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March 5, 2009

Mr. Jeffrey Owens
Director, Centre for Tax Policy and Administration
Organisation for Economic Co-operation and Development
2, rue André-Pascal
75775 Paris
France

Re: **Transfer Pricing Aspects of Business Restructurings**

Dear Mr. Owens:

We are writing on behalf of the Treaty Policy Working Group to comment on the Discussion Draft on the Transfer Pricing Aspects of Business Restructurings (the "Discussion Draft"), released for comment by the Committee on Fiscal Affairs on September 19, 2008. The Treaty Policy Working Group is a group of companies with substantial global operations that are headquartered in OECD member countries throughout the world and represent a broad spectrum of sectors. Our member companies began working together in 2005 to analyze and address tax treaty policy and administration concerns on issues of mutual interest.

Treaty Policy Working Group members support the OECD as the primary international forum for development of common positions on cross-border tax policy and administration issues. As global companies seeking to avoid double taxation or unexpected taxation and the resulting cross-border controversies, we appreciate the time and effort that OECD member country officials and OECD Secretariat members devote to this important work. The OECD's current work on business restructuring issues is of great interest to us, given the focus many tax administrations are already devoting to these issues. We need—and believe that tax administrations also need—clear guidance in advance that provides adequate certainty, establishes a principled basis for applying relevant treaty provisions, and reflects a true international consensus. We welcome the opportunity to comment on the Discussion Draft from this perspective.

Mr. Jeffrey Owens
March 5, 2009
Page 2 of 29

Executive Summary

The decision of the Committee on Fiscal Affairs to commence a dialogue in January 2005 on the tax treatment of business restructurings¹ was a prescient one. Many tax administrations have now publicly expressed concern about such transactions, and some have already initiated examination, litigation, or legislative efforts. It is, therefore, appropriate for the OECD to consider the nature of these transactions to ensure that the arm's length principle will be applied properly to business restructurings. It is also appropriate and, indeed, critical for OECD member countries to develop a consensus on the issues identified, as the Transfer Pricing Guidelines² (the "Guidelines") must be applied in a consistent manner across jurisdictions if double taxation and inappropriate taxation are to be avoided.

Treaty Policy Working Group member companies are in full agreement with much of what the Discussion Draft provides. We appreciate the obvious care and deliberation with which the Discussion Draft was developed. The OECD Joint Working Group and Working Party No. 6 met frequently over several years to consider a long list of potentially divisive issues.³ It is impressive to see that a consensus position has been achieved on so many of these issues. We congratulate the many Delegates and Secretariat members who contributed to this effort on this important achievement.

In particular, we welcome the Discussion Draft's acknowledgment of the following key points, among others:

- The treatment of business restructurings should be consistent with existing transfer pricing rules as reflected in the current Guidelines.

¹ The Discussion Draft acknowledges that there is no legal or universal definition of the term "business restructuring," but defines it for purposes of scoping the OECD project as "the cross-border redeployment by a multinational enterprise of functions, assets and/ or risks". See Discussion Draft, paragraph 2. We adopt the same definition for purposes of these comments, but suggest below that it would be helpful to focus the scope further.

² OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*.

³ See, e.g., OECD Committee on Fiscal Affairs mandate to Joint Working Group on Business Restructuring and agenda for meeting with Business Advisory Group on Business Restructurings at http://www.oecd.org/document/0/0,3343,en_2649_37989760_38791616_1_1_1_1,00.html.

Mr. Jeffrey Owens
March 5, 2009
Page 3 of 29

- In determining an arm's length result for related party transactions of post-restructuring entities, the same pricing approach should be applied as in any other case.
- Risks may be managed by a party other than the one that bears them.
- A party dealing at arm's length may not have the power to refuse a contractual termination or other conditions of a restructuring.
- "Profit potential" is not an asset and the arm's length principle does not require compensation for the transfer of profit or loss potential *per se*.
- There should be no presumption that all contract terminations or substantial renegotiations should give a right to indemnification at arm's length.
- Profits earned during periods prior to a transaction have no probative value for the transfer pricing analysis of periods following the transaction.
- Pricing solutions should generally be sought to achieve arm's length outcomes.
- Application of the arm's length principle to recharacterize or disregard the agreed terms or form of a contractual arrangement should be reserved for exceptional cases that fall within one of the two narrow exceptions specified by the Guidelines.
- The objective of any recharacterization should be to arrive at a characterization or structure that comports as closely as possible with the facts of the case.
- There may be good commercial reasons, including tax reasons, for a business restructuring.
- Tax administrations should not ordinarily interfere with the business decisions of a taxpayer as to how to structure its business arrangements.
- In circumstances where reliable data show that similar transactions or arrangements exist between independent parties, it cannot be argued that such an arrangement between related parties would lack commercial rationality.

Mr. Jeffrey Owens

March 5, 2009

Page 4 of 29

- The mere fact that a related party arrangement is not seen between independent parties does not in itself mean that it is not arm's length.
- It can be particularly difficult in practice for tax administrations to assess whether an arrangement is commercially rational. Problems of double taxation may arise if such an assessment is not shared by the other State.
- In evaluating whether a party would at arm's length have had other options realistically available to it that were clearly more attractive, due regard should be given to all the relevant conditions of the restructuring, to the rights and other assets of the parties, to any compensation or indemnification for the restructuring itself and to the remuneration for the post-restructuring arrangements, as well as to the commercial circumstances arising from participation in a multinational group.
- There can be legitimate group-level business reasons for a multinational group to restructure. In practice, where a restructuring is commercially rational for the group as a whole, it is expected that an appropriate transfer price would generally be available to make it arm's length for each participating group member.

Notwithstanding these and the many other positive contributions made by the Discussion Draft, we would like to take this opportunity to suggest some respects in which we believe clarification or modification would be appropriate:

- The Discussion Draft seems in places to accept or propose interpretations that extend beyond or are in conflict with the current Guidelines. Any change or detrimental new interpretive gloss of existing guidance should not be adopted without careful consideration by policymakers and tax administrators and a full dialogue with stakeholders. Any suggestion to the contrary in the Issues Notes should be clarified prior to their finalization, to avoid raising issues of procedural propriety and legal relevance.
- A literal reading of some portions of the Discussion Draft might suggest that business restructurings may be taxed differently from other transactions in some respects, notwithstanding the initial statement rejecting such an approach. We submit that this would be inappropriate as a matter of policy. In addition, it is unclear how special rules for business restructurings would work in practice; given the Discussion Draft's broad and imprecise definition of business restructurings, the scope of special rules likely would not be clear enough to enable voluntary compliance and equitable administration.

Mr. Jeffrey Owens
March 5, 2009
Page 5 of 29

Provisions of the Discussion Draft that could be read to suggest different treatment for business restructurings should be clarified.

