



ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT



RESPONSE OF THE COMMITTEE ON FISCAL AFFAIRS
TO THE COMMENTS RECEIVED ON THE
SEPTEMBER 2008 DISCUSSION DRAFT ON THE
TRANSFER PRICING ASPECTS OF BUSINESS RESTRUCTURING

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CENTRE FOR TAX POLICY AND ADMINISTRATION

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A. Background and process followed

A.1 Origins of the project

1. In January 2005, in recognition of the widespread phenomenon of business restructurings by multinational enterprises (“MNEs”) and of the tax issues they raised, the OECD Centre for Tax Policy and Administration organised a Roundtable on Business Restructurings (“the January 2005 CTPA Roundtable”) which was attended by senior officials from OECD member countries as well as from China, South Africa and Singapore and by a wide panel of private sector representatives.¹ Government and private sector participants addressed a broad range of issues, including administrative approaches taken in examinations, treaty, transfer pricing and VAT issues. The discussions at the January 2005 CTPA Roundtable demonstrated that business restructurings raise difficult transfer pricing and treaty issues for which there was insufficient OECD guidance with respect to their treatment under both the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (hereafter “the Guidelines”) and the OECD Model Tax Convention on Income and on Capital (the “Model Tax Convention”). These issues, which involve primarily the application of transfer pricing rules upon and / or after the conversion, the determination of the existence of permanent establishments (“PEs”), and the recognition or recharacterisation of transactions, may lead to significant uncertainty for business as well as for governments and possible double taxation or double non-taxation, in the absence of a common understanding. Recognising the need for work to be done in this area, the Committee on Fiscal Affairs (“CFA”) decided to start a project to develop guidance on these transfer pricing and treaty issues.

A.2 Involvement of the Committee on Fiscal Affairs and subsidiary bodies

2. In 2005 the CFA created a Joint WP1-WP6 Working Group on Business Restructurings (“the JWG”), *i.e.* a group of treaty and transfer pricing experts that was formed as a subsidiary body of Working Party No. 1² and Working Party No. 6³ to carry on the OECD’s project on business restructurings.⁴ The JWG made a detailed review of the treaty and transfer pricing issues raised by business restructurings, discussed sometimes differing country views thereon, and was able to make significant progress towards more common positions.

3. At the end of 2007, having taken stock of the progress made to that point, the CFA decided to refer the work on the transfer pricing aspects of business restructurings (*i.e.* the issues under Article 9 of

¹ See http://www.oecd.org/document/6/0,3343,en_2649_37989760_34535302_1_1_1_1,00.html.

² Working Party No. 1 is the CFA’s subsidiary body with responsibility for the Model Tax Convention.

³ Working Party No. 6 is the CFA’s subsidiary body with responsibility for the TP Guidelines.

⁴ See background information on the approval of a mandate for the JWG at http://www.oecd.org/document/11/0,3343,en_2649_37989760_38087051_1_1_1_1,00.html.

the Model Tax Convention) to a newly created Working Party No. 6 Special Session⁵ on Business Restructuring (the “WP6 BR”), and the work on the PE threshold aspects (Article 5 of the Model Tax Convention) to Working Party No. 1. The new Chapter IX of the Guidelines has resulted from the work done on the transfer pricing issues by the JWG and the WP6 BR.

4. For purposes of the work on the new Chapter IX, the CFA instructed the JWG and the WP6 BR to base their analysis on the existing transfer pricing rules.

A.3 *Involvement of the business community*

5. The January 2005 CTPA Roundtable was attended by a wide panel of private sector representatives, and their input was taken into account by the OECD.

