

Transfer Pricing Aspects of Business Restructurings

Framework for a response to a series of OECD draft issues notes
October 2008

Contents

Summary of key points

Observations and recommendations

- 1 Welcome aspects
- 2 Objective of the issues notes
- 3 Definition of business restructuring
- 4 Recognition of transactions
- 5 Recognition of individual contractual terms
- 6 Arm's length conditions
- 7 Asset analysis
- 8 Economic significance of risks
- 9 Documentation and comparability

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Summary of key points

We would like to convey our compliments to the OECD for their efforts in preparing this draft series of issues notes on the transfer pricing aspects of business restructuring. We appreciate that there are conceptual difficulties in applying the arm's length standard in the context of restructurings and that the consequences of some reorganisations can be emotive.

This document represents a framework for a response to the invitation to comment issued on 19 September 2008. During the consultation period we will seek the views of our clients and we will submit a final, more detailed response in due course. We have organised our responses thematically, rather than following the structure of the notes, because we feel that certain key issues permeate the entire document. In summary, our observations and recommendations are as follows:

1 Welcome aspects

In many respects the draft echoes the common sense, balance and pragmatism which typifies the existing Transfer Pricing Guidelines (hereinafter TPG). We outline what we believe to be the most important and welcome clarifications and reiterations in section 1.

2 Objective of the issues notes

The discussion draft broadens the number of possible interpretations of the TPG, which will in turn increase the incidence of double taxation. Certain critical sections of the TPG should be re-written to improve consistency, to codify current practice and to provide clarity.

3 Definition of business restructuring

The draft should clarify the definition of a business restructuring, removing the presumption at 18.2 that a reorganisation will, by definition, include a transfer of some kind.

Except where it is clear that the conduct of the parties contradicts the terms of the agreement, a contract duration which is different from that specified in an agreement should not be implied.

4 Recognition of transactions

The majority view that the test of whether a reorganisation is commercially rational need only be met at an overall group level is welcome, but consensus is required on this critical issue. To the extent that a group-level decision creates non-arm's length outcomes for individual subsidiaries the guidance should specify that this should be dealt with through adjustments to pricing, not by adjustments to other conditions.

The guidance should clarify what the term 'practical impediment' in 1.37 means, and specifically 'inability to arrive at an appropriate price' should not qualify as an impediment.

5 Recognition of individual contractual terms

There is no difference in principle between non-recognition of a component of a transaction and non-recognition of an entire transaction.

The TPG does not enable adjustments to contractual terms in any circumstances other than the exceptional cases referred to in 1.36 et seq. The primacy afforded by the TPG to the actual transactions undertaken remains a wise safeguard against double taxation, and this standard should not be relaxed. The term 'exceptional' should be defined.

6 Arm's length conditions

Taxpayers are to be requested to demonstrate that the individual terms and the overall structure of a transaction are arm's length in nature. This test should not be retained. If it is to be retained then the guidance should specify that it is a generic test (i.e. is this the *kind* of thing third parties do?), not a test which requires detailed analysis of third-party data.

If this test is to be retained a taxpayer should only be required to demonstrate that the conditions of its transactions as presented are in the arm's length range of possible outcomes, not that they must constitute the 'most likely' arm's length outcome.

7 Asset analysis

The fundamental importance of assets should be stressed more strongly in this draft, and in particular it should contain a definition of what does and does not constitute an intangible asset.

Some precision is required around the concept of non-transferrable intangibles, and some examples should be provided.

8 Economic significance of risks

The draft should feature stronger recognition that financial capacity to bear significant risks is key to determining both a pricing mechanism and a consequent profit outcome.

Increased emphasis should be placed on the economic importance of more significant risks, such as economic conditions, money and stock market conditions, competition and the availability of raw materials and labour as outlined in para 34. Less discussion should be devoted to comparatively immaterial risks such as slow-moving inventory risks.

If the intent of the discussion draft is to permit tax authorities to challenge cost contribution arrangements, and the ownership of IP rights developed under those arrangements, merely because one party to the arrangement lacks R&D management personnel, the discussion draft should say so explicitly. This would represent an unfortunate policy and, if intended, a policy that should not be adopted without full consideration and debate.

9 Documentation and comparability

The draft should contain guidance as to the type of documents which 'prudent business management principles' (TPG 5.4) would require in the case of a restructuring. This should not be more onerous than the current standard which specifies that an MNC would not need to prepare or retain documents which it would not prepare or retain in the course of its ordinary dealings with third parties. We note that this standard differs from MNC to MNC.

More clarity is required about the meaning of 'reasonably reliable' and 'non benchmarkable functions' in the context of comparability.

