

## Baker & McKenzie comments on the OECD Restructuring

### Discussion Draft\*

#### **Introduction:**

The OECD released a 56 page discussion draft on Business Restructurings (“Restructuring Draft”) on September 19, 2008. Generally, business restructurings involve cross border redeployment by multinational corporations (“MNCs”) of functions, assets, and risks. Typically, the OECD provides that MNCs have restructured their global business models from vertically integrated business models with full fledged manufacturing and distribution activities and associated services through locally incorporated enterprises to a centrally controlled supply chain model. The focus of tax administrations thus far clearly is on such transactions, but, as noted elsewhere in passing, the Notes define the term “business restructuring” far more broadly in one introductory statement. That statement suggests that a business restructuring may include any crossborder transfer of assets and/or risks and/or functions. We should ask for clarification that this border interpretation is not intended. These centrally controlled models are often located in a tax benefited jurisdiction, with appropriate economic substance and act as the risk taking entrepreneur who overseas limited risk distributors or commissionaires and contract manufacturers typically located in high tax environments with reduced profitability commensurate with their limited risk profit.

Set forth in four Issue Notes, discussed below, are various issues related to these restructurings that, among other things, challenge the pragmatism and appropriateness commercial rationale to the transactions and appear to revise the tenets of the established arm’s length standard. Focusing largely on risk transfer and centralizing of functions, the OECD seems to establish presumptions that imply the very skepticism and adverse attitudes of many taxing authorities and challenge the business judgment of MNCs through a “commercial rationale” standard.

The discussions below address each Issue Note and the concerns expressed by Baker & McKenzie’s Global Transfer Pricing Steering Committee in an effort to produce a constructive dialogue to these critical issues. Generally, OECD’s Restructuring Draft’s Issue Notes address (1) general guidance in the allocation of risks by and among the related parties to the restructuring, (2) the application of the transfer pricing guidelines to the restructuring with compensation and/or indemnifications for any terminations or “buy-ins,” (3) the application of the arm’s length principle to “post restructurings,” and (4) exception circumstances where a restructuring may be disregarded by a tax authority.

#### **Issues Note No. 1: Special Considerations for Risk.**

Issue Note 1 of the Restructuring Draft identifies risk as critically important in reviewing business restructurings and determining related tax consequences. Risk allocation is emphasized

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because certain tax authorities are concerned that business restructurings itself are used as a tax minimization tool, and that a transfer of risk in a functional analysis can purportedly transfer related profit offshore without appropriate compensation or indemnification.

This Issue Note critically refers to converting integrated manufacturers into low risk contract manufacturers and converting full fledged distributors into limited risk distributors. Under an economic analysis, the low risk entities would earn a lower, yet generally more stable return and the entrepreneur in the structure who assumes the risk would be allocated the residual profit resulting from its functions and risks. Often ignored in the potential profit analysis is that substantial risks may have been transferred. The OECD Transfer Pricing Guidelines are repeatedly referenced to the extent they address the reality of a structure versus the structure as presented on paper, almost as if these Guidelines need reinforcement. Paragraphs 1.26 – 1.29 of the OECD Guidelines for example provide in relevant part that:

*“it may be considered whether a purported allocation of risk is consistent with the economic substance of the transaction”<sup>1</sup>, inconsistencies in risk allocation and actual transactions should be interpreted as a signal that the risk allocation is not decisive: “if, for example, a manufacturer sells property to a related distributor in another country and the distributor is claimed to assume all exchange rate risks, but the transfer price appears in fact to be adjusted so as to insulate the distributor from the effects of exchange rate movements, then the tax administrations may wish to challenge the purported allocation of exchange rate risk”<sup>2</sup>.*

Having control over allocated risk (or absent such control) is considered to be an indication of the reality of the risk allocation according to the OECD Guidelines:

*“For example, suppose that Company A contracts to produce and ship goods to Company B, and the level of production and shipment of goods are to be at the discretion of Company B. In such a case, Company A would be unlikely to agree to take on substantial inventory risk, since it exercises no control over the inventory level while Company B does”...and: “Analysis is required to determine to what extent each party bears such risk in practice. When addressing the issue of the extent to which a party to a transaction bears any currency exchange and/or interest rate risk, it will ordinarily be necessary to consider the extent, if any, to which the taxpayer and/or the MNE group have a business strategy which deals with the minimization or management of such risks”<sup>3</sup>.*

Absent convincing control over certain risks can therefore be interpreted as an indication that the risk allocation is artificial and should not be accepted.

Issue Note 1 concludes that in examining the risk allocation between related parties and the transfer pricing consequences of the risk allocation, review of contractual terms is simply not sufficient and that the analysis of a business restructuring must include four additional questions:

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<sup>1</sup> OECD Guidelines paragraph 1.26.

<sup>2</sup> See footnote 1 supra.

<sup>3</sup> OECD Guidelines paragraph 1.27.

- Whether the related parties conform to the contractual allocation of risks;
- Whether the contractual terms provide for an arm's length allocation of risk;
- Whether the risk is economically significant enough to be relevant; and
- What the transfer pricing consequences are of the risk allocation (if any).

Requiring that these questions be considered, Issue Note 1 essentially commences every analysis with the untenable and skewed presumption that related parties abuse their integrated structure requiring MNCs to comply with an increasing burden of proof to substantiate that they are operating at arm's length. The text included in OECD Guidelines paragraphs 1.26 – 1.29 is apparently not considered as sufficient to address this issue by certain countries, and a much increased scrutiny level suggested under the Restructuring Draft implies an unfair and implied burden upon the MNCs, particularly where a tax authority disregards a risk allocation on the grounds that the allocation (as opposed to the pricing) is not at arm's length. The Restructuring Draft explicitly purports to provide guidance that will apply generally and not only to business restructurings. Such guidance is absent in this Draft.

#### **A. Examination of the contractual terms and of the actual behaviour of the parties**

The Restructuring Draft provides that contractual terms are to be reviewed where they exist in writing. OECD Guidelines paragraph 1.28 provides in relevant part that in arm's length dealings, the contractual terms of a transaction generally define explicitly or implicitly how the responsibilities, risks and benefits are to be divided between the parties. Accordingly, an analysis of contractual terms should be a part of the functional analysis discussed above. The OECD Guidelines also require an examination of whether the parties conform to the actual terms of the contract and this is repeated in Issue Note 1<sup>4</sup>. However, the Issue Note adds to OECD Guidelines paragraph 1.27, two examples which require evidence to be provided by related parties as to the terms of an intercompany agreement. They are:

- I. *“Another example that is relevant to business restructurings is where a foreign related party assumes all the inventory risks by contract. When examining such a risk allocation, it may be necessary to examine for instance where the inventory write-downs are taken (i.e. whether the domestic taxpayer is in fact claiming the write-downs as deductions) and evidence may be sought to confirm that the parties' conduct supports the allocation of these risk as per the contract”<sup>5</sup>.*
- II. *“A third example relates to the determination of which party bears credit risk in a distribution arrangement. In full fledged distribution agreements, the bad debt risk is generally borne by the distributor who books the sales revenue (notwithstanding any risk mitigation or risk transfer mechanism that may be put*

<sup>4</sup> Transfer pricing aspects of business restructurings: Discussion Draft for public comment of September 19, 2008, paragraph 21.

<sup>5</sup> Transfer pricing aspects of business restructurings: Discussion Draft for public comment of September 19, 2008, paragraph 23.

*in place). This risk would generally be reflected in the balance sheet at year-end. However, the extent of the risk borne by the distributor at arm's length may be different if the distributor receives indemnification from another party (e.g. from the supplier) for irrevocable claims and/or of its purchase price is determined on a resale price or commission basis that is proportionate to the cash (rather than invoiced) revenue.”<sup>6</sup>*

While the two examples suggest that actual conditions be examined, in reality they appear to instruct that the financial statements of the relevant (related) supply chain entities must be scrutinized to determine write-downs and indemnification payments plus the matching entries at the level of the other (related) supply chain entities before a presented risk allocation can be accepted after a business restructuring. This means that for a related party business restructuring, under the guise of “substantiating the (new) supply chain characterization,” that tax authorities may require a detailed review of the applicable accounting regime and practices related to the intercompany transactions.

