Bloomberg BNA

Tax Management
Transfer Pricing Report™

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The Implications of Transfer Pricing in Bankruptcy

The authors, examining the bankruptcy proceedings of telecommunications company Nortel, say the case calls into question two standard transfer pricing assumptions: that a tested party will remain viable, and that items listed below the line on a company's profit and loss statement should not be part of the transfer pricing analysis.

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In recently concluded bankruptcy trials in the United States and Canada, former telecommunications company Nortel's transfer pricing arrangements featured prominently in the allocation of liquidation proceeds and inter-estate creditor claims.[1] The core issue concerned the allocation among specific members of the former controlled group and other creditors of approximately $7.3 billion in liquidation proceeds, primarily from the sale of Nortel's valuable technology. Various estates and creditors took different, often diametrically opposed, positions on the proper interpretation of a few key clauses in Nortel's transfer pricing agreement. These clauses pertained to Nortel's pre-bankruptcy allocation of operating profits and losses and their applicability to post-bankruptcy allocation of valuable patents and other intangible assets. Additionally, in the context of proving a claim under the U.K. Pensions Act 2004, Nortel's U.K. pension plan trustee and the U.K. pension protection fund alleged that Nortel's transfer pricing benefited some legal entities to the detriment of Nortel U.K.

Despite the high-profile and prolonged bankruptcy, with a price tag of $1.3 billion in professional fees, which has prompted outcry from the pensioners, judges and legal commentators, the relevant transfer pricing issues at the center of the bankruptcy have received surprisingly little attention in the transfer pricing community. It is true that the factors leading to the litigation of transfer pricing issues in a bankruptcy context are highly unusual; nevertheless, a number of valuable les-

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[1] See stories at 23 *Transfer Pricing Report* 323, 6/26/14; 24 *Transfer Pricing Report* 6, 5/14/15. The Canadian court's decision, dated May 12, is available at http://op.bna.com/ITDTR.nsf/r?Open=mmos-9wgmab. The U.S. court's decision of the same date is available at http://op.bna.com/ITDTR.nsf/r?Open=mmos-9wgmbs.

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sons can and should be drawn from the interplay of certain standard assumptions in transfer pricing and transfer pricing results when going concern issues are present. The authors have been involved in the recent Nortel trials and wish to bring to light two standard assumptions in transfer pricing that they believe deserve a second look whenever going concern issues arise.[2]

- The first assumption, which is essentially taken for granted in transfer pricing studies, is that the taxpayer—the tested party in a transfer pricing analysis—is and will remain a going concern. With that assumption in mind, the potential link between the transfer pricing allocation of operating profits and losses for tax purposes and the bankruptcy allocation of assets for creditors is never considered. Moreover, potential comparable firms that have going concern issues routinely are excluded from the comparables set in transfer pricing studies. However, at any moment in time, numerous companies are experiencing various states of financial deterioration and the presence of financial difficulties may warrant the transfer pricing practitioner to question the going concern assumption and its implications such as how arm's-length parties would have bargained in the face of going concern issues.

- The second assumption is that the profit and loss (P&L) statement has a natural break point at the operating profit line and items listed below the line are not part of the transfer pricing analysis.[3] However, any situation that might cause the practitioner to question the going concern assumption also should cause one to examine precisely what is or is not above the line (such as recurring restructuring costs in the face of deteriorating circumstances). In addition, any indication of going concern issues should cause the practitioner to look at balance sheet items (such as pension costs) that ordinarily would be amortized or written down over time through the P&L, but will not in fact receive such treatment the moment insolvency hits.

The cause of the standard and taken-for-granted assumptions may be traced to the now decades-long popularity of the comparable profits method (CPM) and its OECD analogue, the transactional net margin method (TNMM), and the treatment of company financial information by third-party databases. But the analysis that conceptually makes sense for a going concern using the CPM or TNMM makes increasingly less sense when going concern issues are present and when other methods such as a profit split are employed.

The U.S. and Canadian courts agreed that bankruptcy risk was never contemplated in Nortel's transfer pricing and proposed advance pricing agreements. Nevertheless, the Canadian court ruled against ex-post adjustments to Nortel's transfer pricing arrangement, as the proposed adjustments were inconsistent with the technical requirements of the OECD guidelines and had not been stipulated in Nortel's transfer pricing arrangement.

Given the transfer pricing issues raised in Nortel's protracted and expensive bankruptcy litigation and lack of general awareness of these issues in transfer pricing practice, the authors hope that, going forward, explicit consideration of these issues in designing and implementing a multinational group's transfer pricing arrangement will enhance the reliability of the transfer pricing results and lessen the litigation costs if bankruptcy occurs. The rest of this article will:

- examine Nortel's transfer pricing model and intercompany agreement, and the various interpretations of the intercompany agreement by the parties in dispute post-bankruptcy;
- discuss the going concern assumption, its implicit nature in transfer pricing, and its implications;
- address issues involving above-the-line and below-the-line financial data, using restructuring costs to show how this distinction produces winners and losers; and
- consider the transfer pricing treatment of pension costs, examining the different treatment of these costs in the income statement and the balance sheet.

Transfer Pricing Model and Legal Contract

Nortel, once the largest publicly traded company on the Toronto Stock Exchange, was a multinational corporation providing an array of communications and networking products and services to large organizations and public network carriers. Like other multinational of its scale and scope, Nortel had a vast global footprint. Although its global headquarters remained in Canada, the number of its subsidiaries exceeded 140, serving 15 million customers in over 100 countries.

