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INSIGHT: Interaction Between Transfer Pricing and Capital Transactions

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Transfer pricing regulations are new to the Middle East and North Africa (MENA) region; however, we are already starting to see complex issues, challenges and opportunities relating to the definition of an arm's length provision such as:

- should capital items be included in disclosure forms and in local file documentation?; and
- does the definition of a transfer pricing provision relate to revenue transactions in one fiscal period or over a number of periods?

The OECD Transfer Pricing Guidelines—upon which new MENA transfer pricing regulations are based (OECD guidelines) do not make a distinction as to whether a transfer pricing ''provision'' is capital or revenue in nature.

The OECD guidelines are also flexible as to whether the above provision should be viewed over one fiscal year or a longer period (or indeed a shorter period). It is true that the definition of a transfer pricing ''adjustment'' (based on the provision) relates to a company's taxable profits as a result of applying the arm's length principle.

Accounting Treatment Accounting treatment provides an important starting point for assessing the characteristics of many non-vanilla transactions as international financial reporting standards will have been applied in assessing some of the important economic characteristics at play (for example long-term contract accounting for projects that span for longer than one fiscal period).

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Attempting to run a transfer pricing argument out of step with accounting treatment is difficult (but not impossible) depending on the economic situation. That said, there are multiple examples where accounting treatment may or may not be followed for transfer pricing purposes.

In the example of stock options, should the relevant provision for transfer pricing purposes commence at the time of grant, vest or exercise of the option? Legal ownership passes at exercise but the economic right passes at the time of grant.

There is also a growing concept of the ''Tax Balance Sheet''—in particular for financial institutions (one common example is with respect to the trading book being recognized at the head office level for legal/accounting purposes and at the branch level for tax purposes—or maybe a split between head office and the branch).

Tax administrations in the region are requesting transfer pricing information to be filed (either at the time of the tax return or in subsequent months) and it is important that multinational enterprises (MNEs) consider this in their disclosures and ensure that nothing is overlooked from a tax perspective.

Market Penetration Strategy It is common in the region to see start-up losses in the early years of an entity/venture and it might be relevant to view this type of provision over the first two–three years of the venture and not on an annual basis. Tax administrations may accept the taxable loss in early years if it can be shown that the entity has a forecast plan for improvement in coming years.

Internal Revenue Service regulations by way of comparison state that to qualify for ''market penetration'' you have to present a comparable transaction where uncontrolled parties agreed to allow for losses for a certain period for penetrating a similar type of market.

The recent L'Oréal case provides some further clarity on this argument:

- L'Oréal in India is engaged in manufacturing and distribution of cosmetics and beauty products applying the resale price method (RPM) by benchmarking the gross margin against that of comparables;
- the tax administration rejected the RPM on the basis that L'Oréal India was (consistently) incurring losses and the gross margins cannot be relied upon because of product differences in comparables. Accordingly, the tax administration applied the transactional net margin method;
- L'Oréal argued that the losses were due to a market penetration strategy in India and should be considered as an arm's-length provision. The comparables had been released on the Indian market for a longer period than L'Oréal and had established themselves more firmly in the Indian market;
- the Appellate Tribunal observed that L'Oréal India buys products from its parent and sells to unrelated parties without any further processing. According to the OECD guidelines, in such a situation, RPM is the most appropriate transfer pricing method;
- L'Oréal India had also produced evidence from its parent that margin earned by the parent on supplies to L'Oréal India was 2%–4% or even less;
- the Appellate Tribunal found that profit earned by the parent was reasonable at arm's length and hence there was no shifting of profits by L'Oréal India to its parent.

Thin Capitalization Most readers will be familiar with thin capitalization rules which result in adjustments to the level of interest deductions based on a deemed amendment of the capital funding structure (e.g. tax administrations could challenge the balance of debt/equity and make re-characterizations to restrict interest deductions).

It is a fact that profit-based ratios (interest cover and debt to profits) are becoming more important to investors and therefore more relevant at arm's length. However, there are still challenges to the overall intra-group debt structure based on transfer pricing principles.

