February 18, 2009

Via Email: jeffrey.owens@oecd.org

Mr. Jeffrey Owens
Director of OECD
Centre For Tax Policy And Administration

Re: 2008 Business Restructurings Discussion Draft

Dear Mr. Owens:

I. Introduction

This letter is in response to the request of the Centre for Tax Policy and Administration of the Organisation for Economic Co-Operation and Development ("OECD") for comments on the September 19, 2008 Transfer Pricing Aspects of Business Restructurings: Discussion Draft for Public Comment ("Restructurings Discussion Draft"). As is explained in a preface to the Restructurings Discussion Draft, it only covers transactions between related parties in the context of Article 9 of the OECD Model Tax Convention on Income and on Capital (the "OECD Model") and the Commentary thereunder. Thus, the Restructurings Discussion Draft does not address the attribution of profits within a single enterprise on the basis of Article 7 of the OECD
Model; the OECD will address that separately. As further explained in the preface, the Restructurings Discussion Draft is based on “the existing transfer pricing rules.”¹ The preface explains that restructurings involve primarily the application of transfer pricing rules, whether before, after, or upon the restructuring in question.

This letter sets forth the comments of the Transfer Pricing Discussion Group on the Restructurings Discussion Draft. By way of background, the Transfer Pricing Discussion Group consists of U.S. and foreign-based multinationals in numerous industries.² Participants in the Group have a wide range of activities, including research and development, licensing, manufacturing, distribution and services of various types. The Group meets regularly to discuss matters directly and indirectly related to transfer pricing. From time to time, the Group submits comments on governmental proposals as well as those of the OECD. The Group submitted comments to the OECD on the January 25, 2008 Transactional Profits Methods Discussion Draft for Public Comment and participated in the OECD Consultations on that and other related subjects in November 2008. The Group congratulates the OECD on its work, and the process it chose, for the transactional profits methods project.

The Transfer Pricing Discussion Group concurs with the OECD observation in the preface of the Restructurings Discussion Draft that restructurings can raise difficult transfer pricing and other issues for which there is currently insufficient OECD guidance.

¹ Restructurings Discussion Draft, p. 2.
² As members of the Group are not principally engaged in the banking industry, its comments do not focus on issues within that industry.
under both the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the “OECD TP Guidelines”) and the OECD Model.

The Group commends the Joint Working Group and Working Party No. 6 for their efforts in producing the Restructurings Discussion Draft. The Group believes that the Restructurings Discussion Draft is a constructive document that heads in the direction of achieving the OECD goals of reducing the level of uncertainty and increasing the amount of guidance. Furthermore, the Group endorses many of the substantive transfer pricing principles about restructuring expressed in the Restructurings Discussion Draft.

The Group welcomes the request of the OECD for public comments on the Restructurings Discussion Draft and intends for the Group’s comments in this letter to further enhance OECD guidance on this subject. The Group encourages the OECD to consider having a Consultation, like the recent one for transactional profits methods issues, at which a panel of private sector representatives, members of governments, and the OECD can discuss written submissions and further clarifications or other improvements suggested for the Restructurings Discussion Draft.

The Group’s comments focus initially on the main topic of the second of the four Issues Notes in the Restructurings Discussion Draft: the arm’s-length compensation for the restructuring itself. The Group believes this topic is a critical one.
II. Comments on Issues Note No. 2

A. Causing Realization: The Roles of Domestic Law and the OECD Model

As its first recommendation, the Group suggests that OECD clarify the roles of domestic law and Article 9 of the OECD Model in determining the types of restructurings that (a) may result in the realization of income and (b) to which Article 9 of the OECD Model can apply to determine the amount of compensation due to one or more related parties involved.

The OECD TP Guidelines do not address the issue of what rules and factors cause income to be realized\(^3\) and therefore be subject to the OECD TP Guidelines when related parties are involved. Likewise, the Restructurings Discussion Draft does not directly address the issue of what legal standards cause income to be realized in a restructuring, although it does contain observations that are relevant to this topic.

In contrast, the 2008 Commentary on Article 7 of the OECD Model clearly acknowledges that before its principles can apply:

1. income must be realized;

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\(^3\) For U.S. tax purposes, income must be realized and recognized to be taxable and for U.S. transfer pricing rules to apply. This letter treats the OECD's use of the term "realisation" as being consistent with the combination of realization and recognition for U.S. income tax purposes. However, it would be useful for the OECD to explain what it means by "realised" to assure that there are no misunderstandings. It should be noted that U.S. domestic transfer pricing rules can cause certain transactions between related persons for which income is realized, but not otherwise recognized, to be recognized and subject to the application of the transfer pricing rules. Other countries' transfer pricing rules may operate differently.
2. realization is determined under a country's domestic law; and

3. the standards for realization will vary from country to country.

Fourth, while Article 7 may permit a state to exercise its domestic law to cause the realization of income, Article 7 does not, in certain jurisdictions,\textsuperscript{4} itself trigger the realization of income for any particular transfers otherwise within the scope of Article 7.

