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APPENDICES TO LECTURE OUTLINE**

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**APPENDIX 65 (OECD BUSINESS RESTRUCTURING)**

**Material:**

OECD, Transfer Pricing Aspects of Business Restructurings: Discussion Draft for Public Comment, 19 September 2008 to 19 February 2009 (introductory portion, p. 1-13)

Giammarco Cottani, "Transfer Pricing Aspects of Business Restructurings: Discussion draft for public comments", *Tax News Service*, IBFD, 6 October 2008, Volume 42, Issue 42, p. 459

Kevin A. Bell, "Practitioners Say OECD Restructuring Discussion Draft Would Inject Tax Collectors' 'Business Judgment' Into Audits, *Tax Management Transfer Pricing Report*, BNA, September 25, 2008, Vol. 17, No. 10, p.399\*

Kevin A. Bell, "Canadian, U.K. Tax Official Embrace OECD Draft on Restructurings", *Tax Management Transfer Pricing Report*, BNA, October 9, 2008, Vol. 17, No. 11, p. 460\*

Molly Moses, "Practitioners Discuss Intangibles Migration Under OECD Restructuring, Other Provisions", *Tax Management Transfer Pricing Report*, BNA, October 9, 2008, Vol. 17, No. 11, p. 454\*

Amy S. Elliott, "OECD Official Highlights Developments in Business Restructurings Project", *Tax Analysts*, October 23, 2008

Amy S. Elliott, "OECD Official Highlights Business Restructurings", *Tax Notes International*, October 27, 2008, Vol. 52, Number 4, p. 286

Chaid Dali-Ali and Simon Langlois, "OECD Discussion Draft on Business Restructurings: Is the OECD on the Right Track to Achieving Its Objectives?", *Tax Management Transfer Pricing Report*, BNA, November 6, 2008, Vol. 17, No. 13, p. 543\*

Alan W. Granwell and Paul Flignor, "A Summary of the OECD Draft on The Transfer Pricing Aspects of Business Restructurings", *Tax Notes International*, November 17, 2008, Volume 52, Number 7, p. 549

Richard Tremblay and Steve Suarez, "The OECD Discussion Draft on Transfer Pricing Aspects of Business Restructurings – Canadian Considerations", *TMIJ*, February 13, 2009, Vol. 38, No. 2, p. 98\*\*

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## The OECD Discussion Draft on Transfer Pricing Aspects of Business Restructurings — Canadian Considerations

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### Introduction

On September 19, 2008, the OECD released a draft discussion paper titled “Transfer Pricing Aspects of Business Restructurings” (the “Report”), comprised of a series of Issue Notes on various aspects of internal business reorganizations.<sup>1</sup> The Report represents the OECD’s attempt to offer greater interpretational guidance on the application of the 1995 OECD Transfer Pricing Guidelines<sup>2</sup> (TPG) to business restructurings, such as:

- conversion of full-fledged distributors into limited-risk distributors for a related principal;
- conversion of full-fledged manufacturers into contract or toll manufacturers for a related principal;
- transfers of intangible property rights to a centralized IP entity; and
- rationalization or specialization of operations (e.g., manufacturing, sales, service, etc.).

This article outlines the apparent direction taken by the OECD in this important expansion of the scope of the transfer pricing gospel as contained in the TPG. We will consider a few of the main issues or concerns raised by the Report, using examples to illustrate the concerns. We will assume that the reader is familiar with the TPG.

<sup>1</sup> Available at [http://www.oecd.org/document/7/0,3343,en\\_2649\\_33753\\_41328775\\_1\\_1\\_1\\_37427,00.html](http://www.oecd.org/document/7/0,3343,en_2649_33753_41328775_1_1_1_37427,00.html).

<sup>2</sup> Organisation for Economic Co-operation and Development, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 1995.

