International

Giammarco Cottani*

OECD Discussion Draft on Transfer Pricing Aspects of Business Restructurings: Summary of Business Comments and Issues for Discussion

The author provides an overview of the main areas of interest arising from the business comments received on the OECD Discussion Draft on the Transfer Pricing Aspects of Business Restructurings. The comments received from the business community are being analysed by the OECD and will be discussed at a consultation meeting with commentators that will take place in Paris on 9-10 June 2009. The OECD will then determine the extent of the further work needed to finalize its guidance on the transfer pricing aspects of business restructurings.

1. Introduction

This article will provide an overview of the main areas of interest arising from the business comments received on the OECD Discussion Draft on the Transfer Pricing Aspects of Business Restructurings[1] (the Discussion Draft). The comments received from the business community are in the process of being analysed by the OECD and will be discussed at a consultation meeting with commentators that will take place in Paris on 9-10 June 2009. The OECD will then determine the extent of the further work needed to finalize its guidance on the transfer pricing aspects of business restructurings.

2. Background and scope of the OECD Discussion Draft

Business restructurings by multinational enterprises have been a widespread phenomenon in recent years. They involve the cross-border redeployment of functions, assets and/or risks between associated enterprises, with consequent effects on the profit and loss potential in each country. Restructurings may involve cross-border transfers of valuable intangibles, and they have typically consisted of the conversion of fully fledged distributors into limited-risk distributors or commissionaires for a related party that may operate as a principal; the conversion of fully fledged manufacturers into contract manufacturers or toll manufacturers for a related party that may operate as a principal; and the rationalization and/or specialization of operations.

The Discussion Draft is the outcome of more than three years of hard work by the OECD, in which a proactive dialogue with the business community played a crucial role. In January 2005, in recognition of the widespread phenomenon of business restructurings by multinational enterprises (MNEs) and of the tax issues raised thereby, the OECD Centre for Tax Policy and Administration organized a Roundtable on Business Restructurings (the January 2005 CTPA Roundtable), which was attended by senior officials from OECD Member countries as well as from China, South Africa and Singapore and by a wide panel of private sector representatives. Government and private sector participants addressed a broad range of issues, including administrative approaches taken in examinations, as well as treaty, transfer pricing and VAT issues. The January 2005, CTPA Roundtable acknowledged that these restructurings raise difficult transfer pricing and treaty issues for which OECD guidance under both the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines) and the OECD Model Tax Convention on Income and on Capital (OECD Model Convention) is needed. These issues involve primarily the application of transfer pricing rules upon and/or after the conversion; the determination of the existence of, and attribution of profits to, permanent establishments (PEs); and the recognition or non-recognition of transactions. In the absence of a common understanding on how these issues should be treated, they may lead to significant uncertainty for business and governments, as well as possible double taxation or double non-taxation. Recognizing the need for work to be done in this area, the Committee on Fiscal Affairs (CFA) decided to start a project to develop guidance on these transfer pricing and treaty issues.

In 2005, the CFA created a Joint Working Group of delegates from Working Party No. 1 (responsible for the OECD Model Convention) and Working Party No. 6 (responsible for the OECD Guidelines) to initiate the work on these issues. At the end of 2007, having taken stock of the progress made to that point, the CFA referred the work on the transfer pricing aspects of business restructurings to Working Party No. 6, and the work on the PE threshold aspects to Working Party No. 1.

The Discussion Draft that was released on 19 September 2008 has resulted from the work done on the transfer

* Transfer Pricing Advisor, OECD. The author would like to thank Ms Caroline Silberztein (Head of the OECD Transfer Pricing Unit) and Ms Mary Bennett (Head of the OECD Tax Treaty, Transfer Pricing and Financial Transactions Division) for the valuable comments provided during the drafting of the article. The views expressed in this article are those of the author and do not commit the OECD nor its Member countries.

1. Discussion Draft on the Transfer pricing Aspects of Business Restructurings. See www.oecd.org/document/7/0,3343,en_2649_33753_41328775_1_1_1_1,00.html.

pricing issues by the Joint Working Group and Working Party No. 6. It comprises four Issues Notes:

– Issues Note 1: Special consideration for risks;
– Issues Note 2: Arm's length compensation for the restructuring itself;
– Issues Note 3: Remuneration of post-restructuring controlled transactions; and
– Issues Note 4: Recognition of the actual transactions undertaken.

