

Transfer Pricing Issues in Business Restructurings

Mike Murphy – December 6, 2008



LEADERSHIP • PROBLEM SOLVING • VALUE CREATION



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- ▲ **Objective: Provide a holistic framework describing the potentially complex set of transfer pricing considerations required by business restructurings.**

What Restructurings Are of Interest?

Key events may occur that warrant a review of your transfer pricing model. Drivers and events are often interlinked – for example the development of a new product leads to potential IP value

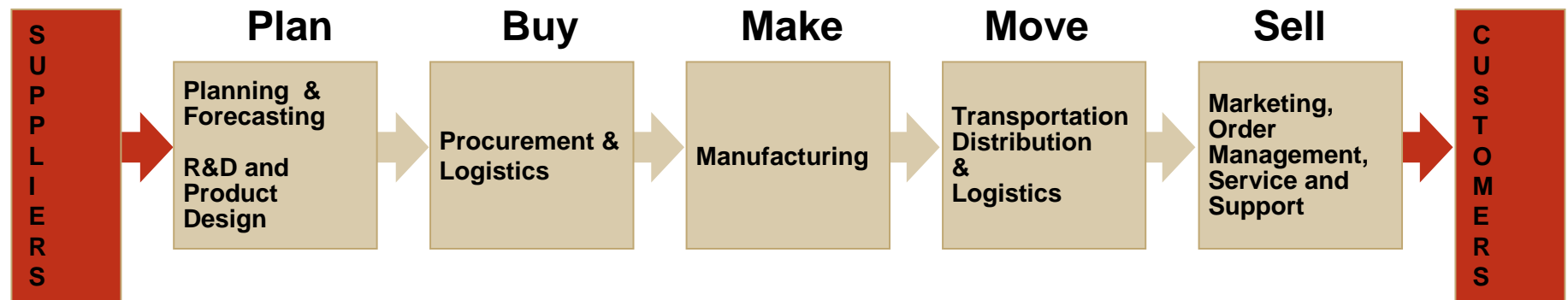
M&A RELATED ...

- Acquire a company
- Acquire a brand or other IP
- Outsource manufacturing to a 3rd party
- Outsource services (IT, F&A, etc.) to a 3rd party

RESTRUCTURING RELATED ...

- Establish internal shared services center (e.g., IT, procurement)
- Add a new product line; expand into a new geographic market
- Creation of centres of excellence (e.g., marketing and sales, etc.)
- Centralize regional management
- Develop new products (R&D), services, or other IP (e.g., software)
- Revise business model (e.g., migrate to internet based)
- Business reorganization directed at cost cutting/rationalize production

Restructurings Can Affect Multiple Parts of Supply Chain



The supply chain mapping is complemented by other analyses to complete the description understanding of the enterprise:

- ▲ transactions flows (legal, cash, physical, process)
- ▲ value chain/economics
- ▲ functional analysis
- ▲ legal & organizational structures

