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and Development (OECD)

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515/500

Dear Mr Owens,

Discussion Draft on Transfer Pricing Aspects of Business Restructurings

We would like to thank you for the opportunity to provide the OECD with our comments on the Discussion Draft on Transfer Pricing Aspects of Business Restructurings.

1. General Remarks

The IDW supports the OECD's efforts to develop guidance on transfer pricing aspects and their tax treatment in cross-border business restructurings. In our opinion, this is essential to ensure that internationally a more uniform treatment by national financial authorities is achieved. In Germany the Reform Act of Business Taxation (Unternehmenssteuerreformgesetz 2008) was enacted in 2008. The rules in this Act are relevant for tax treatment of business restructurings and their evaluations, in particular, with regard to the application of the arm's length principle. Pursuant to the Reform Act, the comparable uncontrolled price method is the first choice when determining transfer prices within a group. If a business function including all chances and risks involved is transferred (function restructuring), the so-called "agreed scope" has to be determined based on the transfer of the function as a whole (transfer package) taking into account interest rates for market capitalisation adequate to the function and its risks. If an essential intangible asset is subject matter of a business transaction, it is assumed that an independent third party had agreed on a price adjustment

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clause, permitting prices to be adjusted subsequently if the scheduled earnings differ from those actually achieved.

After these general remarks, the IDW would like to refer to some issues in the discussion draft which are essential from the German profession's perspective:

2. Issues Note No. 1: Special Considerations for Risks (paragraphs 1 to 45 of the draft)

Issues Note No. 1 of the draft deals with the allocation of risks in business transactions between related parties. Para. 19 states that the takeover of risks is crucial in connection with the transfer of functions. The following paragraphs define this statement for particular issues. The draft assumes that the allocation of risks reflects the actual circumstances, and that appropriate consequences are drawn to determine the transfer price. To our understanding, this would only apply to the allocation of risks in connection with the transfer of assets a third party would be willing to pay for. In this regard, the draft mentions tangible and intangible assets (including contractual rights) as well as the transfer of activity – ongoing concern. The draft does not cover the transfer of risk items as such. Para. 64 of the discussion draft supports this interpretation confirming that the term „profit/loss potential“ has to be distinguished from the term „assets“ in order to ensure that a mere „profit- or loss potential“ shall not have the quality of an asset. However, the draft provides no guidance to which extent assets have to be transferred and whether management functions have to be transferred as well. We consider the latter essential to ensure that the principal is able to realize the potential profit. As these questions are crucial with regard to tax purposes of a restructuring, the draft should be amended accordingly (see also our comments to Issues Note No. 4).

In the absence of evidence of rights and obligations in a comparable situation, the draft stipulates that rights and obligations are to be determined as if the parties transacted with each other at arm's length. In our opinion, this provision is too extensive as it enables tax authorities to use fictitious business transactions as a basis for taxation. This would allow for a taxation based on these fictitious transactions, which would neither be in line with general taxation principles nor with the arm's length principle. Therefore, we suggest deleting paragraph 52.

According to the draft, tax payers are requested to provide additional documentation on cross-border restructurings. Thus, according to Para. 53, companies are requested to prove, which anticipated synergy gains are to be achieved by the restructuring. Para. 133 defines that evidence has to be provided to which

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extent arrangements have been modified through business restructurings. In our opinion, the documentation obligations envisaged in the draft are not covered by the purpose of the rule and constitute an unreasonable burden to the company transferring assets. These documentation requirements may lead to tax authorities disregarding restructurings simply because documentation requirements have not been complied with in due form, although the transaction would have met the requirements of a transfer pricing control. In our opinion, such consequences should not be permitted.

In this regard, we would like to indicate that according to a court decision of a German fiscal court, even in case of non-compliance with the formal requirements during cross-border services between a company and its controlling shareholder the adequate remuneration determined according to the arm's length principle pursuant to para. 9 OECD Model Convention is deductible operating expenditure (decision of Finance Court of Cologne, 22/08/2007, 13 K647/02). We suggest modifying the draft accordingly.

It is internationally accepted that on determining the price the vender's as well as the vendee's view are to be considered. However, this does not mean that total information transparency within a group may be implied which may cause financial authorities drawing negative conclusions from the mere fact that a total information transparency does not exist.

3. Issues Note No. 2: Arm's Length Compensation for the Restructuring Itself (paragraphs 46 to 122 of the draft)

Issues Note No. 2 deals with questions of compensation in cross-border restructurings. The company transferring functions or intangible assets is entitled to compensation by the receiving company. It is possible to transfer tangible and intangible assets (including contractual rights). In our opinion, the information given on compensation for intangible assets should be more precise. The draft only confirms that intangible assets may be transferred to the IP-company within a group to improve internal control and provide for central administrative services to be administered on group level. We would appreciate, if the information with regard to the determination of arm's length compensation were defined more precisely.

