In this issue:

Respond, recover, and thrive: Transfer pricing considerations in the time of COVID-19

For many businesses, COVID-19 has created unprecedented and unforeseen financial challenges. The combined effect of the containment efforts, including the imposition of travel restrictions, have resulted in disruptions to global supply chains, weaker demand for goods and services, and declines in international tourism and business travel. The financial markets have also declined, as demonstrated by the retreat in stock prices since the beginning of the outbreak. While it is too early to have a clear view of the full economic impact, global multinational enterprises (MNEs) should not just consider how to respond now, but also consider how to plan to recover and thrive as the world weathers and emerges from the current situation. In particular, transfer pricing considerations should be top of mind for MNEs as a potential global recession induced by COVID-19 may impact their overall global tax positions, particularly for industries most seriously affected by the outbreak.

This article provides some thoughts regarding the potentially complex interplay between the transfer pricing policies typical of many MNEs and the impact of some of the most pressing economic issues that are expected to arise from the COVID-19-related business disruption.

It is important to point out that transfer pricing policies operate within a potentially complicated global tax ecosystem, where broader issues related to other tax positions must be taken into consideration. Thus, transfer pricing advisors should be mindful to include consultation with international tax, business tax services (BTS), and other tax specialists. For instance, it is possible that adjustments to intercompany transfer pricing policies might significantly affect other US income tax provisions, such as reporting of global intangible low-taxed income (GILTI), foreign-derived intangible income (FDII), foreign tax credits (FTCs), the base erosion and anti-abuse tax (BEAT), and the business interest deduction limitation under IRC Section 163(j). In addition, a client's modification to its transfer pricing policy may impact the client's existing contractual and regulatory obligations with third parties or local governments and tax authorities.

Plan to respond: Reducing cash tax expenses through transfer pricing

Many MNEs have principal company structures whereby limited-risk entities (*i.e.*, operational entities) are generally compensated by the principal company such that the limited-risk entities earn positive taxable income based on comparable company benchmarks, regardless of the complex set of intercompany transactions between them. Absent an adjustment to the comparable company benchmarks for the existing supply chain arrangements or the existing transfer pricing policy, the limited-risk entities will likely continue to report positive taxable income and therefore have cash tax expenses, even when the global MNE's income turns negative. At the same time, in situations as unprecedented as those created by COVID-19, MNEs will likely want to evaluate arm's length options to conserve cash as much as possible.

COVID-19 presents a unique event that few, if any, MNEs may have planned for. Among many other concerns, an immediate question is whether the limited-risk entities should bear some of the burden imposed by COVID-19. While transfer pricing rules may allow latitude for companies to alter their transfer pricing in response to real-world events, each MNE should consider the details based on its specific facts and circumstances.

Given the unprecedented uncertainty and fluidity of the current situation, MNEs are not likely to have immediate and definitive answers. Because many companies may have already experienced reductions in sales and/or production, irrespective of the duration of the current situation, it is reasonable to conclude that by year end many MNEs will be reporting substantially lower overall profitability across their supply chains, potentially limiting transfer pricing policies.

MNEs anticipating substantial disruption may consider proactively reevaluating their current transfer pricing policies, including benchmark returns for some group companies. Any implementation of a change to transfer pricing in certain circumstances may result in a reduction of current cash tax liabilities, consistent with cash preservation objectives, and should be appropriately and contemporaneously documented.

In this regard, considerations may include, but not be limited to:

- Reexamining the criteria that were used to identify comparable companies. This may require relying on different comparable companies than had been considered historically.
- Reevaluating the number of years of data to determine the range of results for the period related to COVID-19 in the context of any discernible business cycle effects.
- Considering whether certain adjustments specific to COVID-19-related issues may or may not be appropriate under the circumstances.

Plan to recover: Managing liquidity with transfer pricing

As the effects of COVID-19 persist, MNEs are expected to face continued liquidity pressure. An updated transfer pricing policy that takes COVID-19 into account can keep cash centralized for easier access and use for operations. Nevertheless, such policy changes, coupled with other economic events, may necessitate financial rebalancing as earnings and values may be impacted along with market liquidity, with cascading effects on capital structures. For example:

- Existing debt financing, both third party and intercompany, may be bound by incurrence or maintenance covenants (*e.g.*, debt to EBITDA), which may now be at risk of breach. Waivers to covenants or amendments to existing loans may be required to avoid defaults.
- New debt financing, both third party and intercompany, may face greater-than-usual challenges.

MNEs should understand how changes in their supply chain pricing arrangements will interact with these other issues and how such changes might impact any other liquidity solutions they might be contemplating, such as cash pooling and group indebtedness. In addition, such other liquidity solutions will have special transfer pricing considerations of their own.

Plan to thrive: Broad-based tax planning

As mentioned above, MNEs are likely to experience significantly different operating results because of COVID-19. Recent changes in US income tax law, not only with respect to the Tax Cuts and Jobs Act of 2017 (TCJA) but also the recently enacted Coronavirus Aid, Relief, and Economic Security (CARES) Act, need to be considered from a broad-based perspective. As a result of the complexity and interconnected nature of these provisions, transfer pricing planning should be done with an MNE's overall tax profile in mind.

For instance, transfer pricing is interwoven into several typical international tax computations, such as:

- Limited-risk distributors are often tested income entities within the GILTI regime. Changes to the profitability of such entities could have a corresponding change to the MNE's GILTI inclusion.
- Many MNEs are projecting lower revenues and potentially higher costs for 2020. This in turn is expected to generate net operating losses (NOLs) that, as a result of the CARES Act, can be used to generate cash tax refunds in years when the tax rate was 35% rather than 21%. To the extent transfer pricing changes impact a US entity's 2020 NOL, either directly or indirectly (*e.g.*, through a change in the GILTI inclusion), the amount of the 35% refund available would be affected.
- To the extent that US entities incur current year taxable losses, they may permanently lose Section 250 deductions (*i.e.*, GILTI and/or FDII) as well as GILTI FTCs.
- Changes to US profitability due to COVID-19 and/or related transfer pricing adjustments will also affect US entities' ability to deduct interest expense in the current year under Section 163(j). The complexity of this effect is compounded by elections available to taxpayers under the CARES Act to change the interest limitation from 30% of EBITDA to 50% and to utilize 2019 adjusted taxable income for 2020.
- Changes to US profitability due to COVID-19 and/or related transfer pricing adjustments may have an impact on an MNE's BEAT liability as well, because the computation of modified taxable income in 2018 and/or 2019 may be increased by the base erosion percentage of any NOL that arises in 2020.

Conclusion

In many cases, an MNE's intercompany transfer pricing policies, contracting, managing transaction flow may not have contemplated economic stress such as that caused by the COVID-19 global pandemic. Consistent with the arm's length standard, MNEs may want to consider whether changes to historical transfer pricing may be appropriate. To the extent any adjustments are made, MNEs would be well advised to respond now by preparing supporting documentation evidencing that any unanticipated financial results can be traced to factors related to the COVID-19-induced economic issues. In addition, any change in transfer pricing policies should be made with an eye to the MNE's overall tax profile, such as cash tax and liquidity concerns, in alignment with their plans for recovery.

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COVID-19's impact on transfer pricing in Japan

The topic dominating conversations globally is the COVID-19 (novel coronavirus) pandemic. In addition to the serious health impact of the virus, it also is impacting vital components of the global economy, such as production, the supply chain, consumption, and financial markets. Industries such as airlines, hospitality and tourism, electronics, consumer goods, pharmaceuticals, and medical equipment are experiencing this impact, and global markets are volatile.

It is still early in the timeline of the virus to have a clear view of the extent of the economic impact. One point of reference may be the SARS outbreak in 2002-03. As of the date of writing, the COVID-19 outbreak is more far-reaching than the SARS outbreak (both in terms of countries with infections and the number of infections). Using this as a benchmark, it is reasonable to expect that the impact of the COVID-19 outbreak may be significantly greater than the SARS outbreak.

It is in this context that global multinationals are beginning to consider how a potential downturn may impact their tax and transfer pricing positions, particularly for industries seriously affected by the outbreak.

In Japan, the government has taken measures relating to tax compliance in response to the outbreak, such as extending the due dates for filing individual income tax returns, consumption tax returns, and gift tax returns. For companies, the corporate income tax and consumption tax payment deadline may be extended under existing disaster relief measures with the approval of the tax authorities.

At the date of writing, no public announcement has been made with respect to measures specifically relating to transfer pricing. This article explores potential transfer pricing implications of COVID-19 on common operating models in Japan and looks at possible practical steps taxpayers can take to proactively address their transfer pricing position.

Impact on taxpayers

While the reach of the coronavirus outbreak is global in nature, certain industries and businesses are likely to be more sensitive to a resulting economic downturn. For example, businesses that typically involve a higher ratio of fixed costs may be expected to be more affected than those with a greater proportion of variable costs.

Industries with large fixed costs, such as manufacturing, are likely to experience a significant effect. Distributors also are likely to be affected, to the extent that they need to sell a certain volume to cover fixed costs. In Japan, given the extremely robust labor laws leading to a less flexible workforce scale, labor costs may be considered akin to a long-term fixed cost for a business. Depending on the length of the outbreak, businesses with large permanent employee workforces may be substantially impacted. Other businesses with large capital or labor costs may be similarly impacted.

Impact on "limited-risk" transfer pricing models

Many foreign multinationals operating in Japan use "limited-risk" models based on the transactional net margin method (TNMM) of pricing. Such a model may be used for contract manufacturers, contract R&D service providers, and limited-risk distributors. Limited-risk pricing models are often considered to give taxpayers a "guaranteed return" for their activities, benchmarked against the profit margins of comparable companies in the Japanese market. However, foreign tax authorities and taxpayers may question the outcome of such pricing models in the event of a significant market downturn, which may result from the COVID-19 outbreak.

At a high level, the impact of such a market downturn may likely depend on the risk profile of the Japanese subsidiary. For example, a typical limited-risk distributor may be exposed to certain market risks that may result in a loss of revenue streams. If the Japanese distributor is responsible for managing and controlling its fixed costs, it may be exposed to such risk to the extent of those fixed costs.

In order to form a view on the impact of the coronavirus outbreak on a particular Japanese subsidiary, the taxpayer would need to consider its analysis of the risk profile of the subsidiary. Any analysis of risk should start with the terms of the intercompany contract. Taxpayers should review their intercompany contracts as part of their analysis of the risk profile of the Japanese subsidiary. For companies that do not have intercompany contracts, taxpayers may wish to look at their course of dealings over the past few years.

Practical considerations

From a practical perspective, Japanese taxpayers typically approach compliance and risk management through the use of an advance pricing agreement (APA) or a "document-and-defend" strategy (that is, preparing annual transfer pricing documentation to use as a basis for defense in the event of a potential future audit). The practical considerations of the above issues for both strategies are described below.

