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Re: *Transfer Pricing Aspects of Business Restructurings*

Dear Mr Owens:

On 19 September 2008, the Committee on Fiscal Affairs (CFA) of the Organisation for Economic Co-operation and Development (OECD) released a discussion draft on the *Transfer Pricing Aspects of Business Restructurings* (hereafter the "discussion draft" or "report"). The discussion draft addresses transfer-pricing issues posed by business restructuring transactions as well as post-restructuring controlled transactions among related parties in the context of Article 9 of the Model Tax Convention. It sets forth guidance to taxpayers and taxing authorities on the treatment of those transactions. On behalf of Tax Executives Institute, I write to express concern that the discussion draft is likely to increase uncertainty, thereby exacerbating the number, scope, and degree of controversy between taxpayers and taxing authorities as well as among taxing authorities themselves.

TEI Background

Tax Executives Institute was founded in 1944 to serve the professional needs of business tax professionals. Today, the organization has 54 chapters in Europe, North America, and Asia. As the preeminent international association of business tax professionals, TEI has a significant interest in promoting sound tax policy, as well as in the fair and efficient administration of the tax laws, at all levels of government. Our 7,000 members represent 3,200 of the largest companies in the world.

Executive Summary

TEI commends the OECD for undertaking the study on business restructuring and issuing its report for public consultation. The report represents an important step in developing a methodology for applying the OECD's Transfer



Pricing (TP) Guidelines to business restructuring transactions and post-restructuring controlled transactions. Indeed, there are many helpful statements on the role of taxpayers and tax authorities as well as guidance on the application of the TP Guidelines.

There are, however, aspects of the report with which we disagree. On balance, we believe the report:

- encourages tax authorities to substitute their judgment for taxpayers in determining whether a restructuring transaction is commercially rational;
- fails to provide guidance to ensure that cases of double taxation will be resolved in accordance with Article 9(2);
- fails to provide an analytical framework through which taxpayers may determine (and their financial statement auditors may confirm) whether the restructuring (or post-restructuring controlled transactions) will be safe from recharacterisation or adjustments; and
- increases taxpayer documentation burdens, especially to document “alternative” transactions — ones that either independent parties might engage in or that might have been “realistically available” to the transferor(s) and transferee(s).

Consequently, we encourage the OECD to weigh the comments by TEI below and consider reissuing another discussion draft before revising the TP Guidelines or the Model Tax Convention.

Prefatory Comments

According to paragraph 7 of the discussion draft, business restructurings are typically accompanied by a reallocation of profits among the members of the multinational enterprise (MNE) group. One objective of the OECD’s report is to discuss the extent to which a reallocation of profits is consistent with the arm’s length principle (under Article 9 of the Model Tax Convention) and more generally how the arm’s length principle applies to business restructurings. Other objectives are (1) to ensure that business restructurings do not lead to unintended “double non-taxation” and (2) to limit the risk of double taxation of MNE profits.

TEI commends the OECD for initiating the study and attempting to provide guidance on the application of the transfer-pricing principles to business restructurings. Recent legislative and administrative efforts by some countries attacking business restructurings strongly suggest a need for guidance. In keeping with the OECD’s goal of promoting sustainable economic growth, the discussion draft attempts to balance the competing interests of the OECD Member States in protecting their tax bases and permitting businesses to optimise their structures and operations in order to compete in a global environment.

Regrettably, the report seemingly favours the views of Member States that believe their tax bases are being eroded by restructurings and fails to reflect the extent to which commercial business



needs drive restructuring transactions. The report helpfully acknowledges that taxpayers are entitled to structure their business operations as they see fit:

Tax administrations do not have the right to dictate to an MNE how to design its structure or where to locate its business operations. MNE groups cannot be forced to have or maintain any particular level of business presence in a country. They are free to act in their own best commercial and economic interests. . . . In making this decision, tax considerations may be a factor.¹

The overall tenor and tone of the draft, however, is not as dispassionate as the TP Guidelines require. Indeed, references to “so-called toll manufacturers,” “mere facts,” and other pejorative phrasing could encourage tax authorities to attack a restructuring where less profit flows to a jurisdiction after one of the four identified transactions.² What’s more, because non-OECD countries may convert the report into tax legislation or regulations, the ultimate effect may be detrimental to OECD-based businesses.

The report also omits discussion of the need for countries to ensure that their tax systems remain competitive. This is not to suggest that countries should engage in a “race to the bottom;” rather, it is a reminder that taxes can be an impediment to business efficiency. For example, in the absence of effective cross-border tax loss utilisation rules, companies must be mindful of where they incur costs as well as whether they are incurring the proper amount of expenses to achieve the expected returns. Where losses mount, business functions and costs must be shifted to achieve better after-tax results. Indeed, in a competitive global marketplace, businesses must ensure that all operating costs in their supply chains are minimised. Since tax rules and market conditions are continually changing, businesses must restructure periodically to align costs, especially following the acquisition of a new business in a merger or acquisition.

Scope Limitations of the Report

Paragraph 5 of the report states that corporate reorganizations that occur as a result of a merger or acquisition are *not* within the scope of the project. Only *internal* restructurings are within the scope of the project. An MNE’s merger or acquisition of a third party, however, will nearly always be preceded or followed by one or more internal restructurings. Hence, nearly every business restructuring transaction by an MNE will be implicated by this project.

¹ See paragraph 196 of the report.

² The business restructuring transactions noted in paragraph 3 of the report are:

- conversion of full-fledged distributors into limited-risk distributors or commissionaires for a related party that may operate as a principal,
- conversion of full-fledged manufacturers into contract manufacturers or toll manufacturers for a related party that may act as a principal,
- rationalisation or specialisation of operations (manufacturing sites or processes, research and development activities, sales, services), and
- transfers of intangible property rights to a central entity (i.e., a so-called IP company) within the group.



In another scope limitation, Member State domestic anti-abuse and controlled foreign corporation rules are not addressed. This is regrettable since many of the attacks on business restructuring transactions have been, and may continue to be, based on domestic anti-abuse rules. TEI encourages the OECD to reconsider this limitation because nearly any tax measure might be an anti-abuse rule. More important, without guidance on the proper coordination of the Member State anti-abuse rules and Article 9 (as well as other treaty articles) taxpayers will be exposed to substantial risks of double taxation.

Finally, the domestic tax treatment of an arm's length payment, including rules governing the deductibility of payments that are the focus of the report, is outside the scope. Again, TEI regrets this limitation. The goal of the Model Tax Convention is to minimise double taxation. If one country taxes a payment received under its domestic law while the other does not permit a deduction under its domestic law, double tax arises. By suggesting that countries may require an arm's length payment for a restructuring without addressing the treatment of the payer, the report is increasing the risk of double taxation as well as uncertainty for taxpayers.

