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By E-Mail

Mr. Jeffrey Owens
Director
OECD Centre for
Tax Policy & Administration

Re: Discussion Draft on the Transfer Pricing Aspects of Business Restructurings (the "Discussion Draft")

Dear Mr. Owens,

Thank you once again for allowing the business community the opportunity to provide comments to the many important issues raised in applying transfer pricing principles to multinationals' inter-company transactions.

Introduction

1. One manifestation of the increased pace of commercial globalization is the frequency of worldwide business restructurings that has been observed in the last decade. The rate of mergers and acquisitions, divestitures, re-engineering of business processes, focus on cost efficiencies and the rise of developing markets, in particular China and India, are factors that have contributed to such worldwide business restructurings. In our experience such cross border restructurings have often been a result of, and in response to, commercial and market forces. Our experience has shown that tax motivated restructurings occur less frequently than may be feared. This may in part be due to the widespread adoption of transfer pricing legislation around the world and the pre-emptive effect such legislation has had on worldwide tax minimization planning. It is also in part due to the fact that in many cases the operational inefficiencies and obstacles are often too significant to justify maintaining a solely tax motivated structure.

2. One would question why business restructuring is singled out as an issue for transfer pricing purposes, requiring an entirely separate discussion draft paper on the subject. It would be expected that a business restructuring event, like any other inter-company transaction, would be subject to the normal transfer pricing rules and the application of the arm's length principle.

3. Where a business restructuring occurs, one would consider whether any assets have been disposed of in favour of a related company and if so, such disposition must be given an arm's length consideration. Following the restructuring, any post restructuring inter-company transactions that arise would also be subject to the same

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arm's length principle in determining appropriate transfer prices, as they would be if they were structured as such from the beginning.

4. The issue, then, that is specific to business restructuring situations appears to be whether there should be the recognition of a disposition of an asset (tangible or intangible) or other compensatory payment as a result of the business restructuring, which is discussed as Issue Note No. 2. The other issues, we believe, while valid as general transfer pricing issues, are not specific to business restructurings. The questions relating to risks (Issue Note No. 1) and remuneration of post-restructuring controlled transactions (Issue Note No. 3) are relevant to the application of transfer pricing principles, at large.

5. However, of particular concern to us is Issue Note No. 4, which contemplates recognition of the actual transactions undertaken in a business restructuring; in other words, whether the actual transaction should be disregarded or recharacterized by a tax administration. We are concerned that this issue of recharacterization will be given greater legitimacy in the context of business restructurings than it would otherwise be given in the normal course of business.

6. The concern is based on the suggestion that a business restructuring must meet a "commercially rational behaviour test" as outlined in paragraphs 207-213 of the Discussion Draft in order for the structure to be recognized. The Discussion Draft goes on further to state in paragraph 213:

   "...it is worth re-emphasizing that the arm's length principle treats the members of an MNE group as separate entities rather than as inseparable parts of a single unified business. As a consequence, it is not sufficient from a transfer pricing perspective that an arrangement make commercial sense for the group as a whole: the transaction must be at arm's length at the level of each individual taxpayer, taking account of its rights and other assets, expected benefits from the restructuring arrangement, and realistically available options."

7. These statements appear to lay the groundwork for the following positions that can have significant implications for the taxpayer where business restructuring occurs.

   - Taxpayers must demonstrate that the business restructuring is "commercially rational".
   - For a business restructuring to be considered commercially rational, "functions, assets and / or risks" must be transferred.
   - In addition, taxpayers must also demonstrate that it makes "commercial sense" for <u>each</u> entity that is implicated in the restructuring and not only for the group as a whole.

"Commercially Rational" Behaviour

8. It is our view that the way in which businesses are structured or how they operate should not be open to question by tax administrations for purposes of applying transfer pricing principles. We believe this to be the case without exception.

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9. While the OECD recognizes that MNEs are free to organize their affairs as they see fit and that recharacterization of MNE transactions, including business restructurings, should occur only in exceptional circumstances, we believe that the requirement to measure transactions against a standard of "commercially rational behaviour" opens the door to increased instances of recharacterization by tax administrations.

