Comment on "*Discussion Draft on the Transfer Pricing Aspects of Business Restructurings – 19 September 2008 to 19 February 2009*"

I refer to the OECD publication "*Discussion Draft on the Transfer Pricing Aspects of Business Restructurings – 19 September 2008 to 19 February 2009*" (the "**Discussion Draft**"), in which the OECD Committee on Fiscal Affairs invites interested parties to send comments on the Draft before 19 February 2009. The present document represents my comments on specific elements of the Draft as outlined below. For the sake of convenience I include a table of contents:

1 Introduction

1.1 Scope of comment

The present comment is confined to the issue of "*Recognition of the Actual Transactions Undertaken*", as primarily addressed in Note No 4, but also in Note No 1 of the Discussion Draft. Prior to the publication of the Discussion Draft, the requirement to recognise and the authority to restructure actual controlled transactions under Art 9 (1) of the OECD Model Tax Convention on Income and on Capital (the "**OECD MTC**") were primarily addressed in paras 1.36-1.41 of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the "**OECD Guidelines**"). An important feature of the Discussion Draft is that it does not intend to propose amendments to the existing guidance found in the OECD Guidelines other than to clarify the existing guidance (see Discussion Draft para 194).

In my opinion, the clarifying guidance provided by the Discussion Draft generally represents a sensible approach, in particular

- the clarification that OECD Guidelines paras 1.36-1.41 do not provide any guidance as to a country's ability to characterise transactions differently under other aspects of its domestic law than the arm's length principle, such as domestic anti-avoidance rules (see Discussion Draft para 195),
- the clarification that just because a related-party arrangement is one not seen between independent parties should not of itself mean the arrangement is non-arm's length (see e.g. Discussion Draft para 27), and
- the clarification as to the determination of whether the arrangements adopted in relation to a controlled transaction are commercially irrational (see Discussion Draft paras 207-213).

However, on one particular point the approach adopted by the Discussion Draft is unfortunate, not in line with the existing guidance provided by the OECD Guidelines and should therefore be reconsidered. This particular point is the Discussion Draft's proposal as to what types of adjustments should be restricted by OECD Guidelines para 1.36. This proposal is contained in para 201 of the Draft and is referred to as the "**Commented Proposal**" below. Paragraph 201 is worded as such:

> *Paragraphs 1.36-1.41 of the TP Guidelines apply where there is a **dispute about the fundamental nature of the transaction** being examined. The OECD view is that these paragraphs do not restrict a tax administration's ability to adjust the price or other*

> *conditions of a controlled transaction in situations where there is no dispute about* ***the nature of the transaction – and hence, no recognition issue*** *– but where such price or conditions are not arm's length according to guidance provided in other parts of the TP Guidelines* (**bold** added).[1]

Comments on this paragraph and the following paragraph of the Discussion Draft are particularly invited.

Quite interestingly, the Commented Proposal appears to be inspired by a Canadian Transfer Pricing Memorandum issued by the Canada Customs and Revenue Agency in 2005.[2] In this Memorandum it is suggested that "*recharacterization (…)* [i.e. the type of adjustment addressed in OECD Guidelines para 1.37] *generally involves a change to the* ***fundamental nature of the transaction***" (**bold** added). Thus, the Commented Proposal does not appear to be an OECD-invention.

The Commented Proposal suggests that OECD Guidelines para 1.36 should be interpreted so as only to restrict domestic tax administration's authority to change the fundamental nature of the examined controlled transaction. By implication, the Commented Proposal, thus, suggests that the OECD Guidelines should be interpreted so as to grant domestic tax administrations a wide authority to adjust any type of conditions made or imposed in controlled transactions, regardless of their nature, as long as the adjustment does not bring about a change in the controlled transaction's "*fundamental nature*". Such an authority would create a fundamentally different regime than the traditional regime, under which Art 9 (1) OECD MTC would normally only be used to adjust price conditions and the other types of valuation conditions examined in the transfer pricing methods outlined in the OECD Guidelines.

In practice, the Commented Proposal implies that the line of action restricted by OECD Guidelines para 1.36 is defined so narrowly that the restriction inherent in this paragraph is deprived of much of its force and that the paragraph is devoid of much of its meaning. Below I will, as a crucial background, first clarify the difference between establishing and restructuring a controlled transaction (section 2), secondly substantiate that the Commented Proposal is not in line with the existing guidance provided by the OECD material (section 3) and thereafter present a number of policy considerations suggesting that the Commented Proposal should be reconsidered (section 4). Finally, I will summarise my proposals as to what changes should be made to the Discussion Draft (section 5).

As a background for the comments I mention that I am presently working on a PhD-thesis explicitly focusing on the interpretation of OECD Guidelines para 1.36-1.41, this being the reason for my interest in the issue. Although I am employed at the Faculty of Law at the University of Oslo, the comments contained herein are not expressed on behalf of the University of Oslo.

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[1] See also Discussion Draft para 39.

[2] See Canadian Transfer Pricing Memorandum TPM-06, entitled "Bundled Transactions", published 16 May 2005 and available at http://www.cra-arc.gc.ca/tx/nnrsdnts/cmmn/trns/bndld-eng.html.

1.2 Key terminology

For ease of reference, the remainder part of the present comment will apply the following key-terminology:

Valuation adjustments:	The traditional form of adjustments under the arm's length principle not restricted by OECD Guidelines para 1.36, typically price adjustments, adjustments of other conditions examined under the transfer pricing methods outlined in the OECD Guidelines (gross margins, net margins and profits) and adjustment of other possible conditions which only intend to estimate the value of the property or service transferred in the controlled transaction.
Structural adjustments:	Adjustments of conditions of controlled transactions which do not qualify as valuation adjustments, typically adjustments of the actual allocation of functions and risks and adjustments of the conditions stipulating the nature, quality and quantity of the property or service transferred in the controlled transaction.
Restricted structural adjustments:	The form of adjustments under the arm's length principle restricted by OECD Guidelines para 1.36, but authorised in the two circumstances referred to in OECD Guidelines para 1.37.
The economic-substance exception:	The first circumstance referred to in OECD Guidelines para 1.37 in which a restricted structural adjustment is authorised.
The commercial-rationality exception:	The second circumstance referred to in OECD Guidelines para 1.37 in which a restricted structural adjustment is authorised.