Nortel's Transfer Pricing Arrangement

As with all multinationals, the transfers of tangible products, intangibles, services and loans among Nortel's various affiliates across national borders had to comply with the relevant tax regulations on transfer pricing. As the company itself acknowledged, the key profit driver in Nortel's business was the development and maintenance of intellectual property. Given its heavy reliance on IP rights in its products and services, Nortel operated under a research and development cost sharing arrangement between 1992 and 2000. Thereafter, Nortel changed to an R&D-driven residual profit split model that was in force from 2001 through 2008. Under the residual profit split model, Nortel divided its legal entities into two groups: the R&D-contributing residual profit entities (RPEs) and the limited-risk entities or distributors that did not develop valuable intangible property (LREs). The RPEs bore "the full entrepreneurial risk of the Nortel business such as the risks attendant with the substantial and continuous development and ownership of the [Nortel] Technology." There were five RPEs throughout the period, consisting of Nortel's main operating subsidiaries in Canada (NNL), the U.S. (NNI), the U.K. (NNUK), France (NNSA) and Ireland (NN Ireland). Nortel's residual profit split method followed a three-step process:[4]

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[2] The authors do not discuss in this article several other transfer pricing issues that surfaced in the Nortel case. These other issues include contractual form versus economic substance, legal ownership versus economic or beneficial ownership, the analysis of benefits conferred and the implications for risk sharing of contractual arrangements.

[3] An exception involves interest revenue and expense connected with intercompany debt, which are below the line for non-financial companies but subject to transfer pricing analysis.

[4] In actuality, the model was used to split residual losses between 2001 and 2008.

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■ The first step determined a measure of operating profits for each eligible entity to be used for transfer pricing, which operating profits were derived from Nortel's operating earnings under U.S. generally accepted accounting principles. Certain items not considered to be part of operating costs were excluded—most notably restructuring costs that were borne exclusively by, rather than shared among, the RPEs.

■ The second step allocated profits to provide market returns for routine (that is, non-R&D-based) contributions for both the RPEs and the LREs.

■ The third step allocated the pool of residual profits among the RPEs only, based on the relative value of their contributions of intangible property. The total residual profit to the RPEs was equal to the total profit from the first step minus routine returns of the RPEs and the LREs, pooled across all entities.

The residual profit split method was considered by Nortel, its tax advisers and the relevant tax authorities as the most appropriate transfer pricing method.[5] According to Organization for Economic Cooperation and Development guidelines and U.S. Treasury regulations, the profit split method may be considered the most reliable method when intangibles are created on both sides of the affiliated transactions, given that ''under the profit split method, it is less likely that either party to the controlled transaction will be left with an extreme and improbable profit result, since both parties to the transaction are evaluated.''[6] This is exactly the reason for Nortel's determination: all five RPEs were significant contributors and collaborators in Nortel's R&D process and the resulting patents. No market comparables existed to benchmark the RPEs' R&D contribution and remuneration.

Nortel's Transfer Pricing Agreement

Nortel's residual profit split method was developed from mid-2001 to early 2002. It wasn't until late 2004 that Nortel's RPEs entered into a master R&D agreement (MRDA) to memorialize the existing transfer pricing arrangement. The MRDA was stated to be effective retroactively as of Jan. 1, 2001. Its most significant clauses include:

■ Legal ownership of all Nortel technology, as defined in the MRDA, was transferred to NNL, Nortel's main operating subsidiary in Canada, regardless of where the technology was developed.

■ In return, the non-NNL RPEs were granted royalty-free and perpetual exclusive licenses to their own markets.

■ Nortel's residual operating profits were to be split among the RPEs in proportion to their respective capitalized R&D ''stock'' (later changed to their R&D spending over the preceding five years), irrespective of where the revenues or profits originated.[7]

■ Nortel's bankruptcy was not contemplated in the MRDA, although a section of the MRDA was devoted to triggers and buy-outs if one RPE, not the entire Nortel group, ceased to be an RPE or became insolvent.

The MRDA went through four revisions to more accurately reflect changes in market conditions, Nortel's business model and its transfer pricing practices.[8] For example, the MRDA was modified to more accurately reflect the Nortel RPEs' geographic licenses. The original MRDA granted the four non-Canadian RPEs exclusive licenses to their home markets, but not to the rest of world. It was amended in December 2008, effective Jan. 1, 2009, to grant all five RPEs non-exclusive licenses in territories outside their home markets, consistent with Nortel's residual profit split model.

Nortel's Bankruptcy and Allocation Positions

Nortel sought bankruptcy protection in January 2009 in three primary jurisdictions—Canada, the U.S., and the U.K. (collectively for all of Nortel's subsidiaries in Europe, the Middle East and Africa, or EMEA). Disagreements over potential transfer pricing issues among Nortel's legal entities surfaced shortly before Nortel's bankruptcy filing. Upon bankruptcy in January and the decision to liquidate in mid-2009, the Nortel entities and creditors agreed to defer the resolution of the allocation issue and joined forces to auction off the company's remaining assets. During 2010 and 2011, Nortel sold various lines of business and associated intellectual property for approximately $2.8 billion, and in June 2011, sold the remaining patents in its portfolio to the ''Rockstar Consortium'' for $4.5 billion. All together, a total of $7.3 billion was deposited in a bank's lockbox, pending the distribution of these funds to Nortel's ultimate claimants (notably, its pensioners, bondholders, and trade creditors).

