KPMG LLP
2001 M Street, NW
Washington, DC 20036-3310

Telephone 202 533 3800

To	Jeffrey Owens Director of the OECD Centre for Tax Policy and Administration	Date	February 18, 2009
From	KPMG's Global Transfer Pricing Services, contact Clark Chandler	Ref	OECD Discussion Draft on the Transfer Pricing Aspects of Business Restructurings – 19 September 2008 to 19 February 2009

OECD Invitation to Comment on the OECD's Discussion Draft on the Transfer Pricing Aspects of Business Restructuring

Overview

Professionals in the Global Transfer Pricing Services practice of KPMG LLP and certain member firms of KPMG International (hereinafter referred to as KPMG) welcome the opportunity to comment on "Transfer Pricing Aspects of Business Restructurings: Discussion Draft for Public Comment 19 September 2008 to 19 February 2009 ("Discussion Draft"). The increased instances of tax authorities in recent years asserting that large "exit charges" are due when multinational enterprises (MNEs) move functions and risks from one legal entity to another have presented taxpayers with significant challenges. Often, the theories used to support the asserted exit charges go beyond traditional transfer pricing requirements in that they include charges for goodwill and going concern values in addition to charges related to transfers of specific assets. While this is apparent in the new German legislation and in the Temporary U.S. Cost Sharing Regulations, KPMG has seen similar theories asserted on audit by various tax authorities.

It has been KPMG's experience that tax authority views on exit charges are often formulated based on an analysis of the "rights" of the local entity to preserve future profits without taking into account the options available to the counterparty to the transaction. These views, coupled with a willingness to assert contractual arrangements aligned with them, have led to inconsistent positions on the part of different tax authorities, which makes it difficult for taxpayers to comply with such conflicting expectations and which potentially subject taxpayers to double tax.

While tax authorities often verbally acknowledge the importance and existence of risk, as a practical matter they are often unwilling to accept the adverse consequences of risk bearing, insisting, in essence, that companies at arm's length always earn positive profits. Moreover, some tax authorities even expect an exit charge when taxpayers close down or restructure operations that are incurring losses.

Given the above, the OECD's efforts to examine the transfer pricing implications of business restructuring and to develop common approaches to dealing with the transfer pricing issues arising out of business restructuring is very timely. KPMG believes that many of the points made in the Discussion Draft, and in particular its references back to the OECD Guidelines, are appropriate interpretation of the arm's length standard. Specifically, KPMG agrees with the following core principles set forth in the Discussion Draft:

1) "This discussion draft starts with the premise that the arm's length principle and the TP Guidelines do not and should not apply differently to restructurings or post restructuring transactions than to transactions that were structured as such from the beginning."[1]

2) "… profit/loss potential is not an asset in itself, but a potential which is carried by some rights/other assets."[2]

3) "There should be no presumption that all contract terminations or substantial renegotiations give rise to a right to indemnification at arm's length."[3]

4) "…. It is worth re-emphasizing 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."[4]

5) "The determination of the arm's length price for a transfer of intangible property right should take account of *both* the perspective of the transferor and of the transferee…. The general guidance on intangible transfers that is found in Chapter VI of the TP Guidelines is applicable to intangible transfers in the context of business restructurings."[5]

6) "…. the mere fact that independent enterprises do not allocate risks in the same way as a taxpayer in its controlled transactions is not sufficient for not recognizing that risk allocation"[6]

7) "Just because a related party arrangement is one not seen between independent parties should not of itself mean the arrangement is non-arm's length"[7]

[1] Paragraph 16:
[2] Paragraph 18.2:
[3] Paragraph 18.2:
[4] Paragraph 18.4.
[5] Paragraph 79. Italics added.
[6] Paragraph 18.1
[7] Paragraph 27

8) "if an appropriate transfer price . . . can be arrived at . . . the transaction should be recognised under Article 9."[8]

9) "The OECD considers that as along as functions, assets and/or risks are actually transferred, it can be commercially rational from an Article 9 perspective for an MNE group to restructure in order to obtain tax savings."[9]

KPMG agrees that the logical outcome of adherence to the principles set forth above and in the OECD Guidelines is that: "Independent parties at arm's length do implement this type of outsourcing arrangement and do not necessarily require explicit compensation from the transferee if the anticipated cost savings to the transferor are greater than its restructuring costs."[10]

There are a number of other cases in which KPMG agrees with the basic principles set forth in the Discussion Draft, but is concerned that the OECD seems to be backing away from these principles in its more detailed discussion. For example, it is easy to understand the OECD's position that: "The OECD is of the view that at arm's length, an independent party would not enter into a restructuring transaction that is expected to be clearly detrimental to it *if it has the option realistically available to it not to do so*."[11] However, while KPMG agrees with this statement as a general proposition, KPMG believes the analysis should take the options of both parties into account. At arm's length unrelated third parties do *not* make payments to another party unless they are compelled to do so or unless it is advantageous for them to do so. Therefore, while one tax authority may assert that an adjustment is needed because a party would not "agree" to be worse off without any compensation while the other party will benefit, the other tax authority argues that no payment is needed unless the party receiving the payment has the ability, at arm's length, to secure a payment. This would be true if the seller has an enforceable right to that payment (e.g., because of a multi-year supply agreement) but is not true in many cases – customers can often sever long term relationships without making a payment in an arm's length environment.[12]

For this reason, while KPMG agrees with the statement that "… business restructuring situations involve change, and the arm's length principle must be applied not only to the post-restructuring

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8 Paragraph 18.4

9 Paragraph 18.4

10 Paragraph 98.

11 Paragraph 18.4, italics added:

12 As a simple example, consider a renter that enters into a 5 year lease. If the renter wants to break that lease at the end of year 1, the landlord would be made worse off unless a new renter can be found. The landlord would have the legal right to impose an "exit payment" upon the renter. However, if the renter wants to terminate the arrangement after the end of the five year period, the landlord has no legal remedy to prevent this, and therefore no "exit" payment is required. This is true even if the landlord is made worse off due to the lack of a prospective renter to replace the one that has left.

transactions, but also to additional transactions that take place upon restructuring and generally consist of the transfer of functions, assets and/or risks, ”[13] the Discussion Draft should stress that the analysis is done based on the existence of specific individual legal entities and respect the general proposition that these payments should be limited to payments that would be expected at arm’s length.

In addition, the Discussion Draft should explicitly state that while it is clarifying the application of the OECD Guidelines as they apply to Business Restructurings, it is not changing those Guidelines. This is particularly true with respect to transactions that do not involve business restructurings and with respect to Issues Note 4 – the Guidance provided in the Guidelines is explicit and should not be changed.