The arm's length standard as interpreted by the Restructuring Draft appears to significantly disadvantage MNCs over unrelated parties by requiring far-reaching administrative reporting, and actual creation of documentation specifically for transfer pricing purposes, that may be unrealistic and, if possible, extraordinarily burdensome. Furthermore, the Issue Note can be interpreted as amending paragraphs 1.28 and 1.29 of the OECD Guidelines, in that it deems it essentially unreasonable that related parties do not document in writing their allocated or transferred risks before the transactions occur. Paragraph 1.28 of the OECD Guidelines provides in relevant part that the contractual terms of a transaction generally define explicitly or implicitly how the responsibilities, risks and benefits are to be divided between the parties and that as such analysis of contractual terms should be a part of the functional analysis. Where no written terms exist (which does happen frequently in a related party setting), the contractual relationship must be deduced from their conduct and the economic principles that generally govern relationships between independent parties<sup>7</sup>. This last sentence appears rendered largely invalid by Issue Note 1 and substituting a new standard. It is deemed unreasonable (and therefore most likely assumed suspicious) when no written intercompany agreement exists.

## **B. Determining whether the contractual terms provide for an arm's length allocation of risk**

Issue Note 1 continues to analyze whether the contractual arrangements provide for an arm's length allocation of risks. Where comparables exist, they should be reliable. This assumes access to (i) unrelated parties that are sufficiently comparable to serve as a functional comparable; (ii) the text of contractual arrangements of these unrelated parties with other unrelated parties, or (iii) the text of contractual arrangements of other unrelated parties that can be used, provided they are sufficiently reliable.

Although practice has shown that getting access to functionally comparable entities that are unrelated is difficult, obtaining access to contractual arrangements entered into by these

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<sup>6</sup> Transfer pricing aspects of business restructurings: Discussion Draft for public comment of September 19, 2008, paragraph 24.

<sup>7</sup> OECD Guidelines paragraph 1.28.

comparables is yet another challenge that in practice may not always be attainable and/or reliable. Where financial statements and annual reports may be available as these are usually required to be posted with the local chambers of commerce or the relevant Securities and Exchange Commission (or equivalent monitoring organizations) to allow shareholders and creditors access to relevant information of the legal entities doing business, the disclosing of actual contractual arrangements and the filing of contracts is rarely an explicit requirement. And, if these contractual arrangements are by happenstance made available, relevant provisions of the contract are usually redacted or omitted, making them at best unreliable. Alternatively, contractual arrangements can be made available through databases such as LivEdgar or Royalty Stat, but the results of these database searches do not necessarily reflect entire agreements. Additional effort is required to obtain the full contractual agreements, and it should not be overlooked that the word “effort” also includes costs to get access to the detailed data.

## 1. Risk allocation and control

The Issue Note also discusses how a contractual arrangement can reflect which party has more control over a risk, as the OECD Guidelines provide that an additional factor to consider when examining the economic substance of a purported risk allocation is the consequence of a similar allocation in arm’s length transactions<sup>8</sup>. Control over risk is deemed a relevant factor to assist in determining whether a similar risk allocation would have been agreed to between independent parties at arm’s length. Control assumes the capacity to put capital at risk, and how to manage the risk, internally or using an external provider. Issue Note 1 continues to provide that when one party bears the risk, the fact that it hires another party to administer and monitor the risk on a day-to-day basis would not be sufficient to *transfer* the risk to the latter party. This observation assumes that the latter party would be seen as a mere service provider and not as the party allocated the risk (and related burdens or rewards)<sup>9</sup>. The standard suggested for determining whether the day-to-day management qualifies as the actual carrying of risk is that whoever carries the risk can assess the outcome of the day-to-day management of the risk.

The Issue Note provides an example of an investor hiring a fund manager to invest the funds on its account<sup>10</sup>. Absent further discussion, that example is suggestive, in that the investor is, and always remains, the risk taker. Typically, a fund manager is never the ultimate risk taker, regardless of the level of freedom the fund manager is granted to manage the portfolio (even though the fund manager is often awarded a hefty salary if the invested portfolio performs well, however). The recent collapse of the financial markets reflects that losses are incurred by shareholders and investors and not by fund managers. By including this example, it is suggested that a transfer of responsibility is not sufficient to transfer risk and, thus, not sufficient to transfer reward related to that risk. Implicit in this example is that a transfer of responsibility within a related party setting does not transfer risk.

Issue Note 1 further provides for another example, related to a principal hiring a contract researcher. Here, it is assumed that the principal would take action and make decisions to control

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<sup>8</sup> OECD Guidelines paragraph 1.27.

<sup>9</sup> Transfer pricing aspects of business restructurings: Discussion Draft for public comment of September 19, 2008, paragraph 30.

<sup>10</sup> Transfer pricing aspects of business restructurings: Discussion Draft for public comment of September 19, 2008, paragraph 32.

its risk: decision to hire the contract researcher; decision on the budget allocated to the contract researcher; obtaining feedback and reporting from the contract researcher; and/or assessing the outcome of the research activities. The reality is that different levels of outsourcing R&D exist. A researcher may be given a free hand or extremely explicit and detailed instructions. However, in all of these scenarios; the principal can legally and economically remain the owner of resulting R&D in unrelated party situations, however.

The Issue Note concludes on the topic of risk allocation and control with the question whether comments can be received on the term “control” in the context of paragraph 1.27 of the OECD guidelines<sup>11</sup> (the term “control” is used twice in paragraph 1.27: namely when it refers to exercising control over the inventory of Company B in the example where Company A is allocated the inventory risk, and how to deal with business cycle risks, over which typically neither party has significant control). What functions and decisions would amount to control? In practice, in a related party setting, control in the sense of making day-to-day decisions including decisions that affect investments is generally conducted at the entity level where the functions are performed on a daily basis. There will be monthly, quarterly and 6-monthly reporting (submission of financial data and perhaps business reports) and within the scope of the overall monitoring function, a company’s headquarters or a principal entity will determine the direction the entity performing the day-to-day functions should consider. MNCs tend to focus on getting a product or service to the market, and not on becoming exemplary administrators, unless their business is that of offering administrative services. There will be authority to instruct and request audits and detailed information but, in practice, this authority may not always be used. As a sequel, the Issue Note questions whether situations where functions and risk are allocated to an entity that does not perform the day-to-day monitoring are observed in practice and possible.

A next question asked by Issue Note 1 on risk allocation and control is whether it is possible at arm’s length to ask a transferor of risk to perform the day-to-day monitoring and administration functions on behalf of the transferee particularly where it is difficult for the transferee to assess the performance of the former as service provider absent an independent source of information. The underlying question appears to be one focusing on whether financial remuneration can be separated from day-to-day (people) functions performed. Can one transfer functions and risk and subsequently outsource the functions to the initial transferor? The answer must be that financially this is possible. By analogy sale-leaseback transactions commonly exist in the business world. The problem presented for tax authorities here will be that facts appear unchanged, but risk and accompanying reward is transferred. Will this happen in an unrelated setting? It is presumed no to. Is it therefore by definition deemed not at arm’s length and not to be accepted by tax authorities?

Finally, as to risk allocation and control, Issue Note 1 invites comments where risk can be allocated at arm’s length to a party that does not have a greater control over it (in particular in business restructurings). This may exist where risks can simply not be controlled, such as market risk<sup>12</sup>, regulatory risk<sup>13</sup>, credit risk<sup>14</sup> or currency exchange risk<sup>15</sup> when the company does not

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<sup>11</sup> See text and footnote 3 Supra.

<sup>12</sup> Market risk is the risk that the value of future income streams is subject to external market prices or market rates and also local legal requirements. Market risk occurs under adverse sales conditions due to either increased competition in the market place, adverse demand conditions within the market or the inability to develop markets or position products to services targeted customers.

revert to hedging (it should be noted that hedging requires a specific level of expertise and can be a costly exercise just to have the expertise and functionality in-house). It may be quite normal that companies do not revert to hedging and incur the currency exchange risk in particular where currency exchange rates have traditionally been relatively stable on an aggregated basis over a longer period of time. Product liability risk<sup>16</sup> and start-up risks<sup>17</sup> may also be difficult to control. Operational risk<sup>18</sup> and inventory risk<sup>19</sup> appear to be the risks that are easiest to be controlled.

It should also not be overlooked that many business decisions are made at arm's length by unrelated parties with less than perfect information and certainly less than full consideration of the potentially applicable risks. One can reasonably imagine this occurring in the unrelated party world too! Many good ideas are transformed into products or services largely based on a hunch or previous success in assessing whether a product or service would be potentially successful. The application of the arm's length standard assumes a certain level of advance scrutiny and consideration of functions and risks that unrelated parties may very well not apply. As it relates to business restructuring, implicitly the situation where a transferor transfers risks but not day-to-day functions is referred to. Does this business restructuring allow for a reduced rate of return once the risk is transferred? This may appear to be a synthetic transaction, but is that any different from where an insurance company is paid a premium to assume and reimburse damages resulting from risk when the damages arise as a result of an event against which insurance is obtained? The more risk is transferred, the higher the premium.