Over the next three years, Nortel's three bankruptcy estates and various claimant groups were unable to resolve the allocation issue through negotiations and mediations. Official allocation proceedings started in 2013 and ended in May 2015. There were four allocation positions put forward by the parties:[9]

■ The legal title approach proposed by the Canadian estate was premised on the MRDA clause that deemed NNL the legal owner of all Nortel technology. Under its proponents' interpretation, the non-NNL RPEs, which were licensees under the MRDA, were entitled only to operating profits or losses associated with the sale of products that used Nortel technology. Since the $4.5

[5] Nortel's residual profit split model was the basis for its proposed multilateral advance pricing agreements (involving the U.S., Canada and the U.K. for 2001-05 and the U.S. and Canada for 2006-10). In July 2010, after its bankruptcy filing, the U.S. and Canadian tax authorities reached a settlement over Nortel's 2001-05 APA, which resulted in a $2 billion increase in taxable income to NNI and an equivalent reduction in NNL's income.

[6] *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, July 2010, Chapter 2, Part III, C.2, para. 2.113.

[7] The exclusive territory and residual profit split clauses are inconsistent with each other. During Nortel's residual profit split period, the RPEs shared the worldwide residual P&L in proportion to their R&D-based allocations. No RPE had an exclusive claim to any single territory. (The territorial exclusivity provision was included, at least in part, to facilitate the enforcement of legal IP rights.)

[8] Two of these revisions were completed on the eve of Nortel's bankruptcy filings.

[9] For those interested in the exact legal language and legal interpretations, please refer to the original allocation positions submitted by the parties, which can be found by a key word search for ''allocation positions'' (no quotation marks) at http://dm.epiq11.com/NNI/Docket#Debtors=2414&RelatedDocketId=&ds=true&maxPerPage=25&page=1.

billion of patents were not used in Nortel products, only NNL, as the legal owner and licensor, was entitled to the entire proceeds.

■ The revenue approach or fair market value, proposed by the U.S. debtors, would allocate proceeds on the basis of estimated territorial revenue. This was based on the MRDA clause that granted each RPE the exclusive right to its own territory and the nonexclusive right to the rest of the world. Since the U.S. was Nortel's single largest market, this approach would give the U.S. estate the majority of Nortel's lockbox funds.

■ The R&D contribution approach proposed by the EMEA debtors would allocate proceeds based on relative R&D spending as a proxy for R&D contribution. This approach is most consistent with the residual profit split model as used by Nortel to allocate profits or losses before the bankruptcy, but with key inputs developed during the litigation.

■ The fourth approach, the consolidated pro rata allocation model, advocated by the U.K. pension claimants, proposed to allocate the lockbox funds in proportion to Nortel's worldwide claims such that each class of claimants would receive the same pro rata allocation.[10] This approach was justified by the parties' apparent disagreement and economic realities of Nortel's R&D creation process.

In the recently released allocation decisions, it was clearly stated that the courts ''have different interpretations of the MRDA, but agree that the MRDA does not apply to or control the allocation'' of the proceeds from liquidation.[11] As a result, a modified pro rata allocation model was chosen as the ''fair and equitable'' and ''most appropriate and just'' method.[12]

Although the descriptions above are necessarily simplified, they nevertheless show that the first three approaches all are premised on particular portions of the MRDA. There clearly are legal issues outside the transfer pricing economists' scope. Suffice it to say that the MRDA was not drafted in anticipation of the Nortel group's bankruptcy.

Going Concern Assumption

The assumption of a going concern is the usual starting point for any transfer pricing analysis, although this is most often an implicit assumption. The possibility that a company may cease to be a going concern and might even face bankruptcy is rarely explicitly questioned or tested. In fact, the phrase ''going concern'' does not appear in the Internal Revenue Code Section 482 regulations, although ''ongoing concern'' appears in the OECD guidelines in relation to intangible assets.[13]

In various comparable benchmarking analyses, transfer pricing practitioners look at comparable uncontrolled transactions (CUTs) or, more often, at comparable uncontrolled firms (unless a profit split or cost sharing agreement is being used to allocate nonroutine returns or costs). In the latter case, it is standard operating procedure when searching for comparable firms to exclude firms with going concern issues, meaning those firms whose auditors have concluded that ''substantial doubt'' about the entity's ability to continue as a ''going concern'' for a reasonable period of time remains. It also is standard procedure to exclude potential comparables that have exhibited a pattern of losses even if there is no evidence of a going concern issue registered by the auditors. In the typical case of a documentation study that is done using three-year weighted average data, potential comparables that show three years of losses often are excluded, and in some case potential comparables with two years of consecutive losses are excluded. A very similar situation exists in constructing a target range in an advance pricing agreement, where typically the occurrence of four or five years of consecutive losses would demote the potential comparable to the rejection list even if there were no concerns expressed by the auditors.