6. In addition, shortly after it started its work on the treaty and transfer pricing aspects of business restructurings, the OECD decided to set up an informal group of academics, business representatives and consultants (the “Business Advisory Group”)⁶ in order to obtain technical and factual input from the business community on the issues discussed by the JWG in the early stages of its work. In effect it was felt that the project could greatly benefit from discussions with a small group of tax and transfer pricing specialists with significant experience with business restructurings in a variety of industry sectors, which they have acquired either as tax managers of large companies or as advisors. In drawing up the list of members of the Business Advisory Group, the OECD tried to achieve as good a geographical balance as possible while keeping the Group reasonably small for the purpose of ensuring effective discussions. The Business Advisory Group met three times in 2006 and 2007 with the OECD Secretariat and with Delegates of the JWG. The outcome of these meetings was quite positive as all participants, business and governments, were able to express their views in a very constructive fashion. It should be stressed that the Business Advisory Group was by no means intended to be a substitute for a wider consultation process, and an invitation was posted on the OECD Internet site (www.oecd.org/ctp/br) for any interested parties who wished to provide input in the interim on the issues that were within the JWG’s mandate to submit comments to the OECD Secretariat.

7. On 19th September 2008, the OECD released for public comment on the OECD Internet site (www.oecd.org/ctp/br) a draft version of this Chapter (hereafter “the Discussion Draft”). Detailed contributions were received from 37 organisations, reflecting the significance of this work for the business community. These contributions were also posted on the OECD Internet site. A two-day consultation meeting with the commentators was held in June 2009. The outcome of this consultation process was carefully discussed by the WP6 BR in finalising this Chapter.

A.4 *Status of this Chapter*

8. This Chapter was approved by the CFA on 22 June 2010 and incorporated as a new Chapter IX in the Guidelines. The Recommendation of the Council of the OECD [C(95)126/Final] was amended on 22 July 2010 to reflect this and other changes made to the Guidelines.

B. Public comments received on the September 2008 discussion draft

9. The thoughtful written comments received, and the discussions at the public consultation, have been extremely helpful to the work of the OECD in finalising a new Chapter of the Guidelines based on the

⁵ Special Sessions are created by Working Party No. 6 to carry on its technical discussions on a project by project basis. They are open to all Working Party No. 6 Delegates.

⁶ See http://www.oecd.org/newsEvents/0,3382,en_2649_37989760_1_1_1_1_1,00.html.

Discussion Draft. The OECD expresses its gratitude to commentators for their assistance in this project. The participation of the business community in the work on this project has helped to improve and clarify the final product.

10. Comments received were generally of two types. One type of comment contained drafting and editorial suggestions. Many of these have been incorporated in Chapter IX, making it clearer and more precise. Other submitted comments raised issues regarding the substantive provisions of the Discussion Draft. The OECD attempted to reach a balance between the comments requesting more detailed guidance and those concerned with the guidance being too prescriptive. Some of the concerns raised by commentators had broad implications that were beyond the scope of this project and were not addressed or were addressed in the revision of Chapters I-III of the Guidelines (“the revised Guidelines”). Some concerns directly relating to the transfer pricing of intangible property have been deferred to the tentatively agreed future project to revise Chapters VI and VIII of the TP Guidelines. The following discussion summarises some of the important substantive comments from the business community and the action taken by the OECD in response to the comments.

B.1 General Comments

11. Many commentators expressed the view that the Discussion Draft represented a balanced presentation of the most important transfer pricing issues arising in the context of business restructuring transactions. The Discussion Draft was commended as representing “excellent work” and as reflecting “common sense, balance and pragmatism.” Notwithstanding these compliments, some commentators expressed certain general, overarching concerns with the Discussion Draft.

12. Several commentators noted that various statements and examples in the Discussion Draft lacked consensus support from all members of the OECD. Some commentators urged continued work to achieve full consensus. Others suggested adopting a process that would reflect a majority view in a final report and allow dissenting countries the opportunity to register public reservations or observations regarding that majority view.

13. Chapter IX of the Guidelines, which is a revision of the Discussion Draft, is a consensus document endorsed by all OECD members. In most instances, previous differences of opinion have been resolved through further discussion. In a few instances, agreement has been reached to defer detailed discussion and decision until subsequent projects, particularly the Working Party No. 6 project on transfer pricing aspects of intangible property which is tentatively scheduled to commence in 2011.