## **2. Difference between making a comparability adjustment and not recognizing the risk allocation in the controlled transaction**

Issue Note 1 continues to discuss differences between comparability adjustments and where risk allocation is not to be respected. Strong reference is made to paragraphs 1.36 through 1.41 of the OECD Transfer Pricing Guidelines, which consider recognition of actual transactions undertaken. This chapter of Issue Note 1 presents an example of a manufacturer in Country A with related and unrelated distributors in Country B. Country A examines the manufacturer's related party transactions and, in particular, whether the excess inventory risk is allocated to the manufacturer. In the example, this first analysis results in a determination that arm's length transactions qualify at arm's length, and the excess inventory risk is allocated to the manufacturer in Country A. Subsequently, the tax authorities would examine whether there is

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<sup>13</sup> Regulatory risk is the risk that a company will be incapable to supply products or services (or incur extra costs) as result of introduction of new rules or change in existing rules and regulatory requirements to certain industries. These can include new labeling requirements, new quality requirements, or additional levels of approvals from government institutions related to products and services rendered.

<sup>14</sup> Credit risk is the risk that a customer will not be able to fulfill its obligation to pay (in time) for its purchases or services under the contractual terms.

<sup>15</sup> Foreign exchange risk results from changes in currency rates that can lead to foreign exchange profits or losses in case products are purchased in one currency and sold in another currency.

<sup>16</sup> Product liability risk is the risk that the costs of a liability claim are incurred or return of faulty products is required and includes unknown safety risk.

<sup>17</sup> Start-up risks refer to potential failures in connection with a significant investment to launch new products, the market potential of which is unknown.

<sup>18</sup> This includes the risk derived from inefficient operations.

<sup>19</sup> Inventory risk is the risk that products (raw materials or final products) may be non-conforming, lost, damaged, become obsolete or stolen while held in inventory.

reliable evidence from unrelated party transactions supporting that the excess inventory risk is allocated to the manufacturer<sup>20</sup>.

The example continues with the assumption that there is no reliable evidence from the comparable uncontrolled transactions (the unrelated distributor transactions) that excess inventory is allocated to the manufacturer. This observation, according to the direction in the discussion draft, appears to trigger the question whether the related party arrangement is at arm's length (rather than the requirement to make comparability adjustments): *"In this case it would be necessary to determine whether the contractual risk allocation in the controlled transaction would have been agreed at arm's length. One factor that can assist in this determination is an examination of which party(ies) has(ve) greater control over the excess inventory risk"*.

Arguably the Restructuring Draft uses the word "conditions" in the text of Article 9 of the OECD Model Convention to disqualify transactions between related parties if they are not entered into by unrelated parties. That would be contrary to the message conveyed in paragraph 1.10 of the OECD Guidelines, which provides in relevant part *"that a practical difficulty in applying the arm's length principle is that associated enterprises may engage in transactions that independent enterprises would not undertake. Such transactions are not necessarily motivated by tax avoidance, but may occur because in transacting business with each other; members of an MNE group face different commercial circumstances than would independent enterprises."* Article 9 of the OECD Model provides that "where conditions are made or imposed between two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but by reason of those conditions have not so accrued, may be included in the profits of that enterprise and taxed accordingly." The commentary to Article 9 explicitly provides that the provisions of the paragraph only apply if *special conditions* have been made or imposed between the two enterprises.<sup>21</sup>

The term "conditions" or even "special conditions" is not further defined and the position suggested in the Restructuring Draft appears to be that "conditions" refers exclusively to function and risk allocations observed between unrelated parties as opposed to pricing arrangements. This assumes that deviating allocations from what is observed between unrelated parties to always be in violation of the arm's length standard. This begs the principal question whether arm's length pricing requires mainly an *arm's length return* for functions performed, or exclusively that arm's length functions are remunerated. The former would allow for a functional allocation not necessarily observed between unrelated parties, provided the return can be deemed to be at arm's length and the latter would disallow such approach, exclusively allowing for arm's length function allocation and a related return. This assumption is then softened, and the voice of reason appears to return in the Restructuring Draft, when paragraph 38 refers back to the OECD Guidelines paragraph 1.41, which provides in relevant part that *"the tax administration should not disregard a controlled taxpayer purported assignment of risk unless there is good reason to doubt economic substance of the controlled distributor's assumption of (currency) risk. The fact that independent enterprises do not structure their transactions in a particular fashion*

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<sup>20</sup> Transfer pricing aspects of business restructurings: Discussion draft for public comment of September 19, 2008, paragraph 36.

<sup>21</sup> Commentary on Article 9 of the OECD Model Convention concerning the taxation of Associated Enterprises, paragraph 9(2).

*might be a reason to examine the economic logic of the structure more closely, but it would not be determinative.”*

The Restructuring Draft analyzes an example on excess inventory allocated to the manufacturer in a related party situation. It provides that if the unrelated distributors have relatively more control over the excess inventory, the tax administration may conclude that at arm’s length, a manufacturer would not agree to take on substantial excess inventory risk<sup>22</sup>, confirming as such that arm’s length pricing requires mainly that arm’s length functions are remunerated. The tax administration would be allowed to re-assign the consequences from the risk allocation to the related distributors following the guidance of paragraphs 1.25 – 1.27 of the OECD Transfer Pricing Guidelines, in that situation, according to the Restructuring Draft. No mention is made of the possibility to try to determine an arm’s length return for the actual functionality, as found between the related manufacturer and the related distributor. Where risk allocation is a core element of the transaction, and where a dispute on the risk allocation would result in a dispute about the fundamental nature of the transaction, reference is made to paragraphs 1.36 – 1.41 of the OECD guidelines, which address the situations in which the tax administration is allowed to disregard a transaction<sup>23</sup>.

### **C. Determining whether the risk is economically significant**

The general rule of the Restructuring Draft is that significant risk merits attention and a related return. If a risk is assessed as insignificant then the value in terms of profit potential is likely to be correspondingly low and the bearing of that risk would not ordinarily explain a substantial amount of or decrease in the entity’s profits<sup>24</sup>. The Restructuring Draft suggests that transfers of risk are to be scrutinized to determine whether they are sufficiently significant. For example, a reorganization of a buy-sell distributor to a commissionaire would require review of the investment in inventory, the history of stock obsolescence, the cost of insuring stock and the history of loss in transit (if uninsured)<sup>25</sup>. Issue Note 1 appears to suggest that if these questions are answered as being relatively low while the entity involved is a buy-sell entity, there would be no reason to reduce the profit margin being reported after the entity is reorganized in being a commissionaire.

The evaluation of the significance of risk is listed as being a delicate exercise and, in other words, must be thoroughly conducted. This might include a close review of the accounting statements, according to Issue Note 1, because if a risk is not recognized by the booking of a contingent liability, it should be questioned why the risk is not accounted for. If not accounted for, that could indicate that management of the company assumes the risk as not being material or not likely to be realized. If the risk is recognized, the valuation used for accounting purposes may provide a good indication of the probability of the risk materializing and whether it should

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<sup>22</sup> Transfer pricing aspects of business restructurings: Discussion Draft for public comment of September 19, 2008, paragraph 38.

<sup>23</sup> Transfer pricing aspects of business restructurings: Discussion Draft for public comment of September 19, 2008, paragraph 39.

<sup>24</sup> Transfer pricing aspects of business restructurings: Discussion Draft for public comment of September 19, 2008, paragraph 40.

<sup>25</sup> Transfer pricing aspects of business restructurings: Discussion Draft for public comment of September 19, 2008, paragraph 41.

be considered in determining the return allocable to the entity after its business is reorganized, according to Issue Note 1.<sup>26</sup> In other words, if the risk is not accounted for, a transfer of that risk would not result in a reduction of the return allocated to the transferor.

The Restructuring Draft ignores that differing accounting practices may apply in countries under their differing domestic rules and that contingent liabilities may well not be visible. First, a contingent liability is less certain than a provision (the latter is expected to occur, a contingent liability *might* occur). Contingent liabilities often do not ever become actual liabilities. Contingent liabilities are not shown in the balance sheet, but must be disclosed in notes, if at all disclosed, as companies have a great deal of leeway in choosing what to disclose. Also, off-balance sheet accounting may well be applied, and thus make it unclear whether risk is accounted for and reported as a contingent liability. Finally, companies usually have statutory and financial accounting books and records that serve different purposes. Statutory books and records are documents kept by a company to detail important aspects of its operations and structure, and are in the public domain. Financial records serve to ensure that the company is able to monitor and account for how much it is spending, how much it is owed and how much money it has at its disposal, etc.