Transfer pricing documentation

For taxpayers following a document-and-defend strategy, the documentation should be consistent with the outcomes of the risk analysis described above. To the extent that the local entity experiences a significant reduction in profit margin or is in a loss position, an additional explanation and support for this outcome should be provided. Further, the industry analysis typically included in transfer pricing documentation may become a more central aspect of the analysis and documentation strategy in the coming years.

In terms of economic analysis, taxpayers may need to consider the need for adjustments to support the results of their subsidiaries, such as an adjustment for fixed costs to determine the impact of decrease in volume for the selected comparable companies. From a Japanese perspective, the tax authorities often challenge the use of complex adjustments. The authorities typically argue that the Japanese market is broad and deep enough to identify sufficiently comparable companies, and that if the benchmarked companies are truly comparable from a function, asset, and risk perspective, complex comparability adjustments should not be needed. In these circumstances, taxpayers may wish to review the robustness of their existing Japanese benchmarking studies and consider refining their benchmarking strategy if needed.

Finally, depending on the taxpayer's transfer pricing policy, significant year-end adjustments may be necessary during a major market downturn. It is important that the mechanism for such adjustments be contained in an intercompany contract and supported in the transfer pricing documentation.

Taxpayers with APAs

In principle, taxpayers that have APAs should continue to follow the agreed upon outcome under the APA and would generally be expected to be shielded from the impact of the issues described above.

However, APAs generally include a set of "critical assumptions," the conditions on which the agreement is based. Critical assumptions often contain items such as significant changes to economic conditions and fundamental changes in the conditions of a particular industry. When a critical assumption is not met, the taxpayer and the revenue authority may agree to continue to honor the APA, revise the APA, or cancel the APA.

In this context, taxpayers that have an APA should review the terms included as critical assumptions and assess whether the COVID-19 outbreak could trigger a discussion with the revenue authorities to revise or cancel the APA. In the event that a critical assumption has been triggered, taxpayers should consider working with their advisors to initiate contact with the relevant revenue authorities.

Comments

Alongside the concerning health aspects of the coronavirus pandemic are real economic issues. As part of planning for a market downturn resulting from the outbreak, multinationals should proactively consider their tax and transfer pricing positions. Taxpayers with an APA may wish to consider reviewing the critical assumptions and working with their advisors to contact the tax authorities as appropriate. Other taxpayers may wish to consider the risk analysis for their Japanese subsidiary and form a view on whether reduced profitability during an economic downturn would be appropriate. Taxpayers also should review their intercompany contracts, benchmarking, and transfer pricing documentation, and prepare additional support for lower profitability or losses as appropriate.

Finally, a modification to a taxpayer's transfer pricing position may impact existing contractual and regulatory obligations with third parties or local governments and tax authorities regarding customs duties, value added tax, goods and services tax, excise duties, and other regulatory regimes. Taxpayers should evaluate all these issues before implementation of any modifications.

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2019 US APA Report shows continued strong interest in APAs

The Internal Revenue Service released Announcement 2020-02 dated March 25, 2020, the advance pricing agreement (APA) annual report covering the activities of the Advance Pricing and Mutual Agreement (APMA) Program during calendar year 2019. The annual report is issued under § 521(b) of Pub. L. 106-170, the Ticket to Work and Work Incentives Improvement Act of 1999, which requires the Secretary of the Treasury to report annually to the public on APAs and the APMA Program.

The annual report provides a summary of recent APA developments in the APMA Program and a statistical snapshot of the program's APA activities during 2019.

Transfer pricing enforcement is expected to continue to increase throughout the world as countries continue to adopt the Organisation for Economic Co-operation and Development's (OECD) base erosion and profit shifting (BEPS) final recommendations, and US and foreign multinational groups continue to review their existing structures and transfer pricing policies in light of the passage of the 2017 Tax Act (Pub. L. No. 115-97). Consequently, the certainty provided by APAs will continue to play an important role in transfer pricing risk management.

Notwithstanding the above, it is likely that the processing of APAs during 2020 will be affected by the current COVID-19 pandemic. Factors that may contribute to the potential impact on APAs include:

1. The cancelation of negotiation meetings between the APMA Program and foreign competent authorities due to increased travel restrictions;
2. The implementation of remote work for APMA Program personnel, foreign competent authorities, and taxpayers; and
3. Taxpayers' review of their transfer pricing policies and proposed APA terms in light of the current economic climate.

Statistical highlights of the 2019 APA annual report include the following:

Decrease in incoming APA requests: The IRS received approximately 40 percent fewer APA applications in 2019 than it did in 2018. The IRS received 121 APA applications (17 unilateral, 96 bilateral, and 8 multilateral) in 2019, whereas in 2018 it received 203 APA applications. In addition, as of December 31, 2019, APMA had received 29 user fee filings that were not yet accompanied by substantially complete APA applications, less than half the number of user fee filings from 2018.

The significant decrease in APA applications received by the IRS in 2019 as compared to 2018 is likely due to the large number of accelerated filings in 2018, arising from the increase in user fees to request an APA that was implemented by the APMA Program in two phases, with the first increase effective on July 1, 2018, and the second increase effective on January 1, 2019. Some taxpayers who would have filed APA applications in 2019 instead filed in 2018, in order to file prior to the increase in user fees taking effect. In this context, it may be more meaningful to compare the number of APA applications the IRS received in 2019 to the number of APA applications in 2017 and 2016. The number of APA applications the IRS received in 2019 increased by approximately 17 percent compared to 2017 and by approximately 19 percent compared to 2016. This is reflective of an overall trend of increased taxpayer interest in APAs.

Slight increase in completed APAs: During the 2019 calendar year, APMA closed 120 APAs (29 unilateral and 91 bilateral), compared to 107 APAs in 2018. APA renewals accounted for 68 of the 120 APAs executed (approximately 57 percent), with 20 unilateral renewals and 48 bilateral renewals. Approximately 25 percent of all executed APAs included rollbacks. It is likely that a significant portion of APAs with rollbacks resolved transfer pricing audit activity involving either the IRS or the tax authorities of a treaty partner.

Treaty partners involved in bilateral APAs: In 2019 Japan accounted for 32 percent of bilateral APA requests filed, the largest share of any country. Canada accounted for 14 percent, the second largest share of any country. India accounted for 12 percent, which represented a decrease of 9 percent compared to its share of bilateral APA requests in 2018.

Other countries accounting for meaningful percentages of filed, pending, or completed APAs with the United States are Australia, France, Germany, Italy, Korea, Mexico, Switzerland and the United Kingdom.

60 percent of the total number of bilateral APAs executed in 2019 involved bilateral APAs with either Japan or Canada. This does not represent a significant change from 2018, when 59 percent of the total number of bilateral APAs executed involved bilateral APAs with either Japan or Canada. Based on the filed APA requests during 2019 and the IRS's pending inventory of APAs, the percentage of completed APAs with Japan and Canada is expected to decrease as a percentage of the total as other countries become more active in the APA process.

Months to complete APAs: In 2019, the median time to complete a unilateral APA and a bilateral APA was 30.4 months and 40.5 months, respectively. In 2018, the median processing time to complete a unilateral APA and a bilateral APA was 33.5 months and 42.1 months, respectively. Overall, the median time required to complete the 121 APAs executed in 2019 was 38.8 months, which is approximately one and a half months faster than in 2018, but continues the trend of longer processing times for APAs as compared to previous years (for each of the five years prior to 2018, the median processing time for APAs ranged from approximately 32 months to 35 months). This continued trend may not be overly surprising given the reduction in staffing levels at APMA that began in 2016. While APMA is in the process of hiring additional personnel, which should translate into faster processing times in future years, it is unlikely to make a meaningful improvement in processing times for 2020 as it will take time to onboard new personnel, and the COVID-19 pandemic may impact hiring and processing of cases.

Processing time for unilateral APAs decreased by approximately three months from 2018 and by less than one month from 2017. Unlike bilateral APAs, which involve treaty partners, unilateral APAs and their processing time are more within the control of APMA. Due to significantly smaller volumes of unilateral APAs compared to bilateral APAs, the median processing time for unilateral APAs tends to exhibit higher levels of variability than for bilateral APAs.

Processing time for bilateral APAs decreased from 2018 by approximately one and a half months, to 40.5 months. For each of the five years prior to 2018, the median processing time for bilateral APAs ranged from approximately 35 months to 38 months. In 2018, the median processing time rose to 42.1 months, showing an increase in processing time for bilateral APAs compared to the previous five years, which as noted above may be explained in part by the reduction in staffing levels at APMA beginning in 2016.

Some taxpayers renewing APAs benefitted from faster processing times for their APA requests. For renewal unilateral and bilateral APAs, the median processing time was 38.4 months, compared to the median processing time for new unilateral and bilateral APAs of 41.9 months. The median processing time required to complete new APAs did not materially change from 41.7 months in 2018 to 41.9 months in 2019.

APA inventory: The APMA Program had 454 cases in active inventory at the end of 2019: 46 unilateral APAs, 386 bilateral APAs, and 22 multilateral APAs. This represents a small decrease of 4 pending APAs compared to the number at the end of 2018, when there were 458 cases in active inventory. Nearly half of the pending bilateral APA requests involve either Japan or India.

Term length of APAs (including rollback years): Of the APAs executed in 2019, 53 cases had a five-year term including rollback years, while 50 cases had terms of six years or longer. The average term length in 2019 was six years, a decrease of one year from the previous year. The APMA Program and foreign competent authorities may be willing to extend the standard APA term of five years when additional years are needed to address difficult results during a rollback period and/or completed APA years, or to provide some prospectivity in cases when the APA request took a long time to complete. Further, in the context of renewal APAs that were handled expeditiously, the APMA Program has shown a willingness to accept APA terms longer than five years.

Staffing: In September 2018, APMA restructured its management and realigned its teams. As of December 31, 2019, the APMA Program was comprised of one director, three assistant directors (each assistant director oversees two managers who lead teams comprised of team leaders and economists), six managers, 52 team leaders, and 16 economists. The three groups overseen by assistant directors are organized by country, with each group having responsibility for multiple countries. The total number of personnel at APMA at the end of 2019 was 78, which is the same number at the end of 2018, and is a decrease from 83 at the end of 2017.

Cancellations, revocations, and withdrawals: No APAs were cancelled or revoked during 2019. Twelve APA requests (one unilateral and 11 bilateral) were withdrawn in 2019, which is significantly lower than the 21 applications withdrawn in 2018, and more consistent with the eight applications withdrawn in 2017.

APAs executed by industry: In 2019, wholesale/retail trade and manufacturing accounted for 43 percent and 32 percent, respectively, of the total number of executed APAs. Within the wholesale/retail trade industry, merchant wholesalers of durable goods were most common (approximately 63 percent of such cases).

Covered transactions and transfer pricing methods: Forty-three percent of the transactions covered in APAs executed in 2019 involved the provision of services, 38 percent involved the sale of tangible goods, 18 percent involved the use of intangible property, and 1 percent involved other types of covered transactions. These numbers represent a change from 2018, when 35 percent of the transactions covered in executed APAs involved the provision of services, 44 percent involved the sale of tangible goods, and 21 percent involved the use of intangible property.