There may be a realisation of a taxable profit when an asset, whether or not trading stock, ... is transferred ... Article 7 allows [a state] to tax profits deemed to arise in connection with such a transfer. ... In cases where such transfer takes place, whether or not it is a permanent one, the question rises as to when taxable profits are realised. ... However, the mere fact that the property leaves the purview of a tax jurisdiction may trigger the taxation of the accrued gains attributable to that property as the concept of realisation depends on each country's domestic law.\textsuperscript{5}

Although Article 7 does not necessarily cause income to be realized, it can limit a state's ability to attribute profits to certain, and only certain, internal transfers with respect to which domestic law determines that income is realized. Thus, the ability of Article 7 to impose a minimum or threshold for realization and reallocation under Article 7 is an important fifth principle. For example, if a state's domestic laws require income to be realized in connection with the purchase of goods, paragraph 5 of Article 9 can preclude that state from attributing and reallocating profits to that activity and taxing them.

\textsuperscript{4} Article 7 does not necessarily require realization in countries, such as the United States, that permit a taxpayer to choose the more favorable of its internal tax law or the provisions of a tax treaty and, likewise, do not allow the tax authority to impose a treaty provision that is unfavorable to the taxpayer compared to domestic law.

\textsuperscript{5} Commentary on Article 7, paragraph 21. (Emphasis supplied.)
To illustrate the significance of domestic law and of differences in approaches taken by countries, the Commentary to Article 7 refers to countries that may levy tax on a transfer internally (within a single legal entity) as soon as it is made, even though the profits are not actually realized until a subsequent year. The Commentary observes that there can be a serious over-taxation problem due to the difference in time between when the tax is imposed by one country on the outbound transfer, compared to the subsequent time when in the other country profits relevant to the inbound receipt are actually realized.\(^6\)

Part of Article 7's role is to have thresholds or other provisions to reduce the circumstances in which conflicts in domestic laws on realization can create over-taxation.

The Group recognizes that the portion of the Commentary discussed above addresses Article 7 and that the \textit{Restructurings Discussion Draft} focuses on Article 9 rather than on Article 7. However, the issue of when income is realized exists and is important under both Article 7 and Article 9. As discussed above, the OECD Model transfer pricing principles, whether under Article 9 or under Article 7, do not apply to determine the amount of income the particular related party has until such income is realized. Neither Article 9 nor Article 7, nor the OECD TP Guidelines, purport to cause income to be realized; that is the province of a country’s domestic law, at least in the first instance. However both Article 9 and Article 7 can, and should, use thresholds to reduce conflicts between domestic laws that otherwise can create double taxation and over-taxation.

\(^6\) Commentary on Article 7, paragraph 22.
The Group strongly recommends that the OECD clearly set forth the above five principles for purposes of addressing restructurings and other situations under Article 9 (and set forth the first three for purposes of, and in, the OECD TP Guidelines).

These principles are relevant to clarifying various aspects of the Restructurings Discussion Draft, such as Example (A): Conversion of a full-fledged distributor into a “risk-less” distributor in Issues Note No. 4. The example explains that certain countries under certain circumstances would not, under their interpretations of the “arm’s length principle,” accept an intra-group sale of corporate “crown jewels” even if there is arm’s length consideration and the form of the restructuring is consistent with the conduct of the parties. Likewise, Example (B) and Example (C) in Issues Note No. 4 comment on what positions “most OECD countries” and the “vast majority of OECD countries” would take in the facts of the two examples. The examples do not address, but should, whether the views of such countries are consistent with: (1) the OECD TP Guidelines (the Group believes the OECD TP Guidelines are not consistent with certain countries’ views in Examples (A) and (B)); and (2) Article 9 of the OECD Model (the Group believes the proposed reallocations in Examples (A) and (B) would be inconsistent with, and should be precluded by, Article 9).

While domestic laws can differ from each other, there should be clarity on what the position is in the facts of these and other examples under the OECD TP Guidelines and

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7 Restructurings Discussion Draft, paragraphs 214-216.
8 Restructurings Discussion Draft, paragraphs 217-219 and 220-221, respectively.
9 The countries at issue would not accept the transactions as structured and implemented.
Article 9 of the OECD Model. Thus, the Group recommends that these and other portions of the Restructurings Discussion Draft be revised to address clearly the roles of domestic law, the OECD TP Guidelines and Article 9 of the OECD Model, and to provide that the principles of Article 9 preclude reallocations under domestic law that are in violation of the OECD TP Guidelines.

B. Realization: The Recommended Minimum or Threshold for the OECD Model

As discussed above, Article 9 of the OECD Model does not necessarily trigger the realization of income to which the OECD Model’s transfer pricing principles can then be applied. However, Article 9 can and should adopt a minimum standard or threshold for the sorts of restructuring transactions that can cause the realization of income under domestic law and the OECD Model, and that then can be adjusted by a reallocation of income under Article 9. Of course, any such reallocation would have to be subject to the arm’s length principle of Article 9 and the OECD TP Guidelines.