1.3 Main point of comment letter

The main point made by the present comment letter is that all "structural adjustments" are "**restricted** structural adjustments". Hence, in terms of the threshold for undertaking an adjustment under the arm's length principle, the OECD Guidelines should be interpreted so as to draw up a distinction between valuation adjustments and structural adjustments. In contrast, they should not be interpreted so to draw up a distinction between valuation adjustments and structural adjustments not changing the "*fundamental nature*" of the controlled transaction, at the one hand, and structural adjustments leading to such a change of the "*fundamental nature*" of the controlled transaction, at the other.

It is fair to say that the Draft aims at extending the types of arrangements which can be restructured based on the arm's length principle. In principle, there are (at least) two

manners in which to authorise structural adjustments of types of arrangements not presently referred to in the OECD Guidelines:

(i) To refer to these arrangements as additional examples of arrangements which can be restructured in one of the two circumstances referred to in OECD Guidelines para 1.37.

(ii) To narrow down the notion of "restricted structural adjustments" so that the restructuring of these arrangements does not qualify as a restricted structural adjustment (and is therefore not restricted by OECD Guidelines para 1.36).

The Draft adopts approach (ii). This approach is, however, unfortunate, as it will not only open the door to structural adjustments of the intended-to-be-challenged arrangements, but also of other, not intended-to-be-challenged arrangements, the restructuring of which will not change the "*fundamental nature*" of the controlled transaction. Approach (i) should therefore be adopted.

2 The difference between *establishing* and *restructuring* the controlled transaction

2.1 Introduction

When applying Art 9 (1) OECD MTC it is important to distinguish between two particular issues, i.e.

(i) the issue of which "*conditions are made or imposed between the two* [associated] *enterprises in their commercial or financial relations*", and

(ii) the issue of whether these conditions "*differ from those which would be made between independent enterprises*".

Whereas issue (i) concerns the process of *establishing* the conditions of the controlled transaction, issue (ii) concerns the process of *testing* and, possibly, *adjusting* the conditions of the controlled transaction under the arm's length principle. As will be explained further below, issue (i) is not answered based on the arm's length principle (i.e. based on a comparison with the behaviour of independent parties), but rather based on an examination of (primarily) the written agreements entered into between the associated enterprises (if any), other written material shedding light on the terms of the controlled transaction (if such material exists) and the associated enterprises' actual conduct.

The same distinction between establishing the conditions of the controlled transaction and testing and adjusting them based on the arm's length principle applies under OECD Guidelines para 1.36. This paragraph provides that a tax administration's examination of a controlled transaction ordinarily should be based on "*the transaction actually undertaken by the associated enterprises as it has been structured by them*" and that this transaction should not be disregarded or substituted in other than exceptional cases. Before reaching the point where the question of disregarding or substituting the controlled transaction arises, it is necessary to establish the conditions of the controlled transaction actually undertaken. This process is, of course, not restricted by OECD

Guidelines para 1.36. Below I will explain in further detail which lines of actions are included in the process of establishing the conditions of the controlled transaction and are, thus, not restricted by OECD Guidelines para 1.36.

2.2 The OECD Guidelines' notion of "*economic substance*": the factual-substance prong and the arm's-length prong

The wording of Art 9 (1) OECD MTC establishes a rather clear and straightforward distinction between the process of establishing the "*conditions (...) made or imposed*" in the controlled transaction and the process of adjusting/restructuring them based on the arm's length principle, the latter of which requires a determination of whether these conditions "*differ from those which would be made between independent enterprises*". The clarity provided by the wording is, however, blurred by the economic-substance references contained in different parts of OECD Guidelines Chapter I. More in specific: The economic-substance exception – the application of which clearly amounts to a restricted structural adjustment – applies if the "*economic substance*" of a controlled transaction differs from its form.[3] At the outset one would therefore expect that in all cases where a discrepancy between form and economic substance exists and, as a result, the controlled transaction is re-characterised in accordance with its economic substance, this would amount to a structural adjustment which is restricted by OECD Guidelines para 1.36. As a corollary one would also except that such a re-characterisation is not a matter of establishing the "*conditions (...) made or imposed*" in the controlled transaction.

However, in addition to using the phrase "*economic substance*" in their subsection on recognition of the actual transactions undertaken[4], the OECD Guidelines also use the phrase in their subsection on the comparability analysis[5]. Due to this, the issue arises whether the phrase "*economic substance*" is used with the same meaning in both subsections and, if not, what is the difference.

A careful analysis reveals that the subsection on the comparability analysis uses the phrase "*economic substance*" partly with a different meaning than and partly with the same meaning as the subsection on recognition of the actual transactions undertaken. More in specific, such an analysis reveals that the OECD Guidelines' notion of "*economic substance*" has two, distinctly different prongs. These prongs are as follows:

i) <u>The factual-substance prong:</u> This prong is dealt with in OECD Guidelines para 1.26 as well as in their paras 1.28-1.29. Under this prong, discrepancies between the associated enterprises' written contracts (or other written material purportedly establishing the conditions of the controlled transaction) and the enterprises' actual conduct are examined. Under this prong, if such a discrepancy exists, the associated enterprises' actual conduct is deemed to express the actual conditions made or

[3] See OECD Guidelines para 1.37.

[4] See OECD Guidelines Chapter I(C)(ii).

[5] See OECD Guidelines Chapter I(C)(i).

imposed between them. Further, this prong pertains to the issue of *establishing* the "*conditions (...) made or imposed*" in the controlled transaction.

ii) The arm's-length prong: This prong is dealt with in OECD Guidelines paras 1.27 and 1.37. Under this prong, discrepancies between the form of the controlled transaction and the form which independent enterprises would have adopted are examined. Under this prong, if such a discrepancy exists, a tax administration may be authorised to substitute the actual form of the controlled transaction with the form which independent parties would have adopted. Further, under this prong, the form which independent parties would have adopted is – somewhat unconventionally – referred to as the "*economic substance*" of the controlled transaction. Further, this prong pertains to the issue of *restructuring* the "*conditions (...) made or imposed*" in the controlled transaction.