### The Report

The Report purports merely to provide further “guidance” with respect to matters already dealt with in the TPG. It is organized as four Notes:

Note 1: Special Considerations for Risks, dealing with the allocation of risks between related parties in a business restructuring;

Note 2: Arm’s-Length Compensation for the Restructuring Itself, examining under what circumstances some form of compensation should be payable to multinational enterprise (MNE) group members that transfer assets or have opportunities terminated;

Note 3: Remuneration of Post-Restructuring Controlled Transactions, dealing with the application of transfer pricing principles and the TPG to post-restructuring arrangements; and

Note 4: Recognition of the Actual Transactions Undertaken, considering situations where tax authorities can disregard transactions (or structures) actually entered into (or created) by taxpayers in favour of artificial constructs of the revenue authorities where the taxpayer’s transactions or structures fail to meet the revenue authorities’ perception of “*economic and commercial reality* of parties dealing at arm’s length”<sup>3</sup> or differ from “those which would [in the opinion of the revenue authorities] have been adopted by independent enterprises behaving in a *commercially rational* manner.”<sup>4</sup>

The Report purports to start from the proposition that taxpayers are free to arrange their affairs however they choose, stating that situations where a taxpayer’s actual transactions can be ignored (and priced on the basis of recharacterizations that have economic substance according to the revenue authorities) are “exceptional.” However, the Report is replete with situations where the taxpayer’s contracts or legally effective arrangements purportedly can be wholly or partially ignored, amended, or recharacterized. Note 4 sets out those situations in which complete recharacterization is permitted, under more restrictive requirements. In other circumstances the Report would permit legally binding transactions to be priced with varying degrees of respect afforded to their actual terms — i.e., something less than the wholesale Note 4 recharacterization — see “Risk Allocation and Control,” below.

In summary, the Report raises significant concerns for Canadian taxpayers and MNEs. In particular, cer-

<sup>3</sup> See Report ¶18.4, second bullet.

<sup>4</sup> See Report ¶18.4, fifth bullet.

tain aspects of the Report appear to lower the threshold for revenue authorities to second-guess taxpayers on their business decisions and resulting legal agreements. Moreover, various aspects of the Report do not fit well with Canadian domestic tax laws, especially the transfer pricing rules found in §247 of the Income Tax Act (ITA).

### Canada's Domestic Transfer Pricing Regime: Summary

The Canadian transfer pricing system is, as a general principle, based upon the arm's-length principle described in the TPG. These rules, found in §247 ITA, apply to transactions (or a series of transactions) between a Canadian taxpayer and a nonresident person dealing not at arm's-length. Essentially, the operative provisions apply in two circumstances:

- Where the terms or conditions in a non-arm's-length transaction differ from those that would have been made between persons dealing at arm's length, the Canadian revenue authorities (CRA) are permitted to adjust the quantum or nature of the amounts to those that would have been determined under terms or conditions made at arm's length; and
- Where the transaction (or series of transactions) (1) would not have been entered into by persons dealing at arm's length, and (2) cannot reasonably be considered to have been entered into primarily for *bona fide* purposes other than to obtain a tax benefit, the CRA is entitled to adjust the quantum or nature of the amounts to those that would have arisen in whatever transaction (or series) would have occurred between arm's-length parties — the transaction can be completely recharacterized.

The legislation simply establishes the arm's-length principle; nothing in the ITA expressly incorporates the TPG into Canadian law (although a recent court case on a predecessor to §247 did accord interpretive weight to them).<sup>5</sup> The CRA's own administrative policy is based largely on the TPG,<sup>6</sup> although this policy simply represents the tax authority's view of the law and is not the law itself nor binding on a court or taxpayers. As such, there is relatively little firm guidance for Canadian taxpayers to rely on in establishing transfer pricing.

<sup>5</sup> *GlaxoSmithKline v. The Queen*, 2008 DTC 3957 (TCC).

<sup>6</sup> Information Circular, IC 87-2R, "International Transfer Pricing," dated September 27, 1999 (similar to an IRS revenue procedure).

