

**Transfer pricing aspects of business
restructurings**

Comments on the OECD discussion draft

16 February 2009

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1. Introduction and summary of key points

Ernst & Young welcomes the opportunity to comment on the OECD's discussion draft on the transfer pricing aspects of business restructuring.

The wave of business restructuring in Europe and North America over the last decade and the emergence of similar phenomena in Asia Pacific and Latin America means that the topics considered in the discussion draft are of great importance to both tax administrations and taxpayers.

Ernst & Young agrees with the OECD's Working Party on several key concepts in the draft, for example the adoption of an arm's length framework rather than the formulary approach to compensation payments which has started to emerge in some countries.

However, we have several major concerns with the discussion draft, particularly:

1. It is clear from the discussion draft that there has been disappointing progress in achieving consensus on the question of when a tax administration should be permitted to set aside transactions as structured by the taxpayer (i.e. Issues Note 4). Based on our experience, it is vital that a substantial measure of agreement should be reached on this issue. Our own view is that tax administrations should only be able to disregard a business restructuring if there is no commercial rationale for it from a group perspective. Other cases can be dealt with through conventional transfer pricing adjustments where appropriate. Unless powerful safeguards are applied, we fear that the number of cases in which recourse is had to these provisions, even if only to put pressure on the taxpayer to settle, will increase further.
2. It should be recognized that restructuring is a continuous process rather than a one-off event for most groups. Two key points follow from this:
 - i It may well be that (and often is in our experience) an important reason for a reduction in the profitability of "restructured" entities is that transfer pricing had not kept pace with business change with the result that the "restructured" entity was too generously rewarded.
 - ii Guidance should be provided to the effect that minor restructurings should not give rise to potentially taxable transactions.
3. There is a need for much greater clarity around the notion of control of risk (Issues Note 1).
4. The focus on the determination and assessment of the "next best alternatives" available to the parties in an inter-company transaction will likely lead to onerous and burdensome compliance requirements, unless the burden of proof rests with tax administrations to show that a taxpayer has failed to consider an obvious alternative (Issues Note 2).
5. More generally, we are concerned that the analysis envisaged by the discussion draft and the associated documentation will make managing the transfer pricing aspects of business restructurings much more complex and costly.

The refinement or clarification of some of the provisions of the OECD Transfer Pricing Guidelines ("TP Guidelines") in this discussion draft would appear to have implications which go well beyond business restructurings. For example, there would appear to be an inconsistency between the discussion of the control of risk in Issues Note 1 and the guidance on cost contribution arrangements in the TP Guidelines, which is widely interpreted as allowing a separation of economic responsibility from control.

In addition, although domestic legislation is stated not to be within the scope of the discussion draft, we do not think the OECD can ignore the need for any income arising from the

application by a tax administration of several of the concepts in the draft to be unequivocally subject to existing, and possibly strengthened, mechanisms for the elimination of double taxation (as opposed to being excluded from those mechanisms where it is claimed the application of the concept is made under domestic anti-avoidance provisions).

The sections that follow present our comments on each Issues Note.

2. Issues Note 1: special considerations for risks

This Issues Note focuses on issues arising from the transfer and allocation of risks between or among related parties as a result of business restructurings, with a focus on the interpretation of paras 1.26 to 1.29 of the TP Guidelines.

Our comments below relate to:

1. The complexity of determining economically significant risks in a specific set of facts and circumstances
2. The implications of this complexity for the structure of the analysis
3. The nature of economically significant risks
4. The difficulty of determining which related entity is controlling a risk and how this may change as a result of market circumstances
5. The alignment of transfer pricing with performance measurement and risk management processes
6. The risks of an overly granular analysis
7. Some possible implications of the clear statement that allocation of risks drives method selection

2.1 Identifying economically significant risks

The identification of economically significant risks is a matter of great importance and receives only brief attention in this Issues Note. We are concerned that the discussion at this point focuses too narrowly on risks directly associated with related-party transactions and in doing so gives insufficient attention to what are often much more significant risks commercially.¹

Many of the examples of risk given in the discussion draft tend to be relatively straightforward – foreign exchange, credit, losses in transit and inventory risks are all instanced. These may be capable of being identified from accounts or an agreement. But other risks of much greater significance may not be identifiable from these sources; and their allocation may need to be inferred from the conduct of the parties.

For example, capacity risk will be highly significant for a group which must invest substantial sums with long lead times in production capacity expansion. Depending on the facts and circumstances, this risk may need to be assigned to the manufacturer or, if the relationship appears to be analogous to a contract manufacturer with a single customer, to the purchaser.

It should therefore be emphasized that the fact that a risk is not explicitly referred to in agreements or accounts does not mean that it is not economically significant. All such risks are relevant to the selection of the transfer pricing method and the determination of the profit that an entity bearing a risk should expect to earn.

2.2 Implications for the structure of the analysis

Para 20 sets out a four-step process starting from the contractual allocation of risks. For the reasons just stated, in our view the analysis should start with the identification of the economically significant risks (step 3 in the hierarchy of para 20). This will avoid spending

¹ There are some references in the last sentence of para 42 but it does not appear that these have been taken into account.

time on non-significant risks and also ensure that risks which are significant but which may not be specifically allocated in the contract or evident from accounts are considered.

Thus in our view, the step plan should be:

1. Determine economically significant risks
2. Evaluate by which entity(ies) these are controlled and assumed²
3. Determine conformity with contractual allocation
4. Evaluate transfer pricing consequences

2.3 Nature of economically significant risks

The same area of business poses risks on a number of different levels. For example, in the area of product portfolio management, there are risky choices to be made concerning:

- ▶ Which areas of the market offer profitable opportunities
- ▶ Product strategy in the selected market areas
- ▶ Design and development of specific products
- ▶ Product introduction and marketing
- ▶ Upgrading existing products
- ▶ Withdrawal of products at the end of their lifecycle

Since the control of the associated risks could be in different entities, the relative importance of the various dimensions of product portfolio management is of great significance.

In our view, this question can only be answered for specific facts and circumstances; and then only with difficulty and probably ambiguity.

We believe that this complexity should be recognized in guidance and that simplistic analysis should be discouraged.

2.4 Definition of control and identifying which entity is controlling risks

We agree with the definition of control proposed in the Issues Note.³ However, in our experience, it can be difficult to assign control of risks to a specific entity.

We would make a number of points on this:

1. Determining whether an entity has the financial capacity to bear risk is not itself straightforward as it involves the quantification of the potential financial impact of the risk in the context of other risks that the entity may bear responsibility for.
2. As regards decisions to take on risks and their active management, governance processes which define decision rights must be considered. These will often involve a

² For the purposes of our response, the assumption of risk requires the economic ability to bear such risk. For consistency purposes, we refer to the assumption of risk as the ability to bear loss. The control of risk refers to efforts to manage risk through various functions performed with regard to the assumed risk.

³ Page 7 of the Discussion Draft defines "Control" in this context should be understood as the capacity to make decisions to take on the risk (decision to put the capital at risk) and decisions on whether and how to manage the risk, internally or using an external provider."

hierarchy and the location within that hierarchy of the key decision-making level. For example, in some groups little pricing discretion may be delegated; in others, sensitive local pricing is essential and key decisions are delegated.

3. IT systems are increasingly important in managing risk. This is a matter to be taken into account in determining whether a risk is economically significant.
4. As “virtual management structures” become more common, the likelihood increases that a number of entities will be found to be collectively controlling economically significant risks. This illustrates the need for more detailed guidance on what control really means – ultimate responsibility, primary share of collective responsibility, or something else. Without this, the implication of collective control might drive tax administrations towards a greater use of profit split methods, which would run the risk of increased controversy.
5. Control of risks may change over time in response to market conditions and market performance. For example, within the context of an essentially delegated structure for the management of brands, the group’s commercial director might decide it was appropriate to take a more “hands-on” role in managing a poorly performing brand.

2.5 Circumstances in which control of risk is divorced from economic responsibility

As the Issues Note recognizes, in transactions relating to the management of financial instruments, it is relatively common to see a separation of substantial control from economic responsibility. The Issues Note assumes that this is possible because information is available to evaluate the performance of the “service provider.”

We agree that a key issue is whether the entity bearing economic responsibility has access to a reliable and independent source of information which allows it to evaluate the performance of the entity undertaking day-to-day monitoring and control.

However, our view in brief is that the availability of information within highly integrated multinational groups may be such that, if the same level of transparency existed at arm’s length, economic responsibility could be separated from what might appear to be a substantial degree of control.

For example, in a business restructuring context, it might be that the transferor continues to have substantial discretion in relation to important commercial risks. However, the management information and control systems which have been put in place as part of the restructuring fundamentally change the role of the transferor because its performance is now more closely monitored by a knowledgeable transferee.