The proposition that OECD Guidelines paras 1.26, 1.28 and 1.29 at the one hand and para 1.27 at the other concern qualitatively different issues is in fact recognised by Note No 1 of the Discussion Draft, which deals with the former paragraphs in its section A and the latter paragraph in its section B.

2.3 Adjustments under the factual-substance prong is not restricted by OECD Guidelines para 1.36

The distinction between the factual-substance prong and the arm's-length prong is crucial to the present context; only adjustments under the former prong concerns the process of *establishing* the conditions of the controlled transaction which is not restricted by OECD Guidelines para 1.36.

The proposition that the phrase "*the transaction actually undertaken by the associated enterprises*" in OECD Guidelines para 1.36 refers to the transaction as expressed by the associated enterprises' actual conduct if the conduct differs from their written agreement (or other written material) finds support within the OECD Guidelines themselves. First, literally, it is inappropriate to characterise a transaction which is described in a written agreement (or other written material), but which is not implemented in real life, as a transaction which is "*actually undertaken*". Thus, the proposition is supported by the wording of OECD Guidelines para 1.36 itself.

Second, OECD Guidelines para 1.51 points out that the "[s]*ubsequent conduct by the parties* [to a controlled transaction] *will (...) be relevant in ascertaining the* ***actual terms and conditions*** *that operate between the parties*" (**bold** added). Hence, this paragraph clearly suggests that the conduct of the parties will express the "*actual terms and conditions*" of the controlled transaction if the conduct differs from the written agreement (or other written material) previously drawn up. The Discussion Draft uses the same terminology.[6]

Third, the rationale of the restriction established by OECD Guidelines para 1.36 does not suggest that there should be any particular restrictions on the authority to make

[6] See Discussion Draft para 24.

adjustments under the factual-substance prong. This rationale, which is expressed in the last sentence of para 1.36, see *infra* subsection 3.4.2, is the fear that restricted structural adjustments of controlled transactions would be a wholly arbitrary exercise which may trigger double taxation. It is reasonable to assume that the reason why the Guidelines fear that restricted structural adjustments may amount to a wholly arbitrary exercise is the difficulties of establishing whether independent parties would have adopted a different transaction structure than the associated enterprises and, if so, which transaction structure independent enterprises would have adopted. The point of reference for an adjustment under the factual-substance prong is, however, the associated enterprises' *own* conduct, not the transaction structures independent enterprises would have adopted. Generally, the actual conduct of the associated enterprises is far easier to establish than the (actual or hypothetical) conduct of independent enterprises. Further, it is within the power of the associated enterprises themselves to provide evidence as to how they have actually conducted their business operations. In sum, the risk that an adjustment under the factual-substance prong would amount to a wholly arbitrary exercise is not particularly pressing.

2.4 The Discussion Draft's characterisation of adjustments under the factual-substance prong

Note No 4 of the Discussion Draft provides as follows in its para 199:

> *Paragraphs 1.26 to 1.29 of the TP Guidelines provide guidance on the possibility for a tax administration to challenge* ***non-arm's length*** *contractual terms* (**bold** added).

As would follow from the above comments, this statement is not correct insofar paras 1.26 and 1.28-1.29 are concerned. To be more precise: First, fitted into the terminology used by Art 9 (1) OECD, paras 1.26 and 1.28-1.29 are concerned with the issue of which "*conditions are made or imposed between the two* [associated] *enterprises in their commercial or financial relations*", not with the issue of whether these conditions "*differ from those which would be made between independent enterprises*". Thus, the paragraphs concern the process of *establishing* the conditions of the controlled transaction, not the issue of *testing* and, possibly, *adjusting* these conditions under the arm's length principle.

Second, even if a discrepancy between them exists, it may very well be that both the conditions expressed in the associated enterprises' written agreement and the conditions expressed by their actual conduct would have been made between independent enterprises. The point of paras 1.26 and 1.28-1.29 is simply not to examine whether the associated enterprises have behaved differently from independent enterprises, but rather to examine how they have behaved themselves. It is therefore not appropriate to characterise the terms examined under these paragraph as "*non-arm's length contractual terms*".

Third, whereas the reason why associated enterprises do not conform to their written agreements may be the community of interest existing between them, the OECD Guidelines' approach is not to address discrepancies between written terms and actual conduct through application of the arm's length principle. As pointed out by OECD Guidelines para 1.29, independent enterprises ordinarily conform to the terms of their written agreements. If discrepancies between written terms and actual conduct should

have been dealt with under the arm's-length principle this would therefore imply that associated enterprises should be deemed to have conformed to their written agreements (as independent parties do) even if they have actually not. This is, however, clearly not the approach adopted by the OECD Guidelines. Rather, the Guidelines (para 1.29) state that if "*the parties' conduct indicates that the contractual terms have not been followed or are a sham (...) further analysis is required to determine the true terms of the transaction*".[7]

2.5 Proposals

Based on the above comments, I propose as follows:

i) The Discussion Draft should more explicitly distinguish between the process of *establishing* and the process of *restructuring* "*the transaction actually undertaken by the associated enterprises as it has been structured by them*" as referred to in OECD Guidelines para 1.36.

ii) The Discussion Draft should explicitly state that adjustments under the factual-substance prong, i.e. the disregard of written conditions not actually conformed to, is merely a matter of establishing "*the transaction actually undertaken by the associated enterprises as it has been structured by them*" and is therefore not restricted by OECD Guidelines para 1.36.

iii) The statement in paragraph 199 of the Discussion Draft commented upon above should be changed. The paragraph should not characterise the terms examined under OECD Guidelines paras 1.26 and 1.28-1.29 as "***non-arm's length** contractual terms*" (**bold** added).

The proposed changes will, as I see it, remove ambiguity and ease the process of distinguishing the issues which are really controversial and difficult from those which are not.

3 The Commented Proposal's relationship to the existing guidance provided by the OECD material

3.1 Introduction

The Commented Proposal[8] draws up a distinction between structural adjustments which *do* and those which *do not* result in a change in the "*fundamental nature*" of the examined controlled transaction. The Commented Proposal suggests that OECD Guidelines para 1.36 should be interpreted so as only to restrict the former category of structural adjustments. As pointed out *supra* subsection 1.1 the Commented Proposal implies that the line of action restricted by OECD Guidelines para 1.36 is defined so narrowly that the restriction inherent in this paragraph is deprived of much of its force and that the paragraph is devoid of much of its meaning.