Business Restructurings

MNEs devote substantial resources to ensuring that their businesses are profitable, grow, and comply with myriad commercial and tax law provisions, including transfer-pricing rules. They also continually review the efficiency of their operations and the legal structures that support them. In this light, business restructurings are a response to global competitive pressure, changing market demands, regulatory requirements, and technological developments.

Paragraph 4 of the discussion draft states that business representatives at the January 2005 Roundtable said that "business reasons for restructurings are to maximise synergies and economies of scale, to streamline the management of business lines, and to improve the efficiency of the supply chain, taking advantage of the development of Internet-based technologies" We agree, but the list of commercial reasons for business restructurings in the report is too abbreviated to provide sufficient insight and guidance to tax authorities about the legitimate scope and aims of commercial restructurings.³

³ A more comprehensive list of reasons for business restructuring includes:

- allowing more expedient and efficient globalization and expansion of cross-border activity into new jurisdictions
- creating a nimble organizational structure that adapts more rapidly in response to changes in customer or supplier markets
- affording faster deployment of resources and innovation in product development and design and thus faster times to market
- increasing transparency in management accounting, thereby improving the visibility of the value drivers in business lines and providing management with an opportunity to provide guidance for improving efficiency and growth
- redistributing decision-making authority to facilitate the MNE's core objectives and strategies, *e.g.*, to implement matrix organizations or segregate marketing from manufacturing functions
- improving business portfolio management (especially where the MNE has multiple business and product lines) and managing changes in the business, product, or service mix



In addition, MNEs are increasingly focused on developing centralised centres of expertise — whether for research and development, design, engineering, development, product launch, marketing, or services. Moreover, improving access to lower cost supplies whether material or labour are also critical components of a company’s sourcing decisions. Businesses also use restructurings to maximise compliance with regulatory requirements such as environmental or labour laws, anti-competition rules, and even non-income tax rules, such as VAT registration and documentation requirements that can hinder the deduction or recovery of such taxes on business inputs.⁴ Restructurings to increase control over compliance risks enhance an MNE’s control over its local and worldwide reputational risks.

Finally, as a technical matter, paragraph 18.2 of the report states that “business restructurings involve the transfer of functions, assets and/or risks.” Many business restructurings involve a transformation of the operating structure in a fashion that makes before and after comparisons meaningless. Old roles and functions can be abandoned and new and different ones established. In this respect, it is important to distinguish between the *expiration* and early terminations of old contracts. In the case of terminations, it may be that compensation or indemnification payments are due, but in the case of expirations that is not the case. The discussion draft at paragraph 107 states

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- permitting more efficient sharing of best practices, *e.g.*, in manufacturing, marketing, and service across jurisdictional boundaries or across lines of business
 - affording closer access to suppliers and customers by consolidating global operations and key people functions in regional centres of excellence, thus driving value up and down the supply chain
 - pooling risks to make the company stronger and more financially secure in recessionary times
 - optimising cash flow in the supply chain and in financing the legal structure of the enterprise
 - reducing investments in working capital thereby increasing free cash flow
 - increasing the visibility of inventory management in the supply chain thereby (1) reducing investments in stock through better deployment of inventory in the various markets and (2) obsolescence risk
 - improving the sourcing of raw material and other supplies
 - aligning globally or regionally with customer or supplier organizations that are also globalising or consolidating along regional lines
 - improving the management of customer accounts receivable and supplier payables
 - streamlining the supply chain to improve efficiency and drive down costs
 - enhancing the use of Internet-based technology thereby increasing speed of response to market conditions and customer or supplier demands and reducing costs
 - increasing specialization, thereby permitting personnel to focus on critical tasks they must do well in order to achieve excellence, *e.g.*, a plant manager can focus on managing production in the most efficient and environmentally sustainable fashion when she no longer has sales responsibilities.
 - enhancing human resource management, including succession planning and the deployment of skilled people where most needed
 - improving teamwork
 - reducing transfer-pricing risk by standardizing business operations and documentation
 - enhancing cash flow by improving the administration of indirect taxes, *e.g.*, by reducing the number of required VAT registrations and consolidating the tax compliance functions, for which the enterprise serves as a tax collector
 - to correct for gradual changes in a business

⁴ Indeed, transfer-pricing compliance and documentation requirements in many countries impose substantial costs. By standardising and simplifying business models in most countries, companies can reduce their transfer-pricing compliance and documentation costs as well as the risk that the tax authorities will challenge the transfer prices. Regrettably, the discussion draft will increase the costs of the transfer-pricing documentation requirements.



that “an implicit longer term contract should be implied” and as a result compensation may be due. TEI believes that this position is incorrect because it gives the tax authorities the potentially untethered authority to remake contracts. We recommend that the statement be eliminated from the draft because under the TP Guidelines tax authorities do not have an implied right to impute a contract duration longer than that agreed to by the parties.

Many Restructurings Stem from the Nature of the Business

Many businesses follow a standard market-entry strategy. To develop a new market, they find an unrelated agent, make that agent a “partner” (either *de facto* or by a partnership agreement), and when the market matures and the business becomes profitable, buy out the agent/joint venturer, terminate the distribution agreement in accord with the contractual terms, or permit the agreement to expire at the end of its term. Where the principal possesses a strong brand or product, the agent will generally be satisfied accepting a limited role as a distributor and will also accept becoming a joint venture partner with limited rights because there may be other independent agents that the principal can seek to replace the agent. Finally, the agent will accept being bought out, either because the business is becoming larger than the agent’s own, takes too large a part of the overall business activities of the agent, or because the agent wishes to safeguard its economic independence. Since this model governs the business life cycle of principals acting with independent third party agents, it should also be accepted as a business life cycle with related parties as well.

Another frequent restructuring is the consolidation of manufacturing and distribution operations. For many businesses, profit margins are too thin to operate manufacturing and distribution facilities in each major country where it sells products and services. In order to operate profitably today most companies have consolidated their manufacturing and distribution operations so that there is only one such centre in each major geographic region (*e.g.*, Europe, Asia-Pacific, South or North America). The closure of local country facilities is necessary to stay competitive and to remain in business.

MNEs Nearly Always Restructure for Group Reasons — Requiring an Entity-Level Rationale Defeats the Purpose of Organising as an MNE

MNEs operate in an integrated fashion and implement global business models that are rarely found between unrelated parties. They establish entities in new markets in order to overcome barriers and costs to enter a new market. If it were not less costly and more efficient to organise and conduct business in an integrated fashion, MNEs would not have emerged in the marketplace. Thus, by definition, there are efficiencies (or synergies) that are captured or enhanced by a group that may not be available in a market transaction between two independent parties.

