International Tax Review,
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February 19 2009

Jeffrey Owens,
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Re: Discussion draft on the transfer pricing aspects of business restructuring

Dear Mr Owens,

International Tax Review, the leading publication for corporate tax executives at multinational companies around the world, held a one-day event on February 13 in London on the discussion draft on the transfer pricing aspects of business restructuring. The 107 speakers and delegates – tax directors, officials from tax administrations and advisers - came from the these countries in Europe, and the Americas: Belgium, Brazil, Canada, Denmark, France, Germany, Italy, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, UK and the US.

The conference consisted of a series of panels, keynote addresses and two discussion groups on the issues notes. Below are the comments from the discussion groups.

Discussion group 1 covered issues note 1: Special considerations for risks

- Section A of Issue Note One states:
  The allocation of risks between related parties, which is an essential part of the functional analysis, starts from a review of the contractual terms where they exist in writing.

  Section A 25 of Issue Note One states:
  It would be reasonable to expect related parties to document in writing their decisions to allocate or transfer risks before the transactions with respect to which the risks will be borne or transferred occur.

The focus on written requirements is unfair. What should count is evidence of agreement, in whatever form. Actual conduct conforms to the contractual allocation of risk is a logical requirement. Contractual allocation is at arm's length.

- Level of control depends on type of risk and type of organisation. This is not highlighted enough in the draft discussion.

  Section C of Issue Note One states:
  One important issue is to assess whether a risk – and, as a consequence, the transfer of that risk, where applicable – is economically significant. Not all the risks that a taxpayer bears or transfers to a related party have significant profit (or loss) potential attached to them, taking into account the size of the risk, the likelihood of its realisation and its predictability.

The requirement that risk should be economically significant is not correct; in essence it is more a transfer pricing issue (low economic significance, low remuneration) than a condition.

- The draft says that contracts are the starting points (see section A quote) however elsewhere the draft says that contracts are much more important than this. The draft presentation of the issues is too black and white. If there is no arm's length notice period can the contract be ignored? When can the authorities ignore the contractual obligations?

As a policy matter it is unlikely would want to be guided solely by contracts? Contracts should not determine the allocation of risks for pricing purposes. Providing contract reality is reflected on the ground, contracts should be respected.

- Previous guidance from the OECD says more control means more risk is acceptable. Section B1 of Issue Note One refers to 1.27 of the OECD Transfer Pricing Guidelines:
    > In arm's length dealings it generally makes sense for parties to be allocated a greater share of those risks over which they have relatively more control.

- The whole issue of control is too absolute in the draft. How companies control risk should be looked at. How does functional analysis come into play? The flaw with tax authorities is that they only interview one side in functional analysis.
- If you do not have people who exercise control where the profit goes there is a problem.
- It is not possible to manage risk on a functional basis. Where is relevant control to be allocated for tax purposes? Section B2 35 Issue Note One states:
    > The tax administration would examine the contractual terms between the parties and whether they have economic substance, determined by reference to the conduct of the parties, and are arm's length.
- Control is a relative concept, relative to type of risk and type of organisation. A comparison should be made with the more sophisticated concept of Key Entrepreneurial Risk Taking (KERT) and the Significant People Function (SPF) concept in the OECD report on profit attribution to permanent establishments
- The types of control include strategic control, taxable control and operational control. A subsidiary can be controlled centrally in a strict way compared to a subsidiary that has a large degree of independence in terms of decision making. Is there any difference if the subsidiaries change operations, considering the difference in the level of control exerted on the subsidiaries? It is operational control that should count. Strategic group-wide risk management should not play a role. If a local company changes business model does this represent a restructure?
- Control goes to where key decision makers are. It is a quality issue, not a quantitative one. The relocation of a key decision maker is risk transfer and therefore a business restructure. (Compare KERT/SPF concepts mentioned above).
- The report says that location of risks is determined by location of control. The risk in the report is that it will extend this notion. The question is whether control is decisive or just a factor.
- Arm's length risk at belongs to the party who controls it. Sometimes you have to accept risks you have no control over: this is not discussed in the draft document. For tax purposes the tax authorities will look at where control is exercised. However, there are differing types of control and this is not highlighted in the draft.