In addition, there are examples of risk transfer at arm’s length where the risk transferee may not be able to measure the day-to-day activity of the risk transferor, but that certain events will nevertheless result in the transferee assuming responsibility for a risk:

1. Catastrophic (CAT) bonds related to the transfers of property and casualty events such as earthquakes and hurricanes.⁴
2. Credit default swaps (CDS), where only the default trigger event is viewed as a significant change in the financial condition of the underlying corporate entity which would obligate the seller of the CDS to pay the buyer of risk protection. Such events do not require the risk transferee to monitor the daily activities of the risk transferor/service provider.
3. Numerous forms of indemnity insurance. While such risk transfer arrangements have numerous terms and conditions which may limit the payment by the risk transferee,

⁴ See *Catastrophe Bonds* by Liz Moyer, 31 August 2005, available at http://www.forbes.com/2005/08/31/hurricane-catastrophe-bonds-cx_lm_0831catbonds.html.

these are typically limited to situations where the risk transferee has engaged in activities related to moral hazard. In these cases, the day-to-day performance is not measured except for the behavior limited by the terms and conditions which is analyzed after a claim for a risk event is made.

The common element in these examples is that the transferor has no or only limited influence on whether the event occurs so that there is no moral hazard problem.

2.6 Role of formal risk management processes and performance measures

Many groups now have documented risk management processes and these may be helpful in identifying where risks are controlled.

Similarly, an understanding of performance measures may assist in determining where risks are controlled, since a general principle of performance measurement is that they should be aligned with decision-making rights. For example, the fact that manufacturing management will often be measured on non-volume variances from standard costs indicates that they do not have control of market-related risks.

It should be open to taxpayers to support their transfer pricing analysis with such internal evidence, but not mandatory that they do so.

2.7 The risks of an overly granular analysis

We have a concern that the framework proposed in this Issues Note will prompt an overly detailed assessment of how risks are controlled. While the analysis may be relatively detailed, the objective should be to reveal “the big picture,” i.e., the general pattern of control of risk.

This is important because we believe that the proposed guidance may be interpreted as increasing the scope to challenge the allocation of risks to a greater extent than is practical or necessary. The allocation of risks by the taxpayer should in the first instance be respected and only be open to challenge by tax administrations in extreme cases. Challenges should be limited to cases in which there is a systematic mis-alignment between the contractual allocation and control of significant risks to the point that the arrangement lacks economic substance and business purpose.

Implementing such an approach would allow taxpayers to have more certainty in reaching the decisions they make regarding risk allocations. In coming to such a judgment, consideration should be given to the information and circumstances available at the time, and not with the benefit of hindsight.

We also believe taxpayers should not have to document ex ante the rationale for their decisions regarding risk allocations as this an unnecessary burden. Rather, taxpayers' risk allocations should be respected other than in exceptional circumstances. In other words, the burden of proof should be on the tax administrations and it should be high, applicable in narrowly (and better) defined circumstances.

We note that para 163 within Issues Note 3 calls for a focus on significant risks in considering whether the transactional profit split method should be applied. The same injunction is appropriate here.

2.8 Implications of a strict relationship between the allocation of risks and the transfer pricing method

Both in this Issues Note and elsewhere in the discussion draft, the OECD clearly states a view that how the parties have allocated responsibility for the control of risk will drive the

choice of transfer pricing method; and that risk cannot be reassigned through the selection of a method.

In our view, the strict application of these principles could lead to considerable complexity and volatility in profitability. This is because it would in principle be necessary to monitor the source of emerging profit variances and assign them to the responsible entity for their control.

For example, a transfer pricing system might target an operating margin of X % for its distributors. Variances could arise from a range of sources, including overall demand levels, product mix, pricing variances and selling costs. Even within these categories, risks might be controlled by different parties. If the logic of this Issues Note were to be followed, it might be necessary to assign responsibility for specific variances to the entity controlling the relevant risk. This would be very time consuming and, as it is likely that some risks would be assigned to the “tested party,” would increase the volatility of profitability.

2.9 Summary of key points

1. Economically significant risks may well not be identifiable from accounts or agreements.
2. In the light of this, the analysis should start with the identification of economically significant risks rather than from the agreement.
3. The notion of control of risks is a matter of great complexity on which substantially more guidance is needed.
4. There should be guidance that the analysis should focus on a small number of economically significant risks.
5. A strict application of the principle that risks should be borne by the party controlling them could lead to increased profit volatility.

3. Issues Note 2: arm's length compensation for the restructuring itself

This Issues Note considers when compensation payments should be made in the context of restructuring. The Note distinguishes the transfer of risks and assets on the one hand and terminations or changes in contractual relationships on the other.

Our comments below relate to:

1. Some general observations on the overall framework for compensation payments
2. The identification and evaluation of realistically alternative options
3. Retrospective adjustments to compensation payments
4. The status and valuation of goodwill in business restructurings
5. The form of compensation payments
6. The heavy documentation burden that the proposed approach could impose on taxpayers

3.1 Overall framework

We welcome a number of what we believe to be key points emphasized in the Issues Note, particularly:

1. The emphasis on an arm's length framework rather than a formulary approach of the kind that is often the starting point for tax administrations.
2. The recognition that an arm's length framework for determining whether, and if so at what level, compensation payments should be made in the context of restructuring must take account of the perspectives and alternatives open to both transferor and transferee. Although obvious, this point is forgotten every time a claim is made that a starting point for determination of a compensation payment is the loss of profit of the transferor.
3. the clear statement that profit potential is not an asset in itself, although an understanding of profit potential is necessary to setting compensation payments.

However, we believe that there is scope for greater clarity in the framework envisaged in two respects:

3.1.1 Overall approach and objectives

The Issues Note successively considers risk transfers, asset transfers and changes in contractual terms.

These may of course all be features of a single restructuring.

Our understanding of the Issues Note is that the OECD is articulating an arm's length framework which is to be applied to each of these elements if observed in isolation or, more likely, to a restructuring in its entirety. Where the latter scenario applies, there should not normally be, for example, both an indemnification payment for a change in contractual status and a compensation payment for an asset, the value of which depends in large measure on a contractual right under the changed contract. In most cases, the restructuring should be viewed holistically taking account of both the change in contractual status and other commercial considerations.

In our experience, a holistic approach is in many cases likely to give as, or more, reliable an outcome as an asset-by-asset approach. It is always difficult to value individual assets in isolation from one another. This is particularly so when the valuation is being based on realistic alternative options, since any given strategic option can only be defined and evaluated by reference to a complete set of commercial circumstances.

Thus, in our view, the attention devoted to risks, specific assets and contractual rights is misleading and it should be clearly stated that the analysis should normally consider the change as a totality. That is, the post-restructuring situation (defined by reference to the disposition of functions, assets and risks including legal rights) should be compared to realistic alternative options defined also by reference to a business strategy involving the retention by the transferor of some or all of its existing functions, assets and risks and, perhaps, the acquisition of others (e.g., developing a capability currently provided by the transferee).

If this understanding is correct, the overall objective of the analysis is to determine whether, and if so at what level, a compensation payment could be expected to have been agreed if the restructuring had been undertaken by unrelated parties in the light of the alternative options realistically available to them.

For the avoidance of doubt, we are not suggesting that specific assets, risks and contractual rights should be ignored. Indeed, in some cases specific asset valuations may be relevant. Moreover, if assets are sufficiently broadly defined, there is unlikely to be a case for a compensation or indemnification payment unless the transferor disposes of an asset or fails to take up a right. However, in the majority of cases, the context of the valuation is important.

3.1.2 Implications of the next best alternative approach for quantum of compensation payments

The Issues Note apparently fails to draw out a fundamental implication of its own focus on the next best alternative options available to both parties. This is that the maximum and minimum level of compensation payments consistent with the arm's length principle can be determined on the basis of the value of the options available to each party. The minimum (maximum) compensation payment consistent with the arm's length principle is that which leaves the transferor (transferee) at least as well off as it would be if it adopted the next best alternative realistically available to it.

Information on the value of next best alternative options can therefore be used to determine an "arm's length range" for compensation payments. The range may be wide if the benefits of agreement to the restructuring are great or narrow if one or both parties have good alternatives to agreeing to the restructuring.

3.2 Compensation payments and next best alternative

While the emphasis on the realistically available options is attractive conceptually, we anticipate that it will create significant problems in practice. Indeed, there is already experience in an audit context of tax administrations introducing new alternatives which they deem the taxpayer should have considered but which the taxpayer considers to be unrealistic. Such disputes can be lengthy and will almost certainly impose significant compliance costs.

Taxpayers can minimize the risk of lengthy and unproductive disputes by preparing documentation consistent with the proposals in the Issues Note identifying and evaluating alternative options.

However, it is important that tax administrations do not seek to apply hindsight and only challenge the assessment of options made by the taxpayer when there are clear grounds to do so.

We therefore believe that:

- ▶ The burden of proof should rest with tax administrations to demonstrate that the option chosen at the time by the taxpayer was perverse, or not credible, i.e., that there were clearly (and not merely arguably) more attractive options available.
- ▶ This should be determined based upon information reasonably available to the taxpayer at the time of the restructuring, and not with the benefit of hindsight.