The Discussion Draft also looks at issues related to business restructuring with a perspective that is best suited to certain sectors (for example, consumer and industrial) and which is less suited to other sectors (for example, services sectors, including financial services.) This is especially apparent in its examples, which focus largely on fairly conventional industries that involve the manufacture and sale of tangible property. KPMG is concerned that some tax authorities may take concepts that may be appropriate for these industries and extend them in ways that are not appropriate to other industries, and in particular to the financial services and insurance industries. The Discussion Draft should explicitly state that issues have to be evaluated within the context of specific industries

The Discussion Draft seems likely to lead to even higher documentation requirements than currently exist. Many MNEs are already spending hundreds of thousands or even millions of dollars/euros annually preparing transfer pricing documentation to meet the expectations of tax authorities. However, the Discussion Draft seems to expect additional documentation in numerous areas, including:

- Documentation around the rationale and pricing of any shift in function or risk, including the economic purpose of that shift. While this may be a legitimate area of inquiry in many cases, there are also numerous cases where this is simply imposing an additional burden on taxpayers – there is a plant in Country A that has higher costs than the one in Country B and so it is being closed. It seems unduly burdensome to require that taxpayers document every business decision that leads to the movement of a function or risk from one legal entity to another.

- While there is an emphasis on respect for contractual terms, the Discussion Draft also seems to suggest that, unless the related party terms are an exact replica of a third party

[13] Paragraph 18.3; 132:

agreement, the contract has to be accompanied by an economic analysis that shows that the terms of the contract are arm's length.

- There seems to be a substantial level of uncertainty about the level of documentation that is needed around the control of risk. Thus, while KPMG generally agrees with the Discussion Draft's comments on control, and in particular that "….. Control should be understood as the capacity to make decisions … when one party bears risk, the fact that it hires another party to administer and monitor the risk on a day-to-day basis is not sufficient to transfer risk to that other party…."[14] there is substantial uncertainty as to how taxpayers should go about documenting the existence of such control.

- There is a specific concern that the discussion in paragraphs 58-61 may lead to excessive documentation requirements on alternative options for a restructuring, in particular in that it appears to require the consideration of options that were theoretically available but which in fact may never have been considered by management.

The Discussion Draft also appears to call for more documentation around intercompany contracts. While the Discussion Draft emphasizes the need for written documentation of contractual terms and emphasizes that such contractual terms should generally be accepted as the starting point in a transfer pricing analysis, it then appears to provide tax authorities with numerous reasons for second guessing or ignoring such written terms. This could significantly increase the compliance burden placed on taxpayers in that they would have to document the arm's length rationale for their contract terms. Moreover, allowing tax authorities to second guess contract terms could substantially increase the likelihood of double taxation, in that each tax authority would be likely to assert its preferred interpretation of the contractual arrangement. This issue is of particular concern whenever there is a particularly favorable or unfavorable outcome of risk-taking. The OECD should make it clear that tax authorities take on the burden of proof when they disregard the contractual terms set up by the taxpayer. (That said, the tax authorities presumably have the ability to require that taxpayers in fact adhere to the contractual arrangements that they have established.)

As a general matter, KPMG believes that the OECD should provide some guidance as to the *minimum* level of documentation that is needed. Provided taxpayers meet such minimum documentation standards and provided that taxpayers appropriately consider how such documentation may vary for specific situations – e.g., contract R&D, contract manufacturing, commissionaires, etc– tax authorities should accept this as a show of good faith and ask for additional documentation only when and if that is necessary.

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[14] Paragraph 30.

Finally, the OECD should take the opportunity in the Discussion Draft to emphasize that transfer pricing rules should not be interpreted in a way that interferes with legitimate business decision making and investment decisions. Businesses often have to decide whether they are going to manufacture product A in Country 1 or Country 2, and that business and investment decisions will have profit consequences. Under the arm's length principle as set forth in the OECD Guidelines, tax authorities have every right to expect an arm's length payment for the transfer of tangible property, services, or intangible property, provided that such a payment would occur in a transaction between two unrelated parties. But rules governing business restructuring should not require a payment for an investment decision that would not trigger a payment in a third party relationship (e.g., the decision to build a new plant in Country A as opposed to Country B).

More generally the Discussion Draft states that it is limited to transfer pricing issues, and thus does not address other double taxation issues, such as domestic anti-avoidance. Because such issues inevitably arise in the course of business restructuring, this exclusion appears to limit the Discussion Draft's ability to address one of the core elements of the Model Convention -- the minimization of double taxation

Issues Note No 1: Special Considerations for Risks

Issues Note 1 deals with the issue of risk, and covers the role of both contractual terms and the substance needed to incur risk. In dealing with risk, the Discussion Draft starts out stating that while contracts should generally be the starting point in determining how risks are divided among related parties, the examination of contracts is not sufficient, and that the following factors also have to be considered:

- Whether the related parties conform to the contractual allocation of risk;
- Whether the contractual terms provide for an arm's length allocation of risk;
- Whether the risk is economically significant; and
- Whether transfer pricing consequences arise from the allocation of risk.

As a general comment, KPMG believes that the Discussion Draft should state explicitly that the taxpayer's business arrangements, and the risk allocation implied by those business arrangements, should be respected, absent a compelling reason to the contrary. Thus, as long as the taxpayer is clear in its allocation of risk and there are no reasons that the allocation is obviously inconsistent with arm's length considerations, the taxpayer's allocation should be respected by the relevant tax authorities. Any other approach is likely to lead tax authorities to substitute their own judgment about what is or is not an "arm's length" allocation of risk for the taxpayer's actual business arrangement. Each tax authority could then make very different adjustments based on their different interpretations of what is an arm's length allocation of risk, which could increase compliance costs and the risk of double taxation.

Of course, tax authorities can only respect the risk allocations established by taxpayers if those arrangements are transparent and set up before the outcome of a particular risk is known. Therefore, tax authorities have the right to expect such transparency. However, while it is reasonable to have the risk allocation set forth in writing, as is stated in Paragraph 25, and while the OECD acknowledges that such written terms can be inferred from correspondence among the parties as well as written contracts,[15] taxpayers should be able to do this through written intercompany policies, email exchanges, and other forms of communication as well as intercompany contracts and correspondence, as this meets the goal of having something in writing and is easier for taxpayers to monitor/manage.[16] Both sides to the transaction obviously need to be aware of the policies that have been put in place.

In this regard, the Discussion Draft should strengthen its emphasis that tax authorities (and taxpayers) should start their analysis with contractual terms and respect those contractual terms absent a compelling reason to the contrary. Allowing tax authorities to ignore contractual terms and substitute terms of their own could increase the likelihood that tax authorities will take inconsistent positions about the allocation of risks and the consequences of the success or failure associated with the assumption of risk. This makes it more difficult for taxpayers to comply with transfer pricing requirements. In our view the better approach may be to accept the contractual allocations of risk and then evaluate the transfer pricing implications of that risk allocation. Thus, while the factors that the OECD Discussion Draft lists as warranting further consideration are clearly relevant, there should be a strong bias towards respecting the terms set forth by the taxpayer absent evidence that they are clearly inconsistent with the intent or the capabilities of the two parties.

