



February 19, 2009

USCIB Comments on the OECD Discussion Draft on the Transfer Pricing Aspects of Business Restructurings, September 19, 2008

The U.S. Council on International Business (“USCIB”) is pleased to present these comments on the OECD Discussion Draft on the Transfer Pricing Aspects of Business Restructurings (the “Draft Report”) dated September 19, 2008. These comments include endorsements of positions taken in the Draft Report, requests for clarifications, concerns, and responses to the invited comments in the Draft Report.

USCIB promotes international engagement and prudent regulation in support of open markets, competitiveness and innovation, sustainable development and corporate responsibility. Our members include top U.S.-based global companies and professional services firms from every sector of our economy, with operations in every region of the world. With a unique global network encompassing leading international business organizations including the Business and Industry Advisory Committee to the OECD, the International Chamber of Commerce, and the International Organization of Employers, USCIB provides business views to policy makers and regulatory authorities worldwide and works to facilitate international trade and investment.

The USCIB appreciates the considerable effort invested by the OECD and the supporting working groups on this important matter. We believe that the Draft Report reflects the objectives of creating a balanced and pragmatic working document contains many positive aspects. The USCIB applauds several aspects of the Draft Report, including:

- Recognition of the primary role of the OECD Transfer Pricing Guidelines (the “TP Guidelines”) in establishing arm’s length pricing in a business restructuring;
- Affirmation by the OECD that the analysis of the transfer pricing aspects of a business restructuring is based on existing transfer pricing rules and starts from the premise that the arm’s-length principle and the TP Guidelines do not, and should not, apply differently to post-restructuring transactions than to comparable transactions that were structured as such from the beginning.
- Recognition of the difficulty of applying the arm’s-length principle to multinational groups, which requires treating separate members of a multinational group as if they were independent parties;
- Recognition by the OECD, in view of the foregoing conceptual difficulty, that application of the arm’s-length principle to multinational group restructurings must be done in a pragmatic and realistic manner; and
- Reaffirmation of the OECD member countries’ strong support for the arm’s-length



principle and its application and refinement to new issues.

- The general view that the preferred method to resolve disputes among taxpayers and tax authorities in business restructurings are through transfer pricing adjustments rather than through disregarding the restructuring;
- The ability to separate the functions of managing and administering business risks from the financial ownership or the risk;
- Recognition of the benefits many companies realize by managing IP centrally; and
- Recognition of tax planning as a legitimate rationale for a business restructuring.

The comments begin with a general observation on documentation requirements and then are organized by Issue Note in the Draft Report. Paragraph references are provided as necessary (¶).

General Observation on Documentation Requirements

As has been remarked by BIAC, the Draft Report places strong emphasis on establishing a comprehensive set of intercompany agreements, functional and economic analyses and accounting treatments:

- Contractual arrangements concerning the restructuring;¹
- Business reasons for the restructuring;²
- Transactions involved in the restructuring;³
- Options realistically available to achieve the objectives of the parties other than the transactions selected;⁴
- Identification of intangibles involved in the restructuring,⁵ and their profit-making potential;⁶
- Identification of functions, assets, and risks involved in the restructuring;⁷
- Presence of indemnification to the transferor;⁸
- Terms of any termination or renegotiation of any existing agreements;⁹

1 OECD Business Restructuring Discussion Draft ¶¶ 25-26.

2 OECD Business Restructuring Discussion Draft ¶ 53.

3 OECD Business Restructuring Discussion Draft ¶ 50.

4 OECD Business Restructuring Discussion Draft ¶ 59.

5 OECD Business Restructuring Discussion Draft ¶ 78.

6 OECD Business Restructuring Discussion Draft ¶ 78.

7 OECD Business Restructuring Discussion Draft ¶ 88.

8 OECD Business Restructuring Discussion Draft ¶ 102.

9 OECD Business Restructuring Discussion Draft ¶ 103.



- Application of two-sided as well as one-sided TPM analysis, indicating, as it has in other contexts, that profits split methods (two-sided) may need to be used to confirm a one-sided method (such as TNMM);¹⁰
- Identification of potential comparables;¹¹
- Functional analysis of what has actually changed before and after the restructuring;¹²
- All other elements of the transaction in question that is pertinent to the respective elements of the Discussion Draft.