- To avoid creating excessive uncertainty and burden for both businesses and tax administrations, the scope of the business restructuring concept should be refined and narrowed to focus on the more limited types of transactions that are of greatest interest to tax administrations.
- The Discussion Draft contains language that could be read to presume that it is appropriate for tax administrations to inquire and to determine whether a particular risk allocation would have been agreed by independent parties acting at arm's length. It suggests that the allocation of risk is to be respected only to the extent that it has "economic substance" and indicates that this determination will turn not solely on contractual terms but also on whether the related parties conform to the contractual allocation of risks, whether the contractual terms provide for an arm's length allocation of risks, whether the risk is economically significant; and what the transfer pricing consequences of the risk allocation are. The Discussion Draft further suggests that "control" is a key factor in this determination. While these standards would likely be met in many cases in practice, we respectfully submit that certain aspect of this analysis are not fully consistent with the Guidelines and ask that they be reconsidered.
- The Discussion Draft also contains statements that seem implicitly to adopt the general notion that risks attach in some way to particular functions. We do not believe that this is an appropriate reflection of the way risks are addressed at arm's length, and we do not believe that this analysis is consistent with the Guidelines. Under the arm's length principle, the allocation of functions between the parties, including those that relate to risks, bears only on the determination of price and is not a basis for disregarding the risk allocation agreed by the parties. Risk is only one of several parameters, together with functions and assets, that form the basis for determining whether an allocation of income satisfies the arm's length principle.
- In connection with the discussion of low-risk environments and transfer pricing methods, we submit that the relevant transaction for purposes of the transfer pricing analysis is the commercial relationship agreed and implemented by the parties. The remuneration and other terms of the commercial agreement are what determines the risk borne and, therefore, influences the choice of transfer pricing method. In practice, taxpayers should be free to adopt, for example, a cost plus remuneration arrangement in

Mr. Jeffrey Owens

March 5, 2009

Page 6 of 29

an intercompany agreement in order to create a low-risk commercial relationship. This is to be distinguished from the transfer pricing method (such as TNMM) or profit level indicator (such as return on sales) which the taxpayer or the tax administration might use to test the arm's length result of that transaction. It is important to clarify this point because the discussion might otherwise be misconstrued as limiting the use of certain intercompany commercial arrangements or the application of certain transfer pricing methods, or even as affecting the identification of the tested party for purposes of the transfer pricing analysis. These are important elements of transfer pricing analysis that must be ascertainable with certainty in advance.

- We concur with the Discussion Draft's proposition that the transfer of a risk that is "economically insignificant" normally should not give rise to significant changes in the transfer pricing arrangements between the parties. We do not, however, believe that the financial statement review suggested by the Discussion Draft can be more than marginally useful in identifying most risks that are material for transfer pricing purposes. The largest determinants of profit in a business enterprise are not and cannot be reflected on the balance sheet. To avoid misleading conclusions, it is important that the suggested use of financial statements for this purpose be eliminated.
- We respectfully submit that the Discussion Draft focuses too heavily on whether the taxpayer's transactions are structured in a manner consistent with what independent parties might have agreed, rather than on whether the result is an arm's length one. In particular, the discussion of "options realistically available" should be clarified, lest it be taken to signal expanded scope to substitute hypothetical for real transactions. The Guidelines consider available options only for purposes of determining the price at which unrelated parties would be willing to buy and sell, and they focus solely on the entry into an arrangement and not the terms under which an arrangement can be terminated, which involves a quite different analysis. Persons with legal rights and assets can, to a great extent, control what risks and functions they wish to contract for from others. Consequently, at arm's length an entity normally would not be able either to demand no change to the contract with an exiting counterparty or to prevent termination of that contract.
- We believe that the profit potential discussion focuses too heavily on the speculative results of future business activity, rather than on the value of a transferred asset that will be used as an input to that activity.
- The Discussion Draft endorses the acquisition price method as a possible means to determine arm's length consideration for a business restructuring.

Mr. Jeffrey Owens
March 5, 2009
Page 7 of 29

It also could be read to suggest that profit potential may be assimilated into goodwill, and that goodwill and going concern value typically transfer in a business restructuring. We respectfully suggest that these points are mistaken.

- The Discussion Draft suggests that the arm's length nature of the transaction must be assessed from the perspectives of both the transferor and the transferee. A two-sided review may be appropriate for limited purposes under the current Guidelines. However, the whole point of the identification of the tested party is to focus on that member of the related group whose activities and functions are the most relevant and most amenable to the pricing analysis. The Guidelines do not generally require a two-sided analysis, recognizing the significant burdens that would entail. Since the Guidelines apply in the same manner to all situations, there is and should be no special rule on this point for restructured entities.
- We also see no justification for mandating a sales-related indicator for commissionaire or sales agent activities. There appears to be no reason to categorically state that testing a return based on the amount of costs for assets or labor incurred is inappropriate, and the suggestion to this effect appears to confuse the commercial transaction and the profit-level indicator.
- The Discussion Draft should confirm clearly throughout that a before and after comparison of profits from controlled transactions may never be used to support adjustments.
- The Discussion Draft contains various suggestions that terms can be implied into contracts based on speculation as to what other parties might have done. As indicated by the Guidelines, the transfer pricing analysis should always attempt to set an arm's length price for the arrangement as actually entered into by the parties. Thus, it normally is inappropriate to assume or infer terms not in the contract. However, we are starting to see some tax administrations attempting in the examination context to impute significant changes in the terms of the parties' agreements as a first resort, even attributing ownership of IP from one entity to another. The Discussion Draft should clarify that such analyses are inconsistent with the Guidelines.
- The Discussion Draft should indicate consistently throughout that the current Guidelines do not permit recharacterization of the taxpayer's transactions except in two very limited circumstances that do not normally arise in a business restructuring.

Mr. Jeffrey Owens
March 5, 2009
Page 8 of 29

- The Discussion Draft should state unambiguously that the “commercially rational” analysis may be applied only in the very rare circumstances specified in the Guidelines and never as a stand-alone criterion for assessing a transaction.
- It is not clear from the Discussion Draft that a full consensus has been achieved. Rather, a lack of consensus seems apparent on several important points at this stage. We respectfully urge the OECD to press again for full consensus on the remaining points.
- Once the Issues Notes have been finalized in appropriate form, we would urge that their provisions be implemented in their entirety through incorporation by reference into the Guidelines.

Any departure from the arm’s length principle in connection with business restructurings should be avoided. Although it may be tempting to attempt to use the arm’s length principle as a tool to challenge perceived abuses or undesirable results, and not only to set transfer prices, such an approach would seem to lack a firm basis in law or policy. It would introduce a degree of uncertainty that would complicate tax administration and compliance efforts for governments and businesses alike. If the arm’s length principle were made inapplicable to a broad category of transactions, this could also have negative implications for the use of the arm’s length principle and the functioning of the international treaty network in the absence of a viable alternative method.