Transfer Pricing Considerations - Basic

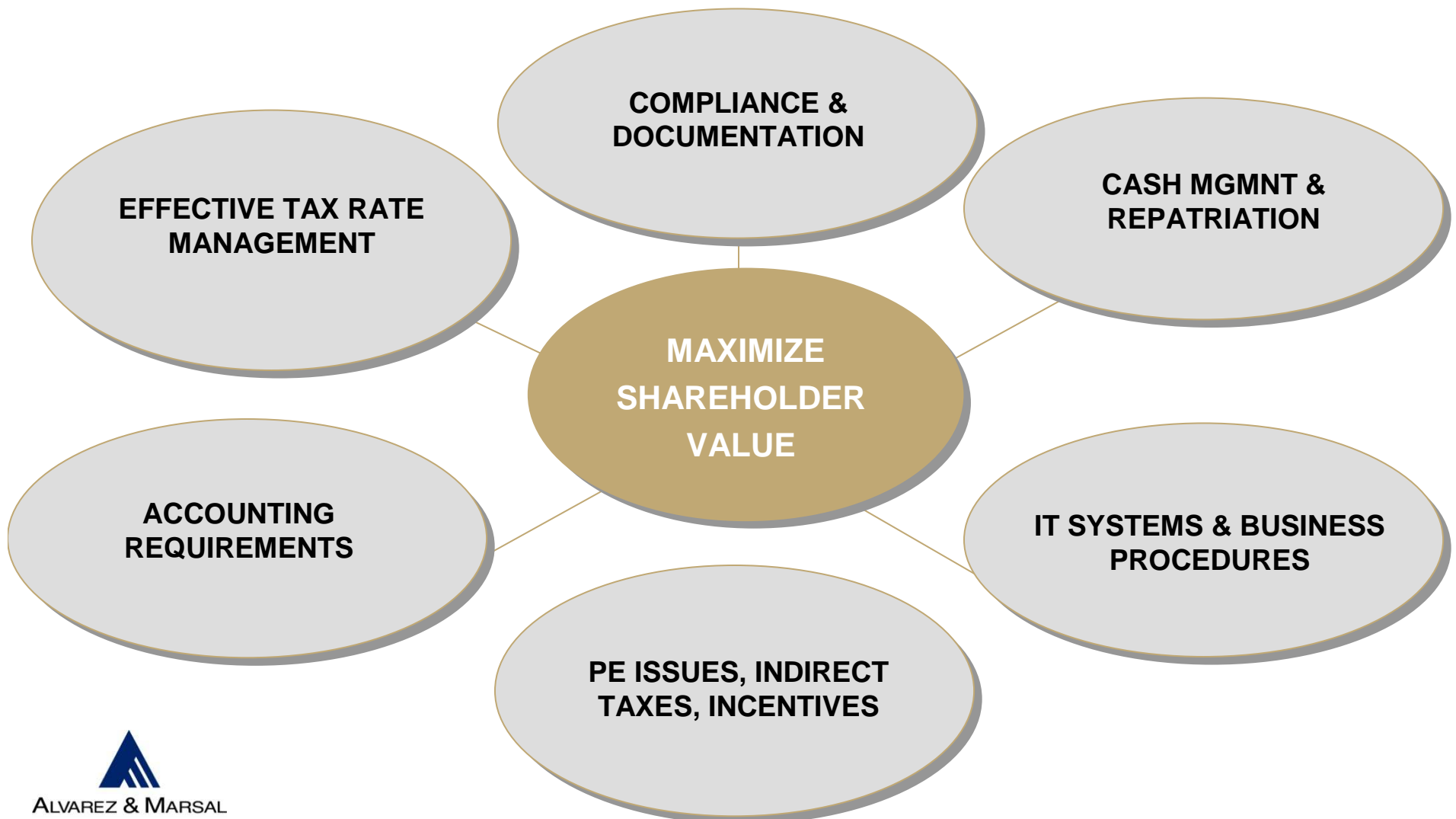
▲ Issues:

- Intercompany sales of parts, components, finished products and other tangible goods
- Intercompany payments for services
- Licenses of IP (software, patents, designs, know how, business procedures, etc.)
- Interest rates on loans
- Performance and financial guarantees