### The Role of Economic Substance in Canadian Tax Law

Historically, Canadian tax law has shown great respect for both the legal relationships entered into by taxpayers and their right to structure their affairs as they wish so as to minimize the amount of taxes legally owing. Transactions are taxed on the basis of the true legal relationships they create, i.e., how the law characterizes them, irrespective of whether their economic attributes are more similar to those of some other form of legal relationship. Of course, a particular legal relationship cannot be created by the parties simply by calling it such; it is always open to a court to find that the legal rights actually created by the parties are different from the label the parties have used to describe them. For example, calling something a "partnership" does not make it so if the legal requirements for a partnership are not met.<sup>7</sup> Beyond that, however, the legal relationships created by taxpayers will generally be respected.

Specifically, there is no general principle to the effect that economic substance takes precedence over validly created legal relationships. Canadian courts will not attempt to recharacterize a legal relationship on the basis that the economic result is more similar to that of some other form of legal relationship. In *Shell Canada Ltd. v. The Queen*, the Supreme Court of Canada stated that:

[T]his Court has never held that the economic realities of a situation can be used to recharacterize a taxpayer's *bona fide* legal relationships. To the contrary, we have held that, absent a specific provision of the Act to the contrary or a finding that they are a sham, the taxpayer's legal relationships must be respected in tax cases. Recharacterization is only permissible when the label attached by the taxpayer to the particular transaction does not properly reflect its actual legal effect.<sup>8</sup>

However, §245 ITA, the Canadian general anti-avoidance rule (GAAR), where applicable *does* allow the CRA to recharacterize transactions. That provision requires three basic elements in order for it to apply:

- The relevant series of transactions produces a tax benefit;

<sup>7</sup> See, for example, *Continental Bank of Canada and Continental Bank Leasing Corp. v. The Queen*, 94 DTC 1858 at 1871 (TCC), upheld by [1998] 2 SCR 298 ("[T]he essential nature of a transaction cannot be altered for income tax purposes by calling it by a different name. It is the true legal relationship, not the nomenclature that governs"); see also *CCLI (1994) Inc. v. The Queen*, 2006 DTC 2695 at ¶26 (TCC).

<sup>8</sup> [1999] 3 SCR 622 at ¶39 (SCC).

- One or more transactions in the relevant series of transactions were undertaken primarily for the purpose of obtaining that tax benefit; and
- The result constitutes an abuse or misuse of the Act or a tax treaty.

While the application of the GAAR arguably involves some consideration of the economic results of transactions, as part of assessing whether or not a statutory misuse or abuse has occurred,<sup>9</sup> economic substance is not in and of itself a basis for such application. Essentially, recharacterization of the taxpayer's validly created legal relationships is permitted only: (1) as part of a GAAR analysis; or (2) under the transfer pricing rules described above, where it is determined that arm's-length parties would not have entered into the transaction and the transaction is primarily tax-motivated. This constitutes a very high threshold for recharacterization.

### Recharacterization, as a Rule, Is the Exception

The TPG sets out at paragraphs 1.36 through 1.41 (excerpted below) the circumstances in which legally valid transactions undertaken by taxpayers can be ignored or recharacterized. These extreme remedies are reserved for "exceptional" situations (emphasis [bold and italic] added):

#### ii) Recognition of the Actual Transactions Undertaken

1.36 A tax administration's examination of a controlled transaction ordinarily should be based on the transaction actually undertaken by the associated enterprises as it has been structured by them, using the methods applied by the taxpayer insofar as these are consistent with the methods described in Chapters II and III. **In other than exceptional cases, the tax administration should not disregard the actual transactions or substitute other transactions for them.** Restructuring of legitimate business transactions would be a wholly arbitrary exercise the inequity of which could be compounded by double taxation created where the other tax administration does not share the same views as to how the transaction should be structured.