A deadline for public comments was set by 19 February 2009. More than 35 contributions were received from the public, demonstrating the awareness and importance of this project within the business community and the significance of the issue addressed.[2]

In March 2009, a Special Session of Working Party No. 6 on business restructurings, represented a first discussion of the comments received and identified the topics that would most benefit from a public consultation to be held on 9-10 June 2009 with the organizations that submitted comments.

3. The Progress Made since 2005

From a general perspective, many commentators welcome the Discussion Draft that "echoes the common sense, balance and pragmatism which characterizes the OECD Guidelines" and "represents an important step forward in developing an international consensus on the important topic of business restructuring".

Most notably, almost all the business commentators recognize that the Discussion Draft properly emphasizes principles including the following:

– The starting point of the analysis in the Discussion Draft is not abusive restructurings. This follows from the comments made by the business community at the January 2005 CTPA Roundtable that tax authorities and the OECD should acknowledge that businesses need to restructure constantly to adapt to new economic circumstances, and that general transfer pricing principles should not be distorted to deal with a minority of abusive cases.

– The OECD Discussion Draft explicitly reaffirms that MNEs are free to organize their business as they see fit. Tax authorities should not interfere in business decisions; their role is to determine tax consequences on the basis of existing rules.

– The transfer pricing analysis of restructurings in the context of Art. 9 of the OECD Model Convention starts from an examination of the taxpayer's contractual terms. Contractual terms are generally respected unless they do not reflect the actual behaviour of the parties or are not arm's length.[3] The authorized OECD approach for attributing profits to PEs that was developed for applying Art. 7 of the OECD Model Convention is a different analytical framework due to the absence of legal contracts within a single legal entity.[4]

– The fact that a related party arrangement is not one seen between independent parties should not of itself mean the arrangement is non-arm's length.[5]

– Profit/loss potential is not an asset.[6] The arm's length principle does not require compensation for loss of profit potential per se. The question is whether there are rights or other assets transferred that carry profit/loss potential and should be remunerated at arm's length.

– There is no presumption that all contract terminations or substantial renegotiations should give rise to indemnification at arm's length.[7]

– In determining whether the conditions of a business restructuring are arm's length, it is important to examine the rights and other assets of each party at the outset of the restructuring.

– It can be commercially rational from a transfer pricing perspective[8] for a multinational group to restructure in order to obtain tax savings.[9]

– A determination that a controlled transaction is not commercially rational must be made with great caution and only in exceptional circumstances lead to the non-recognition of the related-party arrangements. The OECD considers that apparent non-arm's length behaviour should as much as possible be dealt with on the basis of pricing adjustments, rather than by not recognizing transactions.

– The arm's length principle and the OECD Guidelines do not and should not apply differently to post-restructuring transactions as opposed to transactions that were structured as such from the beginning. In particular, there is no different threshold for applying the profit split to post-restructuring transactions and other transactions.

The above list shows that since the beginning of the project in 2005, the OECD has been able to achieve significant progress towards consensus on many complex and potentially controversial issues, in an effort to improve the certainty of the tax environment in which business restructuring transactions take place.

The Discussion Draft, however, represents only a work in progress, and significant areas for further work remain. Commentators have raised issues which are summarized below.

2. Comments received on the Discussion Draft are publicly available at http://www.oecd.org/document/25/0,3343,en_2649_33753_42155737_1_1_1_1,00.html.
3. Para. 26 Discussion Draft.
4. See Report approved by the Committee on Fiscal Affairs on 24 June 2008 and by the OECD Council for publication on 17 July 2008, www.oecd.org/ctp/tp/pe.
5. Para. 27 Discussion Draft.
6. Para. 64 Discussion Draft.
7. Para. 101 Discussion Draft.
8. Notwithstanding the possible application of domestic anti-abuse rules.
9. Para. 196 Discussion Draft.

3.1. Does the OECD Discussion Draft improve certainty?

Several commentators question whether the Discussion Draft provides sufficient certainty with respect to the transfer pricing treatment of business restructurings. Although there are many consensus positions expressed in the Discussion Draft, reflecting the tremendous progress achieved since 2005, concerns have been expressed by commentators about those points on which non-consensus positions remain, in particular in Issues Notes 1 and 4.

