Transfer Pricing
Lost profit potential

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Agenda

- General OECD considerations
  - What is lost profit potential?
- Examples of case law
- Trends and considerations subject to discussion

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General OECD considerations

- OECD on compensation for a decrease in expected future profits due to transfer of functions
  - *"An independent enterprise does not necessarily receive compensation when a change in its business arrangements results in a reduction in its profit potential or expected future profits.* ***The arm's length principle does not require compensation for a mere decrease in the expectation of an entity's future profits****. When applying the arm's length principle to business restructurings,* ***the question is whether there is a transfer of something of value (an asset or an ongoing concern) or a termination or substantial renegotiation of existing arrangements and that transfer, termination or substantial renegotiation would be compensated between independent parties in comparable circumstances****."* TPG 9.39
- OECD on profit potential
  - *"Profit potential is the expected future profits (ex ante profit). In some cases it may encompass losses. The notion of "profit potential" is often used for valuation purposes, in the determination of an arm's length* ***compensation for a transfer of intangibles or of an ongoing concern, or in the determination of an arm's length indemnification for the termination or substantial renegotiation of existing arrangements, once it is found that such compens****ation or indemnification would have taken place between independent parties in comparable circumstances."* TPG 9.40

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General OECD considerations

- OECD on termination or substantial renegotiation of existing arrangements
  - **Terminations or renegotiations of arrangements generally involve changes in the risk and functional profiles of the parties, with consequences for the allocation of profit potential between them**. In addition, the termination or renegotiation of contractual relationships in the context of a business restructuring **might cause the restructured entity to suffer detriments such as restructuring costs** (e.g. write-off of assets, termination of employment contracts), **reconversion costs** (e.g. in order to adapt its existing operation to other customer needs), **and/or a loss of profit potential**. In these situations, the question arises of whether, at arm's length, indemnification should be paid to the restructured entity, and if so how to determine such an indemnification. TPG 9.76
  - There should be **no presumption that all contract terminations or substantial renegotiations should give a right to indemnification** at arm's length, as this will depend on the facts and circumstances of each case. The analysis of whether an indemnification would be warranted at arm's length should be made on the basis of the **accurate delineation of the arrangements before and after the restructuring (…) and the options realistically available to the parties**. TPG 9.78
- Can accurately delineation of the transaction result in EXIT taxation?
  - What if risks and assets were wrongly allocated in the first place, are any assets etc. then transferred and is any profit then "lost"?
  - Changes to the TP-remuneration (within the arm's length range)/TP-method without any changes to the functions performed, risks assumed etc., can compensation be triggered?
  - Changes to the TP-setup in general, is anything og value transferred?

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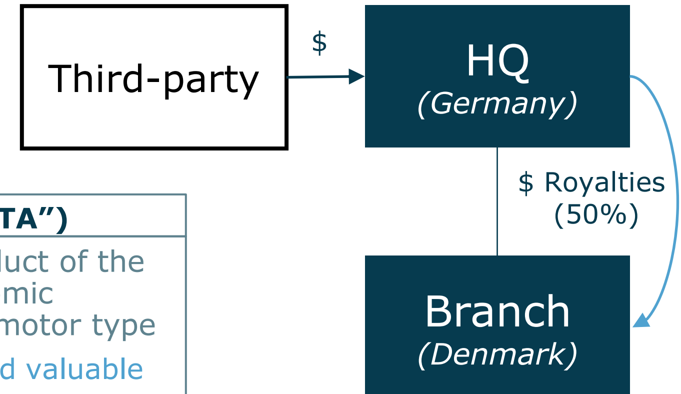
Danish ruling SKM2020.30.LSR (I)

Termination of royalty agreement → lost profit potential



Facts	The Danish Tax Authorities ("DTA")
- Danish branch of a German company, which main activities are licensing and services related to motors • Based on a royalty agreement, the Danish branch received 50 % of the group's royalties from the motor program (50/50 profit split) - As part of a restructuring, the royalties from a certain type of motor should be transferred to the German head quarter. • Remuneration equal to the net income in the termination period (2 years)	- Argued that based on the actual conduct of the parties, the Danish branch had economic ownership of the IPR to the relevant motor type • As the Danish branch had provided valuable input in the development phase • Therefore, termination of the agreement entailed transfer of IPR, which should also be subject to remuneration • Remuneration should be based on lost profit potential in a period longer than the termination period of the agreement

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Danish ruling SKM2020.30.LSR (II)