Underlying all of the above standard procedures is the implicit assumption that the tested party itself is a going concern. The transfer pricing practitioner often is trying to arrive at some reasonable approximation of a ''long run'' or ''steady state'' operating return for the subject company, and thus feels bound to reject those otherwise potential comparables evidencing short-run financial problems. The going concern concept assumes that the business will remain in existence long enough for all the assets of the business to be fully utilized. In turn, fully utilized assets refer to the ability to obtain the complete benefit of the assets' earning potential. Transfer pricing economists routinely follow this thinking and do not make any adjustments to change the rate at which balance sheet items would be depreciated or amortized through the income statement.

As a general rule, transfer pricing economists do not investigate potential going concern issues—they do not, for example, seek out information about an entity's ability or inability to meet its obligations as they come due without substantial asset sales, debt restructurings or externally forced revisions to operations. Nor do transfer pricing economists tend to look at negative trends such as recurring operating losses, working capital deficiencies, negative cash flows from operating activities, adverse key financial ratios or a multiple-year pattern of business restructurings as indicators of potential going concern issues.[14]

Using Nortel as an example, deposition testimony by former employees who had worked in transfer pricing confirmed the critical assumption that the possibility of

[10] All Nortel's creditors are unsecured, although some have cross-entity guarantees.

[11] See U.S. court decision (note 1, above), p. 60.

[12] See U.S. court decision (note 1), pp. 58, 61.

[13] The OECD's guidance on intangibles, released Sept. 16, 2014, as part of its Action Plan on Base Erosion and Profit Shifting, lists ''ongoing concern value'' as an intangible for transfer pricing purposes, although ongoing concern value is closely related to goodwill in the OECD's explanation. See 23 *Transfer Pricing Report* S-185, 9/18/14. Furthermore, the Obama administration has proposed making explicit the inclusion of ''going concern'' in addition to ''goodwill'' and ''workforce in place'' among the list of Section 936(h)(3)(B) intangibles.

[14] Transfer pricing economists typically list risks associated with various external events, including such potential negative events as the loss of a key franchise, license or patent; the loss of a principal customer or supplier; uninsured or underinsured catastrophe such as drought, earthquake, or flood; or legal proceedings or legislation that might affect operations. However, these and other risks usually are not analyzed from the viewpoint of a threat to the continuance of the tested party.

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Nortel's bankruptcy was never contemplated in developing the company's transfer pricing model. Furthermore, deposition testimony made clear that the governing legal document, the MRDA, presupposed Nortel's continued existence as a going concern and was not constructed in contemplation of bankruptcy.

There may be circumstances in which such an assumption is justifiable. For instance, if third-party comparable products or companies exist, arm's-length prices or profits could be benchmarked against them using comparable uncontrolled price (CUP), CUT or CPM regardless of the tested party's financial conditions. The buyer of a standardized product with little or no manufacturing-specific after-sale service likely wouldn't care and would not pay a different price to a financially healthy versus a weak manufacturer. A wholesale distributor, by the same token, would demand the same markups on its distribution services regardless of source. However, such ideal situations are rare for high-tech multinationals and those with valuable intangibles for at least three reasons:

- After-sale services usually are required for large-scale, sophisticated products and services. Companies sometimes underprice the initial sales to generate future service opportunities and sales of parts.
- Multinationals often engage in product and service differentiation to create barriers to entry.
- Most importantly, for the core technologies transferred between different legal entities within a multinational, it has long been recognized that good comparables rarely exist.[15]

In these situations, a profit split often is the best transfer pricing method.

The residual profit split method was the most reliable for Nortel, although it is the furthest from market comparables. Nortel and its five RPEs jointly exploited technology innovations and developed and serviced worldwide customers under one Nortel brand name and corporate umbrella. Each RPE performed R&D in exchange for an opportunity to share in future residual profits. In arm's-length relationships between research joint ventures, the parties must carefully articulate and understand how future benefits will be shared, and the expected payoff to each party must meet or exceed its ongoing R&D costs. As the venture may end up in early termination or insolvency, the participants need to take into account the exit clauses. If, upon such an event, one party has complete ownership of the technology, its future development and the resulting profits, then the other parties either would demand up-front payments for their R&D efforts (or even become R&D contractors instead of risk takers) or undertake very short-term research with only short-term returns.

The fundamental disagreement among the Nortel parties post-bankruptcy was whether and how the former RPEs would share the proceeds from the sale of the valuable intangible assets, especially the $4.5 billion patent portfolio. The Canadian estate interpreted the MRDA to mean that non-Canadian RPEs were licensees to the Nortel technology embedded in Nortel products and services, but not to unused technologies. Other parties strongly objected to this interpretation. The question for transfer pricing economists is whether the Canadian estate's interpretation could be consistent with the results of an arm's-length negotiation. Apparently, Nortel did not perform such an analysis when it developed its transfer pricing model and drafted the legal contract.[16]

The going concern assumption clearly is not always valid, as the situation in Nortel and similar cases demonstrates. However, it has become almost automatic in transfer pricing work to assume a going concern. The importance of this assumption cannot be understated because virtually everything in transfer pricing assumes a going concern—not just the selection of comparables but, as will be shown below, issues such as the appropriate treatment of restructuring costs and pension expenses, among others. At a minimum, transfer pricing practitioners should be aware of whether they are making a going concern assumption and should make choices about comparables and adjustments accordingly if reliable results are to be obtained.