Our detailed comments on each these points are set forth below:

1. General Parameters of the OECD Project

Treaty Policy Working Group members welcome the decision of the Committee on Fiscal Affairs to emphasize two points in particular in introducing the Discussion Draft. First, the Committee helpfully confirms that it directed the OECD’s current analysis of business restructurings to be “based on the existing transfer pricing rules,”⁴ which it specifies to mean “the [OECD] TP Guidelines in their current form.”⁵ The second point emphasized by the Committee is “the premise that the arm’s length principle and the TP Guidelines do not and should not apply differently

⁴ See Preface to Discussion Draft.

⁵ See Discussion Draft, Introduction, paragraph 11.

Mr. Jeffrey Owens
March 5, 2009
Page 9 of 29

to post-restructuring transactions than to transactions that were structured as such from the beginning.”⁶

Treaty Policy Working Group members fully support both of these propositions and agree that they are of particular importance. We respectfully submit that the application of new or unique approaches to the taxation of business restructuring transactions is not viable or appropriate under existing bilateral treaties, if interpreted consistently with existing OECD guidance. Such an approach could raise difficult questions of procedural propriety and legal relevance.

We fully support the Committee’s directive that the analysis be based on the current Guidelines. We are concerned, however, that although the Committee clearly intended this, as noted below, the Discussion Draft seems in places to accept or propose interpretations that extend well beyond or are in conflict with the Guidelines.⁷ Any change or detrimental new interpretive gloss of existing guidance should not be adopted without careful consideration by policymakers and tax administrators and a full dialogue with stakeholders. Any suggestion to the contrary in the Issues Notes should be clarified prior to their finalization.

In addition, a literal reading of some portions of the Discussion Draft might suggest that business restructurings may be taxed differently from other transactions in some respects, notwithstanding the Committee’s rejection of such an approach. We submit that this would be inappropriate as a matter of policy. It also is unclear how special rules for business restructurings would work in practice; given the Discussion Draft’s broad and imprecise definition of business restructurings, the scope of special rules likely would not be clear enough to enable voluntary compliance and equitable administration. Provisions of the Discussion Draft that could be read to permit different treatment for business restructurings should be clarified.⁸ In addition, on a few points, the Discussion Draft explicitly states that its interpretation applies for transfer pricing purposes generally.⁹ These statements should be clarified, lest they be interpreted to suggest by negative inference that other portions of the Discussion Draft apply only to business restructurings.

⁶ See Preface to Discussion Draft.

⁷ See, e.g., Discussion Draft, paragraphs 20, 28, 30, 38, 39, 50, 51, 58, 59, 64, 65, 82, 83, 93, 107, 135, 152, 182, and 184.

⁸ See, e.g., Section 2.B. of Issues Note No. 2 and Sections C-F of Issues Note No. 3.

⁹ See, e.g., Introduction to Issues Note No. 1.

Mr. Jeffrey Owens
March 5, 2009
Page 10 of 29

Finally, we note that the Discussion Draft's very broad definition of business restructuring arguably covers not only the large supply chain restructuring transactions commonly understood by the term, but also many actions that are the result of relatively common management decisions about allocation of functions, engagement of personnel, rationalization of costs, and the like within a multinational enterprise. Contrary to previous indications, the Discussion Draft also states that its analysis applies to routine merger and acquisition transactions and subsequent restructurings. The scope of the project would be less important if the same treatment were accorded in practice to all transactions, but, as noted above, the Discussion Draft arguably could be interpreted as permitting certain differences in treatment of business restructuring transactions. To avoid creating excessive uncertainty and burden for both businesses and tax administrations, the scope of the business restructuring concept should be refined and narrowed to focus on the more limited types of transactions that are of greatest interest to tax administrations, namely those referred to in the Introduction to the Discussion Draft.¹⁰

2. Risk Allocation and "Control"

In its discussion of "special considerations for risks" in Issues Note No. 1, the Discussion Draft contains language that could be read to presume that it is appropriate for tax administrations to inquire and to determine whether a particular risk allocation would have been agreed by independent parties acting at arm's length. It suggests that the allocation of risk is to be respected only to the extent that it has "economic substance" and indicates that this determination will turn not solely on contractual terms but also on:

- Whether the related parties conform to the contractual allocation of risks;
- Whether the contractual terms provide for an arm's length allocation of risks;
- Whether the risk is economically significant; and
- What the transfer pricing consequences of the risk allocation are.¹¹

The Discussion Draft further suggests that "control" is a key factor in this determination. While these standards would likely be met in many cases in practice,

¹⁰ See Discussion Draft, Section A.1.3.

¹¹ See Discussion Draft, paragraph 20.

Mr. Jeffrey Owens
March 5, 2009
Page 11 of 29

we respectfully submit that certain aspects of this analysis are not fully consistent with the Guidelines and ask that they be reconsidered.

It is true that the Guidelines contain an economic substance requirement for controlled transactions between associated enterprises that requires the economic substance of a transaction to be consistent with its form. They further indicate that taxpayers are expected to follow their contracts if they wish to have the provisions of those contracts respected for transfer pricing purposes. However, we respectfully submit that the economic substance requirement authorized by the Guidelines is limited to these provisions, which is a much narrower concept than that suggested by the Discussion Draft.

The concept of economic substance is discussed in only four paragraphs of the OECD Guidelines and only in connection with very limited exceptions to the general rule that the taxpayer's transactions must be respected. Paragraph 1.37 is the only paragraph suggesting that a lack of economic substance may justify the recharacterization of a transaction in certain circumstances. That paragraph indicates that recharacterization of the taxpayer's transaction may be appropriate where "the economic substance of the transaction differs from its form".

The Guidelines also discuss economic substance in paragraphs 1.26 and 1.27. That discussion addresses how to determine whether a particular allocation of risk is consistent with the economic substance of the transaction. It concludes that the parties' conduct is generally the best evidence concerning the "true" allocation of risk. Paragraph 1.27 adds that the consequences of a risk allocation at arm's length may also be considered, noting that, at arm's length, "it generally makes sense for parties to be allocated a greater share of those risks over which they have relatively more control." However, it acknowledges that many risks may be allocated to either party at arm's length and concludes that the issue with respect to such risks is which party actually bears them in practice. The determination thus turns primarily on the facts of the particular case, and not on a hypothetical determination of what independent parties might have agreed.

The final reference in the Guidelines to economic substance appears in paragraph 1.41. That paragraph reaffirms that, while alternative transactions may be used as comparable uncontrolled transactions for pricing purposes, it generally is inappropriate for tax administrations to restructure a controlled transaction or disregard the taxpayer's assignment of risk unless it lacks economic substance, as defined by the Guidelines. As paragraph 1.41 states, "[t]he fact that independent enterprises do not structure their transactions in a particular fashion might be a reason to examine the economic logic of the structure more closely, but it would not be determinative."