The USCIB acknowledges that written contracts and similar documentation certainly serve as anchors in the process of identifying and understanding the transactions and agreements. The range of current filing and reporting requirements for business or asset transfers and transfer pricing documentation are varied and complex among OECD countries, with some countries possessing limited requirements while others require a list of comparable length to the Draft Report. USCIB is concerned that the documentation standards in the Draft Report may lead to duplicative or unnecessary paperwork, increasing the administrative burden to all taxpayers. USCIB requests clarification of the minimum required documentation and guidance on how best to integrate this with local country standards.

Issue Note 1: Special Considerations for Risks

The USCIB agrees with the authors of the Draft Report that the contractual arrangements with respect to risk shifting among the parties to the restructuring should be respected as long as there is sufficient economic substance to the actual transactions. In addition, we also agree that the absence of a risk allocation arrangement among unrelated parties does not imply that the restructured company's allocation of risk is not arm's length.

The Draft Report invites comments on this issue of separation of risk and control, and of what functions reflect control in a business restructuring (*see* comment after ¶ 34). Any comments on this issue must be general in nature, as the facts and circumstances of the industry, nature of the subject activity, and contractual terms differ considerably by company and the specifics of a given business restructuring. We believe the two examples given; the investor/investment manager and the principal/contract researcher (¶ 32 & 33) are fair and appropriate, as the focus on the general relationship of the principal and the agent. We suggest that the key determining aspect that reflects effective separation of management and risk are, in addition to the written contract and ability to suffer the detriment of the loss as mentioned in the Draft Report, is the ability of the principal to make the 'go or no-go' strategic decisions of what to perform and whether the risk-related activity is worthy of continued development and investment. That is, in arm's length arrangements the most important activity related to the

¹⁰ OECD Business Restructuring Discussion Draft ¶¶ 148-149.

¹¹ OECD Business Restructuring Discussion Draft ¶¶ 166-169.

¹² OECD Business Restructuring Discussion Draft ¶ 185.



control of a risk is the ability to approve and or stop the activities that lead to the principal bearing the potential detriments of the risk under consideration.

In addition, the Draft Report request comments on the whether if the transferor of risk can self-monitor administrative functions. The USCIB suggests that this arrangement is common in many self-regulated industries and in many commercial arrangements such as (1) licensing agreements where the licensee has to report volume usage, customer pricing, profitability measures and other metrics to the counterparty (*e.g.*, copyright royalties for music downloads); contractual rights for mineral extraction, and many other industries. Lastly, several third-party organizations such as accountants, lawyers, regulatory agencies and others routinely serve as outsourced monitoring of risk allocation among unrelated parties.

As the Draft Report mentions in ¶40, a key issue associated with business restructurings is “...whether a risk-and, as a consequence, the transfer of that risk, where applicable – is economically significant.” The Draft Report then goes on to state that if a risk is “...economically insignificant then its value in terms of profit potential is likely to be correspondingly low, and the bearing or transfer of that risk would not ordinarily explain a substantial amount of or decrease in the entity’s profits.” The Draft Report then suggests that the assessment of the significance of an economic risk may be determined by reviewing accounting statements identifying any liabilities that are booked related to that risk (¶42). The Draft Report does acknowledge that some risks may not be quantified on financial statements, such as “...possible mispricing, customer appetite, etc.”

Two of the premises behind these comments are questionable. First, finance thinking for the past 50 years has been based on the premise that expected return in *not* related to risk; rather expected return is related to non-diversifiable risk (or so called ‘market risk’). The important point is that there are many risks that can be hedged (*e.g.*, currency risk) or diversified (geographic risk) that do not necessarily lead to higher expected return. Rather, risk that is unique and related to the specific markets that the business participates in is related to expected return. Secondly, liability reserves on accounting statements generally do not relate to expected risks, but rather timing differences in costs (that is, costs that are incurred today but for which the cash outlays will not occur until a different accounting period, such as warranty reserves, pension accounts, etc.). Some liabilities are contingent, but the booking of these reserves (such as tax deferral accounts) are dictated by local accounting requirements rather than underlying business dynamics. Consequently, accounting statements tell us little about the key business risks of a company, which involved the market acceptance of the product or service, pricing and profitability realized, competitive and regulatory environment, and required capital investment. Therefore the USCIB suggests that the OECD working group reconsider the practical guidance on how to determine the economic significance of risk. The USCIB believes that a standard functional analysis identifying the functions, assets and risk borne by each party is a more practical way to characterize the types or risks transferred that then can be quantified by a standard financial risk model.

