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Transfer pricing Aspects of Business Restructuring

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Dear Mr. Owens,

VNO-NCW, the Confederation of Netherlands Industry and Employers, representing the large majority of small, medium and large enterprises in The Netherlands is pleased to respond to the OECD request to send comments on the Discussion Draft on the Transfer Pricing Aspects of Business Restructurings of 19 September 2008 (hereafter referred to as “the Draft”).

VNO-NCW observes that substantial work has been done, progress has been made on the Business Restructuring (hereafter referred to as “BR”) subject and generally supports the majority of conclusions made in the Draft.

VNO-NCW is concerned about ambiguity in the Draft, lack of consensus between OECD members and the inherent risk of double taxation. This concern is strengthened by the fact the Draft introduces new terms such as ‘profit potential’, ‘location savings’, ‘all alternative options realistically available’ and ‘commercial rationality’ without defining these terms; this creates uncertainty and increased risk of double taxation.

The solution to BR issues is founded partly on the presumption that extensive documentation *on legal entity level* of the pre- and post BR situation is available with the taxpayer; the existence of written contracts is seen as an important element. This results in an additional and unbalanced increase of the administrative burden of the taxpayer and, moreover, seems to indicate an increased focus on ‘form’ above ‘substance’. VNO-NCW also observes a confusion/misunderstanding, especially with regard to the difference between (i) the legal structure, relevant for taxation purposes and (ii) the

organizational structure creating the framework for a global MNE acting as one towards 3rd parties.
Finally, although the Draft is based on the existing TP Guidelines, VNO-NCW observes differences in for example the thresholds for reclassification of transactions.

The above will be explained in more detail in specific comments to the four Issues Notes.

ISSUES NOTE No. 1: SPECIAL CONSIDERATIONS FOR RISKS

The Draft states that risks are of critical importance in the context of BR and dedicates the first Issue Note to ‘control’ and ‘allocation’ of risks. Paragraphs 1.26 – 1.29 of the TP Guidelines are taken as starting point and the guidance provided on risk in Issue Note 1, is used as well for specific issues in Issue Notes 2-4. VNO-NCW observes that the Draft attributes an increased relevance to ‘risks’, and the ‘control’ thereof, compared to the TP Guidelines.

Contractual arrangements are the starting point for determining which party bears the risk. ¶25 of the Draft states that it is reasonable to expect related parties to document in writing their decisions to allocate or transfer risks before the transactions occur. VNO-NCW would like to comment that in practice there would be other means like internal policies or directives, by which the allocation and control of risks will be established. For instance, a contract may allocate a credit risk to a Party, this credit risk being significantly reduced in practice by the implementation of a policy, according to which the credit allowed for each client is limited to a fairly low amount.
In this context it is noteworthy that contracts between entities of a MNE only need to cover the essentials and in their detail can differ significantly from contracts between 3rd parties.

The Draft continues that in a situation where no comparable data exists on risk allocation does not mean that the arrangement is not at arm’s length. VNO-NCW strongly agrees with that, the more so because the current business restructurings in large scale MNEs are often specific and therefore not necessarily comparable.

In cases where no comparables are available, ‘control over the risk’ and ‘financial capacity to bear the risk’ are introduced as relevant factors to determine if the allocation of risks is at arm’s length. Where VNO-NCW generally can support this approach, it raises certain questions. ¶31 states that in order to control a risk, performance of day-to-day management is not necessary, as long as one is able to assess the outcome thereof. In the examples provided in the Draft the question is raised which party has the ‘greater control’. This could result in a discussion how the level of control of parties should be weighed to come to the correct allocation of risks. However,

it is the party that has the final control and responsibility over a risk that also assumes the risk for arm’s length purposes. Within a group, this control can be manifested through many instruments such as binding policies, directives and guidelines, authorization rules, operating boards and councils, limits etc. Indeed, such control instruments do not exist between independent parties. This only goes to prove that in identifying the arm’s length allocation of risks between dependent parties, it is not sufficient to look at the contractual agreements (which are the only measure that independent parties can rely on).” In terms of control and the allocation of risks, one has to distinct such control from the control of an ordinary shareholder.
To avoid doubt, VNO-NCW requests OECD to reconfirm that only risks relating to the corporate structure and related contracts between legal entities are relevant for tax purposes, not the organizational structure that allows to MNE to function as one. This distinction is a pillar of the 1995 Transfer Pricing Guidelines.

