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Andreas Bullen is a Ph.D. research fellow at the University of Oslo, Faculty of Law, Department of Public and International Law. Andreas Gerten is a Ph.D. research fellow at the Max Planck Institute for Intellectual Property, Competition and Tax Law in Munich. Birgit Stürzlinger is a research and teaching assistant and Ph.D. candidate at the Institute for Austrian and International Tax Law at the WU Vienna University of Economics and Business.

On December 10-11, 2008, the International Network for Tax Research (INTR); the Max Planck Institute for Intellectual Property, Competition and Tax Law; and IFA Germany held a joint seminar on the OECD discussion draft on business restructurings in Munich. The OECD Center for Tax Policy published a discussion draft on the transfer pricing aspects of business restructurings on September 19, 2008. (For a related article, see p. 973.) The invitational seminar brought together almost 40 experts from academia, business, and tax administration to discuss cross-border business restructurings and their tax implications. The objective of the seminar was to discuss the draft in detail and to bring forward the views of different constituencies in the tax and accounting world on the respective proposals.

I. The OECD Discussion Draft

A. Background

The first morning session, chaired by Hugh Ault (Boston College/OECD), started with a presentation by Caroline Silberztein (OECD), who gave an overview of the draft, which at that point was released for public comment and included only tentative conclusions without reflecting any final views of the OECD member countries. The international consensus on the arm's-length principle requires that profits of parts of a multinational enterprise should be determined as if they were operating independently. Business restructurings (BRs) by global organizations involve the cross-border redeployment of functions, assets, and risks and as a consequence of the associated profit or loss potential within an MNE.

In practice it was observed that intangible property and entrepreneurial risk, which carry the biggest part of the profit or loss potential, are also the most geographically mobile parts in an MNE. Since the mid-1990s, this observation was reflected by conversions typically from full-fledged distributors into commissionaires or full-fledged manufacturers into toll-manufacturers. These conversions typically include the migration of intangibles and risks, together with the associated profit potential, often to low-tax jurisdictions. These conversions often also mean the residual profit or loss no longer remains with the local operation, but is earned by a related party that operates as a principal and centralizes valuable intangibles and entrepreneurial risks. BRs can significantly affect the corporate income tax base in some countries and can be needed by business to adapt to globalization. The OECD's objective is to arrive at a consensus on the correct treatment from an international tax point of view. From a transfer pricing point of view, the question is whether there are conditions made or imposed in the restructuring that differ from conditions that would be made between independent enterprises.

B. Main Drafting Challenges

One of the challenges is that BR, according to Silberztein, is not about the traditional conflict between residence and source countries or between old and new economies, but rather between high-tax jurisdictions that have ''real'' economies and low-tax jurisdictions that will centralize intangibles and entrepreneurial risk.

Another issue is that the arm's-length principle is usually based on a study of comparables. In some BRs it may be possible to find comparables, but many times it is impossible because the MNE is making use of the very fact that it is an MNE to restructure (for example, to implement a global supply chain). Therefore, even when no comparables exist, this does not mean that a transaction is not arm's length. It is recognized that MNEs implement transactions independent parties would not engage in.

Another question is to what extent the draft is importing the authorized OECD approach (AOA) for attributing profits to permanent establishments to article 9 of the OECD Model Tax Convention on Income and on Capital (OECD model). According to Silberztein, there is a big difference between the two concepts. In the AOA for attributing profits to PEs there are no legally binding contracts, and therefore the starting point for attributing assets and risks is an analysis of the relevant significant people functions. In an article 9 context the analysis always starts with contracts; only in the absence of comparables to support the allocation of risks in the controlled transaction, other factors are used to hypothesize how independent parties at arm's length would have allocated the risk. In this respect, two relevant factors identified in the draft are the expected financial capacity to bear the risk and control over the risk.

Finally, Silberztein identified two relatively new concepts (profit potential and location savings) that are touched on in the draft. Profit potential is not an asset but something that is carried by assets; therefore, the question is not if profit potential is decreasing, but if an asset that is carrying profit potential is transferred. Location savings are not considered to be assets either. However, there are still many open questions as to whether — and if so, how — these concepts should be factored in the transfer pricing analysis. From a transfer pricing point of view, the perspectives of both parties to the controlled transaction should be taken into consideration.

C. General Comments: Business Representative

1. Appropriate Incentives for Governments

Next, Krister Andersson (BUSINESSEUROPE) presented his comments. He said that one main problem for achieving the goal of eliminating economic double taxation is that there are no incentives for governments to agree in a timely fashion on how to split taxable profits between countries. Therefore, there are often battles between governments with the company caught in between. To illustrate how an appropriate incentive structure for governments could be created, Andersson used an example of a low- and a high-tax country. If the low-tax country wants to tax a larger share of the tax base, the MNE should not have to pay any additional taxes because it has already discharged its tax obligations, albeit potentially to the wrong country. In case the high-tax country wants to tax a larger share, the MNE should only be obliged to pay the disputed amount times the difference in tax rates. To speed up dispute settlements, it could, for example, also be useful to make the tax revenue dependent on the time it takes until the tax authorities agree on how to split the profit between the countries. During the subsequent discussion one participant argued that there are already incentives for tax authorities because the EU Arbitration Convention also applies to governments and they also want to encourage cross-border investing.

2. Risk Allocation and Control

Andersson continued with how to determine the allocation of risk and control. First, he said there is a difference between risk and uncertainty. In the case of risk, one has knowledge of various possible outcomes, whereas this knowledge is missing in the case of uncertainty. Entrepreneurship is risk-taking under conditions of uncertainty. If the entrepreneurial risk is linked with uncertainty, no intragroup entity can be in control of the risk. Still, risk can be assigned to or assumed by an intragroup entity regarding a business transaction. Also, the mere allocation of capital does not reflect the allocation of risk. Especially when countries have thin-cap rules, the capital allocation is very much influenced by such tax provisions. Andersson also said the emphasis on financial statements for the purpose of risk allocation is misleading. Financial statements only indicate the size of a particular risk and a company's legal and economic risks toward third parties but do not give guidance as to risk allocation between related parties. Finally, Andersson commented on the relevance of risk for allocating profits in general and concluded that the draft is extending the role of risk in comparison to the transfer pricing guidelines (TPG).

3. Documentation

Citing paragraphs 53 and 133 of the draft, Andersson expressed his concern that the draft leads to increased documentation requirements for enterprises, noting that there should be different requirements for intragroup dealings and other transactions. He acknowledged, however, that tax authorities may dispute or even disregard transactions whenever there is no documentation.

4. Reclassification

Regarding reclassification, Andersson said that there are sections in the draft that state that the arm's-length principle does not require compensation for loss of profit potential per se and that business transactions should be recognized as they are performed. He then expressed worries about the substantive sections on how to reclassify transactions. It is very important that tax administrations may only consider disregarding a structure if it impedes the tax administration from determining an appropriate transfer price (stated in paragraph 206 of the draft, which refers to paragraph 1.37 of the TPG). In his view, the draft goes beyond what is expressed in the TPG. Andersson concluded that the draft is ambiguous, too supportive of reclassification, and may legitimize a country's attempt to tax forgone profits and disregard actual business structures. He stressed the need for agreements between countries and warned against the ambiguities in the draft.

D. A Case for Transfer Pricing?

1. What Is Under Transfer Pricing Control?

The third speaker, Wolfgang Schön (Max Planck Institute), questioned whether BRs really are a case for transfer pricing. Referring to paragraph 196 of the draft, Schön said that MNEs are free in how to organize their business operations. Therefore, the question is where that freedom ends and where the control of article 9 OECD model begins. Functions, profit potentials, risks, intangible and tangible assets may be transferred within BR activities, and the question is which of these transfers are under transfer pricing control and which are free. Referring to article 9 OECD model, Schön said that only the commercial or financial transactions between a parent and its subsidiaries or other affiliates are under control but not the group structure as a whole. When setting up an independent enterprise it is the shareholders' task to define the corporate objective, specifically the line of activity and the risk profile.

Profit maximization is, of course, part of that corporate objective, though it may not be the primary goal of a subsidiary, given that subsidiaries are not independent. Also, article 5, paragraph 7 of the OECD model expresses that the control by a parent company does not create a PE, so the case when a parent defines the subsidiary's objective does not lead to a lack of independence. As a consequence, the ''restructuring'' as such does not fall under the examination by transfer pricing rules in full. The subsidiary is not in the position to reject any change in the allocation of functions and activities. Only the termination and renegotiation of contractual obligations and the transfer of tangible and intangible assets must be assessed under article 9, paragraph 1 OECD model. The transfer of profit and loss potential is only adjustable if it is carried by transferred rights and assets.

2. Some Examples

Schön presented four examples to illustrate his view.

