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# TAX CONTROVERSY UPDATE

## Comments on the OECD's "Transfer Pricing Aspects of Business Restructurings"*

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Business restructurings raise complex questions of transfer pricing policy and tax administration. In particular, it is crucial for multinational enterprises (MNEs) to avoid double taxation when they consider restructuring their business across several jurisdictions. MNEs are now facing severe economic challenges and need tax and legal predictability when they decide to restructure their business model to address those challenges. Thus, we discuss below what we see as the most important issue addressed in the OECD's Discussion Draft on "Transfer Pricing Aspects of Business Restructurings" (the "Draft"): the principles that will be used to determine the tax consequences of a business restructuring, including when a tax authority may disregard or recharacterize the MNE's choice of form in the restructuring.

The decisions that MNEs make about their corporate structures (and restructurings) and locations should generally be respected by tax authorities, and tax authorities should instead focus on determining the most appropriate measure of the arm's length remuneration for any such restructuring. This presumption in favor of capital and business mobility is in the interest of sound business and tax policy, and should only be overcome in those cases where the MNE has not in fact done what it has purported to do or where the structure itself practically impedes a tax authority from determining an appropriate transfer pricing result. Within this framework, we will also focus on the concept of control. Separately, we will touch briefly on the concept of profit/loss potential, and how it should or should not be compensated.

In these and other contexts, we commend the OECD for its work to enhance the understanding of MNEs, tax authorities, and transfer pricing professionals. Not long ago, these concepts either were not considered, or were considered in an undeveloped or uninformed manner, and protracted discussions and double taxation hindered both tax administrations and MNEs. With the advent of the OECD's Transfer Pricing Guidelines (the "TP Guidelines") and its Discussion Draft on Transactional Profit

*Substantially similar content was provided to the OECD in response to a request for public comments.

Methods, interested parties have advanced their understandings, policies, and pricing methodologies to a point that current rules, documentation, and other measures of increased transparency sufficiently address most issues.

In the past, a tax authority's transfer pricing tools may have been inadequate to identify, understand, and analyze certain types of business restructurings or similar transactions. However, we believe that alternatives to application of the transfer pricing rules, such as "exit taxes" or similar proposals aimed at business restructurings, are unnecessary in light of the sophisticated approach to transfer pricing issues exhibited by the TP Guidelines, other OECD work, and member countries' tax authorities. The OECD's and tax authorities' experiences developing and applying the TP Guidelines have increased the range of transactions that can be appropriately identified and addressed using transfer pricing rules.[1] For example, tax authorities will obtain significant information from an MNE's transfer pricing documentation about both the business restructuring itself and the comparable transactions or parties with which it can be analyzed. Further, the suggested change in last year's Discussion Draft on Transactional Profits Methods emphasizing the strengths and weaknesses of traditional transactional and transactional profit methods reflects these experiences and improvements and demonstrates the increasing breadth of transfer pricing questions that can be reliably addressed by the TP Guidelines. Therefore, we feel that the TP Guidelines are well-equipped to handle business restructuring transactions.[2]

## When May a Tax Authority Disregard or Recharacterize a Restructuring Transaction?

The most important taxation question facing a restructuring MNE is whether the tax authorities in each country affected by a restructuring will respect the MNE's transactions. Particularly in this time of economic turmoil, we see myriad companies downsizing their staff, closing factories and distribution centres, and seeking location savings. All of these activities can lead to restructurings, and if just one tax authority disregards or recharacterizes such a transaction, the already-struggling MNE will be subject to double taxation. Thus, we applaud efforts to describe instances when it is and is not proper to disregard or recharacterize a restructuring transaction. We particularly appreciate Ms. Silberztein's remarks in London (13 February 2009) that the OECD will be embarking on further work to define the exceptional circumstances in which a transaction may be disregarded or recharacterized.

There is a presumption that the MNE's transaction will be respected. We find the Draft's main discussion on this point in Issues Note 4.[3] The Draft states at ¶ 196 that MNEs "are free to organise their business operations as they see fit. Tax administrations do not have the right to dictate to [a MNE]

how to design its structure or where to locate its business operations,"[4] and later acknowledges at ¶¶ 203-205 that the TP Guidelines clearly provide that "[i]n other than exceptional cases, the tax administration should not disregard the actual transactions [undertaken by a MNE] or substitute other transactions for them."[5] This presumption is sound tax policy that provides MNEs' transactions with needed predictability and promotes economic welfare on a global scale.

