well as to Section 482 can be adjusted ex post by the IRS if no price-adjustment clause has been included in the agreement. Additionally, separate transactions can be aggregated when this is deemed to produce a more accurate valuation.

The German function-shifting regime also uses the posterior adjustment in situations where material intangibles are transferred. Furthermore, the aggregated valuation of a business restructuring by compiling it into a *transfer package* has been limited by several exceptions. This makes the aggregated valuation rather the exception than the standard. However, no adjustment is made as to the type of transaction. A sale remains a sale and is not re-qualified into a licencing transaction.

The OECD has recently taken a similar course by the inclusion of a number of provisions dealing particularly with hard to value intangibles in Chapter IX of the TP Guidelines. Regarding the posterior valuation, arm's length conformity is being sought by using the posterior valuation merely as an indication for the arm's length conformity of the price that the parties originally agreed upon. The posterior valuation shall then not be the foundation of the adjustment either, but rather the events that have been reasonably foreseeable and should therefore have been taken into account when determining the price.



### 6.2.3 Conclusion – Arm's Length Principle – General Features

When considering the features of the transposition of the arm's length principle in general and for business restructuring transactions in particular, a large number of commonalities can be seen. The basis for both the TP Guidelines and the implementation in the US and Germany is the same, yet there are some crucial differences . The existence of many commonalities between the three should be the result of the influence exerted by the US on the OECD, perhaps on account of it being the first mover on transfer pricing issues. This seems to have influend Germany when it introduced the function shifting regulation. Even though many features regarding business restructuring are similar, there are still some stark differences in relation to soft-intangibles, as will be demonstrated in the following section.

In the continued course of the comparison attention should be paid to the size of the void between the treatment of business restructurings in line with FTA, IRC and the OECD TP Guidelines. Especially considering the BEPS project, the gap should not be as wide as it has previously been perceived to be in the relevant doctrine.

# Section II: Treatment of Soft-intangibles

## 6.3 Definition of Intangibles and Delimitation of Soft-intangibles

### 6.3.1 Comparison[935]

Business restructuring transactions involve a number of different intangibles. The particular qualification of the intangible at hand heavily influences its treatment under transfer pricing legislation.

Therefore, we first need to look at the different definitions of intangibles that are employed. This serves the purpose of delimitating between intangible assets and soft-intangibles. As a result, this differentiation yields consequences for the prescribed treatment in case of all three systems that have been considered for comparison.

For the application of the German Function Shifting legislation it is of relevance what constitutes *material intangibles and advantages*. Only for that category of intangibles, besides the transfer package, is a posterior valuation prescribed. The presence of material intangibles and advantages is considered from a qualitative and quantitative perspective. The intangibles and advantages are material if they are indispensable to the function transferred (qualitative) and account together for more than 25% of the entire value of the transfer package which includes all assets and miscellaneous advantages. For this to apply one would need to discern both the miscellaneous advantages derived from the tangible assets, and those derived from the intangible assets. Since assets are clearly defined as separately transferable, the issue arises how to allocate the *advantages* between the two classes of assets/intangibles so that it can be determined whether the 25% threshold is surpassed. A definition which allows for such a categorization does not exist. This problem of qualification and, in this situation, quantification continues even with the escape clauses.

Furthermore, a posterior valuation can be imposed in a situation where there has been a function shifted and valued according to the hypothetical arm's length method. A precise definition of what constitutes a function does not exist. It can merely be approximated using the indications given by a range of examples in the administrative principles. The content of a function cannot be so miniscule that it would be prohibitive for a prudent business manager to pay a remuneration for it.

The issue in the US has been very different. First and foremost, what is relevant for the determination of the tax treatment of intangibles is whether an intangible has been mentioned in the laundry list of Section 936 (h)(3)(B). Discussions surrounding the qualification can then arise as to whether an intangible can be subsumed in one of the precise categories mentioned by section 936(h)(3)(B), the fall back category *other intangibles* of the latter provision, or whether it does not qualify as intangible and instead could originally be exempt as part of the now stripped our active trade or business exception or the foreign trade and business exception - stances taken by both taxpayer and tax authorities in the past, which were particularly contentious with regard to the

[935] See sections: OECD: 3.1.4 & 3.1.5.; Germany: 4.5., 4.6., 4.7.; USA: 5.2.3. & 5.5.

examined soft-intangibles and the allocation of location savings. The extended definition of section 936(h)(3)(B) intangibles does away with the discussions surrounding the qualification, as long as its value is not dependent on its attribution to tangible property or the services of an individual.

Regarding the differentiation of intangibles, the OECD does not specifically discriminate intangibles into trade and marketing intangibles anymore. The use of other commonly employed categories is also denied when dealing with transfer pricing aspects of intangibles. A different standpoint is taken in the BEPS deliverable on Action Point 8 on hard-to-value intangibles and in the conforming amendments to Chapter IX of the TP Guidelines. Even though a categorisation of intangibles for purposes of Chapter VI may not be regarded as sensible for the application of Chapter IX, it is rightfully seen as a necessity. The result of qualifying something as a hard-to-value intangible is the acceptance of a posterior valuation in order to have an indication whether the anterior valuation has actually been at arm's length unless one of the exceptions provided applies.

Prior to the US expanding the IRC definition of intangibles, in comparison, one found three largely different approaches to categorizing intangibles. Even though the definitional problem has been eliminated, there are still differing consequences when evaluating a business restructuring for transfer pricing purposes. The qualification as an intangible yields a tax consequence in the US regardless of the fact that the intangibles may be hard-to-value. This may be achieved by potentially requalifying the transaction as a deemed license payment over the useful period of life of the intangible, or by way of a posterior price adjustment in order to be commensurate with income.



In contrast, the OECD TP Guidelines and the FTA limit measures that are generally seen to be at odds with the arm's length principle to cases that involve hard-to-value intangibles and, furthermore, propose a number of exceptions.

### 6.3.2 Evaluation

In light of the analysis of the three systems, their advantages and drawbacks, at first glance it is tempting to call for clear definitions in order to avoid the many conflicts connected with the qualification of a certain intangible. The sphere of intangibles has become broader and more relevant over time, and mainly soft-intangibles were the last part that has not been subject to tax scrutiny under transfer pricing. Efforts have been made to subject these to arm's length principle as well, and, therefore, to taxation. This is seen in the cases of the tax treatment of a workforce in place and synergies in the US or a function in Germany leading to several discussions on the applicable definition or thresholds that apply.

By contrast, the recent approach voiced by the OECD to hard-to-value intangibles avoids these pitfalls by aiming special measures at intangibles for which no reliable comparables existed at the time of transfer. Together with a wide array of exceptions, the intangibles which in fact at the time of transfer could not be valued correctly or that have a certain residual value, can be properly taken into account. The German approach adds to this an arbitrary exception by including a fixed threshold of 25% of the transfer package.

Added to this are a number of exceptions which further elevate the level of arbitrariness and uncertainty, let alone the high burden imposed on the taxpayer to make use of these exceptions. Contrastingly, the United States had a fixed list of intangibles, but the system is still plagued by numerous discussions in how far something qualifies as intangible or comes within the ambit of an exception based on certain qualities of the intangibles in question.

As was previously observable in the US, a rigid system of categorizing intangibles comes with significant drawbacks because of the endless possibilities of how (soft)-intangibles could be shaped that are to be captured by this sort of provision. Therefore, an approach as taken by the OECD is to be preferred. While not relying on a particular differentiation of intangible categories, a separation has only been made where it is sensible for transfer pricing purposes. However, one can also argue that this approach is too vague and therefore creates uncertainty.

The way chosen in the German FTA, viz. introducing more far-reaching measures for *material* intangibles, can be considered to be similar to the hard-to-value intangible approach pursued in the OECD TP Guidelines. By resorting to a particular set of rules tailored to handle business restructurings, the specificities of those transactions can be considered more accurately. The IRC, on the other hand, deals with business restructurings with its general transfer pricing rules.



Given the breadth of the definitions of intangibles, it may be questionable as to how far the arm's length principle is actually followed. This will become even more apparent in the subsequent evaluation of the individual intangibles. From a conceptual point of view any attempt to take soft-intangibles into consideration needs to be seen as a deviation from the arm's length principle.[936] The most extreme variant of this is simply declaring something to be an intangible proper as it is intended in the US while it is not. Even though one elevates such a soft-intangible, an unrelated party would not or could not remunerate such a transfer if it was at all performable. Neither the external nor the internal specificities of value creation are taken into account – differently than the approaches which only consider soft-intangibles on an aggregated basis. These approaches can be considered to be in line with the arm's length principle if the aggregation occurs in a manner that would also take place between unrelated parties. This abstraction of the transaction is needed because by sticking with a singular valuation one would not be able to apply the arm's length principle to these (soft)-intangibles. Furthermore, these approaches might not take value creation into account to the degree intended by the BEPS project.

[936] Imhof, M., *Business Restructuring: Eine Betriebswirtschaftliche und Steuerrechtliche Analyse*, Köln: Eul-Verlag, (2012), p. 377.

## 6.4 Workforce in Place

### 6.4.1 Comparison[937]

The discussion whether a workforce in place should be seen as an intangible and therefore be remunerated when transferred or made available is mainly a US one, due to it not being included in the list of intangible assets of Section 936(H)(3)(b).

In the US, workforce in place can become an issue where it is transferred to a foreign related entity or placed at the disposal of the latter. While there has been a strong push from the IRS to include workforce in place, the case law for both situations in unison states that there is no value to be attached to a workforce in place which is either transferred or placed at the disposal. Such a discussion of value continues even with the inclusion of workforce in place in the list of intangible assets of Section 936(h)(3)(B).

In the FTA, workforce in place is not an issue of qualifying the workforce in place as a separate intangible but rather a matter of whether a (seconded) employee can trigger the function shifting and how it is then to be taken into account as part of the transfer package.

Regarding seconded employees triggering the functions shifting legislation, it is only expressly excluded in the function shifting regulation and the administrative principles as long as long as no function is transferred with it, which the employee would then exercise at the receiving entity.