Example 1. U.S. parent company P decides to penetrate the German market where it has no activity so far. It sets up a German company G and contributes the necessary capital. The objective of this company is to sell P's products to German customers. P and G enter into a distribution agreement. After six months P decides to liquidate the German subsidiary and to terminate the distribution agreement (in line with the conditions of this contract).

In this case the establishment of G and the design of its objective are not under control of article 9 OECD model. G does not have to pay a consideration for the function allocated to it. This is also true for the risk profile of G, which it has to accept as ''given'' by the shareholders. The distribution agreement as such is within the scope of transfer pricing insofar as G, as an independent profit-maximizing entity having the same objective, would not agree to the particular conditions. This also leads to a full control of the balance between upside and downside risks for G. The liquidation of company G is not subject to transfer pricing control. Transfer pricing rules cannot secure the ongoing existence of a company. That the activities of the liquidated company will now be performed by P itself or by another group company is not taxable as a transfer of a function, activity, or profit potential.

The termination of the distribution agreement, on the other hand, is under the control of article 9, paragraph 1 OECD model. If G has entered into a long-term contract with P to secure amortization of initial investment, G can seek compensation for premature cancellation. Under commercial law there might be an explicit or implicit right of indemnification. Another mechanism to secure taxation in the state of the subsidiary might be that the liquidation of G is taxed as a ''deemed sale'' of existing assets under German corporate tax rules. Also, any transfer of tangible and intangible assets from G to P in the course of the liquidation must be executed as an arm's-length sale. This is regarded as an exchangelike transaction as the subsidiary transfers these assets to the parent company to fulfill its obligation to return the capital to the shareholders. Importantly, the transfer of ''profit potential'' as such does not give rise to adjustments if it cannot be nailed down to adjustable contractual asymmetries or the transfer of assets.

Example 2. P reformulates the company objective of G to change its risk profile. G will lose its position as a high-risk dealer and turn into a commissionaire. The distribution agreement is changed accordingly.

The reformulation of the company objective of G is not under control of transfer pricing as such, which follows *a maiore ad minus* that even full liquidation is not controlled by transfer pricing. However, the change of the distribution agreement is subject to transfer pricing adjustments if the expected net present value of G's future profits is reduced because of an asymmetric change of the risk structure. Any transfer of assets from G to P (for example, customer lists or organizational intangibles) is also under transfer pricing control, even if the assets are still formally held by G but the ''beneficial ownership'' of these assets (''risks and rewards'') is transferred to P.

Example 3. U.S. company P has set up a subsidiary in France (F) to distribute P's goods to European customers. As the business expands and as consumer preferences are different among countries, P decides to set up distribution subsidiaries in every European country. F will in the future only cater to the French market.

The reduction of the company objective of F from an EU-wide customer base to the French customer base is not under the control of transfer pricing, although any premature cancellation of the distribution agreement or transfer of intangibles (customer lists or trademarks, for example) to the parent company or other affiliates is.

Example 4. P has established two subsidiaries in Europe (G in Germany and F in France). Both are involved in the production and distribution of consumer goods. P decides to allocate the production function completely to G and the distribution function completely to F to separate the commercial risks of each line of activity from each other. The expected profits of the companies do not change.

The reorganization as such is not under the control of transfer pricing. The company objectives can be changed (reduced or extended) at will by the shareholders. The cancellation and extension of the relevant production and distribution contracts, though, are subject to transfer pricing control (premature cancellation or asymmetric future risk allocation). There might be a transfer of tangibles and intangibles between G and F, which might even lead to profit adjustments if the value of the mutually exchanged assets is equal (taxation of ''latent gains''). The main point here is taxation of ''exchanges,'' which in most countries is only excluded in the case of material identity of the exchanged assets.

Schön concluded there should be clarity on where the freedom of businesses to rearrange its affairs ends and where transfer pricing control starts. He suggested that the draft should address this issue more prominently, for example, in an introductory part.

3. *Discussing the Limits of Article 9 OECD Model*

During the subsequent discussion, one participant asked how it could be possible not to fall under article 9 OECD model when transferring risks and functions. Another participant mentioned that article 9 OECD model refers to ''all conditions made or imposed,'' which is not limited to the price. Schön clarified that in his view tax administrations should abstain from taking an unduly broad approach when scrutinizing BRs. When a profit potential is transferred without an underlying identifiable asset, the allocation of functions and risks as such should not be under transfer pricing control. Transfer pricing adjustments should be made only in the case of non-arm's-length contractual obligations or transfers of assets. Participants disagreed on whether being an MNE and having its parent and affiliate as a customer is an asset.

II. Special Considerations for Risks

A. Introductory Issues

Issue Note 1 of the draft discusses special considerations for risks. Norbert Herzig (University of Cologne) chaired this session, and the speakers were David Ernick (tax official, United States), Inga Nilsson (industry representative, Sweden), and Achim Roeder (tax adviser, Germany). Both Herzig and Ernick viewed Note 1 as a key point of the draft, and Nilsson said it displays a good understanding of business aspects, particularly in that risk and the allocation of risk is of critical importance to BRs and the allocation of profits and losses among associated enterprises. Nilsson also said a consensus on the approach to risk is important and expressed concern that different countries may have different incentives in terms of assessing risk, depending on their individual circumstances, which might change from year to year. Ernick underscored where risk is systematically situated within the TPG: It is a comparability factor (see, in particular, TPG paragraph 1.23) included in the functional analysis.

Nilsson said the regime created by article 9 OECD model, treating each member of an MNE as an independent entity, differs from how businesspeople see the world, which, in simplified terms, is as one market, without regard for corporate structures. She suggested that the article 9 regime does not fit reality and proposed that this regime should offer flexibility for businesses by allowing them to obtain synergies (for example, through BRs) and to pursue possibilities (in particular, by developing intangibles and making sure the intangibles can be used by all MNE members).

One participant emphasized the difficulties of assessing risk and that these difficulties are amplified in the area of transfer pricing because tax administrations not only have to agree on risk assessment on an *ex ante* basis (that is, before knowing the outcome), but also on an *ex post* basis (that is, after the outcome is known). He said tax administrations are often only interested in the *ex post* outcome and often will not agree on an *ex post* basis. He did, however, stress that tax administrations should agree on risk assessment on an *ex ante* basis; that is, whether risk is allocated and valued in accordance with the arm's-length principle should be assessed on an *ex ante* basis.

B. Valuation of Risk

Ernick stressed that assumption of risk, especially during the financial crisis, may have negative as well as positive impacts on actual profits. As stated in TPG paragraph 1.23:

> theoretically, in the open market, the assumption of increased risk must also be compensated by an increase in the expected return, although *the actual return may or may not increase depending on the degree to which the risks are actually realized.* [Emphasis added.]

He questioned whether it is still correct that increased risk normally leads to increased profits and referred to the recent decline in stock prices, real estate prices, gold prices, and commodity prices. He said that in the present-day environment the primary effect of increased risk is increased *volatility* in profits, not increased *expected* profits. He also said that even deemed-to-be low-risk investments (for example, low-risk bonds) have recently generated losses, but was open to the proposition that recent events can be explained as highly infrequent, catastrophic occurrences. Under any circumstance, as Ernick and several participants saw it, the recent events illustrate the difficulties of assessing the value of risks, especially credit risk. Ernick stressed the importance of having consistent, neutral rules on risk assessment, which are equally apt in good and bad times.

Roeder said the timeline for risk assessment is relatively short, suggesting it would be five years rather than infinite. A participant agreed, but suggested the timeline might be even shorter, not more than three months in some cases. Roeder further suggested that risk aversion may depend on the size of a company, in that smaller companies are generally more risk-averse than larger companies. One participant was skeptical of this proposition, prompting Roeder to say that, in principle, the level of risk-taking can be decided from a company perspective or a group perspective. If decided from a company perspective the decision-maker (that is, the prudent business manager) would be concerned with fluctuations in profits affecting this individual company, but if decided from a group perspective, the decision-maker (that is, the shareholder) would be less concerned with fluctuations affecting the individual company, as this company would only be a part of its total investment generating a part of its total profits. Since a company with small financial capacity is more vulnerable to profit fluctuations than a company with a larger economy, Roeder concluded a smaller company would generally be more risk-averse.

As a pragmatic solution to difficulties in measuring risk, Roeder said tax administrations should confine their examinations to the clearer and less controversial problem areas and, for example, desist from attempting to assess the value of profit potential and synergies.

One participant suggested that risk should be looked on in terms of insurance. More specifically, there are different layers of risk, and when going up the layers the probability of a risk actually materializing goes down (different layers, different frequency). The likelihood of a risk actually materializing must also be taken into account when assessing its value.

