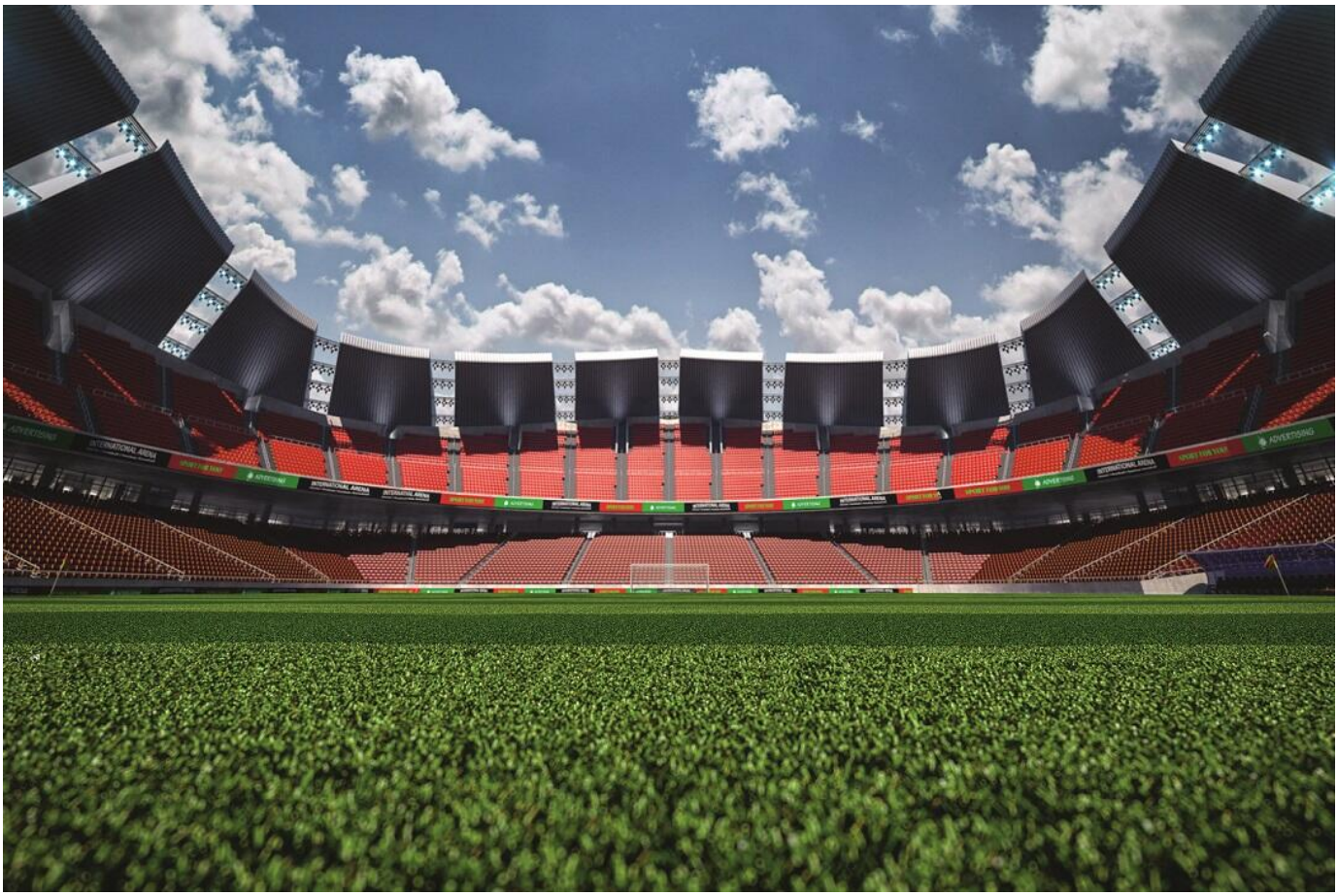
# The new arena

Large Corporate



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*Jo Myers* shares some recommendations for managing risk with transfer pricing of financial transactions

## Key Points

### What is the issue?

Transfer pricing of financial transactions has become a key area of focus by tax authorities. This is seen in the growing number of high-profile tax cases

(GE/McKesson/Conoco) and tax audits in multiple territories

**What does it mean to me?**

Faced with this new environment, multinationals need to review their policies for pricing intra-group transactions and develop globally consistent policies aligned to the developing BEPS agenda

**What can I take away?**

Develop a strategy to manage the increasing risks including designing robust transfer pricing policies, implementing them globally, creating high quality transfer pricing documentation and understanding the options for handling tax audits

Historically, intra-group financial transactions were generally subject to less tax authority scrutiny than those relating to goods or services. But the global financial crisis prompted tax authorities to develop their expertise in this area and a marked increase worldwide in the number of tax audits has resulted. There have also been numerous high-profile tax cases on the transfer pricing aspects of financial transactions, including *General Electric Canada v The Queen* (intra-group guarantees), *McKesson Canada Corporation v Her Majesty the Queen* (debt factoring) and *ConocoPhillips and Bombardier* (cash pooling).

In addition, the Organisation for Economic Co-operation and Development (OECD) project to counter base erosion and profit shifting (BEPS) is expected to have a huge impact on the transfer pricing of financial transactions. The key BEPS actions likely to affect intra-group transactions include:

- action 2 (neutralise the effect of hybrid mismatches);
- action 3 (strengthen controlled foreign companies (CFC) rules);
- action 4 (limit base erosion via interest deductions and other financial payments);
- action 5 (counter harmful tax practices);
- action 8 (intangibles);
- action 9 (align transfer pricing outcomes with value creation: risks and capital);
- action 10 (low value adding services); and
- action 13 (documentation).