This means that in fact a function can be considered to have been shifted where an employee possessing relevant know-how is seconded and performs a function for the receiving entity, resulting in a remuneration, effectively for a seconded employee, that has originally been viewed to imply elements of slavery. This has been mended by making it further conditional upon a third party also willing to remunerate such a transfer.

The position taken in the OECD TP Guidelines is also twofold. In principle, the transfer of an employee to a related entity is not to be compensated and for a secondment it would be appropriate to compensate for the services actually rendered by the employee.

However, in business restructuring scenarios, that generally deal with a workforce in place or, as it is referred to in the OECD TP Guidelines, an assembled workforce, such is considered to be a factor that should be taken into account for determining an arm's length price of a going concern. This is based not only on the benefit that the receiving company obtains by getting a functioning, assembled workforce, and therefore does not have to hire new employees. It is also based on the detriment and limitations that an assembled workforce carries if it does not function well and rather constitutes a liability.

But in cases where secondment or transfer of an employee in fact translates to the transfer of intangibles such as know-how, remuneration should be paid purely for the intangibles and not for the employees.

[937] See sections: OECD: 3.4.3.; Germany: 4.7.4; USA: 5.4.2.

### 6.4.2 Evaluation

Comparing the different approaches, it is striking how workforce in place, which certainly can possess a value for the receiving entity, is taken into consideration in Germany as opposed to the earlier US position. While an inclusion of such a potentially added value would need to occur by considering a workforce in place as a separate intangible asset, under the German FTA such a value would merely be considered as part of the transfer package, thus in aggregation. This leads to different thresholds for valuing a workforce in place. It requires an aggregated valuation, according to the FTA, for which the threshold, considering the numerous exceptions, is set rather high. Yet, it is these exceptions that require valuing the workforce-in-place for matters of applicability.

By contrast, the IRS would consider valuing a workforce in place also as a standalone intangible. However, as Section 936(h)(3)(b) previously stood, a workforce in place can only be considered as part of goodwill or going concern, and not as a separate intangible – an approach, therefore, which is comparable to that embraced by the FTA. But this has changed with the Tax Cuts and Jobs Act, which allows for the qualification of a workforce in place as an actual Section 936(H)(3)(b) intangible. By contrast, the approach taken by the OECD TP Guidelines differs insofar as it considers a workforce in place as a factor that is to be accounted for as part of a going concern. but never considers a workforce in place as a separate intangible, nor as one that is to be remunerated above the services of a seconded employee.



Viewing secondments from the perspective of the IRS, and applying it to multiple employees making up an assembled workforce, such secondments can be characterised as a transfer of an intangible asset which demands valuing the benefit thereof. For the FTA, such a secondment does not trigger the function shifting legislation. Yet, just as in the OECD TP Guidelines, the employees and possibly their services are discerned from the know-how that they bring to the receiving entity.

It is important to test the compatibility of these approaches with the standards of the arm's length principle and value creation, beginning with the arm's length principle which is founded on the principle of applying same prices in controlled situations as in uncontrolled ones. Therefore, the arm's length principle would be best served where a workforce in place is not considered at all or at best as a comparability factor. Given that indentured labour is outlawed in most countries, it would be difficult to equate employees with "assets" in the traditional sense of the term, despite contractual obligations. Therefore, the OECD's (altered) TP Guidelines are accurate in limiting their reliance on workforce in place as a comparability factor.

In these terms the FTA approach is the second best as it only takes a workforce in place into consideration in the limited situations where a valuation as transfer package and thus in aggregation is prescribed by it. In this situation, the effects of a workforce in place would not only be determined in aggregation, but also means with the hypothetical arm's length test. This allows taking into account both the positive and the negative effects which a standing workforce can have .

As the IRC previously stood, i.e. without taking a workforce in place into account as a standalone intangible, compliance with the arm's length principle was warranted. However, the permanent drive to extend Section 936(h)(3)(b) to include a workforce in place which has culminated in its inclusion via the Tax Cuts and Jobs Act, is the least compliant with the arm's length principle since this would allow for the assumption that a workforce in place can be treated like any other asset. The added complication in the case of the US where the IRC intends to also see an influence of a workforce in place which has merely been made available, thus going further than the remuneration of said workforce at arm's length, similarly oversteps that principle.

For an evaluation in terms of the value creation that takes place by assembling a workforce in place, a number of implications need to be considered. The OECD has perfectly discerned the steps of value creation that take place in assembling a workforce in place. In line with this has the new purpose of aligning transfer pricing outcomes to value creation been served, since a workforce in place is at most considered as comparability factor. Furthermore, the value creation that takes place after the business restructuring is left out of the picture for the ceding entity and therefore an application in line with value creation occurs.



Similarly, the default approach when considering the numerous exceptions to a valuation as transfer package in the FTA does not consider the value created in the form of assembling the workforce, or from secondments. Where a valuation as transfer package takes place a workforce in place is in fact part of the aggregated value. In terms of allocation, this translates to conceptually placing half of the value created in the country of the ceding entity and half in the one of the receiving entity. Therefore, one has not allocated the value creation where it belongs due to the default median allocation of the price in the framework of the hypothetical arm's length test. Value created post restructuring could be part of the posterior valuation of the transfer package, which could in turn amount to another deviation from an allocation in line with value creation.

In the case of the IRC, value creation can be said to be taken into account and allocated accordingly where the IRS claims the workforce in place to be an intangible. In these terms, value creation has been best served by creating a specific intangible of a workforce in place. In the case where the workforce in place is not transferred but merely made available to an entity abroad as the result of a business restructuring, the fact that the IRS would like to consider it an intangible does not matter. In this situation, however, the IRS intends to allocate more than just the arm's length charge for the services rendered by the workforce in place. This would only serve the aim of an allocation in line with value creation if the performance rendered by the workforce in place were to be presumed to be of such a particular nature that no one but this uniquely assembled workforce in place could deal with the task. Otherwise, a regular arm's length remuneration of the services of a workforce in place that is made available would suffice to reach an allocation in line with value creation.

Depending on the sector, the knowledge and the creative power of employees and entire teams is essential to the success of a company. Taking this into consideration, once a business is restructured is comprehensible from the perspective of the tax authorities. However, in order to achieve this goal one has pushed the boundaries of artificiality even further. The way in which individual employees function in a workforce-in-place is partly attributable to explicit and tacit knowledge. While discerning the former from the respective employee might just be possible, doing so with the latter is outright impossible and so would be the determination of an arm's length price for it.

Subjecting an assembled workforce as well as seconded employees to a treatment in aggregation for transfer pricing is probably the better solution. Implying that such an approach is tantamount to slavery is far-fetched since there are many situations where actual payments are made from the new employer to the former employer for hiring an employee.[938] Gains or losses resulting from a workforce in place can be pinned down. However, if such a course of action is chosen, it can only be limited to situations of business restructurings and is therefore part of an aggregation of transactions. Qualifying a workforce in place as an intangible asset, however, misses the point, since a workforce in place cannot be owned, and any contract that binds the employees to the employer can be valued apart from the actual employees.

Therefore, the approach taken by Germany is the most viable one. While the intention underlying the escape clauses is clear, the approach and the valuation of a workforce in place appears to be arbitrary. Since secondments are often related to business restructurings, their limited exclusion from the function shifting legislation is understandable. In terms of complying with the arm's length principle, the OECD upholds it best. In spite of the OECD calling for an alignment of transfer pricing outcomes with value creation as a consequence of the BEPS project, this goal is best served by the US and the IRC now including workforce in place as a separate intangible.



## 6.5 Synergies

### 6.5.1 Comparison[939]

Regarding synergies, one needs to differentiate between incidental and deliberate synergies. Additionally, there is the issue of synergies that exist between entities within the group company and parties that are outside it.

In the framework of US taxation, synergies were similarly controversial as workforce in place due to the threshold imposed by Section 936 for qualifying as an intangible. Due to the way the price is determined for a transfer package in line with the FTA, synergies are subjected to a number of particularities under German legislation as well. By contrast, the OECD has dealt with the issue of synergies rather briefly in the BEPS project .

[938] Agency for temporary work and educational costs which are waived under the condition that the employee stays a certain amount of time with the company. The latter can be paid by a new employer interested in hiring the employee before the time period has lapsed.

[939] See sections: OECD: 3.4.4.; Germany: 4.7.2.; USA: 5.4.3.

The two core questions revolving around synergies are their valuation and their allocation. In the absence of synergies as part of the IRC intangible definition, the IRS has resorted to putting synergies into existing categories provided by Section 936. Additionally, the IRS captures synergies by aggregating the previously prescribed "proxy" intangibles. This means that no changes in the actual outcomes are to be expected from the amendments made by the Tax Cuts and Jobs Act. This would be diametrically opposed to the very valid standpoint of taxpayers that synergies should be considered to be a part of goodwill and going concern value and thus used to potentially qualify for the foreign goodwill and going concern exception. However, in the proposed regulations and the recent amendments this very exception has been abolished, and the approach of the IRS on aggregation has been clarified and expanded. Therefore, Section 936 would capture synergies as soon as they can be detected, without exception, or without the necessity of the synergies to meet any threshold.

For the FTA, synergies are only considered where a transfer package is shifted. Therefore, in light of the three escape clauses to the transfer package, the situations in which synergies can be captured are greatly reduced. However, once applicable the hypothetical arm's length test also determines the allocation. Thus, depending on which one of the two entities benefits from the synergy, this would be taken into account by a double sound business manager.



The OECD considers group synergies as mere comparability factors since they cannot be owned nor controlled, but does not consider them to attain the status of an intangible. However, the TP Guidelines differentiate between group synergies that are incidental yet not necessarily small and those that are the result of deliberate actions, such as business restructurings in order to realize synergies. While incidental synergies are neither compensated for nor allocated, those resulting from a deliberate action are compensated for on the basis of a function and comparability analysis. Allocation is to be made in line with contribution made. However, it is also rightfully stated that there are not only synergy rents but also synergy costs.