For those transfer pricing practitioners wishing to do a more thorough job looking for potential going concern issues, in addition to performing a more thorough analysis of the company's financial ratios and any operational or debt restructuring and credit ratings, they should carefully read the auditor's report for any ''going concern qualification,'' management discussion and analysis and notes to financial statements, and search the 10-K and 10-Q reports for the term ''risk factor.''

Above the Line and Below the Line

Much like the going concern principle, the issue of which expenses should be above or below the line has become ingrained in an automatic way in transfer pricing analyses. The ''line'' at issue is the operating profit line in the taxpayer's income statement. The expenses that are shifted always are above-the-line expenses under GAAP, meaning that for GAAP purposes they are included in the computation of income or loss from continuing operations and are not considered extraordinary items. It is very common for transfer pricing economists to shift these expenses from above the line to below the line, effectively removing the shifted expenses from the transfer pricing analysis.[17]

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[15] Modern multinationals exist where pure market transactions do not exist and are not efficient. Instead, the common ownership of assets around the world allows for the most efficient access to foreign customers and differentiated resources.

[16] The transfer pricing arrangement could serve very different purposes before and after bankruptcy. Nortel's equity holders had an interest in Nortel as a single and unified company, and the company's transfer pricing agreement served to minimize global tax liabilities and maximize returns to Nortel shareholders. Nortel's shareholders could have been well served by an allocation system that was economically supportable over the long run for a going concern business, even though it was not necessarily accurate with respect to specific entities at any particular point in time. Nortel's bankruptcy truncated the ongoing process, and the parties were forced to deal with the allocation of assets to creditors rather than shareholders.

[17] The OECD has stated that for transfer pricing purposes it is not bound by accounting or legal definitions. In the U.S., the Supreme Court and lower courts have repeatedly pointed out that financial accounting principles do not control the tax treatment of particular items under applicable provisions of the Internal Revenue Code unless the purposes underlying the applicable code provision are served by applying financial accounting principles. See, for example, *Thor Power Tool Inc. v. Comr.*, 439 U.S. 522, 542, 99 S.Ct. 773, 58 L.Ed.2d 785 (1979).

This is perfectly justifiable if these above-the-line expenses were non-operating or were unconnected to continuing operations and shifting them below the line would improve the ''reliability of the results.'' However, in the authors' opinion, the automatic shifting of certain expenses is not always justifiable and it should not be taken for granted that this reclassification always is correct. Rather, the facts and circumstances of the matter at hand should be examined.

The treatment of some of these GAAP expenses can be shown in Table 1, which is based on Nortel's transfer pricing model during 2001-05.[18] As can be seen, various expenses that were GAAP operating expenses (on the left in Table 1) were moved below the line by being added back (on the right) to create a vastly different amount of operating profits for transfer pricing of approximately negative $7 billion rather than the GAAP amount in excess of negative $29 billion.

[18] Both tables and the graphic in this article are based on author Steven Felgran's expert reports in the Nortel bankruptcy trials.

Table 1: Nortel's Operating Profits (2001-05, in Millions of U.S. Dollars)

	Operating Profits Under U.S. GAAP	Operating Profits for Transfer Pricing
GAAP operating earnings		
Revenue—trade & other	54,724	54,724
Intercompany revenue	24,119	24,119
Cost of revenue	(59,291)	(59,291)
Gross profit	***19,552***	***19,552***
Selling & marketing	(8,282)	(8,282)
Gen. & administrative	(5,447)	(5,447)
Total SG&A	***(13,729)***	***(13,729)***
R&D expenses	(11,470)	
R&D amortization		(13,305)
Writedown of goodwill	(18,358)	
Restructuring costs	(5,028)	
Other adjustments	(399)	396
Total operating expenses	***(48,983)***	***(26,638)***
Operating earnings	**(29,431)**	**(7,086)**

Restructuring Costs

Among the largest items moved below the line were the amortized amount of goodwill and restructuring costs. The latter item is one that in particular may merit a close look each time a transfer pricing analysis is done, especially if going concern issues are present. In fact, the appropriate transfer pricing treatment of restructuring costs in the tested party's financials became an issue in the Nortel case. As explained below, while restructuring routinely is moved below the line, this should not necessarily be an automatic exercise.

First, it should be noted that the word ''restructuring'' does not appear anywhere in the U.S. transfer pricing regulations under Section 482,[19] nor do the terms ''above the line'' or ''below the line.''[20] Moreover, the terms ''extraordinary gains and losses'' and ''continuing operations of the tested party,'' although stated, are not separately defined in the U.S. transfer pricing regulations. As no regulatory guidance is provided, it appears that the removal of GAAP above-the-line restructuring costs has been widely adopted by transfer pricing practitioners based on common practice without considering the taxpayer's circumstances or the method employed. In Nortel's case, the transfer pricing policy that took effect in 2001 stated that restructuring was moved below the line as this was how this expense had been treated previously—that is, in the R&D cost sharing arrangement that existed through 2000.

Of course, there may be sound reasons for pushing restructuring costs below the line, in particular if restructuring is in fact extraordinary and unconnected to ongoing operating profits and if comparable firm data are being used for benchmarking purposes in a CPM analysis. Simply put, to create an apples-to-apples comparison between the tested party and, for example, the Compustat database's standardized financials,[21] the

[19] The word in fact appears numerous times in the 2010 OECD guidelines, but in a different context.

[20] The phrases ''above the line'' and ''below the line'' appear in neither the Section 482 regulations nor the 2010 OECD guidelines.