As to comments requested from the business after ¶34, VNO-NCW notices that there could be valid reasons to have certain functions continue to be carried out by the transferor, particularly where the transferee adds value as a consequence of combining certain risks of a large group of transferees. For instance establishing a supply chain entrepreneur in one location for a large group of companies, where the transferors would support the transferee with certain functions.

Review of accounting statements are considered as source of information for determining whether the risk is economically significant. Although VNO-NCW agrees that the financial statements might be indicative for (the significance of) the risk as such, the relevance of financial statements for these purposes should not be overestimated. The financial statements have a different purpose and could for MNE groups have materiality levels that do not necessarily match with the term ‘significant’. Indeed, financial statements are governed by strict rules in terms of materiality levels and probability of the risk’s materializing. These thresholds may not be relevant within the framework of a Transfer pricing analysis. This is even more so because costs of a risk reflected in the profit & loss account of financial statements are the (end) outcome of managing the risk. Using ex-post costs as measurement is therefore not an indication of how significant the risk is or has been. An example is management of obsolete risks, where the real obsolete costs can be much lower than the potential risk the MNE needs to manage. Moreover, one has to recognize that many risks that are inherent in a business are not capable of quantification and would not normally be represented in financial statements.

ISSUES NOTE No. 2: ARM"S LENGTH COMPENSATION FOR THE RESTRUCTURING ITSELF

In line with the comment above **VNO-NCW observes that through the report new terms are used without a clear definition. This could result in divergent interpretation of these terms between countries, which could result ultimately in double taxation**. Therefore, VNO-NCW would welcome a clear definition of these terms. An example of a new term that requires a clear definition is the term 'profit / loss potential' that is used in the introduction of Issues Note No.2. Although in ¶93 'profit / loss potential' is used as an example of 'goodwill' it assumed that these terms are not synonymous.
VNO-NCW questions the reasonableness, mentioned in ¶53, for the taxpayer to document:

- anticipated synergy gains at the time the restructuring is decided upon or implemented;
- on which assumptions they are anticipated;
- to provide an analysis of the effects of the restructuring on each affiliate or taxpayer (costs and benefits);
- assessment of the other options realistically available.

The information and documentation available on which the BR-decision is taken should be sufficient for the authorities as well.
Beside the general trend that the documentation burden of taxpayers is increasing sharply, there seems to exist some misunderstanding with respect to the way MNEs operate. Most importantly the organizational structure of an MNE follows in many cases the business axis and can be truly global. Restructurings will be initiated based on perceived global needs and expected efficiency gains. This implies information on effects of a restructuring is not automatically readily available at legal entity level. This is even more the case for an assessment of the other options available per legal entity. **If business would be required to evaluate and document every possible option for each legal entity, and do extensive pre- and post analysis for each affiliate, the business processes would be severely hampered.**

Although VNO-NCW also recognizes the needs of tax authorities to be informed in respect of restructurings affecting the tax payers in their jurisdiction, it is stressed that the transactions composing the restructuring should be leading and not the available documentation. As stated above, the availability or absence of certain documentation should not be in anyway an indicator that a certain transaction is at arm's length or not. The principle of substance-over-form should be re-affirmed in this respect. **VNO-NCW asks for a more balanced approach on the topic of documentation that recognizes the increasing compliance burden of taxpayers in respect of preparation of documentation on legal entity level.** Furthermore, because only in very limited number of transactions one allows a "compensation" clause where afterwards one re-assesses the outcome, a comparison with actual effects should therefore not be standard but only applied where that is common in the market. The more so because **VNO-NCW, in line with the TP Guidelines as referred to in ¶55, is of the opinion that using hindsight must be avoided.** Consequently the re-assessment of transactions described in ¶56 and in ¶87 raises concerns because this could in practice result in many difficult discussions where the use of hindsight will play an undesired role.