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[7] Replicated in the Discussion Draft para 26.

[8] See Discussion Draft para 201. Accord Discussion Draft para 39.

The purpose of this main section is to substantiate the above proposition that the Commented Proposal is not in line with the existing guidance provided by the OECD material. This point is of crucial importance, having in mind that Note No 4 of the Discussion Draft declare that it "*does not attempt to propose any amendments to the existing guidance other than clarification of said existing guidance*"[9].

3.2 The wording of Art 9 (1) OECD MTC

As OECD Guidelines para 1.36 amounts to an interpretation of the authoritative statement of the arm's length principle contained in Art 9 (1) OECD MTC, it is of interest to consider whether the Commented Proposal is supported by the wording of Art 9 (1). It can swiftly be concluded that the wording of Art 9 (1) does not provide any support for the proposition that structural adjustments resulting in a change in the "*fundamental nature*" of the examined controlled transaction should be more restricted than structural adjustments which do not lead to such a change. The Commented Proposal is therefore not supported by the wording of Art 9 (1).

3.3 The OECD 1979 Transfer Pricing Report

OECD Guidelines para 1.36 is the successor of paras 15 and 23 of the OECD report "*Transfer Pricing and Multinational Enterprises*" published in 1979 (the "**OECD 1979 Transfer Pricing Report**"). Paragraph 23 of the OECD 1979 Transfer Pricing Report stated as follows:

> *In general, the approach which is adopted in this report to the adjustment of transfer prices for tax purposes is to* ***recognise the actual transactions*** *as the starting point for the tax assessment and not, in other than exceptional cases, to disregard them or substitute other transactions for them. The aim in short is, for tax purposes, to* ***adjust the price*** *for the actual transaction to an arm's length price* (**bold** added).

The paragraph drew up a distinction between adjustments of the price conditions and adjustment of other elements of controlled transactions; the former type of adjustment was the norm, whereas the latter type was the exception. The paragraph did not provide any support for the proposition that only structural adjustments resulting in a change in the "*fundamental nature*" of the examined controlled transaction should be restricted. The Commented Proposal is, thus, not in accordance with the traditional understanding of what would amount to a restricted structural adjustment. True, the OECD Guidelines (see, in particular, their para 1.37) more explicitly than the OECD 1979 Transfer Pricing Report acknowledge the authority to undertake restricted structural adjustments. However, this does not imply that the notion of restricted structural adjustments itself has changed. The distinction drawn up by the OECD 1979 Transfer Pricing Report therefore remains valid.

3.4 The OECD Guidelines

[9] See Discussion Draft para 194.

3.4.1 Paragraph 1.36 first sentence

OECD Guidelines para 1.36 first sentence provides that a tax administration's examination of a controlled transaction ordinarily should be based on the transaction actually undertaken by the associated enterprises "*as it has been structured by them*". What is to be recognised under the paragraph is, thus, the "*structure*" of the controlled transaction, as opposed to the valuation of the property or service transferred in the controlled transaction. The wording of the paragraph neither provide any support for the proposition that only "*core elements*"[10] of the structure should be recognised nor for the proposition that only adjustment of the structure changing the "*fundamental nature*" of the examined controlled transaction should be restricted. Rather, the wording suggests that any element of the "*structure*" of the controlled transaction should be recognised. The Commented Proposal is, thus, not supported by the wording of OECD Guidelines para 1.36 first sentence.

3.4.2 Paragraph 1.36 third sentence

The rationale of the principle established in OECD Guidelines para 1.36 first and second sentence is provided in the third sentence of the paragraph, which reads as follows:

> *Restructuring of legitimate business transactions would be a wholly arbitrary exercise the inequity of which could be compounded by double taxation created where the other tax administration does not share the same views as to how the transaction should be structured.*

The stated rationale does not provide support for the proposition that OECD Guidelines para 1.36 should be interpreted so as only to restrict structural adjustments leading to a change in the "*fundamental nature*" of the examined controlled transaction. As already pointed out *supra* subsection 2.3, it is reasonable to assume that the reason why the Guidelines fear that restricted structural adjustments may amount to a wholly arbitrary exercise is the difficulties of establishing whether independent parties would have adopted a different transaction structure than the associated enterprises and, if so, which transaction structure independent enterprises would have adopted. The extent of these difficulties are not likely to differ depending on whether independent enterprises would have adopted a transaction with a fundamentally different nature than the one adopted by the independent enterprises or whether they would have adopted a transaction of a similar nature, but nevertheless with a different structure. Rather, the difficulties of determining how independent parties would have behaved are likely to be equally present in both situations.

It should also be mentioned that structural adjustments changing the "*fundamental nature*" of an examined controlled transaction will not necessarily have a larger impact on a taxpayer's profits than structural adjustments not changing its "*fundamental nature*". E.g., the disregard of the associated enterprises' allocation of a risk factor may have a significant impact on the arm's length price as well as the profits realised by the party actually allocated the risk and the party to which the risk is re-allocated (depending on

[10] See Discussion Draft para 39.

whether the risk materialises or not). As a consequence, structural adjustments not changing the "*fundamental nature*" of a controlled transaction may also result in heavy double taxation if the other tax administration does not share the same views as to how the transaction should be structured.

Under any circumstance, the reason why structural adjustments are restricted by OECD Guidelines para 1.36 is not that such adjustments would lead to particularly high profit adjustments; if the aim was to restrict adjustments under the arm's length principle leading to particularly high profit adjustments the Guidelines should also have restricted the authority to undertake mere valuation adjustments (e.g. pure price adjustments) which lead to particularly high profit adjustments. The Guidelines do, however, not impose such a restriction.

The Commented Proposal is, thus, not in line with the stated rationale of OECD Guidelines para 1.36.