10. A standard of "commercially rational behaviour" is far too subjective and suggests that there is a normative commercial model that must be followed. This is, in our view, a flawed presumption. Commercial transactions may be structured in many ways and in fact are; the permutations and combinations of different types of transactions are endless. Moreover, it has often been seen that what may appear for one person to be an unreasonable price or transaction, could be seen as an opportunity for another[1]. Therefore, to suggest that taxpayers must follow a certain standard of commercial behaviour is an unrealistic proposition. Such requirement ignores the realities of actual commercial dealings and creates ambiguity and uncertainty in administering the arm's length principle. It is a dangerous proposition to allow tax administrations to second guess business decisions, often also with the benefit of hindsight.

11. In the context of business restructurings, we would re-iterate our previously stated hypothesis that restructurings that are solely tax motivated occur far less frequently than suggested. In that regard, it is likely that the business restructurings that could legitimately be challenged by the "commercially rational behaviour" test would rarely occur and the benefit that would be obtained by subjecting these types of restructurings to this test would be far less than the overall cost to taxpayers of complying with such a standard.

12. In the instances when a restructuring is undertaken for tax motivated purposes, we believe that such transactions should be subject to domestic anti-avoidance legislation, rather than broad transfer pricing principles. It is our opinion that the arm's length principle can be enforced through a pricing adjustment and tax administrations do not have to resort to recharacterizing a structure or transaction chosen by the taxpayer.

Separate Entity versus Single Unified Business

13. One by-product of applying the arm's length principle is the creation of a fictitious arrangement for a related group transacting *as if* they were dealing at arm's length. Because the parties are not actually dealing at arm's length, we are required to make certain assumptions about the transaction between members of the MNE to create this arm's length scenario. The question is: to what extent should the arm's length fiction be applied?

14. The best way to illustrate this dilemma is by way of an example.

    Co. S is a wholly owned subsidiary of Co. P. Co. S operates as a contract manufacturer for Co. P. The arrangement, like most vertically integrated MNE operations, is exclusive on both sides. Co. S is the exclusive manufacturer for Co. P and Co. P is the sole client of Co. S. Co. P has determined that it will be more cost

[1] We would point to the market for junk bonds and sub-prime mortgages as such an example. These are high risk investments that would not be financed under "normal" commercial terms by "rational" investors, requiring a significant premium to obtain financing. The existence of these types of markets (for junk bonds or sub-prime mortgages) suggests that there are those that believe given the right price, any transaction, even one that most people would regard as irrational, could be entered into.

efficient to have manufacturing outsourced to an unrelated lower cost manufacturer. As a result, Co. P terminates the contract manufacturing arrangement with Co. S.

15. Under the arm's length fiction, are we to give recognition to the fact that Co. S has only one customer, which is Co. P; or do we assume that Co. S, as an arm's length entity, may have diversified its client base and acquired other customer contracts? In reality, there are situations where suppliers / customers are economically dependent on a small number of customers / suppliers and accordingly, the economically dependent nature of the relationship that is between Co. S and Co. P is not exclusive to related party situations. The issue of economic dependence gives rise to the question of which party has greater relative bargaining power in this arrangement. In reality, in MNE situations it is usually the parent company that has the greater bargaining power simply by virtue of it being the parent company and directing the operations of the group. If applying the arm's length principle tells us to ignore this factual relationship, and instead recreate a hypothetical arm's length scenario, what arm's length scenario should apply: one where the customer or the supplier has greater bargaining power? We question the basis of either assumption and we submit that any situation other than the reality is arbitrary and unjustified.