1.37 However, there are two particular circumstances in which it may, exceptionally, be both appropriate and legitimate for a tax administration to consider disregarding the structure adopted by a taxpayer in entering into a controlled transaction. The first circumstance arises where the *economic substance* of a transaction differs from its form. In such a case the tax administration may disregard the parties' characterization of the transaction and re-characterise it in accordance with its substance. An example of this circumstance would be an investment in an associated enterprise in the form of interest-bearing debt when, at arm's length, having regard to the economic circumstances of the borrowing company, the investment would not be expected to be structured in this way. In this case it might be appropriate for a tax administration to characterize the investment in accordance with its economic substance with the result that the loan may be treated as a subscription of capital. The second circumstance arises where, while the form and substance of the transaction are the same, the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a *commercially rational manner and the actual structure practically impedes the tax administration from determining an appropriate transfer price*. An example of this circumstance would be a sale under a long-term contract, for a lump sum payment, of unlimited entitlement to the intellectual property rights arising as a result of future research for the term of the contract (as previously indicated in paragraph 1.10). While in this case it may be proper to respect the transaction as a transfer of commercial property, it would nevertheless be appropriate for a tax administration to conform the terms of that transfer in their entirety (and not simply by reference to pricing) to those that might reasonably have been expected had the transfer of property been the subject of a transaction involving independent enterprises. Thus, in the case described above it might be appropriate for the tax administration, for example, to adjust the conditions of the agreement in a commercially rational manner as a continuing research agreement.

1.38 In both sets of circumstances described above, the character of the transaction may derive from the relationship between the parties rather than be determined by normal com-

<sup>9</sup> See, for example, *Canada Trustco Mortgage Co. v. The Queen*, [2005] 2 SCR 601 at ¶56-60.

mercial conditions and may have been structured by the taxpayer to avoid or minimize tax. In such cases, the totality of its terms would be the result of a condition that would not have been made if the parties had been engaged in arm's length dealings. Article 9 would thus allow an adjustment of conditions to reflect those which the parties would have attained had the transaction been structured in accordance with the economic and commercial reality of parties dealing at arm's length.

For the reasons outlined above (i.e., Canadian domestic law), we do not believe that the first "economic substance" ground (in ¶1.37) for ignoring transactions as structured will have much effect in Canada.

The second ground (in ¶1.37) for recharacterization is, however, somewhat more interesting. The premise is that the transactions have economic substance. But, if they are not "commercially rational" and *the structure practically impedes the tax administrators from determining an appropriate transfer price*, the TPG permits recharacterization.

As noted earlier, in certain very limited circumstances, §247 ITA permits non-recognition of legal arrangements for transfer pricing purposes (and provides for such pricing to be determined based on recharacterized arrangements). The relevant portion of this provision reads as follows (emphasis [bold] added):

*247(2) Transfer pricing adjustment*

*Where a taxpayer or a partnership and a non-resident person with whom the taxpayer or the partnership, or a member of the partnership, does not deal at arm's length (or a partnership of which the nonresident person is a member) are participants in a transaction or a series of transactions and*

*(a) the terms or conditions made or imposed, in respect of the transaction or series, between any of the participants in the transaction or series differ from those that would have been made between persons dealing at arm's length, or*

**(b) the transaction or series**

*(i) would not have been entered into between persons dealing at arm's length, and*

*(ii) can reasonably be considered not to have been entered into primarily for bona fide purposes other than to obtain a tax benefit,*

*any amounts that, but for this section and section 245, would be determined for the purposes of this Act in respect of the taxpayer or the partnership for a taxation year or fiscal period shall be adjusted (in this section referred to as an "adjustment") to the quantum or nature of the amounts that would have been determined if,*

*(c) where only paragraph (a) applies, the terms and conditions made or imposed, in respect of the transaction or series, between the participants in the transaction or series had been those that would have been made between persons dealing at arm's length, or*

*(d) where paragraph (b) applies, the transaction or series entered into between the participants had been the transaction or series that would have been entered into between persons dealing at arm's length, under terms and conditions that would have been made between persons dealing at arm's length.*

This provision provides that, for recharacterization to be applicable in domestic transfer pricing legislation, it is not enough that arm's-length parties would be unlikely to enter into the arrangement, or that it would generally not make sense for the transaction to be entered into. A Canadian court must be convinced to the requisite statutory level (i.e., "would not") before it can ignore the actual legal arrangements — even for the purpose of making transfer pricing adjustments. The Canadian statutory language does not permit recharacterization unless the actual arrangements clearly *would not* have been entered into by arm's-length persons.

