

Confidential

Organisation for Economic Co-operation and Development (OECD)
Attn. Mr Jeffrey Owens
OECD 2, rue André Pascal F-75775 Paris Cedex 16 France

Amsterdam, February 16, 2009

Subject: Transfer Pricing Associates' Comments on "Discussion Draft on the Transfer Pricing Aspects of Business Restructurings"

Dear Mr Owens,

Transfer Pricing Associates Global Transfer Pricing Practice ('TPA') is pleased to provide the following comments in response to the OECD Centre for Tax Policy and Administration's public invitation to comment on the series of Issues Notes on Business Restructurings ('Transfer Pricing Aspects of Business Restructurings: Discussion Draft for Public Comment', hereinafter referred to as 'the Discussion Draft'), released on 19 September 2008.

Business restructurings are happening on a daily basis and are an integral part of multinationals' businesses in order to maintain competitiveness. Therefore, TPA underlines the significance of the outcome of the work undertaken by the OECD in relation to business restructurings.

We believe the Discussion Draft is one of the best documents published by the OECD on Transfer Pricing aspects of a multinationals' value chain. On the other hand the document contains no integral responses to all aspects of a business restructuring, e.g. the OECD is not the platform to provide guidance on applicable valuation standards.

In the Annex to this letter, we have summarized our main points of commentary on the Discussion Draft.

Yours sincerely,

Steeff Huibregtse

Comments TPA

1. The Discussion Draft addresses four issues notes. Given the title of the document ‘Transfer Pricing aspects of business restructuring’, TPA suggests to have the following sequence of ‘issues notes’: arm’s length compensation for the restructuring itself (currently as issues note no. 2) and remuneration of post-restructuring controlled transactions (currently as issues note no. 3) reflect the main topic. Subsequently, Special Considerations for risks (currently as issues note no. 1) and Recognition of the actual transactions undertaken (currently as issues note no. 4) are giving the boundaries within which such Business Restructuring is taking place. The current sequences provided by the Discussion Draft puts an unbalanced emphasis on the ‘Special Considerations for risk’ section.
2. The current definitions and description of the words synergies, efficiencies of scale and efficiencies of location (i.e. referred to as location savings) will lead to a lot of controversial disputes. For example: will tax authorities define location savings as an autonomous component of a Business Restructuring. TPA suggests defining synergies and efficiencies of scale and location as a species of the genus ‘profit potential’. This would mean that such benefits cannot be classified as an asset. The Discussion Draft indicates that profit/loss potential is not an asset, but a potential which is carried by some rights or other assets.
3. The Discussion Draft does not define a threshold, above which Business Restructurings can be considered to attract a corporate income tax liability. For example: a shift of assets, including a major brand-name, in most cases will be considered a shift of assets and profits leading to a capital gain/goodwill recognition at the country of origin. TPA suggests that only significant Business Restructurings leading to a shift in profits would be subject to an analysis as described under issues note no. 2 and 3. Otherwise the hundreds of commercial decisions a multinational takes on a yearly basis would be subject to scrutiny, monitoring and compliance requirements as outlined in the Discussion Draft, which would put a disproportionately high administrative burden on multinationals.
4. Given the large number of variables under a Business Restructuring which could lead to an increasing number of disputes between a taxpayer and tax authorities, TPA suggests to stimulate accelerated Mutual Agreement Procedures (MAP). This way, the high uncertainty on tax liability positions, would be limited in time, assuming a clear set of guidance is given on how tax authorities and taxpayers need to deal with most of the relevant variables. For example: (a) what is the threshold attracting a taxable event under the Business Restructuring guidelines? and (b) what valuation techniques are applicable for – in general – complex transactions, whereby taxpayer and tax authorities are using the same or similar points of reference on proven and used valuation techniques?