A major part of the problem that has been fixed in the framework of the Tax Cuts and Jobs Act is the closed list of intangibles of Section 936(3)(h)(B). This Act eliminates the foreign goodwill and going concern exception and at the same time broadens the application of aggregate valuation. Yet, the Act still does not provide for a clear threshold. While the FTA contains a threshold for aggregate valuation, it goes amiss due to the way the escape clauses work and would have to be applied by taxpayers. The TP Guidelines do not offer a clearer guidance on when an aggregated valuation is necessary and synergies are therefore to be captured. However, the differentiation based on whether the synergies have been incidental or are the result of deliberate action is more instructive than the thresholds handled by the FTA in so far as in a business restructuring the creation of synergies is often central. Still, the TP Guidelines point out that synergies cannot be an intangible asset, thus contradicting the approach chosen by the IRS. Another factor which is dealt with in greater detail in the German function shifting legislation is the allocation of

the synergistic benefits. By using the hypothetical arm's length test, the actual contribution flowing from the synergies can be accounted for. Determining the value this way also makes it possible to consider that there are not only synergy rents but also synergy costs. This is in line with the TP Guidelines.

### 6.5.2 Evaluation

Evaluating the systems presented teleologically, namely to tax, among others, soft-intangibles, they appear to be applicable also in the in the context of business restructuring transactions. The IRC is no longer plagued by having a closed list of intangible assets which originally did not mention any of the soft-intangibles. Additionally, the removal of previously available exceptions, which also be covered synergies, leads to a situation where non-abusive transfers are no longer accounted for. Similarly, there is still no clarity as to when an aggregated valuation is warranted. This needs to be seen as the result of amending a system that has been conceived expressly excluding assets necessary for the conduct of active trade and business as well as (foreign) goodwill and going concern.

The intent of the German function shifting legislation has been a different one right from its inception, which allowed for it to better accommodate bona fide transfers. In that regard, the threshold of when a valuation as transfer package needs to take place is clearer. Also the three escape clauses reduce the likelihood of companies actually facing a taxation for compensation that goes beyond the value of individual assets. Furthermore, the applied standard of the prudent business manager is able to take into account that synergies can come at a cost.



The approach taken by the OECD comes close to the German one but makes the very valid points of differentiating between incidental and deliberate synergies as well as the clear statement that synergies are not assets but rather a comparability factor. Yet, in cases where they are the result of deliberate action, compensation is to be made in line with the contributions of the ceding and receiving entity.

The German function shifting legislation and the results of the BEPS project that are proposed for the TP Guidelines are capable of achieving their intended goal. However, the approach of taxing synergies, which are no different than goodwill or going concern value, are only present within groups but are never available to unrelated entities. For this reason proposals for simply adding a synergy intangible to Section 936(h)(3)(B) in order to fix the US situation cannot be considered viable.

Due to the fact that a synergy cannot be a standalone intangible asset, a large degree of abstraction in the valuation process, such the hypothetical arm's length test, is necessary. Complementing such measures, given the high uncertainty whether synergy rents can in fact be realized, with a posterior adjustment which can not only work for the benefit of the tax authorities but also for that of the taxpayer is required. However, even in that case synergy rents would need to be allocated between the ceding and receiving entity, which is contrary to the fact that a synergy is the result of the existence and interaction of two

entities. If it was not for that, a synergy would not be present, which makes a demand for an allocation of synergy rents in line with the entities' contribution rather absurd.

Evaluating the solutions in terms of the arm's length principle that is presented by the OECD, the emphasis is on the differentiation between synergies that are the result of deliberate action and those that are of merely incidental nature. While the arm's length principle would be perfectly served by abstaining from taking these synergies into account regardless of their nature, the OECD has chosen to take into account synergies which are a result of a deliberate action, as it is pursued in a business restructuring and have them compensated. Such compensation should be determined by way of functional and comparability analyses. Furthermore, only the synergies that arise between related parties are targeted. Thus, one has disregarded synergies arising incidentally and outside of related entities. One also does not regard synergies as a benefit only but acknowledges that they can also be detrimental to some parties of the group. The allocation of benefits will be aligned to their creation, therefore deviating from the arm's length principle. Yet, this is a matter that only arises after one has accounted for synergies.

The FTA approach towards synergies relies on the transfer package and therefore calls for the consideration of synergistic benefits only in a limited number of cases that can occur in the framework of a business restructuring. Thus, by largely limiting the number of situations where a synergistic benefit would be part of the valuation, one partly serves the arm's length principle due to the multitude of scenarios where the synergistic benefit would not be considered.



If in fact a valuation as transfer package is necessitated, this can only relate to synergistic benefits that were to be compensated for by a prudent business manager. This also extends to synergies that are incidental in nature, and not only to deliberately created synergies, that have been realized. Furthermore, those benefits would be integrated in the valuations that are to be derived internally e.g. from the interaction with other group members as well as externally e.g. thanks to the presence of relevant clusters in the new location. Except for the synergies that are the result of external circumstances in the location of the receiving entity, none of the others are available in uncontrolled situations, which is why compliance with the arm's length principle is not a [?] given. Allocation of synergistic benefits occurs also in a matter not compliant with the arm's length principle, namely split at the mean of the price bandwidth by the hypothetical arm's length method.

Another approach towards synergies is taken in the US. Once again, it hinges on the definition of an intangible. Therefore, as the IRC originally stood, full compliance with the arm's length principle was given but the Tax Cuts and Jobs Act includes synergies by listing goodwill and going concern as a Sec. 936 intangible. The same result has been achieved earlier by using other, enumerated intangibles, that are certainly affected by the synergy as a proxy in order to take synergistic benefits into account for the valuation. A limitation as to the synergies that are considered is not discernible. An allocation that shares the benefits of the synergies between the related entities creating it is not performed – even

in the amendments brought about by the Tax Cuts and Jobs Act. Therefore, for this matter the arm's length principle is not observed.

In terms of value creation, the TP Guidelines are aligned with value creation to transfer pricing outcomes. The key allocation factor put forward by the OECD is the degree to which an entity is causal to the synergy, thereby, an allocation in line with value creation. However, being responsible for a synergistic benefit does not need to translate to value creation, unless one looks at value creation beyond the value chain.

The determination of the price by way of the hypothetical arm's length test and the aggregation taking place in the transfer package make it possible to account for both – value creation that takes place as a result of synergies within the group but also externally. Additionally, the FTA strikes a simple balance in the allocation of such a value creation, namely, by determining the price as the median of the bandwidth of price in the hypothetical arm's length test. This acknowledges that value creation as a consequence of synergies takes place at different stages of the restructuring process and in the ceding as well as the receiving entity. Yet, it is questionable to what extent this can be in line with value creation, considering that synergies arising from the interaction of the receiving entity do not arise with other parties outside of the group. Such a synergy hardly warrants an allocation of any value creation to the country of the ceding entity.

An approach that is quite different to the allocation of synergies previously seen for the FTA can be observed in case of the US. The IRS taps into synergies by using proxies that are certainly positively affected regarding their value as a consequence of synergies or can do so now via goodwill and going concern. An allocation is also effected – namely entirely to the US, where it is the country of the ceding entity. Thus, at what stage and location the synergies have been created is disregarded. As a consequence thereof, value creation is disregarded for the determination of the arm's length price.



## 6.6 Location Savings

### 6.6.1 Comparison[940]

The differences in how the OECD, the United States, and Germany approach location savings are the greatest because the FTA is specifically tailored towards restructuring while the IRC is not at all, and the OECD TP Guidelines only to a lesser degree, prepared to consider the restructuring itself but merely considers the location saving in the price for resulting products and services subsequently transferred between the related entities.

Resulting from the underlying mechanism of the hypothetical arm's length test, the FTA demands half of the location savings unless another allocation can be proven. This also includes a beneficial tax environment and specific tax incentives that are not to be accounted for in the subsequent exchange of products and services between the related entities.

[940] See sections: OECD: 3.4.5.; Germany: 4.7.1.; USA: 5.4.4.

The IRC can capture such location savings only once they have materialised in transactions that take place after a business restructuring and not as part of the undertaken restructuring itself.[941] If done so, the claims laid on the location savings realized by foreign related entities have been repeatedly allocated to that entity and not the domestic one as a consequence of a number of cases. However, the benchmarks have been set enabling the IRS only to consider the location savings in transactions where they are actually passed on to the domestic entity. The case law dealing with these issues thus focused on the relative competitive position of each party in the respective market.

The OECD TP Guidelines and in particular the conforming amendments as a consequence of the BEPS project distinguish between those location savings and local market features that are actual intangible assets, such as government licences and contracts, and those which are not. The latter serve as comparability factor for determining the arm's length price of the transaction. Allocation of the advantages which can be derived from location savings and other local market features is to be effected in line with functions, assets, risks and obviously the bargaining powers of the entities involved in the transaction. If information is available on how the allocation is effected in uncontrolled situations this is to be adhered to. Yet, the contributions of the ceding and receiving entity for exploiting the location savings are also to be taken into account.



Comparing the three approaches, what stands out is the ability of the German Functions Shifting legislation to absorb all location savings, including tax benefits, unlike the IRC, which would only consider location savings but not tax benefits after the restructuring took place and then both ceding and receiving entity engage into a transfer of products or services. A tax benefit that is realized by the business restructuring is out of reach on basis of the IRC. The same holds true for the OECD TP Guidelines, which in fact make a distinction between the treatment of location savings as a comparability factor and its relevance for business restructurings. Yet, the business restructuring transaction itself and the influence that location savings have on it are thus not separately accounted for other than as a comparability factor.

### 6.6.2 Evaluation

By comparing the three approaches on how to account for location savings, it becomes clear that the German function shifting legislation has been specifically created to deal with business restructurings. With the introduction of 367(d) IRC and the addition of the Commensurate with Income standard the US at one point also aimed at business restructurings. Yet, when it comes to capturing location savings that are to be realized as part of the business restructuring itself and not in the actual transfer of assets and transaction in which the parties subsequently engage, the IRC lags behind since it does not specifically accommodate the specificities of a business restructuring. The reach of the provisions found in the OECD TP Guidelines is comparable in that regard. However,

[941] Imhof, M., *Business Restructuring: Eine Betriebswirtschaftliche und Steuerrechtliche Analyse*, Köln: Eul-Verlag, (2012), p. 378.

examples of specifically these location savings and in particular those based on tax savings are numerous and are a matter of developed and developing countries alike.[942]

The guidance that is to be derived from the TP Guidelines describes the relevant issues that relate to location savings and business restructurings but does not elaborate on the value creation that is to be taken into account. This omission already indicates that they are dedicated to the arm's length principle as opposed to value creation. The value creation that is derived from location savings takes place in the country of the receiving entity and not in that of the ceding entity. In terms of the arm's length principle, even the amended TP Guidelines are set out to only serve the arm's length principle while not specifically dealing with value creation. The arm's length principle is served by confining the effects of probable location savings to the comparability of arm's length prices but also to the arm's length price itself. Acknowledging this means that one takes value creation into consideration only indirectly, since the value creation at least in part affects the arm's length price.