3.4.3 OECD Guidelines para 1.37: the example on the application of the second circumstance

The example accompanying the second circumstance discussed in OECD Guidelines para 1.37 refers to a sale under a long-term contract, for a lump sum payment, of unlimited entitlement to the intellectual property rights arising as a result of the transferor's future research for the term of the contract. The example states that in such a case

> *(…) it would (…) be appropriate for a tax administration to* ***conform*** *the terms of that transfer* ***in their entirety*** *(and* ***not simply by reference to pricing (…)*** (**bold** added).

As apparent from its wording, according to the example the type of adjustment authorised by the second circumstance is distinguished from conforming the terms of a transfer "*simply by reference to pricing*". The example, thus, supports the proposition that other types of adjustments than valuation adjustments (such as pricing adjustments) are restricted by OECD Guidelines para 1.36.

3.4.4 Paragraph 1.41

OECD Guidelines para 1.41 illustrates, by means of using an example, the difference between restructuring the examined controlled transaction which, as pointed out by the paragraph, generally is inappropriate, and using alternatively structured transactions as comparable uncontrolled transactions. Under the facts of the example a distributor accepts all currency risk associated with the purchase of goods from a related manufacturer, whereas manufacturers assume the currency risk in similar uncontrolled transactions. According to the paragraph, the fact that the examined controlled transaction is structured different from similar uncontrolled transactions does not as such authorise a domestic tax administration to restructure the risk-allocation:

> *In such a case, the tax administration* ***should not disregard*** *the controlled taxpayer's purported assignment of risk* ***unless there is good reason to doubt the economic substance*** *of the controlled distributor's assumption of currency risk* (**bold** added).

What is of interest to the present context is that the example clearly presupposes that the authority to restructure the actual allocation of currency risk is restricted by OECD Guidelines para 1.36 (while recognising that the allocation could potentially be restructured based on the economic-substance exception). Importantly, the example suggests that OECD Guidelines para 1.36 would always restrict the restructuring of the actual allocation of currency risk; it does not provide any support for the proposition that para 1.36 would only restrict the restructuring if it results in a change in the "*fundamental nature*" of the sale-of-goods transaction. Further, it is not easy to envisage that the restructuring of the currency-risk allocation in a sale-of-goods transaction would ever lead to a change of its "*fundamental nature*". Yet, the Guidelines still suggest that OECD Guidelines para 1.36 restrict the authority to undertake such an adjustment. Paragraph 1.41 of the OECD Guidelines therefore strongly oppose the proposition that OECD Guidelines para 1.36 only restrict the authority to undertake structural adjustments leading to a change in the "*fundamental nature*" of the controlled transaction.

3.5 Other OECD publications

Section B of Note No 1 of the Discussion Draft discusses the determination of whether the contractual terms provide for an arm's-length allocation of risks. As a factor which can assist this determination, the Note refers to the fact that an independent party's willingness to assume a risk may be influenced by its anticipated capacity to bear that risk.[11] Apparently, the Discussion Draft does not interpret OECD Guidelines para 1.36 so as to restrict the authority to restructure a risk-allocation because the risk-assuming party is not financially capable of bearing the risk. Presumably, the reason for adopting this interpretation is that the re-allocation of the risk will (normally) not change the "*fundamental nature*" of the controlled transaction.

However, in an earlier OECD publication addressing the interpretation of OECD Guidelines para 1.36 *et seq – i.e.* "*The Taxation of Global Trading of Financial Instruments*" published in 1998 – a different view was expressed. With a footnote reference to OECD Guidelines para 1.36, this publication states that

> [t]*he Guidelines state that tax authorities normally should not disregard the actual transaction undertaken by the taxpayer or substitute other transactions for them,* [footnote omitted] ***for example, by substituting an alternative transaction with a different assumption of risk*** (**bold** added).[12]

Thus, the publication interpret OECD Guidelines para 1.36 so as to restrict the restructuring of the actual risk-allocation in general, not only if the restructuring leads to a change in the "*fundamental nature*" of the examined controlled transaction.

Further – and of specific relevance to the factor emphasised by the Discussion Draft (financial capacity) – the publication states, with a footnote reference to OECD Guidelines para 1.37, that

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[11] See Discussion Draft para 28.

[12] See "*The Taxation of Global Trading of Financial Instruments*" para 123.

> [a]*n exception would be permitted only if an examination revealed that the economic substance of the transaction differed from its form – i.e. in the above example* ***the party stated to be assuming the risk was unable to do so because it had insufficient capital*** *– or if the "arrangements made in relation to the transaction, viewed in their totality, differ from those which 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."* (**bold** added).[13]

This publication, thus, views the restructuring of a risk-allocation because the risk-assuming party is not financially capable of bearing the risk as a matter of applying the economic-substance exception. As a result, the publication also interpret OECD Guidelines para 1.36 so as to restrict the authority to perform such a restructuring.

The presently discussed OECD publication, thus, suggests that the Commented Proposal does not cohere with the OECD Guidelines. It also suggests, unlike the Discussion Draft, that OECD Guidelines para 1.36 restrict the authority to restructure a risk-allocation because the risk-assuming party is not financially capable of bearing the risk.

3.6 Summary

The above comments substantiates that the Commented Proposal is not in line with, but rather amounts to a significant departure from, the existing guidance provided by the OECD material; the existing guidance does not support the proposition that OECD Guidelines para 1.36 only restricts structural adjustments resulting in a change in the "*fundamental nature*" of the examined controlled transaction. Therefore, and contrary to the Discussion Draft para 194, the Commented Proposal cannot reasonably be characterised as a "*clarification of* (…) [the] *existing guidance*" provided by the OECD Guidelines. Rather, if adopted the Commented Proposal would amount to an "*amendment*[ ] *to the existing guidance*".

3.7 Proposals

Based on the above comments, I propose as follows:

i) The Commented Proposal[14] should not be adopted.

ii) The Discussion Draft should maintain the traditional distinction between valuation adjustments and restricted structural adjustments. This distinction implies that the adjustments not restricted by OECD Guidelines para 1.36 are adjustments of conditions of controlled transactions which intend to estimate the value of the property or service transferred in the controlled transaction, in particular the conditions examined under the transfer pricing methods outlined by the OECD Guidelines, i.e. prices in a wide sense (whether stipulated as an absolute monetary amount, as a royalty rate, as an interest rate or otherwise), gross margins, net margins

[13] See "*The Taxation of Global Trading of Financial Instruments*" para 123.

