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Financial transactions transfer pricing

Revisiting global intra-group funding

Guidance on transfer pricing issues on financial transactions leaves much open to interpretation. Individual jurisdictions develop and implement their own approaches. Recent developments, including legal cases, mean that groups may need to revisit their global intragroup funding profile.

Key points:

- Tax authorities are taking **greater interest in transfer pricing for financial transactions**, particularly where a jurisdiction is a 'capital importer' and so would tend to have interest expense paid out of that jurisdiction. This is inspired by both the G20\ OECD's work on Base Erosion and Profit Shifting ("BEPS") around transfer pricing, and case law developments. Companies are advised to expect further interest from tax authorities after the publication of the OECD's paper on financial transactions, expected later in 2018.
- Tax authorities also have **more information than ever**, as a result of disclosure requirements such as Country by Country Reporting ("CbCR"), and Master files and Local files, and the degree of sophistication applied in working financial transactions transfer pricing cases is increasing as, for example, more tax authorities gain access to specialist benchmarking software.
- Inter-company **financial transactions are under scrutiny** and changes in one tax authority's views can lead to expensive and time consuming audits and potential double taxation if treaty mutual agreement procedures are not available, ultimately resulting in significant unanticipated tax exposures.

Companies that have not examined their financial transactions transfer pricing position for some time are advised to reflect and ensure that consistent policies exist around intra-group funding that are documented and evidenced as arm's length.

This is most often done at the same time as businesses consider the potential impacts of rules around hybrids, interest limitations, withholding taxes, amongst other things, all which serve to potentially limit interest deductibility.

Financial transactions transfer pricing

Rapid pace of change, differing approaches by tax authorities, and enhanced scrutiny, creates challenges.

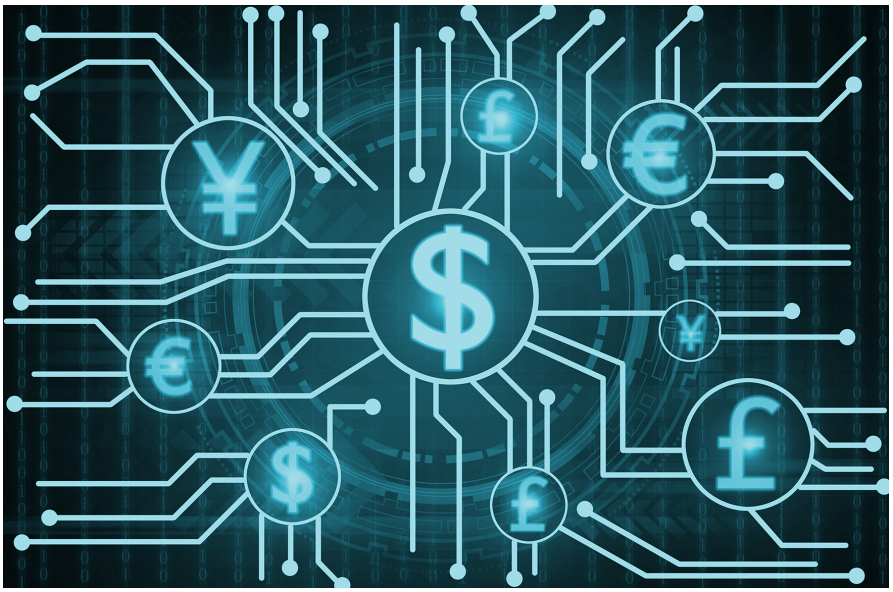
Evolving landscape for a challenging topic

Regulatory and legislative changes
The arm's length standard remains the principle applied to intercompany transactions.

Views on the interpretation of the arm's length principle may differ between tax authorities and companies. Common themes are a strengthening focus on substance and risks in order to support profit attribution

This focus extends further to encompass options realistically available, actual ability to control and bear risks through making decisions, and the behaviours of the transacting parties. This is notwithstanding the contractual terms of the transaction.

The latest 2017 OECD Transfer Pricing Guidelines elaborate on transactions relating to goods and services, intangible property and business restructurings, but the OECD is yet to publish its final guidance on financing transactions, and therefore its position remains somewhat uncertain.



The 2017 guidelines provide some helpful points of clarification, but still leave much open to interpretation. When uncertainties remain, jurisdictions continue to develop and implement their own approaches.

BEPS-inspired transaction disclosure
The final report on transfer pricing documentation and country by country reporting, released in 2015 under BEPS, sets out the Master file and Local file structure which covers group-wide treasury policies, and thus encompasses intercompany financing transactions.

In addition, the country by country report exchanged between certain jurisdictions, also requires qualifying multinational groups to disclose their intercompany transactions.

Further, a number of countries, such as the UK, Germany and Spain, also require groups above a certain size to publish their tax strategy and tax control frameworks.

These developments are in conjunction with the establishment of a global standard on automatic exchange of financial account information, and a plethora of multilateral instruments (such as Tax Information Exchange Agreements and the Multilateral Convention on Administrative Assistance in Tax Matters).