The German approach towards location savings is a pragmatic one and the only one which offers a solution for the question how to allocate the benefits or disadvantages. Due to the mechanics of application, a transfer package is to be valued in line with the hypothetical arm's length test. The result of this method is the use of the median and thus the theoretic half split of the location savings. Even though it is merely half of the location savings that are captured in business restructurings in the absence of an available reasoning, that very half originates from conditions present in the country of the receiving entity. In light of the underlying arm's length principle, such a division might be reasonable since a location saving only comes about if the ceding and receiving entities engage in the transaction. In that regard, it is a pragmatic solution, yet not necessarily at arm's length. But whether these benefits persist and those location savings are not neutralized by location costs is highly uncertain, let alone whether developing countries are aware of these benefits and are eager to include them in their tax base.

The IRC usually allows for an allocation in conformity with the arm's length principle by not taking location savings into consideration. However, the IRS' interpretation of the law, has been to the disservice of the arm's length principle by allocating location savings exclusively to the ceding entity. While in perfect conformity with the arm's length principle, no location savings should be taken into account as they are available for free to any party in controlled and uncontrolled actions . There is agreement that location savings should be shared but not exclusively allocated to one of the countries. But the IRC/IRS does not propose taking location savings into account for the mere shift of the function abroad.



[942] In particular developed countries attracted attention over the past decade for their sometimes very generous and from the point of view of tax authorities critical Research and Development incentives. A major example for the attraction of such tax incentives is the unsuccessful merger between Pfizer and AstraZeneca: Hoffman, L., Pfizer Sees Tax Savings From AstraZeneca Deal, The Wall Street Journal, April 28 2014: http://www.wsj.com/articles/SB10001424052702304163604579530162313579896 (01.03.2017).

Judging by the results, value creation as a new benchmark to align transfer pricing outcomes is, similarly to the arm's length principle, only of lesser importance . In terms of location savings, another factor needs to be considered for evaluating the solutions chosen – namely in how far they favour either the supply or the supply-demand approach.

In line with the newly established benchmark of value creation, the OECD does not make any additional provisions that would ensure that value creation – neither external nor internal – is being taken into account. It exclusively relies on the arm's length principle and thus fails in its intention to align transfer pricing outcomes with value creation as the value that is created as a result of location specific advantages is clearly attributable to the country of the receiving entity. The arm's length principle, by being based on finding a price between two uncontrolled parties, is by definition not fit to deal with value creation derived from location savings. This goes hand in hand with the general disapproval of the supply-demand approach regarding location specific advantages. This results in the general disregard of a market in the country of the receiving entity. The value creation (external) that results from the market provided is therefore disregarded straight out.

The German approach works differently. While considered partly at odds with the arm's length principle, it is able to indeed capture value creation by way of the transfer package and the hypothetical arm's length method. In fact, the German approach even captures value creation that is the result of the supply-demand approach. Hence, it also accounts for the previously frowned upon market that is provided by the receiving country. However, location specific advantages being most intrinsic to the country of the receiving entity, the allocation is not in line with value creation by merely allocating the other half to it. This is particularly the case in which the German approach would already consider location savings in terms of the function – something that is freely available to everyone – regardless whether related or unrelated.

The way the IRS tried to deal with location savings is the opposite of an allocation that is in line with value creation, namely, allocating all the benefits that were derived from the location of the receiving entity to the country of the ceding entity, the USA. However, this approach has not been upheld in court. Therefore, it is possible to say that the approach prescribed by the IRC is in line with value creation by not taking into account location savings and therefore allowing for an allocation to the country they have been derived from. Consequently, this would hold true for both cases: the internal and the external value creation.

# Section III: Posterior valuation

## 6.7 Posterior Valuation[943]

Posterior valuation is en vogue among tax authorities. It provides them with a powerful tool to fill the "perceived" knowledge gap between the taxpayer and the tax authorities. Therefore, a clause allowing for posterior valuation is found in all three of the analysed systems. They vary greatly, however.

### 6.7.1 Scope of Posterior Adjustment Provisions

#### *6.7.1.1 Comparison*

The situations in which the application of a posterior valuation is envisaged differ, which leads to a significant difference in scope.

According to the FTA, a posterior valuation is envisaged in cases where the valuation of the transferred asset in connection with the function shifted requires the determination of the price by way of the hypothetical arm's length test. In relation to business restructurings, this is likely to occur in cases where it is necessary to consider the shift of a transfer package since the collection of functions assets and risk will often result in the absence of comparables or adjustable comparables. Furthermore, it is required that a significant intangible asset has been the subject of the hypothetical price determination. Even though limited in application to significant intangibles valued in line with the hypothetical arm's length price, the actual reach in case of a business restructuring goes further, due to the lack of comparables/adjustable comparables.

In contrast to this stand the provisions of the IRC which reach significantly further. In fact, two different provisions, 367(d) and 482 IRC cause a posterior adjustment. The regime of imputed royalties of Section 367(d), which need to be *contingent upon productivity, use or disposition*, applies to all intangibles as listed and extended in Section 936(h)(3)(b) and includes workforce in place and goodwill and going concern value. Furthermore, the scope of Section 367(d) has been extended in its application, eliminating the foreign goodwill and going concern value exception.

Similarly, the CWI standard of Section 482 applies to intangible property of Section 936(h)(3)(b). However, it does not apply where intangibles are transferred for less than a year and in situations where comparables are available for applying the CUP method. If the comparables require adjustment or another method to be used. Furthermore, the applicability of the CWI standard depends on whether there is an agreement in place which further limits the use of the intangible. Other factors determining the actual adjustment can only be *ex post facto* events.

The 2017 OECD TP Guidelines only consider an ex-post adjustment to be warranted if third parties could reasonably be expected to include a price adjustment clause, or to renegotiate an agreement to account for actual deviations in value on the basis of unforeseen

[943] See sections: OECD: 3.4.6. & 3.4.7.; Germany: 4.9& 4.10.; USA: 5.6.

events. An adjustment would have to take place on the basis of what third parties would have done to deal with the uncertainty, like the inclusion of a price adjustment or earn out clause. This is the case in which a valuation is sufficiently uncertain. Such uncertainty should be demonstrated by the tax authorities. In situations where such an uncertainty is not present, the application of hindsight is not appropriate. In the course of the BEPS project, the stance taken by the OECD has been further refined. An ex-post valuation is now to be regarded as an indication for the arm's length conformity of the anterior valuation. This is considered as rebuttable *presumptive evidence* for the presence of uncertainties and can be the basis for evaluating whether it has been properly accounted for. This approach needs to be differentiated from considering the results of an ex-post valuation for an ex-post adjustment.

The scope for which a comparison between anterior and posterior valuation is suggested is limited to hard-to-value intangibles for transactions conforming to specific conditions. This solution is further limited by a number of exceptions.

Comparing the scope of the price adjustment provisions, the most far-reaching one is Section 367(d) and 482 IRC. While 367(d) applies to virtually all intangible assets that are shifted abroad, Section 482 provides a general exception to intangibles that are ceded for less than a year or valued using the CUP method. This contrasts with the approach followed by the German function shifting legislation, which merely applies to function shifting issues where a significant intangible is shifted and has been valued by applying the hypothetical arm's length method. While this severely reduces the scope of the price adjustment clause, the results of the BEPS project and the changes to be applied to it anticipate a posterior valuation only as part of rebuttable evidence that can be conducted in cases where hard-to-value intangibles are transferred. A valuation at hindsight is still not considered part of the OECD TP Guidelines.



#### *6.7.1.2 Evaluation*

The main argument for a posterior adjustment that is brought forward by the tax authorities is the information asymmetry between taxpayer and tax authority - the surmised consequence being that related parties would not agree on arm's length terms. Limiting the scope to situations where the information asymmetry is largest is therefore sensible, considering the added administrative burden that is levied on the taxpayer in order to show that the agreement has been at arm's length.

In that regard, the scope chosen in Sections 367(d) and 482 IRC is too wide, in particular since the exceptions applying to Section 367(d) have been removed and a price adjustment of Section 482 is only expressly excluded as long as the CUP method has been used. The use of adjusted comparables opens up the possibility of a posterior adjustment undertaken by the tax authorities, since that way it no longer is in scope of the exclusions banking on applying the CUP method. Conversely, the scope of the German posterior adjustment is far more limited as it only applies to significant intangibles that are part of a function shifting and that have been valued by applying the hypothetical arm's

length method. While it is sensible to enable a posterior adjustment in a situation where a valuation is based on something as artificial as the hypothetical arm's length method, the requirement of the intangible asset being *significant* is hardly a constructive solution. Yet, even more limited is the approach pursued by the OECD TP Guidelines for hard-to-value intangibles. This is certainly more focused on eliminating the information gap perceived by the tax authorities. In particular, a number of qualities of the intangibles and the transaction are considered which signify uncertainties in regard to the commercial exploitation of the intangible.

Overall, the arm's length principle cannot be said to be served well – not even by the approach proposed by the OECD for hard-to-value intangibles. First and foremost, it has been demonstrated on several occasions that in uncontrolled situations the parties do not include a price adjustment clause. The often-cited information asymmetry between taxpayer and tax authorities only exists in a limited number of scenarios. This eliminates the argument of related parties handling artificially low prices for intangibles and functions that are going to increase in value after the transfer has taken place.