Finally, the Restructuring Draft implements the requirement for a level of detail that severely increases the administrative cost to meet the burden of proof, and an aspect that will be difficult to observe under unrelated parties and comparables.

#### **D. What the transfer pricing consequences of the risk allocation are?**

Issue Note 2 discusses the transfer pricing consequences of risk allocation in detail, yet Issue Note 1 provides for some considerations specific to risks before the actual risk allocation is addressed.

##### **1. Transfer pricing consequences of a risk allocation that is recognized for tax purposes.**

Issue Note 1 concludes that if risk is significant enough to be recognized, the party that bears the risk should:

- Bear the cost of managing and mitigating the risk;
- Bear the cost arising from realization of the risk including the effects on asset valuation; and
- Be compensated by an increase in the expected return for carrying the risk<sup>27</sup>.

No mention is made of allocation of losses related to the risk. One would think that parity is important.

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<sup>26</sup> Transfer pricing aspects of business restructurings: Discussion Draft for public comment of September 19, 2008, paragraph 42.

<sup>27</sup> Transfer pricing aspects of business restructurings: Discussion Draft for public comment of September 19, 2008, paragraph 44.

## **2. Can a transfer pricing method be used to create a low risk environment?**

Issue Note 1 identifies that merely stating that an entity is remunerated on cost plus basis does not make it a low risk entity. The method applied does not dictate the existence of risk; it is the functionality of the entity that should dictate the method to be applied. Apparently, the applied transfer pricing method is sometimes used as reasoning for arguing that an entity has no or little risk. It is the functionality of the entity that triggers a choice of transfer pricing method and cost containment is generally a vehicle employed to limit risk.

### **E. Comments on Issue Note 1**

Issue Note 1 addresses four fundamental concerns. First, how much third party validation of a form of risk allocation is needed for the allocation to be respected, (i.e. the scope of the reasonably available alternatives requirement.) Second, the legitimacy of the “control” element as a factor to determine whether the risk allocation is to be respected. Third, what functions constitute control over a particular risk. And, fourth, whether risk management can be separated from control if the principal cannot adequately monitor the agent. Indeed, the importance of written contracts and contractual terms is paramount. Business restructurings often lead MNCs to implement global business models that are rarely found between unrelated parties given that MNCs typically work in an integrated manner. Hence, with the lack of effective comparables, these issue place undue borders on MNCs and given undue flexibility to tax authorities to impose their own notions of third party behaviour.

We observe that MNCs were established largely to tackle barriers (i.e. cost) to get to market. According to R.H. Coase, a firm (multinational enterprise) emerges largely because there is a cost of using the price mechanism<sup>28</sup>. If it is possible for transactions to be organized within the MNC at less cost than would be incurred if the same transactions were carried out through the market, an MNC has a role to play. In essence, profit maximization (or efficiency) requires the substitution of MNCs for markets if the cost of using markets becomes large relative to the cost of its management<sup>29</sup>. The Restructuring Draft imposes market conditions to (that which Coase refers to as) the “nature of the firm (MNC)”, and, therefore, challenges the fundamental reasons for existence of MNCs by assuming that its nature is one that favors tax minimization, and that a transfer of risk in a functional analysis allegedly solely serves to transfer related profit offshore. Ignored is the fact that transfers may also involve substantial risks which has a correlative impact on foregone or potential profits.

If this analysis is consistently applied, that would mean that MNCs by definition will be required to pay a “cost of doing business” under the arm’s length standard, to place them on par with unrelated companies. This cost will consist of corporate income taxes due, to be allocated to those tax authorities that aggressively pursue the issue and increased costs of controversies.

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<sup>28</sup> R.H. Coase, the Nature of the Firm. The price mechanism assumes that supply is adjusted by demand and production to consumption, by a process that is automatic, elastic and responsive.

<sup>29</sup> Id.

## Issues Note No. 2: Arm's length compensation for the Restructuring.

### A. The concept of profit potential

The determination that business restructuring has taken place has important consequences for whether, when and to what extent compensation is required and any compensation received can be deemed as consistent with the arm's length principle<sup>30</sup>. The Restructuring Draft basically treats business restructurings as "transfers of functions, assets and/or risks with associated profit/loss potential between associated enterprises"<sup>31</sup>.

Under this concept of business restructurings, the Restructuring Draft appears to significantly extend the canon of transactions (potentially) taxable on the occasion of business restructurings. Although this is consistent with recent trends in practice and regulation by a number of tax authorities who seek to increase taxation beyond the traditional catalogue of profit realizations, it begs the question whether this is good tax policy. These profit realizations are deemed to have taken place without any realization of profit on the market. Taxation without realization should remain an exception and should only be implemented based on particular and diligent justification.<sup>32</sup>

The Restructuring Draft implies that profit potential exists beyond the traditional catalogue of intangible assets. Profit potential as used in the Restructuring Draft is similar to the goodwill of a business. It is generally recognized that only specific combinations of assets, contractual and factual opportunities and/or people can carry goodwill. The most important of these combinations is a business as a whole (as distinct from the shares in a corporate entity or the interest in a partnership carrying on the respective business). Further, tax rules have also assumed that so-called "part-business" may carry goodwill, in particular if they contain external customer relations and include the generation of proceeds on the market. The exact definition of the concept of "part-business" in national tax laws differs. A supra-national example may be the concept of "part-business" in the EU merger directive. Beyond businesses and "part-businesses", smaller and less autonomous segments of a business, do not generally carry goodwill or profit potential.<sup>33</sup>

The concept of profit potential presented in the Restructuring Draft violates this general international consensus on units of analyses that can carry goodwill in two ways: First, the Restructuring Draft routinely presumes that profit potentials are or may be connected with assets, rights or risks. The language of the Restructuring Draft thereby insinuates that the existence and relation of a profit potential to a set of assets redeployed is a general phenomenon rather than a noteworthy exception. Second, the Restructuring Draft does allow imputing a profit potential as to a single function, asset or risk rather than to an (autonomous) combination of assets, functions

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<sup>30</sup> Section 46 et seq. of the OECD Discussion Draft.

<sup>31</sup> Section 46 of the OECD Discussion Draft

<sup>32</sup> In addition, by establishing fewer requirements for business restructurings and their taxation than, by comparison, the new 2008 German transfer pricing rules, the Restructuring Draft appears to be at least as aggressive in widening the international tax base as the German rules. It must be questioned whether this has been the intention of the OECD.

<sup>33</sup> German case law, for example, which recognized goodwill even, where much less than a "part-business" was transferred, rather confirms this principle by highlighting exceptions than diluting it.

and risks. This effectively represents an aggressive extension of the concept of goodwill that will most likely increase and exacerbate international double taxation.

The easy inference to taxable compensation is displayed in section 51 of the Restructuring Draft. This paragraph presumes that even though there is a legal arrangement of short term in place that does not allow for compensation on termination, the Restructuring Draft explains that the actual conduct consisting of a long term marketing or market development effort “may be indicative of a longer term arrangement, and hence greater rights than those indicated by the (short term) legal contractual arrangement”. The inference of additional rights really is a fiction, here. When applying the arm’s length standard, the real question would be whether a third party would or would not have demanded greater compensation, for ongoing sales or services, given that the contractual arrangement can be terminated at short term.

## **B. The treatment of synergies**

Section 53 of the Restructuring Draft expresses the expectation that businesses will document anticipated synergy gains from business restructurings before a restructuring is in place. The Restructuring Draft goes on to say that it would be reasonable to expect this documentation to include an assessment of other options be made on the basis of an individual entity perspective. It should be clear that this documentation, if in existence, is not to be created taking a single entity perspective. Rather, the whole nature and *raison d’être* of an MNC is to replace the market by implementing a hierarchy for the coordination of economic actors. This implies that a synergy analysis would be created to take a group perspective<sup>34</sup>. Requiring additional documentation on the basis of a single entity perspective, therefore, represents a significant additional documentation burden on businesses. It is questionable whether this additional burden is reasonable.<sup>35</sup>

The Restructuring Draft makes a distinction between group-wide and local synergies. It assumes a tension between the optimization of group-wide synergies and the maintenance of local synergies. It concludes that “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 transfer price analysis, as such, opening up the door to a demand for compensation due to the loss of local synergy benefits

The concept of synergies used in the Restructuring Draft is already vague and elusive in the business world. In business and valuation practice, capturing synergies, let alone allocating synergies to individual entities or country operations, is a notoriously vague exercise. Furthermore, in the experience of the authors the postulated dichotomy between group-wide and local synergies appears highly artificial. It appears hardly conceivable to act on these comments in a transfer price analysis other than to analyze profit implications of a restructuring with diligence and care. Because of these ambiguities, eliminating the comments on the dichotomy between group-wide and local synergies from the Restructuring Draft would be prudent.