As discussed further below, additional guidance on documentation may be helpful in this regard.

Our interpretation of this Issues Note is that the alternatives to be considered include purely hypothetical ones outside the group, e.g., a related distributor contracting with a non-group supplier as an alternative to agreeing to a restructuring of its role within the group. The correct interpretation should be made explicit.

In addition, although the legal rights of the parties are clearly relevant to the determination of their next best alternative option, assessing and valuing those rights in a specific jurisdiction could be a matter of great complexity and cost.

3.3 Retrospective adjustments to compensation payments

It is difficult to see how it will be possible to implement the suggestion in para 88 that compensation payments should be subject to the provisions in the TP Guidelines allowing retrospective adjustments when intangible assets are of particularly uncertain value.

Valuations based on the principles set out in the Issues Note will reflect the emphasis placed on the next best alternative option. There could therefore be a need for a retrospective adjustment if, with the benefit of hindsight, the value of the next best alternative option would have been materially different.

In order to apply retrospective adjustments, it would therefore be necessary to keep the value of next best alternative options under review. Indeed, theoretically, it would be necessary to keep under review the question of whether the next best alternative option was indeed selected as the basis for valuation.

In our view, this demonstrates that retrospective adjustments in other than the most extreme circumstances of mis-valuation are not practical.

3.4 Treatment of goodwill

We have described above our understanding of the framework envisaged by the Issues Note. One of the few reasons for doubting that our understanding is correct is the discussion of goodwill in paras 93 and 94.

Goodwill is normally understood to be the difference between the consideration for a transaction, or the total business value derived in some other way, and the total value of the separately identifiable assets and liabilities of the business. As such, the goodwill value is derived from other valuation information. It cannot be separately valued.

The business valuations from which the value of goodwill is normally derived are on a “going concern” basis.

Total business valuation techniques from which goodwill valuations are derived will not be applicable to business restructurings unless:

- ▶ Valuation multiples from comparable restructurings between unrelated parties can be identified

- ▶ The transferor truly has a realistic alternative option of continuing in business on the pre-restructuring basis (i.e., going concern is a realistic alternative)

We have also noted above that compensation payments consistent with the principles of the Issues Note can only be determined on a composite basis.

The separate valuation of goodwill may therefore be both unnecessary and inappropriate.

3.5 Form of compensation payments

The discussion draft only considers the form of compensation payments in its discussion of local intangibles in paras 89-90 where alternative remuneration mechanisms are considered depending on whether the intangibles are transferred or remain with the restructured entity.

We believe that this is an important issue that requires a more general consideration.

In some cases, a business restructuring clearly involves the transfer of an asset or right and a lump sum payment is likely to be appropriate. In others, at arm's length the transferee would require the continuing cooperation of the transferor so that the total compensation payment might be expected to be spread over a number of years. It is quite possible to envisage that the overall compensation payment should comprise a lump sum payment and a stream of continuing payments which, overall, compensate the transferor for not adopting its next best alternative.

3.6 Burden of documentation

Based on our experience, the need for documentation of the business rationale for a restructuring from a group perspective is generally recognized.

The clear statement in the discussion draft (Issues Notes 2 and 4) that it needs to be demonstrated that the restructuring was in the interests (after allowing for possible compensation) of all entities affected, clearly adds significantly to the documentation burden. Indeed, para 53 recognizes that this extension of documentation is for transfer pricing and not for commercial purposes.

It would be helpful to have additional guidance on what this documentation should include.

3.7 Summary of key points

1. We welcome the adoption of an arm's length framework for determining whether compensation payments are appropriate and the rejection of formulary approaches.
2. However, the implied focus, which we recognize to be necessary, on the realistically available alternatives of both parties, opens up a potential for controversy which can only be contained if the burden of proof rests with tax administrations to demonstrate that the taxpayer failed to consider a clearly more attractive alternative.
3. Retrospective adjustments to compensation payments are impractical in a valuation framework based on next best alternatives.
4. Goodwill valuations on a going concern basis are only relevant if going concern is a realistically available alternative.
5. Depending on the facts and circumstances, compensation and indemnification payments may be "lump sum"; a series of payments over time, or a combination of the two.
6. More guidance is needed on documentation.

4. Issues Note 3: remuneration of post-restructuring controlled transactions

This Issues Note considers transfer pricing following a business restructuring⁵ including the choice of transfer pricing method and the impact of restructuring on remuneration. Examples relating to purchasing and location savings are presented.

Our comments relate to:

- ▶ A very brief observation on methods
- ▶ The relevance of a comparison of profits before and after restructuring, with a particular emphasis on the reliability of pre-restructuring transfer pricing

4.1 Choice of transfer pricing method

In general, we agree with the points made in the general discussion of methods in paras 125 to 169. In particular:

- ▶ There is no reason to apply different standards to post-restructuring transactions, although the facts and circumstances of the restructuring should be taken into account in the post-restructuring comparability analysis (e.g., the contribution of legacy intangibles).
- ▶ The use of the transactional profit split method should be reserved for cases in which both parties make significant contributions which cannot be benchmarked.

The latter point does deserve emphasis in view of the particular difficulty in identifying comparables for the transactional structures often adopted following a restructuring in order to implement a business model which spans a number of countries.

In this connection, the term “non-benchmarkable contributions” is not one we would recommend, as it is all too easy to drop the preceding adjective “significant.” Once the adjective is lost, an invitation is issued to apply profit split whenever a tax administration determines that reliable benchmarks are not available. That would be unwelcome, and undoubtedly lead to a higher incidence of controversy.

4.2 Before and after comparisons

It is our experience that tax administrations will often seek to reconcile pre- and post-restructuring profits and seek to place the onus on the taxpayer to justify the change (normally a reduction) by reference to changes in the allocation of functions, assets and risks, which the taxpayer can show to be commensurate.

The discussion of this question starts (in paras 181 and 182) robustly, and in our view correctly, with a statement that pricing should be set by reference to uncontrolled transactions rather than prior controlled transactions. However, in paras 184 to 187, the discussion acknowledges a role for before and after comparisons, including as a sanity check (186) and the question of:

“...whether or not it is appropriate to allocate the whole residual profit to the foreign related party in view of the actual risks and intangibles of the ‘stripped’ entity and the foreign related party” (185).

⁵ There is an acknowledged overlap between this Issues Note and the review of transactional profits methods. Ernst & Young has contributed to the transactional profits methods review and no further comments are made here on general issues relating to these methods.

This discussion raises two important points.

Although the point is acknowledged in para 186, the question of pre-restructuring profits deserves more consideration. Business restructuring cases typically involve established businesses. In a number of cases, there will have been incremental business change over a period of years which may not have been reflected in the transactional structure and transfer pricing policy. When the business change involves progressive centralization, as it often does, the transfer pricing policy will tend to result in a higher than arm's length level of profit in the entity which is subsequently restructured.

In these cases, the "restructuring" which attracts the attention of tax administrations is likely to be the re-design of the transactional structure and transfer pricing policy in response to cumulative change over a period of time and perhaps prompted by one large change in a series. An example would be a decision to concentrate a range of functions already managed at a regional level in a single location and adopt a principal company transfer pricing model.

In our view, the consistency of the pre-restructuring transfer pricing with the arm's length principle (and, narrowly, with the pre-restructuring economic and comparability analysis) is therefore central to the question of whether any significance attaches to pre-restructuring profit.

Our second point concerns the role of sanity checks and lines of inquiry as to the reasonableness of the residual profit attributed to the foreign related party. As noted above, elsewhere in this Issues Note there is a clear statement, with which we agree, that profit split methods are to be reserved for cases in which the functional analysis clearly shows that both parties are making significant contributions which cannot be reliably priced using benchmarking approaches. The discussion here seems to open up the possibility of a role for an informal profit split analysis. While we recognized that a corroborative analysis can be helpful, we do not think it is appropriate to envisage an unstructured analysis and, in effect, require the taxpayer to undertake a complex and onerous profit split analysis when, in the context of the transactional profit methods review, it appears to be generally agreed that there should be no requirement for the application of a second method.

4.3 Summary of key points

1. Although a transactional profit split analysis may be helpful as a corroborative analysis in some cases, there should be no suggestion of a requirement for such an analysis to be undertaken unless both parties are making economically significant contributions which cannot be reliably benchmarked.
2. "Before and after" comparisons of profitability can be very misleading in business restructuring cases as the pre-restructuring transfer pricing may not have been adapted to prior business change.

5. Issues Note 4: recognition of actual transactions undertaken

This Issues Note seeks to clarify existing guidance on the exceptional circumstances in which a tax administration may not have to recognize a transaction presented by the taxpayer. This limited scope – it is explicitly stated that no amendments to guidance are intended – and the fact that countries appear not to have agreed on the appropriate treatment of fairly simple examples indicate the difficulty of achieving consensus and the consequent continuing risk of lengthy disputes quite possibly leading to double taxation.