The Discussion Draft is particularly troubling when it states that: "Where reliable data evidence a similar allocation of risk in contracts between comparably situated independent parties, then the contractual allocation between related parties is regarded as arm's length."[17] It then goes on to state that: "However, where no comparables exist to support the contractual allocation of risk between related parties, it becomes necessary to determine whether that allocation of risk is one that might be expected to have been agreed between independent parties in similar circumstances."[18] This language seems to invite tax authorities to substitute their judgment for the structure actually put in place by the taxpayer. Instead, the Discussion Draft should make it clear that tax authorities should

[15] Paragraph 26
[16] This may already be implicit in the OECD draft.
[17] Paragraph 27
[18] Paragraph 28.

respect the structure that MNEs have established to meet their business needs, and limit their analysis to a determination of what pricing is appropriate within the context of the business arrangements established by the taxpayer. In this regard, the Discussion Draft should explicitly acknowledge that third parties enter into a wide range of different types of contracts with substantially different allocations of risk, and that therefore there is no single “arm’s length” allocation of risk in a given situation. It is entirely possible that in one transaction a manufacturing entity may choose to provide price protection and will agree to take back unsold product from its third party distributors, thereby insulating them from significant risks, while in another transaction between similarly situated parties, the distributor may enter into a “take or pay” arrangement with the manufacturer that not only provides for cost plus pricing but also entails minimum volume guarantees. Taxpayers should have the flexibility to enter into a wide range of risk allocations, provided that these are detailed up-front and the relevant legal entities have the capacity to manage and bear such risks.

Thus, KPMG believes that the OECD Discussion Draft needs to clarify the statement that: “…it is the low risk nature of a business that should dictate the choice of a given transfer pricing method, and not the contrary.”[19] While this may be appropriate in the context of testing an after the fact result, clearly the process used to *set* transfer prices plays a key role in determining the allocation of risk. As a consolidated entity, taxpayers bear the risk that the prices that they receive from their customers will increase (decrease) by 5 percent in a given year. If the taxpayer uses a resale price method to set prices, a portion of this change in price will be passed back to the supplier, and therefore the risk related to this price change will be shared between the distributor that is selling the product and the manufacturer that is producing the product. Conversely, if the taxpayer uses a cost plus method to set prices, this change in price will not change costs, will not change the transfer price, and therefore the effect of the price change will be borne by the distributor only. Either contractual arrangement is equally arms’ length, assuming that the legal entity that is bearing the risk is capable of controlling and bearing that risk.

The better point would be that intercompany contracts/policies used to set transfer prices *can* affect risk and *can* create a low risk environment, assuming that the risk taker can control that risk and has the financial resources needed to take on that risk. The transfer pricing method used to test prices should then be the one that is consistent with the allocation of risk that the taxpayer has selected.

Failure to Adhere to the Terms of Intercompany Agreements

Third parties are generally required to adhere to contractual terms, and the same can be expected in a related party context. Therefore, a systematic deviation from the terms of intercompany agreements may call the validity of such agreements into question.

[19] Paragraph 45.

However, the Discussion Draft should make clear that minor/inadvertent deviations will not provide grounds for ignoring the key terms of the contract. Moreover, wherever possible, the appropriate response on the part of tax authorities to this issue should be making an adjustment that is consistent with the terms of the agreement, and which therefore in effect enforces the agreement. On a case by case basis it should be determined whether deviations from contract terms are to be treated as a "key" element of the contract. If there is a deviation with respect to such a key element, the core principle should be to make the narrowest possible adjustment to the contract. The entire agreement should be disregarded only as a last resort.[20]

As an example of this point, the OECD notes that if an agreement provides that the foreign related party assumes all inventory risk, it may be necessary for the tax authority to review where such inventory write-downs were taken.[21] Such a review may be appropriate, but if this review shows that the write-downs were taken locally and not passed back to the foreign related party in accordance to the terms of the contract, the appropriate action on the part of the tax authority is to make an adjustment that shifts the inventory write-offs to the foreign party in accordance with contractual terms. The tax authority should not, absent evidence of broad willful neglect on the part of the taxpayer, use this as a basis for re-writing the contractual terms.

Determining whether contractual terms provide for an arm's length allocation of risks

The OECD Discussion draft lists two factors as being of particular importance in evaluating whether or not risk allocations are consistent with those that would be undertaken at arm's length:[22]

1) which parties have control over the risk; and

2) which parties have the financial capacity to bear risk.

KPMG agrees that these are both relevant factors, and has further observations as stated below.

Control Over Risk

KPMG believes that the OECD Discussion Draft correctly indicates that control "… should be understood as the capacity to make decisions to take on the risk (decision to put the capital at risk)" (Paragraph 30) but that "While it is not necessary to perform the day-to-day monitoring and

[20] In this regard, many third party contracts have a section that says if one part of the contract is found to be invalid or unenforceable, it does not cause the entire agreement to be severed, but rather that the other sections of the contract would still apply.

[21] Paragraph 23.

[22] Paragraph 28.

administrative functions in order to control risk (as it is possible to outsource these functions), the OECD is of the view that in order to control a risk one has to be able to assess the outcome of the day-to-day monitoring and administration functions by the service provider….” In this regard, KPMG would like to emphasize that third parties often enter into contracts where they will assume (part of) a risk without actually managing that risk. For example, when a company invests in derivatives, it assumes the risks associated with the derivatives but does not manage that risk. Another example of this can be found in banks, where a bank may take a risk participation in an asset, but the asset is managed by someone else. The entity will be entitled to a part of the total gain (or part of the total loss) commensurate with its risk share (30%, 50%, etc). In “fund of fund management,” the fund managing the fund is not managing the underlying assets.

KPMG also agrees in general with the criteria that the OECD has listed in the Discussion Draft, e.g.:

- the ability to decide among reasonable alternative suppliers of the good or service affecting the risk;
- the ability to determine what is produced or what specific types of services should be performed;
- the information needed to exert control over budget decisions;
- the expectation that the decision maker will receive the information needed to evaluate the business or activity in question on a regular basis; and
- the general ability to assess the outcomes of both past decisions and future options.