Collectively, these new developments require businesses to be transparent with tax authorities and provide information for tax authorities to assess intra-group financial transactions. The number of multilateral audits is also set to rise as a result.

Transfer pricing documentation under the OECD Master file and Local file structure requires information on a group-wide treasury policies, including intercompany financial transactions.

Ample information for tax authorities to assess intra-group financial transactions.

Jurisdiction specific legislation and case law

There is also various jurisdiction specific legislation and tax authority interpretations, which will almost certainly create further uncertainties and complications.

For example, whilst reducing taxpayers' administrative burden, safe harbour rules in various countries may also undermine the consistency, and potentially the robustness, of the taxpayers' group-wide transfer pricing policy on intercompany financing.

Regarding case law, *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation [(2017) FCAFC 62]* highlights the increasing scope of the economic factors to be considered in pricing intercompany loans, particularly in loan relationships between a subsidiary and its wider group, as well as the borrower's hypothetical alternatives in arm's length circumstances (further detail included on page 4).

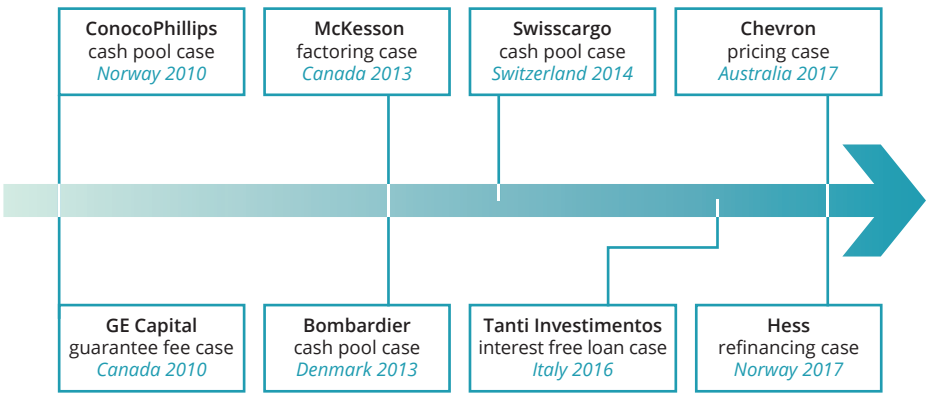
In addition, transfer pricing issues must always be considered alongside other legislation that impacts financial transactions, such as interest limitations, anti-avoidance rules that might limit deductibility, and withholding tax rules that may impact different instruments in different ways. Much of this wider set of rules has also undergone wholesale change in many jurisdictions as a result of BEPS.

Separately, *Bombardier v Danish National Tax Tribunal [(2013)]* concerns the arm's length pricing policies applicable to cash pooling arrangements and the remuneration for the pool operator. This case shows 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 the wider corporate group (further detail included on page 4).

An increasing amount of international case law exists and may be used by tax authorities as a reference point in considering the arm's length principle for financial transactions.

Intercompany financing transactions are clearly on tax authorities' radar. For those who have historic support for their intercompany financing transactions, it may be time to check whether the existing arrangements remain appropriate.

Timeline of landmark cases involving intercompany financing transactions



Intercompany financing transactions are clearly on tax authorities' radars

What's that got to do with the price of a group's intercompany debt?

Imperfect information

Commercially, the pricing of financing transactions is influenced by many factors including the embedded risks, collateral, currency, and prepayment features.

It is likely that multinational enterprises will have many external financing activities, which may potentially be economically comparable and thereby usable for transfer pricing purposes.

However, the bespoke nature often associated with intercompany financing means that third party transactions involving the taxpayer could be considered economically non-comparable; externally, details of any potentially comparable transactions are often opaque.

As a consequence, the increasing reliance on secondary corporate bond market information may necessitate various adjustments to boost comparability to the tested financing transaction.

The impact of such adjustments can be significant – the chart below shows the spread between AA rated and BB rated US$ benchmark curves is 2.39% at a 10 year tenor, but decreases to 0.96% at a 2 year tenor. This highlights the potential impact of tenor and credit ratings on the pricing of an intercompany financing transaction.

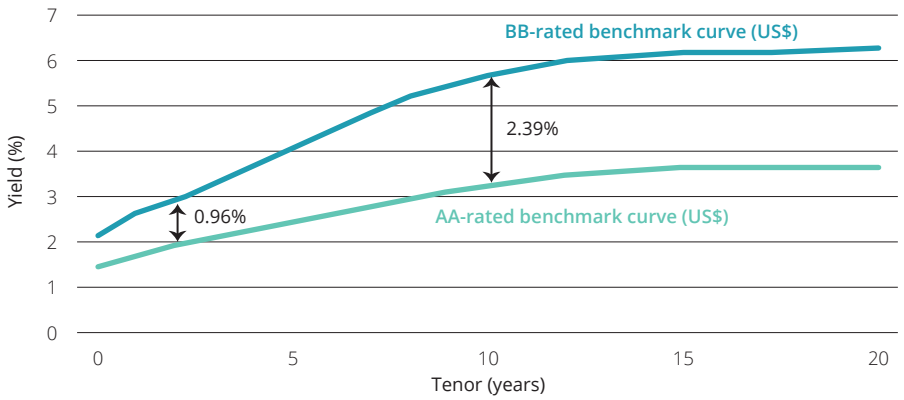
Articulating Function-Asset-Risk in group financing