The Group recommends that the OECD express the minimum threshold of realization authorized under Article 9 and the OECD TP Guidelines in terms that are as clear and unambiguous as is possible. More specifically, the Group recommends that if, but only if, the domestic law of a state requires the realization of income for a restructuring, then in order for that restructuring to be taxable and adjustable by a reallocation under Article 9, it must involve the transfer of “Property”. The Group recommends that Property be defined to include only the following:
1. Tangible assets;

2. Intangible assets such as patents, trademarks, trade names, designs or models, as well as copyrights of literary, artistic or scientific work and intellectual property such as know-how and trade secrets that are legally protected and commercially transferable; and

3. Contracts containing rights that are commercially enforceable.

The *Restructurings Discussion Draft* mentions the above items and appears to be in agreement with the above definition. For instance, the Group believes the *Restructurings Discussion Draft* does not intend for a mere transfer of risks or functions to be a restructuring that potentially requires compensation; the transferor must have the enforceable contractual right to retain and exercise the risks or functions. The Group agrees in this regard with the following statement in the *Restructurings Discussion Draft*:

> 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 profits/loss potential *per se.*

Unfortunately, other parts of Issues Note No. 2, as well as parts of Issues Notes Nos. 1 and 3, are not as clear as the above statement and can be read, hopefully incorrectly, to suggest that a mere transfer of functions and risks, that are not contractually protected, might also constitute a restructuring that can require compensation under Article 9 of

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10 *Restructurings Discussion Draft*, paragraph 64. (Emphasis supplied.)
the OECD Model. More generally, the Restructurings Discussion Draft can be read to suggest that other non-Property “transfers” between related persons might also constitute restructurings and potentially require compensation.

For instance, the Group recommends that the OECD clarify an example contained in paragraphs 73-77 of the Restructurings Discussion Draft. The example is intended to illustrate some of the issues that can arise in valuing raw material and finished products that are transferred as part of a restructuring. The example suggests three possible approaches to determining the value, all three of which involve understanding matters such as conditions, functions and risks. However, the example does not state whether the company that used to operate as a “fully-fledged” manufacturer and distributor, and that transferred the raw materials and inventory, had enforceable contractual rights (e.g., exclusive rights) under the prior arrangement to operate as a “fully-fledged” manufacturer and distributor. If not, then the transferor should not be compensated for the raw materials and inventory by using an arm’s length price that includes a return on, for example, marketing activities and marketing intangibles of the transferor. Thus, the example omits facts central to understanding the conditions and risks, if not also the functions.

This is in contrast to an earlier example in the Restructurings Discussion Draft that starts out by stating that “a related party distributor is operating at its own risk under a

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11 See, for example, paragraph 49 of the Restructurings Discussion Draft.
long-term contractual arrangement ... ." Thus, the Group recommends that the example beginning at paragraph 73 state whether or not the "fully-fledged" manufacturer and distributor had a long-term contract with enforceable rights and, depending upon the OECD's choice of facts, revise the remainder of the example accordingly. The Group believes that if in a revised example the manufacturer and distributor did not have a long-term contract with enforceable rights of value, then the only transfers in the restructuring for which a treaty containing Article 9 should permit local law to require realization, allow a reallocation and impose tax are the transfers of the raw material and finished products. And, these tangible property transfers should be priced as suggested in the preceding paragraph.

An example of the need for more clarity on this point in other parts of the Restructurings Discussion Draft is found in Issues Note No. 3. That Issues Note refers to restructuring a "long established" full-fledged distributor into a limited risk distributor. Again, to avoid unintended inferences from being drawn, this should be revised to refer to a full-fledged distributor operating as such under a long-term contract conveying enforceable rights.

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12 Restructurings Discussion Draft, paragraph 68. (Emphasis supplied.) As is explained below, this example should also state that the distributor had exclusive or other enforceable rights to market and sell the products in question.
C. Realization: Significance of Commercial Law

The Group concurs that it is necessary to consider whether commercial legislation or case law provides indemnification rights.\textsuperscript{13} The Group endorses the OECD statement that there “should be no presumption that all contract terminations or substantial renegotiations should give a right to indemnification at arm’s length.”\textsuperscript{14} The Group notes, however, that the current discussion of commercial legislation and case law is essentially limited to one paragraph and recommends that this discussion be expanded. This is an essential element of the analysis of whether certain restructurings between related parties can be taxable and subject to reallocation under Article 9 because they involve a transfer of Property. This expansion can usefully be done by, among other things, adding examples based on actual court cases illustrating important commercial law principles, such as cases in which one party sues the other for damages in connection with contractual disputes, whether infringement, termination, or restructuring. The Group offers the following two examples which are based on a U.S. District Court decision.\textsuperscript{15}

Example 1

A and B enter into a master agreement under which A appoints B to be A’s exclusive marketing agent with respect to all units of Data Access Storage Devices (“DASDs”) in A’s inventory. After the master agreement between A & B expires, B contracts with A to purchase 48 DASDs at

\textsuperscript{13} Restructurings Discussion Draft, paragraph 102.
\textsuperscript{14} Restructurings Discussion Draft, paragraph 101.
$20,000 each. B has a customer, C, that wants to acquire these 48 DASD units. A few weeks later, A sells to B only 21 of the DASD units, claiming that the additional 27 are not in fact available. B sells the 21 DASD units to C. B subsequently sues A for the $80,000 in “lost profits” relevant to the additional 27 DASD units that A had agreed to sell to B and that B had offered to sell to C.

**Held**, because A and B had a contract setting forth a specific product, the price and the quantity, and because their agreement was not conditioned on the availability of the 48 DASD units to A, A must under the applicable commercial law pay B “expectancy damages” (i.e., for B’s lost profits on the 27 DASD units B could have sold to C).