For potential cost sharing APAs, taxpayers should also consider that the preamble to the final cost sharing regulations under Treas. Reg. §1.482-7 provides that the IRS has the authority to negotiate an APA covering a platform contribution transaction and include a commensurate with income waiver.

The comparable profits method (CPM) was used to evaluate 81 percent of the transactions involving the transfer of tangible and intangible property in 2019, which represents a decrease from 86 percent in 2018. Of those transactions, 64 percent used the operating margin as the profit level indicator (PLI) and 36 percent used other PLIs, such as the Berry Ratio and the mark-up on total cost.

For services transactions, the most frequently applied method was also the CPM (82 percent of cases, compared to 86 percent of cases in 2018). Of those services transactions applying the CPM, 65 percent used the operating margin or the mark-up on total cost as the PLI. In 2019, the majority of APAs that covered services transactions also included tangible or intangible transactions, which were not tested under a separate PLI.

While the CPM was still the most frequently applied method in 2019, compared to 2018, the use of the CPM to evaluate transactions decreased by 5 percent in respect of transactions involving the transfer of tangible and intangible property and by 4 percent in respect of services transactions.

Adjustment mechanisms: The majority of the transactions covered in APAs executed in 2019 target an interquartile range. Those APAs include a number of mechanisms for making adjustments to the tested party’s results when the results fall outside the range or do not match the point required by the APA. Some examples of the mechanisms included in the 2019 executed APAs include an adjustment bringing the tested party’s results to the closest edge of the range applied to the results of a single year, an adjustment to the closest edge of the range applied to the results over the APA term, an adjustment to the specified point or royalty rate, and an adjustment to the median of the range for a single year.

APA boilerplate and APMA Program contact information: The annual report also includes the version of the APMA Program’s model APA agreement that was released in 2018 and a link to the list of primary APMA Program contacts. APMA made significant revisions to the model APA agreement in May 2018,[1] representing the first substantial update to the model APA agreement since 2004. In November 2019, APMA provided to our team[2] an updated version of the model APA agreement that more closely resembles the model prior to the May 2018 revisions.

In light of the BEPS final reports and the adoption of CbC reporting requirements by many jurisdictions and corresponding increased audit activity, the demand for APAs will likely continue to be strong. Although the potential impact of the COVID-19 pandemic on APAs is unknown at this time, the pandemic is likely to have an effect on the processing of APAs, due to a variety of factors. Taxpayers with an APA in force should be considering whether there has been any breach of critical assumptions that would necessitate revising their APAs. In comparison, taxpayers with pending APA requests should be actively reviewing the potential impact of COVID-19 to their business and the proposed transfer pricing method, and considering whether to propose new comparability adjustments and/or critical assumptions. Taxpayers without an APA may wish to consider an APA to address losses incurred by the COVID-19 pandemic.

To discuss whether an APA may be advisable for your organization, please reach out to one of the contacts listed.

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OECD releases report on transfer pricing of financial transactions

The Organisation for Economic Co-operation and Development (OECD) on 11 February released final guidance on the transfer pricing aspects of financial transactions. The long-awaited release marks the first time the OECD transfer pricing guidelines (TPG) will be updated to include such guidance.

The report takes into account the comments received in response to the non-consensus public discussion draft released 3 July 2018 and was released as part of Actions 8-10 of the base erosion and profit shifting (BEPS) project, which began in 2013.

The 2015 final reports on BEPS Actions 4 and 8-10 mandated follow-up work on this topic. Pursuant to that mandate, the guidance is meant to clarify the application of the TPG to financial transactions, in particular, the accurate delineation analysis under Chapter I.[3]

Sections A to E of the report will be included in the TPG as Chapter X. The guidance in Section F of the report will be added to Section D.1.2.1 in Chapter I of the TPG, immediately following paragraph 1.106. Section B provides guidance on the application of the principles contained in Section D.1 of Chapter I of the TPG to financial transactions. Sections

[1] On September 4, 2018, APMA released a revised version of the model APA agreement that fixed two problems, including allowing comments and edits to be saved under the specific name of the editor and fixing incorrect phrasing under Appendix A, section 4(b), regarding the royalty for the license of intangible property.
[2] The version of the model APA agreement made available in November 2019 has not yet been formally released by APMA.
[3] All references to the OECD TPG are references to the 2017 version of the TPG.

C, D, and E of the report address specific issues related to the pricing of financial transactions (that is, treasury functions, intragroup loans, cash pooling, hedging, guarantees, and captive insurance). This analysis elaborates on both the accurate delineation and the pricing of the controlled financial transactions. The last section of the report provides guidance on how to determine a risk-free rate of return and a risk-adjusted rate of return in situations in which an associated enterprise is entitled to any of those returns under the guidance in Chapters I and VI of the TPG.

Overview

Debt versus equity determinations

The report includes guidance that reflects an approach of accurate delineation of the actual transaction to determine the capital structure (the mix and types of debt and equity) used to fund an entity within a multinational enterprise (MNE) group, although the report emphasizes that the guidance is not intended to prevent countries from implementing other approaches under domestic legislation.

The report indicates that an approach of accurate delineation, which may include a multifactor analysis, can be used before pricing a loan to determine whether the purported loan is regarded correctly or should be recharacterized as equity for tax purposes.[4] Furthermore, the report suggests that the recharacterization as equity of a purported loan is not limited to an all-or-nothing consideration; rather, the report allows for a bifurcation of a purported loan between debt and equity as part of the accurate delineation analysis.[5]

The report lists a number of factors that may be used to distinguish intercompany debt from other forms of funding such as equity, including the following:

- The presence or absence of a fixed repayment date;
- The obligation to pay interest;
- The right to enforce payment of principal and interest;
- The status of the funder in comparison to regular corporate creditors;
- The existence of financial covenants and security;
- The source of interest payments;
- The ability of the recipient of the funds to obtain loans from unrelated lending institutions;
- The extent to which the advance is used to acquire capital assets; and
- The purported debtor’s failure to repay on the due date or to seek a postponement.

Identifying the commercial or financial relations and economically relevant characteristics of financial transactions

In accordance with the guidance established in Chapter I of the TPG, the report states that accurate delineation of financial transactions should begin with the thorough identification of economically relevant characteristics of the transaction, consistent with the application to other transactions. These include:

- An examination of the contractual terms of the transaction;
- The functions performed, assets used, and risks assumed;
- The characteristics of the financial products or services;
- The economic circumstances of the parties and the market; and
- The business strategies pursued by the parties.

The accurate delineation of a transaction “requires analysis of the economically relevant characteristics of the transaction. These economically relevant characteristics consist of the conditions of the transaction and the economically relevant circumstances in which the transaction takes place.”6 Depending on the context in which the term is used, the accurate delineation of a transaction may enable it to be correctly characterized (*e.g.*, debt v. equity

[4] This approach of accurate delineation applies to certain financial transactions mentioned in the report, including intragroup loans, cash pooling, hedging, guarantees, and captive insurance arrangements.
[5] The bifurcation approach is consistent with the draft Treas. Reg. §1.385, although the final regulations moved away from this methodology.
[6] Paragraph 1.35 of the TPG.

v. some apportionment between the two) and may entail the examination of factors that may impact comparability beyond a transaction or arrangement in isolation.

In applying the arm's length principle to a financial transaction, the guidance states that consideration of the conditions that independent parties would have agreed to in comparable circumstances is necessary. It is also necessary to consider the options realistically available to each of the parties to the transaction.[7]

The report states that when the accurate delineation analysis shows that a funder lacks the capability, or does not perform the decision-making functions, to control the risk associated with investing in a financial asset, it will be entitled to no more than a risk-free return as an appropriate measure of the profits it is entitled to retain.

The report also states that an accurate delineation analysis should consider the MNE group's global financing policy, including preexisting loans and shareholder interests. In one example, a 10-year term loan is more accurately delineated (and therefore should be priced) as a series of refreshed one-year revolver loans, based on the MNE group's financial policy practices, and the use of the proceeds to manage short-term working capital requirements.

Treasury functions: Intragroup loans, cash pooling, and hedging

The report states that the organization of the treasury function will depend on the structure of the MNE group and the complexity of its operations. Differences in the treasury function may flow from variations in the function's degree of autonomy and the range of activities it performs. The report sets out transfer pricing considerations that arise from treasury activities such as intragroup loans, cash pooling, and hedging activities. The report also emphasizes that the treasury function will usually be a support service to the main value-creating operations of an MNE and in some cases, remuneration to the treasury function should be priced by applying the intragroup services guidance in Chapter VII of the TPG.

Intragroup loans

In determining an arm's length interest rate on intragroup loans, a number of factors should be considered, including:

- The lender's and borrower's perspectives;
- The borrower's credit rating and credit rating of a specific debt issuance;
- The effects of group membership (and associated implicit support);
- Incurrence and maintenance covenants;
- Guarantees; and
- Loan fees and charges associated with the transaction.

In considering the lender's perspective, the report suggests an evaluation of the lender's ability to bear the risks associated with the borrower's potential default on the loan. A similar concept is also seen in the section of the report on guarantees and the guarantor's ability to bear the financial risk associated with providing a contractual guarantee. Such an analysis is likely to be an important aspect of the accurate delineation of the transaction. However, the report does not offer any guidance or examples as to how the financial ability to bear the risk should be measured or evaluated.

In considering the borrower's perspective, the report states that a borrower acting on its own commercial interest would seek to optimize its weighted average cost of capital in balance with its short-term and long-term funding needs. In one example, the report suggests that a borrower would generally seek secured funding ahead of unsecured funding, provided it takes into account the potential need for subsequent financing transactions and the scarcity of collateral.

The report looks beyond contractual terms to consider that the lender and borrower are related parties, that the funding is in fact intercompany and not third-party debt, and that the borrower is a member of a larger MNE group. For example, consideration is given to the fact that intercompany loans are frequently subordinated to third-party

[7] For example, in the case of an entity that advances funds, other investment opportunities may be contemplated. From the borrower's perspective, the options realistically available include broader considerations than the entity's ability to service its debt, for example, the funds it actually needs to meet its operational requirements.

loans in many jurisdictions. This suggests that there may be a need to perform a legal analysis with respect to bankruptcy laws and seniority. The guidance also highlights that covenants may be less important in a related-party context and that certain intragroup loans may effectively be secured lending even if no security is contractually given. Finally, consistent with paragraphs 1.164 through 1.167 of the TPG, the report considers the effects of group membership via implicit support, even in the absence of a contractual guarantee.

The guidance emphasizes the importance of both quantitative and qualitative factors in determining arm's length pricing. Qualitative factors include both the effects of group membership, as discussed below, and also qualitative aspects of the borrower's business. Specific guidance is provided on considerations for conducting credit rating analyses and performing comparability adjustments to account for influences of controlled transactions and the potential impact of passive association. The report acknowledges that credit ratings can serve as a useful measure of creditworthiness and to help identify potential comparables. Furthermore, the report highlights that in performing a credit rating analysis, it is important to note that the financial metrics of the borrower may be influenced by other controlled transactions (such as sales, or interest expense). In situations where a credit rating estimate for a particular entity using an established approach may result in an unreliable outcome (for example, due to the presence of controlled transactions), the report suggests that it may be appropriate to rely upon the group credit rating for pricing of an intragroup loan.[8] However, no specific guidance or examples are provided as to how these situations should be best addressed.