The fact that this information asymmetry only exists to a limited degree is the result of the difficulties that even the most experienced actors in a certain industry face. In this context, it is interesting to note the following observations made in an empirical study by Scott *et al*. They studied the likelihood of start-ups successfully commercializing their products, relative to the expectations of the entrepreneurs and their mentors.[944] The authors of that empirical analysis drew three conclusions which found no advantage for either party in evaluating business. Firstly, those ventures that have received an initial interest from mentors are in fact more likely to succeed, namely to reach commercialization.[945] Secondly, it has been found that there is a strong significant relationship between success of a venture in an R&D intensive sector with intellectual property and the mentor interest already present.[946] Yet, there has only been a weak and insignificant relationship in sectors that are not R&D intensive, such as applications for web and mobile, and products directed towards consumers as well as enterprise software.[947] Thirdly, the industry background has not been a *critical determinant* for correctly determining the successfulness for the evaluated ventures. Ironically, the correlation between success of a venture and the mentor's interest is strongest for mentors not holding a doctoral degree.[948]

The first finding implies that the successfulness of a venture can be predicted to some degree. The argument that could be based on this, i.e. that there actually is an information asymmetry, is alleviated by the two additional findings. On the one hand, the



[944] Scott, E.L. et al., Are "Better" Ideas More Likely to Succeed? An Empirical Analysis of Startup Evaluation, Harvard Business School Technology & Operations Mgt. Unit Working Paper No. 16-013 , 2015; available at: http://dx.doi.org/10.2139/ssrn.2638367; 15.09.2016.

[945] Scott, E.L. et al., Are "Better" Ideas More Likely to Succeed? An Empirical Analysis of Startup Evaluation, Harvard Business School Technology & Operations Mgt. Unit Working Paper No. 16-013 , 2015, p. 3; available at: http://dx.doi.org/10.2139/ssrn.2638367; 15.09.2016.

[946] Ibid. p. 3&4

[947] Ibid. p. 4

[948] Ibid, p. 4

ex-ante predictability is highest where there is already documented intellectual capital, particularly in R&D intensive sectors. Therefore, valuations of a business restructuring that were to take place in such an intellectual property driven sector could in fact be based on existing intangibles and (adjusted) comparables. Conversely, the predictability where such intellectual property is not yet present is rather insignificant. On the other hand, this particular study has shown that in order to predict the successfulness ex-ante it does not matter whether that evaluation has been made by an industry expert or not. Therefore, even if it is possible to predict the success of a venture ex-ante, it is a judgement call that cannot only be made by experts of that particular sector.

Hence, the claimed information asymmetry between taxpayer and tax authorities cannot serve as an argument for violating the arm's length principle. However, this study shows that, even though ill-defined, the German approach of only considering transfers of functions connected to a significant intangible, is sensible. A lack of a price adjustment clause should also be in favour of tax authorities, given the prerequisite that a successful venture cannot be predicted any better by experts of a sector than by a group of people with a diverse set of backgrounds, since the additional risk that is being run by one party should lead to a higher remuneration.



Additionally, if one considers the example of the pharmaceutical industry where a stark increase in value of drug formulations is often observed, the creation of blockbuster drugs is contrasted by a large number of failures in the (pre)clinical trial phase, leaving only 10% of the candidates to succeed.[949] This exemplifies perfectly how difficult it is to predict ex-ante the success of such a venture and thereby its increase in value.

Besides the issues arising from an arm's length perspective, posterior valuations are also to be evaluated from the new iteration namely the OECD's aim of aligning transfer pricing outcomes with value creation. Seen from that perspective, a posterior adjustment is particularly problematic since in an arm's length scenario the profit potential that is entangled in a function or an intangible is remunerated at the time of transfer. Increases in value that take place at a later stage could, of course, be contributed to the intangible or the function and its qualities upon transfer. However, if a transfer in fact took place at such an early stage, the input that stems from the ceding entity compared to the one of the receiving entity, depending on the kind of intangible, is substantial. An alignment of transfer pricing outcomes with value creation would call for an abstention from posterior adjustment.

Looking at this issue from the perspective of the pharmaceutical industry, even though this industry is characterized by some particularities, it shows that posterior adjustment and the alignment of value creation with transfer pricing outcomes do not go together. This is the result of extremely long development processes.[950] While a large

[949] BIO, Clinical Development Success Rates 2006-2015, BIO Industry Analysis, 2016, p. 3; https://www.bio.org/sites/default/files/Clinical%20Development%20Success%20Rates%202006-2015%20-%20BIO,%20Biomedtracker,%20Amplion%202016.pdf (01.03.2017).

[950] Kaitin, KI; Deconstructing the Drug Development Process: The New Face of Innovation http://www.ncbi.nlm.nih.gov/pmc/articles/PMC2953249/pdf/nihms238072.pdf

part of the time is consumed in clinical trials after the original iteration of the drug has been developed, this stage still requires efforts in order to commercialize the product. Even if a pharmaceutical product emerges successfully from the clinical trials and obtains the relevant approvals of the drug agencies, it requires a tremendous financial effort to actually market the product. This becomes particularly apparent when considering that the marketing budgets of the largest operating pharmaceutical companies are larger than those for research and development.

### 6.7.2 Posterior Adjustment – Timeframe, Trigger & Subsequent Adjustment

Different thresholds apply for actually triggering a posterior adjustment. Similarly, different solutions have been embraced for the applicable time frames in which such an adjustment can be triggered. The adjustment that follows is then not necessarily based on hindsight but rather on the circumstances that existed at the time of the conclusion of the transaction but are presumed not to have been taken into consideration, therefore arriving at an agreement that is not in conformity with the arm's length principle.

#### *6.7.2.1 Timeframe*

*6.7.2.1.1 Comparison*



The timeframe that is considered for a one-time posterior adjustment and the transaction in line with the FTA is 10 years. An adjustment within this period is possible if there is a serious deviation from the projected profitability of the transferred function including the significant intangible leading to a price that lies outside the originally determined price range. Such a serious deviation is, however, not limited to an increase in value. It affects either the minimum or the maximum price that is to be determined for the receiving entity. If the *serious deviation* means that the actual profits have surpassed the expectations, the adjustment is made on the basis of the recalculated maximum price. However, a *serious deviation* is also present where the new maximum price of the receiving entity lies below the original minimum price. In that case, the price range is established on the original minimum price of the ceding entity and the new maximum price of the receiving entity. The rules for posterior price adjustment are not applicable in cases where the transaction is settled on the basis of a profit or turnover dependent license.

The timeframe in which a price adjustment can take place for Section 482 is five years, as long as in these first five years after the transaction no adjustment became necessary. However, within the first five years these adjustments can be made annually, and if this is in fact done there is no time limit. Regarding Section 482 it is necessary to differentiate between a number of requirements that are set out, the absence of which creates the possibility of a posterior adjustment regardless of events that take place after the agreement has been made and those which only occur after the agreement has been made. Focusing on the issues arising ex-post that can trigger a posterior adjustment by the tax authorities, these are essentially two, and since the requirements of the escape clauses are structured cumulatively, either of the two can trigger the application of the

price adjustment. Firstly, the functions that are performed by the receiving entity were not substantially altered. Secondly, the aggregate profits or cost savings that have in fact been realized for the taxable year or any other prior year do not deviate by more than 20%. But if any of the events causing the deviation from the projected earnings have been foreseeable or extraordinary, no adjustment is to be made. The breadth of such an adjustment is based on the circumstances known at the time of the adjustment.

Regarding these aspects, Section 367(d) IRC, which leads to an annual deemed royalty payment, is insofar different as only the useful life of the intangible shifted determines the limit for adjustments. Any particular threshold triggering subsequent price adjustments does not exist.

The guidance on posterior adjustments that can be derived from the OECD TP Guidelines is shy about the specific time frames in which such an adjustment should be effected. The approach pursued prior to BEPS is permissive to some degree to posterior adjustments. It is expressly limited to the transfer of intangibles, either independently or as part of a business restructuring whose value is highly uncertain. In such a situation, the OECD presumes that independent parties would resort to price adjustment clauses, to shortening the duration of the contract or to including provisions that allow for the renegotiation in case of unforeseen events. It is emphasized that tax authorities should inquire and follow what independent parties would have done – in particular what information has been taken into account. This should be done in particular where a taxpayer is uncooperative, potentially leading the tax authorities to the conclusion that independent taxpayers would have included a price adjustment clause. This allows the tax authorities to make adjustments on the basis of such a clause and relying on information that is available at the time of the adjustment and for all open years. For intangibles whose valuation was sufficiently uncertain at the moment of transfer as part of a business restructuring, prompting independent parties to include a clause for price adjustment or renegotiation, a posterior adjustment on the basis of such clauses is warranted according to the Guidelines. For other situations it is reiterated that the use of hindsight is not permissible.



The approach taken by the OECD within the BEPS framework is more refined and said to be in conformity with the arm's length principle. It is directed towards the addition of a newly defined category of intangibles and HTVIs, in addition to the pre-existing guidance for HTVIs. This approach is complemented by an indicative list of features common to transactions of hard-to-value intangibles. If such a transfer occurs, the *ex-post* valuation can be used as an indicator to determine in how far the *ex-ante* terms of the agreement have been in line with the arm's length principle. Pivotal to this determination is whether all of the effects have been accounted for in line with their respective probability. Based on this approach to this problem, as it is perceived by the tax authorities, there are a number of escape clauses, On the one hand these clauses rest on making projections that take into account what is reasonably foreseeable and that factors which were not foreseeable are causal to the difference between *ex ante* and *ex post*. This is also true where bilateral or

multilateral APAs apply to the transaction of the hard-to-value intangible. On the other hand, the escape clauses also apply where either the compensation or the revenue within a period of five years after commercialisation commencing with the generation of revenue for the receiving entity stayed in a bandwidth of ±20%. Should these escape clauses not be applicable, an adjustment can be made on the basis of the ex-post valuation in so far as it can be concluded that unrelated parties would have resorted to a clause allowing for a price adjustment or a renegotiation. An adjustment based on hindsight in situations where no hard-to-value intangible is transferred or one of the escape clauses applies, is rejected.