The TP Guidelines were developed to ensure the arm’s length principle is observed in transactions between related parties. They prevent the manipulation of transfer prices by requiring a comparison of transactions between members of an MNE group to what independent third parties operating at arm’s length would have done. The report, especially Issues Note 1 (paragraphs 19-45), would expand the TP Guidelines to require validation of an MNE’s post-restructuring business structure and risk allocations against that of third parties. Given the nature of an MNE, that requirement is unrealistic. As important, where an MNE’s structure (or risk and profit allocation)

cannot be validated against a third-party structure (or contractual allocation), the report encourages tax authorities to scrutinise and recharacterise, rather than respect, the restructuring and subsequent controlled transactions, of an MNE.

As important, governments will never analyse the profits of an independent third party in order to determine the proper allocation of functions, risks, or assets — and the corresponding profit return — between unrelated counterparties. Yet, Issues Note 2 (paragraphs 46-122), which discusses arm's length compensation for a restructuring, devotes considerable attention to the proper allocation of business restructuring "synergies" and compensation to the individual entities within the group. Synergies are elusive to capture in any transaction and allocating the profit that arises by cooperation among individual entities within an MNE is nearly impossible to determine with precision. As important, allocating such returns to individual entities within an MNE by reference to what arm's length parties would do is equally impossible since the "synergies" of cooperation would likely not be observed between independent parties.

To the OECD's credit, the report attempts to provide balance between group- and entity-level applications of the report's principles. For example, the statement in paragraph 27 that "just because a related party arrangement is one not seen between independent parties should not itself mean the arrangement is non-arm's length" is helpful. So, too, is the statement at paragraph 213 that "there can be legitimate group-level business reasons for an MNE group to restructure." Far too often, though, the report favours recharacterising a group's transactions — thereby disrupting a taxpayer's expectations — because of its emphasis that "it is not sufficient from a transfer pricing perspective that an arrangement makes commercial sense for the group as a whole: the transaction must be arm's length at the level of each individual taxpayer, taking account of its rights and other assets, expected benefits from the restructuring arrangement, and realistically available options."⁵ As a result, the report has a flavour of "heads, tax authorities win; tails, taxpayers lose."

Groups generally restructure for business reasons determined at the group level and they should not be required to justify the business purpose of the restructuring at the level of each entity. Moreover, there should be no expectation that the benefits attained *by the group* through the restructuring should be allocated to each entity that participates in the restructuring. In order to satisfy the arm's length principle, all that should be required at the individual entity level is confirmation that (1) the rights and assets are transferred at their respective fair market value (*i.e.*, at a price that would have taken place between independent parties) and (2) the post-restructuring controlled transactions of the restructured entities and associated enterprises are also priced at arm's length.

Failure to Discuss Options for Correlative Adjustments Ensures Double Taxation

Paragraph 61 of the report states that satisfying the arm's length principle for a business restructuring requires "an evaluation of the conditions made or imposed between related parties, at the level of each of them." Further, "the fact that the cross-border redeployment of functions, assets, and/or risks may be motivated by sound commercial reasons at the level of the MNE group (*e.g.* in

⁵ See paragraph 213.



order to derive synergy gains at a group level), does not answer the question whether the transfers are arm's length from the perspectives of both the transferor(s) and the transferee(s)." TEI believes this conclusion, and several similar statements, saddle MNEs with a nearly impossible burden: proving an arm's length price for a transaction or series of transactions for which there may be no comparable. As a result, taxing jurisdictions may invoke Issues Note 2 to require compensation from an entity or entities in a jurisdiction — which one or ones are entirely unclear — that benefit from the group synergies. Hence, the report subjects MNEs to double taxation when restructuring in order to realise group synergies. If the OECD moves forward with its report, TEI strongly recommends that it include a provision for correlative relief for *any* enterprise in the group that is required to make any form of payment for the restructuring.

OECD Should Consider Providing a Safe Harbour for Group Restructurings that Preclude a Requirement for an Analysis at the Level of Each Individual Taxpayer

Within any MNE group, there can be wide variations in the profitability of each separate enterprise. Indeed, even where a group as a whole is profitable, individual enterprises within the group will incur losses owing to many factors, including market competition, costs, and poor management decisions. Since non-tax-effected operating losses substantially increase a group's reported effective income tax rate, one objective of many group restructurings is to limit (or eliminate) the number of unprofitable, inefficient entities within the group. One means of addressing the lack of effective cross-border loss sharing is to restructure business operations, simplifying the business model in many jurisdictions in return for more consistent (*i.e.*, less volatile), albeit potentially lower return, where the business risks and functions are effectively "stripped" and transferred to another entity.

TEI submits that most business restructurings are driven by sound commercial reasons apart from tax savings. Assuredly, when management determines that a restructuring is necessary an MNE's tax advisors will seek to obtain the most beneficial tax result for the restructuring as well as the post-restructuring transactions. As important, Paragraph 212 of the report confirms that "it can be commercially rational from an Article 9 perspective for an MNE group to restructure in order to obtain tax savings." We concur.

TEI recommends that the OECD consider providing a safe harbour (or rebuttable presumption) for when a restructuring transaction is considered to have commercial rationality and be at arm's length for all members of the MNE group. Specifically, where the MNE group can show that its post-restructuring effective tax rate falls within a reasonable range of the statutory tax rates for the countries involved in a business restructuring transaction (*e.g.*, an overall rate between 20 and 30 percent), the jurisdictions affected by the restructuring transaction should accept it as commercially rational and at arm's length.⁶

⁶ TEI acknowledges the challenge of developing an acceptable measure and invites the opportunity to meet with representatives of the OECD and Member States to discuss potential approaches. A post-restructuring effective tax rate within 75 percent of the group's pre-restructuring composite tax rate (as determined under local generally accepted accounting principles) should also provide a reasonable safe harbour.

Recharacterisation or Non-recognition of Restructuring Transactions

Paragraphs 18.4 and 205 of the discussion draft restate the general principle of the TP Guidelines that “the non-recognition of a transaction is not the norm but an exception to the general principle that a tax administration’s examination of a controlled transaction ordinarily should be based on the transaction actually undertaken by the associated enterprises as it has been structured by them, using the methods applied by the taxpayer” TEI concurs. Hence, we welcome the statement that a group rationale for a transaction will support the commercial rationality of a transaction.⁷

In addition, Paragraph 1.37 of the TP Guidelines provides two sets of circumstances under which tax administrations may disregard the structure of a taxpayer’s transactions. The first is where the economic substance⁸ of the transaction differs from its form; the second is where the arrangements differ from those that would have been adopted by arm’s length parties and “the actual structure practically *impedes* the tax administration from determining an appropriate transfer price.” (Emphasis supplied.) In respect of the latter condition, it would be helpful for the OECD to address when a structure “impedes” the determination of an appropriate transfer price. Surely, the mere inability to find a comparable or otherwise arrive at a transfer price should not give tax authorities license to disregard or recharacterise a transaction. Otherwise, given the nature of a group, it is more likely that there will be intercompany transactions that do not occur between independent parties, which means that tax authorities will be more likely to recharacterise intra-group transactions.

