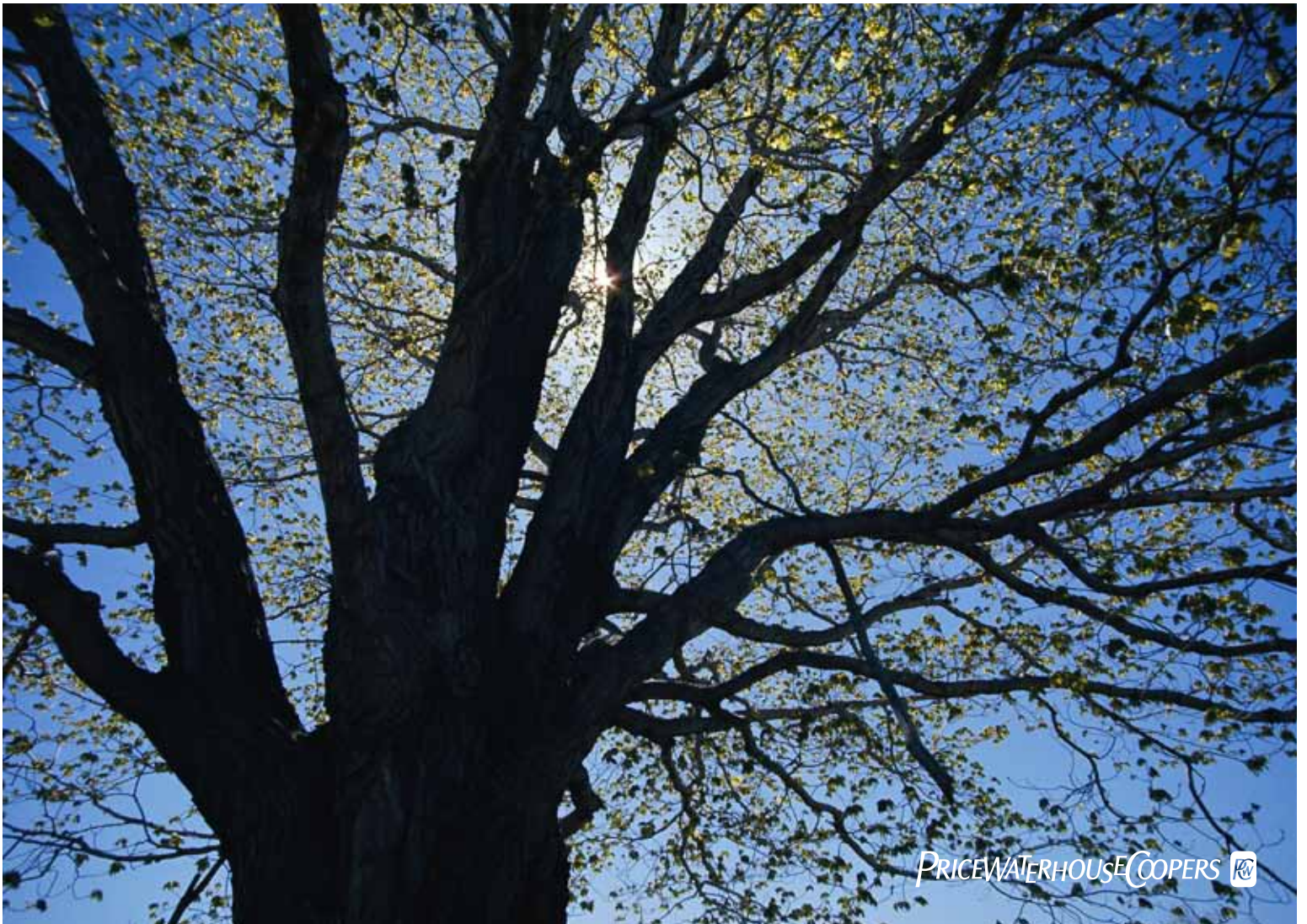


Tax controversy and intragroup financial transactions:  
An emerging battleground

# Transfer pricing perspectives

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# Tax controversy and intragroup financial transactions: An emerging battleground

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Taxation authorities have significantly increased their focus on intragroup financial transactions, including related-party loans, credit guarantees, factoring arrangements, cash pools, and other forms of financing and credit risk transfer arrangements. With the current global financial crisis limiting the availability of once plentiful and relatively inexpensive external funding, many taxpayers in their “hunt for cash” have seen their intragroup financial transactions increase significantly. In this article, we provide an overview of why intragroup financial transactions are receiving so much attention from taxation authorities, key areas of controversy, and potential actions for taxpayers to consider. In addition, although financial transactions can create tax risk, they are also a source of opportunity, notwithstanding recent events. We raise several potential opportunities that may benefit taxpayers.

