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Editorial

Financial Crisis, Business Restructuring and the OECD Discussion Draft

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The last year has been characterized by a financial crisis and an economic downturn. Many businesses have experienced severe setbacks, and in an attempt to survive as a business, cost reductions and business restructuring are on everyone's mind. We have already seen major changes in the financial landscape, and I am sure that we will see drastic changes in the corporate sector in the years to come.

Taxes may not be at the centre in all of this, but every business decision will also have tax consequences. Many States have changed their tax rules in response to the recession. Carry back of losses, accelerated depreciation of assets, and postponement of tax payments are some of the measures that have been enacted.

Despite the day-to-day difficulties we witness, major challenges in the tax area are still ahead of us. Huge deficits are now piling up, and the need to secure tax revenues in the future could make governments and tax authorities disregard sound taxation principles, such as only taxing net profits (allowing full recognition of costs on a timely basis and only taxing realized income and gains) and making appropriate use of the arm's length principle for the avoidance of international double taxation.

There were worrying signs already before the financial crisis. Businesses increasingly encounter international double taxation where revenue authorities' claims to tax profits arising from international transactions overlap. Governments are facing few, if any, incentives to refrain from taxing a larger part of the total cake than they rightfully should. In many cases, governments retain tax revenues for years before a dispute is settled, and the final outcome may very well result in taxation of more than the net profit of the business group.

Disputes regarding pricing of intra-group transactions are essentially a matter between governments. Yet, such disputes are generally carried out at the expense and to the detriment of the individual taxpayer. Lacking unambiguous and commonly accepted pricing principles, to reduce the risk of unfair tax claims, it could be argued that a group should only have to pay the incremental tax on the disputed amount (no additional tax if the low tax jurisdiction wanted to tax a larger fraction of the group net profit). As of yet, however, this has been disregarded by tax policy makers. To create incentives for tax authorities to ensure swift dispute resolutions, one might need to establish rules that reduce the tax liabilities as time passes, or rules providing for mandatory arbitration.

Regrettably, the international tax policy discussion has not adequately focused on how to increase investments, in particular, not with respect to restructurings and cross-border investments. Instead, governments have sent representatives to the Organization for Economic Cooperation and Development (OECD) to discuss how tax revenues could be upheld in business restructuring situations. After a few years of non-transparent discussions, the OECD in September 2008 presented for public comment a Discussion Draft on Transfer Pricing Aspects of Business Restructuring. The document reflects deep and detailed thinking about how the principles and terms of the OECD Transfer Pricing Guidelines (TP Guidelines) and the OECD Model Income Tax Convention apply to restructurings. It also reflects an understanding that restructurings are important global commercial events. The OECD Secretariat should be commended for the work as important progress has been made. The desire of governments to secure short-term revenues, however, is still in focus to a large extent.

In addition, consensus among governments is still lacking in some key areas. These relate, inter alia, to how arm's length pricing applies to group activities and to how, in the group's decision making, the subsidiary's relation to the group can be comparable to that of an independent entity, as well as to the need to articulate with clarity what is meant by 'exceptional circumstances' when re-characterization of a restructuring by a tax authority may be called for.

It is apparent that documentation requirements increase as will the role of contracts when a company has to explain itself to tax authorities. The formal requirements may not increase, but in practice, more time and efforts will have to be spent on documentation to meet the claims from various tax authorities. Furthermore, the situation for small- and medium-sized businesses has not been adequately addressed. They do not have the same experience as larger groups have in transfer pricing documentation, in general, and, in particular, such documentation in a business restructuring situation.

On 9–10 June 2009, the OECD organized a consultation in Paris on the OECD Discussion Draft on the Transfer Pricing Aspects of Business Restructurings. Both governments and business representatives were present. The discussions were fruitful, and many misunderstandings were sorted out. The concept of 'commercially rational' was discussed, and government representatives did not in general seem interested in having their tax authorities judging whether an actual business transaction made sense from a business perspective or not. Of course, wholly artificial transactions would have to be handled in a special manner.

One area that was explicitly taken off the OECD agenda at the 9–10 June consultation was exit taxation. Even though the majority of OECD members are members of the European Union, the linkages between the OECD work and the corresponding work at the EU level were not addressed.

This topic was, however, on the agenda a week later, at an international tax conference in Stockholm, arranged by the Confederation of Swedish Enterprise. The EU perspective, as formulated under EC law and in conjunction with other non-legislative EU codes and guidelines, certainly plays a role for the applicability of OECD guidelines in the Internal Market, especially with respect to exit taxation.