C. Written Agreements and Actual Conduct

Although agreeing that written agreements form a useful point of departure for the tax assessment, Nilsson was concerned that too much emphasis is given to *the form* of written agreements (see, in particular, the draft paragraph 25). She argued that in terms of the need for written agreements, associated and unrelated parties are not in comparable circumstances, as no income is made by doing business within the group. In her experience, parties enter into written agreements primarily if they are unrelated or if there are legal requirements to do so. Associated enterprises tend not to enter into written agreements because there are many cross-border contractual relationships within a group and concluding contracts is time-consuming and costly. If associated enterprises do enter into written agreements, the agreements tend to be less detailed than when the enterprises are unrelated. It is more important for the latter agreements to be detailed, as written contracts are the only instruments that can be used to regulate the conditions of such agreements. Nilsson said the expectations on written contracts between associated enterprises must be reasonable. In the absence of a written agreement, she suggested that the associated enterprises' actual behavior should be taken as evidence for the true allocation of risk in particular and for the true contract in general. She also said written agreements should always be examined as part of the functional analysis.

The draft stresses the need to examine whether associated enterprises' actual behavior conforms to the terms of their written agreements (paragraph 21) and suggests that if a discrepancy between written terms and actual behavior exists, the actual behavior will express the actual terms of the controlled transaction (paragraphs 22-24). These statements were largely viewed as uncontroversial. Nilsson fully understood and agreed with the proposition that written agreements must reflect actual behavior. One participant added that mere ''paper-shuffling'' should not be honored during a transfer pricing examination.

Nilsson said that the actual risk allocation can be difficult to identify through an examination of the associated enterprises' actual behavior, particularly if no risk has materialized and no costs have been incurred for the purpose of managing the risks.

Nilsson also was skeptical of the proposition that the risk allocation between associated enterprises can be identified by reading the financial statements (for example, draft paragraph 24). She said financial statements mostly express legal risks and do not illustrate the risk allocation between related parties. Financial statements can only serve as an indication, not as evidence for the actual risk allocation between related parties. In particular, she said tax administrations should not only pay notice to formal indemnification clauses, but also to *de facto* indemnification clauses built into the transfer pricing and business model. Roeder and several participants agreed with Nilsson on the (modest) relevance of the financial statements.

D. Arm's-Length Risk Allocation

1. In General

The disregard of actual risk-allocation if perceived to be non-arm's-length was regarded as quite different from and far more controversial than the disregard of written agreements not actually conformed to. Nilsson said written agreements should be respected provided that they reflect economic reality. As Roeder saw it, the threshold for restructuring the actual transactions of associated enterprises, including the threshold for disregarding the manner in which they have actually allocated risk between them, should be high. An important reason for a high threshold is that associated enterprises have the possibility of allocating risk in quite a different manner than independent enterprises, for example, because associated enterprises have greater possibilities of control. He said the formal written contract (if conformed to) should be given more weight than suggested by the draft, as independent parties are free to allocate risk through contract and as legal agreements are what binds people to risk. In his view contracts are not merely sometimes, but always, important. A participant stressed that a contract should be respected if the associated enterprises have actually conformed to it. He added that the reason for having a contract is to agree in advance on future events so as to avoid disputes.

In determining whether associated enterprises' actual risk allocation is arm's length, the draft proposes that the tax administration should emphasize (1) which party has control over the risk and (2) a party's financial capacity to bear the risk (see draft paragraph 28). One participant said that a risk may be controlled by another party than that which is financially capable of bearing it. Thus, these factors may provide different answers as to how a risk would have been allocated between unrelated parties. Nilsson said the financial-capacity factor would be the most relevant in relation to risks not controlled by any of the parties to a controlled transaction.

2. *Control*

Different opinions were expressed as to the appropriateness of the control criterion (see TPG paragraph 1.27 and the draft paragraphs 29-34). Nilsson agreed with the draft, both in principle and detail, and suggested that no party would assume risk without some sort of control. In her experience, separating risk and control would be viewed as gambling.

Roeder said the control criterion is inappropriate as even independent parties may assume risks that they cannot control in a meaningful manner. One participant representing a tax administration was skeptical of the proposition that independent enterprises would assume risk without being able to control it (save perhaps for insurance businesses). As he saw it, if an independent party is not able to control a risk, it will either not assume it or hedge it (if assumed). Roeder nevertheless said that independent parties sometimes assume risk without being able to control it, even beyond insurance businesses.

Another participant questioned whether the alleged correlation between risk assumption and ability to control (see TPG paragraph 1.27) can be put on an equal footing with (thus, being just as fundamental as) the well-recognized correlation between risk assumption and size of expected profits (see TPG paragraph 1.23). Yet another participant said that the control criterion is a very difficult concept.

Ernick raised the question of whether the control criterion blurs the traditional distinction between article 7 and article 9 OECD model. The crux of this distinction is that in the PE context (article 7), risks must follow people and functions as there are no binding contracts, whereas in the associated enterprises context (article 9), risks (functions and assets) are traditionally transferrable by contract. He said, however, that the control criterion does not require day-to-day monitoring of a risk (see draft paragraph 31), as long as the risk-assuming party is capable of assessing the outcome of the day-to-day monitoring (assumption and management of risk can be on different hands). Therefore, Ernick concluded that risks can still be separated from functions in the article 9 context. Although in principle accepting that the traditional distinction between article 7 and article 9 still applies, one participant representing a tax administration argued that separation of risk by contract would normally not take place between independent parties.

Nilsson, supported by Roeder, said that control is exercised differently in an MNE group than between unrelated parties. Within an MNE group special control instruments, such as binding policies, guidelines, directives, authorization rules including a number of limits and ranges, operating boards, councils, and committees exist to ensure that business is performed as demanded by the top management and to effect control. Similarly, one participant argued that risks cannot be allocated in the same manner in an MNE group as between independent parties, as there is greater flexibility as to the different solutions to risk allocation within MNEs.

Nilsson said that the control criterion found in TPG paragraph 1.27 (that is, ''relatively more control'') is difficult to apply to a group and that different interpretations may be adopted in different countries. As the special control instruments are used to exercise ultimate (or indirect) control, she said that ''ultimate control'' would be a more appropriate criterion. A participant agreed with this view, but raised the question how an ultimate control criterion would be applied in practice. To illustrate ultimate control, Nilsson used an example of a headquarters decision as to the allowed inventory risk of local entities. The headquarters would, through central guidelines, typically dictate that the local entity should behave within a range, for example, stipulating how many trucks a local entity should purchase for resale. The local entity would be authorized to act at its own risk within this range, but would not be authorized to stipulate the range in the first place (for example, in terms of frames and numbers).

In the extension of the suggested ultimate control criterion, the issue was raised whether ultimate control would always be exercised by the top parent company. One participant said that local entities would control risk in a narrow sense, whereas in a wide sense the top holding company, rather than the local entities, would control the risks. Another participant said that it would not be a realistic option to assign all risk to the headquarters, as this would reduce the tax revenue of the states in which the local entities are established. He said that risk should be distributed equally (albeit based on the facts and circumstances) among the local entities.

3. Financial Capacity

The draft proposes that financial capacity to bear risk should be emphasized as a factor in determining whether the associated enterprises' actual risk allocation would have been adopted by independent enterprises (the draft paragraph 28). Roeder said that a party's financial capacity to bear risk should influence the pricing assessment instead of leading to the restructuring of the actual risk allocation.

4. Alternative Factor: Cost of Risk

As an operationalization of the factors proposed by the draft (control and financial capacity, see draft paragraph 28), Roeder said that independent parties would allocate risks, in particular more conventional types of entrepreneurial risk, to the party who, as they see it, has the lower cost of assuming the risk. He presented the following simplified formula, which can be used to explain the expected future value of risk cost:

$$\sum_{t=1}^{n} \mathrm{EV_t}\ (1+i_t+r_t)^{-t}$$

where EV = expected future value of risk cost;

i = risk free base rate;

r = risk premium; and

n = end of planning horizon.

He acknowledged that it may be difficult to estimate the cost of risk. In particular, as the valuation of risk is influenced by risk aversion, the same risk can be evaluated differently by different parties.

E. Risk and Transfer Pricing Method

The draft paragraph 45 stresses 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. One participant expressed concern with this statement.