**Example 2**

A and B enter into a contract under which A appoints B to be its exclusive remarketing agent with respect to two DASDs that A purchases from B and then leases to C for 24 months. At the time when A and B enter into their agreement, A and B believe that towards the end of its lease C will trade-in the two DASDs it leases from A for newer models that would, after the trade in, then be remarketed to another customer. A and B agree in their contract that as compensation for B’s remarketing services with respect to the two DASD units first leased to C and then traded in by it, A will pay B a fee equal to 5 percent of A’s remarketing proceeds.

Toward the end of C’s two year lease, A, without B’s knowledge, markets newer model DASDs to C. C then trades in to A the two DASDs that C had earlier leased from A. In the exchange, C leases from A two newer model DASDs. A then remarkets the two older DASDs A received from C in the trade-in to another customer and receives $8.8 million in proceeds from the remarketing. B sues A for the 5 percent fee, equal to $440,000, that B claims is due to it on A’s proceeds derived from remarketing the older DASDs to a new customer.

**Held**, B is not entitled under the applicable commercial law to the 5 percent fee because B played no role in procuring the DASD trade-in of the two units originally leased to C or in remarketing these units to another customer. Moreover, an “exclusive” agency does not bar the principal, A, from itself dealing directly with customers; it only bars A from appointing a person other than B as A’s agent. The contract between A and B did not confer upon B the exclusive right to sell the DASDs.
As the above judicial analyses of actual third party contracts illustrates, in order for there to be a sustainable claim for damages because one party allegedly infringed on the commercial rights of another, the party claiming damages must have clear, specific and enforceable rights. This is the case in Example 1. On the other hand, and as illustrated in Example 2, it is not sufficient, at least in the United States, to sustain a claim of damages merely because one party “takes over” the functions, assets or risks that the other party would have, or could have, carried out, held or taken. The second party must clearly have the right, to the exclusion of all others, to carry out the functions, own and employ the assets, and bear the risks.

The Restructurings Discussion Draft appears to support the view that these same contract law principles should apply to an analysis of whether one affiliate is entitled to damages (i.e., income) under Article 9 and under the OECD TP Guidelines (and whether the other affiliate is entitled to claim a deduction under Article 9 or the OECD TP Guidelines for its payment of the damages), when there is a restructuring. However, it would be helpful if the OECD TP Guidelines and the Commentary for Article 9 stated definitively that: (1) if, under contract law principles, a particular restructuring between affiliates would trigger a sustainable claim for damages, then it is appropriate for there to be income (and deductions) with respect to the restructuring under the OECD TP Guidelines and Article 9; and (2) conversely, if such a restructuring between affiliates would probably not give rise to a sustainable claim for damages under the applicable
commercial law, then it is not appropriate for there to be income, deductions or a
reallocation under Article 9 or the OECD TP Guidelines.

Thus, if a tax authority, under its domestic tax law, proposes to reallocate income
between two affiliates in circumstances similar to those of companies A and B in
Example 2, then the Group believes that the taxpayer should be able to rebut this
proposal. It would argue that the proposed adjustment is, first, in conflict with the arm’s
length standard as expressed in the OECD TP Guidelines, particularly if clarified as
suggested by the Group in this letter. Secondly, if there is an income tax treaty based
on the OECD Model in force between the countries in which A and B reside, then the
taxpayer should be in a position to assert that such a proposed allocation must be
withdrawn as it is in violation of Article 9 as discussed in this letter.

Conversely, if two affiliates find themselves in circumstances similar to those of
companies A and B in Example 1, then they should know, based on OECD guidance,
that A should compensate B for their restructuring. However, if compensation is not
provided, and under the domestic tax law of B’s country income is realized because of
the restructuring and can be reallocated, then Article 9 and the OECD TP Guidelines
should not preclude this from occurring.

The Group supports this reading of the Restructurings Discussion Draft and believes
that it should be clarified to emphasize these principles and to illustrate them through
real life examples and explanations such as the ones set forth above.
D. Realization: The Role of the Terms of a Related Party Contract

The Group believes that it is problematic to second guess whether the terms of a related party contract are mirrored in contracts between third parties in similar circumstances and, if not, should in essence be reformed by a taxing authority to provide terms other than what the related parties actually agreed upon and followed in practice. The Restructurings Discussion Draft provides an example where a related party is required to make a significant investment “for which an arm’s length return might only be reasonably expected if the contract was maintained for an extended period of time.” The OECD then suggests that where the risk was material, the parties should have demanded a term for the contract that matches the period of time needed to recover the investment as well as an indemnification right in the case of earlier termination by the counter party.\(^\text{16}\)

The Group understands the concerns that led the OECD to include this example, but believes it wrongly addresses the significance of the length of time of the third party contractual arrangements and should not try to impose a length of time for the related party contract other than what was agreed upon. Instead, the focus should be on the amount of the related party compensation and whether at arm’s length it should have involved higher annual amounts or up-front compensation, given the length of its term.

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\(^{16}\) Restructurings Discussion Draft, paragraph 108.
Tax authorities should be strongly discouraged from assuming or speculating about what contractual terms and conditions, such as the number of years of a contract’s term, “would have been reasonable” for independent parties to agree upon, particularly on the basis of hindsight. Instead, the OECD should continue to follow and emphasize the traditional and sound rule that when related parties enter into a contract that they implement consistent with its terms, then that transaction or structure should be accepted for tax purposes. Of course, the amount of related party compensation should be at arm’s length under the OECD TP Guidelines and Article 9.

