Financial transactions: A complex landscape for taxpayers and tax authorities

Mo Malhotra, Ariel Krinshpun and Ockie Olivier evaluate how the OECD guidance on financial transactions will influence an increasingly convoluted transfer pricing environment.

In 2012, the G20 nations called on the OECD to develop an action plan on base erosion and profit shifting (BEPS). A number of actions in the OECD's BEPS Action Plan can have an impact on financial transactions, and of particular note are Actions 2 (neutralising the effects of hybrid mismatch arrangements), 4 (limitation on interest deductions) and 8-10 (transfer pricing). The potential for complexity, inconsistency, controversy, and double taxation to arise from the interrelation of measures targeted at financial transactions should not be underestimated. Such challenges are created by the BEPS initiative, varying local implementation, and its combination with pre-existing and other anti-avoidance rules in many territories.

Achieving consensus amongst OECD member countries on transfer pricing (TP), in particular, took longer than anticipated. This may have to do with the complexities of seeking consensus amongst member states on what exactly is an acceptable arm's-length standard, when it comes to a financing transaction. The non-consensus discussion draft released in 2018, prior to the final OECD guidance on financial transactions (the guidance) ultimately released in February 2020, received over 1000 pages of responses. In many cases, commentators expressed concerns about the inconsistency of approaches adopted to date by fiscal authorities, subjectivity inherent within many concepts, and the apparent incompatibility of certain concepts with domestic laws.

The guidance, to achieve the stated aim of contributing to "consistency in the interpretation of the arm's-length principle and help avoid transfer pricing disputes and double taxation", needed to address these points.

Overall, the guidance is welcome, in the sense that it is the first attempt at consensus multi-jurisdictional guidance in this space, but subjectivity remains, and the interpretation of the guidance by taxpayers and tax authorities may differ.

We reflect below on some of these aspects, which leaves space for interpretative differences.

Accurate delineation

The guidance requires an examination of the contractual terms and the characterisation of financial transactions, the relative functions performed, assets used, and risks assumed by the parties, along with an evaluation of their business strategies and economic circumstances. This helps to evaluate whether a "purported loan should be regarded as a loan", with the implication that it may be regarded as something else, for example, equity.

An analysis of the conditions that independent parties would have agreed to in comparable circumstances is therefore necessary. The guidance states that where the entity providing funding, lacks the capability to perform, or does not in fact 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 that it is entitled to retain.

In this evaluation, documentation is important. The guidance refers not only to the group's financial policies, including pre-existing loans, shareholder interests and the actual loan instrument, but also to the behaviour of the parties and the actual conduct and economic principles that govern their relationship.

The taxpayer, however, is left to establish a number of matters, for example:

- How to allocate a risk adjusted return? If the guidance in this context applies to a transaction, it may imply a 'third' jurisdiction, not party to the tested transaction, performs the aforementioned lending activities and so may be entitled to a return. This risks income imputation in the 'third' territory, and an associated need to seek relief. Traditional treaty relief mechanisms may not prove to be adequate if this eventuality arises.
- What are the counterfactuals, or options realistically available? A recent international tax case concerning a long-term loan highlighted the increasing scope of the economic factors to be considered in pricing inter-company loans, particularly in loan relationships between a subsidiary and its wider group, as well as the borrower's hypothetical alternatives.

  The court held that an independent borrower in similar circumstances could have provided security and operational and financial covenants to acquire the loan, which would have resulted in a lower interest rate. On appeal, the court also considered the availability of an explicit parental guarantee being obtained. Ultimately, in deciding against the taxpayer, the court took into account the group's policies regarding financing arrangements, among other things.

Differing perspectives

The guidance places emphasis on examining not only the borrower's perspective, but also the perspective of the lender. On the part of the borrower, the relevant functions would usually include ensuring the availability of funds to repay the principal and the interest on the loan on time, providing collateral, if needed, and fulfilling any other obligations derived from the loan contract.

From the lender's perspective, the guidance requires an assessment of the lender's decision to make a loan, how much to lend, and on what terms. This will involve an evaluation of various factors relating to the borrower, economic factors, and other options realistically available to the lender for the use of the funds.

This leaves the potential for challenge. For example, it can lead to a scenario where a lender provides funds within a group, marking the best outcome for the group. Cash is moved internally from one entity to another – but in isolation: the lender could have achieved a better outcome, notwithstanding that may have meant that the group or borrower may have then had to source funds externally to fulfil the borrower's need, leaving the group worse off overall.

In this context, there are risks associated with evaluating every option realistically available to the lender outside the group, and there may be points to articulate in defence of the position around why a lender may accept a worse alternative on an individual transaction, to obtain wider benefits of group membership. Subsidiaries are rarely islands, disconnected and alone, and therefore the broader group context may be important.