In addition, several commentators consider that some of the terms used in the Discussion Draft are too ambiguous and leave room for differing interpretations by taxpayers and tax authorities alike. In their opinion, such lack of clarity does not provide sufficient certainty and predictability as to the transfer pricing treatment of business restructurings. In this regard, concepts such as "arm's length allocation of risks", "commercially rational behaviour" and "other options that would be realistically available at arm's length" are regarded by these commentators as too subjective, in their view rendering the analysis of these type of transactions more difficult. One commentator suggests that a greater use of examples could help establishing recognizable criteria that could be applied in a more objective manner.

Another aspect in relation to the provision of certainty is the possibility of resolving disputes in mutual agreement procedures (MAP) or arbitration.[10] In the view of one commentator, in many cases the use of recharacterization procedures is accompanied by sanctions that deprive taxpayers of the possibility to have access to a MAP. This commentator therefore suggests the introduction of a mechanism whereby, whenever a tax authority considers recharacterizing or disregarding a transaction, it should enter into a discussion with the authorities of the other state(s) concerned as to the legitimacy of the recharacterization or disregarding of the transaction. Another commentator, referring to the situation whereby two tax authorities could not agree over whether or not a particular transaction should be recognized or could be recharacterized, suggests that lacking agreement between the two authorities, the transaction should be respected as entered into by the taxpayer and only a pricing adjustment could be made, i.e. the transaction should not be disregarded by one tax authority alone unless a symmetrical treatment and compensating adjustment can be obtained in the other country concerned.

In the view of another business representative, the OECD should consider providing either a safe harbour or a rebuttable presumption clarifying circumstances when a restructuring transaction should be respected, e.g. when the multinational group could show that its post-restructuring effective tax rate falls within a reasonable range of statutory tax rates for the countries involved in a business restructuring (e.g. an effective tax rate between 20% and 30%).

3.2. Business restructuring and documentation requirements

Documentation issues arising from the Discussion Draft drew much attention from the private sector. On the one hand, commentators generally understand the focus on documentation from the perspective of tax authorities when it comes to substantiating the transfer pricing aspects of business restructurings. On the other hand, some commentators express serious concerns about what they perceive as an excessive documentation burden and disproportionate compliance costs imposed by the Discussion Draft on MNEs.

In particular, some business representatives have expressed concerns that the Discussion Draft could be read as requiring taxpayers to test and document alternative options that would have been realistically available at arm's length but that are not implemented or even considered by the multinational group (see 3.4.). While it is not the intention of the OECD to require taxpayers to document all kinds of alternative options to their controlled transaction, further work is needed to clarify the meaning and purpose of this notion and when (and how) alternative options should be documented by taxpayers.

Other commentators highlight that all the documentation required by the tax authorities may not be at the taxpayer's disposal, and that there is no clear guidance in the Discussion Draft on how to determine whether the documentation provided is or is not sufficient, thus leaving some uncertainties about cases where tax authorities may be justified to either make a transfer pricing adjustment or even reclassify a transaction because of lack of taxpayer documentation.

In the view of another business representative, the Discussion Draft as well as other recent OECD publications, shows an increased tendency to expand the type of documentation that may be requested by tax authorities for transfer pricing purposes. For this commentator, the resulting documentation burden goes beyond a reasonable level of acceptance. Several commentators urge the OECD to review the reasonableness of the list of documentation requirements that is seemingly imposed in the Discussion Draft, whereas others suggest that some guidance should be developed as to a minimum level of transfer pricing documentation needed to substantiate a business restructuring (maybe in light of a "prudent business management principle" for documentation requirements). This is an area that the OECD will need to clarify, as transfer pricing documentation requirements are a matter of best practices and of domestic law, rather than a requirement posed by Art. 9 of the OECD Model Convention.

