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Chicken or the egg: TP, BEPS, and local- country legislation

Are transfer pricing controversy cases on the rise because of the OECD's BEPS initiative or local country legislation? Deloitte's Stan Hales and John Henshall explore the dynamic globally.

One common prediction regarding the G20/OECD-led BEPS initiative was that as rules were implemented and practical aspects interpreted, a global increase in transfer pricing (TP) controversy would ensue. That prediction seems to have come true, as seen by the significant rise in the number of TP court cases recorded around the world since the BEPS project began. In turn, that growing body of case law has influenced members of the OECD's Inclusive Framework (now more than 120 countries), Committee on Fiscal Affairs, and ultimately country-specific tax law.

Historically, local case law led to changes in local tax law. In some cases, limited consideration was given to the tax implications for the country on the other side of the transaction, as the protection of domestic fiscal policy under local law usually took precedence. Today, the domestic tax law-making process brings other countries into the equation. Proposals from the OECD, supported by case law in various countries, have actually become law in many other countries.

Country-by-country reporting (CbCR), a proposal orchestrated as a 'minimum standard' by the OECD Inclusive Framework, is now implemented into law and practiced in many jurisdictions, alongside bilateral relationships for the exchange of information. As of November 2018, 74 signatories to the CbC's multilateral competent authority agreement (MCAA) have completed more than 1,900 bilateral exchanges of taxpayer CbC TP reports. It seems inevitable that future TP controversies will subsequently arise.

Transfer pricing cases

In 2018, few transfer pricing cases were limited to the application of local country law, like the US Appeals Court decision in ***Altera Corp. and Subsidiaries v. Commissioner of Internal Revenue*** (No. 16-70496, 9th Circuit, 2018).

The principal issue in ***Altera***, the inclusion of stock-based compensation costs in cost sharing, was also considered by the Israeli Supreme Court in ***Kontera Technologies v. Tel-Aviv 3 Assessing Office*** (943/16). However, the latter reached the opposite conclusion under Israeli law.

While cases concerning local TP law are important for their application in that country, other cases may have greater potential geographic scope, and therefore may be more valuable to the TP and tax professionals' community. Cases that consider the application of OECD-based concepts and principles, or that look at the detailed application of one or more methods to measure an arm's-length price (or value in particular business transactions) can have broader application. However, court decisions in one country will not be binding on tax authorities or courts elsewhere (but they may be informative), as each court is interpreting law based on an international treaty (Article 9 of the OECD Model Tax Convention).

As cases are finalised, a clearer direction regarding uncertain positions usually arise. With the frequency of TP cases showing no signs of abating, 2019 may produce a wealth of guidance regarding the application of TP laws and practices that have their foundation in the arm's-length principle. In 2018, Denmark provided the most TP court decisions, with four cases decided. In total, 12 countries contributed to the 29 cases reported in 2018.

In assessing an arm's-length price or value (as between unconnected parties), one trend that can be identified from these cases is that courts will look to whether the position claimed by either side is fair to both parties. The courts will strike down any analysis that does not result in a fair allocation of profit to both parties, or is not commensurate with the way the business generates value, even though it may have technical, logical, or legal merit.

Several cases in 2018 illustrate this point. In the UK, ***Union Castle Mail Steamship Company v. HMRC*** (UKUT 316) took into account the value of newly issued shares, while in Germany, ***Hornbach-Baumarkt v. Finanzamt Landau*** (Case C-382/16) took into account the position of the group parent when considering whether an interest-free loan would be made.

In ***Denmark v. Water Utility Companies*** (Case No. 27/2018 and 28/2018), the Danish court ruled that the discounted cash flow method for valuing an asset would be inappropriate in cases where the income from the asset is suppressed. In such cases, there are similarities to an earlier UK case (***DSG Retail Ltd v. HMRC***, UKFT 31, TC, 2009), in which the court ruled against an argument (that while eminently sensible), did not result in a reasonable sharing of profit.

For TP and tax professionals, this should serve as a reminder to exercise 'good professional judgement' in any work, and not to rest arguments on the accurate, technical application of a method that nonetheless produces an unreasonable or absurd result.

Two other technical points of considerable note were decided in 2018. The first concerns the ECJ's decision in ***Hornbach-Baumark***, where the court concluded that TP legislation does not violate the EU's fundamental freedoms. While TP legislation applies to cross-border transactions differently in many jurisdictions to same-country transactions (potentially in violation of Article 49 of the Treaty on the Functioning of the EU), it is a necessary and proportionate response by the tax authorities in the defence of the consistency of their tax regimes.

