

1st International IFA Czech Branch  
Transfer Pricing Conference  
16 October 2018



# Business Restructuring and continuing losses

Lenka Lopatová, Transfer Pricing Manager



[www.kdpcr.cz/ifa2018](http://www.kdpcr.cz/ifa2018)

## Definition of business restructurings



Chapter IX of OECD Transfer Pricing Guidelines

- Cross-border reorganisation of the commercial or financial relations between associated enterprises, including the termination or substantial renegotiation of existing arrangements
- 1. Centralisation of intangibles, risk and functions**
    - a) Conversion of full-fledged entity into limited-risk entity
    - b) Transfer of intangibles or rights to a central entity
    - c) The concentration of functions in a regional or central entity and reduction in scale of function carried out locally
  - 2. De - centralisation of intangible, risk and functions**
    - a) De-specialisation of operations
    - b) Downsizing of operations
    - c) Closing of operations

## Reasons for centralisation

- Maximization of synergies and economies of scale
- Streamlining of management of business lines
- Improvement of efficiency of the supply chain
- Less regulatory risks
- Need for specialisation
- **Investment incentive**

**Motivation by tax benefit does not of itself warrant a conclusion that it is a non – arm´s length arrangement.**

3

## Reasons for de-centralisation

- Relationships with third parties generate losses
- Over capacity situation as a result of slowing economy
- Innovative competition

**Frequently question of tax administration:**

**Would the independent taxpayer continue to operate its existing business under same conditions?**

4

## Reasons for de-centralisation

**if not**

Is there a more favourable option than restructuring?

- Termination of activities (costs?? – expert opinions)
- Company sale (price?? – expert opinions)

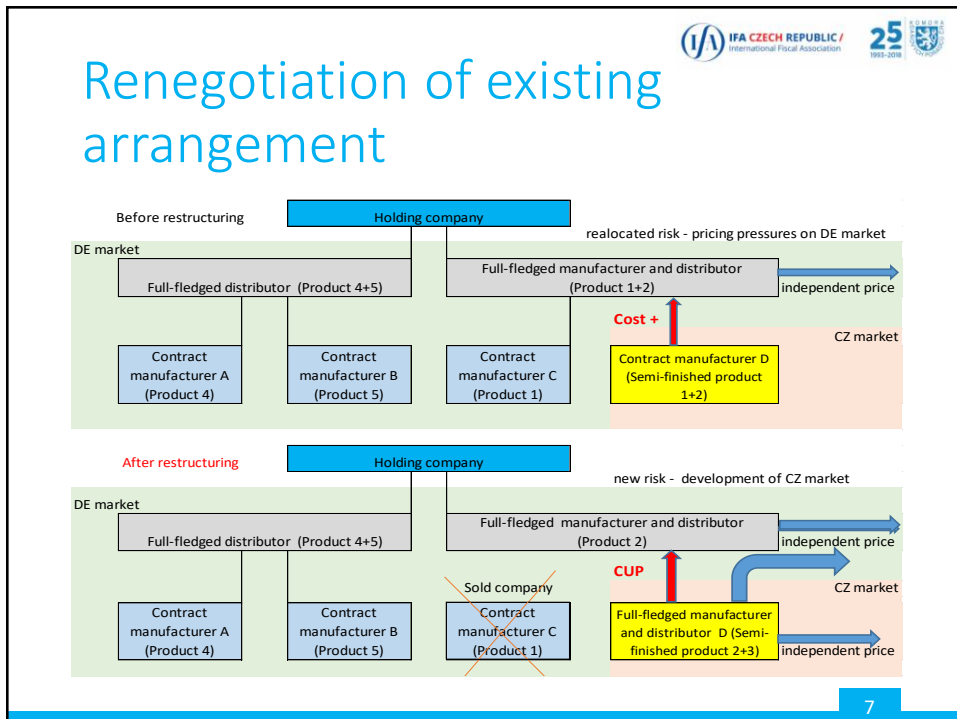
5

## Documentation of business restructurings

- Master file
  - Identification of the company that will manage and control the result of the restructuring
  - Commercial rationality of restructuring as a whole
- Local file
  - Explain the aspects of restructuring transactions affecting the local entity
  - Evaluation of the consequences on profit potential
  - Restructuring arrangement must be arm's length at the level of each individual taxpayer

Tax benefit at group level do not determine the arm's length principle at the entity level.