14. Some commentators requested changes and expansions in the Discussion Draft that WP6 considered beyond the scope of its mandate, including requests to revise certain aspects of the existing Guidelines. It is important to recognise that this project was limited in scope to the application of the guidance contained in the existing Guidelines in the context of business restructurings. In developing the guidance on business restructuring, the Working Party maintained the concepts originating from the 1995 Guidelines, in particular at paragraphs 1.15, 1.23, 1.26, 1.27, 1.29, 1.41 (paragraphs 1.34, 1.45, 1.48, 1.49, 1.53, 1.69 of the revised Guidelines). Comments requesting modification or expansion of the Guidelines or other actions beyond this defined mandate were not followed.

15. Some commentators expressed the view that the Discussion Draft was drafted in a manner that placed too much emphasis on subjective determinations. They pointed to concepts contained in the Discussion Draft such as “arm’s length allocation of risks,” “options realistically available,” and “commercially rational behaviour” as being imbued with subjectivity. Some commentators expressed the view that the subjectivity inherent in the determinations required under the Discussion Draft would

inevitably give rise to controversy and double taxation and urged that revisions of the Discussion Draft include special measures to protect against double taxation.

16. The process followed by WP6 was to address in the Discussion Draft certain issues relevant to business restructurings by making reference to concepts already found in the Guidelines. The OECD recognises that a certain level of subjectivity is inevitable in transfer pricing determinations. That being said, drafting changes and clarifications have been made throughout Chapter IX to limit insofar as possible subjective elements of the Discussion Draft.

17. The OECD is of the view that, thanks to the efforts made by member countries and the comments received from the public throughout this project, more common understanding of how to apply the arm's length principle to business restructurings was reached and that there will be an enhanced level of tax certainty on the issues raised by the widespread phenomenon of business restructurings. The OECD also believes that concerns regarding double taxation arising in connection with Chapter IX of the Guidelines should be considered in the broader context of OECD work. Chapter IX of the Guidelines, like other sections of the Guidelines, reflects an effort to clarify the operation and application of Article 9 of the OECD Model Tax Convention. The Model Tax Convention contains provisions addressing relief of double taxation and mechanisms for the resolution of controversies through MAP, including the mechanism of mandatory, binding arbitration. These processes are fully applicable in the context of business restructurings and the OECD continues its efforts to improve and enhance the operation of treaty dispute resolution processes.

B.2 Documentation Issues

18. Several commentators suggested that various provisions of the Discussion Draft would create an excessive documentation burden for taxpayers. Comments point to places in the Discussion Draft where documentation requirements seem to be increased. Some commentators suggested the adoption of a "prudent business management" standard to limit documentation demands.

19. Particularly as relates to documentation requirements, a number of drafting amendments were made to avoid creating the impression that documentation requirements are created by Article 9 of the Model Tax Convention. The OECD believes that the preparation by taxpayers of appropriately comprehensive transfer pricing documentation is a good practice that can assist taxpayers in their compliance efforts and assist tax administrations in enforcing transfer pricing laws. Moreover, the preparation of documentation provides taxpayers with a useful opportunity to present their views to tax administrations regarding the consistency of their controlled transactions with the arm's length principle. Such presentations can sharpen the focus of the review by tax administrators and narrow the scope for possible disagreement. A taxpayer that prepares documentation contemporaneously with a transaction can only increase the understanding of its transfer pricing positions. When a taxpayer prepares documentation only in response to an audit inquiry from a tax administration, it will not always be clear that a transfer pricing analysis was performed at the time of the transaction. Finally, it is important to remember that the specific required content and timing of transfer pricing documentation are matters properly left to local country law. Whatever is said regarding documentation in the Guidelines is only intended to provide general guidance for tax administrations to take into account in developing their domestic law and to assist taxpayers in identifying documentation that would be helpful in showing that their controlled transactions satisfy the arm's length principle (see paragraph 5.1 of the Guidelines).