[14] See Discussion Draft para 201. Accord Discussion Draft para 39.

and profits. Adjustments of other types of conditions of controlled transactions are restricted by OECD Guidelines para 1.36, including conditions establishing the allocation of functions and risks and conditions stipulating the nature, quality and quantity of the property or service transferred in the controlled transaction.

4 Policy considerations

4.1 Introduction

There are also a number of policy considerations suggesting that the Commented Proposal should not be adopted. The purpose of the present main section is to present these policy considerations.

4.2 The Commented Proposal is not supported by the stated rationale of OECD Guidelines para 1.36

As substantiated *supra* subsection 3.4.2, the Commented Proposal is not supported by the stated rationale of OECD Guidelines para 1.36 (as expressed in the paragraph's third sentence). Whereas this supports the conclusion that the Commented Proposal *is not* in line with the existing guidance provided by the OECD material, it also serves as a reason why the Commented Proposal *should not* be adopted.

4.3 The Commented Proposal lacks a *rationale*

The Discussion Draft does not provide a rationale for adopting a distinction between structural adjustments leading to a change in the "*fundamental nature*" of the controlled transaction and structural adjustments which do not lead to such a change. The Discussion Draft merely provides that

> [i]*n practice transfer pricing adjustments consist in adjustments of the profits of an enterprise attributable to adjustments to the price and / or other conditions of a controlled transaction (e.g. payment terms or allocation of risks). This does not mean that all transfer pricing adjustments, whether involving an adjustment only to the price or also (or alternatively) to other conditions of a controlled transaction, or as a result of evaluating separately transactions which are presented as a package in accordance to the guidance at paragraphs 1.43 and 6.18 of the TP Guidelines, should be viewed as consisting in the non-recognition of a controlled transaction under paragraphs 1.36 – 1.41 of the TP Guidelines. In effect, such adjustments may result from the examination of comparability, see in particular paragraphs 1.15 and 1.26-1.29 of the TP Guidelines (and paragraph 38 above).*[15]

This statement brings about several remarks. First, very few interpreters of the Guidelines – if any – would suggest that OECD Guidelines para 1.36 restrict "*all transfer pricing adjustments*", even those "*involving an adjustment only to the price*". The statement concerning this is therefore superfluous and inclined to obscure what really is the issue. Second, whereas the "*examination of comparability*" can lead to adjustments under the

[15] See Discussion Draft para 198.

factual-substance prong if a written agreement is not actually conformed to, see *supra* subsection 2.3, the examination of comparability cannot lead to the disregard or substitution of the "*conditions (...)* [actually] *made or imposed*" in the controlled transaction; such a line of action would have to be based on an application of the arm's-length test.

In line with the fact that the Discussion Draft does not provide a rationale for the Commented Proposal it is also difficult to identify such a rationale. As substantiated *supra* subsection 3.4.2, the reasons for restricting the authority to undertake structural adjustments are equally present regardless of whether or not the adjustments leads to a change in the "*fundamental nature*" of the examined controlled transaction. The absence of a rationale for adopting the Commented Proposal suggests it should not be adopted.

It should be mentioned that the Canadian Transfer Pricing Memorandum which the Commented Proposal appears to be inspired by, see *supra* subsection 1.1, does also not provide a rationale for adopting the "*fundamental nature*" criterion. Therefore, there is no apparent reason why the Draft should be inspired by this Memorandum.

4.4 The Commented Proposal is ambiguous

The key criterion used by the Commented Proposal is whether a structural adjustment leads to a change in the "*fundamental nature*" of the examined controlled transaction.[16] The Commented Proposal does, however, not explain what the "*fundamental nature*" of a transaction *is*. The Commented Proposal is therefore ambiguous and may lead to a number of different interpretations, both by OECD Member countries and non-Member countries adhering to the OECD Guidelines. Such differences in interpretation may lead to double taxation.

4.5 The Commented Proposal creates a difficult threshold-issue

Under the Commented Proposal a tax administration would be required to determine, before undertaking a restricted structural adjustment, whether the intended-to-be-undertaken adjustment would lead to a change in the "*fundamental nature*" of the examined controlled transaction, as its authority to undertake the adjustment would depend on the answer to this issue. Even if the Discussion Draft *had* provided a more detailed explanation of what is meant by the "*fundamental nature*" of a transaction, such a vague legal standard would still be vulnerable to individual interpretations. Due to this inherent ambiguity in the "*fundamental nature*" criterion, the above determination may prove to be a difficult one to perform. Further, and also due to the criterion's inherent ambiguity, the risk that two tax administrations will disagree on the application of the criterion to concrete factual situations is significant. The criterion itself may, therefore, give rise to double taxation if the tax administrations involved in a transfer pricing case disagree on whether the structural adjustment undertaken by one of the tax administrations has changed the "*fundamental nature*" of the examined controlled transaction.

[16] See Discussion Draft paras 39 and 201.

True, the traditional distinction between valuation adjustments and restricted structural adjustments, see *supra* subsection 3.7 proposal (ii), also creates a threshold-issue. However, the traditional distinction is far more intuitive than the distinction inherent in the Commented Proposal. Also, the traditional distinction is less ambiguous and therefore less vulnerable to individual interpretations and resulting double taxation.

4.6 The Commented Proposal has far-reaching consequences outside the area of business restructurings

Note No 4 of the Discussion Draft aims at discussing some important notions in relation to the application of the existing guidance found in the OECD Guidelines' subsection on recognition of the actual transactions undertaken[17] in the context of business restructurings.[18] The Discussion Draft, however, also states that it

> *(…) starts from the premise that the arm's length principle and the TP Guidelines do not and should not apply differently to restructurings or post-restructuring transactions than to transactions that were structured as such from the beginning.*[19]

Consequently, whereas the Commented Proposal is advanced in the context of business restructurings, it will, if adopted, provide general guidance as to the interpretation of OECD Guidelines para 1.36. As a result, if the Commented Proposal is adopted, OECD Guidelines para 1.36 would only restrict structural adjustments leading to a change in the "*fundamental nature*" of a controlled transaction in context of business restructurings as well as in the context of any other type of controlled transaction (sale of goods, provision of services, transfers of intangibles, cost contribution agreements, financial transactions and so on).