However, the Discussion Draft should make it clear that industry attributes should be taken into account, and that in some cases the entity that puts capital at risk may be different from the entity that actively manages such risk in arm’s length situations. Finally, KPMG is concerned about the level of documentation tax authorities might expect over a particular entity’s control over risk, and the resulting compliance burden, particularly given that one of the key questions that the OECD did not address is the type of documentation that would be needed to document a specific legal entity’s ability to control risk. KPMG’s past experience has been that certain tax authorities tend to require a lot of documentation. Given this, KPMG would recommend that the following list be used:

- identification of the decision makers, and their background
- an identification of information that is provided to the decision makers

- a list of the key decisions made by the decision makers.

Finally, the Discussion Draft should not impose artificial restrictions that interfere with the practical requirements that govern the monitoring of risks and investment decision by MNEs. Many MNEs have a business line approach to monitoring risk and making decisions rather than a legal entity approach – the decision as to where to source a specific product or where to build a specific plant may be made by a decision making group that has representation from multiple different legal entities. Local entity "control" over risks should be assumed as long as the legal entity that is bearing the risk has representation on such decision making bodies.

Financial Capacity

The Discussion Draft is generally silent on the impact of financial capacity on an entity's ability to bear risk – it suggests that the lack of financial capability may be a reason to disregard contractual terms but does not address the issue of whether financial capability is a consideration in the determination of which entity does in fact bear risk. The Discussion Draft implicitly assumes that control and capacity will be with the same party, but they need not be, and are not in third-party situations such as insurance.

This is a key limitation of the Discussion Draft, particularly with respect to transactions in which financial capabilities/consequences are a key consideration. If a given legal entity has invested (or puts at risk) a billion dollars/euros, the financial commitment per se speaks to the allocation of risk. For example, if a pharmaceutical company has made substantial investments over a 10 year period in the development of a new drug through legal entity A, the tax authorities of legal entity B should not disregard this investment when it generates a successful outcome simply because the "right person" for monitoring risks was not housed in legal entity A. This issue is of particular concern in industries that are not the focus of the Discussion Draft – the financial services industry, the insurance industry.

Acknowledgement that MNEs bear real risks

As is evidenced by the recent economic downturn in many countries, MNEs bear real risks that they cannot control – for example, if movie makers decide to support one specific high definition technology over another high definition technology, companies that have committed to the alternative high definition technology have costs that they will never recover. The Discussion Draft should acknowledge that while tax authorities have the right to expect an up-front identification of which entity is bearing such risks, they should appreciate that such risks exist and that hypothetical profits that would have existed but for a severe adverse outcome of risk cannot be taxed.

Finally, taxpayers that can show that the appropriate entity has the ability to bear and monitor its risks should *not* have to find a third party "example" in which the same risk allocation occurs. Even if such examples exist they may be very hard to find in the public domain – this is not the level of detail that is presented in corporate annual reports. Moreover, MNEs may have situations that are not replicated exactly in third party relationships.

Comparability Adjustments and Not Recognizing the Risk Allocation in the Controlled Transactions

As has been discussed above, KPMG believes that, absent a compelling reason to reject the "contractual"[23] allocation of risk, the OECD should encourage tax authorities to respect the contractual allocation of risk and address issues through comparability adjustments and/or adjustments to compel taxpayers to adhere to contractual terms rather than by changing such contractual terms. Otherwise, it will be very difficult for taxpayers to comply with tax authority expectations as one tax authority may respect the contractual allocation of risk and base its analysis on that contractual allocation of risk while the other tax authority may conclude that a different allocation of risk is "more" arm's length and base its analysis of this "more arm's length" allocation.

This is particularly true in the example that the Discussion Draft presents where "excess inventory" risks are borne by the manufacturer in transactions with related party distributors and by the distributor in third party relationships.[24] As long as the manufacturer is able to (i) evaluate and control such risk and (ii) has the financial capacity to bear such risk, tax authorities should deal with this issue as a comparability adjustment and not by disregarding contractual terms. The comparability adjustment in terms of expected profits is one that is relatively easy to make. It is also relatively easy to deal with the consequences of an adverse (or positive) outcome of the excess inventory risk *if* the terms of the intercompany contract are respected. It is, however, very difficult to deal with the consequence of an adverse (or positive) outcome of excess inventory risk if the two tax authorities feel free to change the contractual allocation of risk to a more "arm's length" allocation of risk upon audit. If, for example, there is an adverse outcome of risk and the inventory is written off, the tax authority auditing the manufacturer is likely to assert that the loss should be borne by the distributor under an "arm's length" allocation of risk while the tax authority auditing the distributor is likely to assert that this loss should be borne by the manufacturer under the terms of the intercompany contract.

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[23] Either through contract or through other formal documentation.

[24] Paragraph 37.

Determining whether the risk is economically significant

The OECD appears to be concerned that the shift of relatively minor risks will be used to support significant shifts in profits. The Discussion Draft states that: "If a risk is assessed to be economically insignificant then its value in terms of profit potential is likely to be correspondingly low, and the bearing or transfer of that risk would not ordinarily explain a substantial amount of or decrease in the entity's profits."[25] While this statement is correct, it is important to keep in mind that there may be substantive changes in arrangements that may lead to a substantial shift in profits that do not trigger the need for a payment – e.g., the fact that a license with a 10 year term expires allowing the licensor to enter into a different arrangement that is more favorable to it than the old license.

More fundamentally, there is the question of how to determine which risks are or are not "economically significant". There may be some "risks" that occur all of the time but in small amounts – the risk that a retail customer will not pay for a sale made on credit – while there are other risks that are very unlikely but which have the potential for a devastating impact if they occur – asbestos liability claims. Finally, there may be risks that are thought to be minor that turn out to be of great significance, as is evidenced by the housing loans in which "good" loans were bundled with "bad" loans and the resulting composite was initially sold as a "low risk" asset that has in recent months turned into a "high risk" asset. The Discussion Draft should acknowledge that there are significant complexities to the evaluation of risk and that these complexities may vary with industry and with the specific circumstances of specific taxpayers.

The suggestion that the existence of a contingent liability (reserve) on the balance sheet may be useful in identifying risks should be either deleted or treated as a very limited tool. Many such reserves that are set up for accounting purposes are either for relatively minor risks (e.g., an acknowledgement that one in a thousand customers is unlikely to pay for products that were purchased on credit) or are formed well after the risk has materialized (e.g., companies often do not book contingent liabilities for litigation until after they have been sued). In addition, many key risks incurred by multinationals are not "quantifiable" enough to appear on a balance sheet. KPMG fears that the current suggested wording by the OECD in relation to using contingent liability reserves as an indicator of risk taking may lead tax authorities to use balance sheet analyses as the ultimate tool to accept or reject a taxpayer's identification of risk bearing, based on its functional analysis. As indicated above, the absence of such a provision, for example, does not contradict the fact that a certain risk does exist and can indeed be borne by the taxpayer in question.

[25] Paragraph 40.