6



## Reallocation of economically significant risk

### Which risk is more economically significant ?

1. Likelihood of the inventory risk materialising (risk was recorded in the financial accounts of full-fledged DE distributor in the past)
2. Potential profits or losses arising from the market risk (prising pressures and market conditions according to DE and CZ market research)

9

## Functional analysis

- Examination of allocation of risks between associated enterprises before and after the restructuring is an essential part of the functional analysis.

| Activity description                | Weight of activity | Before de-centralisation |               | After de-centralisation |               |
|-------------------------------------|--------------------|--------------------------|---------------|-------------------------|---------------|
|                                     |                    | parent company in DE     | company in CZ | holding company in DE   | company in CZ |
| Investment planning                 | 3                  | xxxx                     |               | x                       | xxx           |
| Financing                           | 3                  | xxxx                     |               | x                       | xxx           |
| Research and Development            | 4                  | xxxx                     |               | x                       | xxx           |
| Production planning                 | 2                  | xxxx                     |               |                         | xxxx          |
| Production                          | 2                  |                          | xxxx          |                         | xxxx          |
| Purchase of material for production | 2                  |                          | xxxx          |                         | xxxx          |
| Acquiring customers                 | 4                  | xxxx                     |               |                         | xxxx          |
| Negotiating sales prices            | 2                  | xxxx                     |               |                         | xxxx          |
| Marketing                           | 3                  | xxxx                     |               |                         | xxxx          |
| Human resources for production      | 2                  | x                        | xxxx          |                         | xxxx          |
| Brand care for DE/CZ market         | 3                  | xxxx                     |               |                         | xxxx          |
| Calculation of the final price      | 2                  | xxxx                     |               |                         | xxxx          |
| Invoicing to the final customer     | 1                  | xxxx                     |               |                         | xxxx          |
| Handling of complaint               | 1                  | xxxx                     |               |                         | xxxx          |
| Customer care                       | 2                  | xxxx                     |               |                         | xxxx          |

10

## Consequences of risks that is restructured

### Which party assumes a specific risk by reference to control and financial capacity?

1. Application of arm's length principle to the restructuring itself
  - Compensations payments for restructuring itself ( inventory depreciation, irrecoverable debts, severance pay)
2. Application of arm's length principle to the post-restructuring transactions
  - Analysis of changes in contractual terms
  - Determination of significance of risk which was transferred
  - Reallocation of profit

11

## Compensations payments during the restructuring

|   | 2008      | 2009      | 2010      | Restructuring period |         |         |         |
|---|-----------|-----------|-----------|----------------------|---------|---------|---------|
|   |           |           |           | 2011                 | 2012    | 2013    | 2014    |
| Production of CZ company for DE parent company              | 100%      | 100%      | 100%      | 90%                  | 70%     | 10%     | 10%     |
| Production of CZ company for DE independent customers       |           |           |           |                      |         | 20%     | 20%     |
| Production of CZ company for new independent customer in CZ |           |           |           | 10%                  | 30%     | 70%     | 70%     |
| Distribution through DE parent company on DE market         | 100%      | 100%      | 100%      | 90%                  | 70%     |         |         |
| Distribution through CZ company on DE market                | 0%        | 0%        | 0%        |                      |         | 30%     | 30%     |
| Distribution of CZ company on CZ market                     |           |           |           | 10%                  | 30%     | 70%     | 70%     |
| Turnover  | 1 000 000 | 930 000   | 890 000   | 650 000              | 670 000 | 720 000 | 890 000 |
| Operating costs   | 1 090 000 | 1 050 000 | 1 040 000 | 730 000              | 700 000 | 715 000 | 850 000 |
| Operating profit  | -90 000   | -120 000  | -150 000  | -80 000              | -30 000 | 5 000   | 40 000  |
| Realized mark up for operating costs                        | -8,26%    | -11,43%   | -14,42%   | -10,96%              | -4,29%  | 0,70%   | 4,71%   |
| Mark up of independent manufacturers                        | 2,00%     | 2,00%     | 2,00%     | 3,00%                | 3,00%   | 3,00%   | 3%      |
| Contractual claim for compensation of sales risk            | yes       | yes       | yes       | no                   | no      | no      | no      |
| Adjustment - tax effective                                  | 111 800   | 141 000   | 170 800   | ????                 | ????    | 0       | 0       |
| Intra group loans   | 0         | 90 000    | 240 000   | 320 000              | 350 000 | 2 000   | 0       |
| Bank loans  |           |           |           |                      |         | 350 000 | 345 000 |
| Equity  | 121 800   | 142 800   | 163 600   | 83 600               | 53 600  | 58 600  | 98 600  |
| Tax deductible interest                                     | yes       | yes       | yes       | yes                  | no      | yes     |         |
| Capacity utilization  | 100%      | 93%       | 89%       | 73%                  | 75%     | 81%     | 100%    |