16. The separate entity approach requires us to evaluate a business restructuring from all sides. In doing so, we are asked to examine whether it makes commercial sense for all parties and that all parties have considered "realistically available options". Besides the fundamental issue of what constitutes "commercial sense", as discussed above, if we are to interpret "commercial sense" as commercially beneficial, we believe that this test would fail in many business restructuring situations for at least one of the parties. For instance, in the above example, where the manufacturing activity is re-located because of cost competition, the incumbent manufacturer would not benefit from this restructuring decision and it would not make commercial sense for that party to accept the restructuring, although it is commercially beneficial for Co. P and the entire MNE group.

17. The requirement to demonstrate that all parties to the restructuring have assessed "realistically available options" is ambiguous. In reality, there are many instances of the unilateral termination of a contractual arrangement between parties dealing at arm's length. Many contracts provide for termination upon notice and do not necessarily require any compensation for such termination. On the other hand, even where contracts are terminated, as may be permitted under the contractual terms, parties may choose to take legal action to obtain compensatory damages caused by the termination. Under the OECD approach to evaluating business restructurings, would we be required to consider one of the "realistically available options" of Co. S to be a demand for compensation for the restructuring? To do so would be taking the application of the arm's length principle to an unreasonable extreme and this is likely not what is contemplated under the OECD Guidelines, but which could very well be the result of an interpretation by a tax administration.

18. The example in paragraph 68 of the Discussion Draft asks us to "assume that, based on its rights under the long term contract with respect to these transactions, it [the restructured entity] has the option realistically available to it to accept or refuse being converted into a low risk distributor..." It would be worthwhile for the OECD to provide more specific examples of what types of rights would allow a distributor within a multi-national group to consider options other than those which have been decided by the parent company for restructuring purposes.

19. Our view is that it is unnecessary to evaluate the "realistically available options" or to evaluate whether the business restructurings make commercial sense, either for each entity or as a group. Such guidance can only lead to further ambiguity and differences of interpretation given the subjective nature of such an exercise.

20. We submit that the starting point in evaluating a business restructuring is the evaluation of the contractual arrangement of the parties, both in its legal form as well as its legal substance (i.e. whether the parties have acted consistently with the legal terms of the arrangement). In our above example, if the contract between Co. S and Co. P provides for termination with notice, without any further compensation, then Co. P should be permitted to exercise this right without any further evaluation of the merits of this business restructuring. Apart from the issue of the contractual terms, if Co. S, in providing such manufacturing service has developed certain know-how or other intellectual property that it transfers to the new manufacturer, then such transfer would warrant a disposition for which Co. S should be remunerated. This transfer would be a result of the business restructuring as structured by the taxpayer and recognizing such transfer is a question of fact, which does not require us to make further assumptions or create hypothetical scenarios of alternative ways in which parties dealing at arm's length would act.

Transfer of Functions, Assets and Risks

21. Another cornerstone of the transfer pricing principles as they relate to business restructuring appears to be the requirement to transfer functions, assets and / or risks as indicia of the occurrence of a restructuring. We address the specific questions related to risks in the following paragraphs, in particular with regard to the notion of control in the context of paragraph 1.27 of the OECD Guidelines.

22. The Discussion Draft appears to suggest that a bona fide commercially driven restructuring has occurred where there has been a "transfer of functions, assets and/or risks with associated profit/loss potential between associated enterprises." In Paragraph 30 of the Discussion Draft the OECD presents its view that "control should be understood as the capacity to make decisions to take on the risk (i.e. the decision to put capital at risk) and decisions on whether and how to manage the risk, internally or using an external provider".

23. We believe that the question of "control" as it pertains to business restructuring situations stems from whether the transferor has truly relinquished "control" of said function, asset and/or risk to the transferee. In our view, there are two factors which constitute "control": first, whether the entity has the *capacity* to undertake the requisite decision making in regards to the transferred activity; and secondly, which entity *bears the cost* associated with the transferred function, asset and/or risk.

24. The first factor pertaining to the capacity to undertake decision making can be manifested both in the actual functions carried out by persons (e.g. employees, agents, directors) on behalf of the entity or in the decisions made by the "mind and management" of the corporation, as embodied in the decisions made by the board of directors of a corporation.