Transfer Pricing Consequences of risk allocations

The Discussion Draft should state explicitly that tax authorities should respect and abide by the consequences of risk allocations. As indicated above, the Discussion Draft should acknowledge that while tax authorities have the right to expect an up-front identification of which entity is bearing such risks, they have to respect the fact that such risks exist and that they cannot tax hypothetical profits that would have existed but for a severe adverse outcome of risk.

Issues Note No. 2: Arm's Length Compensation for the Restructuring Itself

KPMG agrees with a number of the basic observations that the Discussion Draft makes about arm's length compensation for the restructuring itself: the respect for contract terms, the observation that the interests of *both* parties have to be taken into account, the references back to the basic arm's length principles set forth in the OECD Guidelines, the observation that there should be no presumption that a payment will have to be made in a restructuring. However, KPMG is also troubled by other parts of the Discussion Draft, and in particular those cases in which the Discussion Draft seems to focus excessively on the interests of the transferor while ignoring the options available to the transferee. KPMG notes that most of its concerns arise when the Discussion Draft sets forth some core principles – e.g., that the options of the transferee as well as the transferor have to be considered – and then fails to follow them (e.g., in saying that a transferee may be expected to pay even if the transferor has no enforceable right to require such a payment.

When is a Payment Needed?

The Discussion Draft notes explicitly that "There should be no presumption that all contract terminations or substantial renegotiations should give rise to indemnification at arm's length"[26] and that "The general guidance on intangible transfers that is found in Chapter VI of the TP Guidelines is applicable to intangible transfers in the context of business restructurings."[27] KPMG strongly agrees with both of these points.

The Discussion Draft also notes that, in determining whether compensation is needed and in determining the amount of compensation, the interests of *both* parties have to be taken into account.[28] The Discussion Draft also states that: "Taking account of the transferee's perspective is important both to value the amount of an arm's length indemnification, if any, and to determine what party should bear it."[29] This is a key point, since its has been KPMG's experience that tax authorities auditing the transferor often talk about the transferor "giving up" property/cash flows

[26] Paragraph 101.
[27] Paragraph 79.
[28] Paragraphs 58-61; paragraph 66, paragraph 79, paragraph 83.
[29] Paragraph 116

without including in their analysis any evaluation of the question of whether transferor would, at arm's length, be in a position to extract payment from the transferee. More specifically, under the arm's length principle an entity should only expect to get paid if it could expect such a payment at arm's length, e.g., because it is has the right to enforce a contract.[30] If the transferee has the option of walking away from a business arrangement without payment or other adverse economic consequences, no payment would be made at arm's length.[31]

More specifically, the Discussion Draft should state that:

- Tax authorities should not deem rights, obligations or the existence of intangible assets that do not otherwise exist between the parties – except in very limited circumstances as described in Issues Note 4 and in no other circumstances.

- Under no circumstances should tax authorities construe rights, obligations or intangible assets that would not exist between parties dealing at arm's length.

Finally, the Discussion Draft notes that at arm's length expected returns depend upon risk,[32] but that a shift in risk may also involve a shift in assets that carry profit potential. While KPMG agrees that, if valuable tangible and intangible assets are moved along with the shift in risk, then an arm's length price has to be paid for whatever assets are shifted. KPMG also believes that the Discussion Draft should be modified to state explicitly that no payment is needed if the only differences between the pre-restructuring and post-restructuring expected profits can be attributed to a shift in risk and there are no transfers of intangible property per se.

Contract Terms

The Discussion Draft also notes, appropriately, that the starting point for evaluation of whether a payment is due is an examination of the terms of the intercompany contract.[33] The Discussion Draft then qualifies this by noting that, because related parties do not have the same adverse interests as unrelated parties, they may enter into contractual terms that would not have been agreed to at arm's length. As an example, the Discussion Draft cites the example of a manufacturing arrangement in which the manufacturer will need five years to have a reasonable expectation of recovering its

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[30] This is not to say that other economic factors, such as economies of scale or location savings, may not affect the determination of the profits that would be expected at arm's length.

[31] Note that the discussion draft *assumes* a long term contract in paragraph 68.

[32] Paragraph 66.

[33] Paragraphs 99; 103.

investment, and notes that the manufacturer would not agree to make the required investment without some assurance that the arrangement would last for at least five years.[34]

KPMG agrees that unrelated parties clearly try to protect their financial interests at arm's length, and that this could lead to a five year supply contract in the example in Paragraph 109. However, such a contract may take/often takes the form of one that has an initial term of five years followed by a provision that after the five years either party could break the contract by giving, for example, 90 days notice. Under such circumstances, the legal entity that is buying from this manufacturer is likely to have to pay a penalty if it breaks the contract in year 3, but would not be expected to pay anything at arm's length if it severs the relationship in Year 7, provided that it gives 90 days notice. Moreover, the fact that the manufacturer *expects* to be profitable after five years should not be taken as a guarantee that it *will* be profitable – if sales are half of expected levels, the manufacturer may in fact not have recovered its investment after five years, but these losses would not justify a presumption that the contract term would be extended.

Moreover, the Discussion Draft then lessens its respect for contractual terms and in fact may encourage tax authorities to impute contractual terms that do not exist in other sections. For example, Paragraph 51 states that:

> … a restructured entity may legally be under a short term or "at will" contractual arrangement at the time of the restructuring. However, the actual conduct of the entity in the years or decades prior to the restructuring, for example in developing its market without explicit compensation from another member of the MNE group, may be indicative of a longer-term arrangement, and hence greater rights than those indicated by the legal contractual arrangement."

The issue is that the simple existence of a long standing relationship does not imply a long term contract, nor does spending that generates short term benefits. Therefore, while a distributor that incurs significant losses in the first several years of selling a new pharmaceutical product would not do so absent the expectation of long term market rights, a distributor that has incurred significant advertising costs for a number of years but which has always reported consistent profits has probably reaped short term benefits from that advertising and would not need a long term contract to justify such expenditures. KPMG believes that certainty is one of the cornerstones of an equitable tax system; there is already enough uncertainty surrounding transfer pricing in general without the additional potential confusion brought along by tax authorities imputing changes to a taxpayer's established business structure. Tax audits should start by respecting the contractual terms put in place by the taxpayer and focus on the pricing implications of those terms. Any other

[34] Paragraphs 108; 109.

approach could increase the uncertainty faced by taxpayers as each of the tax authorities examining the transaction is likely to infer contractual terms.

Finally, KPMG would also prefer the Discussion Draft to explicitly state that if the taxpayer has an intercompany contract and has demonstrated that it is arm's length based on the guidance given in Issues Note 1, all tax authorities auditing the transaction should start from the premise that the contract defines the rights of the parties.