Finally, paragraph 209 states that “independent enterprises, when evaluating the terms of a potential transaction, will compare the transaction to the other options realistically available to them, and will only enter into transactions if they see no alternative that is clearly more attractive.”⁹ TEI believes this standard is unworkable in the context of MNE groups. First, the requirement is open ended and seemingly requires taxpayers to consider and document a range of possible alternatives to the restructuring transaction. Second, the standard introduces considerable subjectivity into the examination of arm’s length conditions. Rather than examining the transaction actually entered into by a taxpayer, tax authorities would be permitted to consider what other options “might” have been considered by independent third parties. On balance, we believe the proposed standard considerably

⁷ See paragraph 207 of the report.

⁸ The first bullet point of paragraph 18.1 states that the “contractual allocation of risk between associated enterprises is . . . respected only to the extent that it has economic substance.” Other paragraphs in the report also refer to the possibility that the “economic substance” of a transaction may differ from the contractual terms governing a transaction between related parties. The report cites paragraphs 1.26 to 1.29 of the TP Guidelines in support of the proposition. We note that the domestic laws, especially the jurisprudence, of OECD Member States are inconsistent about the scope and application of the economic substance concept. Countries that adhere to a more formalistic interpretation of contractual arrangements (which would include a requirement that the parties act in accord with the agreement) may apply the OECD report in a different fashion from those where the economic substance concept is embedded in the law. As a result, the same transaction may be treated differently in the transferor and transferee jurisdictions, leading to controversy about the application of the concept to a restructuring. The report should acknowledge this and urge countries to use the mutual agreement procedures to resolve differences in domestic law interpretations of the economic substance concept.

⁹ Paragraphs 58-61 discuss when options are “realistically available.”

lowers the threshold in the current TP Guidelines for recharacterising transactions. Thus, contrary to the statement in paragraph 196 that MNEs “can organise their business operations as they see fit,” tax authorities will be given discretion to substitute their judgment for what constitutes a “commercially rational” transaction. As a practical matter, the standard is likely to discourage much needed business restructurings and require taxpayers to maintain inefficient business operations.

Documentation

Paragraph 25 states that “it would be reasonable to expect related parties to document in writing their decisions to allocate or transfer risks *before* the transactions with respect to which the risks will be borne or transferred occur.” (Emphasis supplied.) In addition, paragraph 53 states that “it would be reasonable for the taxpayer to document, at the time the restructuring is decided upon or implemented, what [its] anticipated synergy gains are and on what assumptions they are anticipated. This is a type of documentation that is likely to be produced for non-tax purposes, to support the decision-making process of the restructuring. For transfer-pricing reasons, it would also be reasonable to expect such documentation to provide an analysis of the effects of the restructuring *on each affiliate or taxpayer* (costs and anticipated benefits) as well as an assessment of the other options realistically available to it.” (Emphasis supplied.) Finally, paragraph 133 states “it is essential in business restructuring cases that a comparability (including functional) analysis be performed both for the pre-restructuring and for the post-restructuring arrangements and that the actual changes that took place upon the restructuring be documented.”

As a preliminary matter, we are concerned about the ever-increasing and non-uniform documentation burdens that taxing authorities are imposing on MNEs in respect of transfer-pricing issues.

Next, under TP Guideline 5.4 “prudent business management principles” require a taxpayer to document the basis for the arm’s length nature of its transactions. Under current standards, however, taxpayers are *not* required to prepare or retain documents that it would not otherwise prepare or retain in the ordinary course of managing its business. This principle affords taxpayers flexibility in managing their affairs. In addition, paragraph 1.28 of the TP Guidelines provides that the contractual terms of a transaction generally define explicitly or implicitly how the responsibilities, risks, and benefits are to be divided between the parties and that an analysis of contractual terms should be a part of the functional analysis. Where no written terms exist, the contractual relationship must be deduced from conduct and the economic principles that govern relationships between independent enterprises.¹⁰ Thus, whereas the TP Guidelines afford taxpayers flexibility in their documentation, paragraph 25 of the report requires that taxpayers document their risk allocations *before* restructuring transactions occur. Indeed, paragraph 25 vitiates paragraph 1.28 of the TP Guidelines by deeming it unreasonable that no written intercompany agreements exist. Paragraph 26 exacerbates taxpayers’ concerns by implying that the absence of documentation justifies special scrutiny by taxing authorities.

Next, paragraph 53 requires documentation of the restructuring at the group and individual-entity levels. Many if not most MNE restructurings are undertaken for group reasons and, depending

¹⁰ See TP Guideline 1.28 and also paragraph 26 of the report.

on the restructuring transaction, it may not be possible to identify a business purpose for the restructuring at the individual entity level. Moreover, in certain restructurings, such as the centralization of a purchasing function or the creation of an agency/principal sales structure, the benefits of the group's restructuring may not be assignable to the individual entities and it may not be possible to determine which entity or entities should pay or receive compensation for the restructuring. Requiring documentation at the entity level in such cases would impose an unreasonable burden on multinational groups. So long as the group confirms that the assets (including any intangibles) of each individual entity are transferred (and compensated) at their respective fair market values, the burden of proving the arm's length nature of the restructuring transaction should be satisfied.

Finally, given the wide variation in taxpayer recordkeeping practices, it is unclear what documentation the report would require. At a minimum, the report should confirm that taxpayers are not required to document all potential transaction structures and explain why it chose the transaction that it did. In addition, the OECD should provide examples of the types of documents that taxpayers are expected to retain.

Comparability of “Non-Benchmarkable” Functions

Paragraph 161 observes that there are cases where a tax authority and a taxpayer will disagree on the outcome of the comparability analysis, including the functional analysis, or disagree on the transfer-pricing method. This is likely to be the case, the report avers, where the tax authorities find “non-benchmarkable (*e.g.*, strategic) functions” or intangible assets. The report implies that it will never be possible to find a “reasonably reliable” comparable for a strategic function. To the extent the report's comment is intended to apply to management services, TEI disagrees. Management services have long been an accepted charge. TEI recommends that the report provide additional guidance about the meaning of the terms “reasonably reliable” and “non-benchmarkable function” for purposes of applying those terms in a comparability analysis.

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In addition to the foregoing general comments on the structure and purposes of the report, we have the following comments on specific paragraphs.

