Intercompany financing transactions
A growing source of transfer pricing risk
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About our series

As we noted in the first article of our “Eight for 2018” series studying transfer pricing risks, “… whatever year it is, the leading cause of risk in successive EY Tax Risk and Controversy Surveys is perennially agreed to be transfer pricing (TP).”

In that first article—which studied the transfer pricing challenges around the sale or transfer of intellectual property (IP)—we noted that “while the majority of the transfer pricing risks identified in this series are not new in nature, companies should expect that these issues will either resurface or grow with renewed vigor, given that tax administrations are now far better able to identify potential transfer pricing issues.” That is certainly true of our second topic—that of intercompany financial transactions (ICFTs).

Our series of articles is available online for your convenience at: taxinsights.ey.com/archive/archive-articles/8-challenges-to-consider-in-transfer-pricing-risk.aspx and a description of each of the eight pieces is included at the end of this report.

A fast-growing area of transfer pricing scrutiny

While many companies raise money on the capital markets, the way in which they then use ICFTs to efficiently capitalize their businesses around the globe represents the lifeblood of a multinational enterprise’s (MNE) operations, impacting companies in every sector.

But over the last few years, a recently increased focus on the transfer pricing treatment of ICFTs is driving a new phase of tax disputes, with few signs emerging of consistency of treatment between jurisdictions, despite the work of the Organisation for Economic Co-operation and Development (OECD) to address this complex issue.

These challenges are well known to standard setters and policymakers sit at the center of many new transfer pricing recommendations being implemented as a result of the OECD’s base erosion and profit shifting (BEPS) project. The disputes also continue to become more common in national level legal systems, with court cases progressing through many judicial systems and often into the Mutual Agreement Procedure (MAP program). But at the same time, taxpayers are struggling to make full sense of the changing environment and to understand what is or is not now acceptable.

All hands to the pump

The dissimilar approaches adopted by the various tax authorities within transfer pricing audits, and the need to have distinct transfer pricing solutions for specific industry sectors have both highlighted that taxpayers need to be proactive in managing their transfer pricing risk in this area.

3 July 2018 saw the OECD release its first public discussion draft on the transfer pricing aspects of financial transactions. This draft has attracted a strong response from both the nonfinancial and financial services sectors.

The discussion draft represents the first official OECD comments and proposals on the transfer pricing aspects of financial transactions. Although the Discussion Draft is a non-consensus document, it provides insight into the OECD’s direction of thinking. Most global businesses are involved in financial transactions, and therefore the guidance will be relevant for them. With the OECD having received public comments to the Discussion Draft from almost 80 interested parties in early September 2018, the next step is for that organization to issue a public consensus discussion draft by the beginning of 2019. The ultimate plan of the OECD is to reach a final agreement at the respective working party level by April 2019.

Common challenges related to ICFTs

One of the most common financial transactions involves establishing the interest rate for an intercompany loan. However, this also involves determining the supportable “arm’s-length” quantum of debt, i.e., pricing the loan terms as if it had been made at arm’s length, for which a debt capacity analysis is commonly performed.

While some jurisdictions may have a specific thin capitalization regime that sets these parameters more definitively, the tax regulations in other countries support a more flexible spectrum of acceptable debt-to-equity ratios, so long as the taxpayer has undertaken an appropriate analysis that establishes their leverage parameters.

Intercompany guarantees, meanwhile, if not accompanied by appropriate transfer pricing support, can also have significant repercussions during a tax audit. Once detected, guarantees can be highly material and are some of the most difficult transactions to price. Performance guarantees, which are often issued as a business need may be especially neglected from a risk management perspective, especially when coordination with the tax function is lacking. These often surface when the guarantor is called upon to make good on its obligation. Additionally, the appropriateness of interest rate on cash pooling arrangements (e.g., as featuring in the ConocoPhillips case) and support for the discount on factoring transactions (e.g., the McKesson Canada case) are being routinely scrutinized by several tax authorities, all of whom bring their own specific complexities.

On the taxpayer side, a common misconception can be that the pricing of an intercompany loan is a routine exercise. But this myth has been shattered by the “Chevron case,” where the Australian court’s decision shows the level of sophistication and rigor expected in a transfer pricing analysis to determine an appropriate interest rate, including a detailed review of the contractual terms and conditions and evidentiary issues.

Prior to Chevron, the GE Canada case revealed the Canada Revenue Agency’s preference to assess the credit rating of an entity based on its position in the overall group rather than its stand-alone financial strength. This so-called “halo effect” assumption has been acknowledged by several tax authorities, whereas some other jurisdictions continue to advocate that the true spirit of “arm’s-length treatment” should not involve an entity’s relationship with the group or the parent entity. The net effect of both cases together is to create a sea-change in tax authority approaches — not just in Canada and Australia, but among other jurisdictions around the world.

Today, divergent treatment across jurisdictions, limited data options for reliable benchmarking and a significantly increased volume of intercompany financial transactions occurring have all converged to place taxpayers in a difficult situation.

Identifying and assessing these risks, and then delivering coordination between the tax and treasury/finance departments is an important step towards well-informed decision-making in pricing financial transactions.

