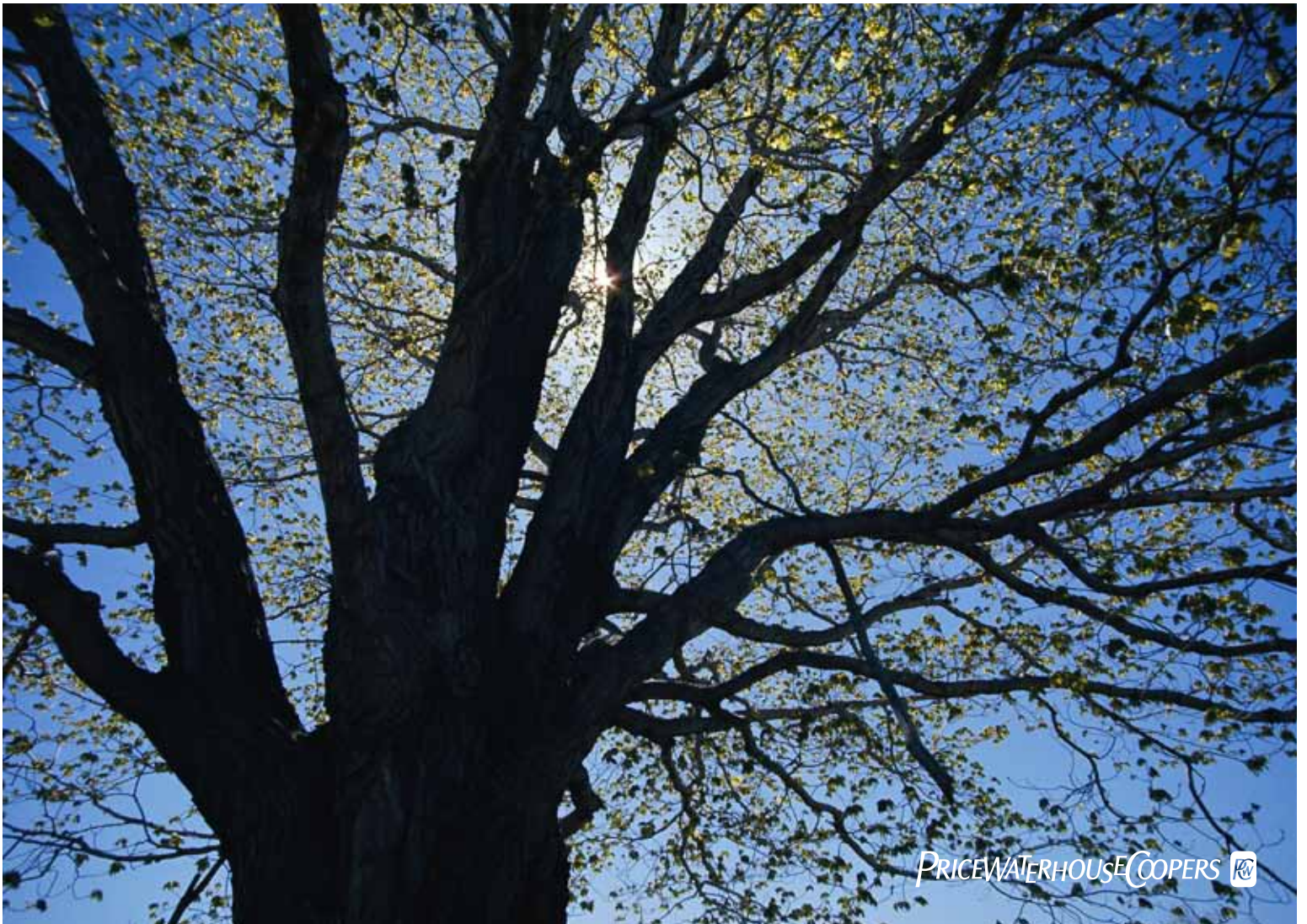


OECD holds public consultation on business restructuring discussion draft

Transfer pricing perspectives

Re:solutions
moving towards certainty



OECD holds public consultation on business restructuring discussion draft

While the Discussion Draft reflected consensus among OECD member countries across many issues, it also suggested quite openly the existence of differences of opinion between governments on some critical issues—a lack of consensus which the OECD now seeks to narrow or resolve through its continuing deliberations.