VNO-NCW notes that the concept of 'options that would have been realistically available to the restructured entity' raises serious concerns. In a MNE with a (large scale) business restructuring it may not be realistic to assume that each alternative is being explored on a legal entity level. More and more decisions are taken based on a multi country approach without looking at each country independently. In case more than a few affiliated companies participate in a business restructuring this creates potential for significant disputes with multiple tax authorities.

Moreover, each legal entity is free to organize its business as it sees fit and is not obliged to demonstrate that it has implemented the "best option".

Indeed, first of all, the answer to the question on whether an option is "the best one" may largely depend on the duration over which it is considered and on many factors, which are unknown at the time of the decision. Therefore, this discussion may lead to very different views and result in double taxation.

Secondly, in practice, the decision of implementing a Business restructuring depends on many financial but also non financial factors, which may be very difficult to assess.

Therefore, the key question is not what options could have hypothetically been implemented but whether the BR which has been actually implemented is arm's length. Naturally, within this framework, the pricing agreed by the parties is absolutely key.

The starting point laid down in ¶64 that the arm's length principle does not require compensation for profit / loss potential *per se* is supported. Only the transfer of rights or assets may be compensated at the time of the restructuring.

The profit / loss potential is not compensable *per se* and should only be a factor to take into consideration when valuing the rights/ assets, which are transferred within the framework of the BR. Moreover, when performing such a valuation, it is important to keep in mind that the profit/loss potential, which is transferred depends naturally on the assets which are transferred but also on the functions and risks that the transferee will perform and assume in the future. Now, the transferor has not to be compensated for such a transfer of functions and risks, since the transferee will assume them.

In other terms, although the potential profit/loss may be considered to a certain extent within the specific framework of the valuation of the assets, which are transferred, it is important to take into account that the transfer of the profit/loss potential depends on many other elements than the transfer of assets, other elements for which the transferor has not to be compensated for.

§65 states that *"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 […] the future profit/loss expectations in relation to the risk at hand."* However, one might consider that the transfer of profit / loss potential which would result from a transfer of a risk to be assumed in the future by the transferee may not have to be compensated for.

For instance, within the framework of the conversion from a distributor operating at its own risk to a low risk distributor involving the transfer of the Credit and collection risk to the supplier, the profit/loss potential associated with the transfer of this risk should not be compensated for.

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VNO-NCW recognizes the point made in ¶95 that a restructured entity can also be saved from becoming 'loss-making', which could deliver a benefit to the restructured entity, and adds that the goal of the restructuring can be to ensure that the restructured entity remains competitive, i.e. to be able to stay in business. The example of 'outsourcing' in ¶98 is fully in line with this.

The starting point of ¶101 that there should be no presumption that the arm's length principle requires indemnification for all contract terminations or substantial renegotiations is supported. The described analysis to conclude whether compensation is required for a restructured entity again raises the concerns stated above about the reliance on available documentation including specific termination clauses. Further VNO-NCW observes that some of the examples could certainly raise discussions, e.g. in ¶107 where 'implicit longer term contract should be implied', that potentially result in double taxation. In this respect also the example of ¶122 is not quite clear. Why should P bear the costs if it seems to be implied that somewhere else in the group there will be a benefit, but not with A en C. This could only be the case if it is clear that this benefit would be with P.

ISSUES NOTE No. 3: REMUNERATION OF POST-RESTRUCTURING CONTROLLED TRANSACTIONS

VNO-NCW supports the general conclusion that the arm's length principle and the TP Guidelines do not and should not apply differently to post-restructuring transactions as opposed to transactions that were structured as such from the beginning. As stated before VNO-NCW is concerned about the trend, also present in this Draft, that extensive documentation by the taxpayer is the solution for everything. The required comparability (including functional) analysis to be performed both for the pre-restructuring and for the post-restructuring arrangements as well as the actual changes that took place put a heavy administrative burden on the taxpayer. Especially, the fact that the Draft mentions many examples that the restructured entity is not necessarily in the same position as a 'structured entity' makes it very difficult, if not impossible, to find third party comparables. In any case if the taxpayer prepares extensive documentation it would be reasonable, also based on the concept of the burden of proof, to explicitly state in the Draft that generally deference would need to be given by the tax authorities to documentation prepared.