Intellectual Property The plethora of case law in this area could be the subject of a further article in itself but, to summarize, it is common to see challenges to license fees and buy-in payments based on a challenge to the net present value of the underlying intangible assets based on transfer pricing principles. This is a classic example of capital transactions being challenged under transfer pricing regulations and leading to tax adjustments.

Business Restructuring and Re-Characterizations The recent Cameco case highlighted the dangers of a potential re-characterization of a structure by tax authorities.

In this case, the Canadian mining company, Cameco Corp., sells uranium to a wholly owned trading hub, Cameco Europe Ltd., registered in low tax jurisdiction, Switzerland, which then re-sells the uranium to independent buyers. The parties had entered into a series of controlled transactions related to this activity and as a result the Swiss trading hub, Cameco Europe Ltd., was highly profitable.

The tax authorities contended that this was:

- a sham transaction;
- requiring re-characterization due to non-arm's length pricing that was not commercially rational; and
- non-arm's length requiring a transfer pricing adjustment.

The courts disagreed on all three counts with the following important distinctions:

- sham—requires an element of deceit whilst this was a commercial/legal structure and ''the legal foundation of a tax plan'';
- commercially rational in all cases—re-characterization may apply where arm's length parties would not have entered into the transaction or series on any terms or conditions but instead would have entered into an alternative transaction or series. The court cautioned that comparability analysis lies at the heart of the transfer pricing rules and, as a result, any alternative transaction or series identified must be constructed with due regard for all the relevant circumstances in which the actual transaction or series was entered into;
- transfer pricing analysis was robust and in line with the OECD guidelines.

Re-characterizations of the above nature in which revenue and capital transactions are ignored are not common and the OECD confirms that this should only be relevant in exceptional circumstances.

U.K. Case Law and the OECD Guidelines—Union Castle Recent case law in the U.K. highlights the interaction of local regulations with the OECD guidelines.

In this case Union Castle Ltd claimed a 40 million pound ($50 million) tax deduction/loss relating to the write-off of a debit arising from the ''derecognition'' of a financial asset (cash flows from certain FTSE based derivative contracts).

Central to the ruling was the discussion of whether capital transactions are subject to transfer pricing regulations and the ruling cited paragraphs 7.9 and 7.10 of the OECD guidelines:

''In our judgment, the distinction drawn in the OECD Guidelines between shareholder and non-shareholder activity does not operate as a blanket exclusion from the ambit of ''provision'' for the purpose of [local law] concerning share capital between associated persons. Paragraph 7.9 of the Guidelines is concerned with what is described as a narrow range of cases where an activity is performed by a group company because of its ownership interest in one or more group members, but where that activity is not needed by the other group members and would not be paid for by them if they were independent enterprises''.

The tax authorities disagreed that a tax loss had been suffered at arm's length and issued an assessment disallowing the loss and the Tribunal found in favor of the tax authorities listing the following:

- capital transactions are subject to the U.K. transfer pricing rules;
- issuing of shares meets the requirements of ''making or imposing conditions in commercial and financial relations'' as required by Article 9 of the OECD Model Convention;
- OECD guidelines apply to debt financing; and
- share transactions, which have an effect on income taxation, must be within the U.K. transfer pricing rules.

Note that whilst local transfer pricing regulations may contain specific elements relating to the definition of a provision, any case law judgment that refers to the OECD guidelines will have application to other jurisdictions.

Planning Points Transfer pricing adjustments will certainly impact taxable profits in at least one financial year—however, as the examples above demonstrate, transfer pricing should not be viewed (solely) as a revenue concept over one fiscal period.

Tax administrations may be able to make adjustments to capital items through transfer pricing regulations (and the knock-on effect would have impact on annual taxable profits).

MNEs may also be able to set transfer pricing policy to align with the economic realities of the specific business (e.g. long-term contracts, development projects, market penetration strategies, etc.).

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