Further, it is not enough for a court to determine that the actual transactions would not have been entered into; the court must further assess transfer pricing consequences based on the transaction that it determines the parties *would* have entered into. Merely finding a more likely alternative transaction is insufficient. The statute requires a level of certainty not only that the actual transaction would not have been entered into but also that the recharacterized transaction would have been entered into. (As an aside, we would observe how elevated an MNE's risk is of double taxation arising due to an economic-substance-based recharacterization being made in one country but not the other (Canada) to override legally binding arrangements involving Canadian participants.)

And note that neither of the TPG conditions for recharacterization find their way *verbatim* into §247(2)(b) ITA — in fact, there is no apparent congruency. Tax reduction motives are irrelevant for the

TPG. And “commercially rational” is not clearly synonymous with “arm’s length” — nor, admittedly, are these two terms clearly mutually exclusive. Arm’s-length persons can and do enter into transactions that most would judge to be not commercially rational (the poor investment acumen of doctors is legendary). There are also dozens of cases in Canada where the courts have found that an investor had no “realistic expectation of profit” despite the absence of any non-arm’s-length dealing, and resulting deductions were denied due to the failure to meet the profit purpose requirements of the ITA. It is, therefore, far from clear that absence of commercial rationality will ever find its way into Canadian jurisprudence as being synonymous with non-arm’s-length dealing.

However, the example of commercially irrational behavior given in the TPG (¶1.37) — “a sale under a long-term contract, for a lump sum payment, of unlimited entitlement to the intellectual property rights arising as a result of future research for the term of the contract” — might be found to be subject to §247(2)(b) ITA treatment on the basis of not meeting the arm’s-length standard therein in conjunction with a primary tax reduction purpose. But, as outlined above, the requisite threshold is that arm’s-length parties *would* not have entered into the transaction.

### The Report and Non-Exceptional-Circumstances Recharacterization

Of particular concern to Canadian taxpayers is that, after formally acknowledging that the TPG consider it appropriate to ignore the legally binding relationships created by the taxpayer only in “exceptional” circumstances, the Report clearly goes on to enunciate a variety of situations in which tax administrators are invited to do just that, either directly or indirectly. We believe that in many such cases there will simply be no basis in Canadian domestic law to support such recharacterization of the taxpayer’s legal arrangements.

The Report deals with recharacterization in two ways: in Note 4, which discusses the circumstances in which recharacterization is *formally* being used by tax authorities, and elsewhere in the Report where the discussion proposes the use of various theorems (often based on the elevation of economic substance over the legal substance of the taxpayer’s contracts) that informally amount to the recharacterization of the taxpayer’s arrangements. Both of these amount to an extension of the existing principles in the TPG (some of which, as discussed above, already go beyond what the existing Canadian domestic law would seem to allow).

### Risk Allocation and Control

Part B.1 of the first Note (on risk allocation) deals with “Risk Allocation and Control.” The espoused

principle is that risk cannot be shifted to a party who does not have the personnel to manage it — or to supervise contractees who manage it. Thus, according to the Report, assuming risk is allocated by contract from A to B, if B has the financial ability to bear the risk but does not have the requisite personnel to control/manage it, the profit attributable to the risk will remain with A — assuming the risk is capable of being managed. There is, of course, no guarantee that the jurisdiction in which B resides will accept this control theory or the premise that B does not in fact have the requisite personnel to control the risk. Double tax will result unless B’s revenue authorities accept that B need not pay tax to that jurisdiction on the profits that B has *legally* earned in respect of the capital that it has put at risk in that jurisdiction. The Report’s theoretical premise is that commercially rational parties would not assume a risk that they are either not in a position to manage/control or at least in a better position to manage/control than the assigner.<sup>10</sup>

The TPG link to this economic theory in the Report is the discussion in paragraphs 1.26 to 1.29 of the TPG. In paragraph 1.27 of the TPG the following statement is made: “In arm’s length dealings, *it generally makes sense* for parties to be allocated a greater share of those risks over which they have relatively more control.” This statement on its own is, of course, unobjectionable. Neither is the following statement later in that paragraph in respect of a particular example provided: “In such a case, Company A would be *unlikely* to agree to take on substantial inventory risk, since it exercises no control over the inventory level while Company B does.”