- The taxpayer
  - The original royalty agreement was remuneration of services
  - The Danish branch was not a (co)owner of the motor program, except with respect to a small part
  - Termination of a service agreement, should only be compensated for the (lost) expected profits in the termination period

- The Danish National Tax Tribunal
  - The Danish branch had economic (co)ownership of the IPR, which was transferred as part of the termination of the service agreement. The compensation should be more than the lost profit potential in a period longer than the termination period.
    - With reference to OECD TPG 2017, the actual conduct of the parties is of significant importance
      - (external) royalties was split 50/50
      - The 50/50 ("service")-remuneration was not supported or substantiated by any calculations or analysis
    - Existing information prior to the restructuring is of significant importance (9.120)
    - Emphasis on the existing royalty agreement entered into and the TP documentation
      - remuneration for build IPR related to the motor program
      - no documentation on the choice of 50/50 split

- (Economic) (co)ownership of IPR was transferred and thereby lost profit potential
  - Follows from the TP documentation that the Danish entity had contributed to re-design and development of a motor type included as an integrated part of the motor program
  - Remuneration based on lost profit potential in the termination period is NOT sufficient

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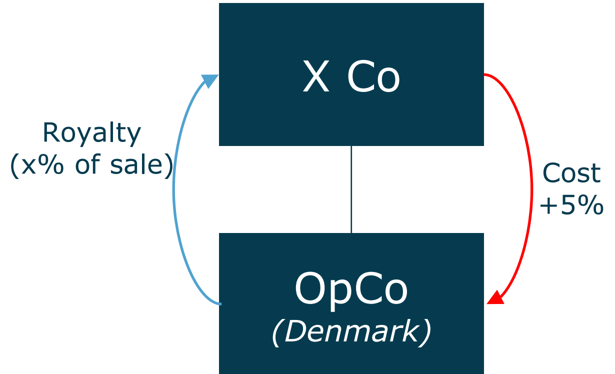
Danish ruling SKM2020.387.LSR (I)

Conversion of software sales company to a commissionaire

Facts

- Danish company transferred from a sales company to a commissionaire
  - The distribution agreement was terminated and replaced by a commissionaire agreement
    - All revenue was booked in Denmark
    - Paid x % of the total invoiced software sale (royalty)
    - New: TNNM (cost reimbursement + margin on total net invoicing)
  - The Danish company should continue to sell software, but on behalf of the group company
    - Third-party Customer contracts entered before the restructure would stay in Denmark until termination
    - All new third-party Customer contracts were entered into on behalf of the group company, including renewal of existing agreements



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Danish ruling SKM2020.387.LSR (II)

Conversion of software sales company to a commissionaire

- The Danish National Tax Tribunal
  - The taxpayer has described the restructuring and made a FAR- and comparability analysis pre and post the restructure
    - Not important that the "delineated transaction" by the tax authorities was not described
  - The DTA proofed that the conversion (termination of distribution agreement) triggered transfer of valuable IPR (marketing intangibles)
    - To what extent would a fully-fledged distributor accept to be converted into a low risk distributor?(9.45-9.47)
    - Existing TP documentation
      - The Danish company had built significant and valuable client relations and had exhaustive knowledge of the clients IT-systems and therefore needs
      - Considered a significant factor for ongoing profits
    - Renewal of existing contracts (by X Co) is considered a transfer of clients (contractual rights) (9.67)
    - Remuneration should be based on expected (lost) profit potential in 10 years
      - Based on expected lifetime of clients (taking into account the business line)
        - The tax authorities: eternal/perpetual cash flow
        - Taxpayer: the expiration of the actual contracts (3-5 years)

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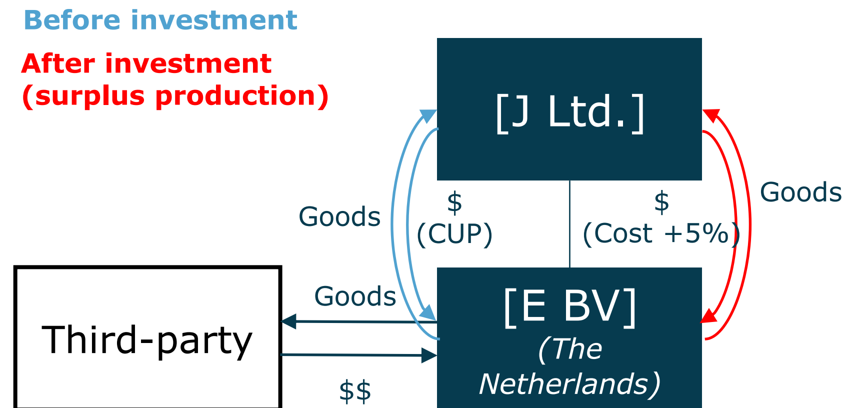
Dutch ruling no. 1 (I)