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<sup>34</sup> See footnote 29.

<sup>35</sup> R.H. Coase, *The Nature of the Firm*. The price mechanism assumes that supply is adjusted by demand and production to consumption, by a process that is automatic, elastic and responsive.

As the term synergy tells (SYN-ERGON (Greek) = working together), synergies are only conceivable where two (related) parties join forces and cooperate. By definition, they do not, as a rule, appear among unrelated parties transacting with each other on a quid pro quo basis on the market. The market behaviour of independent parties, however, is the yardstick of comparison under the arm's length principle. By necessity, the arm's length principle cannot answer the question to which individual party the gain from cooperation should be allocated. It would thus be prudent if the Restructuring Draft were to show restraint in the face of an impossible task and leave the allocation of synergies to bona fide substantive taxpayer arrangements, which, as experience shows, are usually well founded on business reasons.

It is logically impossible to allocate to individual entities' gains that result from joint cooperation if the measure of allocation shall be market behaviour of unrelated parties. The only exception is present where independent parties enter into a joint venture or a co-development arrangement sharing profits or costs in a defined way. Only where analogous arrangements are implemented by unrelated parties is it a feasible exercise to allocate income on the basis of the arm's length principle. Transfer pricing practice has developed practical approaches to allocate synergies in those situations with the help of profit splits and cost sharing/cost allocation methodologies. These efforts are and should remain the exceptions rather than the rule.

### **C. The consideration of other options available to the parties**

In discussing the (need for) compensation as a result of business restructuring, the Restructuring Draft asks whether the transfer of a profit or loss potential following from a business restructuring is an arm's length transaction. Under the arm's length principle, the question, however, cannot be whether the transaction is an arm's length transaction, but rather must be whether the transaction actually performed does or does not have to be adjusted in its terms and conditions to satisfy the standard of unrelated party behaviour. Should a transaction by its nature not be found among unrelated parties, then this may be proof of the limitations of the arm's length principle. These limitations should have no per se consequence on the tax treatment of these transactions. Those transactions remain legitimate and taxpayers have the same right to legal and fair taxation as if, prima facie, the transaction mirrors unrelated party behaviour in the market.

The heavy emphasis on the analysis of options that would have been realistically available to the transferor and the transferee in an arm's length setting appears to be the first resort analysis taken by the Restructuring Draft in the face of limits of the arm's length standard. The Restructuring Draft goes as far as to mention that an unrelated party could have as a better option to not enter into the restructuring and that the cross border redeployment of functions, assets and/or risks may be motivated (solely) by sound commercial reasons at the level of the MNE Group. The inherent danger here is that the interested and subjective assessment of tax administrators of alternative options available and their speculation on income consequences for the parties concerned takes the place of a reasoned and fair approach to taxation made on the basis of close scrutiny and understanding of business factors. Further, in many cases the restructured party simply has no alternative at arm's length to refuse the restructuring, particularly where it does not own any relevant intellectual property. These parties may not be able to simply just say "no".

An example of this “overheated” approach to business restructurings is provided by discussing the conversion of a full fledged manufacturer into a contract manufacturer variously throughout the Restructuring Draft. The Restructuring Draft poses the question if merely the transition from a riskier profit situation to a lower risk, stable, routine profit situation should be compensated. This question invites speculations on conceivable, but yet unearned future profits and disregards the value of a long term stable return.

#### **D. The discussion of examples of profit changes**

Examples presented in section 69 of the Restructuring Draft are certainly illustrative to the discussion. Some comments are in place, however. In case No. 1, the example is misconstrued. The discussion of the example in section 70 invites the question of a compensation for conversion of the full risk distribution. This is just the opposite of the appropriate tax treatment. The average profit margin on historical data is 2 %. The midpoint of future profit expectations is also 2 %. The guaranteed, stable profit post conversion is also 2 %. Given some risk aversion, the general economic principle correctly invoked in section 66 calls for a lower margin than 2 % as a guaranteed, stable profit, say for 1 %. This is because a higher expected return goes along with higher risk so that a lower risk premium in a stable profit situation implies a lower return. Opposite to what is alleged in section 70, in case No. 1 an independent party would be asked to pay for the conversion rather than being paid one (if at all there should be a payment).

In case No. 2 the average of historical data on profit margins is 7 %, but the range of results of future profit expectations appears quite unrealistic in that it only contains positive values and does not reflect the possibility of losses. On its face, the discussion in section 70 is correct to ask whether compensation should be due. However, as said, the premises on which the case is developed appear unrealistic and should be revisited.

Case No. 2 suffers from the same deficiency as case No. 1. The guaranteed stable profit of 2 % per year is exaggerated in comparison with an uncertain profit ranging from 0 % to 4 %. This deficiency is increased when one, more realistically, assumes that in a situation of increased competitive pressures and uncertainty losses are likely as a matter of future profit expectation.

#### **E. On the Determination of compensation**

Section 78 of the Restructuring Draft states that “an essential part of the analysis of a business restructuring is to identify what intangible assets were owned ... (and) what intangible assets if any were actually transferred ...”. From a policy standpoint, this should not only be an essential part of the analysis but, when it comes to compensation for the restructuring, it should be the only analysis. In addition to the economic and tax reasons given above, practically speaking, the tax revenue will be raised based on a precise analysis of intangibles and their value on actual reallocation. Raising significant tax from mere profit potentials is an uncertain prospect as the resistance on the side of taxpayers to the taxation of mere hopes of future profit will be significant. This would be an interesting analysis in the current financial environment.

In theory, it makes sense to include the perspective of both the buyer and the seller, i.e. the transferee and the transferor of a function when valuing an intangible profit potential. This is

certainly in line with the arm's length standard of taxing related parties as if they were on equal footing with unrelated parties trading functions or assets in a business restructuring. This concept implies, however, to reflect the conditions of market transactions especially in in-transparent and imperfect markets as the market for the business functions. One of the salient characteristics is that there is information asymmetry between the transferor and transferee / buyer and seller of a function. Ordinarily, the transaction parties will not have information about the profit expectations of the other. Tax administrations and tax legislators may be able to pursue a documentation requirement whereby related parties need to document the profit expectations of the related entities involved in a business restructuring. However, this would certainly be a flawed implementation of the arm's length principle. This effort should involve the reflection of the information asymmetry described.

This concept will certainly have to be explored further, but it is certain that a good estimate of a seller of a function about the profit expectations of the buyer is given by the routine returns achievable with a function. This follows clearly from the concept and definition of what is a routine function. A routine return is a return that can be measured by reference to or by observation of empirical data on market returns either at an output level (i.e. return on sales, total cost plus margins etc.) or at an input level (i.e. return on capital). Because the profit expectation of the buyer of a function can be inferred by the seller in the open market by reference to empirical/market data, but only to that extent, this is an arm's length limit to using both parties' profit expectations in the valuation of intangibles and in the determination of compensations.

This implies that non-routine returns contained in the profit expectations of the "buyer" of functions, and assets cannot ordinarily be a determinant factor in that determination. Only in exceptional circumstances where the seller of the function can know about future non-routine returns should they be considered. An example is where a transfer of an intangible for the seller from history knows about past non-routine returns earned. An unrelated party can be expected to be able to make some estimations about future returns of the traded intangible, but it will not know about the other party's exact profit (and synergy) expectations.

#### **F. Ex post adjustments**

In the discussion of the possibilities of adjusting intangible valuations ex-post on the basis of a presumed price adjustment mechanism, there is a bias in favor of adjustments based on hindsight. The Restructuring Draft explains that it is questionable whether a valuation made in times of uncertainty at about the transaction date should require a price adjustment mechanism. Whereas the draft is correct in pointing out that the mere existence of uncertainty should not require an ex post adjustment this is clearly not the point. On the contrary, to make clear that the existence of uncertainty at the time of transaction is an insufficient condition or evidence for an ex post adjustment may be appropriate. It would be prudent to leave the burden of proof for unrelated parties agreeing on a price adjustment mechanism with the tax authorities because these questions are notoriously difficult and intricate to research and quantify with any degree of precision.

## **G. Local intangibles**

The discussion of local intangibles in the Restructuring Draft displays a bias in favor of the payment of compensation. It states that where local intangibles are found to exist and to be transferred to a foreign related party that transfer should be remunerated at arm's length. The Restructuring Draft thereby ignores the prior and fundamental question of whether a local intangible exists and which of the parties the intangible has had to be allocated to. It is perfectly acceptable for businesses to structure the allocation of intangibles in an agreed and substantive way so that, for example, a local marketing intangible is held by an out of country entity that has funded and taken control of the intangible.