The second noteworthy case was the decision of the US Court of Appeal for the Eighth Circuit in ***Medtronic & Consolidated Subsidiaries v. Commissioner of Internal Revenue*** (No 17-1866). Justice Shepherd noted that when a court seeks the arm's-length royalty for use of intellectual property (IP), this is the same as looking for a reasonable royalty in patent infringement cases. Shepherd then cited decisions of the court in commercial infringement cases between unrelated parties to support his conclusion that insufficient work had been undertaken in the tax court to demonstrate comparability of the selected comparable uncontrolled transaction (CUT). Justice Shepherd's opinion leads to the following two points. First, the factors indicating comparability (or a lack thereof) for intangible cases are not the same as those for goods or services transactions. TP and tax professionals must understand the appropriate comparability factors and ensure that they are addressed in the course of the work.

Second, some third-party decisions will be useful in helping the assessment of questions that are encountered in TP work. The ***Medtronic*** case involved a CUT comparability analysis, but there is no reason to think that the relevance of court decisions in other matters arising in third-party disputes concerning intangibles could not also be drawn upon in TP work. There is a significant volume of that material available.

National court challenge influences on OECD proposals

How may these new court cases manifest themselves in future OECD proposals and the tax law of different countries? An examination of history is revealing.

The non-consensus OECD public discussion draft on financial transactions under BEPS Actions 8–10 (the discussion draft) from July 2018 contains many concepts from local country case law. Underlying much of the discussion draft commentary is local country case law from many different countries covering related-party (or intragroup) loans, cash pooling, hedging, guarantees and captive insurance.

Capital structure and loans

In discussion draft Box B.1 and Box B.2, the OECD questions what type and number of factors should be considered for debt versus equity classification, and whether the entire amount of funding must be delineated as equity (or as a partial pro-rata share that may be debt, with a portion re-classified as equity).

Compare that approach to the US's all-or-nothing characterisation of debt versus equity in Treasury Regulation §1.385, which uses a multifactor approach to address the debt/equity classification. This new US tax law is based on years of case law (***Estate of Mixon v. United States***, 464 F.2d 394, 1972), ***Laidlaw Transportation v. Commissioner of Internal Revenue*** (75 TCM 2598, 1998), and others. However, the documentation provisions under section 385 have been effectively withdrawn under proposed rulemaking.

In contrast, the Australian arm's-length debt test contained in the Australian thin capitalisation regime in sections 820-105 and 820-215 of the Income Tax Assessment Act 1997 (as well as Taxation Ruling 2003/1) disallows only a portion of excess interest on a proportional re-classification of debt-to-equity funding.

Cash pooling

In discussion draft Box C.8, the OECD questions the allocation of group synergy benefits among cash pool members. One relevant case is ***Norway v. ConocoPhillips*** (HR-2016-988-A, 2010), which uses a profit split to allocate the netting benefit based on deposit contributions (in a clear benefits allocation) to effectively increase the interest rate paid to Norway-based depositors. This is the basis of paragraph 127 of the discussion draft. This case also appears to underline the UK's HMRC guidance (INTM 503200, International Manual, 2017) to apportion synergy benefits to structural advantages in cash pooling arrangements.

Paragraph 97 refers to zero balancing, which is the focus of ***Switzerland v. Swisscargo AG*** (Federal Supreme Court, October 2014, Case No. 4A_138/2014). A case from the Portuguese tax arbitration court in 2012 for a cash pooling arrangement also uses a profit split. The court in that case rejected the comparable uncontrolled price (CUP) method in ***Anon v. Tax and Customs Authority*** (Case 55/2012-T, 2012, Arbitration Court).

Mirroring paragraph 128 of the discussion draft in ***Denmark v. Bombardier*** (Admin. Tax. Ct., Case 12-0189459, 21 Oct. 2013), the court ruled on a zero interest spread using the same interest rate for both depositors and borrowers in the cash pool.

Financial guarantees

In draft box D.1, implicit support is recognised, valued, and priced under ***Her Majesty the Queen v. General Electric Capital Canada Inc***. (FCA 344, 2010). However, paragraph 143 notes that a parental guarantee letter to a third-party bank for loans of an affiliate may confer no benefit.