The subject matter of intercompany financial transactions is both broad in scope and very deep in technical complexity. This report will specifically focus on intercompany lending for nonfinancial and unregulated firms, and address the following topics:

- An overview of some common intercompany financial transactions
- A discussion of common technical issues, challenges and important considerations for taxpayers
- The perspectives of the OECD and other national jurisdictions
- A review of leading practices that companies should considering adopting in response

# Common intercompany financial transactions

ICFTs are primarily used by MNEs to fund their global operations. In many cases, the treasury department tends to be centralized, taking advantage of financial synergies that may exist within the group structure, thus reducing overall funding costs and improving group-wide liquidity.

Some common intercompany financing transactions utilized include:

- Intercompany loans: Intercompany loans tend to be the most common source of intragroup funding. Typically, the group treasury is responsible for raising funds from capital markets and then disbursing them to subsidiaries in the form of loans. The primary benefit of this activity is that it ameliorates the potential lack of purchasing power of individual entities who may otherwise have to raise funds independently; the higher credit risk or limited access to liquid markets for these entities would typically increase the overall cost of borrowing.

- Cash pooling is also a popular MNE cash management tool. Pooling excess cash available in various subsidiaries and then reallocation such funds to operations in need of funds creates an efficient structure for managing working capital. The cash pool manager acts as an intermediary (and in some cases bears additional risk by providing its own capital) and, in the process, reduces the need for external borrowing by an MNE.

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1. “Halo effect” is often used to describe the adjustment to a subsidiary’s credit rating that would result from the network benefits of being part of a large multinational group.

2. Importantly, this article approaches the above issues in the context of separate legal entities and does not discuss branch allocation.

3. These represent some of the more common intercompany financial transactions and are not meant to be exhaustive.
Factorizing of receivables is also used by MNEs to enhance liquidity, by releasing funds that might be unavailable due to non- or delayed payment by purchasers. Typically, an entity suffering from shortage of working capital may sell its receivables to a related party at a discount. The proceeds from this sale resolves the working capital requirements of the selling party, whereas the discount compensates the buyer of the receivables (i.e., the factor) for risks of non- or late payment, and any costs associated with servicing and collecting these receivables. As with other intercompany financial transactions, pricing of factoring across borders creates complex transfer pricing considerations.

Guarantees commonly take the form of financial guarantees, but may also include performance guarantees from the parent or a highly capitalized affiliate. Such guarantees may help a subsidiary secure a loan or a specific contract at favorable terms and conditions (e.g., lower interest rate on a loan or lower reserve requirement for a higher risk project). Since most of these transactions provide a direct benefit to the recipient, and a risk of potential loss/payout for the guarantor, these transactions are usually accompanied by a guarantee fee to the guarantor as compensation for its services.

Hedges are a commonly-observed form of intercompany financial transaction. An MNE may enter into hedging transactions for many reasons, including the protection of subsidiary cash flows from unexpected events. From an efficiency perspective, MNEs tend to centralize hedging to take advantage of natural offsets and hedges, thus reducing the overall cost of hedging. While this strategy increases overall group profitability, it does create ICFTs that need to be priced and documented, thus leading to the need for transfer pricing to be applied.

Insurance captives is another form of risk and cash flow management used by MNEs. Similar to hedges, insurance captives help subsidiaries manage cash flows from unexpected events triggered by specific types of risks. To the extent that these group risks are centralized, intercompany transactions are created that in turn require transfer pricing support.

For each of the above issues, EY’s detailed submission to the OECD discussion draft contains further analysis of common issues. The submission may be accessed at: http://www.oecd.org/ctp/transfer-pricing/Compilation-of-public-comments-BEPS-actions-8-10-transfer-pricing-financial-transactions-discussion-draft-part-2.pdf.

Country overview — United Kingdom

HMRC, The UK’s tax authority, has long seen itself as an ambassador for the application of the arm’s-length principle (ALP), especially in regard to the transfer pricing of related-party transactions, says Martin Rybak, a London-based associate partner in the EY Transfer Pricing & Operating Model Effectiveness network (Ernst & Young - United Kingdom).

This applies equally to financial transactions transfer pricing (FTTP). “With respect to thin capitalization, many territories rely on some form of safe harbors or earnings stripping rules. The UK’s transfer pricing rules, however, rely upon the ALP for accurate delineation of the transaction and the pricing thereof,” says Martin.

Notably the reliance on the arm’s-length standard prevails and is required prior to any application of the UK’s Corporate Interest Restriction rules, which were implemented in response to BEPS Action 4. As such, UK legislation requires all factors to be considered in evaluating the following:

• Whether the loan would have been made at all at arm’s length
• The amount which the loan would have been at arm’s length
• The rate of interest and other terms of the loan that would have been agreed at arm’s length

In consideration of the above questions, UK legislation requires the borrowing entity in the UK to be assessed on a stand-alone basis.

The application of the UK’s transfer pricing rules may therefore result in a recharacterization to reflect an accurate delineation of the transaction, typically only for transfer pricing purposes, and/or a repricing of the transaction.