With regards to the Paragraph C5, the Example related to the "*implementation of a central purchasing function"* seems to suggest that procurement savings should be split between the participating units. VNO-NCW note that the sharing of costs and savings will very much depend on the facts and circumstances of the case. For many MNEs it is difficult to identify comparable structures or transactions between independent parties. The legal and operational aspects of establishing and maintaining such structures with third parties seem prohibitive, certainly cross border. Moreover, the rationale for an operating unit within an MNE to enter into such procurement structure could involve other arguments than the mere reduction of prices. For instance, an MNE may decide to enter into such structure to avoid having to invest in the knowledge about and expertise for a certain commodity or raw materials market. Obviously the transfer price must be at arm's length and will take these as well as other facts into account. VNO-NCW very much agrees with the statement made in par. 175 that *no inference should be drawn ... that the positive effects of synergies should always be shared amongst the members of the grou*p."

In respect of the discussion on location savings and their attribution to the parties involved in a business restructuring, it is not clear how the Draft views the status of the so-called "bargaining power" as referred to in ¶189, in relation to the 'bargaining theory' or 'Shapley valuation'?

With regards to the most reliable method in cases where there are significant non-benchmarkable contributions, VNO-NCW supports the view that the transactional profit-split method may be appropriate and, more generally the guidance stated in § 1.26 and 1.27 of the OECD Guidelines.

With regards to the Location savings, the fact that activities are transferred to a low-cost jurisdiction does not constitute an asset per se. Such transfer may take place to reduce the cost price of a product necessary to remain efficient and cost competitive. In a 3rd party relationship the transferee would typically not compensate the transferor. The same should apply for a transaction within a MNE.

Also, further details on the example described in §193 would be welcomed. In particular,
it is not clear how the subsidiary in Country Y, which has just been put in place, could have developed engineering services which would be so specific that it would be the only one to be able to provide them. It's true that the subsidiary could have developed valuable intangibles, but only over time, and not within the framework of the business restructuring.

ISSUES NOTE No. 4: RECOGNITION OF THE ACTUAL TRANSACTIONS UNDERTAKEN

VNO-NCW strongly emphasizes that MNEs are free to organize their business as they see fit. This does not mean that apparent wholly artificial structures should not be questioned, but tax authorities should be very restrictive in challenging the structures used. Apart from the specific situations as described in paragraphs 1.36-1.41 of the TP Guidelines, discussions on the arm's length nature of a BR should only relate to pricing of the transactions.

VNO-NCW observes that the concepts of 'commercial rational behavior' and the questions on what constitute 'exceptional cases' are far from crystallized and is particularly concerned about the divergent view existing among OECD Members such as mentioned for example in ¶207 and ¶216. These divergent views and interpretable concepts in practice result in uncertainty and potential double taxation, exactly what business aims to avoid. This is all the more a concern since different or vague interpretations by Tax Authorities result in Tax payers not being allowed access to MAP or arbitration. This is only possible if there is a conflict with terms of the treaty. This can be resolved by a re-draft of art. 25-1 of Model Treaty by including a reference to "double taxation caused by treaty allocation rules" in addition to conflicting views.

In respect of ¶211 it is stressed that BR often lead MNE groups to implement global business models that are unique and which may not be observed between non-integrated independent parties. ¶212 states that it can be commercially rational for an MNE group to restructure in order to obtain tax savings, which in a strive to maximize efficiency and competiveness is very clearly recognized from a business perspective

VNO-NCW shares the view as described in ¶213 that the 'commercial rational' test should be applied for the MNE as a whole, whereby the transactions resulting from the BR should of course be at arm's length for the involved legal entities. If functions, assets and / or risks are transferred non-recognition is therefore not possible and any discussion should be limited to the pricing of the transactions.

CONCLUSION

VNO-NCW appreciates the opportunity to present its views on the Discussion Draft on the Transfer Pricing Aspects of Business Restructurings, especially since a common and consensus approach in this area is essential in a rapidly globalising world.

The commonly agreed and consensus approach is required to provide some certainty to both Taxpayers and Tax Authorities to avoid not only double taxation but also non-deduction of costs incurred.

Yours sincerely,

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International Tax Committee

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