B.3 Reasoning in a Theoretical Arm's Length Environment

20. Commentators noted the tensions that sometimes exist between the normal management and decision-making processes of an MNE group and the necessity of reasoning within the constraints of an

arm's length theoretical environment. They suggested that notions contained in the Discussion Draft such as "control over risks" and consideration of "options realistically available" cannot properly be evaluated in an MNE context by reference to transactions between independent enterprises. These commentators suggested that the OECD should develop principles related to transfer pricing for business restructurings which accurately take into consideration typical MNE group decision-making processes and management control structures. Similarly, commentators observed that synergies derived from operating as an integrated MNE group are difficult to analyse by reference to transactions between independent enterprises transacting on an arm's length basis.

21. The OECD recognises the difficult tensions that necessarily exist between MNE group management and operating models and the demands of rules based on the arm's length principle. It is not the intention of the OECD to require that associated enterprises actually behave as would independent enterprises in negotiating and agreeing to the terms of the arrangements in question. Rather, it is the intention that the results of transactions between associated enterprises be consistent with those that would result from the normal commercial behaviour of comparable independent enterprises (see paragraph 9.174 of the Guidelines). The OECD work on business restructurings has sought to reasonably apply concepts already present in the Guidelines in the context of business restructurings and in doing so to strike a proper balance between ensuring that the unique features of MNEs are recognised and satisfying the need to identify results that are consistent with transactions between independent enterprises.

B.4 Risk Allocation

22. Commentators raised a number of issues relating to the provisions of the Discussion Draft that address allocation of risks. Some commentators argued that paragraph 1.27 of the Guidelines (paragraph 1.49 of the revised Guidelines) does not provide an independent basis for a tax administration to disregard a taxpayer's allocation of risk or to effectively rewrite the terms of contracts between associated enterprises. According to some of these commentators, control over risk should not be a consideration in whether risks are appropriately allocated and taxpayers' agreements regarding the allocation of risk should be generally respected. Commentators suggested that in certain types of transactions between independent enterprises, allocation of risk without day-to-day control over the risk is common. It was suggested that the Discussion Draft should more clearly acknowledge that day-to-day management of risks can be outsourced by the party bearing the risk, without entailing a transfer of the risk to the entity to which risk management is transferred.

23. Chapter IX clearly states that the analytical framework to allocate risks between associated enterprises under Article 9 of the Model Tax Convention differs from the AOA that was developed for attributing profits to a permanent establishment under Article 7. Some notions that could create ambiguity were eliminated (*e.g.* the reference to core and non-core elements of the transaction). In addition, a number of clarifying changes were made to the discussion of the allocation of risk. Chapter IX of the Guidelines makes it clear that, as a general rule, tax administrations should seek to address risk allocation issues through pricing adjustments and that disregarding or modifying risk allocations in taxpayer agreements should be limited to exceptional circumstances (see paragraph 9.38). This approach is consistent with the approach under paragraphs 1.64 – 1.69 of the revised Guidelines.

24. At least one commentator expressed a concern that in the (re)insurance industry, it is very important to distinguish between the term "transferring risks" in the business restructuring sense and the term "risk transfer", being the basic activity of insuring risks on behalf of another party.

25. It is not the intention of the OECD to apply guidance on business restructuring to all the situations where a risk is transferred as a result of subscribing to an insurance policy with an entity the core business of which is the provision of insurance.

26. Some commentators suggested that the financial capacity to assume or bear risk should be given greater prominence in revising the Discussion Draft. Certain commentators suggested in this regard that it should not be necessary for an entity to have sufficient capital to cover any risk that may come to fruition. Rather, commentators suggested that an entity could insure against the risk or hedge the risk and still be appropriately determined to be bearing the risk as among members of the MNE.

27. The discussion of financial capacity to assume risk was expanded and clarified. The notion of “anticipated financial capacity to bear risk” that was in the Discussion Draft was replaced with “financial capacity to assume risk” at the time when risk is allocated to an associated enterprise, which is a less uncertain notion.

