As the severity of the global financial crisis fades and the Euro zone shows signs of stabilising, governments continue to seek a cure for the economic stimulus hangover.

Progress, but no guarantees for the consistent treatment of intercompany financing transactions

Progress, but no guarantees for the consistent treatment of intercompany financing transactions

Current tax regimes in a post-crisis world

As the severity of the global financial crisis fades and the Euro zone shows signs of stabilising, governments continue to seek a cure for the economic stimulus hangover. Naturally, this remedy consists of a cocktail made of politically sensitive spending cuts mixed with the comparatively sweeter taste of changes in tax regulations and treaties. Consistent with this theme, the OECD, in its review of base erosion and profit shifting (BEPS), has been proactive in recognising the pressures that the new economy has imposed on the wealth of nations. In short, the review aims to determine whether current tax regimes allow for the allocation of taxable profits to locations other than where the actual business activity occurs, and to provide strategies for those countries concerned about BEPS.

Not surprisingly, intercompany financing transactions are highlighted both in the BEPS initiative and in three documents published by the OECD in July 2013, namely, the *Action Plan on Base Erosion and Profit Shifting*, the *White Paper on Transfer Pricing Documentation*, and the *Revised Discussion Draft on Transfer Pricing Aspects of Intangibles*.

Collectively, these documents recognise the transfer pricing and tax treatment of intercompany financing transactions in a level of detail not seen before. This is not to say they provide guidance to the transfer pricing community on how to price these transactions (this guidance is anticipated with the release of the revised transfer pricing guidelines in December 2015); rather, they provide a clear indication that we can expect more attention paid to the arm's length pricing and tax treatment of these transactions from both tax authorities and financial statement auditors.

> ***Post-crisis: Expect more focus on arm's length pricing & tax treatment***

This guidance should be welcomed because it attempts to establish at least some consistency among global members of multinationals. For example, in the White Paper on Transfer Pricing Documentation, the OECD proposes a masterfile portion to documentation that gives information on a multinational's intercompany financial activities accompanied by a local country file demonstrating that the MNE has complied with the arm's length principle in that country. Clearly the objective is