Multinational enterprises often enter into intercompany financing transactions involving numerous countries, from the most common (loans and on-demand facilities) to the more complex (cash pools and derivatives). The desire for a consistent and easy-to-implement policy across the group may conflict with the different views from various tax authorities and increase the risk of double taxation.

From a transfer pricing perspective, a clear articulation of the functions, assets and risks of group companies party to intercompany transactions will invariably be the starting point in supporting the pricing terms. However, the delineation of economic contributions in the financing context can be nuanced and dependent on circumstantial factors, such as debt quantum, market liquidity and wider financing objectives.

In particular, internal structures such as cash pools, factoring, and guarantees can change fact patterns substantially. An equal amount of financing, as compared to an isolated intercompany loan without a guarantee, may need to be priced differently. In order to withstand scrutiny and potential challenge, groups need to demonstrate the economic soundness of the pricing basis in their transactions.

Illustration of impact and tenor and creditworthiness on pricing



Source: Thomson Reuters Eikon Data as of 16 November 2017

Case law examples – key points

Chevron Australia
A US subsidiary borrowed externally in US dollars at an interest rate of around 1.2%, with the benefit of a guarantee from the ultimate parent, Chevron Corporation. It then on-lent the funds to an Australian subsidiary at an effective interest rate of around 9% in the period under review. This interest rate was based on a stand-alone credit rating of the Australian subsidiary, using the actual terms and conditions of the facility.

The Australian subsidiary was issued with transfer pricing assessments on the basis that the interest rate on the loans was considered to be in excess of an arm's length rate. An appeal by the taxpayer was rejected.

The Australian Court concluded that it was reasonable to assume that at arm's length, the borrower would have provided the customary security and covenants, which would have significantly decreased the cost of funding of the borrower. Had the Australian subsidiary sought to borrow money from an unrelated third party, it would have likely attempted to undertake all reasonable measures to secure a lower rate. In not doing so, the subsidiary had artificially inflated its "arm's length" cost of borrowing.

The Chevron case is important beyond the context of pricing financial transactions as it considers a taxpayer's arm's length behaviour. Specifically, it is necessary to consider all the reasonable alternatives to a transaction that could be entered into instead.

Bombardier
A Danish company entered into a cash pool operated by a group company. Depositing entities received interest income at base rate minus 0.5%, and entities in overdraft were charged interest at base rate plus 1.15%. The group believed that this pricing policy was favourable to the cash pool participants when compared to the deposit and overdraft rates they would achieve with a third party bank.

The Danish tax authorities successfully argued that depositing cash with a third party bank is not comparable to depositing cash in an intercompany pool; the cash pool administrator was riskier than a third party bank as it was a member of a group with a weaker credit rating than a typical bank. The tax authorities thus deemed that the interest receivable by the Danish company should be based on the interest rates that would generally be paid by companies with a similar credit rating to the cash pool administrator. The Administrative Tax Court upheld this assessment, and reaffirmed the principle that the creditworthiness of the cash pool leader should be assessed by reference to that of the group as a whole.

Following the judgement in this case, the significance of a cash pool administrator to a group as a whole should be considered in assessing its creditworthiness (as to the extent it considered core or integral to the group, it may be able to adopt the group's creditworthiness rather than being assessed on a standalone basis); cash pool deposit rates should account for the riskier nature of pool administrator compared to a third party bank.

Why Deloitte?

With a globally co-ordinated network of international tax and transfer pricing professionals, Deloitte is able to assist groups around the world, across the entire spectrum of industries and scale of organisations, having worked with, for example, numerous S&P 500 and FTSE 100 businesses in this area.

Our deep expertise in intercompany financing and transfer pricing has been built firmly on policy design, economic analysis, in depth debt market knowledge and pragmatic documentation.

Our projects range from interest rate benchmarking studies, pricing, documentation to support filing positions, tax authority interaction, through to wholescale pricing overhaul of internal treasury operations.

We are committed to helping you navigate this complex, distinct, but vital issue.

Contacts

Shaun Austin
EMEA Leader, Transfer Pricing
Tel: +44 (0) 121 695 5011
Email: saustin@deloitte.co.uk

Mo Malhotra
Director, International Tax
Tel: +44 (0) 191 202 5511
Email: mmalhotra@deloitte.co.uk

Michael Gordon-Brown
Director, International Tax
Tel: +44 (0) 20 7007 2304
Email: mgordonbrown@deloitte.co.uk

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