The TP Guidelines identify two exceptions to this general rule. A tax administration may disregard or recharacterize a transaction under either of the two following circumstances:

- When its form is inconsistent with its economic substance; or
- When the
  - » Transactional arrangements, "viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner," and
  - » "[A]ctual structure of the transaction practically impedes the tax administration from determining an appropriate transfer price."[6]

These exceptions to the presumption are important to the effective and efficient administration of tax authorities' laws and rules. However, we offer the following comments to assist with tax authorities' interpretation of these exceptions in the context of business restructurings, such that MNEs will have added comfort in a consistent and predictable outcome.

## EXCEPTION 1: TRANSACTIONS IN WHICH FORM IS INCONSISTENT WITH SUBSTANCE

The first exception expressed in the TP Guidelines states that a tax administration may disregard or recharacterize a transaction when its form is inconsistent with its substance. The Draft observes that a main instance of this inconsistency within the context of business restructurings arises with respect to the allocation of risk among related parties. The TP Guidelines note the need to consider "whether a purported allocation of risk is consistent with the economic substance of the transaction,"[7] and one "factor to consider in examining the economic substance of a purported risk allocation" is whether the "parties [are] allocated a greater share of those risks over which they have relatively more control."[8] The Draft draws on this portion of the TP Guidelines in proposing a test for determining whether a particular allocation of risk in a restructuring transaction respects the consistency between form and structure – namely, whether the party that bears the risk has both control over the risk and the financial capacity to bear it.[9] Further, the Draft defines control as "the capacity to make decisions to take on the risk … and decisions on whether and how to manage the risk."[10]

While the Draft's definition suggests that *both* elements must be present for "control" to be found, we believe that different affiliates of an MNE can separately exercise these two forms of control, and that the presence of *either* form of control could be sufficient when the taxpayer has the financial capacity to bear this risk. That is, there can be economic substance to a transaction when only one element of control is present.

Even more importantly, however, Mayer Brown believes that the manner in which tax authorities evaluate control and financial capacity in practice is more vital to MNEs than abstract concepts of control. Consequently, we believe that tax authorities should evaluate the concepts of risk and control in the context of the risks assumed and controls exercised by unrelated entities in the comparable transactions or comparable parties used to evaluate an MNE's transfer pricing policies. If the control exercised and risks assumed by an MNE's affiliates following a business restructuring are comparable to the control exercised and risks assumed in comparable unrelated transactions or by comparable unrelated parties, or if reasonable adjustments can be made to reflect the differences, then it should be clear that the substance of the transaction is consistent with its form. The increasing sophistication with which OECD member country tax authorities approach transfer pricing questions allows the risk and control issues to be fully and adequately addressed in the application of the TP Guidelines.

## EXCEPTION 2: TRANSACTIONS THAT IMPEDE A TAX ADMINISTRATION FROM DETERMINING AN APPROPRIATE TRANSFER PRICE

The TP Guidelines establish a second exception to the general presumption that a MNE's transaction as structured shall not be disregarded or recharacterized by a tax authority. The language of the exception is such that a tax authority may only disregard or recharacterize a transaction when the transaction's arrangements, "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 of the transaction practically impedes the tax administration from determining an appropriate transfer price."[11] Thus, the tax authority must first find that the arrangements are inconsistent with that which independent enterprises would have adopted, and that those arrangements practically impede the determination of an appropriate transfer price; the corollary of this exception is that if an appropriate transfer price can be determined, then it is not relevant whether the arrangements are inconsistent with those independent enterprises would have adopted, and the tax authority must respect the arrangements.

Unfortunately, "practically impede" is not defined, and thus will not provide the MNE any comfort, certainty, or predictability. We ask that the OECD provide additional guidance on the meaning of "practically impede" for these purposes; in any case, we

expect that "practically impede" does not include instances where the determination of an appropriate transfer price is merely difficult, but rather refers to instances where the structure itself causes there to be no reasonably comparable transactions (for transaction-based methods) and no reasonably comparable parties (for profit-based methods), and the structure itself does not allow for any reasonable adjustments to alleviate any such impediment. After all, since the promulgation of the TP Guidelines in 1995, MNEs and tax administrations have garnered significant expertise in evaluating, on an arm's length basis, the transactions that occur between members of MNEs; in most cases, the MNE's[12] restructuring transactions should be respected.