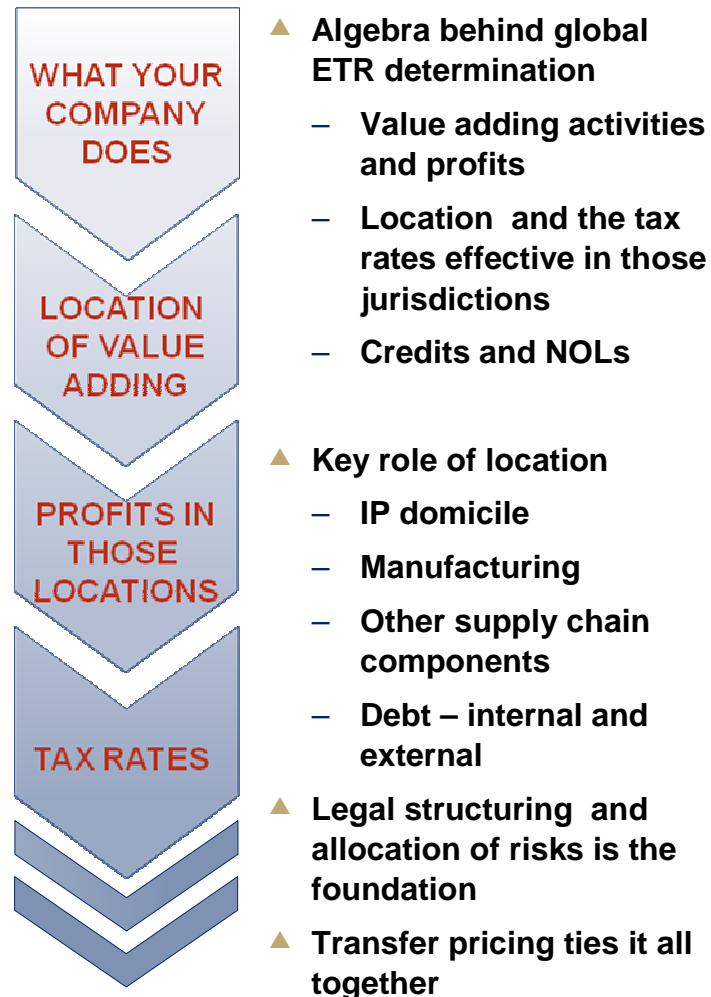
▲ Compliance needs – policies, reports, and intercompany agreements

- Important to avoid tax audit risks
- But there is more to consider ...

Transfer Pricing Considerations - Advanced



Determinants of Global ETR



Transfer Pricing Considerations – Before Restructuring

- ▲ **Location considerations**
 - **Business operation requirements will be key driver**
 - **Understand the implications of the location decision**
 - **IP special considerations**
 - **Always consider platform for future growth**
 - **Exit costs can be significant for later changes**

- ▲ **Legal structuring affects allocation of risks and rewards/losses within the group**
 - **Affects all aspects of the business supply chain**
 - **Requires alignment of business operations and economic substance**
 - **Ultimately driven by business operation requirements**
 - **Exit costs can be significant for later changes**

- ▲ **Transfer pricing ties it all together**

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Legal Structuring Illustration – Sales Channel

BUY-SELL (FULL-FUNCTION OR PURE) DISTRIBUTOR

Distributes at highest level of market (i.e. to full-function distributors)
Can be responsible for development of marketing and/or design intangibles
Holds inventory, Sales force, warehousing

LIMITED RISK DISTRIBUTOR

Limited inventory, credit, warranty or specific risk
Sales force; No significant intangibles

COMMISSIONAIRE (CIVIL LAW AGENT)

Sells in own name for the risk & account of undisclosed principal
Regulated by Civil Law Code
No inventory, credit, warranty or specific risks
Sales force; No significant intangibles
Identifies buyer; Acts as intermediary

AGENT (COMMON & CIVIL LAW)

As Commissionaire but regulated only by contract and applicable commercial law
Marketing Representative responsible for marketing and order
Solicitation only

DIRECT SALE

Sold direct from principal, no sales intermediary
Usually ebusiness sale

Legal Structuring Illustration – Manufacturing

FULL OR PURE MANUFACTURER

Sources raw and intermediate materials for its own risk and account and therefore has inventory risk Often holds intangible assets (such as process know-how and developed technology) and performs R&D activities for its own risk and account . Manufacturing is often combined with distribution activity such that the same entity holds sales force and performs sales and marketing and therefore has credit and other specific risks . A combined manufacturer-distributor generally has product and market risk

CONTRACT MANUFACTURER

A contract manufacturer is a manufacturing services provider
Source raw materials and is a secured source of finished goods supply
for one or more ‘principals’
Has very limited inventory risk
Has no or few production/technology intangibles
Normally separated from sales & marketing and therefore has no credit risk

CONSIGNMENT MANUFACTURER

As contract manufacturer, but principal is the source of supply for significantly
all raw materials
Has no inventory, credit, warranty or other specific risks.
Holds no intangible assets

Legal Structuring Illustration – Procurement

DIRECT PURCHASE FROM SUPPLIERS

Operating companies contract with and are directly supplied by supplying entities

PURCHASE THROUGH GROUP SOURCING COMPANY

Direct supplies and invoices from suppliers to operating companies

Pricing/contract terms negotiated by sourcing company
Service fee paid to sourcing company