The report considers implicit support to be an important factor in evaluating credit risk. The report proposes a facts and circumstances-driven approach based on the entity's relative importance to the group to determine the impact of implicit support. The report suggests that in cases in which the borrower would be likely to receive support from other group members, the borrower's credit rating is likely to be more closely linked to the group rating. In more limited circumstances, when a borrower is determined to be less likely to receive group support, the borrower's credit rating may be more closely linked to the stand-alone credit rating of the entity.

The report outlines the transfer pricing approaches to determine arm's length rates, including the comparable uncontrolled price (CUP) method, a cost of funds approach, credit default swaps, economic modelling, and reliance on bank opinions. However, the report indicates that the use of credit default swaps and economic modelling to price intragroup loans should be used only in the absence of information on comparable uncontrolled transactions. Further, the last item – reliance on bank opinions – generally would not be regarded as providing evidence of arm's length pricing.

Cash pooling

Cash pooling enables a group to benefit from more efficient cash management by (notionally or physically) bringing together the balances on separate bank accounts. The report indicates that accurate delineation of cash pooling arrangements would need to take into account the facts and circumstances of the balances transferred, but also the broader context of the conditions of the pooling arrangement as a whole.[9]

The report discusses two broad pricing schemes for cash pooling transactions: rewarding the cash pool leader and rewarding the cash pool members. The appropriate basis on which to reward the cash pool leader depends on the specific facts and circumstances of the arrangement.[10]

The report discusses two approaches to allocating the benefits of cash pooling to the participating members (that are not necessarily mutually exclusive):

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[8] In situations when the group does not have an external credit rating, consideration may be given to conducting the credit rating analysis at the MNE group level for assessing the controlled transaction.
[9] It is necessary to determine:
1. The nature of the advantage or disadvantage,
2. The amount of the benefit or detriment provided, and
3. How that benefit should be divided among members of the MNE group. Paragraph 10.120 of the guidance.

[10] Paragraph 10. 129 of the guidance. An example is provided whereby the cash pool leader performs coordination services but bears no credit risk and accordingly should earn rewards commensurate with a service provider. In a second example, the cash pool leader performs additional functions, controls and bears the financial risks contractually allocated to it, and has the financial capacity to bear those risks, and should be compensated commensurately.

- Enhancing the interest rate for depositors and borrowers; and
- Allocating cash pooling benefits to depositors, and not borrowers, within the group (in situations in which there is genuine credit risk to the depositors).

The guidance states that cross-guarantees and set-off rights between participants in the cash pool may be required, which would raise the question whether guarantee fees should be payable. The guidance says that under circumstances where members providing cross-guarantees do not have control over membership in the pool, have no control over the quantum of debt that is guaranteed, and may not be able to access information on the parties for whom it is providing a guarantee, the guaranteed borrower may not be benefitting beyond the level of credit enhancement attributable to the implicit support of other group members. In such cases, the report concludes, no guarantee fee would be due, and support in case of a default from another group member should be regarded as a capital contribution.

In a discussion on hedging, the report states that when a centralized treasury function arranges a hedging contract that an operating company enters into, the centralized function can be seen as providing a service to the operating company and should be rewarded accordingly. However, when hedging positions are not matched within the same entity, even though the group position is protected, more difficult transfer pricing issues may arise.

Guarantees

The report provides guidance on how to accurately delineate and price financial guarantees.

As stated in the guidance, when the effect of a guarantee is to permit a borrower to borrow a greater amount of debt than it could in the absence of the guarantee, it is necessary to consider whether a portion (incremental borrowing capacity) of the loan *from the lender to the borrower* should be more accurately delineated as a loan *from the lender to the guarantor* (followed by an equity contribution from the guarantor to the borrower),[11] and whether the guarantee fee paid with respect to the loan portion is arm's length.

The report discusses both explicit guarantees (legally binding contracts) and implicit guarantees (anything less than a legally binding commitment). In general, the benefit of any such implicit support would arise from passive association and not from the provision of a service for which a fee would be payable. In an explicit guarantee, a borrower generally would not be prepared to pay for a guarantee if it did not expect to obtain an appropriate benefit in return (that is, a cost of debt-funding lower than its non-guaranteed borrowing costs adjusted for implicit support and costs associated with the guarantee).

The report states that the examination of financial guarantees under accurate delineation also needs to consider the financial capacity of the guarantor to fulfill its obligations in case the borrower defaults. This requires an evaluation of the guarantor's and the borrower's credit rating (including the effect of implicit support), and of the business correlations between them.

The report describes five pricing approaches for circumstances in which a guarantee fee is found to be appropriate:

- The comparable uncontrolled price (CUP) method (although finding sufficiently similar guarantees between unrelated parties may be unlikely);
- The yield (differential) approach;
- The cost approach;
- The valuation of expected loss approach; and
- The capital support method.

The yield approach prices the guarantee based on the benefit provided to the borrower (that is, from the borrower's perspective), whereas the cost, valuation of expected loss, and capital support methods price the guarantee based on the cost to the guarantor (that is, from the guarantor's perspective). With the exception of the CUP method, these pricing approaches address only the maximum or minimum amounts an unrelated borrower or lender may be willing to pay or receive for a financial guarantee, and do not address how to consider prices above or below these limits.

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[11] A similar question was not posed with regards to implicit support.

Captive insurance companies

Some MNE groups manage risks within the group through a captive insurance company, a group member that provides insurance-type services exclusively or primarily to members of the group. The report provides guidance on applying the arm's length principle to these transactions. A frequent concern when considering the transfer pricing of captive insurance transactions is whether the transaction is accurately delineated as such. The report provides indicators, all or substantially all of which would typically be expected in an independent insurer:

- Diversification and pooling of risk in the captive insurance;
- The economic capital position of the entities within the MNE group has improved as a result of diversification and there is therefore a real economic impact for the MNE group as a whole;
- Both the insurer and any reinsurer are regulated entities with broadly similar regulatory regimes and regulators that require evidence of risk assumption and appropriate capital levels;
- The insured risk would otherwise be insurable outside the MNE group;
- The captive has the requisite skills, including investment skills, and experience at its disposal, including employees with senior underwriting expertise; and
- The captive has a real possibility of suffering losses.

The report emphasizes the importance of the captive's ability to control, and the financial capacity to assume the insurance risk when allocating risk (and return) to MNE group members.

In cases where the captive is not found to exercise control functions related to the insurance risk, an analysis under Chapter 1 of the TPG may conclude that the risk has not been assumed by the captive or that another MNE is exercising these control functions. In the latter case, the report states, the return derived from the investment of the premiums would be allocated to the member(s) of the MNE group that are assuming the risk.

Two methods are discussed that may be appropriate for the pricing of premiums: CUPs from available comparable arrangements between unrelated parties (or internal comparables) and actuarial analysis. The report also provides for a method that builds to an arm's length level of profitability as the sum of underwriting profit plus investment income. Further, the report provides guidance on the pricing of agency sales and arrangements whereby a captive is used to achieve synergies for the MNE group.

Risk-free and risk-adjusted rates of return

The report provides guidance on how to determine a risk-free rate of return and a risk-adjusted rate of return that is added to Section D.1.21 in Chapter I of the TPG.

If the accurate delineation of the actual transaction shows that a funder lacks the capability, or does not perform the decision-making functions, to control the risk associated with investing in a financial asset, the guidance states that it will be entitled to no more than a risk-free rate of return.[12]

The guidance mentions that government-issued securities serve as one – but not the only – reference for estimating risk-free rates, and other alternatives may be considered based on the prevailing facts and circumstances of each case. Alternatives may include interbank rates, interest rate swaps, or repurchase agreements of highly rated government-issued securities.

The report refers to the following relevant considerations for determining a risk-free rate:

- Eliminating currency risk;
- Temporal proximity of the reference security to the tested transaction; and
- Matching the maturity of the reference security to the tested transaction.

The report states that in a situation in which a party providing funding exercises control over the financial risk associated with the provision of funding, without the assumption of or control over any other specific risk, it could

[12] In such a situation, the guidance states that, subject to other constraints, the funded party would still be entitled to a deduction up to an arm's length amount in respect of the funding.

generally expect only a risk-adjusted rate of return on its funding. In general, the expected risk-adjusted rate of return on a funding transaction can be considered to have two components, *i.e.*, the risk-free rate and a premium reflecting the risks assumed by the funder.

The report discusses several approaches for estimating a risk-adjusted return, including those that are based on the return of a realistic alternative investment with comparable economic characteristics, a cost of funds approach, or a risk-premium to the risk-free return based on the information available in the market on financial instruments issued under similar conditions and circumstances.

Conclusion and key takeaways

The guidance provides methods for determining the arm's length compensation for financial transactions, and it emphasizes an accurate delineation analysis as an approach to determine whether the transaction is characterized correctly or should be recharacterized for tax purposes. To accurately delineate financial transactions, the report indicates that it is necessary to perform an examination of the transaction's contractual terms (explicit and delineated); the functions performed, assets used, and risks assumed; the economic circumstances of the parties and the market; and the business strategies pursued by the parties.

Overall, the guidance provided in the report highlights the need for MNEs to revisit and develop intragroup policies (and revisit associated funding agreements) to address any ambiguity regarding how tax authorities might interpret their intragroup financing transactions.

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Canada cancels transfer pricing circular

The Canada Revenue Agency (CRA) has cancelled its information circular IC87-2R, *International Transfer Pricing*, effective December 30, 2019.

IC87-2R was issued on September 27, 1999, for the purpose of providing guidance on the application of the Canadian transfer pricing rules that are found in section 247 of the Canadian Income Tax Act.

A comprehensive document at the time of its issuance, IC87-2R set out the CRA's views on transfer pricing and its position on the application of the Organisation for Economic Co-operation and Development (OECD) report, *Transfer Pricing for Multinational Enterprises and Tax Administrations* (the OECD TPG) that was issued in 1995.

Rationale for cancellation

The CRA notified Canadian taxpayers of the cancellation of IC87-2R on its webpage used by the public to access the publication and on its transfer pricing webpage.

On the transfer pricing webpage, the CRA states that the circular, which reflects the policies in place on the date it was published, has been archived. The CRA directs Canadian taxpayers to its transfer pricing memoranda that it issues periodically to supplement and update its transfer pricing policy and to provide guidance on specific aspects of the transfer pricing legislation.

It is noteworthy that on its transfer pricing webpage, the CRA directs Canadian taxpayers to the 2017 OECD TPG and continues to state that the Canadian transfer pricing legislation and administrative guidelines are generally consistent with the 2017 OECD TPG.