10. Art. 25 OECD Model Convention.

3.3. Members of multinational groups vs. independent enterprises

According to some commentators, the Discussion Draft does not appropriately reflect the realities of the decision-making process within MNEs and, as a consequence, seems to establish unrealistic standards when testing the arm's length principle at the individual entity level with respect to the discussion of "control over risks", "options realistically available" and of the anticipated benefits expected from entering into a business restructuring. For these commentators, the Discussion Draft does not appropriately recognize the difference between the legal structure relevant for tax purposes and the organizational structure of MNEs acting as one global entity towards third parties. In particular, they note that business restructurings often are entered into because of global needs and expected efficiency gains that can hardly be evaluated at a separate entity level.

The OECD is aware of this conceptual difficulty and, as noted at Para. 7 of the Discussion Draft, "the implementation of integrated business models and the development of global organizations highlight the difficulty of reasoning in the arm's length theoretical environment". In effect, the arm's length principle treats members of a multinational group as operating as separate entities rather than as inseparable parts of a single unified business, and the question arises as to how to reconcile this theoretical framework with the factual differences that exist between parts of MNEs and independent parties. This is an issue that will be discussed with business commentators at the 9-10 June 2009 consultation meeting.

3.4. "Options that would have been realistically available at arm's length"

Another concept that drew much attention from the business community is that of "options that would have been realistically available at arm's length". The view expressed in the Discussion Draft[11] is that this notion is relevant to both comparability and pricing of the transaction[12] 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 Paras. 1.36-1.41 of the OECD Guidelines. 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 enter into the transaction only if they see no alternative that is clearly more attractive. Some commentators regard this notion as too subjective and possibly creating a disproportionate compliance burden if taxpayers were requested to test and document, for transfer pricing purposes, alternative options that they did not consider implementing.

Some commentators find that the Discussion Draft does not clarify (1) whether such options must be tested at the individual or group level and (2) whether the alternatives to be considered include purely hypothetical ones outside the group (e.g. a related distributor contracting with a non-group supplier as an alternative to agreeing to a restructuring within the group) or only options available within the group. For one business representative, the suggestion that an analysis of other realistic options should be prepared as part of the transfer pricing documentation would prove to be unhelpful, as the assumptions utilized would be at the very least inaccurate.

On the other hand, some commentators welcomed the introduction of such a notion as it allows taking into account the reality that often at arm's length a party has little or no choice but to accept what is on offer or go elsewhere.

The notion of "options that would have been realistically available at arm's length" also is a subject for discussion with commentators at the 9-10 June 2009 consultation. The OECD will further analyse the relevance and practical implications of this notion in transfer pricing analyses in order to develop as practical and sensible guidance as possible on the topic.

3.5. Business restructurings as a taxable event

Comments received also addressed the identification of the circumstances in which business restructurings trigger a taxable event. Issues Note 2 of the Discussion Draft provides an analysis of how to determine whether, at arm's length, there should be compensation for the restructuring itself. Two situations are identified:
- where there is a transfer of "something of value" (rights or other assets); and
- where existing arrangements are terminated or substantially renegotiated and such termination or substantial renegotiation would have been indemnified at arm's length.

The Discussion Draft makes it clear that the arm's length principle is not about taxing a loss of taxable basis, but rather about aligning the conditions of related party transactions with those which would be agreed between unrelated parties.

Several commentators consider that taxation should occur only upon transfer of "property" and urge the OECD to clarify that a mere transfer of functions or of future profit potential of a business in another state is not a taxable event in the absence of transfer of underlying property.

In particular, one commentator suggests that the Discussion Draft should define property as (1) tangible assets, (2) intangible assets such as patents, trademarks, trade names, designs or models and intellectual property such as know-how and trade secrets that are legally protected and commercially transferable and (3) contracts containing rights that are commercially enforceable.

11. See Para. 209 of the OECD Discussion Draft: "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".
12. See Para. 1.15 OECD Guidelines.

This raises complex questions in a context where there is no international consensus on the definition of intangible property for transfer pricing purposes.

3.5.1. The definition of realization and the taxable event

Specifically, some commentators express the view that, in the absence of a transfer of property, the following should not be treated as taxable events under Art. 9 of the OECD Model Convention:
- a transfer of profit potential;
- a transfer of functions;
- a change of commercial relationships;
- the creation of service centres or adding of certain services to an existing service centre; and
- the creation of a new manufacturing or distribution subsidiary.