5. TPA understands that the Discussion Draft in the case of a Business Restructuring would first lead to the valuation of one or more assets, either tangible or intangible. Under section C.3 (paragraphs 93-97) the Business Restructuring involving the transfer of an ongoing concern, e.g. an activity, is described and analyzed. TPA has learned that most multinationals will be following the transfer of assets, and only in a selective number of Business Restructurings will they be able to address the shift of an activity to somewhere else. The accumulation of multiple transfers of assets (i.e. bundling/package/basket approach to separate transaction in time) during a certain period of months or even years, according to TPA, should not necessarily lead to the transfer of an activity. In addition, under bundled transactions creating together a Business Restructuring, the timing of when a Business Restructuring has taken place will become critical for the type and level of valuation results. TPA suggests much stronger guidance so that the transfer of assets is used as a starting point, whereas only under special circumstances the transfer of an activity is taken as the basis for the valuation.
6. TPA understands that the Discussion Draft is addressing the circumstances under which a Business Restructuring leads to a taxable event due to a shift of some rights or other assets. TPA urges tax authorities to provide more guidance on the most relevant valuation issues after such a taxable event has been concluded upon: the valuation of rights and/or other assets. In case of little or no experience on valuation techniques, in practice, all Business Restructuring leading to a taxable event, will subsequently lead to a material dispute on the appropriate way to value the rights and/or other assets.
7. Issues note no. 4 could serve as a manual for tax authorities to start disqualifying inter-company transactions between group companies. Although paragraph 205 puts an emphasis that the non-recognition of a transaction is not the norm, but rather an exception to the general principle, subsequent paragraphs seem to indicate some tax authorities might follow a pure motives testing. For example: in case a taxpayer cannot convince these tax authorities that the Business Restructuring was serving more than just tax considerations, such tax authorities would classify the taxpayers behaviour as 'commercially non-rational behaviour'. Such tax audit techniques are dangerous and almost always carry the notion of hindsight, where tax authorities are simulating business transactions based on business motives themselves. TPA suggests that OECD uses stronger wording to block such 'motive testing' – as integral rather than a marginal test mechanism - and the increasing number of disputes triggered by such integral testing. For illustration purposes: the testing by tax authorities of an inter-company transaction based on the behaviour of 1 or 2 prudent business managers will lead to an integral check on whether the taxpayer should have taken such decision in the first place, which role and responsibility is not in the hands of tax authorities, but rather the exclusive domain of the taxpayer(s).

Issues Note no. 1 (page 17) ‘Risk allocation and control’, question by OECD:

a) Comments are invited from the business community on the meaning of the word “control” in the context of paragraph 1.27 of the TP Guidelines, and on what functions or decisions typically amount to control, in particular in business restructuring situations.

b) Comments are especially invited from the business community on the question of whether it is possible at arm’s length to ask the transferor of a risk to perform the day-to-day monitoring and administration functions on behalf of the transferee in cases where it is difficult for the latter to assess the performance of the former as service provider in the absence of an independent source of information.

c) Noting the word “generally” at paragraph 1.27, comments from the business community are also invited on cases where risk would be allocated at arm’s length to a party that does not have greater control over it, in particular in business restructuring situations.

Comments TPA

a) TPA suggests that the definition of ‘control’ within the context of article 1:27 of the OECD Transfer Pricing Guidelines, is related to the ‘individual or group of individuals, who is/are putting the capital at risk, which decision is –mostly– communicated through instructions to other individuals arranging the executions on a ‘day-to-day’ basis. TPA suggests that the concept of ‘control’ is not addressed in case the allocation of risks and corresponding control is arranged for in an inter-company agreement and such agreement is in line with what independent third parties would agree upon. Only when no comparable or similar arrangement would be agreed upon between independent third parties, a ‘financial capacity’ and ‘control’ testing would be taken as a next step of analysis.

b) The ‘control’ element needs to be reviewed on a case-by-case basis. The example under paragraph 38 of the Discussion Draft indicates that the analysis in ‘which one of the affiliates has more control over the inventory risks’ could be done by tax authorities, i.e. they can decide to re-assign the consequences from the inventory risk allocation to the related distributors (versus the group manufacturer which according to the taxpayer was running the risks). Although factual analysis seems a starting point to determine which affiliate actually has greater control over the excess inventory risk, the re-assignment by tax authorities should be based on the whole complex of facts, rather than on individual statements by the local group distributors that they control the purchase of inventories. In practice, it is quite common that taxpayers divide inventory risks between group manufacturers and group distributors. This means that the inter-company agreement should more accurately specify which portion of the inventory risk is run by either of the group companies involved.

c) under the revised article 7 OECD Model Tax Treaty, a new concept of ‘significant people functions’ (hereinafter referred to as SPF) was introduced (with a similar concept called ‘key

entrepreneurial risk taking functions’ – referred to as KERT – for financial institutions), which looks at ‘value adding decision makers’, who either are on the payroll of the ‘head office’ or the ‘branch’ of the same legal entity. The SPF concept was introduced as the most indicative way to allocate ‘assets and/or risks’ to either ‘head office’ or the ‘branch’. Obviously, an SPF would be in ‘control’ on ‘assets and/or risks’ as a consequence. TPA suggests that OECD puts an explanation on the relationship between the concepts of ‘SPF’ and ‘control’ to clarify that the practical (and economical) applications might be similar, but that the ‘SPF’ concept applies under article 7 OECD Model Tax Treaty while the ‘control’ concept applies under article 9 OECD Model Tax Treaty.