On a conceptual note, the USCIB would like to suggest that the concept of risk and control of risk is linked closely with the functions and assets (tangible and intangible) that are associated with the risk in question. Economic risk is the bearing of the financial consequences



of managing functions and assets through time, either through direct ownership or through contractual arrangement. Therefore, the USCIB recommends that this section on the control and ownership of risk place greater emphasis on the performance of functions and ownership of assets associated with the risk in question.

Lastly, the USCIB asks for clarification on the role of ‘risk’ and ‘control’ in relation to qualified cost share arrangements. Legal entities in a cost share arrangement often participate in the creation and ownership of intellectual property without the level of direct control specified in the Draft Report. The USCIB would like clarification if the Draft Report could be used to challenge an otherwise qualified cost share arrangement.

Issue Note 2: Arm’s Length Compensation for the Restructuring Itself

A common theme in many paragraphs of the Draft Report is that business restructurings need to compensate for the transfer of assets and risks (and potentially goodwill/going concern, etc.) without specifying clearly what constitutes a transfer. In particular, situations where two related parties, either engaged by long-term contract or long-standing relationship, alter that contract or relationship under a termination clause, for example, , does not constitute a transfer that would require compensation, particularly if these contracts have been negotiated on arm’s length terms comparable to what third parties would require and there is no statutory right of compensation.

Arm’s length commercial contracts specify the legal rights and obligations of both parties, including length of term, indemnities for early termination, mediation process, and allocations of both tangible and intangible assets upon termination or expiration of the contract and other clauses. The USCIB suggests that additional clarification is required in ¶60 on when the transfer of contractual rights requires a compensating payment.

Furthermore, the USCIB believes that traditional transfer pricing methodologies consistent with the TP Guidelines are sufficient to address this situation. Consider the example in ¶92 where “...an entity voluntarily terminates a contract that provides benefits to it, in order to allow a foreign related party to enter into a similar contract and benefit from the profit potential attached to it.” The Draft Report implies that this situation may lead to a compensatory payment to the original entity terminating the contract. The USCIB suggests that expired contracts, under the arm’s length standard, does not necessarily lead to a transfer requiring compensation. Rather, we believe that a functional analysis of the functions performed or intangible assets owned by the entity to exploit the contract will lead to the proper conclusion of whether compensation is required. If the terminating entity brings unique functions or assets to manage the relationship underlying the expired contract, then the functional analysis should be able to identify those specific functions or assets and generate appropriate compensation for them through the ongoing arm’s length return rather than through a buy-out compensatory payment.

USCIB believes the two following statements in this section of the Draft Report require further clarification.

“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." (§64)

"The determination of the arm's length valuation for a transfer of ongoing concern does not necessarily amount to the sum of the valuations of isolated elements that are part of the transfer. In effect, transfers of ongoing concerns between independent parties often take account of any possible "goodwill", i.e., of the profit/loss potential of the activity transferred..." (§93)

Query, is profit potential an asset similar to, or a component of, the goodwill of a going concern as in §93, or is it associated with a transferred asset as in §64? This is an important question, as it relates directly to the question of what has been transferred and what need to be included in the value of a transferred function, asset or risk.

Goodwill is typically viewed as a residual value, the value of a company after all tangible capital and regulatory-defined identifiable assets and liabilities. An example of this would be the accounting for business combinations under FASB 141 which explicitly defines goodwill as the value of a company less the tangible capital and 5 classes of intangible assets – marketing related, customer related, technology based, artistic based, and contract based – and explicitly classifies as 'goodwill' all the remaining value, which includes workforce in place, manufacturing know how, and other unspecified intangible assets.