3.5.2. Intangible assets

The analysis of intangibles raised a number of comments, as well. For some commentators the definition of intangibles should be addressed in the Discussion Draft, focusing in particular on the rising category of what constitute "soft intangibles", as well as providing more details on notions such as profit potential, synergies, location savings and local marketing intangibles.

Furthermore, some business commentators expressed concerns regarding Paras. 87 and 88 of the Discussion Draft, which relate to the transfer pricing analysis of intangibles transferred at a point in time when they do not have an established value. In this regard, the Discussion Draft notes that where the valuation was made in good faith on the basis of information reasonably available at the time of the sale transaction, the question arises as to whether it may still be adjusted subsequently to account for the unexpectedly high profits or losses derived by the transferee from the intangible. The OECD consensus position is found at Paras. 6.28-6.35 of the OECD Guidelines.

Several commentators have construed these paragraphs as enabling tax authorities to redetermine transfer prices after a significant change in value occurred either (1) because of the resolution of known uncertainties or (2) due to an unexpected development. From the perspective of the business commentators, this could place taxpayers in the uncomfortable position whereby one tax authority believes that a large payment is needed, while the other tax authority thinks that no payment is needed or that the payment should be very low. In the same vein, one commentator expressed the view that taxpayers should not "be punished for not knowing the future", and suggests that a time limit of a maximum of five years for such adjustments would be desirable, and that the Discussion Draft should expressly provide for a mechanism of correction in favour of the taxpayer as well.

Other commentators do not deem Paras. 87 and 88 of the Discussion Draft as expressing a bias towards adjustments based on hindsight, but would welcome a clarification of the terms "good faith" and "sufficiently uncertain" used in Para. 88 of the Discussion Draft, so as to avoid possibly discretionary interpretations.

3.5.3. Profit/loss potential

As to the notion of "profit potential", almost all the comments received welcomed the statement contained in Para. 64 of the Discussion Draft that it does not constitute an asset *per se* and that the arm's length principle does not require compensation to be paid for the transfer of such profit/loss potential *per se*. The Discussion Draft notes that the question is rather whether there are rights or other assets transferred that carry profit/loss potential and should be remunerated at arm's length.

However, some commentators find that the above statement is undermined by what in their view is unclear language used in other parts of the Discussion Draft, in particular by looking at the relationship between Para. 65 about the means of valuing a transfer of rights or other assets through an examination of the transferred profit/loss potential associated with those rights or other assets, and Para. 93 of Issues Note 2 of the Discussion Draft about taking into account any goodwill for the valuation of the transfer of an activity (ongoing concern).

According to some, Para. 65 of the Discussion Draft seems to have left open the question of whether only legally recognized rights bearing profit/loss potential require compensation, or whether other less clearly identifiable "assets", such as goodwill or going concern, are recognized so as to trigger a taxable event.

Other commentators argue that the statement of Para. 93 is misleading in that profit/loss potential seems to be equated to the "goodwill" of an ongoing concern. This is something that the OECD will want to clarify at the 9-10 June 2009 consultation and in its revision of the Discussion Draft.

3.5.4. Indemnification of the restructured entity for detriments suffered as a result of the restructuring

All commentators welcomed the statement (contained in Para. 101 of the Discussion Draft) that there should be no presumption that all contract terminations or substantial renegotiations should give right to an indemnification at arm's length. In effect, the view expressed in the Discussion Draft is that a determination of whether the termination or substantial renegotiation of existing arrangements would be indemnified at arm's length should be made, requires an examination of the circumstances at the time of the restructuring, particularly the rights and other assets of the parties, as well as the options which would have been realistically available to the parties at arm's length.

For this purpose, the following four conditions should be examined:
- whether the arrangement that is terminated, not renewed or substantially renegotiated is formalized in writing and provides for an indemnification clause;

- whether the terms of the arrangement and the possible existence or non-existence of an indemnification clause or other type of guarantee (as well as the terms of such a clause where it exists) are arm's length;
- whether indemnification rights are provided for by commercial legislation or case law; and
- whether at arm's length another party would have been willing to indemnify the one that suffers from the termination or renegotiation of the agreement.