With a view to comparing the different provisions, a number of similarities but also striking differences become apparent.[951] Under the FTA posterior adjustments can be made within 10 years of the execution of the transaction, whereas Section 482 of the IRC provides for a much shorter limitation period of 5 years, as can be inferred from a reading of the escape clauses provided within the treasury regulations. The deemed royalty payments based on Section 367(d) IRC are only limited by the useful life of the intangible. While the FTA only allows for one adjustment within that time period, adjustments for matters of Section 482 & 367(d) IRC can be made every year. In case that such an adjustment is made within the first five years, further adjustments in line with Section 482 IRC are possible. The OECD does not propose a timeframe in which such an adjustment should take place. However, a limitation of five years could be read into the OECD approach after commercialisation of the HTVI, once unrelated party revenues for the receiving entity connected to a ±20% threshold have been generated.



*6.7.2.1.2 Evaluation*

Evaluating the time periods within which an adjustment is allowed together with their frequency, the differences between the two approaches become apparent: on the hand, a fixed time period of ten years in which one adjustment is possible, and on the other hand continuous adjustment unless certain requirements are met.

The ten-year period is generally criticised for being too long. However, following through from the argument of the tax authorities that there are intangibles which are transferred at such an early stage in the development that a proper valuation is not possible, then a ten year period is sensible, in particular for industries other than IT, where development cycles can go well beyond ten years. Moreover, if adjusted once, the ability for another adjustment is foregone. Furthermore, it needs to be kept in mind that such a posterior valuation could only take place where the *significant intangible* is entangled in a transfer package, making up a function. Thus, it is also relevant how the function, assets and miscellaneous benefits in the transfer package develop within this timeframe and as part of the transfer package. In particular, a business function can have a lifespan superior to that of one *significant intangible*. On top of this, the entirety of the transfer package

[951] Imhof, M., *Business Restructuring: Eine Betriebswirtschaftliche und Steuerrechtliche Analyse*, Köln: Eul-Verlag, (2012), p. 400.

makes a significant deviation less likely, since the significant intangible is only one of the many components of a transfer package.

Looking only at standalone intangibles and not at entire business functions, as is the case for the IRC and the OECD HTVI proposal, most relevant for the valuation of the intangible is its commercial success. Therefore, the OECD escape clause, tied to a five-year commercialisation period in which it generates unrelated party returns, is sensible. However, it misses the point where an intangible never generates such unrelated returns for instance because it is licensed to another related party for the manufacturing of another product. Besides this one escape clause, the OECD/HTVI proposal does not contain a specific time limit. Similarly, there is only a time limit for the application of Section 482 via an escape clause of five years. Yet, where an adjustment is made once, a continuous, annual adjustment is possible, just as in the working of Section 367(d) that does not know a time limit.

The almost complete absence of a time limitation in case of the IRC and the HTVI proposal should be looked at even more critically than the ten-year time frame imposed by the FTA. In particular when evaluated from an arm's length perspective where unrelated parties on rare occasions do include a price adjustment clause, these are far shorter. Moreover, one should take precautions in situations where the intangible requires substantial investment into the development or marketing by the receiving entity.



Prolonged periods allowing for an adjustment also remove the value creation from the ceding entity, particularly where the intangible requires further investments of the receiving entity, leading to a shift of value creation to that entity. In that regard, both the German FTA and the IRC exceed what is necessary to capture value that has been created in the country of the ceding entity. The HTVI proposal does cater to the argument that tax authorities make regarding the early transfer of intangibles, by making the escape clause dependent on how the revenue develops during the commercialisation. However, by being embedded in an escape clause conditional on its development in value it is not absolute. In order to limit the period of a possible adjustment to a timeframe that takes into account the legal certainty and administrative burden with which the taxpayer is concerned and the interests of the tax authority, which consistently feels blindfolded when intangibles are at stake, tying it to a commercialisation period appears to be the best solution. This makes it possible to track the actual commercial success of the intangible as long as there is a sufficient nexus with value creation that took place in the ceding entity. Therefore, this period should be imposed as an absolute limitation to adjustments. Yet, in order to overcome the lack of a limitation to such a period for intangibles that are either integrated into a substantially more comprehensive product/service or only generate related party returns, one should either fully abstain from adjusting it, or limit it to three years as done by unrelated parties, since value creation takes place [when the intangible is] [?] in the hands of the receiving entity. Furthermore, this has the advantage that tax authorities can also profit where a long regulatory process on the way to commercialisation does not prevent an adjustment.

#### *6.7.2.2 Trigger*

*6.7.2.2.1 Comparison*

The events that trigger an adjustment vary widely. An adjustment on the basis of the FTA can be undertaken on the initiative of the tax authorities where the actual value leaves the area of consent. By contrast, in the case of Section 482 it is the cumulative escape clauses that determine the events for adjustment. It follows that it is not only the rigid threshold of a 20% deviation from the projected earnings of the intangibles which can trigger a posterior price adjustment, but such an adjustment can also be triggered where the functional profile of the receiving entity is significantly altered. Thus, while for the application of Section 482 IRC the actual earnings are considered, for the application of the FTA these are only presumed to have changed in a situation where the value leaves the original are of consent. The element of the functional profile that is altered is also considered in case of Section 482 IRC, but from a different perspective. While the entirety of the function shifting regulation is only applicable where the functional profile of the ceding entity is reduced, Section 482 IRC depends on the functional profile of the receiving entity. The guidance presented by the OECD also operates on the basis of a threshold of ±20%. Yet that applies to the remuneration paid for the hard-to-value intangible and to the revenues generated within the commercialisation period mentioned earlier.

However, the element that lies at the heart of the OECD approach is whether the events that caused the deviation from the projections that were made before the price was set were unforeseeable or could have been influenced by the related parties, and whether the probable events have been accounted for. The additional escape clause for situations where a bilateral or multilateral APA has been granted also fits in with that line of thought, considering in particular the extensive documentation requirements related to the grant of an APA. The FTA does not provide for an escape clause on the basis that events were unforeseeable or that they were not influenced by the related parties, or that have been not properly been accounted for. However, by functioning as a rebuttable presumption for the inclusion of a price adjustment clause, this escape is also present in the FTA, namely when it is possible to show that a prudent business manager would have acted in the same manner and would have refrained from including a price adjustment clause. For this the relevant records need to be kept. The HTVI approach of the OECD is also a rebuttable presumption. By contrast, the adjustments required by Sections 482 and 367(d) IRC are not construed as a rebuttable presumptions.

*6.7.2.2.2 Evaluation*

The mechanisms triggering an adjustment are generally out of touch with business reality when it comes to the inclusion of such clauses in the contracts concluded in uncontrolled situations. Therefore, it can be said that arm's length principle is generally disregarded in terms of triggering a posterior adjustment. In part this is alleviated by a number of escape clauses as previously demonstrated.

Due to the thresholds that apply before triggering a posterior adjustment the alignment with value creation has failed by definition,. presuming that the value creation has in fact occurred in the country of the ceding entity and that it can be attributed to the latter. Furthermore, the value creation would have to be the result of the actions of the ceding entity before the transfer and would be almost impossible to trace after the prolonged periods in which an adjustment can take place and the possible additional contribution of the receiving entity causing the value creation. In such a scenario, value creation is only relevant where the thresholds of the escape clauses are exceeded.

All three iterations of posterior adjustments and the escape clauses contain such a threshold, which is based on the deviation in price. This would potentially disregard smaller amounts of value creation. Due to the similarities triggering the application as well as the escape clauses, this evaluation applies to all of the posterior adjustment versions. Only for Sec. 367(d) such a threshold does not exist and therefore value creation would be best accounted for. However, considering the enormous administrative burden that is tied to relying on the escape clauses (e.g. those provided by the FTA) this should not be understood as an argument against escape clauses: these comply better with the arm's length principle, partly explaining the non-compliance with value creation.



However, the posterior adjustment approaches are even more at fault in terms of value creation where one considers risks, which have downsides as well as upsides, as essential to value creation. Therefore, by having risk shifted to a receiving entity for the development e.g. of an asset whose success or commercial utility cannot be determined at the time of the transfer, value creation takes place in the hands of the receiving entity by risk taking. A posterior adjustment which is performed in the belief that the essential value creation has occurred prior to the transfer by the ceding entity is therefore not in sync with value creation.

#### *6.7.2.3 Adjustments*

##### *6.7.2.3.1 Comparison*

However, what all three approaches have in common is that a downward adjustment in favour of the taxpayer is either impossible or only at the discretion of the tax authorities.

The adjustments that can be undertaken in line with the German FTA and the OECD/HTVI approach are based on the price adjustment clause that unrelated parties are deemed to have included in a similar uncontrolled transaction. Further details on the exact design that such an imposed clause would take are not provided. In Section 482 these adjustments to the consideration can be made annually to reflect the income that is generated by the intangible. This also applies to the deemed royalties of Section 367(d).

The adjustments that were to be effected in line with the FTA or the OECD/HTVI approach would be based on a rebuttable presumption that the originally agreed price has not been at arm's length. An adjustment would then be made to that originally agreed price. By contrast, the US iteration would call "Commensurate with Income" for an adjustment based on a price that the current circumstances would demand.

*6.7.2.3.2 Evaluation*

From an arm's length perspective such posterior adjustments not allowed. On the one hand, it has been shown that unrelated parties do not rely on the adjustment clauses. On the other hand, the arm's length principle is based on determining an uncontrolled price at the moment the transaction takes place. Such determination should, therefore, neither be based on hindsight nor on a posterior consideration of the facts at the time of the transaction.

That leaves the evaluation in terms of value creation. The posterior adjustments as they stand fail to live up to the standard of value creation, since they are entirely based on the presumption that there is an information asymmetry between taxpayer and tax authority, prompting the former to transfer something abroad whose value already exists but only crystallizes in the hands of the receiving entity. An inquiry into the place where value has been created is not foreseen in the posterior adjustment clauses. Moreover, due to the difficulties that both industry experts as well as tax authorities have in assessing the future commercial success, the intangibles shifted abroad value creation needs to be allocated to the receiving entity that takes risk and that most likely undertakes the necessary steps for the value to actually crystallize. Another expression of this inability of the analysed posterior adjustment provisions is the fact that posterior downward adjustments at the mere discretion of the taxpayer are not provided for.