Observations and recommendations

1 Welcome aspects

We welcome the following important reiterations and clarifications:

If a restructuring is commercially rational for an MNE at a group level, then in all but exceptional circumstances, the transactions as presented should not be subject to re-characterisation. It can be commercially rational to restructure in order to obtain tax savings.

The example in paragraphs 220 and 221 suggesting that a restructuring transaction involving the transfer of key personnel and intangible assets should be respected for transfer pricing purposes is both correct and very important.

Non-arm's length behaviour should as far as possible be dealt with on the basis of pricing adjustments, rather than by non-recognition of transactions.

The right to compensation on a restructuring should be based on options that would have been realistically available to the parties based on rights and other assets.

Profit/loss potential is not an asset in itself, but a potential which is carried by other rights or assets, and contractual rights can be valuable intangible assets.

There should be no presumption that all contract terminations or substantial renegotiations give rise to a right to indemnification at arm's length.

If, post restructuring, a tested party does not own unique intangibles or bear particularly significant risks then a transactional profit split is probably not justified, and TNMM is likely to be sufficiently reliable.

An entity's ability to take on risk is based on its financial capacity to bear that risk and on its capacity to take decisions to put capital at risk.

The example pertaining to a central purchasing function is particularly helpful, as is the analysis of location savings and the discussions around the Berry ratio.

In respect of these issues, the draft displays common sense, balance and pragmatism. We are concerned, however, that in a number of places these positions seem to be undermined. The following sections summarise the key issues from PwC's perspective, along with our recommendation to the working party on each of them.

2 Objectives of the issues notes

In places the discussion draft seems inconsistent with the aims and objectives of the OECD.

PwC fully supports the mission of the OECD. This mission, outlined in para 7 of the TPG, is to contribute to the expansion of world trade on a multilateral non-discriminatory basis, in furtherance of which it works to build a consensus on international taxation principles.

Whilst it is clear that the OECD does not intend the draft to provide guidance on the interpretation of domestic anti-abuse rules, it occasionally lacks the balance and neutrality of the TPG, and, surprisingly, has the feel of a 'weapon' against the consequences of the expansion of world trade. Some of the language and tenor reveals an 'assumption of manipulation' of the kind discouraged by the TPG. (for example, expressions such as 'so-called toll manufacturer' and 'mere facts' seem redolent of a concern to preserve national tax bases).

An MNC's freedom to determine its business structure and contractual arrangements is a fundamental tenet of the existing TPG and practice. The draft guidance introduces significant uncertainty in respect of this freedom. The guidance also lacks clarity in a number of key areas.

The discussion draft broadens the number of possible interpretations of the TPG, which will in turn increase the incidence of double taxation. Certain critical sections of the TPG should be re-written to improve consistency, to codify current practice and to provide clarity.

The draft could adopt more neutral terminology (for example, 'commonly called' could be used in place of 'so called').

3 Definition of business restructuring

At 18.2 the draft states that ‘business restructurings involve transfers of functions, assets and/or risks’. This is not always the case.

Business restructuring frequently involves a transformation of the operational paradigm such that 'before and after' comparisons are not meaningful. Frequently old roles and functions are disbanded and new and different ones are designed and implemented. Also the nature of intra-group relationships often changes as a result of a reorganisation. For example, if territory A made high profits as a licensee, but in keeping with a new group-wide strategy its license is not renewed on expiry and that territory subsequently enters a distribution agreement under which it makes a more modest, stable return, there should be no assumption that a transfer of any kind has taken place.

In this regard it is particularly important to examine whether contracts have been allowed to expire and then not renewed, or have been terminated before their expiry date. In cases where terminations occur before the expiry date, then compensation based on profit foregone may be due at arms length. This would not be true of expired contracts. One of the more alarming suggestions in the draft is that ‘an implicit longer term contract should be implied’ in certain circumstances, which would in turn create an implied right to compensation. It will rarely be possible to assert that an agreed contract term is demonstrably not arm’s length given the wide range of possible arm’s length contracting scenarios.

We understand that it is not the OECD's intention to allow an assessment of ‘opportunity profit’ by tax authorities. Several sections of the draft seem to allow for such an assessment.

The draft should redefine the term ‘business restructuring’ removing the presumption at 18.2 that a reorganisation will, by definition, include a transfer of some kind.

The term ‘redeployment’ which is used elsewhere in the draft, would not be appropriate in all cases, but is preferable to ‘transfer’.

A contract duration which is different from that specified in an agreement should never be implied in any circumstances.

4 Recognition of transactions

Some countries believe that transactions driven by decisions which are commercially rational at the group level are capable of non-recognition at a subsidiary level.

This type of situation is described in the TPG at 1.10, which deals with the ‘practical difficulty’ which can arise because ‘associated enterprises may engage in transactions that independent enterprises would not undertake’. Such transactions would be contemplated by an MNC because ‘there is no risk to the overall group’s profit’.