HMRC takes a risk-based approach to transfer pricing. Transactions with a higher risk profile, whether so derived by complexity or materiality, will tend to attract higher levels of scrutiny. Intercompany financial transactions such as debt pricing and cash pooling have been an area of focus for many fiscal authorities, as indicated by the OECD’s non-consensus Discussion Draft on FTTP. HMRC is no exception in this regard.
Intercompany financing transactions

Identifying common transfer pricing risks

While each financial transaction should be evaluated and priced based on its own specific merits, facts and circumstances, there are some broad issues that pose challenges to tax authorities and taxpayers alike, and require deep technical analysis in order to apply the arm’s-length principle—not only to meet tax authority requirements, but also to avoid the risk of double taxation. Some of these factors are addressed below. While some of these factors are specific transactional challenges, others have asymmetric treatment across different jurisdictions. Therefore, addressing these issues must be a careful balancing act based on the authorities involved, and in each case, the transfer pricing impact(s) of each issue must be fully considered. Here are just some of the pertinent questions that must be addressed in respect to each type of transaction:

- **Intercompany loans**
  - Borrowing capacity: could the borrower have secured funds from an unrelated entity? And if so, could that have been done at a lower interest rate?
  - Structure of the debt: what is the commercial viability of the terms and conditions of the intercompany note?
  - Level of subordination: does the presence (or absence) of third-party or first-lien debt have a corresponding effect on the interest rate?

- **Credit rating**: is the rating based upon the pure financial standing of the subsidiary or is it based on its affiliation to a larger group—and therefore subject to the “halo effect”?

- **Redemption feature**: does the long-term loan include a payable on demand feature and does that affect its overall pricing (and therefore transfer pricing treatment)?

- **Cash pooling transactions**
  - Functional and risk profile of the cash pool manager: Is the cash pool provider a pure service provider, or does it bear additional credit risk?
  - Nature of the cash pool balances: are the cash pool balances short term in nature, or are they balances outstanding over a prolonged period?
  - Interest rate earned by excess cash depositors: do such interest rates accurately reflect the pooling benefits?

- **Financial guarantees**
  - Benefit of the guarantee: Is there a reduction in cost of borrowing, and if so determine by how much, and what impact this may have on transfer pricing aspects?
    - The quantum of savings would be a function of the credit rating of the borrower (whether stand-alone or halo-effect adjusted)
  - If there is no credit enhancement, then does the taxpayer need to determine how else to measure the benefit
    - Is it possible to calculate the expected loss of the guarantor?
    - Is it possible to measure the liquidity benefit from the guarantee? And is it possible to determine how to compensate for the liquidity benefit?

Australia’s Chevron case has been perceived as driving a new phase of opportunistic challenges under inquiry. However, in recognition that financial transactions are complex and that there may be opposing views on appropriate pricing approaches, HMRC has, at a policy level, indicated a desire to strike bilateral APAs for financial transactions—not only with the Australian Taxation Office, but also with other tax authorities. It is also worth noting that both the UK and Australia have committed to mandatory binding arbitration under BEPS Action 14; as such, any differences in approach will need to be reconciled—or a decision by a tribunal may decide in favor of one of the positions.

In order to provide robust support for any filing position, taxpayers should undertake a thorough analysis in order to demonstrate compliance with the ALP and confirm that transaction of all types are documented accordingly. Where further comfort or certainty is required, a clearance may be sought under HMRC’s Advance Thin Capitalization Agreement process, or where relevant, by way of a bilateral APA.

Moving forward, HMRC is likely to take guidance from the final output of the OECD’s work stream on FTTP, and any major changes in this area are likely to be driven by this, in concert with any future impact of the UK’s corporate interest restriction rules.

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Factoring transactions

- Credit risk determination: is there a need to determine recourse vs. nonrecourse factoring and who bears the ultimate credit risk? (which itself needs to be carefully factored into transfer pricing treatment)
- Servicing rights: does it need to be determined which entity will bear the servicing cost and if that should be a part of the factoring discount
- Profitability: does the factoring discount include a profit element for the factor

Hedges/captives and performance guarantees

- Regulatory issues: do any current regulatory issues exist, or do the active discussions at OECD or other regulatory bodies are under discussion. (e.g., capital requirement for a pension guarantee) impact ongoing operations?
- Capital reserve: does the risk bearer have the capacity to bear the risk —and determine the arm’s-length remuneration as a result?

Country overview —Canada: court’s decision may arm taxpayers with new approaches

The transfer pricing issues related to ICFTs have captured the attention of both the Canadian Revenue Agency (CRA) and The Tax Court of Canada (TCC), says Lisa Watzinger, a Business Tax Advisory Manager in the Canadian tax practice of EY (EY Law LLP).

The TCC, for example, recently rendered its decision in Cameco Corporation v. The Queen, 2018 TCC 195, which concerned adjustments made by the Canada Revenue Agency (CRA) by applying, in the alternative, both Canadian transfer pricing provisions: the repricing of a transaction or series of transactions (ss. 247(2)(a) and (c) of the Income Tax Act (ITA)) and the recharacterization of a transaction or series of transactions (ITA ss. 247(2)(b) and (d)). The facts surrounding the Cameco case are complex, and are set out in an EY Global Tax Alert.①

This was the first decision involving an adjustment under s. 247(2)(d). An adjustment under that provision can be made if the conditions in s. 247(2)(b) are met —namely: i) the transaction or series would not have been entered into by arm’s-length parties, and ii) the transaction or series can reasonably be considered not to have been entered into primarily for bona fide purposes other than to obtain a tax benefit. According to the Court, the test under (i) is satisfied where the transaction (or series) is not commercially rational. For a further analysis on the Cameco decision, see the EY Tax Alert 2018-33.

As described by the TCC, the recharacterization provision could apply to intercompany financing transactions if they are not commercially rational and are entered into primarily to obtain a tax benefit. However, the TCC made comments that may restrain the types of transfer pricing adjustment (or any “recharacterization”) that may be made under s. 247(2)(d). The Court stated that s. 247(2)(d) “does not authorize the Minister to recharacterize the transaction or series identified in the preamble.”