## **Why are financial transactions increasingly a key source of tax controversy?**

The transfer pricing aspects of intragroup financial transactions are becoming increasingly contentious. One key reason for this is that the pricing of financial transactions, as with many other areas of transfer pricing, is inherently subjective. At the same time, the value of these transactions can be significant.

For example, to arrive at an arm’s length interest rate for a loan, one needs a process for evaluating the credit quality of the borrower (i.e. the probability that the borrower will default over a given time period and the amount of loss in the event of a default) and an approach for estimating credit quality and the terms of the transactions to available internal and external comparable transactions. Even when using a structured approach, the credit analysis and the selection of comparables require subjective judgment and expertise. Additionally, even if the parties setting prices possess the knowledge and judgment to accurately estimate an arm’s length price for a transaction, the reviewer of the prices (such as a taxation authority) might not possess the requisite expertise.

Another important source of controversy for some borrowers is the impact on operating profits of high yield loans provided by private equity firms. This has led in some countries (e.g. Germany and Italy) to the introduction of specific earnings stripping rules in order to limit the amount of interest that can be deducted from operating profits. In the Netherlands, the Ministry of Finance is investigating the possibility of completely removing group interest from the tax environment.<sup>20</sup> Furthermore, the financial crisis, which has dominated the news over the past year, has demonstrated to taxation authorities that financial markets are a complex area, particularly once the transfer pricing implications of these transactions are considered. As such, it has raised their awareness of and focus on intragroup financial transactions.

<sup>20</sup> On Monday 15 December 2008, the Dutch Secretary of State for Finance sent a letter to the Dutch Second Chamber regarding the division of corporate income taxation costs between taxpayers and the various issues surrounding the treatment of intragroup interest. This letter contains a number of thoughts on possible reforms to the system of corporate income taxation in the Netherlands. It would appear that the primary focus of the Secretary of State for Finance is the (partial or complete) “de-fiscalisation” of intragroup interest.

The presence of country-specific safe harbour rules and expectations further increases the potential for cross-border disputes.

Estimating arm's length terms for an intragroup financial transaction is further complicated by the fact that taxation authorities have provided little concrete guidance as to how taxpayers should price these transactions. This is compounded by the lack of guidance from the OECD, which increases the possibility that taxation authorities will take significantly different approaches when evaluating intragroup financing. Hence, financial transactions represent yet another area where an approach that may be acceptable to taxation authorities in one jurisdiction may not be acceptable in another. The presence of country-specific safe harbour rules and expectations further increases the potential for cross-border disputes. It should also be noted that substantiating interest rates through the solicitation of non-binding bank quotes is not acceptable to most sophisticated taxation authorities.

Some taxation authorities are also beginning to challenge the pricing of financial transactions using a combination of transfer pricing and tax-related arguments. As an example, in Australia, the Australian Taxation Office ("ATO") has indicated that multiple provisions of the Tax Act may impact whether a taxpayer receives a deduction on a loan, including the general deductibility provisions, the debt/equity rules, the thin capitalisation legislation, and the transfer pricing rules. The presence of overlapping (and potentially conflicting) rules in a single jurisdiction can complicate the process of pricing and structuring intragroup debt. Furthermore, differences across jurisdictions can also increase the risk of a challenge, even for relatively simple transactions.

### **Some areas of focus by taxation authorities**

Most taxation authorities, including those that have expended considerable effort to better understand financial transactions, are grappling with the complex issues that these transactions can raise. Based on our experience in Canada, Australia, New Zealand, the Netherlands, and other jurisdictions, some of the issues that taxation authorities seem to be examining closely include:

- Related-party loans with interest rates or credit margins that might appear high to taxation authorities relative to local benchmarks;
- Credit guarantee fees, particularly where the taxation authority perceives the fee to be "high" or the total amount paid is significant;
- Taxpayers with relatively high debt/equity ratios compared with their peer group;
- Transactions lacking in substance or with terms and conditions that a taxation authority views to be lacking an economic rationale, or that are not documented in a written agreement;
- Not exercising prepayment or call options included in an intragroup loan agreement when market conditions suggest an arm's length party would;

- Debt pricing and/or debt amounts that result in ongoing low levels of profitability;
- The allocation of the benefit derived from internal cash pooling and other centralised group arrangements among participants;
- Appropriate rates of return for transactions where a taxpayer serves as a “booking entity” or otherwise acts as an intermediary in a transaction.