Commercial Practices

The Discussion Draft also notes that commercial practices and local rules may provide a basis for inferring that a payment is needed at arm's length (e.g., if local law requires a one or two year notification before a business arrangement can be terminated). KPMG would like the Discussion Draft to stress *both* that tax authorities should take such local rules into account in evaluating the payment, and that tax authorities (or taxpayers) should be able to demonstrate that such local commercial practices are in fact binding on participants of (third party) transactions.

Goodwill and Going Concern

The Discussion Draft states that payment may be needed for goodwill and going concern value if there is a transfer of the "… total bundle of assets (possibly including contractual rights, workforce in place, goodwill, etc.)" While KPMG agrees that in some cases the value of a bundle of rights may differ from that of the individual rights, and therefore may require an analysis of the bundle as a whole, KPMG believes that the term "goodwill" has widely varying interpretations and therefore references to goodwill are likely to be interpreted in significantly different ways by different tax authorities. Instead, references to broadly defined terms such as "goodwill" should be replaced with the affirmative statement in Paragraph 196 that:

> MNEs are free to organize their business operations as they see fit. Tax administrations do not have the right to dictate to an MNE how to design its structure or where to locate its business operations. MNE groups cannot be forced to have or maintain any particular level of business presence in a country

For example, if an automotive manufacturer is going to shut down plants or consolidate production at other plants for business reasons, this will adversely affect its parts suppliers. However, such parts suppliers do not either receive a payment or sue the automotive company for their lost business. The application of the OECD Guidelines should not impose a different regime simply because of the existence of a related party relationship.

KPMG is troubled by the example given in Paragraph 94, in which a manufacturing activity that was performed by one manufacturer in an MNE (M1) is transferred to another entity (M2) in order to benefit from location savings. At arm's length, the legal entity(ies) buying from M1 may very well shift their business to M2 either to realize lower prices immediately or, even if they are paying the same price, to link up with a supplier that can remain viable if prices fall in the future. The issue of whether M1 would or would not expect a payment at arm's length would be governed by its ability to secure such a payment in an arm's length arrangement -- e.g., if it had a long term contract or if local commercial law required a substantial notification period. The Discussion Draft should acknowledge that if the buyer(s) are under no obligation to make any payment at arm's length, they should not be required to make one merely because they are related parties. The mere fact that someone has bought from M1 in the past does not provide M1 with the ability to require that the buyer continue to source products from M1. Once again, it is important to evaluate the reasonable alternatives of *both* parties to the transaction.[35]

Who Pays?

The Discussion Draft's comments on which of various entities would be expected to pay for restructuring charges it fails to consider the reasonable options of the various parties involved.[36] The basic fact pattern is that there is a manufacturing contract between A (the buyer) and B (the manufacturer). A terminates the contract with B, and starts to buy products from C. The key questions posed in the Discussion Draft are (i) whether B is entitled to payment and (ii) if so, from whom?

The question of *whether* B is entitled to payment should be based on the principles that have been discussed above – would B expect to receive a positive price at arm's length? The question of *who* should pay B depends upon the nature of rights. In this regard, while the Discussion Draft suggests that there are circumstances in which C would pay B to obtain the manufacturing contract,[37] it would be relatively unusual at arm's length for C to have an obligation to pay under the terms of a contractual arrangement between A and B – contracts can be used to enforce payments among the participants in the contract, but such contracts do not bind entities that have not entered into the agreement. On the other hand, it would be appropriate for C to pay B for specific property that C buys from B (e.g., technology, trademarks).[38]

The Discussion Draft also suggests that there may be cases in which the parent company P (presumably located in Country D) would make a payment to B as neither A or C would pay B "…

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[35] The German transfer package rules tend to be applied excessively on any micro business restructuring. If the OECD insists on a compensation reflecting the going concern, it should make clear that this requires a minimum amount organizational independence, i.e. if not a separate branch of activity at least a separate cash generating unit.

[36] Paragraphs 116-122

[37] Paragraph 120.

[38] Or if there were the transfer of "in the money" contractual rights from B to C.

because neither of them expects to derive sufficient benefits from the change."[39] Once again, B should only expect a payment if it would occur at arm's length. Thus, if P acquires technology or trademark rights as a result of the termination of B's relationship with A, then a payment would be appropriate. However, the fact that P may have a higher market value (e.g., the price of its equity has increased) because it is manufacturing in a lower cost location after the restructuring than before the restructuring, does not create a transaction between P and B that has to be paid for under the arm's length principle as set forth in the OECD Guidelines. Taken to the extreme, requiring a payment for business decisions that do not generate a specific transaction could imply that if P decides to get out of the business of making electronic games produced by B and into the business of selling game software made by C, the tax authorities of B could assert that B has to be paid simply because P has decided to invest in software rather than continuing to invest in electronic games.

Finally, the Discussion Draft should state that a tax authority that believes an adjustment to transfer pricing is needed due to restructuring also has an obligation to explicitly identify which entity it believes should make the payment. It has been KPMG's experience that some tax authorities will state that a payment is due to cover shutdown costs/cover lost profits as something that is due to the transferor, but without identifying which other member of the MNE would be expected to pay it at arm's length. While this issue is not unique to business restructuring (in cases in which Company A buys from related party B and sells to related party C, if the tax authority of Company A makes an adjustment it should be able to identify whether the adjustment relates to Company A's transactions with B or its transactions with C), it may be more prevalent in business restructuring cases to the extent that adjustments are made simply to preserve profits rather than based on an evaluation of specific property rights and contract terms.

Restructurings in which the transferor continues to use the transferred assets

The Discussion Draft discusses situations which the original transferor continues to use intangible assets that it has transferred to a different entity, particularly in the context of the centralization of technology and other intangibles. In such cases, the Discussion Draft notes that:

- The analysis should take the perspectives of both the buyer and the seller into account;[40]
- The transaction has to take the situation of the individual legal entities into account, and the existence of group benefits does not obviate the need to evaluate whether payments are needed among individual entities.[41]

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[39] Paragraph 122.
[40] Paragraph 82.

- "… the entirety of the commercial arrangement between the parties should be examined in order to assess whether the transactions are at arm's length."[42]

KPMG would like to encourage the OECD to add that following points to its Discussion Draft:

- As long as there is the appropriate substance, the fact that the transferor continues to use the intangibles in question in a different role should not, by itself, enable tax authorities to disregard that transaction as structured by the taxpayer. The issue should be one of determining the correct price, not ignoring the business structure.

- Consistent with the above, tax authorities should respect the contractual terms that govern the restructured business arrangement, provided of course that the taxpayer has complied with the requirements set forth in Issues Note 1.

