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To,
Mr. Jeffrey Owens,
Director
Centre for Tax Policy & Administration
OECD

19/02/2009

Regarding:- **<u>Comments on Discussion Draft on Transfer Pricing Aspects Of Business Restructurings</u>**

Dear Mr. Owens

This is in reference to your invitation to comment on various issues on the above listed subject on your web site, I, CA. Krishan Vrind Jain on behalf of My Firm Jain K. Vrind & Co. practicing Chartered Accountants in the field of Taxation from India is pleased to forward these below mentioned comments for your consideration.

If you need any further clarifications please don't hesitate to contact me personally on the below mentioned contact information.

Regards

| **Contact for follow up:** | |
|---|---|
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Do you authorize the OECD to publish your contribution on the Internet site www.oecd.org/taxation?

☐ Yes I authorize you to publish the same

Comments has been provided on various issues by referring to page and point No.'s of the draft and specific portions of the draft at some places are in Italics on which the comment has been given that is in bold type. Below are our general comments before starting with the specific ones.

**General comments**:-

At various places OECD comments that the common commercial sense to earn profit should only be the criteria to restructure the business, where as the actual business working realities sometimes are totally different which may call for a less advantageous decisions to be taken to safe guard the business interests of a business entity.

One other general comment which should be taken care is that no Tax administration should be allowed to comment upon how a business should be profitably run leave aside the adjustments to be made to the taxable incomes.

How and when the valuations has been arrived at in good faith while keeping in view certain future predictability should not be left to be decided in the hands of Taxation Authorities. Rather there should be some independent mechanism to deal with these kind of issues.

The other issue regarding the treatment of a particular item as Intangible asset, should be very clear like only intangibles which can be legally enforceable, should be taken as transferable asset.

## Comment

1. **Page no.18,**

**Point no.38**

As noted at paragraph 1.41 of the TP Guidelines, the fact that independent enterprises do not allocate risks in the same way as the taxpayer in its controlled transactions is not sufficient for not recognising the risk allocation in the controlled transactions, but it might be a reason to examine the economic logic of the controlled distribution arrangement more closely.

- It may be the case that at arm's length, the same risk allocation would have been agreed as in the controlled transaction, *e.g.* because the manufacturer has relatively more control over the excess inventory risk as it makes the decisions on the quantities of products purchased by the distributors. In such a case, the risk allocation would be respected and a comparability adjustment might be needed in order to eliminate the effects of any material difference between the controlled and uncontrolled transactions being compared.

- Assume now that it is found that the distributors have relatively more control over the excess inventory risk as they make the decisions on the quantities of products they purchase from the manufacturer. *In such a case, the tax administration may conclude that at arm's length, a manufacturer would not agree to take on substantial excess inventory risk by, for example, agreeing to repurchase from the distributors at full price any unsold inventory*. In such circumstances, the tax administration may re-assign the consequences from the risk allocation to the related distributors following the guidance at paragraphs 1.25-1.27 of the TP Guidelines (*e.g.* by challenging the manufacturer's obligation to repurchase unsold inventory at full price) if the allocation of that risk is one of the comparability factors affecting the controlled transaction under examination.

**In Our view looking at actual business practices in certain industries, the above said position can be very detrimental for the enterprises, if, the rigid interpretation to this guidance is given by the Tax administrations. There are certain industries for e.g. in the case of Publication, Music Industry and even Pharmaceuticals also,** *manufacturer would agree to take on substantial excess inventory risk by, agreeing to repurchase from the distributors at full price any unsold inventory* **.**

## Comment

2. **Page no.23,**

**Point no.58**

The application of the arm's length principle is based on the notion that independent enterprises, when evaluating the terms of a potential transaction, will compare the transaction to the other options realistically available to them, and they will only enter into the *transaction if they see no alternative that is clearly more attractive. Consideration of the options that would be realistically* available at arm's length is relevant to comparability and pricing of the transaction (see paragraph 1.15 of the TP Guidelines) and also for the assessment of whether it would be commercially rational for a party to enter into the restructuring transaction in the context of the application of the guidance on recognition of transactions at paragraphs 1.36 – 1.41 of the TP Guidelines.

**In our view, there might be genuine consideration to reduce the competition or to penetrate the new market segment, the MNE may be ready to incur losses rather than profits. Urge to increase top line sometimes is more important for the MNE rather than bottom line, so this policy draft can create a space for increased litigation. Or sufficient safe guards are required to be built by way of allowance for adjustments of these kind of factors.**

## Comment

3. **Page no.24,**

**Point no.64**

The profit / loss potential is not an asset, but a potential which is carried by some rights or other assets. The arm's length principle does not require compensation for loss of profit / loss potential *per se*. The question arises whether there are rights or other assets transferred that carry profit / loss potential and should be remunerated at arm's length. Here, profit / loss potential should not be interpreted as simply the profits / losses that would occur if the pre-restructuring arrangement were to continue indefinitely. *On the one hand, if an entity has no discernable rights and / or other assets at the time of the restructuring, then it has no compensable profit potential. On*

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*the other hand, an entity with considerable rights and / or other assets at the time of the restructuring may have considerable profit potential, which must ultimately be appropriately remunerated in order to justify the sacrifice of such profit potential.*