Rather, it permits the Minister to “identify an alternative transaction or series that in the same circumstances would be entered into by arm’s-length parties in place of the transaction or series and then to make an adjustment that reflects arm’s-length terms and conditions for that alternative transaction or series. Because the adjustment is based on the arm’s-length terms and conditions of an alternative transaction or series, the adjustment may alter the quantum or the nature of an amount.” The Court rejected the “recharacterization” of a transaction as proposed by the 1995 Guidelines to Article 9 of the OECD Model Tax Convention—which the 1995 Guidelines distinguish from the use of an alternatively structured transaction that can serve as a comparable uncontrolled transaction. According to the Court, s. 247(2)(d) applies only the latter approach, as its text is quite different from Article 9.

The Court’s rejection of ss. 247(2)(b) and (d) in this case and its rejection of s. 247(2)(d) as a recharacterization provision may arm taxpayers with a position that other transactions should not be recharacterized, in particular in the context of the CRA’s current project in which it has been applying ss. 247(2)(b) and (d) to recharacterize hybrid debt (treated as debt in Canada, but as equity for tax purposes in the lender’s jurisdiction—often the United States) as equity for Canadian tax purposes.

A number of broadly similar case are at various stages in the objections/appeals process in Canada, and it will likely be some time before one reaches the courts. Whether a court agrees that ss. 247(2)(b) and (d) are applicable in these circumstances remains to be seen. Hopefully the Federal Court of Appeal will provide further guidance on the scope and limits of these provisions in the Minister’s appeal of the Cameco decision. But when all is said and done, two points shine through: first, this is one of the most complex areas of work for the TTC. And second, the treatment of such issues at the hands of the CRA may well change in the future.

While the tax department is usually responsible for addressing the tax and transfer pricing treatment (and compliance) of all intercompany transactions, financial transactions can be vastly different than operational intercompany transactions in nature; for instance:

- Operational transactions are captured above the earnings before interest and taxes (EBIT), while financial transactions are recorded below EBIT.
- Operational transactions may be ongoing and recurring, requiring annual analysis and documentation. In some cases, financial transactions can involve one-off transactions that are documented at the time that the transaction is executed and not on an annual or recurring basis.

In addition to the above, there are a number of important considerations for tax departments in relation to ICFTs. In many cases financial transactions can be highly material in nature. ICFTs may be in the billions of dollars and small changes to interest rates utilized can create changes to the tax position of the related parties involved, which in turn can lead to tax consequences such as higher group effective tax rates, non-deductible penalties, and interest costs.

Another challenge for the tax department is that certain internal financial transactions may be difficult to identify. This can occur in situations where a business unit may enter into an arrangement such as a financial or performance guarantee without notifying group treasury or the tax department. Similar to intercompany lending, guarantees can be material in nature, and can subsequently create new tax exposures for the enterprise.

Another important issue for consideration involves the recent trend whereby tax departments are automating many functions, such as the operationalization of transfer pricing policies. The automation of ICFTs can present challenges due to the nonrecurring and highly bespoke nature of these transactions. In that respect, automation may not be the most efficient option, but may actually increase risk.

Country overview — India’s stance is changing

Similar to those in other emerging economies, MNEs in India have also started to increasingly undertake various intra-group financial transactions in the form of intra-group loans, guarantees, and infusions of capital through equity or through hybrid instruments including compulsorily convertible debentures, optionally convertible debentures, zero coupon bonds etc.

In order to cover such transactions under the scope of transfer pricing law, the Finance Act (2012) with retrospective effect from 1 April 2002 (Editor’s note: this is not a typographical error) widened the definition of international transactions to include transactions including:

- Capital financing, including any type of long-term or short-term borrowing, lending or guarantee;
- Purchase or sale of marketable securities; or
- Any type of advance payments or deferred payments or receivable; or
- Any other debts arising during the course of business

Therefore, intercompany financing transactions are explicitly covered under the Indian Transfer Pricing (TP) regulations. Since the enactment of the aforesaid provisions, and considering the material nature of such transactions, tax authorities in India have sought to challenge the terms of the financial transactions from a transfer pricing perspective, and continue to closely scrutinize the economic substance of such transactions.

While lower tax authorities may insist on the use of domestic interest rates for benchmarking such transactions against globally acceptable base rates such as the London inter-bank Offered Rate (LIBOR) for foreign currency lending/borrowings, appellate authorities and even Advance Pricing Agreement (‘APA’) authorities have validated globally sanctioned methods for determining the arm’s length price.

Apart from the rate of interest on a loan, other aspects which have attracted the attention of tax authorities are issues such as the purpose of the funding, and critical terms such as convertibility, moratorium on payments, etc. in order to test the quasi-equity nature of the debt and its subsequent impact on interest cost deductions and receipts.
The tax authorities are increasingly questioning the rationale for providing interest-free loan/corporate guarantees that may be issued by an Indian headquartered company to its overseas group entities for purposes such as an acquisition, initial phase of operations, etc. Taxpayers consider such funding/guarantees as quasi-equity in nature, while the tax authorities tend to take a different view, contending that an interest rate/guarantee fee ought to be charged on the same.