## **H. Ongoing concerns**

The inflationary search for additional sources of tax has also affected the discussion of ongoing concerns or goodwills as objects of taxation. The Restructuring Draft displays a misunderstanding of the nature of goodwill of a business or ongoing concern by repeatedly equating an ongoing concern with "an activity". (See the discussion above on units of analysis which can carry goodwill.) The use of the example of the transfer of an ongoing concern contained in section 94 of the Restructuring Draft is supportable. This example is relatively clear and unequivocal and supports the conclusion there that goodwill/ongoing concern has been transferred. The point, however, is that already under traditional tax rules the practitioner arrives at a similar conclusion. No additional reflection on profit potentials, goodwills or ongoing concerns is needed to come to the conclusions of this example.

## **I. Termination of contracts: The relation between the law and unrelated party behaviour**

The Restructuring Draft discusses the question of indemnification where a restructured entity has had a contractual relationship that is terminated or substantially re-negotiated. The Restructuring Draft seems to apply a two stage analysis. On the first stage the legal analysis of both statutory provisions, case law and of the contract at hand will give a first answer as to the appropriate compensation. At the second stage, however, it is ultimately the behaviour of unrelated parties in comparable situations that is giving the final answer. There may be cases theoretically where an unrelated party does not insist on compensation even though it is legally entitled to, and indeed, the author has experienced such situations. On the other hand, there may also be situations where the independent party does not in effect have a legal claim for compensation but manages to be paid one. To the extent these – certainly rather exceptional situations – can be evidenced by the taxpayer, they present the right answer. In many cases, on the other hand, the result of the first stage legal analysis will be controlling and will be guiding the practitioner to the right answer.

The Restructuring Draft also discusses whether from the point of view an arm's length analysis implicit terms of an intercompany relationship have to be imputed over and beyond any written or manifest terms of the intercompany relation. The example used is a highly specialized manufacturer which has expanded significant investment in a new manufacturing unit. Before the payback on the manufacturing investment has been obtained, the related party terminates the contract in accordance with its contractual terms. The Restructuring Draft then asks whether the

manufacturer, in an arm's length setting, would not have sought mitigation against that behaviour to be protected in case of insufficient payback on its investment. It has to be pointed out that the burden of proof of such an unusual mitigation arrangement should certainly be on the tax administration. In the open market, there is no certainty for obtaining payback on an investment. Taxation should not be developed on the basis of a different, mainly illusory premise or some notion of commerciality. Again, the observable behaviour of unrelated third parties should be the first choice of standard in assessing related party behaviour for purposes of income allocation.

## **J. Comments on Issue Note 2**

The likely explosive issue in this Issue Note is the notion that reasonable options may exist for the restructuring and the seemingly second guessing of the business reasons for the restructurings. As noted above, the restructured party simply may have no alternative at arm's length to refuse the restructuring. Whether the transfer of a business opportunity asset that follows from a business restructuring is an arm's length transaction from the perspective of both the transferor and transferee depends on a number of factors, including, the realistic options available, the expected returns to the parties after the restructurings, and the compensation and profit potential from the surrender of the business opportunity asset. Indemnifications and determination of this latter point can be most complex.

## **Issues Note No. 3: Transfer Pricing Aspects of Post-Business Restructurings**

### **A. Background**

Issues Note 3 concentrates on the application of the arm's length principle and the transfer pricing guidelines to post-restructuring arrangements and the necessity, apart from the restructuring operations themselves, to document the changes that may result from the restructuring between the pre-restructuring and post-restructuring agreements. In large part, the Restructuring Draft ponders that arm's length principles do not apply differently to post restructuring transactions compared to those as originally established. Fairly or unfairly, the Restructuring Draft draws undue attention to those restructuring as if they are inherently ill conceived.

The main question raised by this Issue Note is about whether, and to what extent, the transactions occurring after a restructuring should be treated differently from transactions that would be realized by MNCs that would have remained structured the same way from the beginning, notwithstanding the facts and the business environment may have changed.

Issue Note 3 also addresses the specific question of the application and selection of the appropriate transfer pricing method. It notably restates that a hierarchy exists among the traditional transaction methods and the transactional profit methods, and that the Comparable Uncontrolled Price ("CUP") method is always preferable where it can be considered reliable, even if the status of last resort method of transactional profit methods should be abandoned. Curiously, one could question if the OECD Transfer Pricing Guidelines are now considered insufficient.

Independently from restructuring issues, Issue Note 3 also provides clarification about the notions of tested party and the profit level indicators that should be used when benchmarking sales based activities such as a commissionaire or sales agent. Even though the OECD does not take any definitive position on these issues, it indicates that even though only one party would be tested there is a need for a complete functional analysis of both parties to a transaction. These issues do not directly relate to the discussion on business restructurings and the question arises of whether they would rather be treated within the framework to the current discussion on transactional profit methods, for which the OECD published a discussion draft in January 2008.

## **B. Identifying differences between restructurings and “structuring”**

Issue Note 3 states on several occasions the principle underlying restructurings should not be an exception to the application of the arm’s length principle and that the transfer pricing guidelines should not apply differently to post-restructuring transactions, as opposed to transactions as initially structured. A strict application of this principle would lead to create a clear distinction between the operations of restructuring themselves and the post-restructuring transactions, and recognize that if the restructuring operations gave rise to an arms’ length compensation (as addressed under part II of the Restructuring Draft), the post-restructuring transactions should not be adversely affected. In other words, this would lead to a confirmation that an MNC should not be treated differently merely because it underwent a restructuring, if no real differences can be identified as compared to an MNC that would be so structured from the beginning.

However, Issue Note 3 provides that even if the arm’s length principle must be applied in all cases, restructurings can generate factual differences with transactions that did not result from a restructuring, which could affect the comparability of post-restructuring transactions with these “ordinary” transactions. These differences could arguably result from remaining obligations derived by the parties from prior arrangements, specific contractual terms or market conditions.

A first example in this Issue Note is where a fully fledged distributor would be converted into a limited risk distributor, and where the restructured distributor would be entitled to negotiate specific favorable terms, such as the absence of trial period. Issue Note 3 emphasizes that, when compared to a limited risk distributor established in a market where the group never had any previous commercial presence, a limited risk distributor converted from a full-fledged distributor would not need to make market penetration efforts, nor bear any marketing or contribute to the development of intangibles. However, once it has borne this market penetration, marketing and development effort, a limited risk distributor structure from the beginning would not have different functions, risks or assets than those of the restructured limited distributor. It is questionable how this would be relevant to determine post-restructuring transfer prices.

The position of the Issue Note here is further questionable because, it implies that post-restructuring transactions should per se not be comparable with transactions that would have initially been set up due to the existence of factual differences relating to the prior situation (which should have been dealt with in the restructuring). It seems that it would only be in the exceptional situation where material differences can be identified (and which would in most cases be due to the fact that all consequences of restructuring were not properly considered at that time that a different treatment should be applied.

### **C. Choosing a transfer pricing method**

Based on the discussion of comparability of post-restructuring transactions, Issue Note 3 appears to draw conclusions on the selection of transfer pricing methods. An interesting point raised by the Restructuring Draft is that the application of the CUP method could be specifically appropriate after business restructurings, because pre-restructuring uncontrolled transactions could provide relevant comparables for post-restructuring transactions, subject to specific adjustments.

Further, the Issue Note states that in business restructurings, information is also required for the activities of the non tested party who benefited from transfer of functions, assets or risks. However, the availability of information and costs associated with this documentation is one of the most critical aspects of a transfer pricing analysis. Therefore, requesting information on both parties would lead to increase the burden of enterprises undertaking a business restructuring as compared to other enterprises.

Issue Note 3 also addresses specific considerations about the determination of the tested party, the choice of financial indicators based on costs, sales or assets. Specifically, for a commissionaire or sales agent, the document indicates that a sales-based indicator could be appropriate, potentially combined with a cost-based indicator and that actual costs should be used with caution where the parties are supposed to be incentivized to monitor their level of costs. Here, it appears that, even though these considerations can provide guidance concerning the choice of a transfer pricing method, they could possibly apply to any type of transactions, and should not be limited to post-restructuring arrangements.

For the use of transactional profit split methods, the Restructuring Draft suggests that business models resulting from restructurings may be particularly difficult to benchmark because that restructured party would still bear functions and risks relating to its former status, which would not correspond to its new business model. The Issue Note indicates that the use of a transactional profit split method could be appropriate in these cases. The Issue Note curiously (and maybe inappropriately seems to imply that transactions put in place after business restructurings would in most cases not be benchmarkable, which would increase the potential tax exposures and uncertainly on a number of existing structures. Any finalized version of the Restructuring Draft should address this point.