Comments on Paragraphs of the Report with which TEI Generally Concurs

1. Paragraph 27 acknowledges that “just because a related party arrangement is one not seen between independent parties” does not mean that the arrangement is non-arm's length. TEI applauds the OECD for confirming that MNEs that enter into internal agreements that cannot be found between unrelated parties are not by definition non-arm's length. It would be unrealistic to disqualify management agreements or cost-sharing arrangements as not being at arm's length simply because such agreements are not (or are only rarely) found among unrelated parties.

2. Paragraphs 29 to 34 state the general proposition that risk allocation generally should follow control of the risks. TEI agrees that the party that controls a risk should generally be the



party to whom the risk (and thus the reward) is allocated. The examples involving the fund manager and contract researcher illustrate the difference between controlling a risk and outsourcing the administration of the risk. Regrettably, there are no examples that illustrate the report's focus: conversions of businesses to contract manufacturing and stripped-risk distribution arrangements. TEI urges the OECD to provide examples involving debtor risk and inventory risk within a commissionaire or contract manufacturing environment.

3. TEI agrees with paragraph 64 that a profit or loss potential *per se* is not a transferable asset. The potential for making a profit is too ethereal to be considered a property right. In addition, the profit potential is matched in most cases by an equal potential for loss that would offset a positive value for the right. We disagree with the suggestions in paragraph 65 that the transfer of assets or rights requires an arm's length compensation for the profit/loss potential implicit in those assets. The arm's length principle only requires that there be an arm's length compensation for the assets or rights transferred; there is no right to compensation for a mere expectancy or opportunity for profit. Thus, paragraph 64 should include a statement similar to that in paragraph 101, that "there should be no presumption that all contract terminations or substantial renegotiations should give a right to indemnification at arm's length." Additional comments are provided below on paragraph 64.

4. Paragraphs 67 to 70 illustrate how the tax authorities might analyse whether the transfer of a profit/loss potential following a conversion of a full-fledged distributor to a stripped-risk distributor has been properly compensated. The example compares the five-year historical returns of three full-fledged distributors with the projected returns that the distributors would have received before and after the restructuring.

TEI fully agrees with the conclusion for case number three set out in paragraph 70: It is insufficient to rely solely on historical data when pricing a business restructuring. The illustration, however, may be misleading because it omits any analytic or rationale for determining how the "non-restructured" entity's net profit margins were derived in any of the three cases. For cases one and two, the five-year high and low net profit margins seemingly set the endpoints of the range of future expected returns, but historical data may not be fully representative of the profit and loss variation through a complete business cycle.¹¹ Moreover, projections of future returns are often far too optimistic.

5. Paragraph 78 lays the foundation for the discussion of the treatment of intangible assets in a business restructuring. TEI recommends adding the phrase "and whether unrelated parties would have paid for the transfers" to the final sentence.

6. Paragraph 101 states that there should be no presumption that all contract terminations or substantial renegotiations should give a right to indemnification at arm's length. TEI agrees. Whether arm's length parties would agree to an indemnification depends on the relative bargaining power of the parties at the inception of the agreement.

¹¹ In addition, where the post-restructuring return to the distributor is more stable, predictable, and thus lower risk, query whether the post-restructuring returns, especially in example 1, should not be lower than the historic returns?



7. Paragraphs 130-131 state the general proposition of the report: The arm's length principle and the TP Guidelines do not apply differently to post-restructuring transactions compared with those transactions structured as such from the beginning. We agree, but suggest that the report's attempts to apply the statement are frequently confusing. For example, the report suggests at paragraph 136 (and explains further at paragraphs 177-180) that, where there is an on-going business relationship after an arrangement is restructured (as there always will be in an MNE restructuring), arm's length parties will negotiate the pricing of the restructuring transaction and the post-restructuring arrangement together. Hence, the report implies that conditions for the restructuring and post-restructuring compensation should be considered together. While TEI acknowledges that there are third-party arrangements where the pricing for a restructuring of an agreement and the post-restructuring business transactions can influence the price and terms for each agreement, such transactions are the exception rather than the norm. Moreover, if there were a profit sharing, exclusivity, or non-compete agreement between arm's length parties, the term of the arrangement would be fixed and likely very short term (say, two to three years). Hence, it would be extremely rare that taxpayers or governments would find a comparable arrangement for an MNE restructuring where the pricing of the restructuring and the post-restructuring transactions should be considered together.

8. Paragraphs 148 to 149 explain the difference between a one-sided transfer-pricing method and a one-sided analysis. TEI agrees that in order to determine the appropriate transfer-pricing method and tested party in related party transactions qualitative information must be collected and reviewed about both the tested and non-tested parties. TEI is concerned, though, about the ever-increasing documentation requirements that the OECD and Member States are imposing to resolve transfer-pricing challenges. TEI recommends that the report clarify that when a one-sided method is determined to be the best method, further documentation requirements apply *only to the tested party* and that the collection of data for the non-tested party is limited to what is necessary to determine which party should be tested. In addition, we question the need for paragraph 149 because paragraph 148 adequately addresses the requirement to examine the functions of both parties. Suggesting that post-restructuring business transactions require additional information about the non-tested party could cause confusion.

9. Paragraphs 196 and 208 confirm that that MNEs are free to organise their business operations as they see fit and that it is not for tax administrations to determine the MNE's business structure or level of presence within a country. We concur. Business has the right to determine where it places functions and risks; the role of governments is only to confirm adherence to the arm's length principle and TP Guidelines.

10. Paragraph 213 states that it is "not sufficient from a transfer pricing perspective that an arrangement makes commercial sense for the group as a whole: the transaction must be arm's length at the level of each individual taxpayer, taking account of its rights and other assets, expected benefits from the restructuring arrangement, and realistically available options." TEI appreciates that in examining transactions between non-arm's length parties, the OECD and Member States must apply the TP Guidelines at the individual taxpayer level to determine the remuneration to be earned by such party. At the same time, to be considered non-abusive under paragraph 137, arrangements must satisfy a test of "commercial rational behaviour." It is fundamentally inconsistent to require that MNEs restructure for commercially rational reasons, which frequently can *only* be tested at the

group level or may only apply at the group parent level (*e.g.*, technology export controls), and then require that transactions be tested at the level of each taxpayer as a convenient argument to ignore MNE group-level reasons for undertaking the restructuring.

Comments on Paragraphs of the Report with which TEI Generally Disagrees

1. Paragraph 33 illustrates the allocation and management of risks between a scientific contract researcher and a principal for the development of a scientific or engineering project or process. In commercial practice, principals occasionally subcontract control over such risks to third parties. Hence, TEI recommends that the OECD clarify that a “principal” in the circumstances described in paragraph 33 can purchase the risk control expertise from an MNE’s Headquarters (or other centralised staff) so long as the arrangement is not wholly artificial.