Our comments below relate to:

- ▶ The progress which it has been possible to make on these issues
- ▶ Our overarching views on this issue
- ▶ The OECD's welcome restatement of the respective roles of MNEs and tax administrations in designing business structures including the influence of tax savings
- ▶ The meaning of "exceptional"
- ▶ The two specific points on which the Issues Note seeks comments:
 - ▶ The role and status of paragraphs 1.36 – 1.41 of the TP Guidelines
 - ▶ The framework set out in paragraphs 207 – 213 of the discussion draft for assessing commercial rationality in relation to the second circumstance in which para 1.37 of the TP Guidelines allows a tax administration to disregard the structure adopted by the taxpayer
- ▶ Two detailed points relating to the commercial rationality test

5.1 Progress on recognition of transactions

First and foremost, it is a matter of regret that it has not been possible to make more progress on this issue at a time when some tax administrations are routinely challenging business restructurings on the grounds that the restructuring would not have taken place at all; or that the relationship between the parties is to be characterized in a manner completely different to that presented by the taxpayer.

If consensus is not a realistic objective in the near future, it might be of assistance to taxpayers in managing their affairs at least to have a more transparent statement of the varying perspectives of tax administrations.

5.2 Overarching perspective

Our view on this issue flows from the following extract from the discussion draft, with which we agree (para 213 with the deletion of the cross reference in the final sentence):

"The OECD recognises that there can be legitimate group-level business reasons for an MNE group to restructure. In practice, where a restructuring is commercially rational for the MNE group as a whole, it is expected that an appropriate transfer price would generally be available to make it arm's length for each individual group member participating in it. In this respect, it is worth re-emphasising that the arm's length principle treats the members of an MNE group as separate entities rather than as inseparable parts of a single unified business (paragraph 1.6 of the TP Guidelines). As a consequence, 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."

In our view, it follows that there should only be a need to consider setting aside the transaction structured by the taxpayer if there is no non-tax commercial rationale for the restructuring. In virtually all other cases, it should be possible to design pricing arrangements which share the commercial benefits of the restructuring between the parties affected in a way which ensures that, for each of them, participation in the restructuring leaves them as well off as they would be if they had adopted their realistically available next best alternative.

This logic implies there should be no need to distinguish restructurings involving the transfer of strategically important assets (crown jewels). The statement "everything has a price" is both logically true if economic agents act rationally and enter into specific transactions when they are more profitable than their realistically available next best alternative; and a commonplace of commercial life.

5.3 Roles of MNEs and tax administrations in designing business structures

We naturally welcome the clear statement in para 196 that taxpayers are free to organize their business operations as they see fit in the light of all relevant commercial considerations, including tax considerations; while the role of tax administrations is to determine the tax consequences of the adopted structure subject to the application of treaties and in particular Article 9.

5.4 Meaning of "exceptional"

Only a single, brief paragraph is devoted to this important although seemingly intractable question.

The current level of recourse to these provisions in audits, already referred to in 5.1 above, is clearly not acceptable. There is a clear need for some tax administrations to restrain themselves or be restrained in alleging the applicability of these provisions to a large number of restructuring and structuring transactions.

5.5 Role and status of paras 1.36 to 1.41 of the TP Guidelines

In paras 201 and 202, the Issues Note states that it is the OECD view that:

- ▶ Paras 1.36 to 1.41 do not preclude a tax administration from making an adjustment to arm's length pricing or other conditions when there is no dispute about the nature of the transaction (para 201).
- ▶ Where the conditions set out in these paras are met, Article 9 allows an adjustment to attain the conditions appropriate to the economic and commercial reality of the relationship between the parties.

While our general view is that the application of 1.36 to 1.41 is confined to a very small minority of cases because the vast majority of cases can be dealt with within the framework of the transactional structure adopted by the taxpayer, we would agree with the views of the OECD on how these provisions are to be interpreted.

5.6 Framework for assessing commercial rationality in relation to TP Guidelines para 1.37

Our understanding from the Issues Note is that there is disagreement within Working Party 6 on this issue. A minority of countries are of the opinion that the second circumstance in TP Guidelines para 1.37 does not apply if there was some business purpose to a transaction even if there was arguably a more attractive option. The majority of countries take the view that commercial rationality requires a demonstration that independent parties would have entered into an arrangement similar to that adopted by the related parties.

The remainder of the discussion builds on the latter viewpoint using concepts which are familiar from other parts of the discussion draft. Most particularly, it:

- ▶ Builds on the notion that commercial rationality requires the adoption of the most attractive option realistically available
- ▶ States that if the restructuring is rational for the group as a whole, appropriate transfer pricing arrangements which ensure that each entity affected by the restructuring expects to be better off than it would if it had adopted its next best realistically available alternative
- ▶ Notes that even if the second circumstance applies, tax administrations must consider whether the structure adopted prevents the tax administration from determining an appropriate transfer price

As the discussion notes, the logic and analysis are the same as in Issues Note 2 where the question is whether a payment is to be made for the transfer of valuable assets or as an indemnity for termination or a substantial change in a commercial relationship.

While it would seem inconsistent to apply a different standard and approach in the context of para 1.37, it is clearly a weaker test than that proposed by the minority of countries. If the approach proposed by the OECD were to be adopted, it is to be expected that claims that para 1.37 allows a transaction to be disregarded would increase. Consistent with the comments we have made above and in response to Issues Note 2, we would be concerned that tax administrations would assert the existence of realistic alternatives that taxpayers regard as spurious. Irrespective of the outcome, compliance costs would increase substantially.

Our view is therefore that the framework proposed should be adopted only if, as we proposed above, a mechanism can be found to balance the interests of taxpayers and tax administrations in ensuring that reasonable and well-founded claims that a taxpayer had failed to consider realistic alternative options.

An ongoing lack of consensus represents uncertainty for MNEs and tax administrations alike. This would damage the perception of the value of the draft, at least in regard to this Issues paper. A more radical solution might be needed to resolve the situation. Consideration might, for example, be given to the need for a tax administration to show that a restructuring (or any other transaction they perceive to be non arm's length) was solely tax motivated, before disregarding it. As we also noted above, this may well not be within the power of OECD to achieve.

5.7 Detailed interpretation of commercial rationality test

One detailed question concerning the framework is whether it implies that a tax administration can challenge the commercial rationality of the other party's decision. This may seem obscure but we are aware of examples of tax administrations challenging the location decision of transferees (i.e., the entity acquiring functions, assets or rights). Provided that the next best alternative test is satisfied for the transferor there would seem to be no scope within the bounds of the arm's length principle for a challenge to location decisions.

In addition, there is a need to confirm that the commercial rationality test is to be applied after allowance for restructuring payment. This is clearly indicated in paras 59 and 213 but was, we understand, denied by some tax administration representatives at a conference late last year.

5.8 Summary of key points

1. There is an urgent need for tax administrations to reach a consensus on the circumstances in which they set aside the transaction as structured by the taxpayer, including a definition of “exceptional” aligned with its natural meaning.
2. In our view, in virtually all cases it should be possible to use transfer pricing, including compensation payments, to allocate the benefits of restructuring in a way which ensures that all entities are at least as well off as they would have been if they had adopted the next best alternative realistically available to them.