As existing guidance for establishing arm’s length terms for financial transactions is limited in most jurisdictions, it is advisable to have an understanding of the local sensitivities of a given taxation authority (or the examiners that you may deal with), particularly in advance of completing a material transaction that may create significant tax risk.

### **Impact of the passive association debate**

Traditionally, many taxpayers have established arm’s length terms for their related-party financing transactions by evaluating the credit quality of a subsidiary on a stand-alone basis (i.e. under the assumption that the borrower is an independent entity that is not related to the lender), which is arguably consistent with OECD guidance. At paragraph 1.6 in its Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, the OECD notes that “the authoritative statement of the arm’s length principle is found in paragraph 1 of Article 9 of the OECD Model Tax Convention, which forms the basis of bilateral tax treaties involving OECD member countries and an increasing number of nonmember countries.” It further notes that “by seeking to adjust profits by reference to the conditions which would have obtained between independent enterprises in comparable transactions and comparable circumstances, the arm’s length principle follows the approach of treating the members of a multinational enterprise (“MNE”) group as operating as separate entities rather than as inseparable parts of a single unified business. Because the separate entity approach treats the members of an MNE group as if they were independent entities, attention is focused on the nature of the dealings between those members.”

However, in a recent case in Canada, the Canada Revenue Agency has sought to argue (within the context of the pricing of intragroup credit guarantee fees) that a third-party lender would lend to a subsidiary of a major multinational group (or, more broadly, assume its credit risk) at a lower rate than that implied by a pure “stand-alone” result in light of its affiliation with its parent. Such a “passive association” argument raises several key issues, ranging from the empirical (to what extent do lenders account for group affiliation of subsidiaries that are not formally guaranteed by their parent) to the transfer pricing specific (such as whether a consideration of the potential links between a parent and its subsidiary are consistent with the arm’s length principle).

From a practical perspective, even if the concept of passive association is inconsistent with the arm's length principle, it appears to have been embraced, at least for now, by several sophisticated taxation authorities, including Canada, the Netherlands, and Australia. Hence, until tax courts or taxation authorities provide more definitive guidance, taxpayers may need to consider the possibility that a taxation authority will not consider it appropriate to evaluate the credit quality of a subsidiary of a multinational enterprise on a pure stand-alone basis, and if an adjustment for "group membership" is necessary, how it should adjust the pricing or the documentation of its intragroup financial transactions to proactively address this potentially vexing issue. At the same time, for outbound transactions, taxpayers need to consider the possibility that a taxation authority might question instances where taxpayers have provided credit support but have not applied an appropriate arm's length charge that reflects the risk assumed by the guarantor.

### **What can you do?**

In light of the current focus of taxation authorities on financial transactions, taxpayers might consider a variety of measures, including:

- Establish a comprehensive transfer pricing policy that covers existing and planned intra-group financial transactions;
- Periodically revisit the policy (at least annually);
- Implement legally enforceable, robust loan agreements;
- Evaluate "both sides" of material transactions—does the transaction "make sense" economically for both parties involved?
- Structure and price transactions in a manner consistent with the firm's tax risk tolerance;
- Monitor global developments—current Canada Revenue Agency or ATO viewpoints may be adopted by other taxation authorities.

### **Some potential opportunities**

While significant risks may exist in pricing and structuring intragroup financial transactions, current financial market conditions also provide an opportunity for taxpayers to revisit their intragroup financial transactions and ensure they are consistent with the arm's length principle, which in many cases will mean higher credit spreads.

### **Intragroup loans**

Opportunities may exist for both existing and new loan transactions. As a starting point, taxpayers should review the terms of existing intragroup loan agreements. For transactions that are about to mature, it may be possible to incorporate revised pricing that reflects current credit market conditions. In addition, taxpayers should carefully review any embedded options incorporated into existing transactions (such as early prepayment provisions granted to borrowers or the ability to demand early prepayment granted to lenders), with a view toward aligning existing agreements with current market conditions where possible. When reviewing the terms of a transaction, it is important to consider the perspective of both the borrower and the lender (and their respective tax jurisdictions) to ensure consistency with arm's length behavior. Taxpayers should also evaluate the consistency of any re-pricing with the taxpayer's broader financial transactions pricing policy.