By Joseph Andrus (PwC US) and Isabel Verlinden (PwC Belgium)

On June 9 and 10, 2009, the OECD held a Public Consultation on its Discussion Draft on Transfer Pricing Aspects of Business Restructurings (the “Discussion Draft”). The two-day Public Consultation brought together representatives of more than 30 national tax agencies, the OECD Tax Policy Directorate, and representatives of the business community including company tax directors and advisory firm representatives to discuss points of disagreement arising from the Discussion Draft.

The Discussion Draft was published by the OECD in September 2008. It addresses in four lengthy issues and notes several important transfer pricing aspects of the taxation of internal business restructurings. Among those issues are the treatment of allocation and transfer of risk among related parties, the question of whether and when internal business restructuring transactions require arm’s length compensation and/or indemnification, the question of how transfer pricing rules should be applied to the parties to a business restructuring transaction following the restructuring, and the question of whether and when governments have the ability to disregard a taxpayer’s restructuring transaction for purposes of applying transfer pricing rules. While the Discussion Draft reflected consensus among OECD member countries across many issues, it also suggested quite openly the existence of differences of opinion between governments on some critical issues—a lack of consensus which the OECD now seeks to narrow or resolve through its continuing deliberations.

The Discussion Draft generated tremendous interest in the business community as evidenced by more than 400 pages of written comments provided to the OECD on its work. While the written comments were generally complimentary of the OECD work on business restructurings, they also reflect significant disquiet in the business community over some key issues addressed in the Discussion Draft. Continuing intense interest in the topic was indicated by the attendance of more than 150 representatives at the Paris Public Consultation. The Public Consultation provided an opportunity for a face to face exchange of views between governments and the business community. While it was not expected to result in a full meeting of the minds, it provided a useful airing of the critical issues addressed in the Discussion Draft.

This article summarises the key discussion topics from the Public Consultation. It should be recognised that the discussions by design focused far more attention on areas of actual and possible disagreement between business and governments than on the broad areas of consensus reflected in the Discussion Draft.

Disregard or recharacterisation of taxpayer restructuring transactions

The single Discussion Draft issue causing greatest concern in the business community is clearly the analysis in Issue Note 4 regarding the circumstances under which governments can disregard or recharacterise business transactions. This section of the Discussion Draft primarily seeks to interpret paragraph 1.36 of the OECD Transfer Pricing Guidelines suggesting that tax authorities may disregard transactions that both lack “commercial rationality” and where the nature of the transaction makes it impossible to determine an arm’s length price for the transactions undertaken.

In introducing this topic at the Public Consultation, the representative from Australia stated that in Issue Note 4, the country delegates were focusing principally on “shell company” structures that were lacking in business substance. He also indicated that it was intended that where restructuring transactions could be dealt with on a transfer pricing basis, that would be done—asserting that Australia had addressed numerous restructuring cases in Advance Pricing Agreements (APAs) and audits and in the vast majority of cases had found transfer pricing resolutions to the issues.

The Discussion Draft itself suggests that the circumstances when a transaction would be disregarded are exceptional. The business commentators, however, expressed concern that the descriptions of the term “commercially rational” in the Discussion Draft were sufficiently vague that there was serious exposure to recharacterisation based on naked assertions that “unrelated parties would not have undertaken the transaction in the same way” or that the transaction is not “arm’s length.” This concern is exacerbated by suggestions at various points in the Discussion Draft that commercial rationality must be tested both at the group level and at the individual entity level.

Representatives from the PricewaterhouseCoopers network of member firms, in providing the initial business response to this topic, suggested that the discussion of commercial rationality in the Discussion Draft should be expanded to indicate that any transaction which has a bona fide non-tax business purpose at the group level, and where the taxpayer actually carried out the described transactions and dealings in a manner consistent with its agreements, should be deemed to be commercially rational. This led to a lively discussion of the scope of serious government concerns regarding transfers of assets and income to principal companies having no or limited functions. In particular the Dutch representative raised the difficult question of how a transaction having a valid but limited business purpose should be treated. An example put forward was a situation involving the centralisation of back office functions in a low-tax jurisdiction with a transfer of high value intangibles to the low-tax entity appended to the transaction.

An issue closely related to the potential disregard of business restructuring transactions involves the treatment of taxpayer allocations of risk for transfer pricing purposes. This issue is addressed in detail in Issue Note 1 in the Discussion Draft.

Certain business commentators expressed the view that the only requirement for commercial rationality should be whether the entity receiving assets has the financial wherewithal to bear risks associated with such assets. Functions, it was asserted, could be “outsourced” because unrelated parties routinely engage in outsourcing transactions. There was clear government scepticism regarding this view. Other commentators suggested that it could be appropriate for governments to insist on some alignment of functions and risks.