International restructuring and allocation of risk

- Key words:
  - *To contract manufacturer from fully fledged, allocation of risk through change in remuneration, realistic alternatives, benchmarking*

Taxpayer's point of view

- Dutch group company → production of chemicals → Fully fledged (CUP) → operating in a volatile market but has historically performed well in this market
- 2008: Invests heavily (EUR 4M) in production facility and increases capacity with 39%
- From 2012: Enters into supply agreement with [J Ltd.]. [J Ltd.] is under the supply agreement obliged to purchase the whole surplus capacity (39%) at Cost +5%
- Thereby, significant production and market risks are transferred to [J Ltd.]
- During the audit the Dutch entity prepared a BM analysis: Median = 5% (on costs) for comparable companies.
- If a transfer has occurred, taxation should have taken place in 2011; NPV of lost profit potential



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Dutch ruling no. 1 (II)

Dutch ruling re. International restructuring and allocation of risk

- Dutch Tax Administration (”DTA”)
  - The manufacturer’s remuneration was too low in the income year 2012 and onwards, i.e., the supply agreement was not in accordance with the arm’s length principle and should be ignored
  - The DTA did not agree with the conversion into a contract manufacturer, arguing that the contractual transfer of taxpayer’s manufacturing risks is in conflict with historical, economical and actual reality
- The Court
  - The court *rejected* the conversion to a contract manufacturer arguing that it was not in the taxpayer’s interest to enter into the supply agreement as:
    - Unlikely that an unrelated party would be willing to surrender the substantial (expected) margins for a ‘risk free’ return of 5%, despite taxpayer operating in a volatile market
    - Taking historical performance into account, the supply agreement was not the best among realistic alternatives especially since the investment implied an increased scale and thereby possibly larger margins
    - No actual change in functions (production and logistics) or asset base
  - The monthly profits transferred from the Dutch entity should be adjusted on a monthly basis and not as a one-off transaction in 2011
  - BM was rejected – not comparable companies and [E BV] should not act as tested party (too complex)

Discussion point: Would the outcome have been different, if the parties entered into an explicit agreement on transfer of risk from 2012 which included remuneration of lost profit potential?

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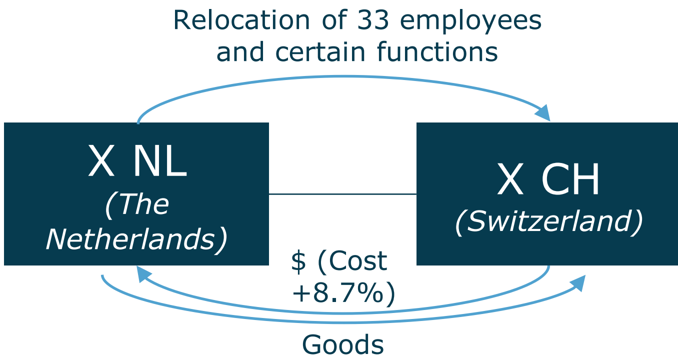
Dutch ruling no. 2 (I)

International restructuring and lost profit potential

- Key words:
  - *From fully fledged to toll manufacturer, relocation of employees, TP Documentation, asset transaction or transfer of profit potential?*

Taxpayer's point of view

- Dutch processor of cocoa- and soybeans (X NL – consisting of two companies subject to joint taxation), managing the supply chain for both business lines (incl. purchase, production and sales) at its own expense and risk, i.e., acting as a fully fledged manufacturer
- 2007: the group decided to centralize functions in a newly established Swiss company (X CH) → 33 employees relocated from X NL to X CH
- X NL was converted into a toll manufacturer, assuming no risk related to purchasing raw materials → therefore only entitled to receive routine remuneration (cost plus 8.7%)
- Taxpayer: primarily an asset transaction with an arm's length remuneration of EUR 2M



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Dutch ruling no. 2 (II)