Thus, the Group is also troubled by the inquiry in Example (B) of Issues Note No. 4 as to whether there is “reliable evidence” that third parties structured the ownership of brand names and attached risks in the same manner as did the controlled entities in the example. The example says that the absence of “reliable evidence” of similar third party structures could be a basis for “most OECD countries” not to recognize the related party agreement as it was structured contractually and implemented. The Group believes that such rejections of structures by OECD member countries are inconsistent with, among other things, (1) the OECD standard that respect should be given to related party contracts that are implemented consistent with their terms; and (2) the OECD’s acknowledgement that related parties enter into transactions that independent parties might not, in part because the related parties “face different commercial circumstances than would independent enterprises.”17 In fact, the OECD TP Guidelines go on to

17 OECD TP Guidelines, paragraph 1.10.
acknowledge that "the owner of an intangible may be reluctant to enter into licensing arrangements with independent enterprises...". This expression of tolerance in the OECD TP Guidelines for related party transactions that differ from third party structures is in sharp contrast with the statement in the Restructurings Discussion Draft that "most countries" would not, under their domestic laws, accept the related party licensing arrangement described in Example (B). The Group recommends that the OECD TP Guidelines and Commentary for Article 9 clarify that the OECD's standards conflict with such potential positions under domestic laws.

A careful examination of how unrelated parties allocate product liability risks reveals other difficulties with attempting to determine and demand conformity with the terms and conditions that third parties adopt. Third parties use many different contractual approaches to product liability and other matters.

Product liability is, for example, an emerging issue in licensing agreements. Typically third parties hold each other harmless in licenses unless one party is at fault. Liability costs may be shared using a set percentage, or based on the liability if it can be traced to pre-licensed events (with the licensor paying the costs) or post-license events (where the licensee pays the costs). One recent related party license provides that if it cannot be determined which party was at fault, then the damages and costs are divided 80/20 between the licensee and licensor, respectively. Provisions on product liability insurance may also be included.
Even with these different contractual risk allocations, in the event of a product liability claim, both the licensor and the licensee will be sued, and fault is often difficult to assess. Because of the uncertainties in litigation, risk may be greater than anticipated.

The differing allocations of product liability amongst third parties illustrates that tax authorities should not attempt to base their evaluation of whether related party contractual terms and conditions should be respected based on whether the related parties followed one or the other of the numerous ways that unrelated parties define their contractual terms on similar items. Instead, these differing marketplace allocations of risk reinforce the wisdom of tax authorities accepting related party terms and conditions, whether concerning risks or other matters, based on whether the affiliates follow them in practice. This is a much more straightforward, administrable and conceptually sound approach. Transfer pricing rules and Article 9 should adjust compensation, not the terms and conditions that affiliates adopt and follow.

Thus, returning to the OECD example mentioned above, the Group respectfully suggests that the transaction between the affiliates and the conditions of the contract, including the length of its term, should be respected. However, there may well be a basis for a tax authority to argue, based on marketplace transactions, that at arm’s length the compensation would have been greater with such a short term, or have included upfronts, and to reallocate income accordingly.
These comments from the Group are relevant to paragraphs 108-114 of the *Restructurings Discussion Draft*.

**E. Realization: Concluding Comments**

Consistent with the above recommendations, the Group agrees with the OECD statements concerning the transfer of goodwill, but only in circumstances in which there is in fact a transfer of a bundle of assets that includes tangible and intangible Property (as defined here). Goodwill should not be taken into account merely on the transfer of an activity or a risk and the Group recommends that the OECD make this clear.

The Group concurs with the *Restructurings Discussion Draft*’s statement that when a party voluntarily decides to undergo a restructuring of a business in exchange for the savings anticipated with having another more efficient or lower cost person undertake the same activities, there is no need for any compensation to the transferor. A common example of such a situation involves the creation of a global or regional center for services, such as back-office administrative operations, for affiliates. The OECD has discussed service centers in related contexts such as Chapter VII of the OECD TP Guidelines and the 2008 changes to the Commentary on Article 7. However, it would be useful if the OECD clarified that the creation of a service center, or adding certain

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18 The OECD recognizes that it is common for the provision of services to be “merely part of the general management activity of the company taken as a whole” and as such “it would usually be appropriate to treat the cost of providing the services as being part of the general administrative expenses of the enterprise as a whole which should be allocated on an actual cost basis ... without any markup to represent profit to another part of the enterprise.” Commentary on Article 7, paragraph 37.
services to an existing service center, is not the type of restructuring for which
compensation should be required between affiliates.

Such clarifications for service centers also would be consistent, in certain fact patterns,
with the statement in the Introduction to the Restructurings Discussion Draft that:

The OECD considers that as long as functions, assets and/or risks are
actually transferred it can be commercially rational from an Article 9
perspective for an MNE group to restructure in order to obtain tax
 savings.\textsuperscript{19}

Another commonplace “restructuring” involves a situation where a MNE group,
most commonly its parent company, decides that the Group’s global business
requires the creation of a manufacturing or distribution subsidiary in a country in
which there is not yet an affiliate. Setting up the subsidiary, contributing cash to
it and providing it with the opportunity to engage in manufacturing or distribution
should not be a restructuring requiring compensation under the OECD TP
Guidelines or for which Article 9 permits a reallocation. This recommendation is
subject to the comment above that the new affiliate does not receive Property
within the meaning of this letter.