A moving picture

Jurisprudence on this front is still evolving and Tribunals have taken mixed views, driving tax uncertainty. Further, there is no settled position on when a guarantee is considered to be a chargeable service, nor on what the basis of computation should be. Adjustments are often made on an ad-hoc basis, without any scientific analysis in support. While the lower tax authorities often compare bank guarantees with corporate guarantees entered into between group companies, judicial developments have held that such a comparison between bank guarantees and corporate guarantees is incorrect.

An important step by law makers in attempting to provide certainty has been the introduction of revised safe harbour rules, wherein a LIBOR-based spread has been specified for outbound loans based on the currency of the borrowing and credit rating of the borrower. Further, revised safe harbour provisions have included a flat guarantee fee rate for provision of corporate guarantee transactions. But such safe harbors do not necessarily take into consideration various factors affecting the guarantee fee rate, such as purpose, tenor, etc. Further, in order to attain certainty over complex financial transactions, taxpayers have been applying for APAs. It is important to note that in FY 2017-18 alone, 11 intra-group financing transactions have been covered through APAs between tax authorities and taxpayers.

India, being an active contributor to the OECD’s BEPS project, has implemented various action plans through amendments in local law. Pursuant to Action 4, India introduced provisions which limits the deductibility of interest on borrowings from associated enterprises (AEs).

Further, as a result of Action 13, detailed information pertaining to financing arrangements and entities involved in central financing activities of the group to be reported in the Master File will further enable tax authorities to obtain a more holistic view of intra-group structures, and provide them with more data points to validate the nature of the intra-group financing transactions. In this regard, it is also important to note the introduction of General Anti-Avoidance Rules (‘GAAR’) in the Income Tax Act, wherein the tax authorities have been empowered to re-characterise debt as equity and vice versa if an arrangement fulfills certain conditions.

Taking a more global view

The Indian tax authority is gradually maturing and is increasingly referring to guidance available globally. The Draft discussion paper issued by OECD on the transfer pricing aspects of financial transactions, guidance provided by Australia’s Taxation Office on the pricing of intra-group loans, and landmark judgements such as GE Capital and Chevron are all being closely tracked by the tax authorities.

The availability of greater information to the tax authorities may likely change the nature of transfer pricing controversy, moving forward. Taxpayers can expect more questions on complex financial transactions as the government-to-government information exchange channels deepen and widen, and the Master File and Country-by-Country data become accessible globally. The Indian tax administration is also increasingly deploying technology for collection, collation and analysis of data. This would feed into a more targeted and well-designed tax policy and assessment.

In the current era of transfer pricing where Indian tax authorities and Indian Courts are examining substance over form, it will be a necessity for taxpayers to maintain robust documentation to support the judgement arrived at while determining the arm’s length nature of various intra-group financing transaction.

Comments provided by Arati Amonkar (Partner), Shraddha Doshi (Manager) and Naman Shah (Senior Consultant) all of Ernst & Young LLP.
The OECD perspective

As a part of the OECD’s and G20’s BEPS Action Plan, initiated in 2013, a specific work stream was charged with developing detailed guidance on the most frequent transfer pricing issues in the area of financial transactions.

More concretely, the 2015 report on Aligning Transfer Pricing Outcomes with Value Creation pursuant to BEPS Actions 8-10, and the 2015 report on Limiting Base Erosion Involving Interest Deductions and Other Financial Payments pursuant to BEPS Action 4 mandated follow-up work on the transfer pricing aspects of financial transactions.

As noted earlier, the OECD issued a discussion draft on the transfer pricing aspects of financial transactions on 3 July 2018, as part of the wider BEPS initiative. While the OECD were careful to point out that the discussion draft is not a consensus document, it is a useful starting point for taxpayers who wish to understand the potential direction of travel and as such, invited comments from various interest groups and taxpayers.

The discussion draft aimed to provide the OECD guidance to taxpayers and tax authorities to address the nature and character of various financial transactions and on matters involving pricing. Prior to the publishing the Discussion Draft, the OECD had not provided specific guidance on transfer pricing aspects of financial transactions.

Under their mandate, the Discussion Draft represents the first OECD document on this topic, aiming to clarify the principles included in the OECD transfer pricing guidance, as well as specific issues frequently arising in the area of transfer pricing of financial transactions. Each of the ICFTs described in this report were covered in the Discussion Draft.

After receiving almost 80 public submissions in response, the OECD is expected to issue a second public Discussion Draft early in 2019.

Country overview: Australian taxpayers remain on high alert following key court case

Following the Chevron case, the Australian Taxation Office (ATO) have adopted a significantly more aggressive approach to scrutinizing the pricing of intra-group funding. Furthermore, Australia’s transfer pricing legislation contains explicit ‘reconstruction’ provisions, which allow for related party arrangements that the ATO deems to lack substance, or are inconsistent with arrangements that would have been entered into with an independent party, to be reconstructed in order to assess the appropriate transfer pricing position. Where the ‘reconstruction provisions’ are deemed to apply, the actual terms and conditions will be set aside and replaced with the arm’s length conditions for the purposes of assessing any ‘transfer pricing benefit’.

Taxpayers must be mindful of these provisions in establishing related party funding arrangements and ensure that the overall commercial rationale of any arrangements can be supported.

According to Caroline Walker, a Perth-based transfer pricing partner with Ernst & Young Australia, common themes observed in ATO scrutiny of ICFTs include:

► Challenging whether similar funding arrangements entered into with an independent lender would reasonably have been expected to include additional security or a parental guarantee (on the basis that it is in the economic interest of the borrower to source the lowest possible cost of funds and/or it is consistent with the general practice of the corporate group of which the taxpayer is a member), such that a different credit rating should have been assumed for pricing purposes, resulting in a lower interest rate for inbound funding.