### **D. Example of the implantation of a central purchasing function**

Issue Note 3 addresses the example of an MNC who establishes a central purchasing entity for the negotiation with third party suppliers of raw materials for all manufacturing plants of the group. Depending on the facts and circumstances, it suggests that different methods should be considered: the CUP method if the raw materials are traded on a commodity market, and a cost plus or a profit split methods, with the necessary adjustments, so that the positive effects of synergies or inefficiencies can be allocated between the members of the group. The Issue Note refers to the prices that would have been obtained on the free market for comparable supplies in comparable circumstances, but does not draw any specific conclusion in relation with the fact that the central purchasing entity would have been created under a restructuring process or that it would have been created as such from the beginning.

Part D of the Issue Note 3 explains that an arm's length compensation for the restructuring itself could be achieved through payments of post restructuring transactions that would differ from a market remuneration, instead of through an up-front payment. However, the Restructuring Draft acknowledges that this would be difficult to structure and monitor. This issue is not a post-restructuring issue, but mainly relates to the modalities of the restructuring itself and should therefore have been handled at that time. The Restructuring Draft, however, creates a situation where the pre-restructuring, restructuring, and post-restructuring phases are all aggregated, which is contrary to the general principal that each of these phases should be treated autonomously. Benchmarking a transfer pricing method here would require the identification of comparable transactions that would at the same time result from a restructuring and not an up-front payment. It is also possible that the tax treatment that would be applied to an up-front compensation for a transfer of assets or functions could materially differ from the tax treatment applicable to the current post-restructuring transaction (e.g. the treatment of capital gains or transfer tax).

#### **E. Making comparisons between profits earned before and after the restructuring**

Issue Note 3 addresses comparisons of the profits earned by a party to a controlled transaction prior to, and after the restructuring, by reference to the profits earned before the restructuring, adjusted to reflect the transfer of functions, assets and risks. The Restructuring Draft acknowledges that this comparison would not be sufficient under article 9 of the OECD Model Tax Convention. Even if, as stated by the Issue Note, information about pre-restructuring transactions could be useful to understand the arm's length nature of the restructuring itself, it does not appear that a before-and-after comparison should be used to assess the arm's length nature of post-restructuring transactions. If actual functions, risks and assets were transferred, this should be considered in the remuneration of the restructuring operations themselves (addressed under Part II herein). Taxpayers would certainly not understand the fact that transactions realized under a former business model would have an impact on their current level of profit and potentially lead to a different level of remuneration as compared with independent competitors. Also, questions would arise about the time-period during which these pre-restructuring operations should be considered and documented.

Under the general rules governing the burden of proof (depending on the countries), the tax authorities should demonstrate that a transaction would not be arm's length. The approach of the Issue Note does not appear to be in line with this principle, because it would request taxpayers to document (i) the transfer pricing policy applied before the restructuring, (ii) the compensation of the restructuring itself with the justification of its "commercially rational" nature, and (iii) the differences between the pre and post-restructuring transactions. A question may arise here as to how far back this information should go to be included in the transfer pricing documentation. Another point of complexity would be where several successive restructurings would be undertaken.

Maybe the use of before-and-after comparisons should be limited to an optimal sanity check on the changes in the allocation of profits and tax administrations should not be entitled to challenge the transfer price applied after a restructuring on this sole basis, without realizing a complete transfer pricing study of the transaction reviewed.

## **F. Dealing with Location Savings**

Issue Note 3 also contains a brief discussion about the specific issue of location savings and whether and how location savings that are derived from a business restructuring should be attributed among the parties under the arm's length principle. Examples are provided of a enterprise in the clothes industry that would relocate its manufacturing activities in a country where labor costs are significantly lower, under a contract manufacturing arrangement, and concludes that the contract manufacturing activity should be benchmarkable. On the other hand, Issue Note 3 takes an example where value-added engineering services are relocated in a subsidiary, and these engineering services cannot be obtained from third parties with the same quality standards, and concludes that in the absence of relevant comparables, a profit split method should be appropriate.

The response obviously depends on what independent parties would have agreed at arm's length in similar circumstances and normally depends on the functions, assets and risks of each party and on their respective bargaining powers, and in particular on whether the relocated activity that gives rise to the location savings is a highly competitive one. It is curious why so much emphasis is put on the restructuring to appreciate the arm's length character of the post-restructuring transaction. They are distinct operations even though some level of interconnection can exist.

## **G. Comments on Issue Note 3**

It is quite puzzling why the existing OECD Transfer Pricing Guidelines are apparently not considered sufficient to address Issue Note 3. There is an inherent presumption that the arm's length principle may be applied differently to post business restructuring, notwithstanding clear statements in the Restructuring Draft to the contrary.

### **Issues Note No. 4: Recognition of the actual transaction undertaken.**

#### **A. Background**

Issues Note 4 addresses whether, and in what circumstances, taxing authorities have the right to recharacterise intercompany transactions occurring within an MNC group for transfer pricing purposes. The term "recharacterise" is used throughout this analysis as analogous to "non-recognition" (the latter term is used in the existing OECD Transfer Pricing Guidelines), as it has generally been accepted that, if transactions are not recognized, then a recharacterisation will be the implied result which could also result in a different transaction being deemed to have occurred for transfer pricing purposes.

The relevant paragraphs of the OECD Transfer Pricing Guidelines are contained at paragraphs 1.36 - 1.41, that set out the two circumstances in which the OECD envisaged recharacterisation could be considered;

- Where the economic substance of a transaction differs from its form; and
- Where, while the form and substance of the transaction are the same, the arrangements made in relation to the transactions, viewed in their totality, differ

from those that would have been adopted by independent enterprises behaving in a commercially rational manner, and the actual structure practically impedes the tax administration from determining an appropriate transfer price.

Issue Note 4 emphasises that interpretation of these paragraphs is restricted purely to recharacterisation of transactions for purposes of transfer pricing adjustments covered by Article 9 of the OECD model treaty, and does not provide any guidance as to a country's ability to characterise transactions differently under its own domestic law. This is relevant in certain jurisdictions, for example the UK, where the tax administration have argued historically that they have the ability to recharacterise through the reference in domestic legislation to whether a taxpayer "would" have structured a certain transaction with an independent party in the same manner as the equivalent intragroup transaction has been structured.

As a general matter, in a number of paragraphs throughout Issue Note 4, it is reconfirmed and emphasised that MNCs are free to organise their business operations as they see fit, and that tax administrations do not have the right to dictate how an MNC designs or structures its locations of its business operations. This is one of the fundamental reasons that tax administrations have therefore typically respected transactions as presented by the taxpayer, and is a good argument that they should continue to do so for greater certainty and simplicity, other than in exceptional circumstances.

#### **B. Determining transaction nature and substance**

Given that the paragraphs 1.36 - 1.41 of the OECD Transfer Pricing Guidelines dealing with recharacterisation refer to the need to evaluate a transaction's economic form and substance, the Issue Note confirms that it is therefore an important starting point to properly identify and characterise the controlled transaction under review properly.

Issue Note 4 confirms that contractual terms are an important starting point in the process for identifying the transactions. This perspective corresponds with the outcome of certain U.S. litigation in the 1990s in transfer pricing, where it was held that the contracts underlying transactions were critical and generally overriding evidence in the process of identifying and characterising transactions. Issue Note 4 also refers to the fact that it is important to ascertain whether reported allocation of risk between the parties is consistent with the economic substance of the transaction and whether the related parties have indeed conformed to the contractual allocation of risks. Most taxpayers would agree that these are both important steps and that where economic substance is not present or the contractual position has not been respected, then it may be reasonable to consider recharacterising those transactions.

#### **C. Comparable transactions, or lack thereof**

The Issue Note confirms that the existence of comparable transactions between independent parties should be treated as prima facie evidence that recharacterisation is not appropriate, but that it may shed light upon the allocation of risks that do occur and therefore the pricing of the transactions. This corresponds to existing guidance, and is fundamentally the basis of testing transfer pricing of all transactions, not just business restructuring.

However, many taxpayers may disagree with the OECD analysis in Issue Note 4 where it is not possible to find comparable uncontrolled transactions of the nature of the tested intragroup transactions. Here, the Issue Note suggests in particular that tax administrations should then assess whether the transactions and related risk allocations “make commercial sense” and, if not, consider recharacterisation.