Intangibles transferred at a time when they have no value

The Discussion Draft notes that an intangible may be transferred at a point in time when "… it does not yet have an established value…."[43] and that under such circumstances "… the main question is to determine whether the valuation was sufficiently uncertain at the outset that the parties at arm's length would have required a price adjustment mechanism, or whether the change in value was so fundamental a development that it would have led to a renegotiation of the transaction."[44]

While KPMG realizes that many tax authorities are worried that taxpayers will shift something that they believe will ultimately have significant value at a time when that value is hard to establish or is very low, KPMG also believes that enabling tax authorities to "reset" transfer prices after there has been a significant change in value either because of the resolution of known uncertainties (e.g., when a pharmaceutical compound is transferred in Phase 1 clinical trials there is substantial uncertainty as to whether it will get to market; five years later that uncertainty may very well have been resolved in one way or the other) or due to an unexpected development is almost certain to place taxpayers in a situation in which one tax authority believes that a very large payment is needed and the other tax authority thinks that no payment is needed or that the payment should be very low.

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[41] Paragraph 83. (par 83 seems to question whether the disposal itself was arm's length. But at the same time stating that centralizing IP may be a purely business driven transaction? There should not be any inconsistency: if a transaction is commercially justified then the transaction itself should be acknowledged and possible consequences should be evaluated.

[42] Paragraph 85.

[43] Paragraph 87.

[44] Paragraph 88.

KPMG would also note that if intangible x had a low/uncertain value in year 1 when it was transferred from A to B, but is found in Year 10 to have a very high value:

- The high value determined based on the information available in year 10 is *not* the value that existed in year 1 as it is based on developments and information that have occurred in years 2 through 9;

- If the increase in value is attributable to activities that were carried out by B in years 2 through 9, entity B potentially has contributed the most to the value that exists in year 10; and

- If the increase in value is attributed to some unrelated event that occurred in year 5, for example, this is unlikely to have triggered a renegotiation at arm's length – the price of a foal sold at six months of age is generally not renegotiated upward when the foal wins the triple crown three years later or, at the other extreme, the fact that the horse may break down in a race does not lead to a renegotiation of the original sales price.

While tax authorities have the right, and even the duty, to assess whether forecasts were reasonable if actual events depart significantly from projections put forth by the taxpayer, they should not be able to use hindsight to undo risk allocations that have been made by taxpayers, particularly if taxpayers can show that such allocations would have occurred at arm's length. Moreover, if the forecasts/projections are used for business purposes and spending/investment decisions, the general presumption should be that they represent the best information that was available to the taxpayer at the time.

Implications for Documentation

As noted above, KPMG is concerned that the Discussion Draft will lead to a significant increase in the already substantial documentation requirements associated with transfer pricing. The Discussion Draft appears to implicitly require an economic analysis to show that contractual terms are consistent with those that would be expected at arm's length, additional documentation whenever a plant is shut down or moved, and perhaps even an explanation for why a given product is sourced from legal entity A rather than legal entity B. The Discussion Draft then goes even further, suggesting that tax authorities have to understand the reasons for any significant deviations between expected synergies and actual synergies.[45] While KPMG understands the reason for this statement, it would like to stress that (i) tax authorities should not be encouraged to reject a business rationale that was based on expected synergies simply because they failed to materialize and (ii) this has the

[45] Paragraph 56

potential for putting a large documentation burden upon taxpayers. [46] Finally, tax authorities may use this information to infer pricing that would not occur at arm's length – the fact that one affiliate may have significantly lower costs than another (possibly due to location savings) is not information that would be disclosed in an arm's length negotiation. KPMG does not believe that the assumption that all information is available to both parties should be used by tax authorities to infer that all location savings would go to the buyer or that profit split outcomes are the "best measure" of arm's length outcomes is appropriate or should be encouraged by the Discussion Draft.

Once again, KPMG believes that the Discussion Draft should indicate the *minimum* contemporaneous requirements needed for such documentation, and point out that tax authorities have the ability to collect additional information upon audit.

Issues Note No. 3: Remuneration of Post-Restructuring Transactions

Issues Note 3 discusses the remuneration of post-restructuring controlled transactions, and thus deals with relatively conventional pricing issues. KPMG agrees with the Discussion Draft when it states that: "The arm's length principle and the TP Guidelines do not and should not apply differently to post-restructuring transactions as opposed to transactions that were structured as such from the beginning (see Section B below)."[47] Therefore, there is nothing about a restructured transaction that requires a different set of rules than any other intercompany transaction.

KPMG also agrees that the nature of the functions and assets that were in place prior to the restructuring *may* either (i) dictate that a payment has to be made as a result of the conversion or (ii) have an impact upon the profits/pricing of the restructured entity. If, for example, the restructuring involves the termination of a contract or the effective transfer of intangibles, a payment is likely to be made for this at arm's length. Similarly, if the legal entity that has been restructured owns a trademark or valuable technology before the restructuring and continues to own it subsequent to the restructure, then it can expect to earn profits that reflect the ownership of such intangibles. Having said this, a simple shift in risk should not require a payment; the change in the risk profile of the relevant entities will be reflected in their potential profitability.

KPMG is concerned, however, with some of the comments in the Discussion Draft. For example, the Discussion Draft states that: "It is worth remembering that it is the low risk nature of a business that should dictate the choice of a given transfer pricing method and not the contrary."[48] In truth,

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[46] Paragraph 57: "Given that the arm's length principle applies on a separate entity rather than group wide basis, local synergy gains or losses may contribute to the profit/loss potential of the restructured entity, and may need to be taken into account in the analysis of the transfer pricing consequences of the restructuring….."

[47] Paragraph 124.

[48] Paragraph 143.

the risk allocation among the different participants to a controlled transaction is in large part dictated by the contractual terms that exist, and two entities that are carrying out very similar or even identical "functions" may have different risk profiles, and as a result use different transfer pricing methods. If Affiliate A manufacturers socks that are sold to Affiliate B which acts as a distributor selling them to third parties in its local market, there are at least three discrete allocations of risk that are possible and which may all be equally arm's length:

- Affiliate A may be a de-risked supplier that is paid on a cost-plus basis, with Affiliate B bearing the risk of market fluctuations in the price of socks. A TNMM with Affiliate A as the tested party may be the appropriate pricing method under such circumstances based on expectations and without retroactive adjustments.

- Affiliate B may be a de-risked distributor that receives a relatively low but assured profit margin, with Affiliate A bearing the risk of market fluctuations in the price of socks. A TNMM with Affiliate B as the tested party may be the appropriate pricing method under such circumstances.

- Affiliate A and B may share risk equally, in which case a profit split method may be the most appropriate transfer pricing method.