One might well agree with this statement from a purely theoretical or hypothetical perspective and *prima facie*, without any deeper factual background, it appears unlikely that such a situation would occur. But as explained above, the threshold for recharacterization under §247(2)(b) ITA in Canada requires much more than mere likelihood.

If §247(2)(b) ITA is not applicable to permit recharacterization, then §247(2)(a) ITA should not be interpreted so as to permit selected aspects of transactions to be ignored or recharacterized in making the determinations under §247(2)(c) ITA. So if §247(2)(b) ITA is inapplicable, then as long as a contracting party actually assumes a risk or disposes of property, the CRA is limited to determining the “terms and conditions” of the transactions that were actually entered into. That does not mean a sale can be turned into a license or that a risk transfer can be ignored. Price is obviously one of those terms and conditions that can be

<sup>10</sup> See Report ¶¶18.1 and 30.

adjusted. Timing of payments and interest rates would obviously also qualify. But the CRA cannot determine price as if the transactions — including the risk assignment — had been different.

Further, where a Canadian party is involved, applying the risk management or control theory in the Report's Note 1 is even more fraught with peril than at first appears, because a negative determination requires a court to find that a corporation's employees — and, more importantly, its Board of Directors — either did not have the ability to monitor or manage risks undertaken or chose not to do so even if they had the ability. The common law presumes that directors manage the affairs of the company and exercise central management and control, barring convincing evidence to the contrary.<sup>11</sup> The Report appears to permit revenue authorities to reach the opposite conclusion far too easily. Canadian courts will be loathe to reach such a conclusion where a board purports to exercise its judgment in relation to activities undertaken by a corporation, as such a conclusion would effectively amount to a breach of its statutory or fiduciary duty.

#### Intangible Transfers: Note 1 Meets Note 4

One of the aims of the Report appears to be to assist revenue authorities in attacking transfers of intangible property to offshore shell companies. Example B in Note 4 (“Example B”) clearly telegraphs the drafters' intention in this regard.<sup>12</sup> The facts assumed are outlined below.

Intellectual property (brand names) is transferred from Company A to newly set-up offshore Company Z in Country Z. Company Z is managed by a “local trust company.” The assumption is that “Company Z does not have people (employees or Directors) who have *the authority to and effectively do* perform control functions in relation to the risks associated with the strategic development of” the intellectual property (emphasis added).<sup>13</sup> In Canada, this would be tantamount to a finding that Company Z was not resident in Country Z because the directors have abdicated their duty to manage, and so the transfer pricing result is in a sense completely moot.

The example further assumes that Company Z does not have the “financial or economic capacity” to bear the risks associated with the brand names it has acquired and the associated worldwide marketing campaign. Presumably this is what makes this example a Note 4 item rather than merely a Note 1 item, as economic capacity would not appear to be a necessary

condition for the application of the risk control theorem under Note 1, which speaks only of “control” in the context of paragraph 1.27 of the TPG being interpreted as “*the capacity to make decisions to take on the risk (decision to put capital at risk) and decisions on whether and how to manage the risk, internally or using an external provider. This would require the company to have people — employees or directors — who have the authority to, and effectively do, perform these control functions.*”<sup>14</sup> There is no mention of financial capacity to assume risk as being part of the control theorem in Note 1 of the Report.

In a foreign subsidiary with a properly functioning Board of Directors, it is difficult to see how a negative finding under the Note 1 control theorem could ever be reached in Example B, above, provided that offshore Company Z retains the services of a competent service provider — see for example the following excerpt from Note 1 (emphasis [bold and italic] added):

30. . . . Thus, when one party bears a risk, the fact that it hires another party to administer and monitor the risk on a day-to-day basis is not sufficient to transfer the risk to that other party.