The ‘practical difficulty’, which can sometimes arise in such cases, is just that: a difficulty. It does not give a tax authority license to re-characterise. Importantly, it is not the same as the ‘practical impediment’ test in TPG 1.37. Nevertheless, para 206 of the draft implies that a tax authority’s ‘inability to arrive at an appropriate price’ would in-and-of-itself represent a practical impediment. The ‘appropriateness’ of a price is a matter of judgement, and ‘inappropriateness of price’ would not be a sound basis for re-characterisation.

It is disappointing that a minority of countries seem to have undermined what would otherwise represent very useful guidance. Given that there is clearly a dissenting minority on certain issues it would have been helpful, in the interest of transparency, if this draft had been published with “observations” indicating which countries depart from the majority view on these issues.

The majority view that the commercial rationality test need only be met at an overall group level is welcome, but consensus is required on this critical issue. To the extent that a group-level decision creates non-arm’s length outcomes for individual subsidiaries, the guidance should specify that this should be dealt with through adjustments to pricing, not by adjustments to other conditions.

The guidance should clarify what the term ‘practical impediment’ in 1.37 means. Inability to arrive at an appropriate price should not qualify as an impediment.

5 Recognition of individual contractual terms

The discussion draft interprets TPG 1.26 to 1.29 in such a way as to allow for piecemeal re-write of individual contractual terms where substance is found to differ from form.

An interpretation of TPG 1.26 to 1.29 which allows for piecemeal changes to individual terms of a contract undermines a key principle of the guidelines. Para 1.36 states that 'in other than exceptional cases, the tax administration should not disregard the actual transactions or substitute other transactions for them'. There is no difference in principle between non-recognition of a component of a transaction and non-recognition of an entire transaction.

Paragraphs 1.26 to 1.29 should be interpreted in context. These paragraphs form part of the section of the guidelines which addresses factors determining comparability of the tested transactions relative to a benchmark (TPG 1.17). The ensuing comparison provides insight on whether the profit arising from the controlled transaction should be adjusted. It does not give license to change its form. This interpretation is strongly supported by the commentary to Article 9 of the OECD Model tax treaty.

As discussed in greater detail in points 6 (arm's length conditions) and 8 (economic significance of risks) below, the draft overstates the ability of taxing authorities to disregard transactions that are properly reflected in taxpayer agreements and which are consistent with taxpayer conduct. Where those conditions apply, the arrangements of the taxpayer should be respected and taxing authorities should limit themselves to consideration of adjustments to the prices of transactions that actually take place. The addition of a further requirement that the taxpayer's arrangements must conform to subjective notions of what unrelated parties do will only lead to unscripted controversy and adjustments that are extremely difficult to resolve through treaty MAP processes.

The TPG does not enable adjustment of contractual terms in any circumstances other than the exceptional cases referred to in 1.36 et seq. The primacy afforded by the TPG to the actual transactions undertaken remains a wise safeguard against double taxation, and we do not think that this standard should be relaxed.

6 Arm's length conditions

In several places the draft contemplates a 'pass or fail' test which asks whether the conditions surrounding a transaction are arm's length. If the test is failed then conditions may be adjusted.

It would certainly be possible to show that a certain *type* of transaction might be contemplated by arm's length parties, and this is the approach which is taken in para 98 in connection with outsourcing arrangements. If this test is a generic test, as appears to be the intention, then it will very rarely be failed by the taxpayer.

If, by contrast, the test requires close comparability in all respects for the arm's length circumstances to be deemed comparable, then this test will always be failed by every taxpayer. It is common, for example, in a restructuring scenario for licenses to be terminated or for brands to be sold. There are many instances of this type of transaction at arm's length, but by their very nature, valuable intangibles tend to be unique, so a perfect comparison will be impossible to find.

Under either a generic or a strict test, if no comparables are available, then the draft asks whether the contractual position is one that 'might have been expected to have been agreed between independent parties in similar circumstances'. In this regard, the range of possible arm's length outcomes is very wide, for example in 110-112 four potential arm's length ways of structuring a manufacturing termination are contemplated. If, in the rare instance where the conditions as presented were not within the realms of possible arm's length conditions, it is not clear what would be interposed. Para 68 and 169 suggest the possibility that the tax authority can interpose conditions that 'would have been' agreed. It is not clear how this would be determined. In this regard, see Isabel Verlinden's contribution to the Business Advisory Group, a copy of which was published in PwC's Global TP Perspectives Magazine, Autumn 2007 (attached).

The new 'arm's length conditions' requirement should not be retained. If it is, then it should be a generic test, not a test which requires detailed analysis of third-party data. In addition, a taxpayer should only be required to demonstrate that the conditions of its transactions as presented are in the arm's length range of possible outcomes, not that they must constitute the 'most likely' arm's length outcome.