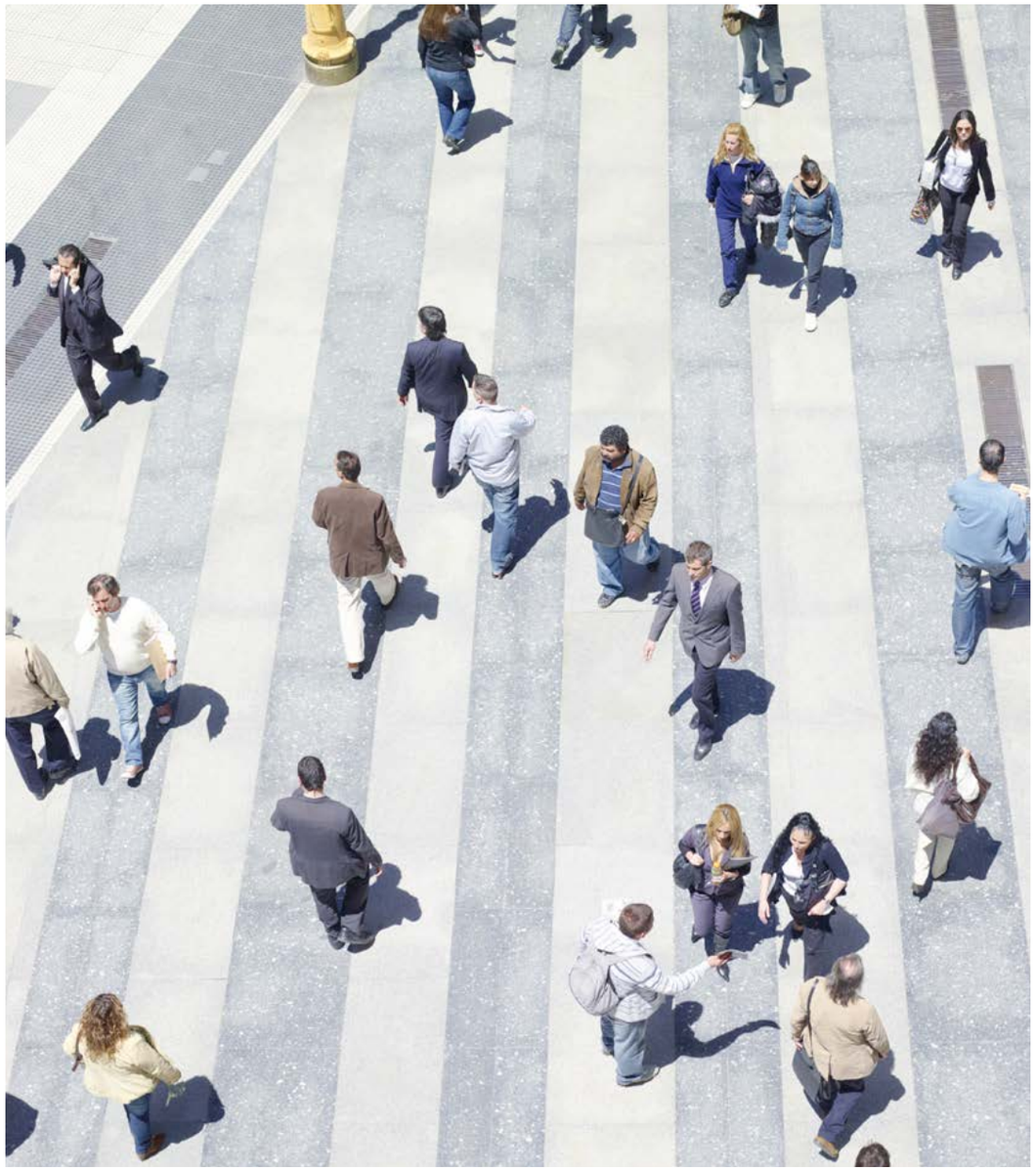
[1] At stake for Tyco is $883.3 million in additional taxes plus penalties of $154 million related to an IRS challenge of intercompany financing with certain international subsidiaries related to acquisitions and restructurings in the late 1990s. At stake for Ingersoll-Rand is a potential levy of $400 million and $700 million of additional withholding and income taxes with respect to a portion of the interest payments on intercompany debt to a Bermudan affiliate.

Progress, but no guarantees for the consistent treatment of intercompany financing transactions

to improve the ability of a tax authority to evaluate transfer pricing risk specific to individual financial transactions and verify the consistent application of a transfer pricing policy to these transactions.

For financial transactions, the proposed approach to documentation is superficially simple and yet fundamentally complex, as evidenced by our PwC survey of 40 countries that addresses these issues. The survey focuses on country-specific legislative requirements for pricing of intercompany loans as well as staff's experience with tax authorities' positions on various aspects of the transfer pricing of financial transactions.[1]

Based on the responses, it is clear that transfer pricing legislation and general practice with respect to these issues is inconsistent across territories and, in many cases, still evolving. Nevertheless, some key themes have emerged from the survey in relation to (i) whether transfer pricing and thin capitalisation rules are embedded in tax law; (ii) generally accepted methods to evaluate arm's length interest rates on intercompany loans; (iii) the preferred method to evaluate the arm's length nature of guarantee fees; and (iv) whether passive association (i.e. where the creditworthiness of the subsidiary is evaluated based on its membership in a multinational group and assumes that the parent will intervene if the subsidiary encounters financial difficulty) should be accounted for in analysing arm's length interest rates and guarantee fees.