The OECD has recognised the likely impact of BEPS on intra-group financial transactions and is planning to publish detailed guidance.

These changes coincide with multinational groups entering into increasingly sophisticated intra-group financial transactions. The factors for these trends include globalisation, the need to maximise the use of internal cash resources and the desire to manage financial risks better. As a result, more multinationals than ever have cash pools and centralised treasury operations. Since the financial crisis there has also been a tendency for parent companies to provide financial guarantees for their subsidiaries' third party borrowings, creating transfer pricing risk on guarantee fees payment.

The combination of a sharper tax authority focus on the transfer pricing of financial transactions and the increasing scale and sophistication of intra-group financial transactions has created an environment of unprecedented risk.

## Costs of transfer pricing adjustment

The costs of suffering a transfer pricing adjustment on an intra-group financial transaction can be high and extend well beyond the payment of additional tax.

For example, consider a typical intra-group loan which is put in place for five years where a tax authority raises an enquiry in year two of the loan. Given most enquiries take between one and two years to resolve, an adjustment may be agreed on the loan in year four. The adjustment then has a retrospective application, leading to additional tax, interest and potentially penalties. Any adjustment creating double taxation will take longer and cost more to resolve. For some groups, there will be reputational as well as financial implications arising from such adjustments.

## Risk management strategy

Given the changing environment and heightened risk of adjustments, multinationals are considering how best to react. The primary tasks are to develop robust transfer pricing methodologies that can be implemented consistently worldwide and to create documentation aligned to the latest OECD requirements. It is also important to recognise the areas that tax authorities are most likely to challenge and understand the options for dealing with their audits.

## Transfer pricing documentation

Under BEPS action 13 guidelines there are heightened requirements for transfer pricing documentation, including for financial transactions. As a consequence, multinationals are reviewing their transfer pricing methodologies for pricing intra-group debt and other intra-group financial transactions such as guarantee fees to ensure they are aligned to tax authority expectations. To support this they are creating documentation in the OECD prescribed formats.

It is important for groups to develop and implement transfer pricing methodologies consistently worldwide or face being made to justify inconsistencies. There have been instances of a tax authority challenging a group for using different public information databases for benchmarking similar transactions in different regions and obtaining adjustments on the basis of using a single database.

## Key stakeholder alignment

It is increasingly important that tax, treasury and business staff are involved in decision-making on intra-group financial transactions and that this is documented internally. Tax authorities often ask to see contemporaneous documentation supporting the commercial rationale for making a particular intra-group loan. The authority will have assumed that treasury and business people will have been involved in a loan that is a bona fide commercial one (as opposed to having a BEPS element).

## Recent audit experience

In the past, the most likely areas of challenge were on interest rates on intra-group loans (and in particular whether and to what extent group affiliation should be a factor) and in some jurisdictions thin capitalisation (whether a loan is in substance debt or equity). The likely areas of challenge have expanded in recent years. For example, tax authorities now regularly challenge the terms and conditions attached to a loan other than the rate, including duration and whether the debt is amortising. Tax authorities are also challenging other areas of intra-group financial transactions. These could include the level of guarantee fees if a parent or the other group companies provide financial guarantees for a subsidiary’s debt, the transfer pricing for cash pool arrangements and the arm’s length level of reward for group finance companies based on analysis of their functions and risks.

## Managing tax audits

Multinationals being challenged by tax authorities in one or more jurisdictions need to fully understand all the options for handling a transfer pricing dispute in the area of financial transactions. These can be broken down into reactive and proactive measures.

Reactive measures are taken when a tax authority has opened an enquiry and an adjustment has been agreed. These include accepting the adjustment, which will most likely result in accepting any double taxation created by it, and may be feasible in small cases. They also include appealing to an independent tribunal or making a claim for relief under a double taxation treaty.

Proactive measures are taken to manage the risk of a subsequent enquiry and include unilateral and bilateral advance pricing agreements (APAs). A unilateral APA will provide certainty in one country only; but a bilateral APA will provide certainty on both sides of a transaction. For some transactions that are large or complex, an APA can be a valuable way of managing the increasing risks attached to intra-group financial transactions.

In some jurisdictions it is possible to access the relatively new dispute resolution mechanism known as a joint tax audit. The basic principle of this is that two tax authorities simultaneously audit a particular transaction to share relevant information and negotiate an agreement, including with the participation of the group. In a pilot study recently, the German tax authority carried out a joint tax audit of a group financial transaction with its Dutch counterpart. The outcome was positive, with double taxation avoided and the dispute settled within a year. It is likely that more tax authorities will be prepared to enter into joint tax audits since they may present an efficient way to resolve disputes in many cases.

## Risk management recommendations

The rapidly changing tax environment for intra-group financial transactions, combined with the increasing size and sophistication of intra-group financial transactions and treasury operations, suggests that groups need to develop enhanced strategies to manage risk in this area.

The key elements for such a strategy may include:

1. Designing robust transfer pricing policies for financial transactions and implementing these consistently worldwide.
2. Creating transfer pricing documentation for financial transactions in line with the latest OECD requirements.
3. Developing a strategy for handling tax audits in view of all available options.
4. Ensuring that tax, treasury and business staff are involved in making decisions on intra-group financial transactions and that this is documented internally.