III. Arm's-Length Compensation

A. Approach of the French Tax Authorities

During the third session Issue Note 2 of the draft, dealing with the arm's-length compensation for the restructuring itself was discussed. After giving a brief summary of the issues in the draft, Bruno Gibert (tax adviser, France) started presenting the approach of the French tax authorities within advance pricing agreements and tax audits. For about one year, the French authorities have been developing a position in the context of BR, but their approach is still evolving. The French authorities start with trying to assess in great detail what has happened. They try to find out if any changes in the decision process took place, if there was any reduction of personnel in France, and if any risks that materialized in the past were transferred. According to Gibert this is perfectly in line with the OECD approach. The only problem that occurs is that the French as well as the OECD want to identify one day to make a before and after appreciation, but in reality restructurings will very often be an evolving process. Next, the French authorities extensively review the contractual relationships to assess whether any goodwill or clientele was transferred outside of France, which is also in line with the OECD approach. If something of value has been transferred, the question is also how to value such an asset. The French authorities have implemented two methods: first, the capitalization over a period of the marketing expenses borne in the past by the restructured entity; and second, the discounted cash flow method to assess the value of any transferred goodwill. The OECD does not address valuation issues at the moment, but it is an important question.

In assessing the French authorities' position, Gibert said that contracts were important and a good starting point for analyzing a BR but also commercial law and case law about the termination of contracts between unrelated parties must be taken into account. Under French commercial law, the termination of an agreement only gives, under very specific circumstances, rise to a right for indemnification; for example, when the termination notice can be viewed as too short. From case law one can conclude that a right for indemnification may arise after a length of a contract period. Another important challenge is to determine whether an asset has been moved. For example, in the case of a conversion from a full-fledged distributor to a commissionaire, the assets such as trademarks, patents, or goodwill are not necessarily transferred. The other party may, for example, only get the right to use the assets. Gibert said that for the compensation of the restructuring itself one has to take into account the contracts as well as commercial law to find out what has really happened and if there is a right for indemnification. The second important question is to identify if an asset has been moved. In this context more work should be done on the section of location savings. He also expressed concern about the risk of taxation of profit potentials that could arise from the draft.

B. Business Calls for Clarity and Consensus

Chris Lenon (business representative, United Kingdom) presented the business perspective on compensation for BR. He said that for business the avoidance of double taxation is most important. The role of the OECD in tax matters is to agree on a framework for member states and to provide for a consistent interpretation of difficult issues in transfer pricing. For business it is crucial that the position in the OECD commentaries is very clear. It is only of limited value when it is ambivalent or provides support for inconsistent positions being taken by either fiscal authorities or taxpayers. Therefore consistent and clear statements by the OECD are needed.

Lenon said that there are disagreements among the OECD member states as well as between the OECD member states and the European Court of Justice. He expressed concern that the absence of a strong OECD position could lead to unilateral action by governments, which raises the risk of double taxation, reduces business competitiveness, and hinders economic growth.

> **It is the taxpayer's task to explain what has happened, what the business reasons are, and what the anticipated benefits are from the BR.**

He further said that from a business perspective there should not be any taxing right for unrealized or accrued profits. Lenon said future profits or losses cannot be attributed to ''business opportunities'' or other similar notional assets that have no legal or accounting existence or accepted valuation methods. In case of exit charges for transfer of ''business opportunities'' or ''profit potential'' or ''something of value,'' several issues could lead to double taxation; for example, the situation when the transferor is taxed but there is no corresponding deduction for the transferee. Also the disagreement on which group entity should pay the exit charge, as well as the disagreement over the nature of the assets or rights transferred, could lead to double taxation. Similarly, the mismatch of valuation methods could cause double taxation. Also, the timing differences are a disadvantage for taxpayers. This means that the exit tax is payable at the moment of the deemed transfer, but the actual income may not be realized for many years or at all.

Finally, Lenon highlighted the problem of the lack of effective legislative mechanisms for seeking double taxation relief. In his opinion, tax authorities should be forced to come to a solution of taxing conflicts via mandatory arbitration and incentives.

C. Tax Authorities' Perspective

Manfred Naumann (Federal Ministry of Finance, Germany) presented his comments. He first said that there is a difference between exit taxation and transfer pricing. The draft deals with transfer pricing issues only and therefore it always must be assessed what independent third parties would have done. Issue Note 2 deals with the compensation for the restructuring itself. However, a comparison between the situation before and after the restructuring is equally important.

Naumann said that it is crucial for tax authorities to understand the restructuring. Therefore, it is the taxpayer's task to explain what has happened, what the business reasons are, and what the anticipated benefits are from the BR. In this context it is very important that the enterprise is able to provide documentation. In the absence of contracts it is hard for tax authorities to assess what would have been arranged between third parties. It is not necessary to have the same contracts between related and unrelated parties, but it is only important that tax administrations have the possibility to understand what happened. Concerning options realistically available to either party, Naumann said that of course not any option available must be documented.

Regarding the reallocation of a profit or loss potential, Naumann said that there could be positive as well as negative effects for the parties involved. But among unrelated parties, whenever one has positive effects those effects would normally be shared. Also, the BR must be evaluated from the perspectives of both the transferor and the transferee.

Naumann continued with the evaluation of the transfer of an activity. In this case one must look at the total bundle of assets and liabilities associated with the inherent risk. He said that profit potential is not an asset per se but may be attached to assets. In his opinion one will never find goodwill in isolation. In any case when assets and functions are transferred, goodwill attached to them can be found. Goodwill is the hope for future profits, and therefore it is the profit potential of an enterprise. Third parties would always pay for the goodwill, which is the reason why also in the case of BR there must be a compensation for such profit potential. This should also be reflected in the draft. If a loss-making activity is transferred, there may also be compensation if there was compensation between unrelated parties. Regarding the indemnification rights, Naumann said that when a contract is terminated according to the terms of the contract, it is arm's length. In this case tax authorities will accept the result written down in private law.

D. Identifying Profit Potential

One participant asked whether the concept of goodwill is really appropriate for BR. In general this concept is used when the whole enterprise is transferred, but in BR cases only a part of an enterprise is transferred. Naumann answered that it was important that the tax administration understands what is going on to be able to correctly evaluate the goodwill. Another participant asked if there was also negative goodwill and if manpower was included in the goodwill. Naumann argued that there won't be a negative goodwill within a BR because that would be against the interest of the entity. Regarding manpower, he explained that one must always look at the bundle of assets that is transferred. This may include machinery, people, and intangibles, and there may also be a goodwill attached to these assets. Another participant asked whether business opportunity is really an asset that is transferred within a BR. In company law, countries have very different approaches in this respect. For example, in the United States there is a strong protection of corporate opportunities; however, in Germany a very recent decision of the Federal Civil Court held that the parent company can act in the same market as its subsidiary without having to pay any compensation.

The participant also said the terms goodwill and profit potential should not be mixed up. Goodwill is an asset, but not everywhere where there is a profit potential is there also goodwill, and goodwill is not always transferred. Lenon said that an unrelated party would never pay for 100 percent of future profits because then there would be no profit left. Also, an arm's-length price does not always reflect the future profit potential. In many cases the buyer does not tell the vendor what it plans to do with the acquired assets; otherwise the price would go up. Further on, profit potential could emerge without being transferred; for example, when the buying function is centralized and as a consequence of the group's buying power all entities must pay lower prices. In this case new profit potential emerges but is not transferred.

IV. Remuneration

A. Greater Acceptance of Profit-Based Methods?

During the second day's first morning session, which was chaired by Mary C. Bennett (OECD), Issue Note 3 of the draft dealing with the remuneration of postrestructuring controlled transactions was discussed. Dieter Endres (tax adviser, Germany) started with an overview of the issues mentioned in the draft.

The draft contains a summary of the existing guidance on traditional methods and transactional profit methods. The method selected should be that most appropriate in the circumstances without having a clear hierarchy of methods. According to Endres, however, there is a noticeable increase in acceptance of transactional profit methods.

Second, the draft highlights that TPG should not apply differently to postrestructuring transactions than it does to transactions that were structured as such from the beginning. It is essential to do a comparability analysis before and after the restructuring to find out if the situations are really comparable. However, factual differences may affect the comparability analysis and hence deserve specific consideration.

The main topic in Issue Note 3 is the selection and application of a transfer pricing method — first, identify if the allocation of risks and intangibles is arm's length; and second, remember that the risk borne by the business should dictate the choice of transfer pricing method, rather than being a consequence of the method chosen. This is good economic thinking, in contrast to the position of the German statutory regulation to the Foreign Tax Act (Funktionsverlagerungsverordnung). Endres also said, in relation to one-sided methods, the functional analysis must cover both sides. Generally, traditional methods are to be preferred to profit-split methods. However, profit-split methods may be appropriate in the case of nonbenchmarkable functions like unique intangibles or special risks. In this context Endres said that the wording of the draft seems to imply that it would never be possible to find reliable comparables. Therefore, the likelihood of tax authorities applying a profit-split method might increase. The draft also accepts a hypothetical comparison in some cases of imperfect data. However, it is not clear how this would work in practice.

