<u>Comments On Discussion Draft on the Transfer Pricing Aspects of Business Restructurings (OECD Guidelines)</u>

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<u>Issues Note One – The Allocation of Risk</u>

Article 9 of the Model Treaty provides general guidance on the allocation of risk pursuant to paragraphs 1.26 – 1.29. The OECD in Issue Note One recommends looking to which related party has "control" or can make a decision/decisions on the management of risk. This language, like the language proposed by the U.S. Treasury and Internal Revenue Service on the newly Foreign Based Company Sales Income and Contract Manufacturing Regulations does not address real risk. Real risk is the assumption of risk and contractual obligation of risk as defined by intercompany operating agreements and contractual risk, not solely the management of risk. The management of risk is a service performed, not a risk assumed.

<u>Proposed Paragraphs 207-13 and "The Commercially Rationale Behavior Test" and Transfer Pricing Aspects of Restructuring</u>

Software and pharmaceutical firms that transform platform intangible property into second-generation intangible property in the midst of a business and Transfer Pricing Restructuring Program meet the "Commercially Rational Behavior Test" as long as either real business purpose or real business substance exists even though it is a byproduct of the restructuring and carry with it an attendant tax benefit. This conclusion is further substantiated by the OECD's enumerated statement "…that it considers that as long as functions, assets, and/or risks are actually transferred, it can be commercially rationale…for a multinational group to restructure in order to obtain tax savings". Multinationals that migrate platform intangible property to second generation intangible property in royalty favorable countries such as Ireland meet the "Commercially Rational Behavior Test" as long as they are attempting to maximize shareholder value and not just avoid taxes. For example, a software or pharmaceutical company that transforms software from series 1.0 to 2.0 and also maintains a manufacturing and distribution market in Ireland or the European Union do so strategically to maintain continuity between the R&D team and the manufacturing function and or to satisfy customers in the European market that demand Just- In -Time Delivery to reduce inventory costs to maximize their shareholder value. The second generation intangible property would be funded and developed in Ireland with all attendant functions and risks. The second generation intangible property would then be licensed back to the operating entities and the Irish entity would receive favorable tax rates on the royalty income compared to the U.S. and most of Europe. This restructuring is in stark contradiction to IP holding companies set up in "black listed tax haven countries" established purely and solely for the benefit of tax avoidance or tax minimization.

Location Savings - Proposed Paragraphs 207-13 and "The Commercially Rationale Behavior Test" and Transfer Pricing Aspects of Restructuring

Another example of tax minimization legitimately resulting as a byproduct of restructuring and the implications of Transfer Pricing can currently be seen in a slowing global economy. U.S. multinationals that utilize location savings in low-wage countries like Mexico may change their form of business structure or otherwise restructure for legitimate business purposes as exhibited by meeting the "Commercially Rational Behavior Test". This conclusion is further substantiated by the OECD's statement "…that it considers that as long as functions, assets, and/or risks are actually transferred, it can be commercially rationale…for a multinational group to restructure in order to obtain tax savings". Manufacturing operations in Mexico that are integral to maximizing shareholder value globally may be restructured with the elimination of risk, functions, and asset utilization out of necessity to increase global profitability levels through reduced manufacturing costs and ultimately resulting in minimize a multinational's effective global tax rate in the local country . The conversion of a firm exhibiting characteristics of a manufacturing firm via the elimination of the requisite risks, functions, asset utilization, and risk of loss may elected to restructure into either a Contract Manufacturing Arrangement with a guaranteed Cost Plus Arrangement or a Maquiladora which will result in most if not all cases a lower overall effective tax rate for its restructured Mexican operations.

Issue Note Four – Recharacterization of Intercompany Transactions/Non-Recognition of Transactions

Issues Note Four is over reaching and too expansive in its current form. The OECD should consider amending the proposed language. The OECD dramatically expands on the potential for tax authority recharacterization of intercompany transactions in a business planning and restructuring scenario. Firms that engage in restructuring for tax planning purposes may have their planning structure unwound by a over zealous desire of a tax authority to recharacterize an intercompany transactions that is subjective or ambiguous. For example, higher level services may be recharacterized as soft forms of intangible property resulting in royalty payments and potentially withholding taxes if no tax treaty applies. Multinationals would have to incur the additional expense of obtaining an Advanced Pricing Agreement (APA) or alternatively a ruling before entering into a complex planning structure that leaves too much subjective power to the tax authority to arbitrarily recharacterize intercompany transactions. Proposed OECD language seems to indicate that "it should not matter that arm's length parties do not enter into this type of transaction, nor that the transaction lacks commercial rationale which seems to contradict other aforementioned language of the Discussion Draft of "Transfer Pricing Aspects of Business Restructuring". The proposed language seems to expand discretionary authority of the tax examiners based upon existing guidance enumerated in 1.36-1.41 of the Guidelines.