28. Finally, some commentators expressed concern regarding the discussion of the role of comparable arrangements in determining whether a particular allocation of risks is consistent with arm’s length transactions.

29. The drafting of the discussion of the role of comparable risk allocations was clarified. Language was added to clarify that there is no requirement to search for comparables for each risk allocation, but in most cases comparables data will be searched for a transaction that involves, among other conditions, the assumption of risk (for instance, a manufacturing or distribution transaction). It was also made clear that the absence of comparables for a particular risk allocation does not necessarily mean that it is not arm’s length. The notion of control over risk was placed in a more limited context, although the OECD continues to believe that the capacity to assess the outcome of risk monitoring and risk administration is a necessary element of controlling a risk.

B.5 Contractual Terms and the Allocation of Risk

30. Various commentators requested clarification of the statement in the Discussion Draft 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.” Commentators suggested that contractual terms can have the effect of limiting or assigning risk and that such contractual terms should be taken into account in assessing the risks borne by particular members of an MNE group. The statement in question has been clarified in finalising Chapter IX.

B.6 Options Realistically Available

31. Commentators raised concerns about the discussion in the Discussion Draft regarding “options that would have been realistically available at arm’s length”. Some commentators suggested that this was not a relevant inquiry at the level of the individual entity since decisions in an MNE group are made on a group basis and for group purposes. Others suggested that the obligation to consider and provide documentation for numerous alternatives would be administratively burdensome. Finally, some commentators suggested that consideration of purely hypothetical options would be unlikely to advance the analysis.

32. Clarifying changes were made in the drafting of these paragraphs. As revised, Chapter IX of the Guidelines suggests that the Guidelines are not intended to create a requirement that taxpayers analyse and document all possible hypothetical options realistically available (see paragraph 9.64). However, the OECD believes, and Chapter IX of the Guidelines clarifies, that consideration of options available at the individual entity level may be relevant in applying the arm’s length principle to a business restructuring (see paragraphs 9.59-9.64).

B.7 Defining Taxable Events in Connection with a Business Restructuring

33. Some commentators expressed a concern that the Discussion Draft did not define with sufficient precision the circumstances under which income would be required to be recognised in connection with a restructuring transaction. Some commentators suggested that income recognition be limited to situations that involve transfers of interests in property. It was also suggested that the Guidelines should contain a clear statement that transfers of profit potential, transfers of business functions, and changes in commercial relationships should not give rise to income recognition.

34. When applying the arm's length principle to business restructurings, the question is whether there is a transfer of something of value (rights or other assets) or a termination or substantial renegotiation of existing arrangements and that transfer, termination or substantial renegotiation would be compensated between independent enterprises in comparable circumstances. Chapter IX clearly states that the arm's length principle does not require compensation for a mere decrease in the expectation of an entity's future profits and that there should be no presumption that all contract terminations or substantial renegotiations should be indemnified at arm's length (see paragraph 9.65). On the other hand, the OECD did not agree with the comments suggesting that in transactions between independent enterprises, compensation would be provided only with regard to transfers of narrowly defined interests in property. Furthermore, where it is found that compensation would be paid at arm's length, the characterisation of the payment as a taxable event or not is beyond the scope of this project (see paragraph 9.8).

B.8 Intangible Assets

35. It was suggested by some commentators that statements regarding the definition of intangible assets, including references to "soft intangibles", "synergies", "profit potential", and "local marketing intangibles", should be clarified. Other commentators stated that the discussion of valuation of intangibles lacking an established value at the time of transfer, set out at paragraphs 87 and 88 of the Discussion Draft, was biased in favour of the use of hindsight and *ex post* adjustments.