In summary, the Group supports what it believes to be the direction of Issues Note No.
2, and recommends that it be revised consistent with the clarifying suggestions made
above.

\textsuperscript{19} Restructurings Discussion Draft, paragraph 18.4.
III. Comments on Issues Note No. 3

The Group agrees with the Restructurings Discussion Draft that the criteria for selecting and applying a transfer pricing method in post-restructuring cases should not differ from the criteria used in other transfer pricing cases.\textsuperscript{20} The Group also concurs that the “arm’s length principle and the OECD 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.”\textsuperscript{21} The Group questions whether any revisions to Article 9 or its Commentary focusing on restructurings should, as the Restructurings Discussion Draft does now, go beyond these statements of basic principle and also try to reiterate what the OECD TP Guidelines otherwise state. The Group’s concern is that such a restatement for purposes of restructurings under Article 9 might inadvertently deviate from what the OECD TP Guidelines otherwise state and create the impression of two sets of OECD standards: one for Article 9 restructuring and another for other related party transactions. It would be preferable if the Commentary under Article 9 for restructuring merely states that the same standards apply and refer the reader to the OECD TP Guidelines. The OECD may already have this approach in mind.

\textsuperscript{20} Restructurings Discussion Draft, paragraph 124.
\textsuperscript{21} Restructurings Discussion Draft, paragraph 124.
IV. Comments on Issues Note No. 1

A. Risks: Important for Restructurings and Many Other Situations

This Issues Note discusses a topic, “risks”, that is important to a proper transfer pricing analysis of many different types of transactions between related parties that are within the scope of the OECD TP Guidelines or OECD Model Articles 7 or 9. It is vital in many transfer pricing contexts to ascertain how related parties have chosen to allocate risks among themselves, and how the compensation therefore compares to the compensation attributed to similar risks by third parties. If there are differences, particularly material differences, between what third parties compensate for the risks and what is occurring between the related parties, then tax authorities may be justified in making audit adjustments to the related party compensation under the arm’s length standard and, if so, Article 9 should apply.

Although Issues Note No. 1 starts off by saying that risks are of “critical” importance in the context of business restructurings, the Transfer Pricing Discussion Group believes they are just as important in analyzing many other types of related party transactions. In any case, this Issues Note proposes important OECD statements relevant to the treatment of “risks” that should not somehow be confined to, or be considered only in the context of, restructurings. Thus, the Group recommends that the risks discussion, hopefully as revised consistent with the comments that follow, be reflected in the OECD TP Guidelines and other documents that provide transfer pricing guidance generally.
B. Risks: The Terms and Operation of the Contract Are Key; The Proposed “Control” Standard Should Be Substantially Restricted or Abandoned

The Group agrees with many comments in this Issues Note. An important initial and well-established statement is that “the examination of risks in an Article 9 context starts from the examination of the contractual terms between the parties …”. 22

In discussing further the issue of risks, the Issues Note elaborates on existing text in paragraphs 1.25-1.27 of the OECD TP Guidelines. There is, in particular, a discussion in the Issues Note of the role of control in determining whether a related party allocation of risk by contract constitutes an arm’s length arrangement. As written now, the Issues Note explains that in the absence of a third-party contract with a similar risk allocation, a tax authority can speculate about how, in principle, unrelated parties would have allocated the risk, taking into account the notion of “control.” In this regard, “control” is defined in the Issues Note as:

the capacity to make decisions to take on the risk (decision to put the capital at risk) and decisions on whether and how to manage the risk, internally or using an external provider. This would require the company to have people – employees or directors – who have the authority to, and effectively do, perform these control functions. Thus, when one party bears a risk, the fact that it hires another party to administer and monitor the risk on a day-to-day basis is not sufficient to transfer the risk to that other party. 23

The Issues Note goes on to say that:

22 Restructurings Discussion Draft, paragraph 20.
23 Restructurings Discussion Draft, paragraph 30.
While it is not necessary to perform the day-to-day monitoring and administration functions in order to control a risk (as it is possible to outsource these functions), the OECD is of the view that in order to control a risk one has to be able to assess the outcome of the day-to-day monitoring and administration functions by the service provider (the level of control needed and the type of performance assessment would depend on the nature of the risk).\textsuperscript{24}

Consistent with its views about the respect to be given a taxpayer’s contractual terms and conditions generally, the Group’s first suggestion with respect to risks is that a tax authority should respect a taxpayer’s allocation of risks with an affiliate, even in the absence of a third-party contract that allocates risks similarly, if the related parties’ actual conduct with respect to who bears the risk is consistent with the terms of the contract. Issues Note No. 1 already acknowledges that “the parties’ conduct should generally be taken as the best evidence concerning the true allocation of risk.”\textsuperscript{25}

The Group respectfully suggests that the only potentially viable exception to this general rule is where it is demonstrated by the tax authority, with empirical evidence, that unrelated parties in similar circumstances consistently do not share risks in the manner in which the related parties have chosen by contract and have implemented through their conduct and that the choice of the affiliates results in a distortion of income or expense that cannot be reasonably addressed by a reallocation of income or expense (as opposed to imposing a different structure on the affiliates). By requiring empirical evidence, this suggestion underscores that tax authorities are not free to second-guess

\textsuperscript{24} Restructurings Discussion Draft, paragraph 31.  
\textsuperscript{25} Restructurings Discussion Draft, paragraph 22. (Emphasis supplied.)
the contracts and behavior of affiliates by way of a theoretical assessment of how two third parties “would have” or “could have” allocated risks between them. As suggested above, it is neither helpful nor consistent with the arm’s length standard, and the respect to be given to the terms and conditions of a related party contract that is in practice implemented consistent with the terms and conditions, to hypothesize how unrelated parties “might have” differed their terms and conditions from what the related parties contracted and implemented.