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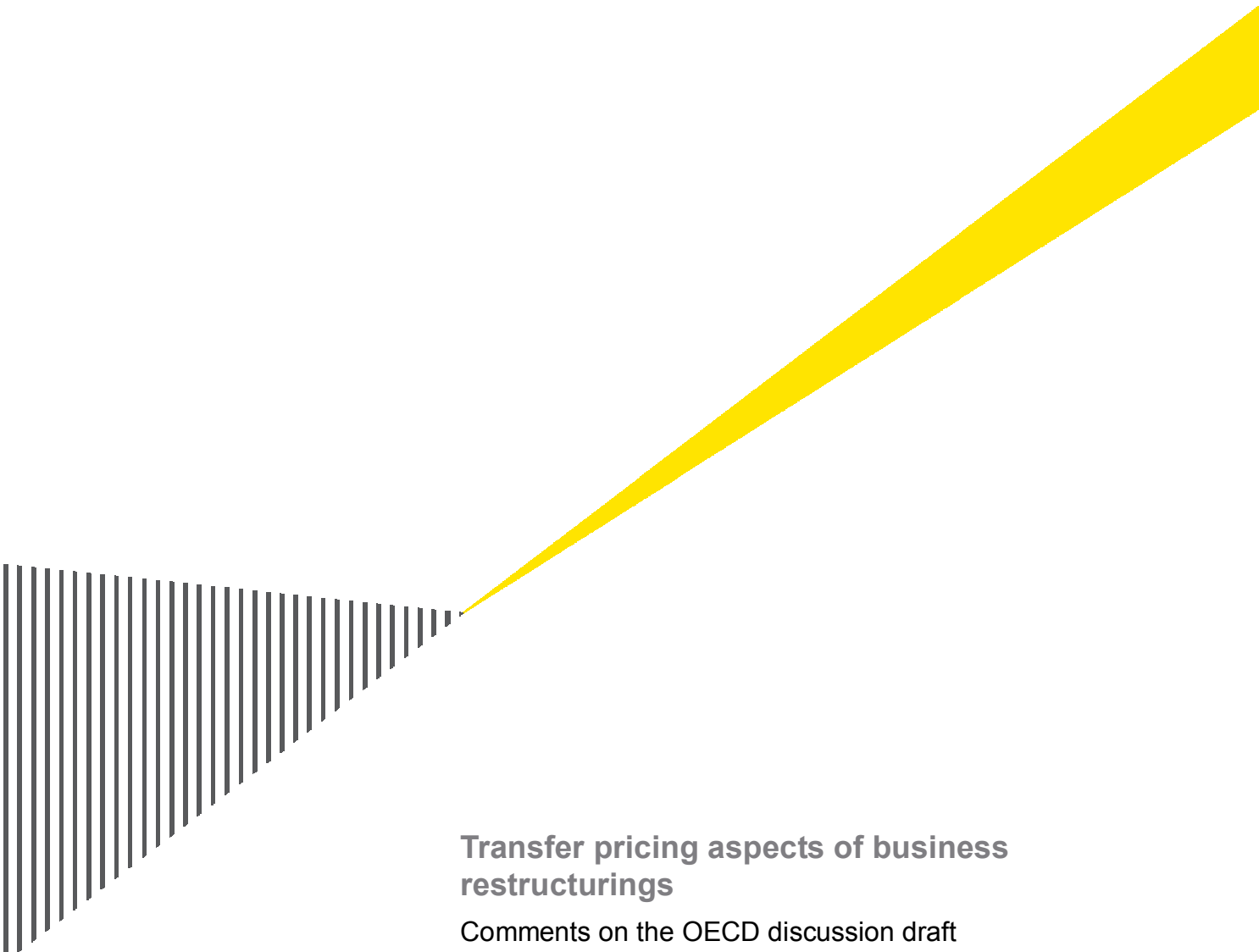
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**Transfer pricing aspects of business
restructurings**

Comments on the OECD discussion draft

16 February 2009

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1. Introduction and summary of key points

Ernst & Young welcomes the opportunity to comment on the OECD's discussion draft on the transfer pricing aspects of business restructuring.

The wave of business restructuring in Europe and North America over the last decade and the emergence of similar phenomena in Asia Pacific and Latin America means that the topics considered in the discussion draft are of great importance to both tax administrations and taxpayers.

Ernst & Young agrees with the OECD's Working Party on several key concepts in the draft, for example the adoption of an arm's length framework rather than the formulary approach to compensation payments which has started to emerge in some countries.

However, we have several major concerns with the discussion draft, particularly:

1. It is clear from the discussion draft that there has been disappointing progress in achieving consensus on the question of when a tax administration should be permitted to set aside transactions as structured by the taxpayer (i.e. Issues Note 4). Based on our experience, it is vital that a substantial measure of agreement should be reached on this issue. Our own view is that tax administrations should only be able to disregard a business restructuring if there is no commercial rationale for it from a group perspective. Other cases can be dealt with through conventional transfer pricing adjustments where appropriate. Unless powerful safeguards are applied, we fear that the number of cases in which recourse is had to these provisions, even if only to put pressure on the taxpayer to settle, will increase further.
2. It should be recognized that restructuring is a continuous process rather than a one-off event for most groups. Two key points follow from this:
 - i It may well be that (and often is in our experience) an important reason for a reduction in the profitability of "restructured" entities is that transfer pricing had not kept pace with business change with the result that the "restructured" entity was too generously rewarded.
 - ii Guidance should be provided to the effect that minor restructurings should not give rise to potentially taxable transactions.
3. There is a need for much greater clarity around the notion of control of risk (Issues Note 1).
4. The focus on the determination and assessment of the "next best alternatives" available to the parties in an inter-company transaction will likely lead to onerous and burdensome compliance requirements, unless the burden of proof rests with tax administrations to show that a taxpayer has failed to consider an obvious alternative (Issues Note 2).
5. More generally, we are concerned that the analysis envisaged by the discussion draft and the associated documentation will make managing the transfer pricing aspects of business restructurings much more complex and costly.

The refinement or clarification of some of the provisions of the OECD Transfer Pricing Guidelines ("TP Guidelines") in this discussion draft would appear to have implications which go well beyond business restructurings. For example, there would appear to be an inconsistency between the discussion of the control of risk in Issues Note 1 and the guidance on cost contribution arrangements in the TP Guidelines, which is widely interpreted as allowing a separation of economic responsibility from control.

In addition, although domestic legislation is stated not to be within the scope of the discussion draft, we do not think the OECD can ignore the need for any income arising from the

application by a tax administration of several of the concepts in the draft to be unequivocally subject to existing, and possibly strengthened, mechanisms for the elimination of double taxation (as opposed to being excluded from those mechanisms where it is claimed the application of the concept is made under domestic anti-avoidance provisions).

The sections that follow present our comments on each Issues Note.

2. Issues Note 1: special considerations for risks

This Issues Note focuses on issues arising from the transfer and allocation of risks between or among related parties as a result of business restructurings, with a focus on the interpretation of paras 1.26 to 1.29 of the TP Guidelines.

Our comments below relate to:

1. The complexity of determining economically significant risks in a specific set of facts and circumstances
2. The implications of this complexity for the structure of the analysis
3. The nature of economically significant risks
4. The difficulty of determining which related entity is controlling a risk and how this may change as a result of market circumstances
5. The alignment of transfer pricing with performance measurement and risk management processes
6. The risks of an overly granular analysis
7. Some possible implications of the clear statement that allocation of risks drives method selection

2.1 Identifying economically significant risks

The identification of economically significant risks is a matter of great importance and receives only brief attention in this Issues Note. We are concerned that the discussion at this point focuses too narrowly on risks directly associated with related-party transactions and in doing so gives insufficient attention to what are often much more significant risks commercially.¹

Many of the examples of risk given in the discussion draft tend to be relatively straightforward – foreign exchange, credit, losses in transit and inventory risks are all instanced. These may be capable of being identified from accounts or an agreement. But other risks of much greater significance may not be identifiable from these sources; and their allocation may need to be inferred from the conduct of the parties.

For example, capacity risk will be highly significant for a group which must invest substantial sums with long lead times in production capacity expansion. Depending on the facts and circumstances, this risk may need to be assigned to the manufacturer or, if the relationship appears to be analogous to a contract manufacturer with a single customer, to the purchaser.

It should therefore be emphasized that the fact that a risk is not explicitly referred to in agreements or accounts does not mean that it is not economically significant. All such risks are relevant to the selection of the transfer pricing method and the determination of the profit that an entity bearing a risk should expect to earn.

2.2 Implications for the structure of the analysis

Para 20 sets out a four-step process starting from the contractual allocation of risks. For the reasons just stated, in our view the analysis should start with the identification of the economically significant risks (step 3 in the hierarchy of para 20). This will avoid spending

¹ There are some references in the last sentence of para 42 but it does not appear that these have been taken into account.

time on non-significant risks and also ensure that risks which are significant but which may not be specifically allocated in the contract or evident from accounts are considered.

Thus in our view, the step plan should be:

1. Determine economically significant risks
2. Evaluate by which entity(ies) these are controlled and assumed²
3. Determine conformity with contractual allocation
4. Evaluate transfer pricing consequences

2.3 Nature of economically significant risks

The same area of business poses risks on a number of different levels. For example, in the area of product portfolio management, there are risky choices to be made concerning:

- ▶ Which areas of the market offer profitable opportunities
- ▶ Product strategy in the selected market areas
- ▶ Design and development of specific products
- ▶ Product introduction and marketing
- ▶ Upgrading existing products
- ▶ Withdrawal of products at the end of their lifecycle

Since the control of the associated risks could be in different entities, the relative importance of the various dimensions of product portfolio management is of great significance.

In our view, this question can only be answered for specific facts and circumstances; and then only with difficulty and probably ambiguity.

We believe that this complexity should be recognized in guidance and that simplistic analysis should be discouraged.

2.4 Definition of control and identifying which entity is controlling risks

We agree with the definition of control proposed in the Issues Note.³ However, in our experience, it can be difficult to assign control of risks to a specific entity.

We would make a number of points on this:

1. Determining whether an entity has the financial capacity to bear risk is not itself straightforward as it involves the quantification of the potential financial impact of the risk in the context of other risks that the entity may bear responsibility for.
2. As regards decisions to take on risks and their active management, governance processes which define decision rights must be considered. These will often involve a

² For the purposes of our response, the assumption of risk requires the economic ability to bear such risk. For consistency purposes, we refer to the assumption of risk as the ability to bear loss. The control of risk refers to efforts to manage risk through various functions performed with regard to the assumed risk.

³ Page 7 of the Discussion Draft defines "Control" in this context should be understood as the capacity to make decisions to take on the risk (decision to put the capital at risk) and decisions on whether and how to manage the risk, internally or using an external provider."

hierarchy and the location within that hierarchy of the key decision-making level. For example, in some groups little pricing discretion may be delegated; in others, sensitive local pricing is essential and key decisions are delegated.