> **The main topic in Issue Note 3 is the selection and application of a transfer pricing method.**

Next, the draft mentions the relationship between the compensation for the restructuring and postrestructuring remuneration. Endres said it is self-evident that tax administrations will take into account the entirety of arrangements in a case of BR. Further on, the draft deals with the comparison of profits earned before and after the restructuring. It stipulates that a change in profits is not enough to support a transfer pricing adjustment but could play a role in understanding the restructuring.

The last section in the draft discusses location savings, which can be achieved when costs are lower in one location than in the other. The question is how such savings should be shared among the parties. Endres said that the suggestions in the draft are relatively general. If, for example, simple manufacturing is delegated to a contract manufacturer in a low-cost country, location savings will largely be achieved in the country of the principal. However, not all independent contract manufacturers will be prepared to pass on the full advantage of their low costs to their principals through a cost plus agreement. The situation could also be different when one considers the provision of highly specialized services. In this case tax benefits will mostly accrue to the country of the provider. Thus, the result depends on competition and on the relative bargaining powers. Endres also said that the draft does not mention subsidies and tax reliefs as possible reasons for location savings. This is good, as it would be a strange result to share such advantages with the other country.

B. Tax Administration's Perspective

The second presentation was given by Mike Hogan (HM Revenue & Customs, United Kingdom). He said that Issue Note 3 is rather uncontroversial from his perspective and therefore agreed with many points made by Endres. It is true that the TPG should not apply differently to postrestructuring transactions but the comparability analysis is affected and needs to take account of the difference in facts between a restructuring and a structuring or start-up. For example, in the case when a normal distributor becomes a risk-stripped distributor, the previous contracts and options realistically available must be considered whereas they just don't exist in the case of a start-up. BR always involves change, and this change must be documented. The before-and-after comparison is a very important part because it sheds light on the value-drivers. Of course, a lower profit does not always mean that there must be a transfer pricing adjustment, but tax administrations will examine why this is the case. Hogan also said that the functional analysis determines the transfer pricing method, not vice versa.

> **William Morris said that it must be acknowledged that transfer pricing is a very emotional subject.**

Concerning the example on centralizing the purchasing function, the draft does not draw any definite conclusions about who gets the benefit of the cost-savings from the restructuring, nor how any inefficiency costs should be shared. He agreed that most important are the benefits that could be expected by the parties and the options realistically available, including the option not to participate if it was going to be detrimental. Regarding the ongoing relationship between the restructured entity and the transferee, there may be a trade-off between the remuneration of the transfer and the remuneration for the postrestructuring services. From the perspective of the tax administration this may provide some scope for manipulating prices, and, according to Hogan, the draft should comment on this issue more clearly. Concerning how to share location savings, Hogan said that the draft gives useful examples of when either the head office or the subcontracting party should get all the benefits or when the benefits should be split.

C. Acknowledging the Emotions

Finally, William Morris (business representative, United Kingdom) presented his comments. Unlike the expected call for clarity, consensus, and reduced documentation requirements, he said that it must be acknowledged that transfer pricing is a very emotional subject. He said it is dangerous to build intellectual structures over these emotions because much remains unspoken. This is particularly true for postrestructuring transactions where governments might feel that they are not told the truth, first when the restructuring takes place, and second when after the restructuring the business is still there largely unaltered. Everyone should remember that the OECD model was established to promote cross-border investments and trade and to prevent double taxation. Instead of every enterprise having to collect huge quantities of facts, enterprises should be able to concentrate on doing what their business actually does. Of course, documentation is a key element. But it is important that business acknowledges that some transactions are simply not genuine. Once that is done, there could be significantly lower burdens on genuine BRs that would be recognized and accepted by governments. This would be a much simpler way to move forward for businesses and for tax administrations.

D. Increased Importance of Profit-Split?

During the subsequent discussion one participant asked why profit-split should not be an element of the analysis in every case. The reasoning is that between unrelated parties, profits also play an important role. When agreeing on a deal, one considers what either party contributes and how the possible outcome could be shared. Also, in discussions with tax authorities, profit-split is always an issue. Therefore, the OECD should probably focus more on this. Morris in general agreed with the suggestion to refine the arm's-length principle somehow. He said that even in a true arm's-length situation, people are often hiding facts, so even under the best of circumstances the test is always going to be somewhat subjective. If more objective rules could be agreed on, that could be very useful. Endres asked if the draft really expresses a move toward profit-based methods. Silberztein responded that the OECD is discussing moving away from the current strict hierarchy of methods to an approach whereby the most appropriate method to the circumstances of the cases should be chosen. In any case, profit-split should not be a favored method for all post-BR transactions, but this method is available for specific circumstances (for example, when both parties to a transaction contribute significant unique intangibles). Hogan added that in BR it is very difficult to find comparables and that is why profit-split in many cases is the only method left. Profit-split is normally not seen between unrelated parties, but this may be true for transfer pricing generally, not just in the restructuring context. Endres said that between unrelated parties there are also lucky sales. Another participant stated that profit-split between third parties is unusual and that negotiations are typically directed by market prices. Hogan acknowledged that profit-split might not reflect a third-party situation, but the problem is that tax authorities do not have all the information and in the absence of comparables they have to use the profit-split method.

The discussion turned to the logical connection between the transfer pricing analysis of the restructuring itself and the postrestructuring transactions. One participant mentioned that, for example, when a lot of intangibles are transferred, the consideration within the postrestructuring transactions will be lower. From a tax point of view this makes a big difference because any adjustment for the restructuring itself will lead to an upfront payment. However, a sensible postrestructuring arrangement may provide relief from that. The question is therefore whether business really has a choice to provide for appropriate postrestructuring agreements that relieve them from upfront payments. Also, the tax administration that missed the opportunity to tax the restructuring in the first place might in return have a sharper look at the postrestructuring transactions. Responding to that, Morris said that maybe the draft in this respect is too generous to business. The most important issue is to get the transfer pricing in the BR right; maybe governments should have more discretion to look at this, but postrestructuring transactions should be out of this and be treated just like normal transactions. Endres would not deduct from the wording in the draft a choice between having an upfront payment or higher remuneration within the postrestructuring transactions because all plans must be documented in advance.

Morris also said that the area of cost sharing is very difficult because there is often too much latitude for different arguments and arrangements. He stated that governments should probably not allow unrestricted cost sharing because, as with other areas, that leads to a significant compliance burden on all taxpayers. It would make the law, as well as the administrative burden, simpler for the majority of transactions if some of the abusive transactions were forbidden, rather than made subject to transfer pricing.

V. Recognition of the Actual Transactions

A. Introductory Issues

Issue Note 4 of the draft concerns recognition of the actual transactions undertaken, that is, the issue addressed in TPG paragraphs 1.36-1.41. The chair was Mary C. Bennett (OECD) and speakers were Hubertus Baumhoff (tax adviser, Germany), Tobin Hopkins (tax adviser, United States), and Michelle Levac (tax official, Canada).

Baumhoff said that in line with TPG paragraph 1.36, tax administrations are in principle only entitled to adjust prices of controlled transactions, not to change the legal character of the transaction. Tax administrations should, thus, not replace actual transactions with deemed transactions. He did, however, recognize that nonrecognition is authorized in two specific circumstances referred to in TPG paragraph 1.37; that is, ''where the economic substance of a transaction differs from its form'' and ''where . . . 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.'' One participant said that TPG paragraphs 1.36 et seq. raise a number of questions.

Bennett said that Note 4 has triggered discussions within the OECD. Baumhoff said that Note 4 was the most crucial chapter of the draft, contains highly controversial statements, and may lead to extremely controversial answers in practice. Hopkins said that whereas the draft is generally an extremely good document, Note 4 is unclear and/or ambiguous in several regards, and should provide more practical guidance on some points. Several participants shared this opinion, and Baumhoff said that guidance is urgently needed on the practical application of TPG paragraphs 1.36 et seq. to BRs. Hopkins also said it was important that the OECD reach a consensus and remove ambiguities, as the OECD's guidance would not be useful if totally ambiguous. Clarity is particularly important in the area of nonrecognition, as disagreements between tax administrations would create a more black and white situation than disagreements in the area of pricing adjustments. Levac said that it is difficult for the draft to be transparent (express different opinions) and not to be ambiguous at the same time. She also stressed that the draft is only an *interpretation* of the existing TPG, contended that tax administrations normally agree on which types of transactions should not be recognized, and said that nonrecognition should only be resorted to in clearly abusive cases. One participant representing a tax administration was critical of parts of Note 4, especially the contradictory statements in some paragraphs. Following the discussions it was pointed out that they highlighted the ambiguities of the draft and the difficulties of the problems it addressed.