d) TPA has developed a concept of responsibility centres (investment, profit, revenue and cost), which allows taxpayers in a more natural way to allocate the most appropriate risks to the group company or companies involved in an inter-company transaction, depending on their individual ‘roles and responsibility’ profile. A full description of this concept is provided in appendix A to this letter.

Issues note no. 2 (page 25) ‘Transfer pricing consequences of a reallocation of profit / loss potential that follows from a reallocation of risks, rights and / or other assets’, question by OECD:

Comments from the public are particularly invited on this issue: whether compensation by the transferor to the transferee for the transfer of potential losses and liabilities would be agreed between independent parties at arm’s length, taking account of both the amount of the possible losses and the probability of the risk’s materialising, and

whether it would be preferable for the transferor to pay the transferee to take over the activity rather than to simply stop performing the activity and incur the associated windup costs;

Comments TPA: An independent party would only be willing to take rights and/or other assets against a payment, only in case it expects an upside in the future, through for example higher profits and higher markets shares.

TPA concludes that to the extent a group entity acting as an investment or profit centre (the party which transfers) gives up its position to generate residual results for future years, such a situation might – also between third parties – require a recognition of special rights and/or other assets being transferred. Such special rights and/or other assets will have to contain a significant portion of intangible property, which can be protected by the party considering to transfer its rights and/or other assets. TPA confirms that third parties in most cases agree upon a lump-sum payment structure or alternatively on an earn-out structure, typically not exceeding a three years price adjustment mechanism.

On the contrary, TPA confirms that group entities acting as cost centre in a fully competitive environment cannot be considered to have any unique intangible assets to be transferred, i.e. the absence of material intangibles is a strong indication that no significant capital

gains/goodwill can be recognized upon a Business Restructuring at the level of the group company who is considering to transfer its rights and/or other assets.

Issues note no. 4, (page 54) ‘Transactions actually undertaken. Role of contractual terms. Relationship between paragraphs 1.36-1.41 of the OECD Transfer Pricing Guidelines and other parts of the TP Guidelines’. Question by OECD

Business comments are particularly invited on the view expressed at paragraph 201 and 202.

Paragraph 201: Paragraphs 1.36-1.41 of the TP Guidelines apply where there is a dispute about the fundamental nature of the transaction being examined. The OECD view is that these paragraphs do not restrict a tax administration’s ability to adjust the price or other conditions of a controlled transaction in situations where there is no dispute about the nature of the transaction – and hence, no recognition issue – but where such price or conditions are not arm’s length according to guidance provided in other parts of the TP Guidelines.

Paragraph 202: Where paragraphs 1.36-1.41 of the TP Guidelines do apply, Article 9 would allow an adjustment of conditions to reflect those which the parties would have attained had the transaction been structured in accordance with the economic and commercial reality of parties dealing at arm's length (see paragraph 1.38 of the TP Guidelines). In doing so, the objective should be to arrive at a characterisation or structure that comports as closely as possible with the facts of the case.

Comments TPA:

TPA recognizes the need to define when paragraphs 1.36-1.41 of the OECD Guidelines can be applied. The high threshold that ‘taxpayer and tax authority should have a dispute about the fundamental nature of the transaction being examined’ should be worked out, to avoid that at any given dispute – through the use of the word ‘fundamental’ – the existing inter-company transactions are not recognized by tax authorities. ‘Fundamental’ disputes should be related to the whole complex of facts and can never relate to an isolated dispute only on the pricing clause of an existing inter-company transaction.

TPA suggests under paragraph 202 to include the phrase that ‘the objective should be to arrive at a characterisation or structure that comports as closely as possible with the facts and economic reality of the case.

Issues note no. 4 (page 57) ‘Determining whether the arrangements are commercially rational’, question:

Comments from the business community are invited on the interpretations of the “commercially rational behaviour” test that are proposed at paragraphs 207-213.

Comments TPA: TPA refers to point 7 of the comments by TPA above, which addresses the ‘commercial rational behaviour’ testing.

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