Furthermore, with the recent dramatic increase in credit margins, the fair value of many intragroup loans has declined and may produce a beneficial tax loss under the right circumstances (or a profit, for instance, by buying one's own loans or bonds at a discount out of the market, from an "appropriate" group company).

New transactions should be priced under current market conditions. However, taxpayers should account for recent trends in the credit markets. For example, credit to noninvestment grade borrowers (and most borrowers in general) is far more difficult to obtain now than it was a couple of years ago. Borrowers that can obtain funding must generally do so for shorter time periods, with more stringent covenants. Hence, having proper documentation in place that substantiates not only the interest rate on a loan but also the arm's length nature of the amount of the loan and its terms and conditions is crucial, especially in the current market.

### **Credit guarantee fees**

Many companies with loans from third parties are facing demands for enhanced security through guarantees on existing and refinanced debt, and some companies are able to effectively redeploy capital from one related party to another with a guarantee from the corporate group.

Charging a guarantee fee can be contentious in some countries, yet it may be expected elsewhere. Hence, a taxpayer should carefully review all of its intragroup guarantees. In particular, the taxpayer should be prepared to demonstrate that the guarantee provides the guaranteed entity with a benefit and that the guarantor is providing a service that is not being provided only by virtue of its being a shareholder. Where the guarantee confers a benefit, the taxpayer should consider charging for this benefit (note that not charging for a service can provide taxation authorities with an additional argument, i.e., that the credit guarantee may have been provided as a shareholder service, which may be disadvantageous if the guarantor needs to perform on the guarantee).

As with loans, market prices for credit guarantees have increased significantly over the past year. Hence, taxpayers should assess whether the guarantee fees charged on existing guarantees are still arm's length given the change in market conditions, if the pricing of the guarantees are eligible for review.

### **Factoring of receivables**

An intragroup accounts receivable factoring transaction can be beneficial under current market conditions by providing cash to a cash-strapped related party and by potentially producing a tax benefit for taxable related parties.

A factoring transaction involves the sale of accounts receivable at a discount for cash. The sale of a cash-strapped company's accounts receivable can provide immediate cash to the company in a tax-efficient manner. In addition, an intragroup factoring arrangement provides another benefit that many taxpayers do not consider: intragroup factoring is an off-balance sheet transaction. It involves a sale of assets for a fee, and in many countries may not be affected by withholding tax requirements or interest deductibility rules.

An intragroup factoring arrangement increases the assets of the related party purchasing the accounts receivable. If this related party is also the entity within the corporate group that has third-party borrowings, the increased assets may be accepted as collateral to lower the cost of or increase the amount available through third-party borrowings.

## **Cash pooling**

As a result of the financial crisis, companies in need of cash increasingly rely on their internal cash pool(s) for the management of the cash available within the group. Taxpayers need to address certain specific transfer pricing issues that arise from cash pool arrangements, such as how the cash pool operator determines the appropriate interest rate to be applied to intragroup balances, how it prices any underlying (cross) guarantee structure, and how it remunerates the cash pool leader. With the increased use of cash pools and the increase of volumes handled by these cash pools, the attention of taxation authorities to these transfer pricing issues is also increasing.

Recent examples of discussions with taxation authorities in this area relate to the fact that, in practice, positions in a cash pool often end up being long-term loans on which (given the nature of a cash pool) short-term interest is being paid. Furthermore, traditionally the benefit to the group of using a cash pool (i.e. the “cash pool advantage”) ends up being reported by the cash pool leader, which may be a thinly capitalised company that cannot “substantiate” the return on equity that it earns. At the same time, the depositing participants, who may be incurring the credit risk associated with the cash pool, might receive only the rate that they would receive if they had made a deposit at a major commercial bank.

On the other hand, structuring a cash pool properly and taking into consideration the tax position of the participants involved can lead to a tax-optimised situation.

## **Summary**

The subjectivity associated with pricing intragroup financial transactions combined with differing taxation authority views on how these transactions should be priced has significantly increased their tax risk in recent years. This is even more prevalent in the current financial markets, in which taxpayers are forced to use their cash in the most optimal way, in many cases resulting in an increase of intragroup financial transactions. However, while intragroup financial transactions can give rise to potential tax risk, if given appropriate attention and with the appropriate documentation in place, they remain a potential source of opportunity, particularly in light of these recent dramatic changes in the financial markets.

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