Mr. Jeffrey Owens
March 5, 2009
Page 12 of 29

More generally, the Guidelines require the benefits and burdens of a risk to be allocated to the entity that agrees in advance to bear the risk, provided that it has the financial capacity to do so, and, as the Discussion Draft recognizes, they acknowledge that “[i]n the open market, the assumption of increased risk will also be compensated by an increase in the expected return.”¹² The Guidelines add that “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*.”¹³ However, as indicated by the italicized terms, this statement hardly represents a categorical rule regarding the allocation of risks and the Guidelines do not otherwise provide such a rule. Indeed, other portions of the same paragraph note that many types of risks may be borne by either party at arm’s length. Under the Guidelines, the allocation of risks turns in the first instance on the facts of the particular case, and not on a hypothetical assumption of what independent parties might have agreed.

Similarly, the Guidelines do not suggest that a risk may not be transferred between associated enterprises without a transfer of “control” or other “associated people functions.” They do not require the exercise of control, or indeed the performance of any functions, by the risk-bearing entity. Instead, they focus on which party has put its resources at risk. Thus, for example, a distributor that risks its own marketing and advertising resources is distinguished from a distributor, or a contract manufacturer or contract researcher, that is reimbursed for its costs.¹⁴

In practice, risks often are allocated to an associated enterprise with assets and personnel. However, risks are regularly assumed in business without the associated management responsibility. Arm’s length parties permit others to manage risks in many ways. The pricing of the risks may be influenced if the assuming party believes that it has some managerial control over the risks, but transactions clearly occur at arm’s length in the absence of such control.

For example, an insurer can evaluate the risks it is asked to underwrite or assume and can set its policy premiums accordingly, but the primary “manager” of those risks is the insured party itself. As another example, a company that makes a portfolio investment in another company is subject to the risks of the other company. It bears the risks associated with its investment but generally does not have control over how the other company manages its risks. Similarly, there is nothing inappropriate from

¹² See Guidelines at paragraph 1.23.

¹³ See Guidelines, paragraph 1.27 (emphasis added).

¹⁴ See, e.g., Guidelines at paragraph 1.25.

Mr. Jeffrey Owens

March 5, 2009

Page 13 of 29

an arm's length perspective for an entity that brings only intellectual property and financial resources to the table to enter into a cost plus R&D contract, even if the work is managed and performed elsewhere by personnel of a third entity. The entity that actually undertakes the the work will be compensated for its contributions under the contract. If a separate entity manages the work on a day-to-day basis, that entity also will be compensated for that value. The entity owning the IP and bearing the development costs then bears the entrepreneurial risk in the marketplace. No function or risk is unaccounted for, and the two tested parties are subject to straightforward transfer pricing analysis. "Control" may not exist in the IP entity, but there is nothing in the arrangement that is improper from a transfer pricing perspective under the current Guidelines or is not susceptible of proper analysis.

Although the Discussion Draft helpfully recognizes that at least day-to-day management of risks may in some circumstances be outsourced to a party other than the one that bears them, it also contains statements that seem implicitly to adopt the general notion that risks attach in some way to certain other functions. We do not believe that this is an accurate reflection of real business life. There are probably as many ways to separate business risks from functional responsibility (or asset ownership) as there are reasons to do so. For example, the most popular current business model in the computer and peripherals industry is designed to do just that, by outsourcing everything from manufacturing to administrative services. However, it would not be accurate to conclude that the companies that have adopted such organizational decisions have thereby achieved a risk-free state, as they still bear the entrepreneurial risk of success or failure in the marketplace.

At arm's length, the liabilities of the parties will be brought into line with their agreement. Even if the agreement gives one party some management responsibility over a business activity that will cause a risk to be realized in one way or the other, at the end of the day the parties will adhere (or be forced to adhere) to the contract. The allocation of functions between the parties, including those that relate to risks, certainly will have an effect on the compensation arrangement agreed between the parties. Under the arm's length principle, however, the allocation of such functions bears only on the determination of an arm's length price under those conditions and is not a basis for disregarding the risk allocation agreed by the parties. In this regard, risk should be treated simply as one of several parameters, together with functions and assets, that form the basis for determining whether an allocation of income satisfies the arm's length principle.

A transfer pricing adjustment may, of course, be appropriate in connection with a particular allocation of risk. While it is legitimate for tax administrations to scrutinize the pricing of a risk allocation, it is important that genuine risks be respected as "real" even if they do not actually materialize. Unless the transaction

Mr. Jeffrey Owens
March 5, 2009
Page 14 of 29

fails under the very high threshold set by the Guidelines for recharacterization, the analysis applied should be a normal transfer pricing functional analysis to determine where value is added and what an arm's length price would be, given the transactions actually undertaken.

Under the Guidelines, an allocation of risk should, accordingly, be respected without regard to the location of "control" or other personnel functions, provided that the actual conduct of the parties is consistent with the allocation and the risk is borne, as matter of economic substance, by the party to which it was allocated.¹⁵ This approach appropriately prevents unwarranted retrospective adjustments to re-assign the associated benefits and burdens on an *ex post facto* basis.

It is not entirely clear what the basis for the Discussion Draft's emphasis on control is, but it seems reminiscent of much of the new thinking that emerged in the OECD's work on the attribution of profits to permanent establishments. Indeed, at points, the Discussion Draft appears to be adding a KERT-like requirement to the determination of where risks are borne, although the OECD's *Report on the Attribution of Profits to Permanent Establishments* clearly indicates that its analysis applies only for purposes of Article 7 and not for purposes of Article 9.¹⁶ Any extension of these new concepts or similar theories to associated enterprises would raise serious concerns. We would urge that the Discussion Draft be clarified to avoid this.

3. Relationship between Transfer Pricing Method and Low-Risk Environment

Section D.2 of Issues Note No. 1 considers the relationship between the choice of a particular transfer pricing method and the level of risk left with the entity that is remunerated using that method. It makes the following point:

“While the terms on which a party to a transaction is compensated cannot be ignored in evaluating the risk borne by that party, it is worth remembering that it is the low risk nature of a business that should dictate the choice of a given transfer pricing method, and not the contrary.”¹⁷

¹⁵ See Guidelines at paragraph 1.26.

¹⁶ See, e.g., OECD Committee on Fiscal Affairs Report on the Attribution of Profits to Permanent Establishments, Part I, paragraphs 266-267.

¹⁷ Discussion Draft, paragraph 45. See also Discussion Draft, paragraph 143.

