February 6, 2009

Mr. Jeffrey Owens
Director
OECD Centre for Tax Policy and Administration (CTPA)
2, rue Andre Pascal
75016 Paris
FRANCE

Re: Transfer Pricing Aspects of Business Restructurings
Discussion Draft for Public Comment

Dear Mr. Owens:

This letter sets out the comments of PricewaterhouseCoopers with regard to the OECD paper captioned Transfer Pricing Aspects of Business Restructurings - Discussion Draft for Public Comment (the "Discussion Draft"). We have previously shared with the OECD a draft framework for responding to the OECD Discussion Draft. This letter elaborates on certain of the more important points in that draft framework and reflects the substance of many of the discussions on the Discussion Draft between PwC and its clients.

We commend the OECD for preparing a balanced and fair analysis of the business restructurings topic. There are points in the Discussion Draft with which we disagree, as discussed in detail below. However, the overall presentation represents an important forward step in developing international consensus on the important topic of business restructurings. It contains a number of foundational principles that are both important and, in our view, clearly correct. We trust that these points will form the basis of any final report and any future modification of the transfer pricing guidelines based on the Discussion Draft.

Among these critical foundational principles contained in the Discussion Draft that we believe must be retained as the OECD process moves forward to implementation are the following:

- Multinational enterprises (MNEs) are free to organize their business operations as they see fit and are free to act in their own best economic interest.

- Any transfer pricing analysis of a business restructuring transaction should begin with an analysis of the taxpayer's contracts. In situations where those contracts accurately reflect the conduct of the parties, they should be respected and the transfer pricing analysis should be confined to defining arm's-length consideration for the transactions described in those contracts.

- If a restructuring is commercially rational for a multinational enterprise, judged at a group level, then in all but the most exceptional circumstances, the transactions presented should not be subject to re-characterization by tax authorities.

- Non-arm's-length behavior should, as far as possible, be dealt with on the basis of pricing adjustments, rather than by re-characterizing all or part of the actual transactions undertaken.

- Profit / loss potential is not an asset in itself, but such potential arises because of the ownership of tangible and intangible assets and the performance of business functions. Without a transfer of actual assets, no compensation should be due at arm's length as a result of a restructuring.

- An entity's ability to take on risk generally is based on its financial capacity to bear that risk and on its management capacity to take decisions to assume and manage that risk.

In addition to the foregoing fundamental principles, we also agree with the following observations contained in the Discussion Draft:

- Compliance with transfer pricing principles does not constitute tax abuse and it is therefore appropriate to disconnect the transfer pricing analysis in the Discussion Draft from domestic anti-abuse principles.

- It can be commercially rational to restructure in order to obtain tax savings.

- The example in paragraphs 220 and 221 suggesting that a restructuring transaction involving the transfer of key management personnel and intangible assets to a low-tax jurisdiction principal company should be respected for transfer pricing purposes is both correct and very important.

- The right to compensation at the time of a restructuring should be based on options that would have been realistically available to the parties based on their actual intangible property rights and other assets.

- Contractual rights can be valuable intangible assets. Whether transferred contractual rights are valuable intangible assets, such that compensation is required by reason of their transfer, is a question of fact to be determined in each case.

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

- There should be no difference in the post-restructuring application of the transfer pricing guidelines to a restructured multinational enterprise and to a multinational enterprise structured in the same way from the outset of its operations. The arm's-length principle and the Transfer Pricing Guidelines should apply evenhandedly in each situation.

- If, following a restructuring, a tested party does not own unique intangibles or bear particularly significant risks then a transactional profit split is probably not justified, and the TNMM method is likely to be sufficiently reliable.

- The example pertaining to a central purchasing function is particularly helpful, as is the analysis of location savings.

In articulating the foregoing principles, the Discussion Draft displays common sense, balance, and pragmatism. The concerns that we have with the Discussion Draft generally involve issues where these key foundational principles may be undermined to some degree. In this letter we focus on four such issues.

1. Disregard of Restructuring Transactions and the 'Commercially Rational' Standard

Issue Note 4 discusses the circumstances in which governments may disregard taxpayer initiated restructuring transactions in their entirety. The issue note correctly states that tax administration disregard of restructuring transactions should occur only in the most exceptional cases. However, the Discussion Draft leaves open the possibility that restructuring transactions may be disregarded if they are not "commercially rational."

The Discussion Draft recognizes the difficulty of defining this term in any clear way, and ultimately provides no clear definition. It does however lay out certain principles that should be applied. These include the following:

- The totality of the circumstances and not individual elements of a transaction must be considered.

- The fact that comparably structured transactions among unrelated parties cannot be identified is not a sufficient reason to disregard a transaction on the ground that it is not "commercially rational."