25. The question arises as to whether a "shell company" consisting only of a board of directors can be considered to have the "capacity" to undertake decisions that ultimately control functions, assets and / or risks attributed to that entity. The corollary to this issue is: whether a company with no employees of its own can outsource the

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required functions to acquire the capabilities needed to exercise this control; and whether the acceptance of advice and recommendations by the board of directors from outsourced service providers is insufficient in demonstrating that it has exercised its own decision making powers. In other words, it has been suggested by some tax administrations that a board of directors of a shell company that simply accepts directives from the parent company is not factually the "mind and management" of that company and therefore does not effectively control that company. Therefore, if an entity were to "outsource" strategic management functions to a related company and acted on the consultation received from this service, would the associated function or risk be considered not to have been transferred?

26. Our view is that the exercise of mind and management of an entity and the decisions made by the board of directors can not be negated simply because the consultation and advice functions to arrive at these decisions are outsourced. If we choose to ignore the role of the board of directors as the embodiment of a corporation's ability to exercise control over its affairs and if instead we attempt to determine which party has "effective" control by its ability to influence the board of directors' decisions, then taking this reasoning to an extreme we could argue that the parent company "effectively" controls all the subsidiaries in an MNE group and we could never give recognition to the subsidiary's assumption of any function, asset or risk.

27. The second factor that manifests control is the assumption of costs related to the function, asset or risk in question. Cost can relate both to the actual cost to perform the function, acquire the asset or assume the risk or the cost of any consequences arising as a result of performing the function, owning the asset or assuming the risk. For example, a company can bear the cost of assuming credit risk; it may bear costs related to engaging employees to manage the credit function and collect receivables. It will also bear the costs relating to actual bad debt. Alternatively, the entity may not actually undertake the functions relating to extending credit and collecting receivables; such functions may be outsourced to a factoring company, but the entity will bear the costs associated with selling its receivables to the factoring company (i.e. collecting less than the face amount of the receivables).

28. We are of the opinion that the legal substance[2] of an arrangement should prevail in determining whether a function, asset and / or risk has been transferred. We question whether the manifestation of control is in fact relevant to the determination of whether a function, asset or risk has been transferred. In other words, if we accept that every company must have directors that assume responsibility and act on behalf of that company, even a "shell" company, then there must always be a manifestation of control over the assets and risks of the company through the oversight and decision making role of the directors. Unless it is suggested that the directors are merely an agent for the parent company and do not act of their own accord, then it must be recognized that every corporation has control over its assets and risks that have been legally transferred or assigned to it.

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[2] For greater certainty, the term "legal substance" refers to both the legal form (contractual arrangements) and the conduct of the parties that is consistent with the legal form. We distinguish this term from "economic substance". The latter term is one we have seen used often but for which we are unclear of its meaning. It would appear that the term economic substance suggests that legal substance can be ignored in favor of determining some other "reality" that is more consistent with the "economics" of an arrangement. If our interpretation is correct, we challenge such a concept but such discussion is outside the scope of these comments and will be addressed in a subsequent article by the authors of this submission.

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29. The only question, then, is whether such transfer or allocation has been legally transferred and whether the parties act in conformity with the legal arrangement. For instance, if foreign exchange risk has been legally allocated to one party of an MNE group (Company X) through the contractual terms which state that Company X must sell goods to Company Y in the currency of Country Y, then this foreign exchange risk has been legally assigned to Company X. Company X's assumption of this risk would be borne out in its costs to hedge or otherwise manage this foreign exchange risk, in addition to its actual foreign exchange gain or loss. If in fact, Company X sells to Company Y in Country X currency, then factually Company Y has assumed foreign exchange risk and the legal contract that stated the intended terms of the contract has no legal effect (i.e. there is no legal substance to this arrangement). However, we would reiterate that the starting point in this determination is the legal substance and we should not be required to look to any further proof of "effective control".