► Reviewing whether other terms and conditions of any intra-group funding arrangement are consistent with the corporate policies and practices of the broader multinational group, of which the subsidiary taxpayer is a member (e.g., gearing ratios, financial covenants maintained at a group level, overall tenor of loans, and the use of fixed/ floating rate instruments).

► Challenging the currency of borrowings, and whether this is consistent with local commercial requirements or how the taxpayer would have sourced funds from an independent lender.

Intra-group guarantee fees also remain a contentious technical issue, being actively debated by the ATO. Taxpayers can therefore expect any inbound charges for guarantee fees to be heavily scrutinized. In the current environment, there is a heightened risk that the ATO could assert the following, in certain circumstances:

► That inbound related party funding should be assumed to have a parental guarantee (resulting in a lower interest rate being applicable), but without the taxpayer necessarily being entitled to claim deductions for any associated intra-group guarantee fees; or

► That intra-group guarantee fees (or a portion thereof) should be ‘reconstructed’ as capital support.


and treated as non-deductible payments for tax purposes (e.g., if the borrower does not have an arm’s length capital structure and the guarantee cannot be demonstrated to represent a pricing benefit alone).

December 2017 the ATO issued Practical Compliance Guideline (“PCG”) 2017/4 on intragroup financing9, which outlines the ATO’s risk-based compliance approach to intra-group funding arrangements. This PCG recommends that taxpayers should self-assess a risk rating associated with their related party financing arrangements, through two scoring matrices based on:

► Pricing factors (including pricing relative to group position, interest cover, currency, security terms); and
► Motivational factors (including leverage relative to group position, interest cover and tax rate of lender jurisdiction for inbound debt).

The resultant risk rating is classified into one of five ‘risk zones’ from green to red, which correspond with the likelihood of ATO compliance action. Whilst this is not a technical guidance document, it does further emphasise the ATO’s focus on scrutinizing the overall context of intra-group funding arrangements and comparing related party terms and conditions to third party transactions observable in the broader corporate group.

In the context of this environment it is critical for multinational enterprises to undertake a comprehensive analysis of the overall terms and conditions of any intra-group funding arrangements, including:

► Context and purpose of the funding arrangement;
► Evidence that the borrowing entity has an ‘arm’s length capital structure’;
► Comparison of the funding terms and conditions to observable third party transactions of the corporate group (and explanation of any deviation(s));
► Consideration of whether funding with a third party lender would have reasonably been expected to require security and/or a parental guarantee.

The conclusions of this analysis will typically then drive the approach to the credit rating and interest rate benchmarking exercise.

From a thin capitalization perspective, taxpayers remain able to rely on ‘safe harbor’ calculations however, and an increasing number of taxpayers are seeking to rely on the Arm’s Length Debit Test (ALDT) to justify larger debt levels than permitted under the safe harbor calculation. The ATO is currently reviewing the application of the ALDT and further guidance is expected in 2019, which is likely to include a tightening of requirements for supporting analysis and documentation. Overall the technical positions advocated by the ATO continue to be viewed as aggressive in the context of the global tax enforcement landscape, and it remains to be seen how conflicting positions with treaty partners will be satisfactorily resolved through bilateral APAs, MAP or mandatory binding arbitration.

Leading practices for companies to consider

Notwithstanding the complexity of the issues at hand, there are many operational steps that taxpayers should consider implementing:

• First, consider all opportunities for APAs and rulings — preferably of the bilateral or even multilateral nature, if available
• Identify and take stock of all existing intercompany transactions listed in this report and the OEDD’s Discussion Draft — and ensure that this stock of transactions is regularly updated. This includes ensuring that the tax function has close involvement in strategic investments by the business before such investments are actioned
• Prepare a checklist of questions against which to check each ICFT — both in terms of known/current tax authority treatment (both domestically and internationally), but also possible future treatment in relation to the OECD’s ongoing work in this area, and the known stance of each country involved
• Develop and sustain closer connections between business units, the treasury and tax functions — ideally including protocols for identifying ICFTs on an ongoing basis. Alongside ongoing communications, institute regular touchpoints to review both current and future plans for around ICFTs
• During this period in which tax treaties are changing at such a rapid pace, ensure that each documented ICFT includes both current and potential future treaty interaction, including known treaty changes as a result of the use of the OECD’s Multilateral Instrument
• Rigorously document all transactions in a contemporaneous fashion — including identifying and including strong functional and pricing analysis
• Be prepared for future controversy and, view each individual dispute through a lens of a strategic controversy strategy that includes pre- and post-filing considerations, including both use of the MAP and, if needed, litigation
• Continue to closely monitor related developments in this area at both country and OECD levels. Consider the merits of providing business input — either individually or as part of an industry group or confederation — as requested by the OECD
• Embed and document all of the above within the enterprises’ transfer pricing policies, revisiting it periodically to check for relevancy and execution
Concluding thoughts

Transfer pricing is one area of tax (though ironically enough, not actually a tax itself) that is in constant flux. Its place at the very heart of the BEPS project not only cements its importance as a key issue, but guarantees that country interpretations are continuing to change. What is perhaps more static is its place—time and again—at the top of the list of tax risks as nominated in EY surveys by business tax leaders for more than a decade.