- Where real functions, assets and risks are transferred, the fact that the restructuring is undertaken to achieve tax savings does not cause the transaction to fail the "commercial rationality" test.

We agree with these basic principles as far as they go. We are very concerned, however, that the vagueness of the commercial rationality standard, and the obvious disagreement among OECD participants reflected in paragraphs 214 - 221 of the Discussion Draft over the examples illustrating how the standard might be applied in practice, will give rise to significant levels of difficult to resolve controversy. That concern has been heightened by public comments of some individual tax authorities following publication of the Discussion Draft to the effect that their countries would routinely seek to disregard transactions where the arrangements themselves are not "arm's length." PricewaterhouseCoopers does not believe that vague generalizations such as "commercially irrational" and transactions that are "not arm's length" or "not consistent with arm's-length dealing" provide adequate clarity and guidance as to when the exceptional circumstances exist that would give tax authorities the ability to disregard actual transactions.

In our view, the Discussion Draft should clearly state as a core principle that any transaction that has a bona fide non-tax business purpose judged at a group level should not be judged to fail the commercial rationality test. Moreover, it should be clear that such a business purpose need not be the primary motivation for the transaction, but instead that a bona fide business purpose, together with tax savings objectives, are sufficient to defeat any claim that the restructuring transactions should be disregarded. Simply put, tax administrators should not have the right to disregard real taxpayer initiated restructuring transactions that have a bona fide business purpose. They certainly should not be allowed to do so based merely on a subjective declaration that similar transactions would not be engaged in by unrelated parties.

We recognize that the terms and conditions on which individual group members participate in bona fide business restructuring transactions must be evaluated to assure compliance with the arm's-length standard at the individual entity level. At the individual entity level, however, the question should be limited to whether the individual entity has been appropriately compensated for the actual assets it has transferred in the business restructuring transaction, and whether it deals on a basis consistent with the transfer pricing guidelines following the restructuring. An assertion that an individual group member would not have entered into the transaction as a commercial matter should not provide a basis for disregarding the group's bona fide, business motivated restructuring. To the extent that paragraph 213 suggests that the commercial rationality test should be applied at the individual entity level, it should be revised.

In particular, we urge that Example (A) at paragraphs 214 - 216 of the Discussion Draft be clearly described as a situation where tax administrators would have no authority to disregard the transaction. In our view, the transaction plainly has a business purpose judged at a group level. Whether any individual group member would or would not engage in the transaction were it an independent party should be irrelevant to the question of whether the transaction can be disregarded. Instead, the relevant question at the individual entity level should be what level of compensation would have to be provided to fairly compensate for the transferred assets on an arm's-length basis. Paragraph 216 should be rewritten to reflect a consensus view that the described restructuring must be respected and that transfer pricing adjustments, if any, will be limited to the amount of compensation due to Company Z.

2. Respect for Individual Terms of Taxpayer Contracts Related to Risk

As noted above, we are strongly supportive of the fundamental Discussion Draft principle that taxpayer's contracts and commercial arrangements should form the starting point for any analysis of a business restructuring transaction. Issue Note 1 addresses the question of when individual terms of taxpayer contracts may be disregarded or rewritten by taxing administrators. It addresses that question in the context of contractual allocations of commercial risk as between members of the group.

As we understand the Discussion Draft, the OECD believes that taxing authorities should be able to disregard or rewrite individual terms of a taxpayer agreement related to business risks when either of two conditions prevails:

(i) if the agreements lack economic substance in the sense that the actual activities of the parties to the contract diverge from the terms of the written agreement; and

(ii) if the party assuming risks under a contract lacks the managerial capacity and financial wherewithal to either assume or manage the risk.

Stated in this manner, PricewaterhouseCoopers has no disagreement with the basic proposition. We agree with the proposition that the actual conduct of the parties should take precedence over written agreements when the two are not consistent. We also agree with the general proposition that entities purporting to assume commercial risks should have the financial and managerial wherewithal for such an undertaking. We do, however, have concerns about some of the language in Issue Note 1, which we believe to be unnecessary and overly broad.

We do not believe that it is helpful to describe the inquiry as a determination of whether the risk allocation itself is "arm's length." As discussed above, vague and conclusory terms like 'commercially rational' and 'arm's-length risk allocation' add little to the

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resolution of transfer pricing issues. Indeed, by allowing governments to challenge an allocation of risk on the basis of broad conclusory and standardless assertions that "unrelated parties wouldn't do it this way," these terms will add to the level of controversy and to the difficulty of resolving those controversies that do arise.