This interpretation appears to be far removed from the original intent and strict reading of the Transfer Pricing Guideline paragraphs relating to non-recognition of transactions. Given the nature of a group and that, as confirmed by the OECD Transfer Pricing Guidelines, intercompany transactions do occur within groups that do not occur between independent parties, this view could lead to a position where tax authorities would consider recharacterising a far greater number of intragroup transactions, and not simply in business restructurings. This interpretation would remove the more objective tests in paragraphs 1.36 - 1.41, as it would allow taxing authorities greater powers to decide what they believe makes good commercial rationale (the terminology used in Issue Note 4) for intragroup transactions and whether they believe restructuring has been “in accordance with economic and commercial reality of parties dealing at arm’s length”. It is difficult to understand how this can have been the original intent of paragraphs 1.36 - 1.41, particularly given the requirement that, where there is economic substance, these paragraphs require the restructuring “to impede the tax administration from determining an appropriate transfer price”. If a business restructuring can be adequately and supportively priced, then where is the impedance required? The more reasonable and traditional approach would be to say that, unless the transactions are lacking in substance, then tax administrations should accept the characterization, but be allowed to adjust pricing according to the actual facts.

#### **D. “Exceptional” and “commercially rational” transactions**

Issue Note 4 examines the meaning of the word “exceptional” as used in paragraphs 1.36 - 1.41 of the OECD Transfer Pricing Guidelines. The Issue Note reconfirms that “exceptional” is a term that should be interpreted as meaning that all attempts should be made by taxing administrations to make adjustments to transfer pricing on the basis of pricing adjustments, rather than by not recognising or recharacterising transactions. As previously noted, to recharacterise a transaction that has economic substance, pricing would need to “practically impede the tax administration from determining an appropriate transfer price”. This would be an unusual circumstance, as experience is that there are few transactions which cannot be priced, even if such pricing is only in theory.

Issue Note 4 also looks at the term “commercially rational”. Reasonably, the Issue Note states that, in circumstances where reliable data shows that similar transactions or arrangements exist between independent parties, then tax administrations should not be able to argue that the transactions lack “commercial rationality”. One difficulty in interpreting “commercially rational” is that, by the nature of groups, the precise circumstances that might exist between two independent parties may never in reality exist between group companies. For example, functions that may be required to manage the impact of a certain transaction may often exist in different parts of a group rather than in just one entity. Accordingly, a structure may be viable and acceptable within a group situation, but it may never in reality exist outside of a group situation in its independent parts. This situation often makes it difficult to deal with the test set out as to

whether “control” of allocated risk in the restructured MNC is commercially rationale, as that control does not typically sit in any one particular entity.

The Issue Note further states the OECD view that, if an independent party would not enter into a specific restructuring transaction that is clearly expected to be detrimental and it has other options realistically available to it, then two related parties would not enter into the same transactions where one party would lose out. The OECD view appears to deal particularly with the financial implications of the transaction, taking into account various relevant conditions such as the rights to assets of the parties and any compensation or indemnification. This may in part be an acceptable way of approaching certain aspects of business restructuring. In particular, if it is possible to show that each party does have an overall potential financial benefit expected as a result of the restructuring, taking into account any compensation and the future transfer pricing of ongoing transactions after restructuring, then this should arguably be sufficient evidence that the restructuring is acceptable without reviewing other available options.

The potential need to evaluate what other options may realistically be available to each of the parties would again lead to significant practical difficulties. First, it would be very onerous to include such a difficult and open ended test for taxpayers. Also, there is a great deal of subjectivity involved in determining what other options might be available in third party situations. This requirement would be difficult in practice to apply, and tax administrations would again have significant latitude to decide what they believe might occur in a given scenario, leading to material uncertainty for tax payers.

The Issue Note concludes with three examples that may be found for business restructuring. Example (B) relates to the transfer of valuable intangibles within a group to a shell company. Essentially the shell company does not have any resources to manage and control these intangibles, and is required to obtain the necessary services from other group companies, where the services are remunerated on a cost plus basis. The conclusion provided by the Issue Note is that most OECD countries indicate they would not consider recognising the arrangement as structured. Given the extreme nature of the circumstances described, many taxpayers would accept that the financial consequences of the restructuring would not correctly reflect the allocation of risks nor the resulting profitability from the operations to the correct entities.

However, it is important to understand how these conclusions may be reached and how transfer pricing adjustments would be made under the OECD Transfer Pricing Guidelines. Because there is no reliable evidence from uncontrolled comparable transactions that similar restructurings might exist would certainly lead to a question as to the transfer pricing, but possibly should not be determinative in the need to recharacterise. It is likely, for example, that most OECD countries would state that the substance of what had purportedly been done and the substance moving forward would not tie in with the economic form provided for the restructuring, and that the economic ownership of intangibles in substance has not moved to the shell company. In this case, it is reasonable that these countries might suggest recharacterising the transactions involved in this restructuring. This example may therefore not make any statement as to whether these structures would not be adopted by independent parties behaving in a commercially rational manner and that the pricing practically impeded the determination of the transfer pricing price that was the primary reason for that conclusion.

Example (C) refers to the transfer of intangibles to a company that exercises functions. In this example, the previous shell company is replaced by a company which has itself the full substance available to it to control and manage the brands transferred to it. Although the main reasons for the group entering into this restructuring may have been to benefit from a favorable tax regime situation, Issue Note 4 states that a vast majority of OECD countries consider in this case that the transaction should be recognised for transfer pricing purposes, as it has economic substance. This appears perfectly reasonable. In addition, although not explicitly stated, most tax-payers would accept that, if the pricing was not correct, then tax administrations would still then have the right to challenge the underlying pricing.

Example (A) relates to the conversion of the full-fledged distributor into a “risk-less” distributor, and is possibly the most controversial of the examples given in the Note. The example relates to the acquisition of a business that pre-acquisition, owned valuable trade names, valuable retail points and valuable long term contracts with suppliers. In the Example, the acquiring MNC Group operates under a different business model whereby all trade names and other valuable intangibles are owned in a different country, supplier contracts are held by a further entity in a different country and similarly for the retail points. As a consequence, the acquiring MNC restructures the acquired business to transfer trade names, the supplier contracts and the retail points to the various other group companies in exchange for lump sum payments. The business acquired therefore now operates as a commissionaire for the MNC, and its post-restructuring profit potential is significantly less than that pre-structuring. The Example assumes that the actual conduct of the parties’ post-restructuring is consistent with the form of these transactions.

It appears that, provided the pricing of the transfer of trade name, supplier contracts and retail points is at appropriate levels, many jurisdictions would accept that this business restructuring would be reasonable and should be accepted. However, the Issue Note states that some countries believe that “crown jewels” such as valuable trade names would be unlikely to be transferred at any price between third parties, and so that the transaction within the group should be treated as a different transaction or disregarded. This is a troubling conclusion, as centralization of assets in a global economy is a reasonable and commercial form of restructuring for an MNC. The existing OECD Guidelines do not appear to provide any support for the position of these jurisdictions taking this latter position, particularly as the structure does not appear to practically impede the tax administration from determining an appropriate transfer pricing. Accordingly, it appears that these jurisdictions would be taking a view contrary to the interpretation of the OECD Transfer Pricing Guidelines by the majority of jurisdictions, thereby potentially subjecting taxpayers to double taxation. This approach has seemingly lowered the threshold to determine whether a company has acted in a commercially rational manner through the use of the alternative principle which states that the restructuring would “only” go forward if the company saw no other transaction that is “clearly” more attractive. This test argues strongly for maintaining status quo. Is that what was really intended?

#### **F. Comments on Issue Note 4**

Issue Note 4, while making some helpful comments concerning restructuring, the Restructuring Draft is unfortunately flawed in that it is made internally inconsistent by trying to weave the original intent of the OECD Transfer Pricing Guidelines regarding recharacterization

(i.e. exceptional, need for impeding the tax administrations as a criteria, pricing adjustment of transactions wherever possible rather than recharacterisation) with a new ability for tax administrations to subjectively decide on what transactions they believe are “commercially rational”, and to recharacterise at their own discretion accordingly.

The Note also sets out certain situations where OECD member countries already appear to be in conflict with each other over interpretation of the recharacterization principles in relatively common restructuring scenarios, such as in Example (A) above. If this is true and the OECD adopts the position in Note 4 as currently drafted, then it appears that there may be some tough battles ahead between OECD member countries concerning business restructurings and their transfer pricing impact.

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The Restructuring Draft in total sets out many issues involved in business restructurings that are not new or novel and there is no indication that the existing OECD Transfer Pricing Guidelines cannot address these concerns. Accordingly, one questions the underlying premise to the Restructuring Draft. Is it to highlight sensitivity to tax administrators? If so, more balance may be required and the focus should be more to issues not already considered under the existing rules. Further, does this create an overriding blanket to all restructurings that the arm’s length principle must be perused more vigorously? Is there simply a presumption of distrust that gives rise to this seemingly unnecessary detail and review?