31. While it is not necessary to perform the day-to-day monitoring and administration functions in order to control a risk (as it is possible to outsource these functions), the OECD is of the view that in order to control a risk one has to be able to assess the outcome of the day-to-day monitoring and administration functions by the service provider (the level of control needed and the type of performance assessment would depend on the nature of the risk).

32. Assume that an investor hires a fund manager to invest funds on its account. Depending on the agreement between the investor and the fund manager, the latter may be given the authority to make all the investment decisions on behalf of the investor on a day-to-day basis, although the risk of loss in value of the investment would be borne by the investor. In such an example, the investor is **controlling its risks through three essential decisions: the decision to hire** (or terminate the contract with) that particular fund manager, **the decision of the extent of the authority it gives** to the fund manager and objectives it assigns to the latter, and the **decision of the**

<sup>11</sup> See, for example, *Wood and another v. Holden (Inspector of Taxes)*, [2006] STC 443 (CA), [2006] EWCA Civ 26. Leave to appeal was denied by the House of Lords on June 14, 2006.

<sup>12</sup> See Report ¶217.

<sup>13</sup> See Report ¶218.

<sup>14</sup> See Report ¶30.

amount of the investment that it asks this fund manager to manage. Moreover, the fund manager would generally be *required to report back to the investor on a regular basis* as the investor would want to assess the outcome of the fund manager's activities. In such a case, the fund manager is providing a service and managing his business risk from his own perspective (e.g., to protect his credibility). The *fund manager's operational risk, including the possibility of losing a client, is distinct from his client's investment risk*. This illustrates the fact that an investor who gives to another person the authority to make all the day-to-day investment decisions does not necessarily transfer the investment risk to the person making these day-to-day decisions.

33. As another example, assume that a principal hires a **contract researcher to perform research on its behalf**. Assume the arrangement between the parties is that the principal bears the risk of failure of the research and will be the owner of the outcome of the research in case of success, while *the contract researcher is allocated a guaranteed remuneration irrespective of whether the research is a success or a failure, and no right to ownership on the outcome of the research*. Although the day-to-day research would be carried on by the scientific personnel of the contract researcher, the principal would be expected to make a number of important decisions in order to control its risk, such as: the decision to hire (or terminate the contract with) that particular contract researcher, the decision of the type of research that should be carried out and objectives assigned to it, and the decision of the budget allocated to the contract researcher. Moreover, the contract researcher would generally be required to report back to the principal on a regular basis, e.g., at predetermined milestones. The principal would be expected to be able to assess the outcome of the research activities. The contract researcher's own operational risk, e.g., the risk of losing its client or of suffering a penalty in case of negligence, is distinct from the failure risk borne by the principal.

34. It should be borne in mind that there are also, as acknowledged at paragraph 1.27, risks over which neither party has significant control. There are risks which are typically beyond the scope of either party to influence (e.g., economic conditions, money and stock market conditions, political environment, so-

cial patterns and trends, competition and availability of raw materials and labour), although the parties can make a decision whether or not to expose themselves to those risks and whether and if so how to mitigate those risks.

Continuing with our analysis of Example B, we are also told that, following the transfer of its intellectual property to Company Z, Company A personnel continue to perform, like they did before the transfer, services such as human resource management, legal, and tax, on a cost-plus basis. There is no suggestion that the cost-plus fee paid to A is inappropriate in light of the services actually performed by Company A.

Example B goes on to provide, "High ranking officials of Company A fly to the Company Z offices once a year to formally validate strategic decisions [presumably made by Company Z officers or directors] necessary to operate the company. These decisions are prepared by Company A's head office . . . before the meetings take place . . ." [emphasis added].<sup>15</sup> Again, we must bear in mind that the assumption is made earlier in Example B that Company Z does not have directors who have the authority to and effectively do perform control functions.

We assume that, by "preparation" of decisions by Company A's head office, the drafters mean to say the decisions are actually made in Country A. It is not entirely clear what is meant by "formal validation." If local personnel make day-to-day decisions but Company A high-ranking personnel were on the Board of Company Z and ratified decisions made locally at regular Board meetings held in Country Z, then, under Canadian principles at least, Company Z would be considered properly resident in Country Z and, more importantly, it is difficult to see how Example B fails the control theorem as outlined in the Report. But the Example assumes that the directors do not perform control functions, so something else must be meant by "formal validation."