KPMG is also concerned that the comment in the Discussion Draft "The OECD view is that the arm's length remuneration of selling activities (whether buy-and-sell activities, commissionaires or sales agents) should generally be based on a sales-related indicator" ignores some practical realities in terms of intercompany pricing."[49] The use of a commission rate to set the income of commissionaires often may result in wild swings in profitability as sales volumes change from year to year in unexpected ways. KPMG's experience is that such wide swings in profits – often leading to losses when sales go down – substantially increase the chance of controversy with tax authorities. (This is particularly true in the case of wholesale functions or commodity trading where large volumes are handled at low SG&A cost and a fixed commission rate leads to "Berry Ratios" that are viewed as unacceptable by tax authorities.) Taxpayers should have the flexibility, in the implementation of the TNMM especially, to use profit measures that are practical to implement and which smooth erratic fluctuations in results from year-to-year as long as the pricing is consistent with the functions performed and the allocation of risk established by the taxpayer's business arrangements.

In addition, the current wording of Paragraph 152 may be interpreted by certain tax authorities to support a blanket application of a sales-based TNMM approach to selling activities. KPMG has already experienced tax authorities in certain countries interpreting the OECD's work on transfer

[49] Paragraph 152.

pricing, including the OECD Guidelines, as supporting the view that the TNMM is the only applicable method to selling/distributing activities, this being based on the characterization of all selling activities as "normal" or "routine". A mechanical consequence of this approach is that the tax authorities concerned consider it impossible that such activities could ever incur any legitimate losses. This ignores the fact that distributors can and do take risks that result in losses at arm's length.

The discussion of central purchasing functions (paragraphs 170-176) also has a flavor of "head's I win, tails you lose." The discussion in Paragraph 172 suggests that if the central purchasing agent is able to buy products at a low price, the use of a CUP or some other method that leaves the resulting cost savings with the central purchasing agent may not adhere to the arm's length principle, and that prices may have to be adjusted to pass the benefits onto the various manufacturing entities. However, the discussion in Paragraph 175 notes that if marking up the costs incurred by the central purchasing agency leads to higher prices, the manufacturing entities should not have to bear the costs of these "inefficiencies." It certainly cannot be the case that at arm's length central purchasing agencies never realize high profits when they bring efficiencies to the system but that they always incur losses when there are inefficiencies. KPMG believes that the Discussion Draft would be better served if it simply re-iterated the key point that the arm's length principle is applied on a single entity basis, and that the pricing would be based on the specific options available to the central purchasing entity and each of the manufacturing entities operating as discrete economic actors.

Finally, the Discussion Draft discusses the distinction between a one-sided method and a one-sided analysis, making the point that tax authorities need enough information on both parties to determine which party is the more appropriate entity to focus in a one-sided analysis.[50] While KPMG agrees with this in principle, there is the practical issue of how much information is needed to reach such a decision. If the local entity is a de-risked manufacturer or distributor, and it is clear that the counterparty bears risk and has the capacity to bear risk, the amount of information needed on the counterparty may be very limited. Yet it has been KPMG's experience that even under such circumstances tax authorities may try to collect data on the profitability of the counterparty to the transaction even though such data are not required to apply the most appropriate pricing method.

Location savings

The Discussion Draft should explicitly note that location savings should be evaluated in the context of the specific facts and circumstances applying to the transaction, and not based on some generalized "rule". It has been KPMG's experience that tax authorities in high wage cost countries tend to assume that the buyer of products made in low cost areas should be able to capture all or

[50] Paragraph 148.

most of location savings while the tax authorities in low wage cost countries assume that their local manufacturers should be able to realize high profits because of their low costs. As a practical matter, the answer is likely to turn on the functions, capabilities and circumstances of the specific legal entities involved. If the legal entity in the low wage country has significant capabilities that cannot be readily replicated by alternative suppliers in the same or other low wage countries, it may be able to sell at prices that reflect a higher cost base than it has and therefore realize substantial profits. Conversely, if the local entity has very limited capabilities and is closely supervised by the legal entity that is buying its product, it may be unlikely to receive anything more than a low routine profit. Finally, it is important to realize that in many cases the "location savings" may be passed onto the third party customers of the taxpayers, and that they may therefore not lead to higher profits for any of the specific subsidiaries.

Issues Note No. 4: Recognition of Actual Transactions Undertaken

The basic issue that is addressed in Issues Note 4 is whether a tax authority can disregard the actual transaction as structured by the taxpayer, and if so, under what circumstances. KPMG agrees with the comments that are made in the Discussion Draft that "MNEs are free to organize their business operations as they set fit. Tax administrations do not have the right to dictate to an MNE how to design its structure or where to locate its business operations."[51] As a general matter, KPMG believes that tax authorities should only disregard the structure established by taxpayers – assuming that it is consistent with the behavior of the taxpayer – to the extent that there is a lack of substance underlying that structure. (Example B, page 59 appears to be getting at this.)

KPMG is concerned that the Discussion Draft will give guidance that may be misinterpreted by tax authorities when is states that "The OECD is of the view that, at arm's length, an independent party would not enter into a restructuring transaction that is expected to be clearly detrimental to it if it has the option realistically available to it not to do so."[52] While KPMG understands the rationale for this position, it also believes that this statement has to be interpreted in a way that does not limit investment and business decisions. For example, if an MNE decides to shut down a plant in Country A that is making luxury cars and open a plant in Country B that is making hybrid cars, that is an investment decision that is being made by the company (i.e., that it needs to build more hybrid cars and fewer luxury cars, and that this is best done in Country B and not in Country A). This investment decision is likely to make the legal entity that is operating in Country A "worse off" in that it is being shut down. However, this is the result of an investment decision and not a transfer pricing decision. Therefore, while the legal entity in Country A is clearly entitled to a payment for any technology or other intangibles that it provides to its affiliate in Country B, and while it may be

[51] Paragraph 196.

[52] Paragraph 209.

entitled to other compensation under the terms of various intercompany arrangements, it is not entitled to a "shut down" payment merely because of the investment decision.

Similarly, tax authorities should not ignore business arrangements that are set up to allow the business to operate most effectively or to harmonize business arrangements after an acquisition. Example A deals with the sale of a trademark following an acquisition to bring the acquired company's intangible policies in line with those of the acquirer. The Discussion Draft notes that "Some countries however consider that the sale of 'crown jewels' such as valuable trade names is so detrimental to the seller that it would not be possible to arrive at an appropriate price…."[53] The Discussion Draft should reject this view. Prohibiting companies from engaging in this transaction effectively prevents them from structuring their business appropriately. Furthermore, there are in fact a number of arm's length transactions where one party has disposed of or otherwise transferred so-called "crown jewels" to another party with whom it deals at arm's length (these transfers will often include a transfer or shift of risks) and this calls into question the very position put forward at paragraph 216. In other words, the statement found at paragraph 216 may create a structural contradiction between the arm's length principle itself and its application in accordance with paragraph 216. Therefore, KPMG urges the OECD to state clearly that this is a pricing issue, and not a basis for simply disregarding the transaction.

[53] In paragraph 216.