2. Paragraph 42 states that evaluating whether a risk is economically significant “might be usefully informed by a review of accounting statements.” We agree.

Paragraph 42 continues that “if a risk is not recognised by the booking of a contingent liability . . . the question can be raised of the reason” that risk is not accounted for. The paragraph also states that “where the risk is recognised on the balance sheet (*e.g.*, through the booking of a contingent liability), the valuation method . . . may . . . provide a good indication not only of the amount of the possible loss . . . , but also of the probability of the risk materialising.”

As a preliminary matter, the paragraph seemingly conflates actual liabilities (those that are recognised in the balance sheet) with contingent liabilities, which may be recognised, if at all, only in the footnotes to the financial statements. In addition, while accounting standards (whether IFRS or country-specific GAAP) provide guidance on when assets and liabilities, including contingent liabilities, must be booked or disclosed in footnotes, those standards are not entirely consistent with one another and may conflict with local accounting or commercial laws and tax rules. More important, financial, commercial, and tax accounting rules may not always provide guidance on the types and amount of risk that the business restructuring report is focused on. Thus, the absence of a liability in the financial statements (or the absence of a specifically disclosed contingent liability) does not mean the risk is not “economically significant” to the business. Moreover, we disagree with the implication that the absence of a liability represents management’s judgment that a risk is immaterial or unlikely to be realised. Indeed, as the report correctly notes, there are many economically significant risks (such as reputational risk, product quality control, or potential changes in customer taste or demand) that may not be reflected in the financial statements. We believe that the only practical statement the report can make is that a company’s accounts and financial statements aid in understanding the business and the value of *many* but not all risks transferred in a business restructuring. Consequently, we recommend deleting the text between the first sentence and the last two sentences of paragraph 42.

3. Paragraphs 50, 51, and 115 discuss the basis for requiring compensation or indemnification of the transferor in a business restructuring as a matter of legal right. Although TEI agrees that unrelated parties to a legal arrangement or contract will always consider the remedies available by law or contract when the contract is breached or an arrangement is restructured, an



aggrieved party may for prudent business reasons, including other business opportunities and relationships with the breaching party, forgo those remedies or seek less than “full” compensation or indemnification. In other words, the opportunity to continue a profitable business relationship under new or different terms and conditions may trump the full exercise of legal rights. TEI recommends that the OECD clarify that the arm’s length standard does not require a transferor in a restructuring transaction to exhaust all its legal remedies or obtain “full” compensation in every case.

4. Paragraph 51 includes an example illustrating the requirement that the rights and obligations of a restructured entity must be compared with the rights and obligations of contracts governing the relationships between third parties. The example suggests that the conduct of related parties under a short term or “at will” contractual agreement in years or decades prior to a restructuring might indicate “a longer-term arrangement, and hence greater rights than those indicated by the legal contractual arrangement.” Paragraph 52 states that in the absence of a comparable, “it may be necessary to determine what rights and obligations would have been put in place had the two parties transacted with each other at arm’s length.” Together, the paragraphs imply that tax administrations can use hindsight to assert that a long-term contract was intended. We disagree. In addition, the example is incomplete because the risk of termination of a short term or “at will” contract may have been offset by a lower price for the goods or services than otherwise would have been agreed under a longer-term arrangement.

5. The last sentence of paragraph 55 states that paragraph 1.51 of the TP Guidelines recommends that tax administrations avoid the use of hindsight. We concur. Regrettably, the first sentence of paragraph 56 states that, “where there are significant discrepancies between the actual and anticipated synergies of a restructuring, the reasons for such discrepancies should be analysed” so that the proper party or parties can bear the consequences of the non-realization. This seems like hindsight analysis. TEI recommends that paragraph 56 be deleted.¹²

6. Paragraph 64 states that “profit/loss potential is not an asset, but a potential carried by some rights or other assets. The question arises whether there are rights or other assets transferred that carry profit/loss potential and should be remunerated at arm’s length.” Regrettably, the report does not define “profit/loss potential,” a key term used frequently in the report especially Issues Note 2. As a result of the omission, the report is vague about the relationship between assets, rights, goodwill, going concern, and the “profit/loss potential” of each as well as the “profit/loss potential” of the business activity. Paragraph 93 exacerbates the uncertainty by seemingly equating profit/loss potential with traditional notions of ongoing concern and goodwill value.¹³ If, as stated in paragraph 93, the profit/loss potential is inherent in the activity transferred, what profit/loss potential is

¹² At a minimum, the report should caution against the use of hindsight to analyze and measure synergies. If the expected synergies projected by the taxpayer at the outset of the transaction are reasonable, no further analysis should be required to establish (or confirm) the transfer pricing for the restructuring transaction.

¹³ Paragraph 93 states, in part, “transfers of ongoing concerns between independent parties often take account of any possible “goodwill”, *i.e. of the profit / loss potential (if any) of the activity transferred . . .*” (Emphasis supplied.) Is the profit/loss potential inherent in the “activity transferred” as this statement suggests, or is goodwill or going concern the residual value after assigning specific fair market values to identifiable tangible and intangible assets? The latter is the generally accepted accounting practice for acquisitions between independent parties.



assigned to the individual assets or rights transferred and thus potentially subject to a requirement for payment of additional compensation beyond the fair market value of the assets or rights? Because the concept of taxing the profit/loss potential of an asset is vague and potentially misleading, TEI recommends that the OECD provide a definition of profit/loss potential and clarify the relationship between that concept and specific assets (including intangible assets such as customer lists or brand names) and goodwill or going concern value. In no event should the transfer price (or compensatory payment) for a restructuring exceed the fair market value of the assets transferred.

As important, if the transferee in a business restructuring is expected to compensate the transferor for the profit/loss potential inherent in specific assets or goodwill or going concern values, the report should clarify that the host country of the transferee should afford the taxpayer a deduction (either currently as a loss or over time through increased depreciation or amortization) for the amount paid. If the OECD believes that it should defer to local country laws on the issue, TEI again requests clarification of the relationship among assets, goodwill, going concern, and the “profit/loss potential” of assets transferred in a restructuring. The “profit/loss potential” concept is vague, uncertain, and likely does not have a counterpart under most country’s laws for purposes of determining the treatment of a transferee’s payment to a transferor.

7. Paragraph 66 describes factors that affect whether a profit/loss potential transferred in a business restructuring would be compensated if undertaken at arm’s length. Three bullet points list the factors to be considered: (1) the options realistically available based on the “rights” and assets of each party at the outset, (2) the expected return to each party after the restructuring, and (3) compensation that might be required to remunerate the transferor for “surrendered rights” or other assets that carry profit potential. TEI recommends that the report include a fourth bullet point explaining when the transferor will be considered to have “surrendered rights.” This might include, for example, an analysis of the legal relationships created or terminated pursuant to the restructuring. The additional guidance will be important where tax administrations disregard or recharacterise a transaction or arrangement between related parties.