Depending on how narrowly the criterion "*fundamental nature*" is interpreted by domestic tax administrations, the Commented Proposal may trigger structural adjustments of a variety of contractual conditions (other than those estimating the value of the transferred property or services), including

i) conditions allocating functions between the parties,

ii) conditions allocating risks between the parties,

iii) conditions stipulating the quality, quantity and nature of the transferred property or service,

iv) conditions stipulating the duration of the controlled contractual relationship,

v) conditions establishing warranties (e.g. should the transferee purchase a regular or an extended warranty?),

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[17] OECD Guidelines Chapter I(C)(ii).

[18] See Discussion Draft para 194.

[19] See Discussion Draft para 16. See also Discussion Draft para 11.

vi) credit- and payment conditions, and

vii) conditions establishing the governing law of the contract.

Hence, the Commented Proposal will greatly increase the number of issues on which domestic tax administrations may potentially disagree and therefore significantly increase the risk of double taxation as well as the administrative burden on the part of domestic tax administrations (e.g. through an increase of mutual agreement procedures). If the "*fundamental nature*" criterion is interpreted narrowly, this would imply that valuation adjustments (of price, margins and profits) would only be one of many sub-categories of adjustments undertaken based on the arm's length principle. Such a regime would clearly differ markedly from the present-day regime.

4.7 The Commented Proposal creates an intermediate adjustment-category on which the OECD Guidelines provides little guidance

If the Commented Proposal is adopted, this would imply that there would be *three* main categories of adjustments under the arm's length principle:

i) Traditional valuation adjustments (e.g. of price, margins and profits)

ii) Structural adjustments not changing the "*fundamental nature*" of the controlled transaction.

iii) Structural adjustments changing the "*fundamental nature*" of the controlled transaction.

The OECD Guidelines primarily provides guidance on adjustment-category (i), whereas they provide some guidance on adjustment-category (iii) (in their subsection on recognition of the actual transactions undertaken). In contrast, the OECD Guidelines provides little guidance on the intermediate adjustment-category (ii). In particular, the transfer pricing methods outlined in the OECD Guidelines cannot be used to determine whether such adjustments are authorised, as these methods are neither aimed at or apt to examining other conditions than those estimating the value of the property or services transferred in the controlled transaction. Due to the lack of guidance, there is a risk that different countries – OECD Member countries as well non-Member countries – will adopt different criteria for determining whether an adjustment in adjustment-category (ii) is authorised. Such different criteria will ultimately result in double taxation.

4.8 Should structural adjustments not changing the "*fundamental nature*" of the controlled transaction be "*the norm*"?

In its para 205, Note No 4 of the Discussion Draft provides that

> [t]*he words "exceptional" or "exceptionally" at paragraphs 1.36 and 1.37 of the TP Guidelines indicate that the non-recognition of a transaction is* ***not the norm but an exception*** *to the general principle that a tax administration's examination of a controlled transaction ordinarily should be based on the transaction actually undertaken by the associated enterprises as it has been structured by them (…)* (**bold** added).

Under the Commented Proposal structural adjustments not changing the "*fundamental nature*" of the examined controlled transaction are not restricted by OECD Guidelines para 1.36 and, therefore, not subject to this "exceptionality-standard". Para 205 of the Discussion Draft therefore appears to suggest that such structural adjustments should be "*the norm*".

Such a regime raises several concerns. First, with no doubt such a regime would differ markedly from the present-day regime, under which structural adjustments are definitely not "*the norm*" whether or not they involve changes to the "*fundamental nature*" of controlled transactions. The introduction of such a regime would therefore imply a test-project, the consequences of which are highly uncertain. Second, a combination of structural adjustments not changing the "*fundamental nature*" being "*the norm*" and the lack of guidance on how such adjustments should be undertaken is dangerous, as the combination may trigger many cases of double taxation.

4.9 The Commented Proposal creates a strained distinction between OECD Guidelines para 1.27 and para 1.37

The OECD Guidelines' notion of "*economic substance*" has two, distinctly different prongs, see *supra* subsection 2.2. The second one of these prongs, the arm's-length prong, is dealt with in both para 1.27 and para 1.37 of the OECD Guidelines. Both of these paragraphs (i) addresses discrepancies between the form of the controlled transaction and the form which independent enterprises would have adopted and (ii) characterise this as a matter of establishing the "*economic substance*" of the controlled transaction or an element of it. Despite of this identity in the issue addressed and the terminology used by the paragraphs, the Discussion Draft suggests that para 1.27 does not address the same issue as para 1.37.

More in specific, section B of Note No 1 of the Discussion Draft addresses the determination of whether the contractual terms of the controlled transaction provide for an arm's-length allocation of risks. According to Note No 1, a (primary) factor which can assist this determination is the examination of which party(ies) control(s) the risk in question,[20] i.e. the factor addressed by OECD Guidelines para 1.27. What is of interest to the present context is that even if the actual allocation of a risk is restructured because the risk-assuming party does not control the risk, the Discussion Draft apparently do not view this as a re-characterisation of the form in accordance with its economic substance within the meaning of the economic-substance exception established by OECD Guidelines para 1.37.[21] Effectively, the Discussion Draft, thus, suggests that the arm's-length prong of the Guidelines' notion of economic substance has two sub-prongs, i.e. the sub-prong addressed in para 1.27 and the sub-prong addressed in para 1.37.

As I see it, the distinction drawn up between re-characterising the form in accordance with its substance within the meaning of para 1.27 and re-characterising the form in accordance with its substance within the meaning of para 1.37 is strained and remains

[20] See Discussion Draft, Note No 1, section B.1.

[21] Compare Discussion Draft para 38 second bullet point with para 39.

unexplained. Issues which should have been, but which are not, addressed include the following:

i) Is there a fundamental, substantive difference between re-characterising the form in accordance with its substance within the meaning of paras 1.27 and 1.37?

ii) If there is such a difference, what is its nature and which practical consequences does it have?

iii) Why should there be a fundamental distinction between re-characterising the form in accordance with its substance within the meaning of paras 1.27 and para 1.37?

iv) Would it really make any practical difference if the control-criterion referred to in para 1.27 had been a factor which should be emphasised in determining whether the economic-substance exception (established in para 1.37) can be applied rather than being a stand-alone criterion to be applied independent of the economic-substance exception? In concrete: if an associated enterprise has assumed a risk which it is unable to control and a similar risk allocation cannot be identified in contracts between unrelated parties, would a restructuring of the risk allocation only be authorised if the control criterion is a stand-alone criterion, but not if it is a factor to be emphasised in determining whether the economic-substance exception can be applied?