30. Our final comment as it relates to the assumption of risk is in response to paragraph 45 of the Discussion Draft. This paragraph raises the question of whether the use of a particular transfer pricing method can itself create a low risk environment. The OECD suggests that this is not the case and rather, that the risk profile should dictate the choice of the transfer pricing methodology.

31. We are not in complete agreement with this position from a practical viewpoint. We agree in theory that to determine an appropriate transfer pricing methodology one must first assess the risk profile of the parties to establish the most appropriate transfer pricing methodology. Then, if a one-sided methodology is used, one must select the tested party, which is the party that is the least complex and assumes the least risk. Presumably, if both parties assume significant risks a one-sided methodology may not be considered to be the most appropriate in order to give recognition to such risks. However, in reality and further to comments made by practitioners and member states in the recent OECD consultations with the business community[3], a one-sided methodology is almost always used and a profit split methodology, even if applicable in theory, is in practice rarely used. As a consequence, in most situations a one-sided methodology is almost always chosen and the determination of the tested party becomes a question of relativity, that is, which of the parties to the transaction is the least complex relative to each other (which does not necessarily mean that it is a low risk entity).

32. The second limitation to the OECD's position is that again, practically, the TNMM is the most commonly employed transfer pricing methodology (again as was discussed in the consultations). The TNMM compares entities at a net margin level and assumes that the tested party has the same types of risks as the comparables. However, because of the way in which the TNMM is applied, any excess risk of the tested party is effectively transferred to the other party to the transaction.

    For example, if Company Y is a sales and distribution entity for Company X, using the TNMM we determine that the range of third party operating margins ranges from -1% to 6%. We establish the transfer price of the goods sold by Company X such that Company Y earns a net operating margin of 3%. However, Company Y has much higher inventory risk than other companies in its own industry as well as in comparison to the comparables (it may be due to a variety of factors; Company Y's inability to effectively control its inventory, ineffective purchasing decisions, poor forecasting, etc.). This additional cost of the inventory risk is actually borne by Company X

[3] The OECD Consultation with the organizations which provided comments on the Discussion Draft on Comparability and on the Profit Methods, held in Paris on November 17 & 18, 2008.

precisely because of the transfer pricing methodology used and effectively turns Company Y into a lower risk entity because its profit is assured despite the actual risk that may be realized.

33. An argument could be made that this unusually high risk should be excluded from the net margin benchmark – in other words, the 3% comparable margin should be targeted gross of the cost associated with the excessive inventory risk. Practically speaking, this would likely cause difficulties for the taxpayer upon examination by a tax administration, especially if the tested party's operating margin is negative as a result of this additional risk. We are aware of how difficult it would be to justify a negative margin as there appears to be a belief that individual members of a MNE group should generally not operate at a loss, even where the entire group is in a loss position. In part this is because of the separate entity approach versus the single unified business approach, which ignores the consolidated financial results of the MNE group. But, in addition, this is also a result of the view that many tax administrations expect loss making entities in the comparable set to be excluded as potential comparables.

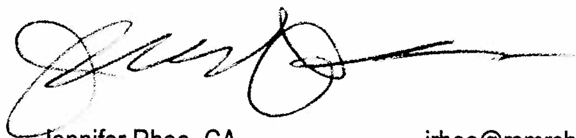
34. For these reasons, we believe that for all intents and purposes, from a practical perspective the administration of transfer pricing practices today often leads to a result where the transfer pricing methodology does in fact create a low risk environment for the tested party.

Conclusion

We thank the OECD for raising these important issues and creating the dialogue that is necessary to assist taxpayers and tax administrations in applying transfer pricing principles in a consistent and reasonable fashion. The Discussion Draft raises many interesting issues as well as perspectives that can be applied to situations even outside of the circumstances of business restructuring. While we understand that the guidelines are just that – guidelines, which can be interpreted in different ways, we encourage the OECD to recognize and promote practical solutions and guidance having regard to the imperfect and subjective nature of this area and the increased compliance burden that transfer pricing requirements have placed on taxpayers in recent years.

Yours very truly,

RSM Richter Chamberland LLP



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