[21] Standard & Poor's Compustat is a database that contains financial information for publicly traded corporations and former companies that no longer file with the Securities and Exchange Commission as a result of events such as mergers, liquidation or bankruptcy. The authors have confirmed with the U.S. Internal Revenue Service that Compustat continues to be

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tested party's financials routinely are adjusted to push restructuring costs below the line.

In general, the primary purpose of excluding ''extraordinary gains and losses that do not relate to the continuing operations of the tested party'' from the definition of ''operating profit'' in Regs. §1.4825(d)(4) is to prevent taxpayers from confusing or compromising their financial results for CPM purposes by including extraneous or one-off transactions. As discussed in a previous article on restructuring costs,[22] in determining whether adjustments are appropriate, ample consideration must be given to maximizing comparability between the tested party and the comparable companies. Adjusting tested party data for restructuring expenses can greatly improve the tested party's comparability with third-party comparables, as Compustat and other databases remove expenses not considered to be related to income from ongoing business operations.

Compustat refers to above-the-line items that it removes as ''special items''[23] and defines them as ''unusual or nonrecurring items presented above taxes by the company.'' Compustat uses a rigid set of guiding principles to move them below the line in order to standardize financial results—in particular, operating income or loss—across companies. Compustat reviews each company's Form 10-K and determines whether any above-the-line item can be considered a special item. Once identified, such special items are moved below the line and thus no longer affect operating income or loss as defined by Compustat.

Compustat's standardization of company financial information sometimes puts it at loggerheads with GAAP principles, especially in Compustat's treatment of special items. For example, under GAAP, the only restructuring expenses that are extraordinary and shown below the line are those connected with the shutdown of an entire operation; all other restructuring expenses, including severance and termination costs, lease termination costs and other exit costs are shown above the line.[24] In fact, Nortel's U.S. GAAP financial statements reported its restructuring costs above the line under a category called ''Special Charges.'' This classification indicated Nortel's judgment and representations to the investing public, accepted by its auditor, that these restructuring costs should be considered part of normal operations. Compustat would not have seen it that way.

The issue for transfer pricing practitioners is whether to continue to adopt the Compustat treatment when restructuring expenses, for example, are ordinary, usual and recurring, or to adhere to the GAAP treatment as described above. It is important to remember that whenever a company is under financial duress, and especially when bankruptcy is a possibility, it is entirely ordinary for restructuring expenses to be incurred year-in and year-out as the company tries to cut costs and realign its cost structure with the source of revenue. One also observes restructuring occurring when there has been a prior period of overinvestment—for example, in facility expansion and new hiring. Both of these conditions were present in Nortel's case—it had overinvested during the years prior to the dot-com bust, and then the bust hit and restructuring expenses were incurred every single year until the 2009 bankruptcy. In this kind of situation, for transfer pricing purposes, should restructuring be treated as ordinary and above the line, or as extraordinary and below the line?

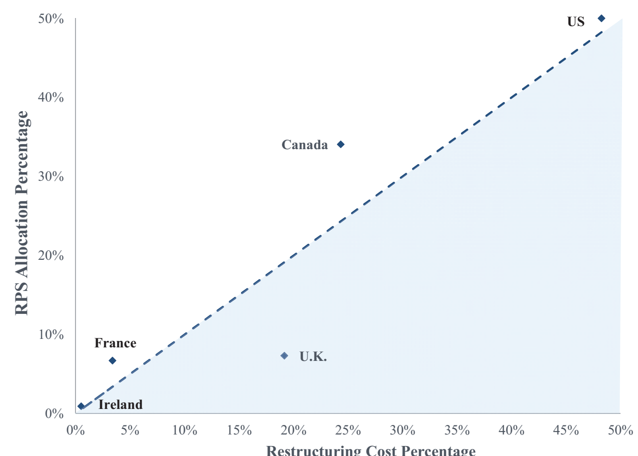
The answer would seem to depend on the facts and circumstances of the matter at hand. However, if the decision is made to keep the tested party's restructuring costs above the line, and if a method is being employed that uses third-party data, it would then be necessary to adjust the comparables' financial results by essentially reversing the database's treatment of the comparables' restructuring costs.

Winners and Losers

In Nortel's case, the transfer pricing method was not CPM but the residual profit split. The question then becomes: should restructuring expenses be in the pool of revenue and expenses that are shared by the residual profit entities, or should restructuring be below the line and borne by each entity individually? In the latter case, the transfer pricing practitioner might have unwittingly set up a system in which there are winners and losers. This would be due to the connection between two ratios—the ratio of a particular entity's restructuring costs to total restructuring costs, and each entity's profit allocation ratio that is used to divide up residual profits (or losses) among the RPEs, as shown in the figure below.

The diagonal line indicates equality between the restructuring cost percentage and the residual profit split allocation percentage, which implies indifference on the part of an RPE between sharing restructuring costs and bearing its own restructuring costs as the bottom-line profit would be the same.

Figure 1. "Winners" and "Losers" under Nortel's RPS Model



the database most often used for comparable firm searches and financial information by the IRS.

[22] Steven D. Felgran, Steven D. Harris, Julie R. Briks and Cherie Lehman, ''Treatment of Restructuring Expenses in the Application of CPM,'' 15 *Transfer Pricing Report* 755, 2/21/07.