More recently, on February 26, 2020, the CRA issued a draft notice to tax professionals that provides some insight into CRA's rationale for cancelling IC87-2R. According to the notice, IC87-2R was cancelled due to its inconsistency with the CRA's current interpretation and application of Canadian transfer pricing legislation, and also because it does not reflect updates to the OECD TPG.

In the notice, the CRA cites two key examples illustrating its views and factors contributing to the cancellation of IC87-2R – the ordering rule and the broader application of the Canadian transfer pricing recharacterization provisions.

Ordering rule

In the draft notice to tax professionals, the CRA highlights that IC87-2R stated that as a general rule, the specific provisions of the Act relating to cross-border debt would be applied before considering the more general provisions of section 247 of the Act. According to CRA, this is inconsistent with its interpretation of the Act's transfer pricing legislation. Except as otherwise specified in the tax rules, the CRA considers that section 247 applies to all cross-border transactions with non-arm's-length entities.

Although not explicitly stated by CRA, it is apparent that the ordering rule was a factor triggering the cancellation of IC87-2R. The ordering rule is intended to provide the Canadian transfer pricing rules in section 247 of the Act priority over any other provision in the Act. The ordering rule was first introduced as part of the federal budget for 2019-2020 and applies to taxation periods that begin on or after March 19, 2019.

The CRA is generally of the view that subsection 247(2) of the Act, which empowers the CRA to adjust amounts associated with a transaction (or series of transactions) to align with prices that would prevail under arm's length terms and conditions, can apply in conjunction with other provisions of the Act. These other provisions include, for example, section 17 of the Act, which generally imputes interest income for a Canadian taxpayer at the prescribed rate on an amount that has been outstanding for an extended period of time and is owed to it by a nonresident person. Given this, there may be instances where both sections 17 and 247 of the Act apply to an intercompany loan extended by a Canadian taxpayer to a foreign related party. According to both the CRA's draft notice to tax professionals and the introduction of the ordering rule, section 247 would take priority over the applicability of section 17, but both sections would apply.

Broader application of recharacterization provisions

The CRA also highlights in the draft notice to tax professionals that the indication in IC87-2R that only in limited instances would it be necessary to recharacterize a transaction under paragraphs 247(2)(b) and (d) of the Act is out of date, because IC-87-2R refers to the 1995 OECD TPG. This is inconsistent with the CRA's current interpretation of the Act's transfer pricing legislation. The CRA is of the view that the updates to the OECD TPG in 2010 and 2017, and the relevant provisions in the Act, provide support for a broader application of the recharacterization provisions.

Implications for Canadian taxpayers

The views expressed by the CRA in its cancellation of IC87-2R are far-reaching and may have meaningful implications for Canadian taxpayers with cross-border intercompany transactions.

As an example, the introduction of the ordering rule may lead Canadian taxpayers to revisit the arm's length nature of interest income that they report on amounts owed to them by non-Canadian related parties. When reevaluating such arrangements and preparing contemporaneous documentation, due consideration should also be given to the newly introduced Chapter X of the OECD TPG (transfer pricing guidance on financial transactions), in February 2020.

As another example, the CRA's new interpretation regarding the broader application of the recharacterization provisions may impose an additional burden on Canadian taxpayers in respect of determining and documenting their intercompany arrangements. This additional burden may be in the form of more extensive documentation of a Canadian taxpayer's reasons for entering into the intercompany arrangements. A taxpayer also may be required to prepare more thorough analyses that conclude that persons dealing at arm's length would have entered arrangements akin to the Canadian taxpayer's intercompany arrangements.

We encourage Canadian taxpayers to carefully consider what these views might mean for them in the context of their intercompany arrangements and from the perspective of the transfer pricing rules in their various counterparty jurisdictions.

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Belgium publishes new transfer pricing circular letter

The Belgian tax authorities on 25 February published the final version of the transfer pricing circular letter in Dutch and in French on their website.
URL: https://www2.deloitte.com/content/dam/Deloitte/be/Documents/tax/TaxAlerts/Circulaire_2020-C-35_NL.pdf
URL: https://www2.deloitte.com/content/dam/Deloitte/be/Documents/tax/TaxAlerts/Circulaire_2020-C-35_FR.pdf

Circular 2020/C/35 provides an overview of chapters I, II, III, VI, VII, VIII, and IX of the OECD's 2017 transfer pricing guidelines, which were amended to reflect the BEPS Actions 8-10 final reports. The circular also provides guidance on certain financial transactions and a high-level discussion of the OECD guidelines on permanent establishments. The circular also states the Belgian tax authorities' position where required and appropriate.
URL: https://www.oecd.org/tax/transfer-pricing/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-20769717.htm

As a general introduction, the Belgian tax authorities declare adherence to the principles of the OECD 2017 transfer pricing guidelines, and state that Belgium is likely to accept future changes to the guidelines.

The TP circular contemplates two separate (and retroactive) entry-into-force dates. Most paragraphs (in line with the OECD 2017 transfer pricing guidelines) will apply to intercompany transactions as of 1 January 2018. However, the provisions listed below, and the recently published Chapter X of the OECD transfer pricing guidelines on financial transactions are applicable to intercompany transactions as of 1 January 2020:

- For comparability analyses, the Belgian tax authorities expect taxpayers to take into account at least three years of comparables, whereas only one year is examined for the tested party (para. 78);
- When testing a party with a limited-risk functional profile against a set of comparable companies, the Belgian tax authorities will not accept comparables in the interquartile range that incurred losses for two or more years (para. 106);
- Unless the tested party is a start-up, the Belgian tax authorities will not accept recently established companies (defined as companies that have been active for less than the four preceding years) as comparables, because of potentially limited data comparability (due to start-up losses, market penetration costs, etc.) (para. 108);
- To improve comparability, the comparables search should be as close as possible to the year in which the tested party transaction under review took place. The Belgian tax authorities recommend an annual update of the financial results of the comparables search and require a regular update of documentation linked to the comparables search regarding any changes in functions performed, risks assumed, and underlying economic factors of the tested party (para. 115);

- The Belgian tax authorities expect taxpayers to update their transfer pricing studies every three years, unless the underlying facts and circumstances require an earlier update (para. 116);
- If the tested party's results fall outside the range of comparable companies (the full range in the case of high-quality comparables, and the interquartile range in other cases) and requires adjustment, the Belgian tax authorities highlight that any point within the range can be acceptable, if it best reflects the tested party transaction's underlying facts and circumstances. If no such specific point within the range can be identified, the Belgian tax authorities would prefer an adjustment toward the median (para. 126).

The Belgian tax authorities highlight that rulings granted before the TP circular's publication remain valid.

With this circular, the Belgian tax authorities confirm the alignment of domestic transfer pricing rules with the BEPS changes to the OECD transfer pricing guidelines, albeit with a specific focus on certain areas and a deviating position on a few topics. It is likely that they will apply these positions in the expected wave of transfer pricing audits.

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OECD releases public consultation document on 2020 review of country-by-country reporting practices

The G20/OECD Inclusive Framework on Base Erosion and Profit Shifting on 6 February released a public consultation document concerning country-by-country (CbC) reporting under BEPS Action 13. The public input obtained in this process will inform the Inclusive Framework's review of the minimum standard for CbC reporting to tax authorities, a project that is scheduled for completion by the end of 2020.

The views and proposals in the document do not reflect a consensus position of the governments involved but are designed to provide substantive proposals for further review and public comment.

The discussion topics on which the Inclusive Framework requested public comments are organized into three categories: general topics concerning implementation and operation of BEPS Action 13, topics concerning the scope of CbC reporting, and topics concerning the contents of the CbC report. Some discussion topics explore potential changes that could have far-reaching impact on MNEs if they are adopted in local legislation, while others may have more limited effects. We review these discussion topics below.

Key topics to monitor

Three discussion topics pose questions that could lead to fundamental changes to the CbC reporting regime:

- Should information in Table 1 be presented by entity rather than by tax jurisdiction?
- Should additional columns be added to Table 1? Items identified in this regard are: related-party interest, royalty, and service income; related-party interest, royalty, and service expense; total related-party expenses; R&D expenditure; and deferred taxes.
- Should changes be made to how constituent entities that are not resident in any tax jurisdiction for tax purposes are categorized for CbC reporting purposes and how information on these entities is reported in Table 1?

Adding more information such as entity-level financials and additional columns might facilitate high-level risk assessments of MNE groups by the relevant tax authorities. However, it may also increase compliance burdens on taxpayers and create a potential for false positives from using the new information.

The Inclusive Framework provides several alternative approaches to reporting information for stateless entities. They generally involve identifying the jurisdiction (if any) in which the profits of the stateless entity are subject to tax. On one hand, such changes might be welcomed by MNEs who have operating entities that are liable to tax but are classified as stateless under the current CbC rules. On the other hand, any of the proposed approaches would involve an incremental increase in the amount of information that must be collected and submitted.

Topics that may impact only a subset of MNEs

Many of the discussion topics relate to potential revisions to the CbC reporting annual revenue threshold, which is currently set at EUR 750 million, or a near equivalent amount in domestic currency as of January 2015, for the immediately preceding fiscal year. This relates to qualification as an "Excluded MNE group" for purposes of exemption from the CBC filing requirements. Discussion topics in connection with the threshold include the following:

- Should separate CbC reports be prepared by MNE groups that are under common control and which in the aggregate have consolidated group revenue above the CbC reporting threshold?
- Should the consolidated group revenue threshold be reduced?
- Should a jurisdiction with a consolidated group revenue threshold denominated in a currency other than the euro be required or permitted to refresh that amount periodically?
- Should the revenue threshold for Excluded MNE Groups take into account more than one year of consolidated group revenue?

Another discussion topic involves whether certain fields required in the XML schema (for example, constituent entity tax identification number and address) that are not specifically identified in the CbC reporting template per the BEPS Action 13 report, should be incorporated into the template. Most US MNEs file their CbC reports in electronic format; therefore, they would not be affected if this suggestion were adopted.

Topics to monitor

Several other topics may lead to additional compliance burdens or complexities for MNEs, although the potential changes are not as fundamental as those described in the first subsection. For example, the Inclusive Framework asks for comments on whether consolidated data rather than aggregate data should be used in Table 1, whether standardized industry codes should be included in Table 2, and whether certain mandatory predetermined fields, such as sources of data and applicable accounting standards used, should be added to Table 3.

Topics already addressed in US regulations

Some topics in the consultation document involve matters that have already been clarified in US CbC regulations in Treas. Reg. §1.6038-4. For example:

- Should a single enterprise with one or more foreign permanent establishments be classified as a group for purposes of CbC reporting?
- Should extraordinary income be included in consolidated group revenue?
- Should gains from investment activity be included in consolidated group revenue?
- When the previous fiscal year of an MNE group consists of a period other than 12 months, should the consolidated group revenue threshold (or, alternatively, consolidated group revenue in the immediately preceding fiscal year) be adjusted in determining whether the MNE group is an Excluded MNE Group?

Most of the potential amendments covered by these topics are consistent with the contents of the US CbC regulations.