## What is the Relationship Between Profit/Loss Potential and Intangibles?

Restructurings often entail the transfer of certain intangible assets from one affiliate to another. The Draft provides,[13] and Mayer Brown agrees, that many of these transfers can be handled under the existing guidance in Chapter VI of the TP Guidelines. Restructurings, however, do raise uniquely difficult issues involving intangibles,[14] and these difficulties can stem in part from different interpretations of definitions or descriptions of these intangibles. Thus, we appreciate Ms. Silberztein's recent remarks in London (13 February 2009), that the OECD will be working to clarify the definitions of intangibles. Perhaps the most important issue to be addressed is that the Draft introduces the notion of "profit/loss potential," but appears to conflate it with going concern value and goodwill;[15] each of these is a distinct concept, and each requires separate consideration, as described more fully below. Notably, we believe that profit/loss potential is appropriately compensated through transfer prices for assets and rights that are part of the restructuring and does not require, or deserve, separate compensation.

First, we agree with the discussion of going concern value found in Issues Note 2, Part C.3, which demonstrates that under certain circumstances it may be appropriate to evaluate a transfer of a whole business – including tangible assets, intangible assets, key contracts, and key personnel – not as a transfer of isolated assets, but as a transfer of an "ongoing concern."[16] This demonstrates that this going concern value may be so intertwined with some group of underlying assets and rights that it can not be tested separately. Similarly, we note that goodwill may reflect some additional value related to other assets due to expectation of continued customer patronage; valuable contract rights, such as a favorable price or a covenant not to compete; favorable perception of the company by customers or the community; or other reasons. As noted above and in the TP Guidelines, we believe these intangibles can be adequately addressed through existing transfer pricing rules, through an examination of the assets or rights transferred.

We believe the same is true of "profit/loss potential," which we consider arises from various assets and/or rights and thus is not separately compensated (or tested). It appears that the Draft reaches the same conclusion, when it states that "One way of valuing a transfer of rights or other assets is through an examination of the transferred profit/loss potential associated with those rights or other assets."[17] However, we would like the OECD to consider amplifying this statement to further clarify that profit/loss potential is a *tool* to be used in valuing rights and other assets, and not a separate asset unto itself.

In that regard, we note that the profit/loss potential that attaches to an asset (tangible or intangible) is reflected in the value of the asset itself. An asset's value is equal to the sum of the net cash flow it is expected to produce over its useful life, discounted to present value with an appropriate (risk-reflective) discount rate. Further, profit/loss potential may pertain to certain rights, such as those under a long-term, fixed-price contract, but the value of the profit/loss potential is found in the rights themselves, and have no separate value. Accordingly, profit/loss potential in a transferred asset or right does not require remuneration separate from the asset or right itself.

In the context of the OECD's continued focus on this area of guidance, we would therefore also welcome a clear position that there should not be any "exit tax" – or compensation for loss of profit/loss potential – from the cross-border transfer of functions, risks, or assets other than the tax that arises by application of the TP Guidelines. The compensation for those transfers, as determined under the TP Guidelines, and as clarified by the Draft, is arm's length, and no additional compensation is needed. Several countries in Europe are taking this untenable position, contrary to EU law, and such treatment unfortunately leads to double taxation.

## Endnotes

1 *Cf.* TP Guidelines ¶ 1.14 , discussed below.

2 *See* Draft ¶ 130 ("[T]he arm's length principle and the TP Guidelines do not and should not apply differently to post-restructuring transactions as opposed to transactions that were structured as such from the beginning.").

3 *See* Draft ¶ 194–221.

4 *See* Draft ¶ 196 ("[MNEs] are free to organise their business operations as they see fit. Tax administrations do not have the right to dictate to [a MNE] how to design its structure or where to locate its business operations.").

5 TP Guidelines ¶ 1.36; see Draft 203–205 (quoting and discussing this provision).

6 TP Guidelines ¶ 1.37.

7 TP Guidelines ¶ 1.26.

8 TP Guidelines ¶ 1.27.

9 Draft ¶ 28.

10 Draft ¶ 30.

11 TP Guidelines ¶ 1.37. The Draft calls each requirement a "cumulative criterion." *See* Draft ¶ 206–207.

12 *Cf.* TP Guidelines ¶ 1.14 ("Experience under the arm's length principle has become sufficiently broad and sophisticated to establish a substantial body of common understanding among the business community and tax administrations.").

[13] Draft ¶ 79.

[14] *See* Draft ¶ 78.

[15] *See* Draft ¶ 93 (discussing "goodwill" and equating it with "profit/loss potential" in the context of an example demonstrating going concern value).

[16] Draft ¶ 94.

[17] Draft ¶ 65.

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