The danger of broad conclusory language is particularly evident in this case where the Discussion Draft acknowledges that it is not necessary to demonstrate that similar allocations of risk arise in arm's-length dealings between unrelated parties and that the most difficult issues arise in cases where comparable transactions do not exist. Indeed, the Discussion Draft acknowledges that reasonable relationships between related parties may not be replicated in unrelated party dealings and that a comparable transaction standard of arm's-length dealing is not required in each instance. The "arm's-length" language of the Discussion Draft may, therefore, do no more than encourage unproductive hypothetical speculation about what unrelated parties may or may not have done had matters been different than they actually are.

Moreover, the example at paragraph 37 does not explore in detail what result is envisaged where a tax authority concludes that ‘control’ is in a different entity from that ‘bearing’ the risk and it is determined that the entity with ‘control’ should have been allocated that risk at arm’s length. The implicit assumption appears to be that this conclusion cannot be drawn if the ‘controller’ does not have the financial capacity to bear the risk. It would be helpful if the OECD could confirm this point. If the ‘controller’ does have financial capacity to bear the risk (both at the level realized historically and the potential risk, taking into account the range and likelihood of possible prospective scenarios), it remains the case that the accounts and tax return of the ‘bearer’ entity will have recognized the impact of such risk bearing, for example:

Risk	Impact of realization
Bad debt, foreign exchange, stock obsolescence	Loss to Profit & Loss account, deduction for tax purposes
Investment in assets through purchase, R&D expenditure	Expense in Profit &Loss account or balance sheet capitalization. Assets recognized in the balance sheet. Tax deduction for expenditure through expense deduction or capital allowance regimes. Tax on gains, tax relief on losses when assets are sold/written off

In our view, the complexities involved in separating the realization of risk and returns on risk from the bearer entity are very challenging indeed. Furthermore, such separation is not in accordance with the arm's-length principle, as risk bearing is clearly a driver of profit and loss in the market. This is recognized in the OECD Guidelines:

> "Functional analysis is incomplete unless the material risks assumed by each party have been considered since the assumption or allocation of risks would influence the conditions of transactions between the associated enterprises".
> OECD Guidelines – Chapter I, paragraph 1.23

If the existence of some level of 'control' over risk carries with it the idea that such control may attract 'ownership' of the risk, and the consequent profit or loss, then what is the result when a risk is managed as part of the responsibilities of a 'virtual' management team? It is increasingly common for MNEs to establish regional and global management structures which assign responsibilities to a team, the members of which are employed by different entities in different countries. In this case, is the risk shared across these entities? Should we totally ignore the fact that one entity alone bears the profit and loss account and balance sheet consequences of risk realization? The difficulties with this analysis are further exacerbated by the fact that risk assumption and realization may well span more than 1 accounting period. For example, a 3 year pharmaceutical R&D program may ultimately fail in year 4 when clinical trials show up unexpected side effects or a 2 year product development initiative may be aborted if a competitor introduces a similar item first into the market. In these instances, the virtual management team may well move around, raising the question of how we should deal with the fact that 'control' has moved over the period concerned.

In our view, it is not tenable to separate the consequences of risk realization from the bearer entity. In a fact pattern where a valuable contribution is made by a non risk bearing entity, that entity should be adequately rewarded by reference to market comparables, but should not be treated as if the risk had been transferred to that entity.

Rather than casting the analysis in broad terms of arm's-length risk allocation, therefore, we recommend that the Discussion Draft simply state, clearly and straightforwardly, that a taxpayer's allocation of commercial risk must be respected by tax administrators where: (i) the allocation of risk is reflected in contemporaneous written agreements; (ii) the conduct of the parties is substantially consistent with those agreements; and (iii) the entity asserted to be bearing a risk has the managerial and economic wherewithal to assume, manage and bear the risk.

We are also concerned that in legitimately requiring 'control' or 'managerial capacity' as a prerequisite to having a taxpayer allocation of risk accepted, the Discussion Draft understates the importance of financial risk bearing. We note that there are many instances in everyday business dealings between unrelated parties where economic risk bearing takes precedence over day to day or ultimate control of the risks being accepted.

The fund management example in the Discussion Draft is one example. The entire operation of the property and casualty insurance industry is a similar example. Insurance companies actuarially evaluate and price the risks they assume, but they do not control or manage their policy holders' risks in any meaningful way. We recognize that in a related party environment, the ability to provide substantive management supervision over risk is often a legitimate prerequisite to the recognition that a risk has been assumed. The importance of that factor should not be emphasized to the exclusion of legitimate risk shifting transactions that are more purely economic, however.

We note particularly that specific consideration should be given in the Discussion Draft to risk allocation transactions whose legitimacy is clearly recognized in the transfer pricing guidelines, but that do not involve managerial "control" of risks beyond economic risk bearing. Common research and development cost contribution agreements are a prime example. In such an arrangement, it is not usually thought necessary that each participant independently manage the amounts expended on research, determine the research program, or perform any of the other tasks that would generally be associated with 'controlling' the investment. Rather, such arrangements are generally respected so long as each party bears a share of research expense commensurate with its expected benefit from the research program. Nothing stated in the Discussion Draft consideration of risk allocations should undermine the approval given to such arrangements in the transfer pricing guidelines.