[23] Compustat lists 20 such special items, including significant nonrecurring items, results of discontinued operations, impairment of goodwill or unamortized intangibles, and restructuring charges.

[24] The most relevant U.S. GAAP principles regarding the determination, timing, presentation, and disclosure of restructuring charges are contained in Emerging Issues Task Force Issue No. 943, SEC Staff Accounting Bulletin (SAB) No. 100, and Statement of Financial Accounting Standard (SFAS) No. 146. In particular, SFAS No. 146 at p. 9 states, ''Costs associated with an exit or disposal activity that does not involve a discontinued operation shall be included in income from continuing operations before income taxes in the income statement of a business enterprise.''

On the other hand, differences between these ratios create winners and losers as follows. Compare an entity below the line (the U.K.) with one above the line (Canada). The U.K. entity has a restructuring cost share of about 19 percent and a residual profit share of about 7 percent—it is a loser if restructuring costs are placed below the line but a winner if restructuring costs are placed above the line. The entity in Canada, on the other hand, has a restructuring cost share of about 24 percent and a profit share of about 35 percent—it has the reverse situation and would be a loser if restructuring costs are placed above the line but otherwise would be a winner.

To look at it another way, the placement of restructuring costs below the line creates an unanticipated and uncompensated benefit from the U.K. entity toward the other RPEs—in particular, the Canadian entity. In short, when using the residual profit split method, whenever an expense falls below the line, meaning the expense percentage exceeds the residual profit percentage, the entity will benefit if that expense is shared through the mechanism of the residual profit split. If the expense is one that is pushed below the line, that sharing mechanism is removed and the results fall out depending on relative profit allocations.

The previously noted 2007 article on restructuring[25] stated in part, ''As restructuring initiatives persist and companies continue to incur restructuring expenses, it is imperative that transfer pricing professionals turn a discerning eye towards the appropriateness of allowing restructuring expenses to remain in the determination of operating profit employed for CPM analyses.'' The authors of this article would expand that statement to emphasize discernment on the part of transfer pricing practitioners toward moving restructuring expenses automatically from above to below the line, and this is especially true in situations where a profit split is employed as the best method.

Transfer Pricing Treatment of Pension Costs

The Nortel bankruptcy litigation brings to light another issue that is important but not covered in the transfer pricing regulations and rarely analyzed in practice: the treatment of pension costs (more precisely, costs for defined benefit plans) when the sponsor or tested party is demonstrably in financial distress.[26] There is precisely one mention of the word ''pension'' in the 2010 OECD guidelines under TNMM: ''Difficult comparability issues can arise where the accounting treatment of some items by potential third party comparables is unclear or does not allow reliable measurement or adjustment. . . . This can be the case in particular for depreciation, amortisation, stock option and pension costs.''[27] The word ''pension'' does not appear at all in the Section 482 regulations.

[25] See note 22, above.

[26] Defined benefit plans are employer-sponsored pension plans in which future benefits to employees often are tied to the employees' tenure at the employer and final compensation.

[27] *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, July 2010, Chapter 2, Part III, B.3.3, para. 2.84.

As discussed above, standard transfer pricing analyses begin with the above-the-line items in a company's GAAP income statement. Among the above-the-line items is the portion of GAAP pension cost reported in the income statement, referred to as ''net periodic pension cost.'' Rarely separately reported, it typically is embedded in one or more of the different expense categories such as cost of goods sold (for example, pensions for plant workers), R&D (pensions for researchers), and selling, general and administrative expenses (pensions for corporate function workers).[28] These are the only pension costs that transfer pricing practitioners incorporate in their analyses, and these costs are dealt with implicitly by relying on the GAAP income statements.

Yet, for multinational companies, pension systems and local regulations differ significantly. Some countries' pension plans have shifted sooner than others from defined benefit to defined contribution plans. Moreover, U.S. GAAP allows but does not mandate what is referred to as ''pension smoothing,'' discussed below. In bankruptcies, pensioners usually are a large claimant of large companies with defined benefit plans. Because the funding gap will receive less than 100 percent recovery post-bankruptcy, the transfer pricing treatment of the pension costs in a multinational could be questioned. This is precisely Nortel's situation, where the company's U.K. pension trust alleged that Nortel's transfer pricing arrangement had an adverse impact on the pension's funding.

There are two main reasons why the net periodic pension cost item in the income statement is insufficient for achieving reliable results for a tested party facing going concern issues. First, net periodic pension cost is only a portion of the GAAP annual cost of the total pension liability. The remainder of the pension liability is accumulated on the balance sheet. Second and more importantly, the GAAP annual pension cost assumes a going concern and, thus, does not measure the economic cost of funding a defined benefit plan. On a stand-alone basis—that is, without recourse to the corporate parent (see below)—the pension funding cost would be higher.

Table 2 illustrates the different measures of Nortel's pension costs for the company's Canada, U.S. and U.K. entities. For example, between 2003 and 2008 (where such data are available), the first row reports the net periodic pension cost recognized in the income statement and the transfer pricing analyses. The second row reports the balance sheet portion of the GAAP pension costs that are deferred and would be amortized into the income statement over time for an ongoing company. Clearly, the magnitudes and relative proportions among the three main Nortel entities differ significantly. On a stand-alone basis, the last row suggests even higher pension costs.