Issue of control.

In what type of circumstances does a risk allocation arise?.

- The discussion draft does not show what control actually means. In section B1 of Issue Note One, it states that
    > control should be understood as the capacity to make decisions to take on the risk (decision to put the capital at risk) and decisions on whether and how to manage the risk. This would require the company to have people who have the authority to perform these control functions. Thus, when one party bears a risk, the fact that it

hires another party to administer and monitor the risk on a day-today basis is not sufficient to transfer the risk to that other party.

The group agreed that control is not an absolute thing. Absence of control does not mean you cannot transfer risk. A change of control equals a change of risk. Thegroup felt that more work should be done in deciding how important control is.

- The group felt an area of control the OECD could look at is the profit allocation of permanent establishment to ensure compatibility (KERT/SPF).
- Factual control is an important factor but needs to be considered on a case by case basis.
- Concluding explicit and detailed contracts between related parties that mirror as much as possible contracts between unrelated parties equals protection. One needs to act consistently in accordance with contracts and think restructuring through in all logically related parties.
- If you transfer risk to a related party you have to show that the party can handle the risk (for example, financially); has the solvency to bear that risk.

  Overall, it was agreed that the OECD needs to clarify the notion of control, what is the difference between control in article nine of the model convention and in the discussion draft.

The second discussion group covered Issue Note 3: Remuneration of post-restructuring controlled transactions

- The document needs more clarity on what taxable events and assets are. Each should be more tightly defined. Some examples would assist.
- For an intangible to rank as an asset in this context, the intangible should be a legally existing right, that is,one capable of legal protection/enforcement (see further below regarding goodwill).
- Different treatments (by different tax authorities) of the interaction between the compensation for the restructuring and the remuneration of post-restructure transactions are likely to cause business restructurings to be subject to double taxation. It would be attractive for member states to agree that if the overall consideration for the restructuring and consequent future transactions could be regarded as an arm’s-length package (that is, what parties at arm’s length might have done, for example, a “high” price for the restructure but correspondingly high prices under a consequent long-term supply contract), then tax authorities should not attempt to interfere, for example, by reallocating the prices actually adopted between the restructure and the post-restructure transactions.
- More detailed consideration needs to be paid to the treatment of goodwill, that is, as regards the asset(s) it represents (see above: only legally extant/protectable assets should be capable of giving rise to exit charges).
- In general, employees (including their expertise) should not be classified as assets.
- While pricing method should not unthinkingly be regarded as determining risk, there needs to be a greater recognition of the effects of contractual allocations of functions, assets and risks: risk may indeed be allocated by contract (and in general would be at arm’s length).
- Notwithstanding the prior point (that is, without prejudice to the importance of bona fide contractual risk allocation being respected by tax authorities), businesses should not have to write contracts in the same degree of detail as parties involved in the arm’s-length principle.
- In relation to location savings, delegates were anxious that taxpayers might find themselves becoming boxed in when compared with their non-OECD counterparts, so after discussion it was felt that it would be dangerous for the discussion draft to become more elaborate in its illustration of examples.
- Delegates were concerned about exchange of information for multi-jurisdictional restructurings. They felt that to defend pricing, large amounts of private information will be passed to counterpart national tax authorities. This may lead to the authorities passing this information down their own treaty network. It was recommended that a limitation of benefits principle in relation to exchanges of information should be proposed in the discussion draft.

- Given the critical importance of comparability analysis, it is suggested that greater attention be paid to assessing just how competitive a market is and how will it evolve in the future.

We hope you will find these comments useful as you work towards producing guidance in this area. Delegates commended OECD staff, the joint working group and the business advisory group for their efforts in issuing the discussion draft.

If you require any further information about the conference discussions, please do not hesitate to contact the publication.

Yours sincerely,

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