# Chapter 7. Conclusion

In the foregoing the various treatments of transactions of (soft)-intangibles have been compared and evaluated. The focus has been on transactions where the arm's length principle struggles most, namely those involving workforce in place, synergies and location savings – thus, soft-intangibles. Furthermore, the arm's length principle is based on an ex-ante valuation. Yet, this is deemed to place tax authorities at a disadvantage due to a perceived information asymmetry. However, it is now, in the framework of the BEPS project, also desired to align the transfer pricing outcomes to value creation. In order to mend these perceived deficiencies, the OECD, Germany and the US have taken a number of different approaches, generally affecting intangible and business restructuring transactions.

The first chapter laid the foundation for the further analysis of the topic. In particular, it centred on the issues that the arm's length principle in light of the BEPS project needs to conform to. Subsequently, it was demonstrated that such an alteration potentially touches upon the choice of supply approach vs. the supply-demand approach. The major issues surrounding soft-intangibles and posterior adjustments have been carved out.

Based on this, the second chapter concerned the reasons for business restructurings in light of demand chain, supply chain, and innovation and product lifecycle management. Furthermore, the performance of R&D as a function that could be restructured and that is at the heart of creating highly valuable intangibles also makes it one of the main targets for tax planning, offering the largest potential tax savings.

The intangibles which are transferred in the course of a business restructuring were analysed in the third chapter. This was done by considering the different types of intangibles that are handled by tax and intellectual property law as well as accounting. This chapter also introduced the benchmark for the comparative analysis by considering the OECD TP Guidelines as well as the results of the BEPS project concerning the soft-intangibles in question as well as posterior adjustments.

The fourth chapter surveyed the German transfer pricing legislation that deals with business restructurings as well as provisions that are adjacent to it in terms of the implementation of the arm's length principle. While the latter includes standard matters such as the thresholds for a party to be related and controlled transactions, it also meant dealing with specificities such as the term function. This term is essential to the German Function shifting legislation.

With the introduction of the German Function shifting legislation, particularly business restructurings have been targeted which can be identified by detecting a shift of a function and attached (intangible) assets. In the event that an inconclusively defined shift of a function is being considered, the German Function shifting legislation requires the valuation as transfer package, hence an aggregation. Due to the uniqueness of such

a transfer package, the determination of an arm's length price is effected by way of the hypothetical arm's length method. The three elements of function, transfer package and hypothetical arm's length test all come into play where a business is restructured.

Three exceptions to the valuation as a transfer package have been added, which substantially reduced the scope of the valuation as transfer package and moreover that of the application of the hypothetical arm's length method. The burden that is put on the taxpayer to make use of the exceptions is significant and can even necessitate the valuation as a transfer package to prove that one of the exception clauses can be relied on. Such a valuation as transfer package is particularly crucial in transactions where soft-intangibles are involved.

Soft-intangibles are absorbed into a transfer package. This also includes a workforce in place which is not considered as an intangible asset but as miscellaneous benefit. Even more far-reaching is the circumstance that a secondment, even though expressly excluded, could nevertheless create a situation that requires a valuation of a transfer package. This autonomous triggering of the function shifting legislation where an employee and material know-how that enables the employee to perform a function is significant in the analysis of the treatment of a workforce in place.

Synergies, being part of the transfer package, hinge on the hypothetical arm's length method. Consequently, this enables an attribution to the parties between which the synergies arose. Both the attribution and the extent to which the benefits of synergies arise to the various entities are questionable. Even though the guidance on this matter that can be derived from the functions shifting regulation and the Administrative Principles is vague, the solution of having them entangled in the transfer package and consequently splitting the benefit thereof in half is a very pragmatic one. Partly, by only considering it where a valuation as transfer package is necessary one avoids the problem of synergies only arising between related parties. This is in part relativized by the way in which the hypothetical arm's length method works and how the receiving entity could create synergistic benefits.



Likewise, the solution for location savings is sought via the transfer package and the hypothetical arm's length method. By setting the price in the middle of the range between hypothetical seller and buyer, the German tax authorities get to tax the benefit of location savings that are unrelated to Germany. This circumstance is questionable given the origin of location savings that are considered for taxation as well as the uncertainty of these location savings crystallizing, especially given the functioning of the posterior valuation.

In light of the uncertainties of soft-intangibles, a posterior adjustment could serve to alleviate the latter. However, the posterior adjustment under the Function Shifting Regulation is based on the presumption that in case a valuation occurred as transfer package and there have been uncertainties as to the value, the parties would have included of their own accord a price adjustment clause. This uncommon circumstance is only relevant where three conditions are met, which narrows down its applicability substantially.

While the German Function shifting legislation deals specifically with a number of issues of business restructuring, the US does not have legislation which specifically targets issues of business restructuring but rather relies on the general transfer pricing legislation. This has been dealt with in Chapter V. While the general implementation of the arm's length principle does not contain anything extraordinary, the applicable regulations have been specifically tailored to deal with cases of business restructurings. Additionally to Sec. 482, Sec. 367(a) and (d) have also been at issue, [particularly Section 367(d) which is special inasmuch as it deals with the transfer of intangibles. Yet, intangibles are also the cornerstone for the application of the other provisions mentioned.

Only where the definition of an intangible had been met, is it certain that Sec. 482 or 367(d) actually do apply. This was an issue in the case of soft-intangibles which by their general definition were not qualified as a proper intangible asset prior to the amendment of Sec. 936(h)(3)(b) and the extension of the list of intangibles to include workforce in place and goodwill and going concern value. Therefore, neither the IRC nor the treasury regulations provide a solution for the treatment of a going concern value and soft intangibles. This problem is apparent throughout the entire treatment of soft intangibles, leading to a situation where taxpayers applied the definition of intangible at will in order for an "intangible" to be either not captured at all by any of the provisions dealt with, or to make it subject to an exception.

The most significant exception in that regard used to be the foreign goodwill and going concern exception, which is no longer applicable as a result of the earlier temporary regulation whose content is now part of the amended statutes. The ATB exception is insignificant insofar as it specifically excludes intangibles, which are not included in the closed list of Sec. 936(h)(3)(B). Driven by matters of qualification of Sec. 936(h)(3)(B) and the subsequent application of Sec. 482, Sec. 367(a) and (d) soft-intangibles were a major field of dispute.

Workforce in place can be part of a business restructuring by being physically shifted or by being made available to the newly formed entity abroad. In the former situation, the reasoning that was brought forward by the IRS is rather compelling, while this is different in the latter case since it is merely a service which is provided and remunerated accordingly. The analysis of these situations and the approach now prescribed by the amended Sec. 936(h)(3)(b) and removed exceptions of sec. 367, hinged on value creation, shows the inconsistency and can be considered a main argument against the qualification as an intangible where the workforce is merely made available.

Similarly contested was the qualification of synergies. The argumentation revolved around either using intangibles where there is no doubt about their qualification as a 936(h)(3)(b) intangible as a proxy to also include synergies, or to do so by way of aggregation. While this issue has been solved in both ways by extending the intangible definition to include goodwill and going concern as well as including aggregation, it still could very well disregard economically completely plausible transactions. Furthermore, as could already be deduced from the earlier refined regulations in aggregation, the IRS intends to allocate

the synergies to the domestic entity, thereby disregarding the very nature of a synergy that is the result of interaction of different assets and entities.

By contrast, location savings are not a matter of qualification but rather of allocation. This matter is driven by two landmark cases resulting in the allocation of location savings to the entity abroad based on competitiveness and bargaining position. Yet, since the allocation of location savings to the entities abroad has been upheld, it is not possible to draw a conclusion on how such an allocation should take place. Furthermore, one needs to recognize that these cases have not been decided on the basis of which country provided the location savings.

It has therefore been exemplified that a closed list of intangibles on whose qualification the subsequent application of Sec. 482, Sec. 367(a) and (d) IRC depends is not fit to deal with the specific soft-intangibles that ought to be considered in a business restructuring transaction. The possible exceptions that were available depending on the qualification of the intangible contribute to this uncertainty. Nonetheless it remains uncertain how a court would determine how the benefits of soft-intangibles are allocated amongst various group entities.

In terms of posterior valuation, it has been demonstrated that one deals with an all-embracing provision of Sec. 482 and Sec. 367(d) IRC whose scope has been extended even further with the deletion of the foreign goodwill and going concern value exception. The CWI standard as implemented in Sec. 482 is merely limited to transactions causing uncertainties in their valuation by way of the transfer pricing method that has been used. Enabling an adjustment in line with the CWI standard over a period of five years seems reasonable, as the timeframe appears to be what unrelated parties are likely to adopt, should they resort to such measures at all. Limiting the exceptions to a price development within a bandwidth of ±20% again opens up the scope for posterior adjustment, making the exceptions generally superfluous.



Thus, it is a recurrent theme when dealing with the application of the analysed provisions that these have not been specifically tailored for situations of business restructuring, nor for the particular soft-intangibles. The resulting shortfalls are then further augmented by expanding the definition of Sec. 936 intangibles and the removal of applicable exceptions. Within this framework, matters of value creation and the investigation of what an uncontrolled situation had demanded become secondary.

Chapter VI was the comparative chapter and thus the place where the most adequate solutions in terms of the arm's length principle and value creation became apparent based on the framework for business restructuring and soft-intangibles. Specifically, regarding aggregation, price determination and definition of intangibles, as well as the treatment of soft intangibles and the elements of posterior valuation comprising of scope, time frame, trigger and envisaged adjustments. Therefore, in the following paragraphs the best solutions are pointed out, based on the aim of providing the solution that is most aligned to the arm's length principle in the sense of what unrelated parties would do and the notion of value creation.