Tax deferral must not lead to higher taxation when businesses restructure across borders than when restructurings take place within a Member State. From the European Court of Justice (ECJ) cases *de Lasteyrie* (C-9/02) and *N* (C-470/04)[1], it is clear that immediate taxation of accrued but unrealized capital gains on assets transferred to another Member State is contrary to the freedom of establishment. Furthermore, a Member State cannot levy a disproportionate burden on a taxpayer as a condition for tax deferral. Any means to preserve the tax claims must be strictly proportional and not entail disproportionate costs for the taxpayer.

As confirmed in the *N* case, a Member State is not prevented from assessing the amount of income on which it wishes to preserve its tax jurisdiction, provided that this does not give rise to an immediate tax charge and that there are no further conditions attached to the deferral. Such a practice is in line with the principle of fiscal territoriality. However, due account has to be taken of any reduction in the value of the assets incurred after the transfer. As a consequence, Member States should provide for unconditional deferral of tax until the moment of actual realization.

In its communication, COM (2006) 825, the European Commission concluded that, although the two ECJ cases mentioned above refer to exit taxes on individuals, their outcomes have direct implications for exit taxes on companies levied by Member States. The Commission concluded that although an unconditional deferral may resolve the immediate difference in tax treatment, double taxation or unintended non-taxation may still arise because of mismatches between different national rules. This can be the case, for example, where Member States apply different methods in the valuation of assets.

In the ECOFIN Council of 2 December 2008, Member States agreed on a non-binding resolution on coordinating exit taxes. There is political agreement on two of the three main features in relation to exit taxation: valuation and dispute settlement. Deferral, being the third aspect, has to be coordinated with those Member States that actually levy exit taxes.

I believe that exit tax regimes should be replaced by systems that ensure a net taxation of company profits linked to the respective transaction at the moment of realization. In that context, caution is needed in calculating the arm's length pricing with regard to the location savings.

Some governments seem to prefer levying tax not only when assets are relocated but also when only functions and risks are altered. This has resulted in a discussion of taxation of foregone profits and location savings. Even if governments consider only cases where actual assets and production have moved, a situation of exit taxation may arise when the arm's length price on relocated assets is adjusted to compensate for profits forgone. This would severely hinder international investments and would be a harmful protectionist measure. To ensure economic efficiency and competitiveness, it is important that governments refrain from such policies.

Instead, emphasis should be placed on recognizing the occurrence of actual profits or losses. While the OECD discussion draft mainly refers to how to tax profits, it should be recognized that the arm's length principle also entails situations of overall losses. The very recent changes in the economic situation highlight this in an explicit way. It should be noted that pricing in accordance with arm's length principles based on the allocation of risks or functions in a loss situation may still not result in taxation of the net profits of a group. Consider the case when a subsidiary in country B experiences losses and is closed down because of better business prospects elsewhere. It is unlikely that the full loss will be recognized at the parent level in country A. At best, some of the loss (closing down costs in country B) will be recognized in country A. However, to achieve taxation of the net profit of the group, full cross-border loss consolidation would be required (a situation that would materialize under a Common Consolidated Corporate Tax Base).

Revenue authorities tend to focus on preserving short-term revenues, showing less interest in mechanisms to avoid creating international double taxation situations and to achieving a timely solution in such situations. Hence, there is obviously a need for dispute settlement procedures.

Although most tax conventions include a provision for corresponding adjustments of profits of the associated enterprise concerned, they do not impose a binding obligation on the Contracting States to eliminate the double taxation.

The EU Arbitration Convention, on the other hand, provides for mandatory arbitration in case Member States fail to reach a mutual agreement on the elimination of double taxation. The Arbitration Convention

[1] European Court of Justice (ECJ) cases C-9/02 *de Lasteyrie du Saillant (F)* and C-470/04 *N. v. Insp. Belastingsdienst/Grote Ondernemingen (NL)*.

still has important shortcomings, although some of these have been remedied through the work of the Joint Transfer Pricing Forum (JTPF) since the adoption of the Code of Conduct for the effective implementation of the EU Arbitration Convention. Nevertheless, the Arbitration Convention could be a valuable instrument in tackling valuation disputes from restructurings between EU Member States. The inclusion of a Dispute Resolution Mechanism at the OECD level not only in business restructuring situations but also more generally would strengthen the OECD guidelines.

To conclude, it is important that the EU tax work is reflected when guidelines are formed at the OECD level. Otherwise, there is a potential risk that some governments may argue that even though a tax rule may violate the EC Treaty or agreements in the European Union, it is justifiable on the basis of OECD guidelines. I would like to emphasize the need for coherence between EU Law and OECD guidelines. Such coherence, however, cannot be taken for granted, and the lack of EU perspectives in the OECD work on business restructuring is an example of that. One must hope that better coordination among the government representatives in each country going to Brussels and going to Paris can be achieved in the future. Furthermore, government efforts must be in accordance with sound taxation principles such as taxation of the net profit and timely elimination of international double taxation if the recovery after the financial crisis is not to be impeded.