7 Asset analysis

The discussion draft gives greater prominence to functions than to assets. It is also unclear about what constitutes an asset.

An accurate understanding of a company's assets (including contractual rights) is critical in determining not only a company's right to compensation but also its bargaining power, its realistic alternatives to accepting a restructuring, its financial capacity to take risk and the availability and appropriateness of comparables.

The draft refers to 'unprotected intangibles which cannot be transferred because they are inherent to the local operation', and it also refers to the potential transfer of local marketing intangibles which have been developed over the years prior to a distributor being restructured. The draft also states that pre-restructuring activities can lead a distributor to 'own some intangible.'

Only intangibles which are capable of separate legal recognition and protection can be characterised as assets. The TPG should not be used to deem the existence of assets or to change the characteristics of assets owned by a company (such as contracts)¹.

Further, an intangible must also be legally transferrable in order to qualify as an asset. Economic phenomena such as market share and synergies may or may not give rise to enhanced profitability, but like profit or loss potential, they are not transferrable in their own right. They attach to and enhance the value of other, legally recognisable, protectable and transferrable assets.

¹ Other than in exceptional circumstances outlined in TPG 1.36 et seq. or in specifically approved instances where there may be a pre-agreed mismatch between legal and economic interests, such as a Cost Contribution Arrangement.

The fundamental importance of assets should be stressed more strongly in this draft. A definition of what constitutes an intangible asset, and perhaps more importantly, what does not, is critical.

The draft should define the concept of non-transferrable intangibles, and provide some examples.

8 Economic significance of risks

Having stressed the importance of economically significant risks in the introduction, the draft majors on relatively immaterial risks, and does not focus to any significant extent on the role of capital.

The draft largely focuses on a distributor's bad debt risks and excess inventory risks and considers control of these risks to be the main determinant of where they should lie for transfer pricing purposes. In practice, these risks are relatively immaterial compared to risks associated with adverse economic conditions, adverse stock market conditions, effective competitor actions and the like.

More material risks of this nature may involve less active management, but a well-run MNC will have a strategy to deal with them, and this would rarely be set at the level of a distributor. In particular, it should be noted that most distributors, full risk or otherwise, would not have the financial capacity to bear more material risks, and their returns would be expected to reflect this limited capacity. The draft is relatively quiet on the subject of financial capacity to bear risk, but in the economic climate at the time of writing, the relative importance of capital can hardly be overstated.

The draft's pronouncements regarding recognition of taxpayer allocations of risk are overly broad and ignore certain situations where those pronouncements should not apply. In particular, it is noted that cost sharing or cost contribution agreements have not traditionally been thought to require that each of the parties to the agreement have personnel capable of evaluating and managing R&D risks. Rather, in the most common arrangements, it is deemed sufficient that the parties in fact bear the appropriate share of economic risk in order for the respective parties' interests in intangible property developed under the agreement to be respected.

Similarly, the example concerning fund management requires that, in order for the structure to be respected, the capital owner should have personnel capable of evaluating and managing risks. This is distinctly different from the authorised OECD approach to the attribution of profits to permanent establishments.

The draft should provide stronger recognition that financial capacity to bear significant risks is key to determining both a pricing mechanism and a consequent profit outcome. If the intent of the discussion draft is to permit tax authorities to challenge cost contribution arrangements, and the ownership of IP rights developed under those arrangements, merely because one party to the arrangement lacks R&D management personnel, the discussion draft should say so explicitly.

9 Documentation and comparability

Contemporaneous documentation requirements

The draft states that 'it would be reasonable to expect related parties to document in writing their decisions to allocate or transfer risks before the transactions occur'.

The draft should contain guidance as to the type of documents which 'prudent business management principles' (TPG 5.4) would require in the case of a restructuring. This should not be more onerous than the current standard which specifies that an MNC would not need to prepare or retain documents which it would not prepare or retain in the course of its ordinary dealings with third parties. This standard differs from MNC to MNC.

Non-benchmarkable functions

The concept of non-benchmarkable functions (para 161) was first outlined in the discussion draft on transactional profit methods. In our response to that draft we expressed concern that there is scope for dispute over what 'reasonably reliable' means in the context of the five criteria for comparability. The expression "non-benchmarkable (e.g., strategic) functions" (in para 161) seems to imply that it would never be possible to find reasonably reliable comparables for strategic functions. This would not be in keeping with common practice around for example, management services which are often strategic in nature.

Please refer to PwC's response to the Issues Notes on Transactional Profits Method dated 7 May 2008, specifically on our position on the concept of "non-benchmarkable" functions.

The Global Tax Monitor, an independent global study conducted by TNS, recently ranked **PricewaterhouseCoopers as the leading Transfer Pricing firm globally** according to reputation and usage figures for 2007*

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