8. Paragraphs 68 suggests and paragraph 169 states that “absent satisfactory comparable data, it may be necessary to determine what conditions *would have been agreed*, had the parties transacted with one another at arm’s length.” The implication is that tax authorities may impose conditions that “would have been agreed.” TEI disagrees. In addition to lacking clarity about how the tax authorities would determine what such conditions would be (or how taxpayers should defend against such assertions), the range of possible outcomes and conditions in negotiations between arm’s length parties can be substantial. TEI recommends that the OECD drop this requirement. If the requirement is retained, taxpayers should only be required to show that the conditions are reasonably within the range of what arm’s length parties would agree to. Taxpayers should not be required to demonstrate that the result is the most likely to occur or be adopted at arm’s length.

9. Paragraphs 105-114 discuss whether the “terms of the arrangement and the possible existence or non-existence of an indemnification clause or other type of guarantee (as well as the terms of such a clause where it exists) are arm’s length.” The issue is whether termination of a business arrangement would cause arm’s length parties to pay indemnification or compensation for the termination.



Most MNEs have longstanding contractual arrangements and those agreements, including the terms (or absence of) termination clauses or indemnification provisions, have, for purposes of taxing the profits of the parties to the arrangement, been accepted as arm's length on audits by multiple taxing authorities.¹⁴ TEI believes that taxpayers should be able to rely on the longstanding acceptance of such agreements as arm's length. For the tax authorities to challenge one clause (such as a termination or indemnification clause) in an agreement when reviewing a restructuring transaction is inconsistent with the authorities' prior acceptance of the agreement. Since all the terms of an agreement ultimately affect the price, challenging the "possible existence or non-existence of an indemnification clause or other type of guarantee" has a corresponding effect that would likely have diminished the profits that were earned and taxed in a previous year. Indeed, if a distribution arrangement were not terminable at will by a producer, the price of products sold to a full-fledged distributor would likely have been higher from the inception of the arrangement because the producer would not have been able to terminate the arrangement expeditiously to seek a better distributor. In other words, the beneficiary of the indemnification or guarantee clause has to pay for that right somehow and the direct or indirect "payment" through higher prices would lower prior reported profits of the beneficiary. As a result, the taxable profits of the distributor should have been lower from the inception of the agreement. TEI recommends that the OECD caution taxing authorities that challenging a termination clause (or challenging the absence of an indemnification agreement for termination of an agreement) has a counterproductive effect on the profits previously reported by the party benefitting from the indemnification or guarantee.¹⁵

10. Paragraph 161 discusses an example where the taxpayer concludes that a cost-plus, resale price, or transactional net margin method is the best transfer-pricing method whereas the taxing authority concludes that a profit split transactional method would be more appropriate. The paragraph is potentially misleading because it suggests that the taxing authority can freely substitute its judgment for the taxpayer's in selecting the best transfer-pricing method. The TP Guidelines require a far more rigorous analysis of the taxpayer's method before the taxing authorities disregard the method actually applied. TEI recommends revising the paragraph accordingly.

11. Paragraph 162 states that there are cases where a transactional profit split method would be used as a "sanity check" to test the outcome of a primary pricing method. We note that the TP Guidelines do not require the use of multiple methods to test the arm's length nature of ordinary business transactions. Once the best method is determined, it is applied. Thus, the suggestion at paragraph 162 that a profit split method should be used as a "sanity check" is inappropriate. MNEs already face substantial, increasing burdens in respect of transfer-pricing documentation. Requiring a second method as a sanity check would double the workload. Merely suggesting that a profit split method should be used as a sanity check will encourage tax authorities to apply this method, which

¹⁴ According tax authorities the power to change individual clauses of an agreement, generally with the benefit of hindsight, is especially unfair to taxpayers. Taxpayers must document the clauses of the contracts are at arm's length when they are entered into and years before a contract is terminated or renegotiated.

¹⁵ The OECD should also clarify that whether parties would agree to an indemnification in a contract depends on the relative bargaining power of the parties at the inception of the contract, not at its termination; the question whether such rights are exercised by the benefitted party depends on the relative bargaining power of the parties at the time of termination or renegotiation of the contract.



will likely increase disputes. It also implies that the profit split method may be preferred to traditional transactional methods, an implication that is inconsistent with the TP Guidelines.

12. Paragraphs 170 to 176 provide an example of the introduction of a central purchasing entity in an MNE group. As a preliminary matter, it is unclear from paragraph 171 whether the central purchasing function results from a restructuring or was established at the outset. The OECD should clarify that fact and its relevance to the analysis.

Next, paragraph 175 discusses the pricing inefficiencies that may arise from the forced purchase by a manufacturing entity of raw materials or components from the central purchasing entity and asks whether at arm's length independent manufacturers would have accepted higher prices than could otherwise be obtained or whether the central purchasing entity should bear the pricing inefficiency by reducing the prices charged to the manufacturer. As noted in the paragraph, these are questions of fact that depend on all the circumstances and it is unclear why the example is even relevant to the discussion draft on restructuring. The TP Guidelines would seem sufficient by themselves to answer the questions posed in Issues Note 3 and the example. If Issues Note 3 is retained in the final report, we recommend that the OECD find a different example to illustrate its concerns.

Finally, TEI recommends that the report discuss the following factors that give rise to inefficiencies, but should not require a transfer-pricing adjustment:

- Employees and managers of an MNE are not all equally diligent and skilled. Consequently, some taxpayers within an MNE will overperform while others underperform and the arm's length principle is not a means of adjusting for differences in employee skills or diligence. In transactions between unrelated parties, party A would rarely, if ever, compensate party B for its inefficiencies by sharing part of its profit with B (or reducing the sales price to B). Where inefficiencies arise from the skills or performance of personnel, MNEs will correct the situation. There is no role for government in the internal management of an MNE.
- Even in transactions between competent third parties, judgment errors occur. Where a taxpayer can show that at the time it undertakes a business restructuring an objectively fair deal has been concluded for the restructuring, it is not the role of the transfer-pricing guidelines to retroactively correct the judgment error. If the post-restructured business transactions do not comport with the arm's length principle, taxing authorities may adjust those transactions without analysing or affecting the restructuring transaction.
- Some "inefficiencies" in pricing can arise because of a conscious business decision to control risks other than pricing in a centralised purchasing function. In other words, businesses choose to centralise purchasing not only to attain price reductions through volume purchases and global negotiations with suppliers, but also to ensure control of the purchasing function for various other compliance reasons. Under prevailing corporate governance policies, controls must be established in order to



avoid conflicts of interest, anti-competitive behaviour, and unethical or illegal payments. Centralization of the purchasing function can be one means of ensuring such control even if it results in increased costs for purchased goods or services. TEI believes that such increased costs should be borne by all members of the group as a normal cost of doing business and thus should not be a basis for a transfer-pricing adjustment. For these reasons, the centralised purchasing function is not a good example to illustrate the report's concerns.