In the case of cash pooling, and drawing that wider, the treasury function – the guidance is detailed, and international case law may provide helpful precedent. A particular case concerned the arm's-length pricing policies applicable to cash pooling arrangements and the remuneration for the cash pool operator. That case showed that the appropriateness of an economic analysis turns on the facts of not just one party, but its relationship and interaction with the counterparty and wider corporate group. The tax authority argued that depositing cash with a third-party bank is not comparable to depositing in an inter-company pool. The pool was riskier than the bank, given the group's weaker credit rating. The court in question upheld this assessment, but reaffirmed the principle that the creditworthiness of the cash pool leader should, in this case, be assessed by reference to that of the group as a whole.

Recharacterisation

The guidance conceives a situation where some or all of a debt advance may need to be recharacterised as equity, and states that "the following economically relevant characteristics may be useful indicators, depending on the facts and circumstances: 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 failure of the purported debtor to repay on the due date or seek a postponement".

In another section, the guidance states that "between associated enterprises the contractual arrangements may not always provide information in sufficient detail or may be inconsistent with the actual conduct of the parties or other facts and circumstances".

This leaves open room for challenge and interpretation. So going forward – comprehensive documentation of intention, conduct, and the terms governing a relationship are advisable to avoid ambiguity.

On characterisation, case law may again provide insights. The US in particular has a rich history with respect to debt vs equity characterisation. For example, in a case going back as far as 1968, a decision was upheld to recharacterise debt as equity. The opinion cited 16 factors that had been raised by courts and commentators to address the issue, and the case established a framework not inconsistent with the accurate delineation framework within the guidance.

More recently, in a 2018 case, the court presented a 14 factor analysis on this point. The decision upheld that the instrument was debt, and focused on the conduct of the parties and the substance of the transaction. In particular:

- There was a legally binding agreement that had the conventional terms typically observed in commercial loan agreements;
- The lender could reasonably expect repayment at the time of issuance given that the borrower had the capacity to service the debt with internally generated cash flow. In addition, expert witnesses provided testimony supporting the creditworthiness of the borrower; and
- Both parties treated the transaction as debt, as demonstrated by conduct consistent with that of a borrower and lender. In addition, the group demonstrated a history of respecting and treating its intercompany loans as debt.

Challenges around characterisation may be set to increase in the future and lead to risks of double taxation. Furthermore, experience suggests that even where agreements are reached around characterising certain amounts as equity, challenges can arise on subsequent repayments, with tax authorities potentially taking the view that any repayment is first set against the arm's-length debt proportion of the instrument, unless there is clear evidence to the contrary.

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Impacts of association

For the first time, the OECD provides a detailed commentary on the potential impact of group membership on the creditworthiness of a borrower in the context of a financial transaction. This concept suggests that a borrower may be able to obtain preferable commercial terms from prospective lenders as a consequence of being a member of a larger corporate group. This is where, for example, lenders expect that a borrower could call upon other members of the group to provide financial support when facing difficulties, and lenders perceive such support is likely to be forthcoming.

Implicit support may have a significant impact when assessing a borrower's creditworthiness, and the guidance establishes that qualitative factors, such as the potential

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benefit of implicit support, should be borne in mind when performing a credit rating exercise for the borrower..

The fact that implicit support may influence the pricing of a controlled transaction contrasts with the general TP assumption of mutual independence between related parties, and has thus been a source of differing interpretations. This can be noted by comparing legal cases in different countries which have, for example, demonstrated differing views as to the extent to which the impact of implicit support should be considered in a TP analysis.

Nevertheless, there is an increasing tendency to take implicit support into account in a number of countries where the new guidance is not contradictory to local law, or indeed where law is silent on the point. In such countries, tax authorities may challenge businesses that do not take implicit support into account following the issuance of the guidance, resulting in potential disallowances of financing costs.

It should be noted that a number of jurisdictions have specific domestic legislation which may restrict the ability of taxpayers to factor in implicit support and therefore need to use stand-alone, rather than group, credit ratings.

The degree to which implicit support may be relevant is explicitly recognised as a matter of judgment, which is a helpful acknowledgement, but leaves room for significant interpretation. This, combined with differing domestic legislative approaches, may increase risks of inconsistency and double taxation.

Conclusion

Overall, the guidance is welcome as it provides a number of helpful clarifications, and in many instances, reaffirms approaches that have historically been adopted in practice or established through case law. However, we have highlighted above just a few of the areas where differences in opinion may arise.

Some multinational enterprises may take the approach of proactively reflecting the guidance, as far as possible, within corporate policies and documentation. However, even this may not fully remove all uncertainties and, in some cases, it may be necessary to resort to mutual agreement procedures (MAPs), if available, following a tax authority audit. For such processes, given the increase in potential points of difference, the process to arrive at mutually agreeable outcomes between tax authorities is likely to become more complex and challenging to navigate.