**In our view, if restructuring is being done, because after having considerable profit potential, the entity was unable to generate profit commensurate with the potential (i.e. say due to lack of local management capability) than what happens? The MNE having no other option, but to restructure that enterprise as a business necessity and even has to pay tax on that restructuring. So some kind of mechanism is required to make adjustments in these kind of circumstances.**

## Comment

4. **Page no 25,**

**Point No. 65**

One way of valuing a transfer of rights or other assets is through an examination of the transferred profit / loss potential associated with those rights or other assets. From a transfer pricing perspective, the determination of the arm's length remuneration for a change in the allocation of the profit / loss potential that follows from the reallocation of risks should take account of:

*Whether compensation by the transferor to the transferee for the transfer of potential losses and liabilities would be agreed between independent parties at arm's length, taking account of both the amount of the possible losses and the probability of the risk's materialising, and whether it would be preferable for the transferor to pay the transferee to take over the activity rather than to simply stop performing the activity and incur the associated windup costs;*

**In our view the compulsion of the MNE to have presence in certain markets or product segments some times may be so strong, that it may agree to pay transferee a**

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**compensation for the transfer of potential losses and liabilities by preferring to takeover the activity rather than stopping the activity.**

## Comment

5. **Page no 25,**

**Point no. 66**

Where there is a transfer of profit / loss potential that follows from a business restructuring, the question arises of whether that transfer is an arm's length transaction from the perspectives of both the transferor and the transferee and in particular whether (and if so how) it should be compensated. The answer will obviously depend on a number of factors, including but not limited to:

- The options that would have been realistically available to the transferor and transferee at arm's length, based on the rights and other assets of each at the outset of the restructuring, that determine the profit / loss potential of either.16
- The expected return to the transferor and transferee after the restructuring. Business restructurings typically involve a trade-off between possibly higher-but-more-volatile profits17 or losses (*e.g.* for a full-fledged manufacturing activity) and lower-but-more-stable profits (*e.g.* for a contract manufacturing activity). At arm's length the expected return would depend on the new risk profile of the transactions (see paragraph 1.23 of the TP Guidelines: "[i]n the open market, the assumption of increased risk will also be compensated by an increase in the expected return18

**In our view, as a prudent business logic the assumption of increased risk will also be compensated by an increase in the expected return stands good but, if product mix has been restructured and compensation is given in other Product lines - how to identify and evaluate it? There is also a possibility of compensation being shifted to some other not directly associated enterprise of the transferee not being the subject matter of the Arm Length Study at a given point and not being made part of the restructuring agreement under question.**

## Comment

6.**Page no.26,**

**Point no. 68**

As another example, assume a related party distributor is operating at its own risk under a long term contractual arrangement for a given type of transaction. Assume that, based on its rights under the long term contract with respect to these transactions, it has the option realistically available to it to accept or refuse being converted into a low risk distributor operating for a foreign related party, and that an arm's length remuneration for such a low risk distribution activity is estimated to be a stable profit of +2% per year while the excess profit / loss potential associated with the risks would be transferred to the foreign related party. *From the perspective of the distributor, the question arises as to whether the new arrangement would be reasonably expected to be sufficiently profitable for it to accept the restructuring, given its realistic – albeit riskier - alternatives. If not, this would imply that the arrangement is mis-priced absent additional compensation to appropriately remunerate the risk transferor for the restructuring.* From the perspective of the foreign related party, the question arises whether and if so to what extent it would be willing to accept the risk at arm's length in situations where the transferor continues to perform the same activity in a new capacity as a low risk distributor.

**Transferee might not be in a situation to negotiate so, rather than loosing the complete contract, Party may accept less advantages condition at a low profit with a same risk profile. So the Arm Length compensation calculations should have a place in built for these kind of situations.**

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## Comment

7. **Page No.30**

**Point no. 87**

*(ii) Intangible transferred at a point in time when it does not have an established value*

87. Difficulties can arise in the context of business restructuring where an intangible is disposed of at a point in time when it does not yet have an established value (*e.g.* pre-exploitation), especially where there is a significant gap between the level of expected future profits that was taken into account in the valuation made at the time of the sale transaction and the actual profits derived by the transferee from the exploitation of the intangibles thus acquired. *This raises the question of whether the valuation at the time of the transfer was an arm's length valuation that was arrived at in good faith on the basis of information reasonably available at that time. Where this is not the case, the price for the transfer may be adjusted.*

**In our view, these type of transactions are very rare in nature and the perfect match of uncontrolled comparables almost becomes impossible to find. The point above raises a serious question about the valuation, whether it was arrived at in a good faith, this gives a vide leverage in the hands of the Tax Authorities to reject the valuation or its very basis at time of transfer with regard to the future profits. There is also no scope of risk associated adjustments given to it. For example, we take Pharmaceutical Industry, suppose a new patented molecule of a life style drug is licensed in or out and valued by keep in view certain market size, but after reducing certain risk costs as to probable litigation that might surface but not in the immediate future. The Tax Authorities can readjust that valuation on the basis, where no such litigations are initiated/ materialized immediately. So as far as the valuation part of any such restructuring is concerned should be best left to the Valuation experts rather than open for any kind of adjustments.**