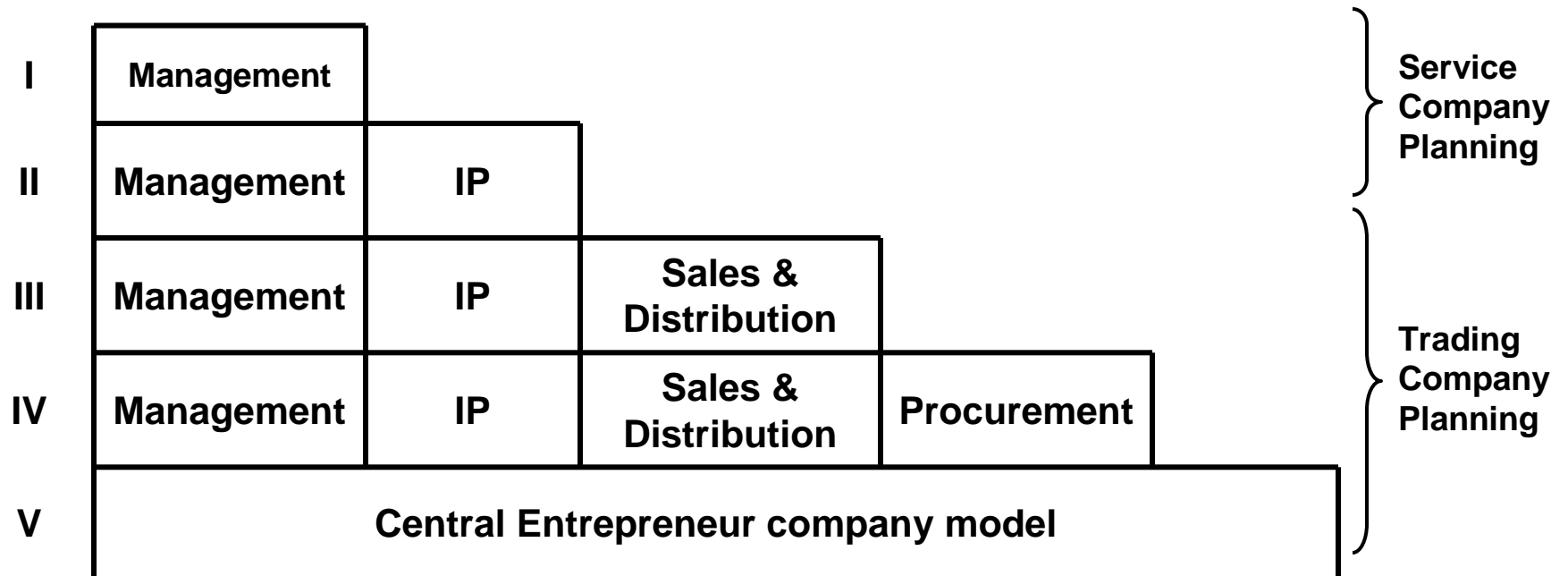
PURCHASE FROM GROUP SOURCING COMPANY

Operating companies contract with and are directly