3. IT systems are increasingly important in managing risk. This is a matter to be taken into account in determining whether a risk is economically significant.
4. As “virtual management structures” become more common, the likelihood increases that a number of entities will be found to be collectively controlling economically significant risks. This illustrates the need for more detailed guidance on what control really means – ultimate responsibility, primary share of collective responsibility, or something else. Without this, the implication of collective control might drive tax administrations towards a greater use of profit split methods, which would run the risk of increased controversy.
5. Control of risks may change over time in response to market conditions and market performance. For example, within the context of an essentially delegated structure for the management of brands, the group’s commercial director might decide it was appropriate to take a more “hands-on” role in managing a poorly performing brand.

2.5 Circumstances in which control of risk is divorced from economic responsibility

As the Issues Note recognizes, in transactions relating to the management of financial instruments, it is relatively common to see a separation of substantial control from economic responsibility. The Issues Note assumes that this is possible because information is available to evaluate the performance of the “service provider.”

We agree that a key issue is whether the entity bearing economic responsibility has access to a reliable and independent source of information which allows it to evaluate the performance of the entity undertaking day-to-day monitoring and control.

However, our view in brief is that the availability of information within highly integrated multinational groups may be such that, if the same level of transparency existed at arm’s length, economic responsibility could be separated from what might appear to be a substantial degree of control.

For example, in a business restructuring context, it might be that the transferor continues to have substantial discretion in relation to important commercial risks. However, the management information and control systems which have been put in place as part of the restructuring fundamentally change the role of the transferor because its performance is now more closely monitored by a knowledgeable transferee.

In addition, there are examples of risk transfer at arm’s length where the risk transferee may not be able to measure the day-to-day activity of the risk transferor, but that certain events will nevertheless result in the transferee assuming responsibility for a risk:

1. Catastrophic (CAT) bonds related to the transfers of property and casualty events such as earthquakes and hurricanes.⁴
2. Credit default swaps (CDS), where only the default trigger event is viewed as a significant change in the financial condition of the underlying corporate entity which would obligate the seller of the CDS to pay the buyer of risk protection. Such events do not require the risk transferee to monitor the daily activities of the risk transferor/service provider.
3. Numerous forms of indemnity insurance. While such risk transfer arrangements have numerous terms and conditions which may limit the payment by the risk transferee,

⁴ See *Catastrophe Bonds* by Liz Moyer, 31 August 2005, available at http://www.forbes.com/2005/08/31/hurricane-catastrophe-bonds-cx_lm_0831catbonds.html.

these are typically limited to situations where the risk transferee has engaged in activities related to moral hazard. In these cases, the day-to-day performance is not measured except for the behavior limited by the terms and conditions which is analyzed after a claim for a risk event is made.

The common element in these examples is that the transferor has no or only limited influence on whether the event occurs so that there is no moral hazard problem.

2.6 Role of formal risk management processes and performance measures

Many groups now have documented risk management processes and these may be helpful in identifying where risks are controlled.

Similarly, an understanding of performance measures may assist in determining where risks are controlled, since a general principle of performance measurement is that they should be aligned with decision-making rights. For example, the fact that manufacturing management will often be measured on non-volume variances from standard costs indicates that they do not have control of market-related risks.

It should be open to taxpayers to support their transfer pricing analysis with such internal evidence, but not mandatory that they do so.

2.7 The risks of an overly granular analysis

We have a concern that the framework proposed in this Issues Note will prompt an overly detailed assessment of how risks are controlled. While the analysis may be relatively detailed, the objective should be to reveal “the big picture,” i.e., the general pattern of control of risk.

This is important because we believe that the proposed guidance may be interpreted as increasing the scope to challenge the allocation of risks to a greater extent than is practical or necessary. The allocation of risks by the taxpayer should in the first instance be respected and only be open to challenge by tax administrations in extreme cases. Challenges should be limited to cases in which there is a systematic mis-alignment between the contractual allocation and control of significant risks to the point that the arrangement lacks economic substance and business purpose.

Implementing such an approach would allow taxpayers to have more certainty in reaching the decisions they make regarding risk allocations. In coming to such a judgment, consideration should be given to the information and circumstances available at the time, and not with the benefit of hindsight.

We also believe taxpayers should not have to document ex ante the rationale for their decisions regarding risk allocations as this an unnecessary burden. Rather, taxpayers' risk allocations should be respected other than in exceptional circumstances. In other words, the burden of proof should be on the tax administrations and it should be high, applicable in narrowly (and better) defined circumstances.

We note that para 163 within Issues Note 3 calls for a focus on significant risks in considering whether the transactional profit split method should be applied. The same injunction is appropriate here.

2.8 Implications of a strict relationship between the allocation of risks and the transfer pricing method

Both in this Issues Note and elsewhere in the discussion draft, the OECD clearly states a view that how the parties have allocated responsibility for the control of risk will drive the

choice of transfer pricing method; and that risk cannot be reassigned through the selection of a method.

In our view, the strict application of these principles could lead to considerable complexity and volatility in profitability. This is because it would in principle be necessary to monitor the source of emerging profit variances and assign them to the responsible entity for their control.

For example, a transfer pricing system might target an operating margin of X % for its distributors. Variances could arise from a range of sources, including overall demand levels, product mix, pricing variances and selling costs. Even within these categories, risks might be controlled by different parties. If the logic of this Issues Note were to be followed, it might be necessary to assign responsibility for specific variances to the entity controlling the relevant risk. This would be very time consuming and, as it is likely that some risks would be assigned to the “tested party,” would increase the volatility of profitability.

2.9 Summary of key points

1. Economically significant risks may well not be identifiable from accounts or agreements.
2. In the light of this, the analysis should start with the identification of economically significant risks rather than from the agreement.
3. The notion of control of risks is a matter of great complexity on which substantially more guidance is needed.
4. There should be guidance that the analysis should focus on a small number of economically significant risks.
5. A strict application of the principle that risks should be borne by the party controlling them could lead to increased profit volatility.

3. Issues Note 2: arm's length compensation for the restructuring itself

This Issues Note considers when compensation payments should be made in the context of restructuring. The Note distinguishes the transfer of risks and assets on the one hand and terminations or changes in contractual relationships on the other.

Our comments below relate to:

1. Some general observations on the overall framework for compensation payments
2. The identification and evaluation of realistically alternative options
3. Retrospective adjustments to compensation payments
4. The status and valuation of goodwill in business restructurings
5. The form of compensation payments
6. The heavy documentation burden that the proposed approach could impose on taxpayers

3.1 Overall framework

We welcome a number of what we believe to be key points emphasized in the Issues Note, particularly:

1. The emphasis on an arm's length framework rather than a formulary approach of the kind that is often the starting point for tax administrations.
2. The recognition that an arm's length framework for determining whether, and if so at what level, compensation payments should be made in the context of restructuring must take account of the perspectives and alternatives open to both transferor and transferee. Although obvious, this point is forgotten every time a claim is made that a starting point for determination of a compensation payment is the loss of profit of the transferor.
3. the clear statement that profit potential is not an asset in itself, although an understanding of profit potential is necessary to setting compensation payments.

However, we believe that there is scope for greater clarity in the framework envisaged in two respects:

3.1.1 Overall approach and objectives

The Issues Note successively considers risk transfers, asset transfers and changes in contractual terms.

These may of course all be features of a single restructuring.

Our understanding of the Issues Note is that the OECD is articulating an arm's length framework which is to be applied to each of these elements if observed in isolation or, more likely, to a restructuring in its entirety. Where the latter scenario applies, there should not normally be, for example, both an indemnification payment for a change in contractual status and a compensation payment for an asset, the value of which depends in large measure on a contractual right under the changed contract. In most cases, the restructuring should be viewed holistically taking account of both the change in contractual status and other commercial considerations.

In our experience, a holistic approach is in many cases likely to give as, or more, reliable an outcome as an asset-by-asset approach. It is always difficult to value individual assets in isolation from one another. This is particularly so when the valuation is being based on realistic alternative options, since any given strategic option can only be defined and evaluated by reference to a complete set of commercial circumstances.

Thus, in our view, the attention devoted to risks, specific assets and contractual rights is misleading and it should be clearly stated that the analysis should normally consider the change as a totality. That is, the post-restructuring situation (defined by reference to the disposition of functions, assets and risks including legal rights) should be compared to realistic alternative options defined also by reference to a business strategy involving the retention by the transferor of some or all of its existing functions, assets and risks and, perhaps, the acquisition of others (e.g., developing a capability currently provided by the transferee).

If this understanding is correct, the overall objective of the analysis is to determine whether, and if so at what level, a compensation payment could be expected to have been agreed if the restructuring had been undertaken by unrelated parties in the light of the alternative options realistically available to them.