Regrettably, the Discussion Draft Note No 4 – exclusively addressing the recognition of the actual transactions undertaken – confines itself to address the commercial-rationality exception (the second circumstance referred to in OECD Guidelines para 1.37) and, thus, does not address the interpretation of the economic-substance exception (the first circumstance referred to in OECD Guidelines para 1.37). This is also somewhat surprising, as Note No 1 devotes considerable efforts on discussing the Guidelines' notion of "*economic substance*", thus suggesting that this is an important issue (which it is).

4.10 The aim pursued by the Commented Proposal can be achieved by other means

Apparently, the primary reason why the Commented Proposal suggests that OECD Guidelines para 1.36 should be interpreted narrowly as only restricting structural adjustments leading to a change in the "*fundamental nature*" of the controlled transaction is to allow for the restructuring of non-arm's length risk allocations. This is an important issue in the context of business restructurings and section B of Note No 1 of the Discussion Draft provides an in-depth analysis of this issue.

As I see it, Note No 1 adopts a sensible approach in suggesting that the risk-assuming party's ability to control and financial capacity to bear the risk is relevant to the determination of whether the actual risk-allocation would have been adopted by independent enterprises. However, the restructuring of the actual risk-allocation based on these factors could just as well be allowed for under the economic-substance exception established by OECD Guidelines para 1.37. There is, thus, no need to adopt the Commented Proposal in order to achieve the aim pursued by it.

True, the economic-substance exception should only be applied exceptionally. However, if the risk-assuming party's lacking ability to control the risk and lacking financial capacity to bear the risk is explicitly recognised as two sub-circumstances in which a re-characterisation of the actual risk-allocation under the economic-substance exception is authorised, the exception would authorise the restructuring of the actual risk-allocation if either of these sub-circumstances are in fact present. Also, if the Discussion Draft provides in-depth guidance on how to determine whether the restructuring of the actual risk-allocation is authorised in these two sub-circumstances, the risk of wholly arbitrary restructurings of the actual risk-allocation leading to double taxation (feared by OECD Guidelines para 1.36 third sentence) is strongly reduced.

For the sake of completeness it should also be pointed out that the Commented Proposal is not necessary in order to allow for adjustments under the factual-substance prong of the OECD Guidelines' notion of "economic substance" (i.e. adjustments based on OECD Guidelines paras 1.26, 1.28 and 1.29). If there is a discrepancy between the written terms of a controlled transaction and the associated enterprises' actual conduct, OECD Guidelines para 1.36 would not under any circumstance prevent a tax administration from deeming the actual conduct to express the "*conditions (...) made or imposed*" in the controlled transaction; this would merely be a matter of *establishing* the conditions of the controlled transaction, not of restructuring them based on the arm's length principle.

4.11 Proposals

Also the policy considerations presented in the present main section supports the proposals provided *supra* subsection 3.7. In addition, these policy considerations bring about the following proposals:

i) The Discussion Draft should acknowledge that the disregard of the associated enterprises' actual risk-allocation amounts to a structural adjustment restricted by OECD Guidelines para 1.36.

ii) The Discussion Draft should acknowledge that restructuring of the actual risk-allocation because the risk-assuming party lacks the ability to control the risk and/or lacks the financial capacity to bear the risk involves the application of the economic-substance exception established by OECD Guidelines para 1.37. These two factors should be listed as sub-circumstances in which a re-characterisation of the actual risk-allocation under the economic-substance exception is authorised.

5 Summary of proposals

For the sake of convenience, I summarise the proposals of the present comments:

i) The Discussion Draft should more explicitly distinguish between the process of *establishing* and the process of *restructuring* "*the transaction actually undertaken by the associated enterprises as it has been structured by them*" as referred to in OECD Guidelines para 1.36.

ii) The Discussion Draft should explicitly state that adjustments under the factual-substance prong, i.e. the disregard of written conditions not actually conformed to, is merely a matter of establishing "*the transaction actually undertaken by the associated*

enterprises as it has been structured by them" and is therefore not restricted by OECD Guidelines para 1.36.

iii) The statement in paragraph 199 of the Discussion Draft commented upon above should be changed. The paragraph should not characterise the terms examined under OECD Guidelines paras 1.26 and 1.28-1.29 as "***non-arm's length*** *contractual terms*" (**bold** added).

iv) The Commented Proposal[22] should not be adopted.

v) The Discussion Draft should maintain the traditional distinction between valuation adjustments and restricted structural adjustments. This distinction implies that the adjustments not restricted by OECD Guidelines para 1.36 are adjustments of conditions of controlled transactions which intend to estimate the value of the property or service transferred in the controlled transaction, in particular the conditions examined under the transfer pricing methods outlined by the OECD Guidelines, i.e. prices in a wide sense (whether stipulated as an absolute monetary amount, as a royalty rate, as an interest rate or otherwise), gross margins, net margins and profits. Adjustments of other types of conditions of controlled transactions are restricted by OECD Guidelines para 1.36, including conditions establishing the allocation of functions and risks and conditions stipulating the nature, quality and quantity of the property or service transferred in the controlled transaction.

vi) The Discussion Draft should acknowledge that the disregard of the associated enterprises' actual risk-allocation amounts to a structural adjustment restricted by OECD Guidelines para 1.36.

vii) The Discussion Draft should acknowledge that restructuring of the actual risk-allocation because the risk-assuming party lacks the ability to control the risk and/or lacks the financial capacity to bear the risk involves the application of the economic-substance exception established by OECD Guidelines para 1.37. These two factors should be listed as sub-circumstances in which a re-characterisation of the actual risk-allocation under the economic-substance exception is authorised.

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Best regards,

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[22] See Discussion Draft para 201. Accord Discussion Draft para 39.

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