Change is not easy

A key objective of the BEPS project was to try and bring a more harmonized approach to transfer pricing interpretation and scrutiny of transfer pricing issues generally and, more recently, to the transfer pricing treatment of ICFTs. But that harmonization has some way to go, and jurisdictions will be aware of the most active and dominant tax administrations. That means that cases such as Chevron in Australia, alongside others mentioned in this report can be expected to sit at the center of a shifting approach to transfer pricing scrutiny, and, as a result, future transfer pricing disputes.

In that regard, and in the absence of any alternative approach to the arm’s-length standard, taxpayers will need to deal with the transactions they have on their books. That means improving transfer pricing defense and taking a more global, strategic approach to tax controversy management. Prevention, as they say, is always better than cure.
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Eight for 2018 — an overview of our leading choices for sources of transfer pricing risk (cont.)

1. IP-related developments
There are several developments that will affect the taxation of IP and IP structures in 2018 and beyond, regardless of whether the IP is transferred, sold, licensed or co-owned through cost sharing arrangements.

Arguably, the two most important developments are first, US tax reform (and potential responses by other countries), and second, the ongoing discussions at the OECD level after changes to Chapter I and VI of the OECD TP Guidelines for Multinational Enterprises and Tax Administrations 2017 (OECD Guidelines). In this second area, the concepts of DEMPE (development, enhancement, maintenance, protection and exploitation) functions and hard-to-value intangibles (HTVI) are particularly complex.

2. High-value services transactions
Closely linked to the issue of IP transfers are the TP aspects of high-value service transactions. Examples of high-value services are strategic and C-suite services, technical services that create or contribute to the development of IP and services with embedded IP. In certain cases, the distinction between IP and high-value services is hard to draw, in turn raising questions of how such a transaction should be characterized for tax purposes and how it should be priced.

3. Headquarter and management services transactions
Many multinational companies (MNCs) provide centralized headquarter management services for the benefit of their entire group. Examples of such centralized management services are corporate strategy, treasury, financial planning and analysis, M&A, accounting, HR and IT, among others.

Tax authorities in the MNC’s headquarters location expect taxpayers to charge out all costs related to services that benefited foreign-related service recipients and will deny deductions of costs that were not incurred to the benefit of the local taxpayer. A challenge arises from the fact that some tax authorities in the country of the service recipient do not allow a deduction for tax purposes of these charges, arguing that the services were either not beneficial, duplicative, higher than what it would have cost the local taxpayer if it had obtained those services from a local service provider or because they object to how costs have been allocated. This situation is sometimes referred to as “stranded cost.”

While the new Section D of the revised Chapter VII of the OECD Guidelines provides for an elective, simplified approach for certain low-value adding services in order to avoid this stranded cost problem, it does not resolve the issue for high-value services that might be centrally provided, such as R&D, sales and marketing, and corporate senior management services.

Companies should expect continued scrutiny of high-value intercompany headquarter and management services charges in 2018 and beyond.
Eight for 2018 — an overview of our leading choices for sources of transfer pricing risk (cont.)

4. Intercompany financing transactions

In the last few years, tax authorities have focused more and more attention on intercompany financing transactions, especially within nonfinancial services organizations.

Nowhere has this been better illustrated than in the so-called “Chevron case,” where the decision shows that TP disputes do not just involve an evaluation of the pricing of related-party arrangements, but a wider, more thorough analysis of the nature of the property involved in order to determine precisely what needs to be priced. This involves consideration of complex contractual questions and evidentiary issues.

Tax and finance departments are often well-positioned to know what intragroup loans are in place, but pricing these loans for tax purposes requires more than just knowledge of current interest rates. Negotiating the world of option adjustments, “halo” effects and debt-capacity analysis may not be a possibility for less well-resourced or experienced tax functions.

Guarantees on commercial transactions, on the other hand, can often be put in place without a tax department’s knowledge and can have significant repercussions during a tax audit. Once detected, guarantees can be some of the most difficult transactions to price. Cash pooling, factoring and other risk transfer transactions are likewise increasingly under scrutiny.

An informed approach to these types of transactions can underpin a company’s broader tax strategy.

With the Chevron case decided in favor of the Australian Taxation Office (ATO), MNCs should be aware of the fact that material intercompany financial transactions entered into by nonfinancial companies is set to become a key focus area of tax authorities not just in Australia, but around the world.

5. Procurement structures

Procurement has evolved into a key function for many MNCs, and it is increasingly involved in strategically driving long-term cost leadership and delivering a cost footprint that supports the MNC’s financial performance, value proposition and positioning in its competitive environment.

From a tax perspective, the broader role of procurement personnel for many MNCs has attracted the focus of tax authorities.

Many countries are now seeking to expand the PE concept, as well as more carefully scrutinizing how synergies are allocated within a group, out of concern for abuse by MNCs.

Tax authorities are particularly concerned that foreign enterprises are performing substantial value-adding activities in their countries; the country, however, cannot tax those in-country activities because the company’s physical presence falls outside the traditional PE concept as defined in double-tax treaties.

The MLI formalizes the BEPS Action 7 recommendations and collectively updates much of the world’s double-tax treaty network to reflect those recommendations, including expanded concepts of the traditional PE types: fixed place PE, construction PE, agency PE and service PE.

As businesses have leveraged procurement into an expanded role, countries have also become more likely to view the procurement function as a value-adding activity. The MLI and BEPS Action 7 have similarly recognized this in seeking both to broaden PE definitions and also to narrow certain PE exclusions that typically applied to procurement models.