Mr. Jeffrey Owens
March 5, 2009
Page 15 of 29

This statement is offered in response to the notion that “because an arrangement is remunerated using a cost plus or TNMM that guarantees a certain level of gross or net margin to one of the parties, that party operates in a low risk environment.”¹⁸

We would submit that the relevant transaction for purposes of the transfer pricing analysis is the commercial relationship agreed and implemented by the parties. We agree that the “terms on which a party to a transaction is compensated ... cannot be ignored,” but we would add that the remuneration and other terms of the commercial agreement are what determines the risk borne and, therefore, the choice of transfer pricing method. In practice, the adoption of, for example, a commercial arrangement in an intercompany agreement which compensates a service provider on a cost plus basis directly contributes to the creation of a low-risk commercial relationship. In such instances, the remuneration formula and other terms directly affect the level of risk borne by the remunerated party. In this context, it is very likely that the TNMM or similar pricing method then becomes the best method to test the arm’s length result from the transaction. The actual intercompany arrangements, however, cannot simply be disregarded because the tax auditor may have a general preference for, say, a profit-based method instead.

It is important to clarify this point because the discussion in this section might otherwise be misconstrued as limiting the application of certain transfer pricing methods or even as affecting the identification of the tested party for purposes of the transfer pricing analysis. These are important elements of transfer pricing analysis that must be ascertainable with certainty in advance.

We would also note that, given that one of the most significant risks is entrepreneurial risk, rather than inventory risk and other more limited risks mentioned in the Discussion Draft, creating a guaranteed profit can be a large benefit to a business. In the current global economic downturn, for example, there presumably will be many service provider/distributor entities that now will be reporting profits while their principals incur losses, instead of the losses they presumably would have incurred absent those limited-risk arrangements.

4. “Economically Significant” Standard and Financial Statements

We concur with the Discussion Draft’s proposition that the transfer of a risk that is “economically insignificant” normally should not give rise to significant changes in the transfer pricing arrangements between the parties. We do not, however, believe that the financial statement review suggested by the Discussion Draft can be more

¹⁸ *Id.*

Mr. Jeffrey Owens
March 5, 2009
Page 16 of 29

than marginally useful in identifying most risks that are material for transfer pricing purposes.

Balance sheet reserves may exist, for example, for bad debts and sales returns, litigation contingencies, accrued payroll liabilities, and the like. However, as confirmed by the current financial crisis, the largest determinants of profit in a business enterprise, such as the general market conditions, the success of the company's business strategy, the acuity of management, and certain material risks borne by the company, are not and cannot be reflected on the balance sheet. To avoid misleading conclusions, it is important that the suggested use of financial statements sheets for this purpose be eliminated.

5. Analysis of "Options Realistically Available"

Some have suggested that business restructurings are inherently non-arm's length, on the theory that an unrelated party would not voluntarily agree to cease using an asset it owns or performing functions or bearing risks that may generate a non-routine return. We would submit that this is not the case. In today's world of diverse and evolving business models, unrelated parties do make rational business decisions to change their functions and asset ownership or otherwise limit their risks.

The question in applying the arm's length standard is what, if any, compensation would have been paid in an independent enterprise context. An unrelated party ordinarily has limited legal rights to impose new conditions at the termination of a relationship and would not have a right to refuse to accept the sort of termination that typically occurs in a business restructuring context. Its bargaining power would depend on whether it owned assets which the other party could not find or contract for elsewhere. We submit that this is the relevant comparison for purposes of the arm's length principle.

Issues Note No. 2 contains a discussion of the concept of "options realistically available" that helpfully acknowledges that a party dealing at arm's length may not have the power to refuse a contractual termination. That said, the Discussion Draft contains other statements, such as the following, that could create confusion because they do not seem to recognize this point sufficiently:

"The application of the arm's length principle is based on the notion that independent enterprises, when evaluating the terms of a potential transaction, will compare the transaction to the other options realistically available to them, and they will only enter into the transaction if they see no alternative that is clearly more attractive. Consideration of the options that would be realistically available at

Mr. Jeffrey Owens
March 5, 2009
Page 17 of 29

arm's length is relevant to comparability and pricing of the transaction (see paragraph 1.15 of the TP Guidelines) and also for the assessment of whether it would be commercially rational for a party to enter into the restructuring transaction in the context of the application of the guidance on recognition of transactions at paragraphs 1.36 – 1.41 of the TP Guidelines.

“At arm's length, there are situations where an entity would have had options realistically available to it other than to accept the conditions of the restructuring, including possibly the option not to enter into the restructuring transaction. In such cases, in assessing the conditions of a business restructuring transaction, the entity would be expected to consider whether any of these other options is clearly more attractive, taking into account all the conditions including any compensation or indemnification for the restructuring.”¹⁹

The Guidelines do consider the “options realistically available” to hypothetical independent enterprises, but do so almost exclusively in connection with the transfer pricing comparability analysis.²⁰ The Guidelines suggest that an enterprise is unlikely to accept a price offered for its product by an independent enterprise if it knows that “other potential customers are willing to pay more under similar conditions.”²¹ The Guidelines also note that an independent enterprise would focus on differences among its options that “would significantly affect their value,” such as whether a lower price for a product would be available from another party.²² However, this analysis relates only to the determination of the *price* at which unrelated parties would be willing to buy and sell. In addition, it focuses solely on the *entry into* an arrangement and not the terms under which an arrangement can be *terminated*, which involves a quite different analysis.²³

The above-quoted Discussion Draft passage appears to suggest that paragraphs 1.36 to 1.41 of the Guidelines may permit use of this available options analysis also to recharacterize or disregard the termination of existing arrangements. We

¹⁹ Discussion Draft, paragraphs 58-59 (citations omitted).

²⁰ See, e.g., Guidelines, paragraphs 1.15 and 1.16.

²¹ See, e.g., Guidelines, paragraph 1.15.

²² See, e.g., Guidelines, paragraph 1.16.

²³ See, e.g., Guidelines, paragraphs 1.16 and 6.14.

Mr. Jeffrey Owens
March 5, 2009
Page 18 of 29

respectfully differ. The Guidelines explicitly recognize that associated enterprises often enter into transactions that independent parties would not conclude and confirm that this fact alone does not provide a basis for disregarding those transactions.²⁴ As discussed below, the Guidelines explicitly prohibit application of the arm's length standard to recharacterize or disregard transactions, except in two narrow circumstances not present in the typical business restructuring.

The Guidelines also contain several references to the parties' presumed "bargaining" positions or power. They begin by acknowledging that associated enterprises often bargain with each other as though they were independent enterprises.²⁵ The other references in the Guidelines to bargaining appear in connection with the discussion of the residual profit split method. Here, the Guidelines note that indicators of the parties' "relative bargaining positions," among other factors, could be "particularly useful in determining an appropriate allocation of any residual profit or loss."²⁶ Paragraph 3.21 of the Guidelines makes a similar point about replicating the outcome of bargaining between independent enterprises in the "free market" for the purpose of splitting the residual profit. However, these very limited references relate specifically to profit splits, and it is clear that the hypothetical bargaining analysis was not intended to apply generally under the Guidelines.