Thus, the Group believes that tax authorities should adhere to the OECD general rule that the parties’ conduct and contract terms are the best evidence, with a limited exception requiring, among other things, consistent empirical evidence of contrary third party behavior. This suggestion will safeguard tax authorities in abuse situations while significantly reducing the need for regular, detailed, and extremely difficult, examinations of related party control and of comparisons to the allocation of risks in actual third party contexts. As indicated above and discussed further below, such examinations and comparisons will be burdensome, subjective and lead to contentious audits. In brief, the Group believes that its recommendation provides a far more administrable and appropriate standard than the one now suggested in the Restructurings Discussion Draft.

While the Issues Note makes a valiant attempt to address how unrelated parties resolve who bears risks by means of an examination of control, the reality is that unrelated parties’ behavior on risks varies greatly. This is illustrated by the discussion below of
how third parties allocate product liability risks. Also, it will be very burdensome for taxpayers and tax authorities to try to establish and document how third parties allocate risk as they usually do not have ready access to the documents, such as contracts, that establish and define such risk allocations. Moreover, and as is discussed next, there is a fundamental flaw in the premise that unrelated parties uniformly equate control with risk bearing.

C. Risks: The Behavior of Third Parties Illustrates Conceptual Problems With the Proposed Control Standard

Two examples of third-party behavior illustrate an important flaw with using control to second-guess the risk allocation between related parties that is reflected in a contract and in their conduct. First, consider the common case of an owner of a patent, A, that transfers to unrelated party B the exclusive rights to develop the patent further and to manufacture, market and sell any resulting product. A also gives B the right to sublicense the patent to someone else who will then develop it further as well as manufacture, market and sell any resulting products. In some circumstances, A itself acquired the patent from another developer and has only a small administrative staff. A requires the transferee, B, to undertake best efforts with respect to the transferee’s development, marketing and other responsibilities. This is as far as A will or can go in attempting to control what happens to the patent subsequent to the transfer, even if A depends upon later milestones or a royalty stream over time, in part or in whole, for its consideration. Thus, B has control over the development, marketing and other activities
which it carries out and that will ultimately determine whether the patent makes it to market and is commercially successful and, if so, to what extent. B’s activities not only affect its compensation as licensee, they determine the compensation of the licensor, A. Of course, under the agreement with A, B can also sublicense to C, in which case the compensation of both B and A that is not received upfront will likely vary based on the activities of C, which are not really within the control of either B or A. Does the proposed OECD standard of control mean that in a related party context such a transferor’s compensation risks have been transferred along with the patent to the transferee? If so, that would deny the transferor’s continued compensation risks relevant to the patent, even though it has very little, if any, meaningful control over its development, etc.

Another marketplace example illustrating the conceptual weakness inherent in the proposed control standard involves warranty and product liability risks in a third-party manufacturing contract. The initial contract between the developer of the product, A, and the unrelated contract manufacturer, B, hired by A to produce it from components supplied by A, calls for B to assume the costs, above a minimum amount, of any product failures or warranty expenses to the extent that they are attributable to its manufacture of the final product. The finished products B manufactures are provided to A for its distribution and sale to customers.

In a subsequent revision of their contract, the two parties agree that B, the contract manufacturer, will no longer bear any of the product failure or warranty risks just
described. Instead, the developer and marketer of the product will do so. To compensate A for bearing the financial cost of these particular risks associated with the activities of the contract manufacturer, A pays B a specific amount less for its manufacturing activities than it did in the first contract.

In the second contract, A has no more control over whether the contract manufacturer makes errors in its production than it does in the first contract. In both contracts, A requires the contract manufacturer to meet A’s standards for quality that the contract manufacturer itself oversees. Under the OECD’s proposed control standard, would a developer and marketer, if related to the manufacturer, have risks associated with product failures caused by the manufacturer under either or both of the contractual arrangements just described?

The Group Respectfully suggests that many of the recent financial calamities in the business world reinforce the view that unrelated parties do not necessarily link control and risk-bearing. How many businesses, institutions and individuals have realized losses due to risks that they undertook but over which they lacked control?

The Issues Note acknowledges the difficulty of addressing the evaluation of risks “over which neither party has significant control.” This acknowledgement underscores the concern of the Group in relying on an assessment of third party risk bearing and related party control in second-guessing an allocation of risks between related parties in a

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26 Restructurings Discussion Draft, paragraph 34.
contract that the parties implement in practice in a manner consistent with its terms. It will be very difficult in many cases to determine which risks are within the parties' control and which are not and how significant they are relatively or absolutely. On the other hand, it is more straightforward for tax authorities to adjust the amount of related party compensation for risk-bearing based on marketplace measures of compensation. Interestingly, the Issues Note recognizes that there may not be any costs incurred in managing or mitigating a risk.\textsuperscript{27} It is not apparent how there could be no costs if there are management or mitigation (\textit{i.e.}, control) activities. However, the Group believes the OECD should not be concerned by the magnitude of, or an absence of, such control costs as it believes control is not a conceptually sound or administrable standard.