1. In terms of the general features that matter for the application of the arm's length principle to business restructurings it has become apparent that the approach which is specifically tailored to business restructurings is the best solution. As seen with the German function shifting legislation compared to the US approach, the former is in principle better prepared to prescribe when an aggregated valuation needs to take place, if only the term business unit was defined in a clearer manner and if there was no opening for also considering transfers of less than a business unit. Connected to this is the valuation of the "transfer package" via the hypothetical arm's length method – ensuring a better compliance with the arm's length principle since it means that there needs to be the hypothetical conscientious business manager willing to have a transaction valued in aggregation as transfer package. It has also been shown that this does not preclude a partial conformity with value creation.
   1.1 For business restructurings the question for the threshold of when to value a collection of assets in aggregation is of interest. In situations where a business restructuring is so far-reaching that an individual valuation of the assets does not yield an arm's length result, such an approach is warranted. However, the threshold should be clear and preferably based on international standards. Therefore, it would be advisable to make reference to the OECD term "ongoing concern" as threshold for the application of function shifting legislation.[952] Furthermore, this threshold should only be considered from the perspective of the ceding entity and in terms of the willingness of the receiving entity to take part in such transaction, but not further consider the conditions in the receiving entity for price determination.[953] With a view towards value creation the latter is also required, since the additional value that stems from the collection of the assets and forming an ongoing concern is exclusive to the ceding entity.
   1.2 Should the threshold for an aggregated valuation have been met then price determination in absence of comparables needs to be arranged in an artificial way. The hypothetical arm's length method as applied in the German FTA appeared to be cumbersome. However, by precisely defining the threshold for the application of this method it would in fact serve its function well by arriving at a price that is the result of an artificial bargaining, even though the required full transparency is questionable from an arm's length perspective – in this very situation it should be considered as a solution to a shortcoming of the arm's length principle while at the same time being in line with value creation.[954]
   1.3 In terms of creating a solution that complies with value creation, similarly the perspective matters. In order to achieve this, it is necessary to only consider



[952] Imhof, M., *Business Restructuring: Eine Betriebswirtschaftliche und Steuerrechtliche Analyse*, Köln: Eul-Verlag, (2012), p. 411.

[953] Ibid., p. 419.

[954] Zech, T., *Verrechnungspreise und Funktionsverlagerungen 2009: die steuerliche Behandlung von Verrechnungspreisen, insbesondere bei Funktionsverlagerungen, nach der Unternehmensteuerreform 2008*, Baden-Baden: Nomos-Verl.-Ges., (2009), p. 408 – 411.

the ceding entity when it relates the threshold for triggering an aggregated valuation. Thereby one accommodates the need to remunerate the potential of the function as well as all the other elements that are accessory to the assets shifted, making up a business unit/ongoing concern. Additionally, any valuation should consider the price as it is in the hands of the ceding and receiving entity which is then to be split in order to comply with value creation (internal & external) as well as the arm's length principle. Thereby one would adhere to the supply/demand approach, which also considers factors such as the provision of the market.

2. Dealing with business restructurings and intangibles makes it necessary to consider the definitions of intangibles applied. While a closed list of intangibles as in the US has been proven to be problematic, creating a special type of intangible as done in the German FTA (material intangible) and the OECD TP Guidelines (hard-to-value intangible) to which specific measures apply is sensible. For soft-intangibles an extension of the definition of intangibles or the creation of e.g. a synergy intangible to include them is not sensible from either an arm's length or a value creation point of view.[955] Yet, including them, as done according to the German FTA, in a transfer package, can limit the cases of them affecting the valuation as would be required by the arm's length principle. Since the effects of soft-intangibles for value creation as singular intangible would be minimal or nil, an aggregated valuation is sensible in terms of aligning transfer pricing outcomes with value creation.
3. Workforce-in-place as a soft intangible, in line with the arm's length principle, should at most be considered as a comparability factor as prescribed by the OECD TP Guidelines. The same applies for value creation because the value of a workforce in place is created only after the execution of a transaction. Value creation of a workforce-in-place only occurs while assembling that specific workforce. Thus, in situations where the workforce-in-place is actually shifted with the ongoing concern, value creation would dictate that the value which can be derived from such a collective of people is only accounted for in the price of the ceding entity.
4. Synergies that merely arise between related entities should not be considered for arm's length purposes. All three systems aim at considering synergies by way of aggregation. But the OECD TP Guidelines would at least limit this to synergies that are the result of deliberate action, attributing it to the entity that is accountable for its creation. As the latter is hardly in line with the arm's length principle, the German approach equally fails in attributing synergies from a methodological point of view. It adopts a more pragmatic approach by deeming each participant to have derived an equal share of the benefits of synergies. However, this is limited to situations where a valuation as transfer package is prescribed and thus the price has been determined by way of a hypothetical bargaining which can account for the contributions made

[955] Imhof, M., *Business Restructuring: Eine Betriebswirtschaftliche und Steuerrechtliche Analyse*, Köln: Eul-Verlag, (2012), p. 411ff.

in the creation of the synergy. In terms of value creation, the OECD TP Guidelines would be most compliant as they aim at an attribution in line with the creation of the synergy. Yet, merely creating a synergy is not necessarily the creation of value.[956]

4.1 Therefore, while disregarding that any of the solutions under review are not complying with the arm's length principle, ideally, following value creation, only synergies that are the result of deliberate action should be considered. Since there might be a synergy created but not necessarily value, it is of the utmost importance to only take synergies into consideration where an aggregated valuation takes place. This allows for the inclusion of any costs for creating the synergies or even negative synergies which decrease the value created.

4.2 The question of allocation of the synergistic benefits/deficits is best solved by way of a hypothetical bargaining procedure, as seen in the German FTA, of an aggregated valuation, since this allows for taking into account what each party can contribute to the deliberate creation of a synergy.

5. Location savings are dealt with in the most compliant way to the arm's length principle by the OECD TP Guidelines by limiting the effects of possible location savings to comparability factors. However, only factors for the attribution of location savings between parties are provided. In that regard, the German function shifting regulation goes further, splitting the benefit in half as part of the price range resulting from the application of the hypothetical arm's length test. Yet, in terms of value creation none of the approaches analysed follows through. This would mean attributing location savings entirely to the receiving entity as well as deviating from the established supply approach and extending it to a supply-demand approach. Only in this way would local market features be respected in the transfer pricing outcome.

5.1 Hence, the optimum for the treatment of location savings from an arm's length perspective is to limit it to comparability factors. However, even in an uncontrolled situation parties can be aware of many different location savings that are available to a party that hypothetically takes over a function. This in turn will lead to a higher asking price and the potential allocation of part of the location savings which the receiving party presumes to realize, to the ceding party.

5.2 The treatment of location savings would be quite different if one considers the role of value creation in the application of the arm's length principle. If aligned to value creation, no value created as a result of a location saving should be remunerated, even if it qualifies as an ongoing concern and an aggregated valuation would be warranted. Such an approach of effectively allocating all the benefits resulting from location savings is also sensible in the current climate where large markets like China or India also demand an allocation in line with the supply/demand approach.

[956] Damodaran, A., The Value of Synergy, New York: New York University, (Oct. 2005); http://dx.doi.org/10.2139/ssrn.841486

6. Posterior adjustments are certainly not compatible with the pure arm's length principle as its application remains marginal between related entities.[957] Yet, the arm's length principle has in that regard been extended to alleviate a perceived information asymmetry. The OECD approach is closest to the arm's length principle, thanks to its very limited scope of hard-to-value-intangibles. Similarly, an alignment of transfer pricing outcomes with value creation would call for an abstention from posterior valuation.
   6.1 Thus, considering the timeframe in which an adjustment should be affected, there is no conflict of aims of the arm's length principle and value creation. Due to the possible dilution of the actual contribution of the ceding entity, a short timeframe is advisable. However, this is not the case in any of the three approaches. In the few circumstances that unrelated parties decide to resort to a price adjustment clause, the timeframe generally hardly ever exceeds three to five years, and this should also be adhered to.[958] In that way, a timeframe applies where it is also still reasonably possible to trace different alterations and contributions from the receiving party that lead to an actual increase in value.
   6.2 The elements triggering a posterior adjustment are linked to the development of the value of the transferred intangible via the escape clauses. Due to the general lack of such clauses among unrelated parties, the arm's length principle is not served. Equally, the alignment of transfer pricing outcomes with value creation goes amiss since the trigger hinges on the value, but tracing the latter in the prolonged timeframes that all three iterations suggest is questionable. Furthermore, one is simply interested in larger price deviations as can be witnessed by the escape clauses and not necessarily in value creation. Therefore, where both the arm's length principle and value creation shall decide on the transfer pricing outcome, it would be necessary to have adjustment clauses that work both to the benefit and to the detriment of the prices set in a posterior adjustment. By nature, it is those intangibles which can yield a return exceeding other assets by far that at same time can underperform greatly.
   6.3 In terms of posterior adjustment, the most arm's length compatible approach is the one proposed by the OECD TP Guidelines, limiting the adjustment to what could have reasonably been known at the time of the transfer. A conformity with value creation is to be denied since it is only approached with the ulterior motive to perform an upward adjustment for the price levied by the ceding entity. This can be witnessed by the mere fact that a downward adjustment at the discretion of the taxpayer is not considered.



[957] Cain, D. et al., Earnouts: A study of financial contracting in acquisition agreements, *Journal of Accounting and Economics*, Amsterdam: Elsevier, (2011), Vol. 51, No. 1-2, p. 153; Lukas, E. & Heiman, C., Bedingte Kaufpreisanpassungen, Informationsasymmetrien und Shareholder Value: Eine empirische Analyse deutscher Unternehmensübernahmen, *R Working Paper*, Magdeburg: Otto-von-Guericke University, Faculty of Economics and Management, (2010), No. 06, p. 2; retrievable at: http://www.ww.uni-magdeburg.de/fwwdeka/femm/a2010_Dateien/2010_06.pdf (02.10.2016).

[958] Piehler, M., *Kontraktgestaltung bei M&A Transaktionen – Bedingte Zahlungsstrukturen zur Verbesserung des Einigungsbereiches*, Wiesbaden: DUV Gabler Edition Wissenschaft, 2007, p. 203.

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# Curriculum Vitae

Thomas Kipka was born on 26 February 1988 in Aschersleben, Germany. Successfully completing the European Law School programme, he obtained an LL.B. from Maastricht University. Subsequently, he followed the LLM programme in International and European Tax Law, also at Maastricht University.

As a part-time PhD researcher at the Faculty of Law, Maastricht University, Thomas wrote this doctoral dissertation between September 2012 and March 2019 under the supervision of Prof. Dr. Rainer Prokisch and mr. Hans Arts. During this time he also worked as international tax advisor at Kallen Accountants en Adviseurs in Geleen, Netherlands. Since 2019 he has been working for KPMG Luxembourg SC.