International restructuring and lost profit potential

- Dutch Tax Administration (”DTA”)
  - Entire purchasing, planning, trading and sales activities had been transferred to X CH (going concern), implying a substantial loss of profit potential
  - Independent party would only give up these activities if compensated for lost profit potential amounting to EUR 320M
- The Court:
  - Focused on market expertise and argued that market expertise had been essential for improving the profitability of X NL
  - X NL should be compensated for transfer of market expertise as:
    - 33 employees have been relocated
    - Significant decline in X NL’s revenue and cash flow post restructuring
    - Corresponding increase in X CH’s revenue and cash flow post restructuring
  - An independent expert estimated the *minimum* value of the transferred profit to be EUR 85M which was followed by the court

Discussion point: The Dutch entity described in their TP Documentation that the employee’s expertise was an important factor to improve profitability, which the court used in their argumentation – would it have led to a different result if the description in the TP Documentation had attached less importance to the role of the employees?

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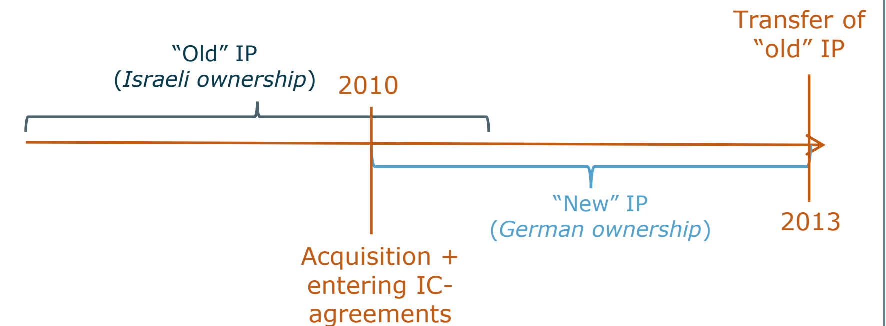
Israeli ruling (I)

Business restructuring (post acquisition)

- Key words:
  - *Transfer of IP, business restructuring, contract R&D, distinction between "old" vs. " new" IP, losses, OECD Guidelines 2010*

Facts

- 2010: A German company (part of a large multinational group) acquired an Israeli company, which had developed an insulin pump, i.e., R&D intensive
  - Acquisition price was USD M180 whereas USD M172 could be allocated to IP developed until 2010 (so-called "old" IP)
- Six months later, four intercompany agreements were entered into:
  - R&D Service agreement (Cost +5%)
  - Support service agreement (Cost +5%)
  - Manufacturing agreement (Cost +5%)
  - License: Parent company pays X% of all sales for the use of "old" IP
- In 2011/2012 the company started to become profit-making and went from 89 to 147 employees
- In 2013 "Old" IP were sold to the German parent company and the operations in Israel were terminated



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Israeli ruling (II)

Business restructuring (post acquisition)

- Israeli Tax Authorities
  - Increased the taxable income in 2010 with the value of functions, assets and risks (going concern) allegedly transferred to the parent company in Germany (the 2010 acquisition price with certain adjustments). Conversion of a fully fledged to limited risk.
  - This was not the best among realistic alternatives
- The Court
  - Found that the IC-agreements implied restructuring resulting in lower risk in the subsidiary in 2010, however after accurately delineation the court found:
    - No transfer of functions
    - No transfer of "old" IP
    - No transfer of risks
  - The company went from loss-making to profit-making (before activities were terminated), the Israeli Tax Authorities did therefore not proof that the IC-agreements were not the best among realistic alternatives

Discussion point: Would it have made any difference if it were post the 2017-update of the OECD Guidelines (introduction of DEMPE-functions)?

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Trends and considerations subject to discussion

- The TP documentation and submitted information (still) play a significant role
  - We see cases where taxpayers try to argue against the FAR analysis in the TP documentation without success – in contrast it seems to decrease their credibility
- Can transfer of risks and functions in itself trigger taxation of “lost profit potential”?
  - Relocation of employees – is it possible to transfer employees?
  - Amended business procedures/reporting lines resulting in shift of control of risks, is this sufficient?
- Increased focus on lost profit potential also among advisors
- Termination or amendments of contractual terms in IC agreements
  - When will third-parties accept termination without compensation?
  - Can a termination period of IC agreements compensate for the remuneration of lost profit potential? How is this sufficiently substantiated/documented?
- To what extent can the guidelines related to HTVI mitigate the risk exposure related to valuation of “lost profit potential”?

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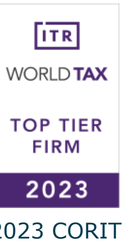

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