According to para. 71 of the draft, a transfer of activity - ongoing concern can also be subject matter of the transfer. This encompasses the transfer of a total bundle of assets as well as corresponding obligations and other liabilities. In our opinion, the definition of the term „ongoing concern“ is too extensive and hardly

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allows for a distinction with regard to the transfer of single assets. Consequently, a lot of transactions will be covered by „ongoing concern“. Ongoing concern would not only encompass whole transfer packages but also the transfer of single departments of a company, f.i. the treasury department. This demonstrates that the term “ongoing concern” should be defined more precisely to draw a distinction with regard to the transfer of single assets. The specification of the term “ongoing concern” is important because on determining the value of an ongoing concern, the appropriate goodwill should be taken into account and not only the individual asset. The transfer of a goodwill requires that an economically independent unit is to be transferred. This is not the case if only departments within a group are transferred. A further difficulty is that the draft offers no opt-out clause that allows for single asset valuation under certain conditions. A single asset valuation could also be necessary with an ongoing concern if the value determined with the cost plus method is not high enough to include a goodwill. The same applies if no essential intangible assets and, therefore, no potential corporate profit is transferred that exceeds the return for capital invested appropriately to risk on the capital market plus entrepreneurial profit. Albeit, the draft does not define a price ceiling. However, a price ceiling is necessary to prevent financial authorities from determining prices at random. The price ceiling could be defined by prime costs as a company would only be willing to pay a compensation based on the costs of production. The draft should be amended accordingly.

Furthermore, in our opinion the statements made with regard to the compensation for transfers of activities should be worded more precisely. Not only the term “profit / loss potentials” (para. 63 et seq.) is used but also the term “goodwill” (para. 93) as well as the term “profit- / loss-making opportunities” (para. 95); however, there is no clear definition of these terms. Although the wording in para. 93 suggests that the term “profit / loss potential” is to be seen as a special form of goodwill. In the end, the meaning of the two terms remains ambiguous. We would appreciate a clear definition.

4. Issues Note No. 4: Recognition of the Actual Transactions Undertaken (paragraphs 194 to 221 of the draft)

Issues Note No. 4 deals with the question whether and to what extent tax authorities have to recognize transactions actually undertaken by a tax payer. We appreciate that the draft confirms the opinion stated in para. 1.36 et seq. of the OECD TP Guidelines that transactions actually undertaken, in general, are to be recognised and non-recognition of transactions actually undertaken should

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be an exception (para. 205). The essential criterion for the recognition of a restructuring shall be its commercial rationality (para. 207). The discussion draft tries to define the criterion “commercial rationality” by applying the realistically available options and, should such options not exist, approving the commercial rationality (para. 209). According to the draft, the determination whether realistically available options exist, should be based on certain aspects, such as all relevant conditions of the restructuring, the rights and other assets of the parties, any compensation for the restructuring itself and the remuneration for the post-restructuring arrangements. We consider it critical that tax authorities shall be entitled to evaluate the commercial rationality of a transaction retrospectively on the basis of a wide scope for judgment and, on the basis of this assessment, refuse to recognise the transaction for tax purposes. As a result, the recognition of a transaction for tax purposes would depend on which “entrepreneurial decision” a financial authority had drawn retrospectively. In order to assess the commercial rationality of a transaction, specialist knowledge of the branch of business is required that tax authorities often will not have. Albeit, there is no clear statement in the discussion draft, whether findings made subsequently should be included in assessing the commercial rationality and who will have to offer proof on the existence of realistically available options. We regard it necessary to take into account the state of knowledge at the time of the restructuring.

Non-recognition of transactions should, in general, be limited to cases of abuse of legal structuring options. A case of abuse could for instance be that no sufficient assets have been transferred to cover the risks in a restructuring. As mentioned above, a definition is to be made to clarify to what extent assets have to be transferred. In cases other than abuse a restructuring is to be recognised. The financial authorities should only be entitled to make amendments. The proof whether realistically available options exist should be assigned to the financial authority. We suggest to amend the discussion draft as mentioned above.

According to para. 196 of the discussion draft multi-national entities are free to organise their business operations as they see fit. In this context, the draft does not provide sufficient information where entrepreneurial freedom to organise business restructurings ends and where the control of transfer pricing begins. Measures a subsidiary takes to comply with the corporate objectives defined by the parent company should not be taken into account with regard to the control of transfer pricing, if the measures are taken as a result of the control exerted by the parent company and not due to contractual arrangements with the parent company. We consider it essential, that criteria be encompassed in the draft to

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distinguish the entrepreneurial freedom to organise business from the control of transfer pricing. This issue could be dealt with in an introductory section.

According to para. 216 of the discussion draft outsourcing shall not be recognised if it is based exclusively on group policy, and economic considerations have not been taken into account. This provision seems to be too extensive. In this case, there are no objective reasons not to recognise the entire restructuring. The discussion draft confirms that the question of recognition has to be based on actual transactions and that these shall not be replaced by fictitious transactions. This means that a group-internal division of functions and any amendments thereon – except for cases of abuse of legal structuring options – is to be respected and shall not be subject to criticism or amendments by the financial authorities. Para. 216 of the discussion draft should be deleted.

For systematic reasons, we suggest that the discussion draft should deal with the basic principles for fiscal recognition of a transaction prior to discussing any questions concerning arm's length compensation.

Apart from that, the discussion draft does not deal with questions regarding the evaluation of the assets. As this issue is an essential aspect in connection with business restructurings, we would appreciate comments thereon. For example, information on the following aspects would be helpful: How should aspects of risks be taken into account in the evaluation process? Should these aspects be reflected in the capitalization interest rate? Should the potential profit transferred be restricted according to the limited economic life of the transferred assets?

If you have any further questions about our views on these matters, we would be pleased to be of further assistance.

Yours sincerely



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