The Report indicates that "most OECD countries indicate that they would *consider* not recognizing the arrangement as structured." Of course, the reference to OECD countries is only a reference to revenue personnel from these countries who agreed to the wording of the draft Report. That their predilection would be to consider not recognizing such an arrangement should not come as a big surprise — it is after all their job to collect tax. Whether their courts would support non-recognition is, of course, another matter.

<sup>15</sup> See Report ¶218. The fact that these high-ranking officials fly in rather than take the train or drive is presumably significant in the same way as auto executives taking corporate jets rather, than regular air carriers to their meetings with the U.S. Congress in Washington to beg for money — it is just bad form.

In the end, the problem with Example B is that there are simply too many negative assumptions made to permit a reasoned application of the risk management and control theorem on its own. Of course, if the Board of the subsidiary abdicates all responsibility for decision-making to the parent and fails to manage the company, bad things can happen. In particular, this could give rise to a determination that it is not resident where it purports to be. It might be taken as very encouraging to tax planners to note that, even with the worst facts imaginable, only a majority of countries would “consider” not recognizing the transfer.

Example C of Note 4 also deals with an intangible transfer to an offshore entity except that everything is done perfectly — including the transfer of part of the transferor’s head office staff.<sup>16</sup> Thirty head office employees are transferred to the subsidiary, 30 are fired, and 15 additional staff are hired in Country Z to deal with the matters formerly handled by head office personnel. All decisions are made in Country Z, control functions in relation to the risks assumed are performed in Country Z, and personnel in Country Z closely monitor the remaining functions performed in Country Z. This example is almost too good to be true in terms of how favorable its assumptions are except for one concession to reality — *the transfer is assumed to be principally tax-motivated*. The Report indicates (at ¶221), “The vast majority of OECD countries consider that in this case the transaction should be recognized for transfer pricing purposes as it has economic substance . . .” (emphasis added).

We are indeed grateful for and duly note a statement that even a primary tax motive does not vitiate a positive commercial rationality finding, as follows from paragraph 212 of the Report:

The OECD considers that as long as functions, assets and / or risks are actually transferred, it can be commercially rational from

<sup>16</sup> See Report ¶220.

an Article 9 perspective for an MNE group to restructure in order to obtain tax savings.<sup>17</sup>

But it is quite surprising that there were any dissenting countries in respect of Example C, given how favorable its assumptions were. (The Report does not indicate which countries reserved.) As noted above, §247 ITA (the Canadian transfer pricing provision) requires a tax motivation for the application of its re-characterization rule. (Canada’s GAAR similarly requires the presence of a tax-motivated transaction.) While we have no way of knowing whether it was one of the dissenting countries, one wonders whether Canada might have been concerned that acceding to the conclusion in Example C would impede the CRA in applying these domestic provisions.

### Conclusions/Observations

If adopted in its present form, the Report will likely generate quite a bit of CRA audit activity in Canada. There will undoubtedly be a tendency on the CRA’s part to assume that the Report is fully supportable under Canadian law. Taxpayers must be vigilant in ensuring that they accept such CRA proposals only if they are in fact sustainable under Canadian law. Judging from the discussion in Note 1 of the Report, the OECD appears to be keen on importing its Article 7 KERT/“Significant people function” approach into Article 9. We do not think this is appropriate when dealing with separate legal entities. On the plus side, there are some helpful comments in the Report, such as the observation that a tax saving motive can be “commercially rational.” Taxpayers in Canada and elsewhere will watch for the final version of the Report with great interest.

<sup>17</sup> That it is “commercially rational” for an enterprise to try to minimize tax, we believe to be self-evident. That restructuring to save tax might not be “commercially rational” unless functions, assets and risks are transferred suggests that “commercially rational” does not bear its ordinary meaning for OECD purposes.

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