With regard to the notion of indemnification of the restructured entity for detriments suffered as a consequence of the restructuring, some commentators expressed the view that in practice, indemnification for future potential detriments is rarely seen in dealings between third parties. According to business commentators, the actual position often followed by third parties is that the issue of indemnification is reflected in the prices charged in any ongoing relationship between the parties. As a result, they consider it as extremely rare for independent enterprises to indemnify another party for detriments when they are not contractually obliged to do so. The conceptual difficulty here is to determine whether the contractual indemnification clause (or absence of indemnification clause) between associated enterprises is arm's length. Again, this is an area that will be further discussed by the OECD at the 9-10 June 2009 consultation and in its further work.

4. Risks

A number of interesting remarks were raised by commentators on the issue of risk allocation as addressed in Issues Note 1 of the Discussion Draft.

4.1. Risk allocation and the role of documentation

The vast majority of the commentators welcomed the statement in the Discussion Draft that taxpayers' contractual arrangements should form the starting point for any transfer pricing analysis in an Art. 9 context. Some commentators express the view that the OECD should clarify how to deal with cases in which written contractual agreements are lacking and whether the absence of documentation could play a role in considering whether the risk allocation between the parties is or is not arm's length.

4.2. Risk allocation and the role of uncontrolled comparables

Commentators welcomed the clarification in the Discussion Draft that the fact that a related-party arrangement is one not seen between independent parties should not in itself mean that the arrangement is not consistent with the arm's length principle. In effect, the position expressed in the Discussion Draft is that where reasonably reliable comparables exist to support the risk allocation, then the allocation is regarded as arm's length; where no such comparables exist, two relevant (but not determinative) factors to determine whether the risk allocation is arm's length are the "anticipated financial capacity to bear the risk" and "control over the risk".

As far as the analysis of the key elements of risk allocation is concerned, commentators focused their attention on three elements, namely (1) the anticipated financial capacity to bear the risk, (2) the control over the risk and (3) and the possibility to reassign the risk among the related parties on the basis of Para. 1.27 of the OECD Guidelines.

4.3. The anticipated financial capacity to bear the risk

Various definitions of the notion of "anticipated financial capacity to bear the risk" were suggested by commentators, as some of them thought that the Discussion Draft does not define the concept clearly enough. In one commentator's view, the Discussion Draft overstates the recognition of control and allocation of risks in areas where it is not needed (e.g. in the area of cost sharing arrangements), whereas a stronger recognition of the notion of financial capacity should be crucial in determining both a pricing mechanism and a sound profit outcome. For one business representative, the Discussion Draft should acknowledge that in order to bear risk a party needs to have the financial capacity to bear the cost of insurance/hedging only, rather than the financial capacity to bear the full costs of the risk materializing.

The OECD will want to clarify the intended role of the notion of "financial capacity to bear risk" as a relevant but not determinative factor that may assist, in the absence of reasonably reliable comparables, in the determination of whether the risk allocation between the parties is consistent with what independent parties would have agreed at arm's length. In effect, the intention in the Discussion Draft was not to set a standard whereby risk would always follow capital.

4.4. Risk allocation and control over risk

Many commentators support the definition of control that is proposed in Paras. 28 and 30 of the Discussion Draft, whereby control, in the context of Para. 1.27 of the OECD Guidelines, should be understood as "the capacity to make decisions to take on the risk (decision to put the capital at risk) and decisions to whether and how to manage the risk, internally or using an external provider". However, according to some commentators, the boundaries of such a notion need to be better defined in the Discussion Draft. For some business representatives, it would be useful for the OECD to take account of the differences that exist between the organizational structure of a multinational group and that of a single entity, as this may affect the determination of where control over risk is exercised (see 3.3.). In fact, some commentators highlight that, within a multinational group, key entrepreneurial decisions are taken by group bodies/committees (typically composed of personnel coming from various countries and different legal entities), and not with any particular entity.

One commentator suggests that the notion of control entails the responsibility for the consequences occurring due to the implementation of the policies determined by the party in control. Another suggests that control, within the definition of Para. 1.27 of the OECD Guidelines, is related to the "individual or group of individuals who is/are putting the capital at risk, which decision is – mostly – communicated through instructions to other individuals arranging the execution on a day-to-day basis".