The government commentators made it clear that there was a difference of opinion among governments as to how business restructurings involving transfers of high value intangibles should be treated. Some governments continue to express the view that even where there are valid business purposes for such transfers at the group level, governments should be able to disregard such transfers since they would never be commercially rational from the point of view of the transferor entity. Governments taking this view suggest that such intangibles simply are not transferred in arm’s length dealings between unrelated parties. Business representatives uniformly suggested that this should be a question of valuation of the transferred intangibles, not a question of disregarding the transaction. The differences in view are crystallised in the first example at the end of Issue Note 4 in the Discussion Draft.

Government representatives noted that they would continue to work to narrow their differences and determine if consensus examples could be published in a final version of their work. They also noted that the broader issue of valuation of intangibles is likely to be the topic of a separate OECD project to be undertaken in the relatively near future.

Taxpayer allocations of risk

An issue closely related to the potential disregard of business restructuring transactions involves the treatment of taxpayer allocations of risk for transfer pricing purposes. This issue is addressed in detail in Issue Note 1 in the Discussion Draft. The US representative introducing this topic at the consultation summarised the Discussion Draft analysis of the issue. He indicated that the Discussion Draft was clear in suggesting that the analysis of risk should begin with an examination of the taxpayer’s contracts. Those contracts are generally to be respected if they reflect an allocation of risk that is consistent with that observed in unrelated party dealings. In situations where comparable transactions cannot be observed, it was noted that the Discussion Draft provides that taxpayer contractual assignments of risk should nevertheless be respected in many instances.

The US representative noted that the Discussion Draft points to financial ability to bear risk and “control” of risk as factors to be considered in determining whether risk allocations should be respected. He emphasised, however, that neither of these was intended to be a mandatory factor and that other considerations could come into play.

Business commentators generally took issue with two features of the Discussion Draft treatment of risk allocation. The first was whether paragraph 1.27 of the Transfer Pricing Guidelines provides an independent basis for disregarding taxpayer contractual undertakings regarding the allocation of risk. It was observed that paragraph 1.27 of the Guidelines is contained in a section on comparability, not in the section of the Guidelines addressing disregard of transactions. They expressed concern that the Discussion Draft was creating from whole cloth an independent basis for disregarding taxpayer contractual undertakings based on absence of control over risk.

The other widely articulated business concern was that the notion of control over risk was unrealistic in view of normal operations of multinational enterprises. Commentators noted that there were strong trends toward diffused, global management structures which made it unlikely that ultimate control of risks in the sense described in the Discussion Draft would or could be centralised in a single legal entity. Some suggested that the control standard be eliminated and that reliance be placed only on taxpayer contracts and financial ability to bear risks.

The government representatives were very clear that they uniformly interpreted paragraph 1.27 of the Transfer Pricing Guidelines to give governments authority to reallocate risk in appropriate circumstances. They acknowledged some lack of clarity in the Discussion Draft over the circumstances in which risks could be reallocated and indicated that they would continue to work to clarify this area. There was no indication at all, however, of a willingness to retreat from the proposition that governments could effectively reassign risks in related party transactions in appropriate circumstances or from the view that some alignment of functions and risks is an important consideration.

It should be noted that this issue has potential application to transfer pricing matters going far beyond the restructuring context, a fact acknowledged by the government representatives.

Transfers of “profit potential”

The Discussion Draft suggests that a transfer of “profit potential” pursuant to an internal business restructuring does not necessarily give rise to a need for compensation. However, it also suggests that transfers of assets should be compensated at arm’s length and further implies that, for this purpose, the notion of asset should be broadly defined. In particular, several paragraphs in the Discussion Draft suggest that intangible assets should broadly include transfers of goodwill and going concern value.

In the Public Consultation, several business commentators expressed misgivings regarding the broad definition of assets and suggested that the effect might be to tax every shift of profit potential. It was suggested by some that taxable transfers should be limited to transfers of legally protected intangible property rights and that goodwill and going concern value, which legally cannot be transferred separate and apart from the business to which they relate, should not routinely be compensable.

The Discussion Draft refers at several points to the necessity of considering the “reasonably available alternatives” to restructuring transactions in determining how transfer pricing rules should be applied to those transactions.