Other items to note

The consultation document states that the OECD is currently developing a CbC reporting Tax Risk Evaluation & Assessment Tool (TREAT). This tool is intended to support tax administrations, including those in developing countries, in performing review and interpretation of CbC reports. The tool will rely on risk factors identified in the OECD publication, *CbC Reporting: Handbook on the Effective Use of CbC Reporting Information in Tax Risk Assessment* (September 2017). In addition, MNEs can conduct their own CbC risk assessments using potential risk factors indicated in the handbook, as a means of preparing for CbC-related queries.

The Inclusive Framework also requested public comments on "the use of CbC reports by tax administrations" and "the number and nature of requests for additional information" from tax authorities. Since all comments on this public consultation document will be made publicly available, interested parties may be able to obtain information concerning the approaches taken by specific tax authorities on their use of CbC reporting data.

Finally, the consultation document fails to address some common issues that MNEs have faced since the introduction of CbC rules. Most notably, some jurisdictions have enacted legislation that requires local filing of CbC reports, although the jurisdiction has no international agreement with the MNE's home jurisdiction. Such local filing requirements are generally acknowledged to conflict with the consensus reached during BEPS Action Item 13 negotiations. Also of concern are repetitive annual notification requirements and local filing requirements that are consistent with the OECD model CbC legislation but nevertheless still bring compliance burdens and information security concerns to MNEs. That said, the Inclusive Framework did seek comments regarding the general status of CbC reporting implementation by local countries. Taxpayers may use this opportunity to raise these and other related concerns.

Next steps

It is anticipated that the Inclusive Framework's review will be completed by the end of 2020.

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Belgium gets ready for 2020 transfer pricing audit cycle

Belgium's tax authorities will launch the 2020 transfer pricing audit cycle in the coming weeks.

Given the recent Belgian transfer pricing developments (a new transfer pricing circular letter) this audit cycle will likely be significant from both a qualitative and quantitative perspective. Thus, taxpayers that receive a transfer pricing audit questionnaire should consider several key items relating to the 2020 cycle.

Strengthened transfer pricing audit squad

The transfer pricing audit cell has been significantly strengthened during the last few years, with more and more tax inspectors gaining in-depth transfer pricing knowledge.

Additionally, the transfer pricing audit team will join forces with the regional tax inspectors of the seven "large taxpayers" centers. In practice, the TP audit team will provide technical support on any transfer pricing issue detected during standard corporate tax audits, which could subsequently lead to an in-depth transfer pricing audit.

Taxpayers thus should be prepared for an increasing number of challenging questions from the tax authorities in the years to come.

Improved selection process

Companies will be selected for the new transfer pricing audit cycle based on the outcome of a risk assessment analysis performed by the so-called "MANTRA" software.

Although the criteria used to perform the risk assessment remain confidential, it may be reasonable to assume that indicators such as volatile sales or profit margins, structural loss-making positions, significant carry-forward losses, high debt-equity ratios, and important year-end adjustments or business restructurings, among others, would lead to an increased likelihood of becoming subject to a transfer pricing audit.

Additionally, compliance with the new documentation requirements – local file, master file, country-by-country (CbC) report, and CbC report notification – will now be used in the audit selection process. Non-compliance with these documentation requirements will dramatically increase the risk of selection. However, taxpayers that do not reach the documentation thresholds are not necessarily precluded from receiving a transfer pricing audit questionnaire.

Standard TP audit questionnaire

Selected companies will receive the standard transfer pricing questionnaire, which typically consists of 30 questions. The 2020 version of the questionnaire is expected to be similar to the 2019 edition, with some minor modifications to reflect lessons learned during previous transfer pricing audit cycles.

It is important to confirm consistency between past or pending transfer pricing reporting to the Belgian tax authorities (for example, in the local file, master file, or CbC report) and the answers provided to tax inspectors during the 2020 audit. Since a new TP circular letter was published on 25 February 2020, tax inspectors will refer to it during the 2020 audit cycle.

Given that a significant amount of information is requested in the standardized transfer pricing audit questionnaire, a taxpayer may opt to request a pre-audit meeting. During this meeting with the tax inspector, the scope of the audit questionnaire can be redefined by targeting certain questions.

Long process often leading to double taxation

On average, a transfer pricing audit in Belgium takes about 18 months to settle, from the date of receipt of the standard transfer pricing audit questionnaire.

This settlement is often the result of extended negotiations that may lead to double taxation. Double taxation can occur when:

1. The same revenue is included in the taxable basis of two related entities located in different countries and
2. The country in which the counterparty is located is under no obligation to adjust the taxable basis in accordance with the Belgian transfer pricing audit results.

To eliminate double taxation, international instruments should be considered.

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Turkey adopts OECD transfer pricing reporting standards

Turkey announced on February 25 its adoption of the transfer pricing documentation standards under the OECD's base erosion and profit shifting (BEPS) Action 13 recommendations.

The announcement – Presidential Decree No. 2151 – was an expected development in the evolution of transfer pricing documentation requirements in Turkey and may be viewed as a result of greater harmonization with the OECD's guidance on this issue. The changes detailed below will have several important consequences for both taxpayers and the revenue authorities alike:

- Increased cooperation and sharing of information will automatically provide the revenue authorities with a broad spectrum of taxpayer information that was not readily available previously.
- Taxpayers could expect increased scrutiny by the revenue authorities of inconsistencies in transfer pricing policies and/or approaches in different jurisdictions.

- Taxpayers that used to handle transfer pricing compliance locally and in a decentralized way may need to revise their internal processes, because the new rules require a more centralized and coordinated approach to transfer pricing documentation and reporting.
- In general, taxpayers will need to commit increased time and resources for transfer pricing compliance.

The decree provides a three-tier transfer pricing documentation approach:

- A master file with global information about a multinational enterprise (MNE) group, including specific information on intangibles and financial activities;
- A local file (similar to the annual transfer pricing report) with detailed information on all relevant intercompany transactions of the group entity in Turkey; and
- A country-by-country (CbC) report of income, earnings, taxes paid, and certain measures of economic activity.

Master file

Turkish corporate income taxpayers that are members of an MNE group with assets and net revenues each of TRY 500 million or more in the previous year will be required to prepare a master file to be submitted to the Turkish tax authorities for fiscal year 2019 and fiscal years thereafter. The master file must be kept on file and submitted to the authorities only upon official request.

The required information in the master file can be grouped into five broad categories:

- The MNE's organizational structure;
- A description of the MNE's business or businesses;
- The MNE's intangibles;
- The MNE's intercompany financial activities; and
- The MNE's financial and tax positions.

Local file/annual transfer pricing report

Corporate taxpayers will continue to prepare an annual transfer pricing documentation report pertaining to their related-party transactions. There is no change with regard to the deadline for preparation of the annual transfer pricing documentation report, which corresponds to the local file under the OECD's three-tier transfer pricing documentation approach.

CbC report

The CbC reporting requirement applies to MNEs whose consolidated group revenues are EUR 750 million or more. The CbC report is to be prepared by the Turkish ultimate parent entity (or another reporting entity if there are multiple Turkish entities). The first CbC report will be for fiscal year 2019 and must be submitted by December 31, 2020.

The CbC reporting obligation also includes a notification requirement. Accordingly, taxpayers should report to the TRA the following:

- Whether they are an "ultimate parent entity" or a "surrogate entity";
- Which entity is responsible for reporting on behalf of the group; and
- The reporting period.

The CbC report must include the global allocation, by country, of key variables for the MNE, including:

- Revenue, profit, tax paid, stated capital, accumulated earnings, number of employees, and tangible assets data pertaining to each country in which the MNE operates; and
- The names and main activities of each of the MNE group entities pertaining to each country in which the MNE operates.

All the above-mentioned documentation must be prepared in the Turkish language.

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Transfer pricing in financial services: The outlook for 2020 and beyond

In this article, Deloitte's financial services transfer pricing (FSTP) network provides an outlook on four key transfer pricing trends (TP) that may impact the financial services sector in 2020 and beyond. These trends cover:

1. The ongoing work of the G20/OECD on the tax challenges arising from the digitalization of the economy,
2. The regulatory environment,
3. The focus of regulators/supervisors, and
4. The impact of technology.

Digitalization of the economy

On January 31, 2020, the G20/OECD Inclusive Framework (IF) on base erosion and profit shifting (BEPS) released a statement about its ongoing work to address the tax challenges arising from the digitalization of the economy. The work is comprised of a unified approach to addressing nexus and profit allocation challenges arising from digitalization (pillar one) and the development of a global anti-base erosion (GloBE) proposal (pillar two). One of the key concerns to be addressed is "that the digitalization of the economy and other technological advances have enabled business enterprises to be heavily involved in the economic life of a jurisdiction without a significant physical presence."

In a recent statement, the IF suggested that regulated financial services organizations may be broadly excluded from the scope of pillar one. The statement acknowledges in section 31 that "most of the activities of the financial services sector take place with commercial customers and will therefore be out of scope *per se*." The statement continues that "there is also a compelling case for the consumer-facing business lines such as retail banks and insurance within financial services businesses to be excluded from scope given the impact of prudential regulation and, for example, bank/insurance licensing requirements that are designed to protect local deposit/policy holders in the market jurisdiction." The proposed sector outline follows the argument that financial institutions are typically required to have regulated entities in local jurisdictions and that such regulatory nexus already creates the necessary taxable nexus as basis for local taxation.

Tax departments of banks, asset managers, and insurers will still need to monitor the ongoing developments at the G20/OECD level closely if the proposed sector outline remains in its proposed form. Further consideration is also required as to whether there are any unregulated elements of the financial services sector – or related to the sector – that may require special consideration. The IF intends to reach agreement on the key policy features of pillar one by early July 2020, with the aim to publish a final report by the end of 2020.

Regulatory environment

Regulation continues to be one of the key drivers of change, directly impacting the tax dimension. The key regulatory developments for 2020 are the upcoming interbank lending rate (IBOR) transition, changing banking regulations, and the Markets in Financial Institutions Directive II (MiFID II).

IBOR transition

Globally, regulators are spearheading one of the most complex transformation programs in recent history under which existing interbank rates (IBR) will gradually transition to alternative risk-free rates (RFRs). The transition will be complex because of significant differences between RFRs and IBRs by region, tenor, and currency. RFRs are overnight indices with no term structure, nearly risk-free, and based on actual transactions, whereas IBRs are term rates, reflect perceived credit risk, and are survey-based.

Tax departments of financial institutions will need to focus on the following areas to manage the transition to RFRs effectively:

- Capture existing financial products (products sold to clients and/or hedging instruments) and financing arrangements based on floating rates that are affected by the transition (depending on transition date of the underlying IBOR and potential transitional arrangements granted by regulators);
- Examine legal agreements with respect to fallback clauses;
- Perform impact assessments and determine transition from IBR to new RFRs and determine new spreads;
- Consider the broader impact on treasury/asset and liability management (ALM) functions of banks with respect to funds transfer pricing (FTP);
- Consider the impact on financial accounts (fair value calculation, hedge accounting, etc.)
- Use appropriate RFRs for new financial products; and
- Assess how to treat costs related to the IBOR transition for tax purposes and potential cost allocations.