For the avoidance of doubt, we are not suggesting that specific assets, risks and contractual rights should be ignored. Indeed, in some cases specific asset valuations may be relevant. Moreover, if assets are sufficiently broadly defined, there is unlikely to be a case for a compensation or indemnification payment unless the transferor disposes of an asset or fails to take up a right. However, in the majority of cases, the context of the valuation is important.

3.1.2 Implications of the next best alternative approach for quantum of compensation payments

The Issues Note apparently fails to draw out a fundamental implication of its own focus on the next best alternative options available to both parties. This is that the maximum and minimum level of compensation payments consistent with the arm's length principle can be determined on the basis of the value of the options available to each party. The minimum (maximum) compensation payment consistent with the arm's length principle is that which leaves the transferor (transferee) at least as well off as it would be if it adopted the next best alternative realistically available to it.

Information on the value of next best alternative options can therefore be used to determine an "arm's length range" for compensation payments. The range may be wide if the benefits of agreement to the restructuring are great or narrow if one or both parties have good alternatives to agreeing to the restructuring.

3.2 Compensation payments and next best alternative

While the emphasis on the realistically available options is attractive conceptually, we anticipate that it will create significant problems in practice. Indeed, there is already experience in an audit context of tax administrations introducing new alternatives which they deem the taxpayer should have considered but which the taxpayer considers to be unrealistic. Such disputes can be lengthy and will almost certainly impose significant compliance costs.

Taxpayers can minimize the risk of lengthy and unproductive disputes by preparing documentation consistent with the proposals in the Issues Note identifying and evaluating alternative options.

However, it is important that tax administrations do not seek to apply hindsight and only challenge the assessment of options made by the taxpayer when there are clear grounds to do so.

We therefore believe that:

- ▶ The burden of proof should rest with tax administrations to demonstrate that the option chosen at the time by the taxpayer was perverse, or not credible, i.e., that there were clearly (and not merely arguably) more attractive options available.
- ▶ This should be determined based upon information reasonably available to the taxpayer at the time of the restructuring, and not with the benefit of hindsight.

As discussed further below, additional guidance on documentation may be helpful in this regard.

Our interpretation of this Issues Note is that the alternatives to be considered include purely hypothetical ones outside the group, e.g., a related distributor contracting with a non-group supplier as an alternative to agreeing to a restructuring of its role within the group. The correct interpretation should be made explicit.

In addition, although the legal rights of the parties are clearly relevant to the determination of their next best alternative option, assessing and valuing those rights in a specific jurisdiction could be a matter of great complexity and cost.

3.3 Retrospective adjustments to compensation payments

It is difficult to see how it will be possible to implement the suggestion in para 88 that compensation payments should be subject to the provisions in the TP Guidelines allowing retrospective adjustments when intangible assets are of particularly uncertain value.

Valuations based on the principles set out in the Issues Note will reflect the emphasis placed on the next best alternative option. There could therefore be a need for a retrospective adjustment if, with the benefit of hindsight, the value of the next best alternative option would have been materially different.

In order to apply retrospective adjustments, it would therefore be necessary to keep the value of next best alternative options under review. Indeed, theoretically, it would be necessary to keep under review the question of whether the next best alternative option was indeed selected as the basis for valuation.

In our view, this demonstrates that retrospective adjustments in other than the most extreme circumstances of mis-valuation are not practical.

3.4 Treatment of goodwill

We have described above our understanding of the framework envisaged by the Issues Note. One of the few reasons for doubting that our understanding is correct is the discussion of goodwill in paras 93 and 94.

Goodwill is normally understood to be the difference between the consideration for a transaction, or the total business value derived in some other way, and the total value of the separately identifiable assets and liabilities of the business. As such, the goodwill value is derived from other valuation information. It cannot be separately valued.

The business valuations from which the value of goodwill is normally derived are on a “going concern” basis.

Total business valuation techniques from which goodwill valuations are derived will not be applicable to business restructurings unless:

- ▶ Valuation multiples from comparable restructurings between unrelated parties can be identified

- ▶ The transferor truly has a realistic alternative option of continuing in business on the pre-restructuring basis (i.e., going concern is a realistic alternative)

We have also noted above that compensation payments consistent with the principles of the Issues Note can only be determined on a composite basis.

The separate valuation of goodwill may therefore be both unnecessary and inappropriate.

3.5 Form of compensation payments

The discussion draft only considers the form of compensation payments in its discussion of local intangibles in paras 89-90 where alternative remuneration mechanisms are considered depending on whether the intangibles are transferred or remain with the restructured entity.

We believe that this is an important issue that requires a more general consideration.

In some cases, a business restructuring clearly involves the transfer of an asset or right and a lump sum payment is likely to be appropriate. In others, at arm's length the transferee would require the continuing cooperation of the transferor so that the total compensation payment might be expected to be spread over a number of years. It is quite possible to envisage that the overall compensation payment should comprise a lump sum payment and a stream of continuing payments which, overall, compensate the transferor for not adopting its next best alternative.

3.6 Burden of documentation

Based on our experience, the need for documentation of the business rationale for a restructuring from a group perspective is generally recognized.

The clear statement in the discussion draft (Issues Notes 2 and 4) that it needs to be demonstrated that the restructuring was in the interests (after allowing for possible compensation) of all entities affected, clearly adds significantly to the documentation burden. Indeed, para 53 recognizes that this extension of documentation is for transfer pricing and not for commercial purposes.

It would be helpful to have additional guidance on what this documentation should include.

3.7 Summary of key points

1. We welcome the adoption of an arm's length framework for determining whether compensation payments are appropriate and the rejection of formulary approaches.
2. However, the implied focus, which we recognize to be necessary, on the realistically available alternatives of both parties, opens up a potential for controversy which can only be contained if the burden of proof rests with tax administrations to demonstrate that the taxpayer failed to consider a clearly more attractive alternative.
3. Retrospective adjustments to compensation payments are impractical in a valuation framework based on next best alternatives.
4. Goodwill valuations on a going concern basis are only relevant if going concern is a realistically available alternative.
5. Depending on the facts and circumstances, compensation and indemnification payments may be "lump sum"; a series of payments over time, or a combination of the two.
6. More guidance is needed on documentation.

4. Issues Note 3: remuneration of post-restructuring controlled transactions

This Issues Note considers transfer pricing following a business restructuring⁵ including the choice of transfer pricing method and the impact of restructuring on remuneration. Examples relating to purchasing and location savings are presented.

Our comments relate to:

- ▶ A very brief observation on methods
- ▶ The relevance of a comparison of profits before and after restructuring, with a particular emphasis on the reliability of pre-restructuring transfer pricing

4.1 Choice of transfer pricing method

In general, we agree with the points made in the general discussion of methods in paras 125 to 169. In particular:

- ▶ There is no reason to apply different standards to post-restructuring transactions, although the facts and circumstances of the restructuring should be taken into account in the post-restructuring comparability analysis (e.g., the contribution of legacy intangibles).
- ▶ The use of the transactional profit split method should be reserved for cases in which both parties make significant contributions which cannot be benchmarked.

The latter point does deserve emphasis in view of the particular difficulty in identifying comparables for the transactional structures often adopted following a restructuring in order to implement a business model which spans a number of countries.

In this connection, the term “non-benchmarkable contributions” is not one we would recommend, as it is all too easy to drop the preceding adjective “significant.” Once the adjective is lost, an invitation is issued to apply profit split whenever a tax administration determines that reliable benchmarks are not available. That would be unwelcome, and undoubtedly lead to a higher incidence of controversy.

4.2 Before and after comparisons

It is our experience that tax administrations will often seek to reconcile pre- and post-restructuring profits and seek to place the onus on the taxpayer to justify the change (normally a reduction) by reference to changes in the allocation of functions, assets and risks, which the taxpayer can show to be commensurate.

The discussion of this question starts (in paras 181 and 182) robustly, and in our view correctly, with a statement that pricing should be set by reference to uncontrolled transactions rather than prior controlled transactions. However, in paras 184 to 187, the discussion acknowledges a role for before and after comparisons, including as a sanity check (186) and the question of:

“...whether or not it is appropriate to allocate the whole residual profit to the foreign related party in view of the actual risks and intangibles of the ‘stripped’ entity and the foreign related party” (185).

⁵ There is an acknowledged overlap between this Issues Note and the review of transactional profits methods. Ernst & Young has contributed to the transactional profits methods review and no further comments are made here on general issues relating to these methods.

This discussion raises two important points.

Although the point is acknowledged in para 186, the question of pre-restructuring profits deserves more consideration. Business restructuring cases typically involve established businesses. In a number of cases, there will have been incremental business change over a period of years which may not have been reflected in the transactional structure and transfer pricing policy. When the business change involves progressive centralization, as it often does, the transfer pricing policy will tend to result in a higher than arm's length level of profit in the entity which is subsequently restructured.

In these cases, the "restructuring" which attracts the attention of tax administrations is likely to be the re-design of the transactional structure and transfer pricing policy in response to cumulative change over a period of time and perhaps prompted by one large change in a series. An example would be a decision to concentrate a range of functions already managed at a regional level in a single location and adopt a principal company transfer pricing model.