The Canadian representative indicated her view that the Discussion Draft had intended to cast a broad definition of intangible property and that transfers of valuable goodwill and going concern value were intended to be treated as assets in defining when a transfer might be taxable. Other country representatives were equally forthright in suggesting that they intended a definition that was broader than legally protectable intangibles. It was further suggested that while profit potential itself was not an asset, that the profit potential carried by transferred assets should be taken into account in valuing the assets transferred in a restructuring transaction. It was suggested that it would usually not be appropriate to value assets transferred in a business restructuring on a break-up or liquidation value basis, but that the value of such assets in a going business should generally be considered.

Business representatives suggested that governments sometimes had a misguided notion that the future profits of a business, and its profit potential, could be viewed as an annuity for valuation purposes. It was suggested that future earnings of a transferred business are attributable, at least in part, to the risks borne and activities undertaken by the transferee following the business restructuring and that proper valuation should take that fact into account.

Role of “reasonably available alternatives”

The Discussion Draft refers at several points to the necessity of considering the “reasonably available alternatives” to restructuring transactions in determining how transfer pricing rules should be applied to those transactions. The government representatives suggested that the “reasonably available alternatives” notion should be considered primarily for pricing purposes rather than for purposes of respecting transactions or assignments of risk. They also suggested fairly strongly that this concept had its most important application at the individual entity level and that the alternatives theoretically available to each party to a business restructuring transaction should be taken into account in determining appropriate levels of compensation to be paid in connection with such a transaction.

Business commentators suggested that it was unrealistic to consider alternatives available to one member of a controlled group since key operational decisions for such entities were generally made by group management. Thus, individual legal entity members of a multinational enterprise likely have little discretion as to whether to participate in a business restructuring.

The comments of government participants in the consultation made it seem unlikely that the Discussion Draft reliance on reasonably available alternatives will be abandoned. The clarification that the concept had primary application in pricing decisions, however, was a useful point of understanding and likely portends some modification of the Discussion Draft language.

Local country anti-abuse rules

There was a brief discussion of the application of local country anti-abuse rules in a business restructuring context. The Discussion Draft indicates that its provisions do not cover domestic law anti-abuse rules. Business commentators requested clarification of the scope of this exception, in particular requesting clarification as to whether domestic statutes such as the recently adopted German rules on business restructurings were thought of as domestic anti-abuse rules or as rules governed by the treaty interpretations set out in the Discussion Draft. Government representatives suggested very strongly that consideration of domestic law anti-abuse rules was outside the scope of the Business Restructuring project. They further seemed reluctant to try and clarify what types of rules either do or do not fall within the domestic law anti-abuse rubric.

The way forward

The governments indicated that they were continuing to work to define the timing and manner of finalising the Business Restructuring project. They suggested that possibilities included converting the Discussion Draft into a new chapter of the Transfer Pricing Guidelines, or merely issuing the Discussion Draft with clarifying revisions as a final report. They also suggested that OECD Working Party 6 operating rules made it important to seek to achieve consensus and that continuing difficulties in doing so on certain issues may require some modification to the Discussion Draft. There was little clarity on timing for next steps, a topic the Working Group hopes to clarify in its continuing discussions later this week.

Conclusion

The business restructuring issue will clearly continue to be one of intense interest to both governments and taxpayers. The OECD will continue its efforts to improve and finalise the Discussion Draft in a balanced manner. The Chair mentioned the need to make some parts less subjective and less ambiguous so as to accommodate business' valid concerns to lessen the risk of double taxation. It will also seek to forge consensus on critical issues. Taxpayers cannot expect, however, that the governments will pull back significantly on their demands that such transactions have functional substance and business motivation if they are to be respected. Some critical issues in the Discussion Draft are likely to be clarified further but its basic outlines are likely to remain fairly stable and quite influential. Forging consensus on issues surrounding transfers of high value intangibles is likely to continue to be very challenging.

This publication has been prepared for general guidance on matters of interest only, and does not constitute professional advice. You should not act upon the information contained in this publication without obtaining specific professional advice. No representation or warranty (express or implied) is given as to the accuracy or completeness of the information contained in this publication, and, to the extent permitted by law, PricewaterhouseCoopers does not accept or assume any liability, responsibility or duty of care for any consequences of you or anyone else acting, or refraining to act, in reliance on the information contained in this publication or for any decision based on it.

© 2009 PricewaterhouseCoopers. All rights reserved. 'PricewaterhouseCoopers' refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

BS-BS-09-0537-A.1009.DvL