Any attempt to expand the discretion to recharacterize or disregard transactions based on an available options or bargaining power analysis would seem inappropriate as a procedural matter in a document interpreting the current Guidelines. In addition, it would be premised on incorrect assumptions about bargaining power between hypothetical unrelated parties. At arm's length, barriers often exist which cause the predominant bargaining power to be with one party to the transaction or the other. Some parties have legal rights that limit the bargaining power of others. For example, those with IP rights can block the entry of others into a market and sue for infringement. Those who legally own a product normally have the ability to choose who will distribute their product. The persons with these legal rights and assets can, to a great extent, control what risks and functions they wish to contract for from others.

In other words, assuming no valid claim of breach of contract or other restriction under applicable law, at arm's length an entity normally would not be able either to demand no change to the contract with an exiting counterparty or to prevent

²⁴ See, e.g., paragraphs 1.10, 1.39, 1.41, 6.13.

²⁵ See, e.g., Guidelines, paragraph 1.5.

²⁶ Guidelines, at paragraph 3.19.

Mr. Jeffrey Owens
March 5, 2009
Page 19 of 29

termination of that contract. Rather, the entity would need to seek an arrangement with a different party if it wished to continue to perform its current functions under current conditions. For example, if a supplier wishes to sell instead through a commissionaire and is willing to assume the economic risks of doing so, it will seek out those sales service providers in the marketplace that are willing to sell those services. If the distribution entity with which that supplier has been dealing prefers to not act on a commissionaire basis, that distribution entity will have to seek work from a different supplier. Absent special contractual or local law provisions, the distributor will not have the power to avoid termination of its existing agreement if the supplier decides not to renew or demands renewal terms unacceptable to the distributor. Existing transfer pricing rules simply do not permit taxation premised on an effective assumption that a service provider can continue to operate indefinitely on a legacy basis where it has no legal right to do so.

The Guidelines presumably were structured as they are largely in recognition of the fact that tax administrations are not normally ideally positioned to make and sustain judgments about what hypothetical unrelated parties would have done, especially without knowing all of the facts of their particular business circumstances. Taken to an extreme, such an analysis would seem to set an undesirable precedent that could be used to attack the arm's length principle more generally. Such a departure from the Guidelines would create significant new uncertainty, controversy, and double taxation and should, therefore, clearly be avoided.

6. Profit Potential

The Discussion Draft correctly acknowledges that "profit potential" is not an asset and that the arm's length principle does not require compensation for the transfer of profit or loss potential *per se*.²⁷ We welcome confirmation of these important points.

The threshold issue is whether there is a transfer and, if so, whether it must be recognized for transfer pricing purposes. As a threshold matter, there must be a transfer of an asset that is the property of the transferor. A transferor can legally transfer assets only to the extent that it has proprietary rights in those assets.

If there is a transfer of an asset, it is recognized for transfer pricing purposes only if it is a protected asset, *i.e.*, an asset that may be protected by law or by contract. This is because a transferee would not pay a transferor at arm's length for property to which the transferor cannot otherwise deny it access. In other words, at arm's length, compensation can be demanded for nonprotected intangibles (*i.e.*, intangibles

²⁷ Discussion Draft, paragraph 64.

Mr. Jeffrey Owens
March 5, 2009
Page 20 of 29

other than patent, copyright, trademark, or other legally granted monopolies) only if the owner/transferor has some ability by contract or otherwise to prevent others from utilizing that intangible.

“Profit potential” is not itself a protected intangible property right. Any productive asset carries with it the potential to generate profits, if employed in a successful enterprise, but profit potential itself has no separate legal significance. Valuable assets which may be transferred in a business restructuring of course must be valued. No enterprise, however, can demand compensation for loss of a “profit potential” as there is no general “right” to maintain the status quo (absent contractual protection to do so).

The provisions of the Guidelines are consistent with this analysis. There is no indication in the Guidelines of any intent to treat “profit potential” as property requiring compensation upon transfer. The Guidelines chapter on transfer pricing considerations involving intangible property treats only certain types of assets, not including profit potential, as relevant for this purpose.²⁸ The only reference in the Guidelines to “profit potential” is a brief discussion, in paragraph 1.10, of the difficulty of valuing certain intangibles due to their uncertain profit potential.

The Discussion Draft makes many references to “profit potential,” without a concrete discussion of the concept. What the Draft appears to be referring to at some points, however, is the profit that eventually arises after the business has made investments, made decisions, and either won or lost in the marketplace. That profit arises from the running of the business. It does not exist as an element of the intangible or tangible asset at the time of transfer. An investor in an asset invests in the asset as an input to run the business. The profit potential discussion is flawed, therefore, in that it focuses on the speculative results of business activity, rather than on the value of an asset that will be used as an input to that activity.

7. Goodwill / Going Concern Value

Issues Note No. 3 contains a similar discussion of goodwill and going concern value:

“Business restructurings sometimes involve the transfer of an ongoing concern, *i.e.* of an activity. The transfer of an activity in this context means the transfer of the total bundle of assets (possibly including contractual rights, workforce in place, goodwill, etc.) and liabilities associated with performing particular functions, including the

²⁸ See Guidelines, paragraph 6.2.

Mr. Jeffrey Owens
March 5, 2009
Page 21 of 29

inherent risks. The determination of the arm's length valuation for a transfer of ongoing concern does not necessarily amount to the sum of the valuations of isolated elements that are part of the transfer. In effect, transfers of ongoing concerns between independent parties often take account of any possible "goodwill", *i.e.* of the profit / loss potential (if any) of the activity transferred, from the perspective of both the transferor and the transferee. Valuation methods that are used in acquisition deals between independent parties may prove useful to value a transfer of activity, including goodwill, between associated enterprises."²⁹

The Discussion Draft thus endorses the acquisition price method as a possible means to determine arm's length consideration for a business restructuring. It also suggests that profit potential may be assimilated into goodwill. We respectfully suggest that both of these points are mistaken.

Most business restructurings do not involve the transfer of an entire enterprise. Accordingly, it seems highly unlikely that the acquisition price method could be the best method.

More generally, we would note that goodwill does not equal profit potential, and both are distinct from going concern value. Goodwill is the value arising from the expectation that customers will return to the usual place. Going concern value is the residual value of a business after the other assets have been identified and valued. These assets typically do not transfer in a business restructuring. The going concern value of a collection of business assets located in a country does not move to a different entity if those assets and persons will now be deployed in the same place in a new set of activities. Similarly, goodwill (as distinct from assets such as trademarks) also normally would not be separated from the functions and assets that remain in place. The value of an intangible normally would not carry with it the value of goodwill that is associated with other business assets which are not transferred. Indeed, goodwill generated through the past activities of a business can disappear in a business restructuring or asset sale, in that it does not automatically reconstitute in the acquirer (and thus does not need to be paid for). Goodwill associated with a trademark is different and does transfer with the trademark. But the residual value of business activities performed with a certain set of assets and personnel typically is not transferred in a business restructuring, or at least not transferred in a manner requiring compensation.