12

## Compensations payments for restructuring itself

- Would be transfer of assets, termination or substantial renegotiation of existing arrangements compensated between independent parties in comparable circumstances?

### **It is necessary evaluate whether:**

1. Historic profits are an indicator of future profits
2. Changes in the business environment can effect profitability

Relying on historical data alone will not be sufficient.

13

## Compensations payments for restructuring itself

### **Following aspects should be considered:**

- Whether commercial law support rights to indemnification
- Whether the absence of an indemnification clause under terms of the arrangement is arm's length
- Which party should ultimately bear the costs related to the indemnification of the party that suffers from termination or renegotiation of agreement

14

## Compensations payments for restructuring itself

### 9.71

If the restructured entity is forecasting future losses absent restructuring, the restructuring might deliver a **benefit to restructured entity from reducing or eliminating future losses if such losses exceed the restructuring costs.**

- Depreciated stocks of DE distributor
- Unpaid receivable of DE distributor
- Transfer of distributor function from DE to CZ including customers' portfolio

The party reducing the risks (DE distributor) should not receive a price that takes into account risks it has given up.

15

## Compensations payments for restructuring itself

- There are however cases where the market value is due to new competitive pressures too low for mark up, which has to be added on cost of manufacturer.

| Results of manufacturer in CZ   | Year | Compensation from distributor | DE market                    |           | CZ market                               |                          |
|---|------|-------------------------------|------------------------------|-----------|---|--------------------------|
|   |      |                               | Product 1                    | Product 2 | Product 2                               | Product 3                |
| Historical profitability of CZ manufacturer without compensation from DE distributor (parent company) | 2008 | yes                           | -8,26%                       | 1,00%     | product was not placed on the CZ market | product was not produced |
|   | 2009 | yes                           | -11,43%                      | 1,00%     |   |                          |
|   | 2010 | yes                           | -14,42%                      | 2,00%     |   |                          |
| Restructualisation - the result will be greater risk and potential of profitability for CZ company    | 2011 | ????                          | Termination of production    | 2,00%     | 3,00%                                   | 4,00%                    |
|   | 2012 | ????                          |                              | 2,00%     | 3,00%                                   | 4,00%                    |
| <b>Change to full-fledged manufacturer with its own distribution</b>                                  | 2013 | no                            |                              | 3,00%     | 3,00%                                   | 5,00%                    |
| Projected profitability of manufacturer   | 2014 | no                            | product will be not produced | 3,00%     | 4,00%                                   | 5,00%                    |
|   | 2015 | no                            |                              | 3,00%     | 4,00%                                   | 5,00%                    |

16

## Compensations payments for restructuring itself

### 9.78

There should be no presumption that all contract terminations or substantial renegotiations should give a right to indemnification at arm's length.

- Cost of partial closing of production in CZ
- Cost of starting a new product in CZ
- Cost incurred to gain a new CZ market
- Uncovered fixed production costs of CZ manufacturer

Which party in MNE group is benefiting from the restructuring???

17

## Experience from tax inspections

Test of multi-year average profitability during the restructuring period???

Comparison with companies that have not undergone a restructuring process???

Aggregate transaction profitability test during restructuring???

During the restructuring of contract manufacturer to full-fledged manufacturer and distributor the new distribution costs are included in the cost base of contract manufacturer to compare its profitability to profitability achieved by independent manufacturer???

**Determination of test party regardless of the moment of changes in ability to absorb the financial risk associated with the new functional profile???**

18

## Recommendation

- Documentation for each restructuring year
- Change in contractual arrangements based on actual changes in risk borne by the parties
- Regular review of restructuring result against the expected results