D. Risks: Rather Than Analyzing Control, Evaluate Financial Capacity

Although equating control and risk bearing is not a well-founded concept or a practical standard, the OECD might consider emphasizing, in the OECD TP Guidelines and Commentary to Article 9, another way of testing whether affiliates have, in substance, allocated risks appropriately. This other approach examines whether an affiliate purporting to bear risk has the financial capacity to bear it should the risk be realized.\textsuperscript{28} In other words, if a contract provides that an affiliate is to bear certain risks which over a three-year period might reasonably amount to $100 million, but the affiliate only has

\textsuperscript{27} Restructurings Discussion Draft, paragraph 44.
\textsuperscript{28} Example (B) of Issues Note No. 4 mentions this as one of many factors relevant to "most OECD countries" not recognizing an arrangement as structured. Example (B) does not emphasize this factor nor address whether the OECD TP Guidelines and the Commentary to Article 9 endorse or require it.
capital of $1 million, and does not insure the risk or take other steps to protect itself, then such low capitalization raises questions about whether that affiliate is really bearing the risk in question. Comparing an affiliate’s financial capacity to bear risk with the amount of risk it purports to assume involves data that are relatively easy to obtain. Depending upon the facts and circumstances, it may be reasonable for a tax authority to conclude that an affiliate cannot, in practice or in substance, actually bear the risk in question. Based on this finding the tax authority can propose an appropriate reallocation.

It does not follow, however, that if a particular entity has the financial wherewithal to bear a risk, then it cannot agree with an affiliate that also has financial capacity that the latter should instead bear the risk. Although it may be tempting for a tax authority to ask why in such circumstances the risk would be transferred from a party that has the capacity to bear it, the initially relevant questions under the arm’s length standard are whether the contract between the parties conveys the risk and whether, in practice, the risk is borne by the party to whom it is transferred. If these questions are answered in the affirmative, then the motivation for the arrangement should not matter in this regard. A remaining question is whether the parties have compensated each other at arm’s length under their arrangement.
E. Risks: Additional Comments

The Group agrees with comments in the Issues Note that in determining the compensation due from a related party to a person that has undertaken risks, it is important to assess whether bearing that risk is "economically significant."\textsuperscript{29} The Group questions, however, whether for many circumstances examining the accounting statements will be a useful means of evaluating whether a risk is economically significant. As the OECD itself acknowledges, "many risks that are inherent in a business are not capable of quantification and would not normally be represented in financial statements."\textsuperscript{30}

A final comment on this Issues Note concerns whether the use of a transfer pricing method can create a low-risk environment. The Issues Note states as follows:

\begin{quote}
It is worth remembering that it is the low-risk nature of a business that should dictate the choice of a given transfer pricing method, and not the contrary. In all cases it is important to ensure that the advocated risk profile and the choice of transfer pricing method are consistent with the functional analysis of the parties.\textsuperscript{31}
\end{quote}

The Group believes that the above statement should be revised so that it will not be interpreted to mean that the result of a "functional analysis" is that risks must follow functions. As is illustrated above, unrelated parties can and frequently do separate risks and functions and they deal with the consequences of such separations contractually in

\textsuperscript{29} Restructurings Discussion Draft, paragraph 40.
\textsuperscript{30} Restructurings Discussion Draft, paragraph 42.
\textsuperscript{31} Restructurings Discussion Draft, paragraph 45.
financial terms (e.g., compensation). In other words, whether or not the “nature of a business” is one of high or low risk is, with all due respect to the view expressed in the Issues Note, many times determined by the contractual arrangements of the unrelated parties, not the inherent nature of the business in terms of activities or functions. Consequently, the financial terms between third parties, which certainly encompass their equivalent of a “transfer pricing method,” can play a large role in dictating whether or not a business bears one or more risks and to what degree.

The same principle applies to related parties. When they enter into a contract where one is intended to bear the risks of certain functions, activities or transactions, this goal should be reflected in and achieved by, among other contractual provisions, their financial arrangements, including the method used for compensation. For example, when one party is assured a full return of costs plus a mark-up (profit) of X percent, then this necessarily means that certain risks (e.g., the risk of cost increases) will be borne by the counter party. Thus, if the contract is drafted and implemented correctly, the compensation method will be designed to help achieve the risk objectives of the parties. In brief, just as is true between unrelated parties, the objective of assigning risks to a related party can be set and achieved independently of what is incorrectly perceived by the Restructurings Discussion Draft to be the risks “inherent” in the nature of the activities and functions in question.

In closing, the Group recommends that this portion of the text be revised along the lines suggested here. That is, when related parties contract for and implement a transfer
pricing method it can have important implications for, or even be a determining factor in, allocating the risks of the parties under the contract.

V. **Overall Conclusion**

In conclusion, the Transfer Pricing Discussion Group again congratulates the OECD on proposing guidance for a challenging series of questions, beginning with when is there a “restructuring” that is within the scope of Article 9 and under what principles one should evaluate the arm’s length compensation for such a restructuring. The Group hopes that its comments will be helpful to the OECD in publishing additional useful guidance on restructurings for taxpayers and tax authorities.

Please contact the undersigned with any questions or comments concerning this letter.

Sincerely yours,

![Signature]

Steven P. Hannes