²⁹ See Discussion Draft, paragraph 93 (footnote omitted).

Mr. Jeffrey Owens
March 5, 2009
Page 22 of 29

8. Two-Sided vs. One-Sided Analysis

The Discussion Draft in several places asserts that the arm's length nature of the transaction must be assessed from the perspectives of both the transferor and the transferee. A two-sided review may be appropriate for limited purposes under the current Guidelines, for example to confirm the choice of which entity is the tested party and to confirm the nature of the transactions entered into with the tested party. However, the whole point of the identification of the tested party is to analyze the party whose activities and functions are relevant to the pricing analysis. The Guidelines do not generally require a two-sided analysis, recognizing the significant burdens that would entail. Since the Guidelines apply in the same manner to all situations, there is and should be no special rule on this point for restructured entities.

We also see no justification for mandating a sales-related indicator for commissionaire or sales agent activities, as suggested by paragraph 152. Economic contributions are made to an enterprise through the deployment of assets and labor, so there is no reason to categorically state that testing a return based on the amount of costs for assets or labor incurred is not appropriate. The text concedes that perhaps a combination of a Berry ratio and a sales-related indicator might work, but we see no reason to exclude the sole application of a cost-based indicator, whether cost plus or Berry ratio. This risks confusing the commercial transaction (*i.e.*, the compensation formula in the intercompany agreement) and the profit-level indicator (*i.e.*, what measure of the comparables and tested entity profit and loss one references in the TNMM analysis).

For example, one could provide in the intercompany agreement for remuneration on a cost plus basis, but depending on the reliability of the data, the nature of the business and the comparables chosen still use operating income as a percentage of revenue as the TNMM profit-level indicator. Similarly, one could use a percentage of revenue commission in the intercompany agreement, but depending on the reliability of the data, the nature of the business and the comparables chosen still use a Berry ratio as the PLI. The statement questioning whether at arm's length commissionaires are compensated on a cost-based basis is not relevant for this purpose, because the PLI does not strictly depend on the commercial transaction. For distribution entities, a gross margin percentage is commonly used as the PLI, but it is not common at arm's length for a supplier to contract with its distributor to sell at a price tied to the distributor achieving a certain gross margin.

Mr. Jeffrey Owens
March 5, 2009
Page 23 of 29

9. Before and After Comparison

The before and after comparison discussed in Issues Notes 2 and 3³⁰ is not realistic as a prescriptive tool. It is clear, as paragraph 182 seems to recognize, that the profits before a transaction can have no probative value to a transfer pricing analysis after the transaction, if only for the reason that the potential comparable (the “before” state) would be a controlled transaction. Also, the prior pricing may be wrong, business conditions may have changed, and giving weight to the prior pricing may disregard the market power of the entity that initiates the restructuring.

However, the discussion goes on to state that a before and after comparison “may provide valuable indications” and could be useful “in the risk assessment phase,”³¹ and that the comparison could play a role in understanding the restructuring itself “and be part of a before-and-after comparability.”³² The text should be clarified to confirm clearly throughout that a before and after comparison of profits may never be used a basis for adjustments, as there is simply no ground, at least under the existing Guidelines, to base a transfer pricing analysis for one year on profits reported in controlled transactions in different years.

What is appropriate is to perform a functional analysis of the tested party (or parties), based on the transactions actually occurring and the functions of the entity actually being performed in the tested year. Functions, assets risks, market conditions, and competitors all can be reviewed. But profits are the result of many factors, including intercompany pricing, and not a simple proof of value contribution for a different year.

10. Terms of the Arrangement

The Discussion Draft contains various suggestions that terms can be implied into contracts based on speculation as to what other parties might have done.³³ As indicated by the Guidelines, the transfer pricing analysis should always attempt to set an arm’s length price for the arrangement as actually entered into by the parties. Thus, it normally would be inappropriate to assume or infer terms not in the contract.

³⁰ See, e.g., Discussion Draft, paragraphs 69, 184.

³¹ See Discussion Draft, paragraph 182.

³² See Discussion Draft, paragraph 184.

³³ See, e.g., Discussion Draft, paragraph 107.

Mr. Jeffrey Owens
March 5, 2009
Page 24 of 29

For example, in the case of a very short-term contract where the party making the investment in the marketplace arguably would not do so at arm's length without the ability to recover that investment, the better approach would be to reallocate the investment to the principal rather than imputing a longer term to the contract. Instead, we are starting to see some tax administrations attempting in the examination context, as a first resort, to impute significant changes in the terms of the parties' agreements, even attributing ownership of IP from one entity to another.

The Discussion Draft should clarify that such analyses are inconsistent with the Guidelines.

11. Recognition of the Actual Transactions Undertaken

On the subject of recognition or recharacterization of transactions, the Discussion Draft begins by framing the issue broadly:

“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.

“Where paragraphs 1.36-1.41 of the TP Guidelines do apply, Article 9 would allow an adjustment of conditions to reflect those which the parties would have attained had the transaction been structured in accordance with the economic and commercial reality of parties dealing at arm's length (see paragraph 1.38 of the TP Guidelines). In doing so, the objective should be to arrive at a characterisation or structure that comports as closely as possible with the facts of the case.”³⁴

We agree with these basic propositions, but are concerned that broad references of this sort to the adjustment of conditions other than price may give the unwarranted impression that adjusting conditions is a typical exercise of the authority to adjust prices under Article 9. The authority to recharacterize or disregard a transaction

³⁴ Discussion Draft, paragraphs 201-202.

Mr. Jeffrey Owens
March 5, 2009
Page 25 of 29

pursuant to the Guidelines is reserved for highly unusual cases. Accordingly, the remedy in all other cases is to adjust prices, not to adjust other conditions. It would be helpful for the Issues Notes to reiterate this point more strongly.

The Guidelines are based on the fundamental proposition that the transactions entered into by the parties are to be respected as structured and then priced with reference to what independent parties would have agreed:

“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... . In other than exceptional cases, the tax administration should not disregard the actual transactions or substitute other transactions for them. 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.”³⁵

The Guidelines thus explicitly prohibit the tax administration from recharacterizing or disregarding the taxpayer’s transactions for transfer pricing purposes, unless one of the narrow exceptions they provide applies. They do this although they also recognize that associated enterprises often enter into transactions that independent parties would not conclude.³⁶ The Guidelines require only an arm’s length *result*: that the profits of each party be comparable to what would have been agreed by parties dealing independently with each other in similar transactions under similar conditions.