supplied by sourcing company

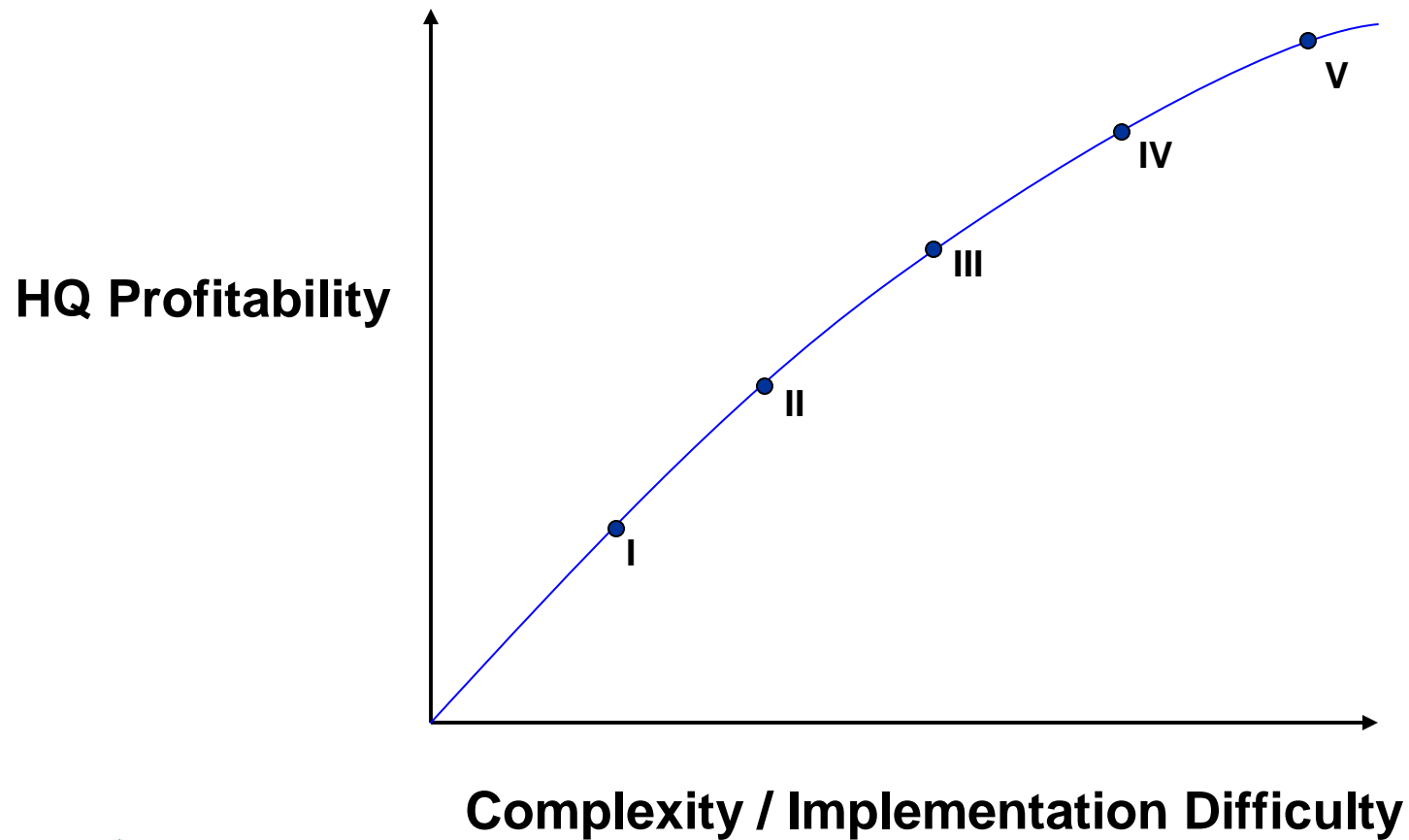
Sourcing company contract with/purchases from suppliers