Another question raised by some commentators is the extent to which the Discussion Draft may be importing into Art. 9 of the OECD Model Convention and the OECD Guidelines concepts that were developed in the context of the authorized OECD approach for attributing profits to permanent establishments under Art. 7. In particular, for some commentators it would be worthwhile for the OECD to better clarify the relationship between the notions of "significant people functions" developed under the authorized OECD approach for Art. 7 of the OECD Model Convention and that of "control over risk", the latter concept applying under Art. 9 of the OECD Model Convention.

In this regard, it could be clarified that because there are no legally binding contracts between a PE and other parts of the enterprise to which it belongs, the authorized OECD approach for attributing profits to a PE attributes assets and risks to the part of the enterprise that performs the "significant people functions" relevant to the creation of the assets or the assumption of the risk. By contrast, in an Art. 9 context, the determination of the ownership of assets and of the risk allocation always starts from contracts (respected only to the extent that they are consistent with the parties' actual behaviour and are at arm's length). As a result, only in the absence of uncontrolled comparables to support the allocation of risk in a given controlled transaction, other factors are used to assist in the determination of whether such risk allocation is consistent with what independent parties at arm's length would have agreed. The notions of "control over the risk" and of the "expected financial capacity to bear the risk" are two relevant but not decisive factors in this determination.

4.5. Relationship between Paras. 1.27 and 1.37 of the OECD Guidelines in the reallocation of risks

Certain commentators expressed some disagreement with the proposal (at Para. 38 of the Discussion Draft) that reassigning risk in a controlled transaction is allowed under Para. 1.27 of the OECD Guidelines when it does not change the fundamental nature of a transaction. To this end, many commentators consider that the taxpayer's allocation of risk should be respected in every case where the conduct of the parties is consistent with the parties' agreements, and that such allocation of risk should not be disregarded based on a rather subjective notion that "unrelated parties would not have done it that way".

Along this line of reasoning, one commentator advocates that Issues Note No.1 of the Discussion Draft should be revised so as to (1) eliminate the requirement that the allocation of risk be "arm's length" and (2) state that risk allocations should be respected whenever risks are allocated in written agreements and the parties behave in a manner consistent with the contractual arrangements.

Another commentator provides a very detailed response on the topic, suggesting that there is a distinction in the existing OECD Guidelines between:
– valuation adjustments, i.e. the traditional form of adjustments under the arm's length principle not restricted by Para. 1.36 of the OECD Guidelines; and
– structural adjustments, i.e. adjustments of conditions of controlled transactions which do not qualify as valuation adjustments, typically adjustments of the actual allocation of functions and risks, and adjustments of the conditions stipulating the nature, quality and quantity of the property or service transferred in the controlled transaction.

This commentator disagrees with the proposal in the Discussion Draft that there would be two categories of structural adjustments, namely those not changing the "fundamental nature" of the controlled transaction (which according to the Discussion Draft are authorized by the OECD Guidelines at Para. 1.27) and those changing the "fundamental nature" of the controlled transaction (addressed at Para. 1.37 of the OECD Guidelines). He considers this interpretation as inconsistent with the current OECD Guidelines and unfortunate, and as inappropriately restricting the effects of Paras. 1.36-1.41 of the OECD Guidelines. In his view, when applying Art. 9(1) of the OECD Model Convention, it is important to distinguish between:
– *establishing* the conditions of the controlled transaction (primarily based on an examination of written documentation and of the actual conduct of the parties – not on the arm's length principle); and
– *testing* whether these conditions "differ from those which would be made between independent enterprises", and where appropriate *adjusting* them, based on the arm's length principle.

He concludes by arguing that the same distinction applies under Para. 1.36 of the OECD Guidelines, and should be more clearly acknowledged in the Discussion Draft.

This again is a complex topic that is on the agenda for the 9-10 June 2009 consultation and on which further work might be needed.

5. Other Recharacterization Issues

Issues Note 4 of the Discussion Draft deals with the recognition of the actual transactions undertaken by the taxpayer and the cases where tax authorities may disregard or recharacterize a transaction. From a general perspective, commentators applaud the OECD's statement at Para. 196 of the Discussion Draft that MNEs are free to organize their business operations as they see fit. However, concerns were raised as to the lack of consensus among OECD member states with regard to some important questions addressed in Issues Note 4.