Baumhoff said that Note 4 should have been Note 1, as Note 4 addresses the starting point of the subsequent analysis of arm's-length behavior and involves the most important question. He also stressed the importance of the freedom of businesses to organize and structure their business activities as they see fit for themselves (see draft paragraph 196). Several participants agreed with this position. Baumhoff referred to this freedom as a fundamental doctrine requiring tax administrations to respect contractual terms as they are actually implemented. Tax administrations should not act as a business manager with superior commercial knowledge or as an all-knowing businessman. He was concerned that Note 4 opens the door for nonrecognition and for tax administrations to substitute the commercial decision of the taxpayer with its own decision.

According to Baumhoff, the burden of proof is a key issue from a practical point of view. More specifically, the issue is whether the taxpayer or the tax administration is responsible for providing evidence that controlled transactions reflect the economic and commercial reality of independent parties. Hopkins suggested that the tax administration should have the burden of proof (in the form of a rebuttable presumption) that the associated taxpayers have behaved in a commercially rational manner.

Referring to the draft paragraph 212, Baumhoff, Levac, and several participants said that a BR cannot be disregarded or restructured merely because it is motivated by tax savings. Baumhoff rejected the opinion, as reportedly argued by some states, that a BR can only be commercially rational if serving nontax purposes. Levac said that tax savings are legitimate and can be commercially rational to pursue (for example, if all competitors pursue them). One of the participants said that under ECJ case law, a transaction cannot be disregarded merely because it is solely tax motivated (see, for example, *Cadbury Schweppes* (C-196/04) paragraph 36); tax competition is accepted by the ECJ.

Referring to TPG paragraph 1.10 and the draft paragraph 208, Baumhoff stressed that it is not in itself sufficient for nonrecognition that an examined controlled transaction is not seen between independent enterprises. The same point was stressed by several participants.

Levac stressed the importance of ''all cards being on the table'' in a transfer pricing examination, as it is important for a tax administration to understand the business and have all the facts. In the absence of complete facts, it may be difficult for the tax administration to know what it is really discussing. Levac said it is very important in the context of BRs to look at changes in the operations due to the BR and to the incentives for the different participants to the BR. Because BRs are driven by the desire to achieve synergies and costs savings, tax administrations will expect such favorable targeted effects to be demonstrated.

Levac also said that risk allocation should normally not be viewed as a nonrecognition issue. Risks should normally be dealt with through a pricing adjustment and only exceptionally as nonrecognition.

Further, Levac suggested that when nonrecognition is authorized, substitution should normally be chosen rather than disregard. The authority to disregard is subject to some practical limitations; for example, that facts and circumstance can change (the transferee may eventually dispose of acquired property if it is able to maintain or maximize its value) and that there are problems in getting access to relevant information. However, she said that it would be appropriate to disregard a mere shell corporation.

Baumhoff and Levac stressed that nonrecognition is an exceptional line of action (see draft paragraph 205). Other participants shared this view. Baumhoff said that non-arm's-length behavior should as much as possible be dealt with through pricing adjustments and that nonrecognition is merely an option of last resort.

Baumhoff also said that nonrecognition of controlled transactions may amount to discrimination of associated enterprises in terms of the manner in which they can structure their transactions; there are generally no restraints as to how independent enterprises can structure their transactions. In particular, he was opposed to the view expressed in the draft paragraph 216; that is, that sale of crown-jewel intangibles can be disregarded, as independent enterprises are generally free to undertake such transfers.

B. Economic Substance

Hopkins saw the first circumstance referred to in TPG paragraph 1.37 as rather uncontroversial, as economic substance requirements have been part of applying the arm's-length principle for a long time. He did, however, point out that in practice the form of uncontrolled transactions does not always cohere with their economic substance. In his experience such discrepancies may be revealed during the comparability analysis. He said that some discrepancies between form and economic substance may be immaterial and suggested that minor discrepancies should not lead to the dramatic exercise of nonrecognition.

Levac said that it has sometimes been suggested that the second condition for nonrecognition under the second circumstance referred to in TPG paragraph 1.37 also applies under the first circumstance referred to by the paragraph.

C. Commercial Rationality

1. In General

The draft's proposal to introduce the realistically available options standard (RAO standard) for determining whether the structure of a controlled transaction is commercially irrational (see, in particular, the draft paragraph 209) raised multiple concerns. A first concern, Baumhoff said, is that the RAO standard could have the effect of authorizing tax administrations to dictate how associated enterprises should structure their controlled transactions and where they should locate their business activities. This concern was shared by the other speakers and several participants. Levac said tax administrations should respect business expertise and knowledge, and recognize that they are not business experts in all industries and that they cannot replace sound business judgment. One participant representing a tax administration argued that the RAO standard is not trying to dictate to businesses how to run their business activities. In his view it is legitimate to question whether a taxpayer would participate in a BR if it would lead to a significant decrease in its profits.

Hopkins emphasized a second related concern, which is that the RAO standard is difficult to apply for tax administrations as it necessitates subjective decisions, and tax administrations often do not have sufficient knowledge about the taxpayer's business to apply the standard. This concern was also shared by several participants. One participant feared the standard will, as a result, trigger many disputes. Hopkins said that while the RAO standard has existed in U.S. law for quite some time, it was hardly used for the first 10 years, but has recently been applied more often.

A third concern, also advanced by Hopkins, is that the RAO standard imposes a heavy burden on taxpayers, especially in terms of the need of identifying options realistically available. Fourth, one participant argued that a subsidiary does not have the option of not complying with its parent company's requests; it cannot fight for its survival. The participant said that a subsidiary cannot fight against its own liquidation, which is the most detrimental thing it can experience. In this participant's view, the subsidiary's options are limited to the price bargaining, that is, to achieve the best option within the arm's-length range of prices. Levac did not share the view that the RAO standard as it is outlined in the draft pertains only to pricing issues.

Hopkins argued that independent enterprises do not always seem to act in a commercially rational manner (this, in substance, being an argument against nonrecognition in the second circumstance referred to in TPG paragraph 1.37). The RAO standard is therefore not an absolute one. Everyone can take a different view on commercial rationality. Levac was skeptical of the proposition that independent parties do not always act commercially rational. If they act in a commercially irrational manner they will not stay in business in the long term (unless subsidies are involved). She said business is generally knowledgeable and acts in a manner that lets it remain competitive and deliver expected returns to its investors.

Baumhoff said that the commercial rationality test strongly resembles the German prudent business manager test, which is established in German case law and has recently been added to section 1 Foreign Tax Act (the German arm's-length provision). The prudent business manager test will be satisfied (in the sense that no adjustment is authorized) if a controlled transaction would have been made by a prudent and diligent business manager with a third party.

Baumhoff and Hopkins raised the question whether the commercial rationality test is a specific characteristic of the arm's-length principle or parallels the arm's-length principle. If this is so, the speakers argued, the test would imply a circular reasoning and be superfluous.

As Baumhoff saw it, the RAO standard does, from an economic point of view, parallel the so-called make-or-buy decision. This decision involves a comparison of the costs and benefits of different business strategies, with the aim of adopting the most favorable strategy.

Baumhoff and Levac said that the threshold for nonrecognition is very high. They said, in line with the draft paragraph 208, that the actual transaction is only commercially irrational if it is ''clearly detrimental'' to the examined taxpayer. Levac suggested that nonrecognition should only be undertaken in abusive situations rather than in the case of legitimate BRs.

Baumhoff raised the issue of whether tax administrations are authorized to use hindsight when applying the RAO standard (this temporal aspect both arises in the process of determining which options are realistically available and in the process of determining whether the actual transaction is clearly detrimental). The use of hindsight would lead to massive discrimination of associated taxpayers and would parallel the U.S. commensurate-with-income standard (see U.S. Internal Revenue Code section 482, second sentence). Even though tax audits take place many years after the transaction is undertaken, the options realistically available should be established from the perspective of the time the controlled transaction is entered into; only information known or reasonably available at that point can be taken into account. Levac and one participant said that hindsight should also not be used in the process of determining whether the actual transaction is clearly detrimental (acknowledging a business representative's comment that even independent enterprises make business decisions based on assumptions that do not materialize).

2. Which Options Need to Be Considered?

The draft (paragraph 209) only refers to the options ''realistically'' available, not to any theoretical options. Baumhoff asked whether it would be necessary to limit the search for realistically available options by means of only taking into account the particular economic and commercial situation of the taxpayer (for example, its business assets, its financial resources, its personnel, or its risk willingness). Hopkins suggested that the question should be answered in the affirmative. Levac said that the RAO standard neither implies that the taxpayer must consider all possible options nor that tax administrations would look at all possible options and make opinions as to what the best options are. She did, however, stress that a thorough functional analysis would be required and that a group cannot choose options that are clearly detrimental, especially to the overall group.