In summary, we recommend that Issue Note 1 be revised to (i) eliminate the requirement that the allocation of risk be "arm's length"; (ii) to clearly state that risk allocations will be respected whenever risks are allocated in contemporaneous written agreements, the parties conduct their affairs in a manner consistent with those agreements, and the relevant parties have the managerial and economic capacity to assume the allocated risks; and (iii) to specifically recognize that with regard to certain risk allocation arrangements, including cost contribution arrangements and common insurance transactions, economic risk bearing alone should be sufficient to support the contractual allocation of risk.

3. Indemnification of Individual Participants in a Restructuring Transaction

As stated above, we strongly support the basic principle set out in the Discussion Draft that a shift of profit potential in connection with a restructuring transaction does not, in and of itself, give rise to a claim for indemnification. Rather, tax should be imposed at the time of a restructuring transaction only if appreciated assets, tangible or intangible, are transferred between the parties to the transaction.

While this principle is correctly stated in paragraph 64 at the beginning of Issue Note 2, the discussion in the Issue Note undermines this basic principle in three respects. First, the Issue Note at paragraph 65 tense., loosely discusses transfers of profit potential as if shifting profit potential between related parties is itself a potentially taxable event. Second, the Issue Note implies an overly broad definition of intangible assets, suggesting that transfers of "soft" intangible assets and goodwill and going concern value may be equated to a transfer of profit potential and may give rise to an exit tax. Third, the Discussion Draft incorrectly implies that the transfer of the opportunity to conduct a particular business activity may be a taxable event.

Profit potential is not an asset. A fundamental principle of taxation is that taxpayers are free to organize their affairs as they see fit. If, for example, a company chooses to perform routine distribution functions on its own account, it is entitled to the profits derived from the performance of those functions. If instead, it chooses to form a subsidiary and hire it to carry on those same routine distribution functions, the subsidiary is entitled to the profits attributable to the performance of those functions. The fact that potential profits may be earned if routine distribution functions are successfully performed does not imply that a change in the entity performing the function constitutes an occasion for imposing tax. The clarity of the Discussion Draft would be enhanced if the question of the imposition of tax at the time of a restructuring transaction were cast exclusively as a discussion regarding transfers of real assets, not in terms of transfers of profit potential. In particular, changes in the entity performing business functions and reallocations of risk rarely should give rise to current taxation in and of themselves. Rather, such changes should generally be reflected in the parties' transfer pricing arrangements going forward.

When protectable intangible assets such as patents or trademarks are transferred in connection with a business restructuring, it is appropriate that tax be imposed if the value of the transferred asset exceeds the transferor's tax basis in the asset. If, however, the intangible assets transferred do not constitute protectable property rights such that an unrelated party would agree to pay for those assets, no tax should be imposed. This category of unprotectable intangibles would certainly include business synergies, goodwill and going concern value, all of which are assets that cannot be transferred separate and apart from a going business. To the extent the Discussion Draft seeks to sweep these types of soft intangibles into the net of taxable transfers, or seeks to equate such assets with profit potential, the Discussion Draft should be revised.

Finally, the Discussion Draft should not state or imply that a transfer between members of the same multinational enterprise of the opportunity to engage in certain business functions is itself a taxable event. Unless such business opportunities are accompanied by intangible assets that give the owner the ability to exclude others from carrying on similar business activities, a business opportunity is not a unique asset and should not need to be paid for.

We agree with the general thrust of the Discussion Draft to the effect that questions of whether indemnification should be provided to a member of the group at the time of a restructuring transaction are essentially questions of fact. Where an entity gives up a unique, protectable asset it should be appropriately compensated. Where no such asset transfers take place, or where the rights transferred are not of a type that can be used to exclude others from engaging in the same activity, compensation is not appropriate. Any other outcome would undermine the fundamental tax principle that taxpayers are free to arrange their affairs as they see fit.

4. Documentation

At several points in the Discussion Draft suggestions are made that taxpayers should provide extensive documentation related to their restructuring transactions. Before and after analyses, contracts, assumptions regarding financial outcomes, and descriptions of motivations all are demanded in one form or another. This continues a trend in recent OECD publications that has alarmingly expanded the types of documentation demanded by taxing authorities. In our view these demands are beginning to go beyond a level that is reasonable or that is even particularly helpful to taxing authorities. We suggest that the Discussion Draft be modified to moderate its demands for taxpayer documentation.

We again congratulate the OECD on an excellent contribution to this difficult topic and look forward to further interaction as the project progresses.

Respectfully submitted,

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