Legal Structuring Illustration – Regional HQ

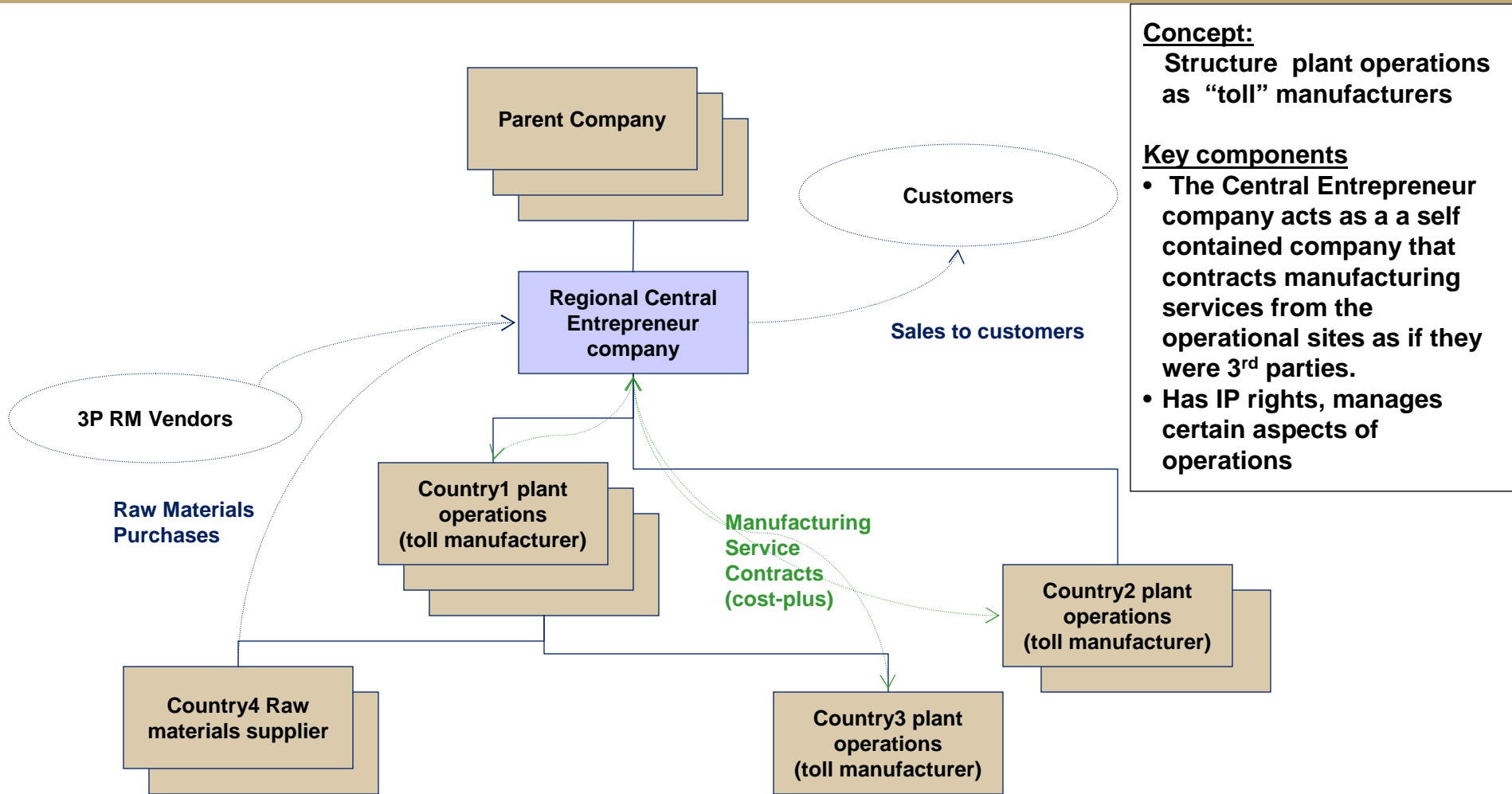
The following are variations of a BU model



Legal Structuring Illustration – Regional HQ



Legal Structuring Illustration – Central Entrepreneur



Concept:

Structure plant operations as “toll” manufacturers

Key components

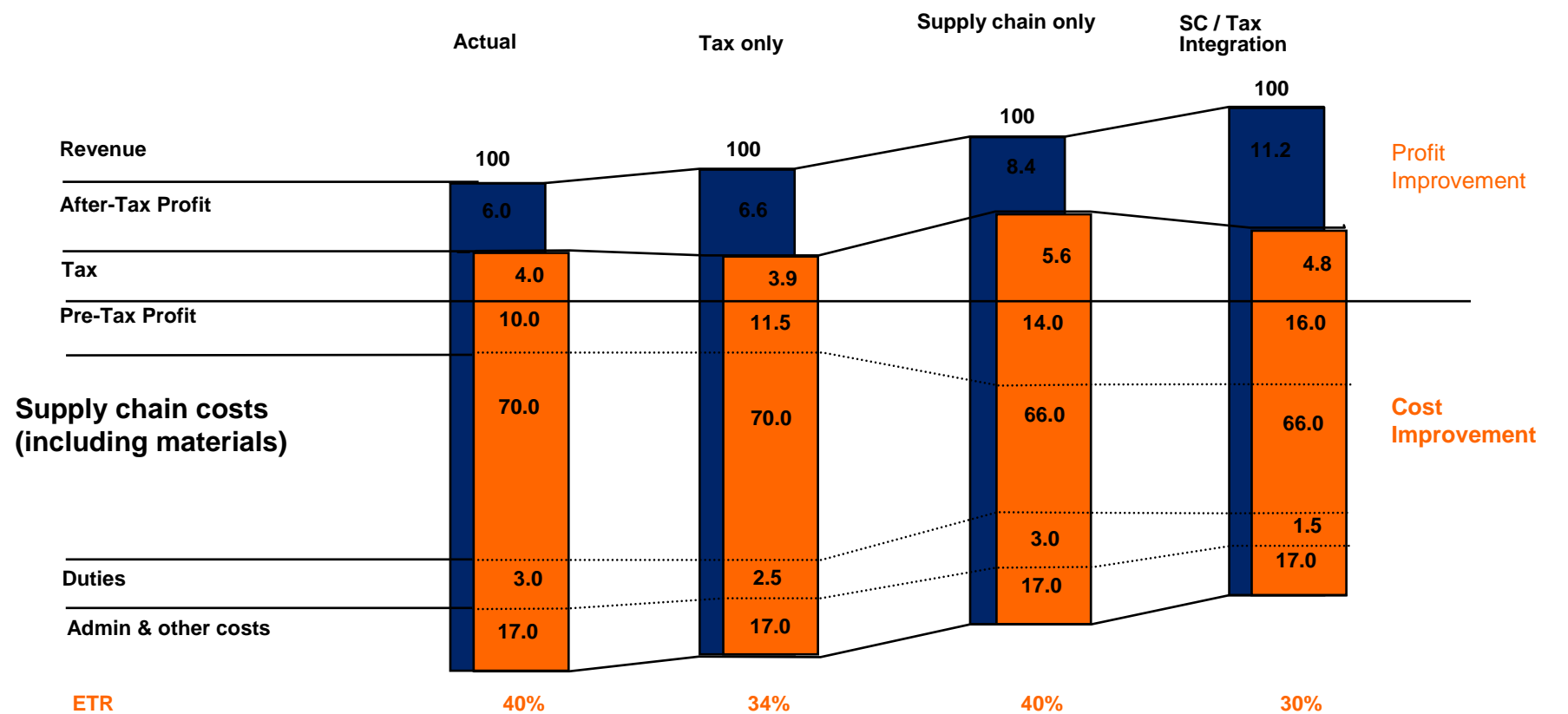
- The Central Entrepreneur company acts as a self contained company that contracts manufacturing services from the operational sites as if they were 3rd parties.
- Has IP rights, manages certain aspects of operations

Legal Structuring Illustration – Central Entrepreneur

- ▲ Includes HQ, IP, S&D, and Procurement from Concepts I, II, III, and IV, plus:
 - CE makes sales to 3rd party customers
 - CE owns raw materials, goods in process, goods in transit
 - CE engages the plants as toll manufacturers. As toll manufacturers, the mills are paid a service fee for their services
 - CE would play a role and have “substance” requirements in scheduling production
- ▲ Central Entrepreneur (“CE”) model would require significant IT systems support since the CE would own inventory and sell to 3rd parties; product cost may be built up at the CE also
- ▲ The toll manufacturer service fee is typically structured on cost plus basis where the cost base includes plant labor, depreciation, and operating costs and expenses

- ▲ Has significant ETR implications
- ▲ Has significant cash management/repatriation implications
- ▲ Has significant indirect tax and customs implications
- ▲ Has significant operational considerations

Integrating Transfer Pricing Planning Implications



Profit Improvement (over actual after-tax profit)

+10%
tax planning constrained by existing operational structures

+40%
40% of the savings go to tax authorities

+87%
supply chain and tax savings - jointly optimized

Concluding Comments

- ▲ **Transfer pricing issues in business restructurings are often viewed as relating only to basic compliance considerations**
- ▲ **Business restructurings, however, provide circumstances under which companies need to consider their future operations and platform for growth**
- ▲ **Need to have a vision and game plan for the future ... and transfer pricing model to support**



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