5.1. The non-recognition of transactions

Some commentators suggest that either the discussion of non-recognition of transactions should be confined to Issues Note 4 of the Discussion Draft, or even that the entire Issues Note 4 should be removed from the Discussion Draft.

The position expressed by the OECD in the Discussion Draft is that a determination that a controlled transaction is not commercially rational must be made with great caution, and only in exceptional circumstances lead to the non-recognition of the related party arrangements. The OECD considers that apparent non-arm's length behaviour should as much as possible be dealt with on the basis of pricing adjustments, rather than by not recognizing transactions.

To this end, one commentator believes that the language at Para. 27 of the Discussion Draft[13] can be read as an invitation to tax authorities to substitute their judgment for the structure actually put in place by the taxpayer. In his view, the Discussion Draft should instead make clear that tax authorities should respect the structure that MNEs have set to meet their business needs, therefore limiting their analysis to a determination of what pricing is appropriate within the context of the business arrangements established by the taxpayer. This is because third parties enter into a wide range of different types of contracts with substantially different allocations of risk, hampering the possibility of obtaining a single arm's length of risk in a given case.

In summing up the positions expressed by the business commentators on this point, four key points emerge:

– Business commentators would welcome further clarification by the OECD that recharacterization or non-recognition of transactions should be limited to the situations described in Para. 1.37 of the OECD Guidelines, i.e. (1) where the economic substance of a transaction differs from its form and (2) where, 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. Under this view, the Discussion Draft should make it clearer that that the powers of tax authorities to recharacterize or disregard transactions should not be extended beyond those that already exist.

– One commentator assumes that the terms "recharacterizing" and "disregarding" at Paras. 1.36-1.41 of the OECD Guidelines are synonymous, and suggests that if this is not the case, taxpayers would benefit from additional guidance as to the difference between the two terms.

– As to the meaning of the word "exceptional" at Para. 1.36 of the OECD Guidelines and in Para. 205 of the Discussion Draft, most commentators agree with the OECD view that non-arm's length behaviour should as much as possible be dealt with on the basis of pricing adjustments, rather than by not recognizing transactions.

– Many commentators urge the OECD to address with more precision the "commercially rational behaviour" test from Para. 1.37 of the OECD Guidelines, as they consider that the concept as it stands would lead to uncertainties, giving tax authorities the possibility to second guess taxpayers' behaviour. In this respect, one commentator suggests that recourse to the UK definition of "partnership" might be useful in better framing the boundaries of "commercially rational behaviour", in that if a person is "carrying on a business" with "a view to profit", such behaviour by definition would be commercially rational. Other commentators expressed the view that the "commercially rational behaviour" test should refer to whether a restructuring transaction was purely tax motivated or whether some commercial non-tax purposes exist.

6. The Way Forward

The number of comments received and their level of details demonstrate the importance of the transfer pricing issues discussed in the Discussion Draft. Many aspects of the Discussion Draft are welcomed by business commentators, highlighting the substantial progress that has been achieved since the project began in 2005.

However, commentators also expressed some areas of concern, making it apparent that further work is needed to clarify and improve the Discussion Draft. The OECD's goal is to maintain a proactive and constructive dialogue with the business community in clarifying the issues that currently are under the spotlight and to ease the dialogue between taxpayers and tax authorities.

In light of the above, the public consultation meeting to be held on 9-10 June 2009 between the OECD and the organizations that submitted comments is expected to be an important step forward on this challenging project.

At the current stage, the OECD's task is paving the way towards consensus to set, as clear as possible, consistent and administrable rules on the transfer pricing aspects of business restructuring transactions. It will be crucial for a successful outcome of the project that all the stakeholders approach the various issues in a reasonable manner on the basis of internationally agreed principles.

13. Para. 27 of the OECD Discussion Draft provides that where reliable data evidence a similar allocation of risk in contracts between comparably situated independent parties, the contractual risk allocation between the related parties is regarded as arm's length. However, the OECD Discussion Draft acknowledges that may result in greater difficulty and contentiousness in the situation where no such data exist. Just because a related party arrangement is one not seen between independent parties should not of itself indicate that the arrangement is non-arm's length.