13. Paragraph 177 states that there may be a relationship between the amount of compensation for the restructuring and post-restructuring compensation. Paragraph 178 provides an example where a taxpayer agrees to forgo restructuring compensation from a foreign party in order to obtain the opportunity to earn higher profits on sales of products to the foreign party after the restructuring. Although TEI agrees that such transactions occur at arm's length, the term of the post-restructuring agreement is generally limited to two to three years. An agreement structured for a longer period exposes the seller to the buyer's entrepreneurial risks.

14. Paragraphs 181 to 187 address the comparison of profits earned by a party to a controlled transaction before and after a restructuring transaction. Paragraph 182 helpfully acknowledges that such a comparison would not "suffice in the face of the requirement posed by Article 9 of the Model Tax Convention for a comparison to be made with uncontrolled transactions." Even if taxpayers were to accept the proposition that information about post-restructuring transactions can provide information to understand whether the restructuring transaction is arm's length, a before and after comparison should not be made to assess the arm's length nature of the post-restructuring transactions. If assets, functions, and risks are transferred in the restructuring, these facts significantly affect the remuneration that should be paid in the post-restructuring transactions. Hence, the relevance of the profits (or prices) earned before the restructuring to the post-restructuring transactions is dubious. The question is whether the post-restructuring transactions are comparable to what independent parties undertake.

15. Paragraphs 188-193 discuss the treatment of location savings. Paragraph 189 states that where significant location savings are derived from a business restructuring, the questions arise whether and how location savings should be attributed to the parties.

TEI has significant reservations about reallocating location savings through post-restructuring compensation among related parties. Location savings are what make markets attractive. Paragraph 189 correctly observes that the conditions for transactions between related parties should mirror what arm's length parties would have negotiated, which normally depends on the functions, assets, risks, and relative bargaining power of the parties. Where an enterprise acting at arm's length is able to obtain location savings, it will not share those location savings with other parties. Correspondingly, between related parties, there is no basis for adding a mark-up for location savings because if there were a mark-up, the location would lose its cost-advantage and potentially its business. Market forces will cause shifts in supply and demand and the price to be paid for the goods or services produced in the low-cost jurisdiction. Any attempt to require a reallocation of location savings among a group of related companies will be a theoretical exercise that simply cannot be confirmed by reference to comparable transactions.



Thus, TEI agrees with the example given in paragraph 191 and the conclusion reached under the last sentence. We cannot, however, agree with the conclusion in paragraph 193. A location's costs are what they are, regardless of the scarcity of alternative service providers or the hidden intangibles a service provider may possess. For example, if Indian engineers generally charge US\$100 per hour to unrelated U.K. clients, then the TP Guidelines require that they charge US\$100 per hour to a related U.K. company (Company X) regardless of the fees Company X may charge its clients. There is no basis for a mark-up or profit split based on location savings.

16. Paragraphs 214-216 provide an illustration of the conversion of a full-fledged distributor to a riskless distributor. In the facts described in paragraph 214, the distributor receives full compensation, presumably an arm's length value, for the transfer of all the property. In paragraph 215, it is assumed that the actual conduct of the parties is consistent with the form of the restructuring and, hence, the compensation for the restructuring and post-restructuring activities would result in an arm's length outcome. Notwithstanding the "arm's length nature" of the transaction at the group level, some Member States would consider the sale of the "crown jewels" such as valuable trade names as so detrimental to the transferor that it would not do so at arm's length. Hence, for these Member States the "group perspective" for determining the commercial rationality of the transaction would not apply.

TEI disagrees and urges the OECD to do more than merely restate the views of the Member States. Every asset has its price. Concededly, certain intangible assets may have considerable value and it may be difficult to find a comparable value to establish the proper arm's length price, but that does not give the taxing authorities the right to recharacterise the transaction. The taxing authorities remedy should be limited to making an adjustment to the price for comparability factors and not to recast the restructuring transaction and the post-restructuring controlled transactions.

17. Paragraphs 217 to 219 provide a comprehensive example to illustrate the overall purpose of the discussion draft and compare a transfer of brand names to a shell holding company with a transfer of such brand names and employees to an operating company. In TEI's view, the difference in result between the "abusive" transaction in 218 and the acceptable transaction in paragraph 220 rests on the transfer of a number of employees "who have the authority to and actually perform control functions in relation to the risks associated with the strategic development of the brand names" to the brand management and marketing company. Although we believe the principal — the transferee company in either brand example — can subcontract the control of the marketing risks back to the Head Office for an arm's length price, we can understand why an OECD country might challenge a transfer to a shell company. The flaw in the example is that it fails to provide meaningful guidance to taxpayers and tax authorities about the critical distinctions between the two cases. Is the difference in result attributable to the number of employees being transferred? If so, how many employees are enough? Does the difference depend on the skills or expertise of the transferred employees? If so, what skills are necessary? Is it a combination of factors? Can there be a balance between employees and external service providers? We recommend that the OECD provide additional guidance to permit taxpayers and taxing authorities to differentiate an acceptable restructuring from an unacceptable one.



Additional Issues for Consideration

The following comments address issues that are not in the report, but we commend them for the OECD's consideration.

1. To provide balance to the report and encourage the exercise of objective analysis by taxing authorities, the OECD should note that arm's length adjustments may, in certain circumstances, require downward pricing adjustments thereby reducing a Member State's allocable share of the enterprise's profit.

2. In discussing the factors that drive business restructurings, the OECD should be mindful that cost savings are always measured by business taxpayers on an after-tax basis because the valuation of a an MNE, especially a publicly traded enterprise, is based on net income as opposed to profit before tax.

Conclusion

TEI appreciates this opportunity to present its views on the Discussion Draft on the Transfer Pricing Aspects of Business Restructurings. These comments were prepared under the joint aegis of TEI's European Direct Tax Committee, U.S. International Tax Committee, and Canadian Income Tax Committee, whose Chairs are Johann Müller, Brian C. Ugai, and Rodney C. Bergen respectively. If you have any questions about the submission please contact Mr. Müller at +45 3363 4374 (or johann.muller@maersk.com), Mr. Ugai at +1 206 318 6313 (or bugai@starbucks.com), Mr. Bergen at +1 604 488 5231 (or bergen@jp-group.com), or Jeffery P. Rasmussen of TEI's legal staff at +1 202 638 5601 (or jrasmussen@tei.org).

Respectfully submitted,

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