Germany's revenue authority argued the opposite, valuing the parental support from a comfort letter at 15 basis points of the loan amount under Germany's ***Hornbach-Baumarkt v. Finanzamt Landau*** (Case C-382/16) of May 2018, which is not in line with the comments in paragraphs 142 and 143 of the discussion draft.

Interestingly, in ***Anon v. Tax and Customs Authority*** (Case 55/2012-T, 2012-Arbitration Court), the court agreed that an implicit guarantee (without a formal guarantee or legal agreement) by the cash-rich subsidiary to the cash-poor parent existed in the cash pooling arrangement, and imputed taxable value to the implicit guarantee.

Captive insurance

In Box E.1, the discussion draft questions the existence of captive insurance, the actual risks and functions of an insurer. Numerous US captive cases, including ***Rent-a-Center and Affiliated Subsidiaries v. Commissioner of Internal Revenue*** (142 T.C., No. 1, 2014), ***Securitas Holdings v. Commissioner of Internal Revenue*** (Memo. 2014-225), ***Kings River Commodities v. Commissioner of Internal Revenue*** (US Tax Court Docket, No. 010448-17), ***Avrahami v. Commissioner of Internal Revenue*** (149 T.C., No. 7, 2017), ***and Reserve Mechanical Corp. v. Commissioner of Internal Revenue*** (T.C. Memo., 2018-86) describe the factors for insurance to exist in the context of

a captive (actuarial risk of loss, shifting the risk of loss, and the distribution of risk via pooling over different claims) in the commonly and accepted sense.

Box E.3's example of a high street retailer of consumer technology goods mirrors the UK case (***DSG Retail Limited v. HMRC***, UKFTT 31, TC, 2009), which allocated the combined insurance profit between the insurer and the sales agent.

The impact of local case law
Ultimately, if the discussion draft is adopted by the G20/OECD inclusive framework and becomes law or practice in various countries, local case law from one country may impact the tax law and national fiscal policy of another country. By implication, local case law helps to inform the OECD Committee on Fiscal Affairs, which published the discussion draft and BEPS actions, which revenue authorities ultimately help promote into local country tax and TP law. Post-BEPS, local country tax and TP case law matters have taken on greater importance, even if they are not legally precedential in other jurisdictions.

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Stan Hales is a transfer pricing partner and economist in the Deloitte tax practice, based in Australia. With over 20 years of experience, Stan collaborates with his clients to solve transfer pricing and tax-related valuation problems, with a focus on the banking and financial services industry.

Stan's clients include primarily commercial and investment banks. Stan led an intragroup bank branch funding project for compliance and documentation under the authorised OECD approach for attribution of profits to permanent establishments, which led to a bilateral advanced pricing agreement on the branch capital, interest expense and local deductions.

Other clients include real estate investment trusts, investment managers, private equity firms, insurance companies, brokerage firms, trading companies, finance companies, and treasury operations at technology, media and pharmaceutical companies. The valuation analyses cover loan valuations, diverse intercompany fees, insurance premia, commissions, credit spreads, guarantees and interest rates on loans, as well as royalty modeling and cost-sharing analyses for intangible property, and cost allocation studies.

Stan's tax controversy experience includes IRS field exams and appeals proceedings; preparing mutual agreement procedure submissions to revenue authorities such as the US Internal Revenue Service, the Australian Taxation Office and the Japanese National Tax Agency; preparing rebuttal papers concerning proposed tax adjustments; and negotiating bilateral advance pricing agreements with revenue authorities.

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Training initially with HMRC, John Henshall became a Deloitte UK partner in 2001. He was the UK firm's lead transfer pricing technical partner, and represented Deloitte UK to HMRC on transfer pricing policy and technical matters until he relocated to Denmark in 2019. John represents Deloitte UK before OECD Working Parties 1 and 6, dealing with permanent establishment and transfer pricing issues. During the BEPS initiative, he contributed significantly to the revision of Chapter VI of the transfer pricing guidelines, the PE definition and the branch allocation rules.

In addition to client work, John has consulted for several governments concerning both compliance with their tax legislation and legislative changes resulting from BEPS whilst remaining attractive to business investment.

John publishes regularly. He is the author of Global Transfer Pricing: Principles and Practice (2nd and 3rd Editions) [Bloomsbury Professional] and a contributing author on transfer pricing to Ray, Partnership Taxation [Lexis Nexis, Tolley].

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