In our view, the consistency of the pre-restructuring transfer pricing with the arm's length principle (and, narrowly, with the pre-restructuring economic and comparability analysis) is therefore central to the question of whether any significance attaches to pre-restructuring profit.

Our second point concerns the role of sanity checks and lines of inquiry as to the reasonableness of the residual profit attributed to the foreign related party. As noted above, elsewhere in this Issues Note there is a clear statement, with which we agree, that profit split methods are to be reserved for cases in which the functional analysis clearly shows that both parties are making significant contributions which cannot be reliably priced using benchmarking approaches. The discussion here seems to open up the possibility of a role for an informal profit split analysis. While we recognized that a corroborative analysis can be helpful, we do not think it is appropriate to envisage an unstructured analysis and, in effect, require the taxpayer to undertake a complex and onerous profit split analysis when, in the context of the transactional profit methods review, it appears to be generally agreed that there should be no requirement for the application of a second method.

4.3 Summary of key points

1. Although a transactional profit split analysis may be helpful as a corroborative analysis in some cases, there should be no suggestion of a requirement for such an analysis to be undertaken unless both parties are making economically significant contributions which cannot be reliably benchmarked.
2. "Before and after" comparisons of profitability can be very misleading in business restructuring cases as the pre-restructuring transfer pricing may not have been adapted to prior business change.

5. Issues Note 4: recognition of actual transactions undertaken

This Issues Note seeks to clarify existing guidance on the exceptional circumstances in which a tax administration may not have to recognize a transaction presented by the taxpayer. This limited scope – it is explicitly stated that no amendments to guidance are intended – and the fact that countries appear not to have agreed on the appropriate treatment of fairly simple examples indicate the difficulty of achieving consensus and the consequent continuing risk of lengthy disputes quite possibly leading to double taxation.

Our comments below relate to:

- ▶ The progress which it has been possible to make on these issues
- ▶ Our overarching views on this issue
- ▶ The OECD's welcome restatement of the respective roles of MNEs and tax administrations in designing business structures including the influence of tax savings
- ▶ The meaning of "exceptional"
- ▶ The two specific points on which the Issues Note seeks comments:
 - ▶ The role and status of paragraphs 1.36 – 1.41 of the TP Guidelines
 - ▶ The framework set out in paragraphs 207 – 213 of the discussion draft for assessing commercial rationality in relation to the second circumstance in which para 1.37 of the TP Guidelines allows a tax administration to disregard the structure adopted by the taxpayer
- ▶ Two detailed points relating to the commercial rationality test

5.1 Progress on recognition of transactions

First and foremost, it is a matter of regret that it has not been possible to make more progress on this issue at a time when some tax administrations are routinely challenging business restructurings on the grounds that the restructuring would not have taken place at all; or that the relationship between the parties is to be characterized in a manner completely different to that presented by the taxpayer.

If consensus is not a realistic objective in the near future, it might be of assistance to taxpayers in managing their affairs at least to have a more transparent statement of the varying perspectives of tax administrations.

5.2 Overarching perspective

Our view on this issue flows from the following extract from the discussion draft, with which we agree (para 213 with the deletion of the cross reference in the final sentence):

"The OECD recognises that there can be legitimate group-level business reasons for an MNE group to restructure. In practice, where a restructuring is commercially rational for the MNE group as a whole, it is expected that an appropriate transfer price would generally be available to make it arm's length for each individual group member participating in it. In this respect, it is worth re-emphasising that the arm's length principle treats the members of an MNE group as separate entities rather than as inseparable parts of a single unified business (paragraph 1.6 of the TP Guidelines). As a consequence, 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."

In our view, it follows that there should only be a need to consider setting aside the transaction structured by the taxpayer if there is no non-tax commercial rationale for the restructuring. In virtually all other cases, it should be possible to design pricing arrangements which share the commercial benefits of the restructuring between the parties affected in a way which ensures that, for each of them, participation in the restructuring leaves them as well off as they would be if they had adopted their realistically available next best alternative.

This logic implies there should be no need to distinguish restructurings involving the transfer of strategically important assets (crown jewels). The statement "everything has a price" is both logically true if economic agents act rationally and enter into specific transactions when they are more profitable than their realistically available next best alternative; and a commonplace of commercial life.

5.3 Roles of MNEs and tax administrations in designing business structures

We naturally welcome the clear statement in para 196 that taxpayers are free to organize their business operations as they see fit in the light of all relevant commercial considerations, including tax considerations; while the role of tax administrations is to determine the tax consequences of the adopted structure subject to the application of treaties and in particular Article 9.

5.4 Meaning of "exceptional"

Only a single, brief paragraph is devoted to this important although seemingly intractable question.

The current level of recourse to these provisions in audits, already referred to in 5.1 above, is clearly not acceptable. There is a clear need for some tax administrations to restrain themselves or be restrained in alleging the applicability of these provisions to a large number of restructuring and structuring transactions.

5.5 Role and status of paras 1.36 to 1.41 of the TP Guidelines

In paras 201 and 202, the Issues Note states that it is the OECD view that:

- ▶ Paras 1.36 to 1.41 do not preclude a tax administration from making an adjustment to arm's length pricing or other conditions when there is no dispute about the nature of the transaction (para 201).
- ▶ Where the conditions set out in these paras are met, Article 9 allows an adjustment to attain the conditions appropriate to the economic and commercial reality of the relationship between the parties.

While our general view is that the application of 1.36 to 1.41 is confined to a very small minority of cases because the vast majority of cases can be dealt with within the framework of the transactional structure adopted by the taxpayer, we would agree with the views of the OECD on how these provisions are to be interpreted.

5.6 Framework for assessing commercial rationality in relation to TP Guidelines para 1.37

Our understanding from the Issues Note is that there is disagreement within Working Party 6 on this issue. A minority of countries are of the opinion that the second circumstance in TP Guidelines para 1.37 does not apply if there was some business purpose to a transaction even if there was arguably a more attractive option. The majority of countries take the view that commercial rationality requires a demonstration that independent parties would have entered into an arrangement similar to that adopted by the related parties.

The remainder of the discussion builds on the latter viewpoint using concepts which are familiar from other parts of the discussion draft. Most particularly, it:

- ▶ Builds on the notion that commercial rationality requires the adoption of the most attractive option realistically available
- ▶ States that if the restructuring is rational for the group as a whole, appropriate transfer pricing arrangements which ensure that each entity affected by the restructuring expects to be better off than it would if it had adopted its next best realistically available alternative
- ▶ Notes that even if the second circumstance applies, tax administrations must consider whether the structure adopted prevents the tax administration from determining an appropriate transfer price

As the discussion notes, the logic and analysis are the same as in Issues Note 2 where the question is whether a payment is to be made for the transfer of valuable assets or as an indemnity for termination or a substantial change in a commercial relationship.

While it would seem inconsistent to apply a different standard and approach in the context of para 1.37, it is clearly a weaker test than that proposed by the minority of countries. If the approach proposed by the OECD were to be adopted, it is to be expected that claims that para 1.37 allows a transaction to be disregarded would increase. Consistent with the comments we have made above and in response to Issues Note 2, we would be concerned that tax administrations would assert the existence of realistic alternatives that taxpayers regard as spurious. Irrespective of the outcome, compliance costs would increase substantially.

Our view is therefore that the framework proposed should be adopted only if, as we proposed above, a mechanism can be found to balance the interests of taxpayers and tax administrations in ensuring that reasonable and well-founded claims that a taxpayer had failed to consider realistic alternative options.

An ongoing lack of consensus represents uncertainty for MNEs and tax administrations alike. This would damage the perception of the value of the draft, at least in regard to this Issues paper. A more radical solution might be needed to resolve the situation. Consideration might, for example, be given to the need for a tax administration to show that a restructuring (or any other transaction they perceive to be non arm's length) was solely tax motivated, before disregarding it. As we also noted above, this may well not be within the power of OECD to achieve.

5.7 Detailed interpretation of commercial rationality test

One detailed question concerning the framework is whether it implies that a tax administration can challenge the commercial rationality of the other party's decision. This may seem obscure but we are aware of examples of tax administrations challenging the location decision of transferees (i.e., the entity acquiring functions, assets or rights). Provided that the next best alternative test is satisfied for the transferor there would seem to be no scope within the bounds of the arm's length principle for a challenge to location decisions.

In addition, there is a need to confirm that the commercial rationality test is to be applied after allowance for restructuring payment. This is clearly indicated in paras 59 and 213 but was, we understand, denied by some tax administration representatives at a conference late last year.

5.8 Summary of key points

1. There is an urgent need for tax administrations to reach a consensus on the circumstances in which they set aside the transaction as structured by the taxpayer, including a definition of “exceptional” aligned with its natural meaning.
2. In our view, in virtually all cases it should be possible to use transfer pricing, including compensation payments, to allocate the benefits of restructuring in a way which ensures that all entities are at least as well off as they would have been if they had adopted the next best alternative realistically available to them.

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