Considering that IBRs are embedded so closely in the day-to-day activities of both providers and users of financial services (regulated and unregulated), stakeholders should keep all aspects of the transition, including the potential tax impact, on their radar and proactively include tax departments in the transition program.

Banking regulatory environment

Banking regulations have a growing impact on the tax position of banking institutions. Triggers include increased capital, liquidity, and counterparty risk requirements, as well as proposed requirements on centrally regulated entities. Banks will need to prepare for compliance with the Capital Requirements Directive V (CRD V) in advance of its June 2021 application date. Divergent implementation of the Basel III revisions will continue to add cost and complexity. Nonetheless, the EU's approach to implementation will become clearer in 2020.

The first key challenge is that banking institutions may need to revisit their existing transfer pricing for the attribution of free capital and to determine an appropriate response on how to consider capital increases in the context of free capital attribution to branches. Capital requirements have been emphasized as a key issue for European banks by the European Central Bank (ECB) and that the supervisory work will continue to focus on capital adequacy, business models, and governance.

The second key change of Basel III is the introduction of higher liquidity requirements for banking institutions. One of the new requirements is the net stable funding ratio (NSFR), which aims to introduce more stable sources of funding. As a result, certain banking institutions already needed to inject longer-term funding into their banking affiliates to meet NSFR targets. This also triggers a range of complex transfer pricing questions on how to appropriately structure and price the provision of long-term funding in the intra-bank context and how to align such funding transactions with existing FTP and treasury policies.

The third key change triggered by Basel III is increased counterparty credit risk (CRR) measures. This affects banks where certain affiliates (and their loan portfolios) are overly concentrated on one counterparty or a group of counterparties. In practice, this forces affiliates to enter into guarantees (which are often internal) to transfer part of the counterparty credit risk to other banking affiliates. This again prompts complex transfer pricing questions on how to appropriately structure and price the provision credit guarantees in the intra-bank environment for tax purposes.

The European Commission (EC) published a range of proposals for the transposition of Basel III (and already part of the future Basel IV framework) into EU law as part of the new CRD V. As part of the proposals, the EC considers introducing a requirement for banks to establish a centrally regulated and supervised entity (known as intermediate parent undertaking or IPU) for non-EU banking groups with substantial EU activities. CRD V is commonly regarded as an opportunity for European regulators to counter fragmented supervision by local regulators and the potential risk of regulatory and supervisory arbitrage in cases in which banking groups are subject to oversight by several local regulators.

Impact of MiFID

MiFID II, which was rolled out in 2018, placed additional restrictions on inducements paid to investment firms or financial advisors by any third party in relation to services provided to clients. Clean share classes emerged as a MiFID II-compliant response to the ban on inducements. Clean shares have no loads, commissions, or other distribution fees, which typically pay for an investment fund's distribution costs, and no platform fees. Nonetheless, the rise of new share classes has led to increased operational complexity.

From a transfer pricing perspective, this implies that asset managers may need to take into consideration the impact of new fee arrangements, share classes, and the unbundling of fees. Most notably, there is a potential impact on existing fee flows, transactions, and transfer pricing policies (especially fee splits and the fee basis for the split). This trend could also affect the availability and applicability of both internal and external market data for benchmarking/testing purposes.

Asset managers increasingly rely on fund distribution platforms. These platforms work as intermediaries between distributors and asset managers, performing administrative functions such as order routing and settlement, data processing, rebate calculations, compliance and managing distribution agreements. Thus, tax departments will need to assess the potential impact on existing fee flows, transactions, and transfer pricing policies.

Tax departments will also need to monitor political developments with the proposed overhaul of MiFID II and revisiting concessions that had been made to the UK in the six years it took to complete the regulations following the UK's departure from the European Union on January 31, 2020.

Focus of regulators

Tax governance: Strong governance is required to deliver financial services in a safe and sound manner. Regulators continue to focus on governance frameworks during their onsite visits where all levels of the organization are scrutinized – from the board to senior management to the business lines. In boardrooms around the world, financial services executives are taking appropriate action against risk. Risks include both traditional financial risk (*e.g.*, credit, market, and liquidity risk) but also non-financial risks (NFR). One of the new NFRs is tax, given the potential impact of tax risks on the financial stability, reputation, capital, and liquidity positions of regulated entities.

Today, financial regulators are already probing tax as one of the indicators of proper management of regulated entities across a range of jurisdictions by requesting information on the tax strategy, policies, agreements, documentation, and the involvement of executives in the identification and mitigation of tax risks.

In view of these challenges, management and boards need to start embracing tax on their governance agenda to meet the expectations of both tax authorities and regulators.

Funds transfer pricing

Since 2016, the ECB and local regulators have focused on creating a more stable banking sector through harmonized rules at the EU level and stricter risk and capital requirements. To achieve this goal, in 2016, the ECB and local regulators launched the business model analysis (BMA), whereby as part of the supervisory reviews the ECB and local regulators assess a range of criteria including strategy, risk management, financial performance, and regulatory compliance to determine the viability of a bank`s business model and operations. Among other areas, the BMA now explicitly focuses on FTP as part of the review of the management of the banking operations, funding structure/management, and profitability management. FTP is not a new concept – it is relevant for most banking institutions, but so far has often been addressed very differently, if at all, across the banking sector based on the maturity of banks, their business model, funding profile, and other criteria.

It will be important for banks that are supervised under the single supervisory mechanism (SSM) to prepare for the BMA campaign and revisit their FTP framework to be aligned with current market practice and to confirm that it meets the expectations of both regulators and tax authorities with respect to pricing the provision and use of funding.

Impact of technology

Technology continues to be a game changer in the financial services sector. Examples include the rise of robotics and automation-related technologies to reduce operating costs, algorithmic models that evolve from internal risk management tools to key portfolio management tools and robo-advisors and artificial intelligence facilitating investment decisions and product selection. The future will entail using digital technologies to automate processes, improve regulatory compliance, transform customer experience, and disrupt key components along the value chain.

This technological upheaval continues to require heavy investment and raises the question of how to structure such investments from a transfer pricing perspective with respect to ownership and use of the resulting intangibles within the group. The essential question is whether technology needs to be characterized as a key intangible for tax purposes going forward, which would also require a change to approaches for the tax treatment of development expenses. The result could be that an allocation of development costs via service (re)charges may no longer be appropriate, but instead a license fee/royalty model may need to be introduced to remunerate the owner of the intangible(s) for the development activities.

Consequently, financial institutions may need to do the following:

- Identify all relevant intangibles and their use, even if use is not subject to remuneration (noting that even the non- remuneration needs to be supported and documented);
- Revisit existing transfer pricing positions regarding remuneration for the use of intangibles (cost recharge vs. license fee);
- Track development activities, especially if performed out of certain (pioneer) locations and decide if strategic development activities should be centralized in specific location(s) to centralize the ownership of intangibles;
- Confirm consistency between tax-related communication and other channels (especially for investor relations and regulatory purposes); and
- Review the completeness and appropriateness of existing transfer pricing documentation and intercompany agreements.

The financial services sector faces a range of future challenges, and transfer pricing is becoming increasingly significant given regulators' focus on tax governance but also the impact of regulatory developments on the tax dimension. It is important that tax departments be properly involved in addressing the upcoming challenges and working with the board and key stakeholders.

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Transfer Pricing Analysis of Vertically Integrated Companies

Vertical integration is an arrangement whereby the supply chain of a company is consolidated under the same company. In general, each member of the supply chain produces a different product or service, and the products combine to satisfy a common demand. Vertical integration secures the supplies needed by the firm to produce its product and the market needed to sell the product.

Vertical integration can occur in different ways. A company tends toward "forward" vertical integration when it controls distribution centers and retailers where its products are sold. An example is an oil and gas company that produces oil and gas and distributes through its retailers. "Backward" vertical integration occurs when a company controls subsidiaries that produce some of the inputs used in the production of its products. For example, an automobile company may own a tire company and a metal company. Control of these subsidiaries is intended to create a stable supply of inputs and ensure a consistent quality in their final product. A company can also adopt both forward and backward integration, in which case it can control most of its supply chain.

By definition, vertically integrated companies perform multiple functions, each of which may be related to a different part of the supply chain. It is also common for multinational enterprises (MNEs) to place each function under a separate legal entity. For example, in a forward vertical integration, manufacturing and distribution functions may be performed separately by two different entities of the same company.[13] When different functions are performed by separate entities of a company, intercompany transactions take place between those entities as the product moves along the supply chain.

In certain industries, vertically integrated MNEs can have several different functions under separate entities, which results in multiple back-to-back intercompany transactions for MNEs. For instance, a manufacturing entity of a chemical company can produce an intermediary chemical that can be used by another manufacturing affiliate to produce the final product, which can then be sold to distribution entities for sale to third parties. When there are such back-to-back related-party transactions, transfer pricing analysis of those transactions under the comparable profits method (CPM) or the transactional net margin method (TNMM) may require a selection and analysis of multiple tested parties, in contrast to the single tested party approach provided by the Treasury regulations under Section 482 of the Income Tax Code (the US transfer pricing regulations) and the OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, July 2017.[14] The following example illustrates the issue.

Example

A vertically integrated MNE has four entities – A, B, C, and D – which are located in countries Q, X, Y, and Z, respectively, and perform the following functions:

- **Entity A:** Manufactures an intermediary product P_A.
- **Entity B:** Uses the intermediary product produced by Entity A to manufacture product P_B.
- **Entity C:** Uses product B to further process it to produce the final product P_C.
- **Entity D:** Owns the intellectual property (IP) of the MNE and purchases the final product from Entity C for distribution to third parties.

Figure 1: Example of Vertically Integrated Intercompany Transactions:

Further, the entities have the following financials with respect to their intercompany transactions:

Table 1	Entity A	Entity B	Entity C	Entity D
Sales	102	132	165	250
COGS	80	102	132	165
SG&A	20	18	18	35
Operating Profit	2	12	15	50
NCP / OM*	2% NCP	10% NCP	10% NCP	20% OM

*NCP and OM stand for net cost plus markup and operating margin, respectively.

The question is how one should test Entity C with respect to Entity C's intercompany transactions. When the entity does not own any IP and performs only routine functions, the typical approach would be to apply the TNMM/CPM[15] to test whether a company earns arm's length returns with respect to its intercompany transactions. As described in the US transfer pricing regulations:

[13] It is also possible that an entity may perform multiple functions in which case transfer pricing analysis would have other challenges outside the scope of this article. See, for example, S. D. Felgran and S. D. Harris, "*Benchmarking the Profitability of Vertically Integrated Companies*", BNA Tax Management Transfer Pricing Report, September 2004.
[14] See Article 2.73 of the OECD transfer pricing guidelines.
[15]TNMM and CPM are used interchangeably in this article to refer to the applicable method in the relevant country. CPM/TNMM is assumed to be the most reliable method in this article to test the transactions. As such, the financial data required for the CPM/TNMM analysis is also assumed to be available.