3. Is the Arrangement Commercially Irrational?

In paragraph 213, the draft proposes that it is ''not sufficient from a transfer pricing perspective that an arrangement makes commercial sense for the group as a whole: the transaction must be arm's length at the level of each individual taxpayer.'' Baumhoff and Hopkins and several participants suggested that it should be sufficient that the BR is commercially rational from a group-level perspective. Baumhoff said group-level effects can exist, rendering the BR commercially rational. Hopkins said that a BR may make complete commercial sense for the group, although it may always seem irrational for one or more parties to it. In his view, it should be sufficient if negatively affected parties received a fair remuneration. Hopkins suggested that a commercial-rationality test should be applied at the group level, whereas an arm's-length test should be applied at the company level. Levac agreed with this view. The two speakers (Hopkins and Levac) did not explain what would be the difference between these tests.

Though Levac was somewhat more reluctant than Baumhoff and Hopkins, she did not think that a BR will be challenged on a nonrecognition basis if there is a group-level rationale to it. She said it would be wise to look at the overall BR to establish what really happened and to identify the incentives. One participant strongly opposed the view expressed by Baumhoff and Hopkins. In his opinion the group-level perspective is not relevant; after all, assessing how independent (separate) entities would have behaved is what the arm's-length principle is all about. He did, however, agree that the group-level perspective could be useful as a starter in understanding the rationale for the BR.

Several participants said that different persons may have different opinions as to what is commercially rational. One participant said that this is illustrated by how independent parties behave at auctions.

4. Practical Impediments to the Pricing

One participant stressed the importance of the second condition for nonrecognition under the second circumstance referred to in TPG paragraph 1.37. This participant suggested that every effort should be made to undertake a pricing adjustment instead of resorting to nonrecognition. The participant struggled with finding practical cases when an appropriate transfer price cannot be determined. In line with the draft paragraph 213, Hopkins would expect that BRs serving a business purpose could be priced.

Another participant suggested that pricing could be used to create a commercial rationale. Hopkins said the issue had been discussed within the OECD, but that no consensus had been reached.

VI. Some PE Issues

In addition to issues relating to the application of transfer pricing rules and the recognition or nonrecognition of transactions, BRs raise issues involving the determination of the existence of, and the attribution of profits to, PEs. David Rosenbloom (New York University) chaired the session addressing these issues, which the draft itself does not cover. Important definitional issues and PE threshold aspects will be considered in a separate discussion draft instead.

A. Demand for Guidance and Clarification

The introductory presentation by Charlotte Winzer (business representative, Germany) highlighted the challenges MNEs face in a global economy. The development of new markets, increasing competition, and a constantly changing business environment call for a centralization of business structures to realize synergy effects and to facilitate fast decision-making procedures. A key element of a tax-efficient business structure is flexibility, allowing for timely adjustments to future developments. In the past, MNEs could rely on a broad international consensus on principles governing the taxation of cross-border transactions. However, the advent of increasingly sophisticated BRs caused many countries to take unilateral measures. In many cases it is unclear whether the measures taken are compatible with established OECD principles. Winzer said that uncertainty and unpredictability resulting from uncoordinated legislative attempts to protect national tax bases can amount to considerable obstacles for business success. Therefore MNEs seek clarification and guidance as to the application of the new provisions to reestablish a reliable framework of rules and principles on which business decisions can be based. Areas of particular interest in the context of BRs are dependent agent PE issues, where demand for guidance exists regarding definitional and threshold aspects, and burden and standard of proof issues.

B. Two Sides of the Agency PE

In his presentation Michael Wichmann (Federal Ministry of Finance, Germany) discussed the agency PE. A typical example of a BR likely to give rise to PE issues is the functional reduction of a full-fledged distribution company to a limited-risk distributor, if there is either a lack of arm's-length compensation for the functional reduction (dependent agent PE) or a mismatch between the contractual shift of functions and the actual performance of significant people functions (''functional'' agency PE).

1. Dependent Agent PE

The existence of a subsidiary and exercise of corporate control does not, by itself, give rise to a PE. However, a subsidiary can constitute a PE if it acts as a dependent agent for its parent company. The requirement of authority to conclude contracts in the name of the principal is given a broad meaning commonly met by limited-risk distributors. When a subsidiary is performing services for a single principal, is subject to detailed instructions, or is economically dependent on its principal it cannot be regarded as an independent agent of its parent company. Interestingly, under article 5(VII) U.N. model, dealing on arm's-length terms is sufficient to prevent an agent working for only one principal to be regarded as dependent, whereas the AOA, distinguishing between the consideration for the agent's activity and the profits attributable to the agency PE created by his activity, does not exclude dependency for an agent remunerated at arm's length.

In Wichmann's opinion a prima facie case for economic dependence can be made when a full-fledged distributor agreed on a functional reduction to a mere commissionaire without receiving arm's-length compensation for the profits forgone, unless there are tradeoffs or economic justifications an independent third party would have accepted under essentially the same circumstances. Once the activities of a limited-risk distributor are found to constitute a dependent agent PE, the host country will have taxing rights over the arm's-length service remuneration of the subsidiary and any additional profit attributable to the dependent agent PE. Wichmann said that the attribution of profits to the PE according to the allocation of significant people functions could override the contractual distribution of profits between the parent and its subsidiary if the contractual arrangement was not supported by the actual allocation or performance of those functions.

2. *'Functional' Agency PE*

The postrestructuring activities of a subsidiary can also be found to constitute a PE of its parent company if there is a mismatch between the contractual shift of functions and the actual performance of significant people functions. A subsidiary acting in a business sphere outside of its own business operations, which economically belongs to the functional sphere of another group company under contractual control, can be deemed a PE as an independent agent acting outside its ordinary course of business (article 5(VI) OECD model). A subsidiary that continues to actually perform the same significant people functions despite a contractual shift of these functions to another group company can also be deemed a dependent agent PE for this other company. A mismatch between contractual and actual business conduct, disparity between functions actually performed and remuneration received or retained, or combination of group control and acceptance of inadequate remuneration compared with the actual functional profile of the subsidiary are all indicators of a subsidiary's legal and economic dependence. Also, the dependent agent has to carry out the business of its principal. In Wichmann's view, this functional agency approach is not limited to sales agency cases since article 5, paragraph 41 of the OECD commentary indicates that the requirement of the carrying out of the principal's business has become a general principle. This approach was tested by courts, for example, in *Interhome* (2003) decided by the French Conseil d'Etat (finding no PE) and a 2004 decision by the German Tax Court of Baden-Württemberg (assuming a PE). Wichmann concluded by stressing the importance of seeing the functional agency approach in the general PE context. The PE threshold has been significantly reduced by the 2003 revision of article 5 OECD commentary. As a consequence, the point of delivery or performance of a service, for example, can constitute a fixed place of business under some circumstances, although the OECD model, in contrast to the U.N. model, does not provide for a services PE. In distinguishing between the different PE concepts, it is crucial to determine whose business or contractual obligations are carried out by whom at which location.

C. Tax Policy Considerations

In the third presentation Carol Dunahoo (tax adviser, United States) focused on tax policy considerations of BRs and related PE issues. In her view, the international tax consensus as developed and promoted through the work of the OECD and bilateral treaties is seriously threatened. Clear, consistent, and administrable rules to avoid or at least minimize double taxation are necessary. Taxpayers and tax administrations alike need to know what these rules are, as this is particularly important in determining the taxation threshold. Companies need to know whether they have a tax obligation in a jurisdiction, and they need to make this determination in advance for financial reporting purposes (FIN 48). It has become common practice for many tax administrations to reinterpret the PE threshold with the assumed goal to find a PE and assert jurisdiction without being limited by their own transfer pricing principles. In the context of BRs, the PE threshold, a treaty test that is supposed to be a mechanism for allocating taxing jurisdiction, is now being viewed by some as a tool to assert taxing jurisdiction in a way it was not intended. Dunahoo said that BR was not a source versus residence taxation issue but rather a tax competition issue. While a case could probably be made for the taxpayer and tax authority alike, it is crucial to find a solution to the issue. Not every single dispute can go to competent authority, because the competent authorities cannot resolve this any better than tax policymakers could. The broader implications for the PE threshold in general ought to be of particular interest. It has been argued that in the BR context the threshold for taxation should be different because BRs sometimes are abusive. The inquiry in the BR area has moved into a FIN 48 context, with taxpayers requesting advice not on whether there is a PE under standard OECD principles but on how likely it is that the competent authorities will take the case and resolve it. A principles-based approach rather than a results-based approach is needed in this area. A system that encourages rather than discourages trade and investment is required. Dunahoo concluded that the first priority ought to be developing a consensus and clear rules before discarding the PE notion in practice.