36. It was recognised by Working Party No. 6 that greater precision in the Guidelines regarding certain concepts related to intangible property would be desirable. However, providing comprehensive clarification is an undertaking that will be very time-consuming and one that has relevance beyond the scope of this project. WP6 has tentatively concluded that it will commence a project on the transfer pricing aspects of intangible property in 2011. This project will address definitional issues among other matters. The drafting regarding the valuation of intangibles transferred at a point in time when they do not have an established value in paragraphs 87 and 88 of the Discussion Draft was clarified to indicate that the provisions of paragraphs 6.28 through 6.35 of the Guidelines govern the treatment of transfers of intangibles when valuation is highly uncertain at the time of the transaction.

B.9 Profit / Loss Potential

37. A number of commentators suggested that the definition of "profit / loss potential" and the references to "profit / loss potential" and "goodwill" in the discussion of "ongoing concern value" in the Discussion Draft were confusing and unclear. In finalising Chapter IX of the Guidelines, an effort was made to clarify the discussion of these matters and the relationship between these concepts. The use of the term "profit potential" was clarified to refer to expected future profits. It is clearly stated that in the context of business restructurings, profit potential should not be interpreted as simply the profits that would occur if the pre-restructuring arrangements were to continue indefinitely (see paragraph 9.67).

B.10 Indemnification of the Restructured Entity

38. In commenting on the discussion in the Discussion Draft regarding indemnification of the restructured entity for the termination or substantial renegotiation of existing arrangements or for detriments suffered as a consequence of the restructuring, some commentators suggested that commercial legislation and case law should be determinative of the question of whether indemnification should be required under the arm's length principle. Other commentators suggested that the circumstances in which indemnification would be provided between uncontrolled entities were extremely rare and that, in the absence of contractual provisions or commercial law requirements, such indemnification should not be required in connection with a business restructuring.

39. The OECD agrees that commercial legislation and case law can play a role in determining whether indemnification should be provided in connection with a business restructuring transaction. However, it does not agree with those commentators that would make the existence or non-existence of indemnification rights under commercial legislation or case law prescriptively determinative of the issue, because the solution under commercial legislation or case law may depend on the wording of contractual arrangements in place, and contractual arrangements between associated enterprises may not necessarily reflect arm's length conditions. Chapter IX has been redrafted to clarify that rights under commercial legislation and case law should be one relevant consideration but not the only one in determining whether indemnification should be provided in connection with a restructuring transaction under the arm's length principle.

B.11 Remuneration of Post-Restructuring Transactions

40. The discussion contained in Issues Note No. 3 of the Discussion Draft was shortened substantially. The fundamental principle is that transactions among controlled entities occurring after a business restructuring should be governed by the same transfer pricing rules as apply to controlled transactions that do not follow from a restructuring. Given that fact, and the simultaneous completion of the revision to Chapters I – III of the Guidelines, it was determined that portions of the Discussion Draft could be eliminated.

B.12 Recharacterisation of Restructuring Transactions

41. Commentators suggested that the content of Issues Note No. 4 relating to recharacterisation of restructuring transactions by tax authorities was flawed. Some suggested that the Discussion Draft gave insufficient weight to the suggestion in paragraphs 1.36 to 1.41 of the Guidelines (paragraphs 1.63-1.68 of the revised Guidelines) that tax authorities should recharacterise transactions only in exceptional circumstances. Others requested further clarification of some of the terms utilised, including the concept of "commercially rational". Others suggested that the content of Issues Note No. 4 should be eliminated altogether. Other commentators suggested that additional examples should be developed providing further guidance on the issue of recharacterisation of transactions.

42. Significant redrafting was undertaken to clarify the material in Issues Note No. 4. The Working Party sought to provide a clearer discussion of the notions of economic substance and of commercial rationality, of the determination whether a transaction or arrangement has an arm's length pricing solution, of the relevance of tax purpose, and of the consequences of non-recognition of a transaction. The Working Party sought to eliminate the perception that it was extending the circumstances under which a tax administration may not recognise a transaction. The examples also were revised and areas of disagreement were removed. The Working Party agreed to defer consideration of some specific issues related to intangibles to the forthcoming project that is tentatively scheduled to begin in 2011.