With MLI-led changes now occurring and many countries separately updating their domestic PE rules in line with BEPS Action 7, MNCs should expect new efforts and inquiries by tax authorities to identify PEs. This means greater risk of tax controversy and potentially additional tax liabilities or tax compliance issues.

The most significant change relates to the blanket exclusion for purchasing activities contained in many bilateral tax treaties, which under the MLI will be narrowed to “preparatory or auxiliary” purchasing activities only.
Eight for 2018 — an overview of our leading choices for sources of transfer pricing risk (cont.)

Procurement functions that rise above the preparatory or auxiliary threshold are therefore at a greater risk of triggering a fixed place PE, when performed through a local office, or triggering an agency PE, when performed through agents or employees present in source markets. The OECD commentary provides some guidance — e.g., that a preparatory or auxiliary activity should not be an “essential and significant” part of activity as a whole — but ultimately the determination will be highly fact-intensive and specific to the specific business. Companies will have to reflect on their core business and competitive advantages, deciding whether procurement is a value driver.

6. Limited-risk entity structures

Many companies’ supply chains involve entities that perform limited functions, own few assets and/or do not bear significant risks. If such an entity performs manufacturing activities, it is referred to as a contract or toll manufacturer. If it performs distribution functions, it is known as a limited risk distributor (LRD).

All of these entities are now being challenged by tax authorities with respect to the limited risk nature of their activities and the low profits associated therein. Tax authorities are arguing, for example, that a company that is being characterized as bearing limited risks “on paper,” (i.e., as per an agreement between the limited risk entity and a related-party principal) in actuality bears significantly more risks and performs more functions than may be stated in the agreement. Examples of criticism expressed by some governments are that LRDs may actually perform significant marketing functions or that contract manufacturers may bear significant idle capacity risks.

Tax authorities may also argue that the contractual separation of functions and risks is often artificial. Additionally, some governments are trying to ensure that any IP associated with a limited-risk function is being captured in their country in terms of its ability to generate revenue, even if that IP is technically not owned by the limited-risk entity.

A further important development that has put limited-risk structures under pressure, and one that is a direct result of the BEPS initiative, is the lowering of the threshold for governments to assert that an MNC with limited-risk entities in a particular jurisdiction has an additional taxable presence through a PE (see previous section) with respect to the functions that might have formerly been performed by the limited-risk entity in that country.

Companies should therefore review their structures with respect to their limited-risk entities, ensuring that they have the appropriate functions and risks analyses are available should a structure be challenged by the tax authorities. In addition to the legally required minimum TP documentation in each jurisdiction involved, companies should have a more robust defense file available that analyzes facts in greater depth, supporting further inquiries or challenges to the structure.

Following the 2015 BEPS recommendations, additional system profits that exceed the contractually agreed compensations for the tested parties may now flow to the intermediary in the absence of a profit sharing mechanism. Depending on the circumstances, the profit share of the intermediary, when compared to the tested parties and in light of its value contributions, could be viewed as excessive by some tax authorities. There is a risk, therefore, that structures similar to this may be challenged by more than one tax administration, going forward.

In the future, and with the benefit of greater visibility of an MNC’s global footprint and location of profits, we expect tax authorities to increase their scrutiny of an MNC’s entire system profit and how their profit is distributed around the world.
Eight for 2018 — an overview of our leading choices for sources of transfer pricing risk (cont.)

7. Two-sided nature of pricing a transaction

Some MNCs have implemented supply chain structures that involve intermediaries located in a different jurisdiction from the location(s) of its manufacturers and distributors, such as regional principals who manage the supply chain and then subcontract related-party manufacturers to produce products and related party LRDs to distribute them.

Such structures may have been set up during a time at which the overall system profit of the supply chain was low, and hence the profit shares of all related parties involved were commensurate with their value contributions.

From a traditional TP perspective, the parties whose profits would be measured to determine whether intercompany transactions were priced at arm’s length would have been the manufacturers and the distributors (the so-called tested parties).

8. Limitation of deductibility of costs based on domestic rules, instead of based on TP adjustments

An emerging TP topic that companies should closely monitor relates to the limitation of deductibility of certain intercompany transactions based on domestic tax rules other than TP, i.e., a limitation of deductibility of intercompany transactions that tax administrations seemingly agree were priced at arm’s length, but where such nondeductibility is conditional on the receiver being an associated enterprise. Or, said differently, TP adjustments disguised as a domestic adjustment issue.

This is set to be a key issue in the future, mirroring the broader issue of interaction between domestic anti-abuse rules and treaty obligations.

Japan, for instance, sometimes uses a domestic “donation” argument to avoid the Mutual Agreement Procedure (MAP) included in its double-tax treaties on a TP compensating adjustment. However, the US IRS and Japan’s National Tax Authority (NTA) have agreed that this is a TP issue and should therefore be addressed through MAP. It remains to be seen how Japan will deal with other treaty partners on the donation issue.

A further historic example of this issue is that the IRS used to use an Internal Revenue Code (IRC) § 162 (Ordinary and Necessary Business Expense) argument for TP adjustments to avoid IRC § 482 and MAP, i.e., deny a deduction in the US as not being ordinary or necessary. In these cases, the IRS Competent Authority has typically disregarded this argument and addressed such an adjustment in MAP.
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EYG no. 000083-19Gbl

1811-2966700
ED None

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