[28] U.S. GAAP mandates certain pension disclosures in the footnotes to the financial statements.

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Table 2: Nortel's Pension Costs (2003-08, in Millions of U.S. Dollars)

	Canada	U.S.	U.K.	Total
Net Periodic Pension Cost	474	297	438	1,210
Change in Accumulated Other Comprehensive Income	(390)	(308)	496	(202)
Total GAAP Pension Cost	84	(11)	934	1,008
Economic Pension Cost Under the Stand-Alone Basis	769	250	1,060	2,080

The authors are not aware of any instance in which a transfer pricing analysis accounted for the financial conditions of a controlled group. However, the notion of accounting for deteriorating financial conditions is entirely consistent with the reliance on facts and circumstances upon which transfer pricing depends, and the need to perform whatever adjustments may be required and appropriate to increase the reliability of the results. For all these reasons, pensions should receive more attention from transfer pricing practitioners, especially if the multinational group operates under a residual profit split model.

Smoothing in Pension Accounting

As noted above, under U.S. GAAP, accounting standards for pension expenses in the income statement are based on the assumption of a going concern. Therefore, it is assumed that the assets necessary to settle pension obligations will be afforded long periods of growth and that the pension sponsor will be prepared to cover any possible shortfalls in the future. Further, the total annual pension costs differ from the pension expense recorded in the income statement as (i) part of the pension costs flows through ''other comprehensive income'' in the balance sheet, and (ii) an unexpected gain or loss on plan assets—that is, the difference between the expected and actual return on plan assets—can be smoothed over a period of time.

Annual pension costs can swing dramatically from year to year, as discount rates and investment returns are market-driven and can be volatile. A change in pension policies also could have a relatively large impact on annual costs. As a result, under U.S. GAAP, the pension sponsor can choose to adopt pension cost smoothing. In this common situation, the annual amount of unexpected gain or loss is added to the previous years' unexpected gain or loss to obtain an accumulated net unrecognized gain or loss on pension plan assets. Similarly, the annual unexpected change in pension benefit obligations is computed and combined with the unexpected plan assets' gain or loss for an unrecognized net gain or loss. This unrecognized net gain or loss is not immediately treated as an expense, but instead flows through other comprehensive income. However, if the amount becomes too large, it is amortized over a period of time. FASB selected 10 percent of the larger of the beginning balance of the projected benefit obligation, or the market-related value of the plan assets, as the cutoff for amortization—hence a corridor. When amortization is required, the minimum amortization equals the net unrecognized gain or loss divided by the average remaining service period, but a higher amortization is allowed.

If an entity's viability is not an issue, then the market and actuarial movements that are reflected on the balance sheet under U.S. GAAP likely will offset themselves over time. Even if they do not, the GAAP mandatory amortization of large accumulated pension costs would occur over time. Thus, in the absence of going concern issues, the delayed recognition in the income statement may not cause concerns about reliability.

Economic Cost of Pension Obligations

In economic terms, the pension plan has an option to ''put'' the obligation back to the pension sponsor. In exchange for such an obligation to cover a shortfall, the sponsor can recognize a lower accounting cost in the near term. For instance, the sponsor could achieve a lower accounting cost by investing the pension assets in modestly risky investments, rather than strict liabilities-matched investments. Implicit in the going concern assumption is the pension plan's reliance on the sponsor to bail out the plan if pension assets in the future cannot fully fund pension liabilities. This option is valuable to a pension plan with a financially strong sponsor. For an entity or a group of companies facing financial challenges, however, it is appropriate to reflect the total economic costs of pension benefits in the transfer price, as a party facing such challenges and negotiating arm's-length compensation of its pension costs would seek to ensure compensation of those total costs.

On a stand-alone basis, the pension assets necessarily should be invested more conservatively—that is, using a relatively low-risk investment strategy including government bonds with maturities that match the maturities of the pension plan liabilities. Using this strategy of conservative investment, the expected return on plan assets would be lower and the funding needed to maintain the plan would be higher than under the going concern assumption. By demanding a larger cash contribution and investing conservatively, there is no need for the pension plan to rely on the sponsor in the future.

Measuring pension costs on an economic basis does not mean providing an immediate funding increase. Realistically, when the multinational is in financial distress, its financial resources are limited and pension issues usually are not at the forefront of the company's strategy. The authors therefore believe that recognizing the economic pension costs and implementing a funding strategy over a reasonable period of time would treat the multinational's pension plans in different countries on a comparable basis.

Conclusion

Nortel's financial challenges and ultimate bankruptcy distinguish it from most other multinational companies that do not have going concern issues. Nev-

ertheless, the Nortel situation casts doubt on the applicability of some standard transfer pricing practices, in particular the assumption that the taxpayer is and will continue to be a going concern. That assumption in turn has implications for the entire transfer pricing analysis and the reliability of the results. Two such implications have been discussed in detail in this article—the routine event of pushing restructuring costs below the line, and the routine inclusion of only a portion of total pension costs booked above the line under U.S. GAAP. Further, the going concern assumption has implications for which a controlled entity might ''win'' or ''lose'' upon dissolution as a function of what has been treated as above or below the line in a residual profit split.

Taxpayers are urged to consider these issues in designing and implementing a multinational's transfer pricing arrangement. Such consideration could enhance the reliability of the results and lessen the litigation costs in the event of bankruptcy.

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