"…in most cases the tested party will be the least complex of the controlled taxpayers and will not own valuable intangible property or unique assets that distinguish it from potential uncontrolled comparables."[16]

In this example, Entity C has two intercompany transactions – purchase of product P_B from Entity B and sale of product P_C to the distributor. Since Entity C is a routine manufacturer that does not own any IP, one may consider testing Entity C based on the TNMM. With respect to Entity C's sales of product P_C to Entity D, one might select Entity C as the tested party since Entity D is the IP owner. In that case, looking at Entity C's financials in Table 1, it might be concluded that Entity C earns an arm's length return if a 10% NCP achieved by Entity C is within the interquartile range of NCP returns established by comparable manufacturers.

Further, regarding Entity C's purchase of products from Entity B, one might select Entity B as the tested party.[17] Entity B also earns 10% NCP and, given that comparable manufacturers earn similar NCP returns, one might conclude that Entity C's purchase of product P_B from Entity B is also priced consistent with the arm's length standard. So, based on this analysis, can one say that intercompany transactions involving Entity C meet the arm's length standard? The answer may not be "it depends." The reason is that when there are back-to-back intercompany transactions, as we observe commonly for vertically integrated companies, tested party financials are also typically based on intercompany transactions, and if those intercompany transactions may not meet the arm's length standard, testing the results based on comparables using the CPM/TNMM may not necessarily be reliable indicators.

In the example, although the NCPs of both Entity B and Entity C are within the arm's length ranges based on comparables, those NCPs are calculated based on cost bases of Entity B and Entity C, which are also based on intercompany transactions. In particular, Entity B's COGS is based on the intercompany price of product P_A purchased from Entity A. When selling to Entity B, Entity A earns only 2% NCP; if 2% is not consistent with the arm's length standard, the intercompany transactions involving product P_A at that price may not be appropriately measured. In such a case, since Entity B's cost base depends on the price of product P_A, the use of the CPM/TNMM for purposes of testing Entity B's intercompany transactions may not be reliable. Similarly, because Entity C's cost base is dependent on the price of product P_B; using the CPM/TNMM to test Entity C's transactions may also not be reliable.[18]

Therefore, when testing an intercompany transaction of an entity that has back-to-back intercompany transactions, one should consider not only the tested entity but also all other intercompany transactions that affect the tested transaction. In other words, transfer pricing analysis may require the selection of *multiple* tested parties as part of the TNMM.[19] In the next sections, specific cases are considered for illustrative purposes.

Case 1 – Routine Intercompany Transactions

Suppose the intercompany transaction chain includes only routine entities, that is, no entity in the chain is considered to own non-routine intangibles. Suppose there are N entities in the intercompany transaction chain; the final entity in the chain is a distributor and all other entities are different manufacturing entities in a vertically integrated supply chain. Figure 2 depicts the transaction chain.

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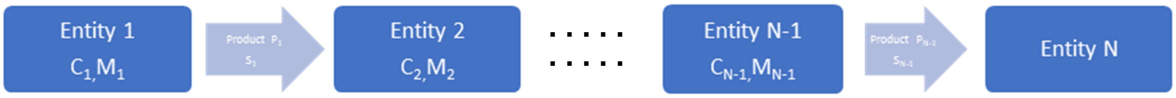
[16] See also Articles 2.65 and 3.18 of the OECD Guidelines.
[17] Some tax authorities only test the local entity in an aggregate manner regardless of the number of intercompany transactions the local entity enters into. In that case, the arguments and conclusions in this article would still apply.
[18] When a tested party has back-to-back intercompany transactions, even though its NCP is within the comparable range, one may also consider checking other ratios for diagnostic purposes. Specifically, ratios that are not dependent on the pricing of intercompany transactions may provide further insights for the tested party. For instance, if one has a comparable benchmarking set to test Entity C, consideration of different financial ratios, such as SG&A to sales ratios may be useful. In addition, consideration of other profit level indicators, such as the return on operating assets, which arguably may be less affected by intercompany arrangements, may also be useful. In the real world, the indicated arm's length NCP ranges may be wide, in which case it is possible that, in an application of the CPM/TNMM, the tested party returns may still fall within the arm's length range.
[19] Since the CPM/TNMM is assumed to be the most reliable method to test the transactions, the analysis requires multiple tested parties. However, if other methods are applicable (for example, the comparable uncontrolled price method), such methods can also be applied to test those transactions.

Figure 2: Routine Intercompany Transactions:



Let T_n for every n=1,2,…,N denote the transaction where entity n sells to entity n+1. Suppose also that for any entity n=1,2,…,N in the transaction chain, the cost base of entity n has two components: cost of purchase of product from the previous entity (S_{n-1}) and the additional cost of manufacturing (C_n).[20] Entity n also applies a markup (M_n)[21] on its total cost base when selling the product to the next entity at a price of $S_n = (S_{n-1}+C_n)(1+M_n)$.

One can then show the price of transaction T_n, *i.e.* when entity n is selling to entity n+1, as follows:[22]

Equation 1:

$$S_n = \sum_{i=1}^{n} C_i \prod_{j=i}^{n} (1 + M_j)$$

As seen in Equation 1 above, the price of transaction T_n (S_n) not only depends on the cost base of entity n and markup applied by entity n but also the cost bases of all entities before entity n as well as the markups applied by all entities before entity n. As a result, in order to be able to test transaction T_n, one may need to test all transactions before transaction T_n. If the testing of all the transactions before transaction T_n is consistent with the arm's length standard, then the TNMM applied to transaction T_n may also be considered reliable.

Given that all entities in the transaction chain are routine entities, it is also possible to benchmark a transaction considering the transactions following the tested transaction. In other words, Equation 1 is derived by applying the arm's length standard starting with the first transaction in the chain. However, one can also start with the last transaction in the chain. Specifically, since the last entity, in this example, is also a routine distributor, the price of the last intercompany transaction can be tested by looking at the results for the last entity, and the testing of the preceding transactions may also proceed recursively in this way.

Based on the approach in this example, one may consider the following construction in Equation 2 for the price of transaction T_n as follows:

Equation 2:

$$S_n = (S_N(1 - OM) - C_N) \prod_{i=n+1}^{N-1} \frac{1}{(1 + M_i)} - \sum_{i=n+1}^{N-1} C_i \prod_{j=n+1}^{i-1} \frac{1}{(1 + M_j)}$$

Where,
OM is the arm's length distribution operating margin for entity N,
S_N is the third-party sales price charged by entity N, and
C_i , M_i , and N are defined as before.

Equation 2 shows that transaction T_n may also be tested by testing the transactions that occur following T_n in the supply chain. Specifically, if the transactions following T_n are tested under the CPM/TNMM based on the benchmarked markups for manufacturers and operating margin benchmarks for the distributor, then the use of Equation 2 may also be reliable for testing transaction T_n. In this case, the reliability of this approach to testing transaction T_n may depend on the availability and reliability of information regarding the transactions following entity n.

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[20] C_n can include additional production costs aside from S_{n-1} as well as any other tolling or service costs incurred by entity n.
[21] We assume all costs are marked up for simplicity; however, passthrough costs can also be added.
[22] Derivations of all equations can be provided upon request.

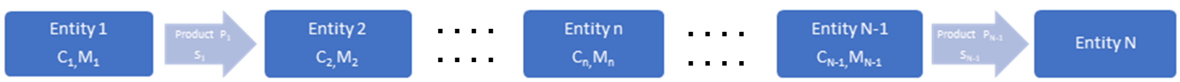
Both Equation 1 and Equation 2 are based on the same principle that all transactions between the tested transaction and a third party are considered, which ensures that the cost base or revenue related to the tested transaction is consistent with the arm's length standard. In these examples, both approaches may require the selection of multiple tested parties.

The only difference between the two approaches is the third-party reference point used in the benchmarking. Equation 1 is derived starting with the first entity in the chain that has purchases only from third parties.[23] Equation 2, on the other hand, is derived starting with the last entity in the chain that sells to only third parties.

Case 2 – Routine Intercompany Transactions and One IP Owner

It is very common for vertically integrated companies to have IP related to their technology and/or tradename/trademark. To account for such a case, consider the same example but with one entity that may be considered to own non-routine IP. Suppose entity n is the IP owner in the transaction chain and other entities are still routine entities. Figure 3 below illustrates this case.

Figure 3: Routine Intercompany Transactions and One IP Owner

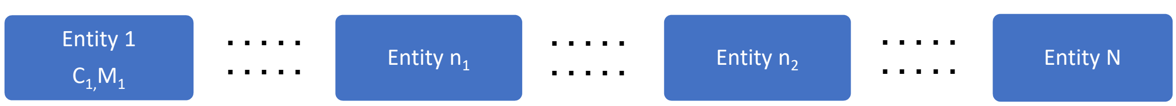


Although entity n cannot be tested directly because it is the entity that owns the IP, the approach described above in Case 1 may also be applied here; that is, transactions preceding entity n can be tested based on Equation 1 and transactions following entity n can be tested based on Equation 2.

Case 3 – Routine Intercompany Transactions and Two IP Owners[24]

Some companies may also have more than one IP-owning entities in their supply chains. Figure 4 illustrates this case.

Figure 4: Routine Intercompany Transactions and Two IP Owners



In this example, entities n_1 and n_2 are the IP owners in the supply chain. The transactions preceding entity n_1 and following entity n_2 in this instance may be tested based on the same logic as described by Equation 1 and Equation 2, respectively. However, transactions between entities n_1 and n_2 may need to be benchmarked with reference to additional comparables[25] because benchmarking entities n_1 and n_2 directly may not be reliable.

Conclusion

The US transfer pricing regulations and the OECD transfer pricing guidelines describe the CPM/TNMM as a one-sided method based on the selection of a single tested party. When MNEs – vertically integrated companies – have back-to-back to intercompany transactions, traditional application of the CPM/TNMM based on a single tested party may not

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[23] The issue is also partially addressed as part of PLI selection in Article 2.94 of the OECD transfer pricing guidelines.
[24] The approach can easily be extended to cover cases when there are more than two nonroutine IP owners in the supply chain.
[25] Additional comparables can be, for example, uncontrolled transactions comparable to transactions T_{n1} or T_{n2-1}. If entity n_1 (n_2) sells (buys) the same products in transaction T_{n1} (T_{n2-1}) to (from) third parties under comparable circumstances, such transactions can be considered as comparables.

always be reliable because certain costs or revenues along the supply chain are the result of intercompany transactions themselves.[26] As such, one may consider selecting *multiple* entities along the MNE's supply chain for purposes of testing transfer pricing.[27]

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[26] Article 2.73 of the OECD transfer pricing guidelines states the complications that may arise when there are back-to-back intercompany transactions; however, it does not provide any specific solution to such issues.
[27] See also Article 3.22 of the OECD transfer pricing guidelines.