D. Transfer Pricing Principles vs. the AOA?

In the subsequent discussion a participant said that the position of emerging countries (for example, Brazil, Russia, India, and China) ought to be kept in mind while discussing BRs and PE issues. Principles OECD member states agreed on must also be acceptable for emerging countries to avoid future double taxation and to promote free trade and growth. It will likely be easier to obtain acceptance of general and clear principles from emerging countries if traditional residence countries do not behave like source countries.

The position of emerging countries ought to be kept in mind while discussing business restructurings and PE issues.

One participant commented on important issues concerning the relationship between article 7 and article 9 OECD model. The first issue was whether it is possible that the same facts that lead to an adjustment under transfer pricing rules also give rise to the assumption of a PE. In other words, the issue is whether the asymmetric detrimental content of a postrestructuring contractual relationship should be subject to adjustments not only under transfer pricing rules but also under PE principles. It was proposed that if available and sufficient to cure the inadequacy, remedies should be limited to transfer pricing adjustments as applied either to the restructuring itself or to the postrestructuring remuneration, and that additional adjustments under PE principles should not be used as an extra penalty. The second issue was whether the concept of a functional agency PE is compatible with fundamental OECD principles. In the context of article 9 OECD model, taxpayers are presumed to be independent entities and contractual relationships are controlled based on the allocation of risks and rewards. Under the functional agency PE concept, important persons that are still employed by the subsidiary may be found to constitute a PE even when the parent and subsidiary are dealing at arm's length. The factual analysis of significant people functions is an element of the AOA for profit attribution to PEs. The AOA has to cope with the fact that a PE is not an independent entity requiring the hypothetical assumption of independence by analyzing the allocation of functions and people employed. The danger is to transfer the AOA to independent companies and to introduce another layer of control beyond transfer pricing adjustments.

In response, Wichmann emphasized the German tax administration's clear preference for transfer pricing adjustments. However, even though the administration fully supports the position that the PE threshold must be significant, it is not willing to give up the PE concept in the context of BR as a potential remedy of last resort. Another member of the tax administration clarified that these PE issues only surfaced after companies started to engage in BRs involving the functional reduction of entities. These stripped down companies gave rise to dependent agent PEs without any prior change to the traditional PE concepts.

In a concluding remark Rosenbloom expressed doubts about whether an appropriate pricing adjustment can solve the PE issue. The key question is whether in cases of incorrect pricing a country can choose to either make a transfer pricing adjustment or assume the existence of a PE or whether it can do both. One participant argued that there should be a hierarchy and that transfer pricing should come first. Rosenbloom said that in solving this issue it is crucial to answer whether there is room for a second level of profits even if the pricing is correct. He agreed with the proposition that transfer pricing should come first, but remained doubtful as to whether that solves the issue in all circumstances, believing there can be situations when a second level of profits exist.

VII. Business Restructurings and EC Law

Uwe Ihli (European Commission) gave the first presentation on BRs and EC law. He focused on issues regarding the corporate tax directives, tax coordination, and tax policy considerations. In the context of BRs, the parent-subsidiary directive is of particular importance when transactions are recharacterized as dividends in kind or constructive distributions. The scope of the interest and royalty directive is not limited to intercorporate payments but also includes payments to and from PEs located in a member state. The merger directive has no significant impact on BRs because it is concerned with legal reorganizations, whereas BRs primarily involve economic restructurings.

Concerning the field of tax coordination, Ihli focused on the nonrecognition of BRs and exit taxation. In light of ECJ case law on fundamental freedoms and the concept of abuse, EU member states are even more limited in the nonrecognition of BRs than other states. Member states are not allowed to distinguish between subsidiaries and PEs of nonresident companies because a different tax treatment could amount to discrimination based on nationality and violate the freedom of establishment. An exception to this general rule applies in the area of exit taxation. In a BR involving a PE, unlike a subsidiary, the exit state cannot levy a tax immediately. However, the exit state may reserve the right to tax unrealized capital gains. In the council resolution of December 2, 2008, on coordinating exit taxation (2008/C 323/01), the member states have agreed on valuation principles and a mechanism for dispute settlement when valuation mismatches occur between the exit and the host state. Details of tax deferral are the only issue left on which no general agreement has yet been reached.

Regarding EU tax policy, Ihli said that direct taxation is a competence of the member states and that the EU Commission is concerned with policy issues when double taxation or double nontaxation amount to obstacles to the internal market or the fundamental freedoms. Areas of particular interest to policymakers include issues relating to the identification and valuation of intangible property or goodwill transferred in BRs or the development of efficient research incentive schemes. Ihli concluded by suggesting that the Arbitration Convention would be an ideal instrument to settle disputes between member states in the context of BRs, though it would first be necessary to reach an agreement among all member states that issues in the context of BRs are transfer pricing issues within the scope of the convention.

Kees van Raad (Leiden University) gave the second presentation on EC law issues of BRs. He stated that the ECJ would play an important role in identifying and deciding fundamental issues. There are two areas in which the ECJ is likely to make important pronouncements; the first is exit taxation. As noted previously, member states have agreed on two of the three outstanding issues in the field of exit taxation. However, no agreement has been reached on the important deferral issue. Under ECJ case law member states will be required to provide for deferral of any capital gain arising from the transfer of functions, assets, or risks to another member state. The second area will probably be disagreements between member states on the consequences of BRs. Many issues are likely to arise in the transfer pricing area and in the context of the transfer of intangibles. Even though the Arbitration Convention provides for arbitration in unresolved transfer pricing disputes, there are major obstacles to the proper operation of the convention.

Some member states do not meet their obligations under the convention and unduly defer the starting point of the time limit before a dispute will go to arbitration. Also, some member states improperly limit the scope of the convention to transfer pricing adjustments under article 9 OECD model, even though disputes concerning the attribution of profits to PEs are also clearly covered by the convention. Van Raad suggested that the ECJ at some point may arrive at the conclusion that excessive delays in settling transfer pricing disputes can amount to the violation of fundamental freedoms. Even outside the area of transfer pricing there is ample room for disagreements between member states (for example, on the transfer of intangibles). When an intangible is transferred within an enterprise the exit country may view the transfer as a sale and apply an exit tax, whereas the other country may apply withholding tax to royalty payments. The ECJ might also have to decide issues arising in the area of agency PEs as discussed in the previous session.

The subsequent discussion evolved around the issue of exit taxation, including how to define an exit tax. One participant said that the ECJ has not yet developed a clear distinction between an exit charge and transfer pricing. In *X & Y* (2002), a tax on capital gains on the transfer of portfolio shares to a foreign company, which would have been deferred had the shares been transferred to a domestic company, was found to be discriminatory and gave rise to exit tax issues. In *Test Claimants in the Thin Cap Group Litigation* (2007), thin capitalization rules applicable to foreign parent companies have been accepted as a remedy against abuse only if a third party had not entered into the same agreement under the arm's-length principle. In this case the Court expressly stated that a non-arm's-length agreement is abusive under EC law. In the light of these two cases BRs could either be seen as a matter of transfer pricing adjustments with the ECJ having accepted the arm's-length principle in the *Thin Cap* case or they could be seen as drawing a distinction between the transfer of functions to another country and the transfer within a single country similar to the *X & Y* case. It remains to be seen how the ECJ will eventually decide this issue.

> **EU member states are even more limited in the nonrecognition of business restructurings than other states.**

Also, one participant said that EU policymakers appear to have a very narrow understanding of exit taxation and tend to limit its meaning to when a taxpayer changes residence and therefore moves his assets across a border or when he transfers assets within a single entity from a head office to a PE. The important issue of the *X & Y* case, the transfer of assets between two related entities raising transfer pricing issues, is not addressed at all. Another issue commented on was whether the taxation of gain from the transfer of an asset in a BR is a tax on unrealized income violating EU law. A discrimination argument could be made when a country has a regime providing for deferral of realized gain on domestic intergroup transactions demanding that gain on cross-border transfers within a group should also be deferred.

VIII. Conclusions

Concluding the seminar, Bennett thanked all participants for their helpful suggestions and comments on the draft. Many ambiguities and issues were identified in the course of the seminar that require further thought. An important general theme was to what extent the fiction of independence used in transfer pricing analyses can be pursued in the context of analyzing related party transactions in the context of BRs. Another subject of general importance is the issue of documentation. Governments have clearly indicated that it is helpful to them to have documentation explaining the structure of and motivation for the transaction. Businesses may also find it helpful to have documentation describing what they are intending to accomplish. However, taxpayers might reserve the right not to be bound by the documentation and may find the burden of producing it unduly onerous in some circumstances. In his concluding statement Schön said that the draft should be looked at in taking a two-step approach. In a first step the goal ought to be to achieve a consensus on the basic tools of analysis, the basic terminology, and the basic distinctions as to where the discretion of the companies ends and where the control of the tax authorities begins. Once the general framework has been established the details and specifics can be developed in a second step. ◆