This is consistent with the approach of Article 9 and its Commentary. As the Guidelines confirm:

“The authoritative statement of the arm’s length principle is found in paragraph 1 of Article 9 of the OECD Model Tax Convention Article 9 provides:

‘[When] conditions are made or imposed between ... two [associated] enterprises in their commercial or financial

³⁵ Guidelines, paragraph 1.36. *See also, e.g.*, paragraph 1.10.

³⁶ *See, e.g.*, Guidelines, paragraphs 1.10, 1.39, 1.41.

Mr. Jeffrey Owens
March 5, 2009
Page 26 of 29

relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.’

“By seeking to adjust profits by reference to the conditions which would have obtained between independent enterprises in comparable transactions and comparable circumstances, the arm’s length principle follows the approach of treating the members of an MNE group as operating as separate entities rather than as inseparable parts of a single unified business. Because the separate entity approach treats the members of an MNE group as if they were independent entities, attention is focused on the nature of the dealings between those members.”³⁷

Thus, Article 9(1) looks to whether profits have been reduced as a result of dealings between the associated enterprises on conditions that independent entities would not have adopted. It assumes and accepts that the “commercial or financial relations” between associated enterprises may differ from those between independent entities. It concludes that the remedy for addressing such differences is an adjustment to the profits *by reference to* independent entity transactions, however, and not the effective substitution of those transactions for the transactions that actually occurred. The OECD Commentary on Article 9 and the Guidelines confirm throughout that the tax administration’s recourse, with very limited exceptions, is to adjust the profits in this manner. Therefore, any interpretation of the arm’s length principle that would generally recharacterize or disregard the taxpayer’s transactions to mirror those that the tax administration believes independent parties would have entered into, rather than simply adjust profits as necessary with respect to the transactions that actually occurred, would appear to lack a basis in OECD guidance.

The Guidelines provide only two exceptions to the general rule that the transfer pricing analysis must be applied to the transaction that actually occurred. First, paragraph 1.37 indicates that recharacterization of the taxpayer’s transaction may be appropriate where “the economic substance of the transaction differs from its form,” citing the example of a capital subscription improperly characterized as interest-bearing debt. Second, paragraph 1.37 also provides that recharacterization of the transaction may “exceptionally” be appropriate where—

³⁷ Guidelines, paragraph 1.6.

Mr. Jeffrey Owens
March 5, 2009
Page 27 of 29

“while the form and substance of the transaction are the same, 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.”

(Emphasis added.) These two exceptions are presented not as illustrative examples but as the sole exceptions to the general rule that the analysis must proceed from the actual transaction.

It is difficult to see how a business restructuring could be seen as impeding the determination of an appropriate transfer price. The Guidelines provide explicit guidance on appropriate pricing for typical limited-risk entities³⁸ as well as guidance on pricing the transfers of intangible assets (in Chapter VI) and tangible assets (throughout the Guidelines) that may occur in connection with some restructurings. Although the indicated pricing may not appeal because it provides a routine return to low-risk entities, the Guidelines clearly do not contemplate that a low-risk distribution or manufacturing arrangement, or a conversion to such a structure cannot be priced and, therefore, should be recharacterized or disregarded. Consequently, this exception in paragraph 1.37 should not apply to the typical business restructuring.

12. Commercially Rational

The Discussion Draft frames as follows its consideration of the “commercially rational” prong of the second exception in paragraph 1.37, which may apply to permit recharacterization if an appropriate transfer price cannot otherwise be determined because of the taxpayer’s structure:

“Consistently with paragraph 196, tax administrations should not ordinarily interfere with the business decisions of a taxpayer as to how to structure its business arrangements. A determination that a controlled transaction is not commercially rational must therefore be made with great caution, and only in exceptional circumstances lead to the non-recognition of the related party arrangements. In circumstances where reliable data show that similar transactions or arrangements exist between independent parties, it cannot be argued

³⁸ See, e.g., Guidelines, paragraphs 1.25, 7.40, and 7.41.

Mr. Jeffrey Owens
March 5, 2009
Page 28 of 29

that such an arrangement between related parties would lack commercial rationality. On the other hand, however, the mere fact that a related party arrangement is not seen between independent parties does not in itself mean that it is not arm's length (paragraph 1.10 of the TP Guidelines). Although there might be situations in which it is clear from the outset that the transactions entered into are not commercially rational, depending on the circumstances of the case, it can be particularly difficult in practice for tax administrations to assess whether an arrangement is commercially rational. Problems of double taxation may arise if such an assessment is not shared by the other Contracting State."³⁹

As stated, these principles closely track the Guidelines and represent, we believe, a reasonable approach. We also appreciate the Discussion Draft's confirmation that:

"In evaluating whether a party would at arm's length have had other options realistically available to it that were clearly more attractive, due regard should be given to all the relevant conditions of the restructuring, to *the rights and other assets of the parties*, to any compensation or indemnification for the restructuring itself and to the remuneration for the post-restructuring arrangements (as discussed in Issues notes No. 2 and No. 3) as well as to the commercial circumstances arising from participation in an MNE group (see paragraph 1.10 of the TP Guidelines)."⁴⁰

The acknowledgement in this statement that the rights and assets of the parties must be taken into account for purposes of this analysis is particularly important.

The recognition, in paragraph 210, of the need to examine the business restructuring transaction in a broader context is also welcome.

What is missing from this discussion, however, is an unambiguous statement emphasizing the fact that this "commercially rational" analysis may never be applied as a stand-alone criterion for assessing a transaction. We would urge further clarification of this point to ensure appropriate treatment of this standard as a rare anti-abuse rule, rather than a subjective prescription of general application.

³⁹ Discussion Draft, paragraph 208.

⁴⁰ Discussion Draft, paragraph 209 (emphasis added).

Mr. Jeffrey Owens
March 5, 2009
Page 29 of 29

13. Need for Consensus

We would urge the OECD to continue to focus on the overarching need for consensus among member countries on the issues considered in the Discussion Draft. Such a consensus was reflected in the Guidelines and has enabled them to serve as a valuable platform for the application of consistent approaches and the resolution of interpretive questions.

We assume consensus on business restructuring guidance remains the goal of OECD member countries. However, it is not clear from the Discussion Draft that a full consensus has been achieved. Rather, a lack of consensus seems apparent on several important points at this stage.⁴¹ We respectfully urge the OECD to press again for full consensus on the remaining points.

14. Form of Implementation

Once the Issues Notes have been finalized in appropriate form, we would urge that their provisions be implemented in their entirety through incorporation by reference into the Guidelines. This should ensure consistent application of their provisions as a whole.

* * *

We appreciate this opportunity to provide comments on the Discussion Draft on behalf of the Treaty Policy Working Group. We would be pleased to provide additional details or to discuss any or all of these issues as the OECD proceeds with its consideration.

Respectfully Submitted,

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⁴¹ See, e.g., Discussion Draft, paragraphs 207, 216, 219, and 221.