Going concern is often viewed as the value created by assembling and organizing the myriad of small assets and incremental relationships that are required to start and maintain a business. This includes licenses and regulatory approvals, lines of credit, legal incorporation, and other contracts. Profit potential is the expectation of future events that are not directly related to the current management of the enterprise, such as a merger, new product launches, new clients or customers. Since goodwill often acts as a catch-all and is valued as a residual after subtracting identifiable value from the total value of an enterprise, the definition may include or exclude going concern or profit potential, which creates uncertainty for the taxpayer and potential controversy for tax administrators.

The key question for the author's of the Draft Report is whether the transfer of an intangible asset at arm's length will be respected as including the profit potential of exploiting the subject intangible (§64) or whether the profit potential will be classified as a goodwill intangible and subject to a separate valuation (§93).

Based on our comments above, the USCIB takes issue with the comment in §65 that accounting standards are helpful for identifying or valuing risks transferred in a business restructuring.

¶¶ 87 – 88 of the Draft Report concern intangibles transferred pre-exploitation and when value is established only with a higher degree of uncertainty. The Draft Report refers to the paragraphs 6.28-6.35 of the TP Guidelines for determining when a compensatory adjustment is required, perhaps due to a price adjustment mechanism that would have likely been included in an arm's length contract. The USCIB would like to stress that the TP Guidelines require (and arm's length parties) only use of information available at the time of the contract signing and request that further clarification of when a price adjustment mechanism is required be provided.



Issue Note 3: Remuneration of Post-Restructuring Controlled Transactions

The USCIB looks forward to the OECD finalizing its review of profit methods as part of its ongoing of transfer pricing policies. The USCIB is supportive of most of the comments in this section, with specific concerns on the issues below.

While the USCIB understands the need to evaluate the business rationale for a restructuring for all the parties involved (§§148-152), we believe that so-called ‘one-sided tests’ are often more appropriate for determining arm’s length profit than ‘two-sided tests.’¹³ Two-sided tests should be used only when both parties of the transaction perform strategic functions or own unique high-value intangible assets that require compensation from the residual income of the transaction. In contrast, where one party owns all of the unique intangible assets or performs all of the strategic functions, a one-sided test is likely to be more reliable. Use of two-sided tests in other circumstances may lead to misleading results and unnecessary controversy.

In §152, the Draft Report asserts that “[t]he OECD view is that the arm’s length remuneration for commissionaire or sales agent activities (whether buy-and-sell activities, commissionaires or sales agents should generally be based on a sales-related indicator.” The USCIB finds this guidance overly prescriptive and believe that a functional analysis of the entity in question could lead to other methods, including cost-based methods, as being the most reliable measure of arm’s length profit.

The Draft Report recognizes that the OECD is currently reviewing its assessment of the selection of most appropriate method to price intercompany transactions, especially as it relates to profit-based methods such as the Transactional Net Margin Method (“TNMM”) and the Transactional Profit Split Method (“TPSM”).¹⁴ The OECD preliminary conclusion is that the Transactional Profit Split Method may be most reliable when unique intangible assets are owned by each party of the transaction, as it is unlikely that reliable outside evidence could be identified sufficient for use under a transactional method or the TNMM.

The Draft Report asserts that there can be situations where the taxpayer and tax authority differ on the presence of strategic functions or unique intangible assets, such as in a restructured ‘limited risk’ distributor. In these situations, which are based on factual disputes, the tax authority can challenge the use of a cost plus, resale price or TNMM method and propose the TPSM as a way to determine the profitability of a ‘limited risk’ entity that it asserts performs strategic functions or owns unique intangibles. (§161).

The USCIB has two concerns with this position. First, that a tax authority may unreasonably assert the presence of strategic functions or unique intangibles managed or owned by a ‘limited risk’ entity?

¹³ As described in the Draft Report, a one-sided test looks only at the characteristics of the tested party in determining arm’s length profit and implicitly ascribes all entrepreneurial return to the principal counter party. Conversely, a two-sided evaluates the unique contributions of both parties of a transaction and is resolved frequently by use of a profit split method.

¹⁴ Discussion Draft on Application of Transactional Profit Methods, January 25, 2008.



Second, is the computational problem of computing the required parameters of a generally recognized profit split method. Profit splits are the least common of the specified pricing methods due to the difficulty of determining the split factors associated with the unique intangibles or strategic functions. Often times, this leads to arbitrary generalized splits. The most analytically rigorous profit split methods involve capitalizing the expenses that are used to create the unique intangibles. This method may prove problematic in the context of business restructurings as most of the entities will have little history of expenses under the restructuring and many of the strategic functions that might be asserted as meriting use of the TPSM such as tradenames or customer lists do not have identifiable expenses to capitalize. Therefore use of the method runs the risk of highly subjective and arbitrary adjustments. The USCIB requests clarity on the application of the TPSM for use in Business Restructurings.

The Draft Report suggests that in the evaluation of a business restructuring that both parties of the transaction should be analyzed to determine the value of any transferred intangible asset (a so-called “two-sided test”) rather than the one party who performs the simpler set of functions or owns limited valuable intangible assets (a so-called “one-sided test”). The USCIB affirms that any review or assessment of the business restructuring should consider the economic impact on all effected parties, both pre and post restructuring. However, the USCIB has strong reservations on endorsing the use of a two-sided transfer pricing method (e.g., the family of profit split methods, or “PSM”) The PSM are only appropriate under this narrow set of circumstances, and if one party is routine in nature, then the PSM are accordingly inappropriate. Under these scenarios, the more proper use of one-sided methods such as the TNMM or of transactional methods are both more reliable and appropriate.

Issue Note 4: Recognition of the Actual Transaction Undertaken

Paragraphs 207 through 213 of the Draft Report address the question of when an intercompany arrangement resulting from a business restructuring can be disregarded as not being commercially rational. The Draft Report stresses that an intercompany arrangement should be respected under all but the most exceptional circumstances and that the preference for resolving a dispute in the characterization of a relationship between related parties should be based on an adjustment to the current structure rather than disregarding that structure. However, the restructured transaction may be disregarded if it “...is expected to be clearly detrimental to it if it has the option realistically available to it not to do so.” (Paragraph 209). The Draft Report acknowledges that the TP Guidelines lack guidance on how to apply the commercially rational standard. The Draft Report offers three examples to help clarify the issue.

A typical business restructuring will involve over a dozen legal entities, performing differing levels of activities and potentially performing a wide array of functions. By definition, a business restructuring attempts to maximize the operational and tax benefits for the entire group of related companies, and many of the operational changes require consolidation of like functions from all related entities (e.g., ownership of all product development rights). Therefore, to realize the potential cost savings, global marketing scope, or common service standards of a business restructuring significant operational changes may be required from several of the affected related companies. It is therefore possible for a tax authority in one country to disregard a restructuring under the commercially rational clause on the basis that it is not in the best



interest of the local country operation even if it benefits the whole group of related companies. In essence, the viability of the whole restructuring could be threatened by the any of the individual tax jurisdictions. The USCIB is of the firm opinion that taxpayers' allocations of risk should be respected in all cases where the contractual allocation is well-specified and the benefits or detriments to bearing the risk are borne by the appropriate party. Such allocations of risk should not be disregarded based on the notion that 'unrelated parties might not have entered into this.' A more reasonable approach would be to focus on identifying an appropriate adjustment rather than disregarding the structure.

The potential treatment by various countries is an additional source of concern. Some countries consider that the commercially rational test is intended to address only situations where there is no business purpose other than tax. A majority of OECD countries appear to endorse the view that it establishes a benchmark as to whether independent enterprises behaving in a commercially rational manner would have entered into a similar arrangement, potentially leading to a disregard of the structure.

The current position raises some significant questions that the USCIB asks for additional clarification:

- How much business and economic substance is required to have a restructuring accepted?
- Should Article 9 of the Model Tax Treaty permit tax authorities to challenge the restructuring itself?
- Do domestic anti-abuse rules apply and is it a MAP issue?

We appreciate the opportunity to participate in this process. We wish the OECD continued success in its efforts on this important topic.

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