[1] http://www.pwc.com/managingthecomplexity

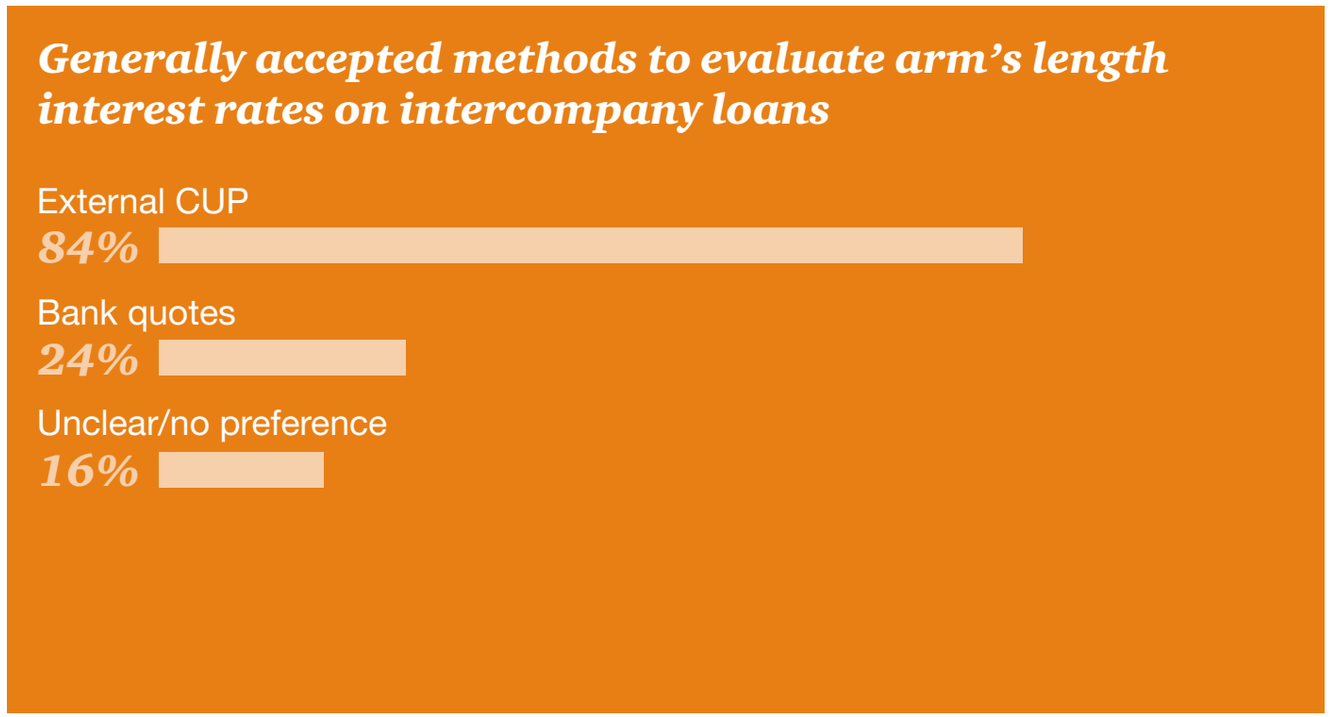
Progress, but no guarantees for the consistent treatment of intercompany financing transactions

Transfer pricing and thin capitalisation rules

While transfer pricing rules and thin capitalisation rules are embedded in the tax law of most responding countries, the transfer pricing rules are often not specific to financial transactions (such rules that explicitly address financial transactions primarily address intercompany loans, in particular in terms of volume and interest rate, with only limited rules addressing intercompany guarantees and cash pooling). To the extent that a country lacks specific guidelines for evaluating transfer pricing applied to intercompany financial transactions, the broader guidance provided in the OECD Transfer Pricing Guidelines is typically referred to.

The most commonly accepted method to evaluate arm's length interest rates on intercompany loans is the internal or external comparable uncontrolled price (CUP) method; over 80% of respondents indicated that the CUP method is accepted, with the remaining respondents reporting no clear guidelines on accepted methods or very specific rules in the transfer pricing regulations.

Application of the external CUP method should typically take into account the terms and conditions of the loan and the creditworthiness of the related party debtor based on a credit scoring analysis as a distinct and separate enterprise. Bank quotes are accepted in approximately one-third of the responding countries, but typically only as secondary evidence of the arm's length nature of the interest rate applied.



Survey: CUP method most commonly used for evaluating arm's length interest rates

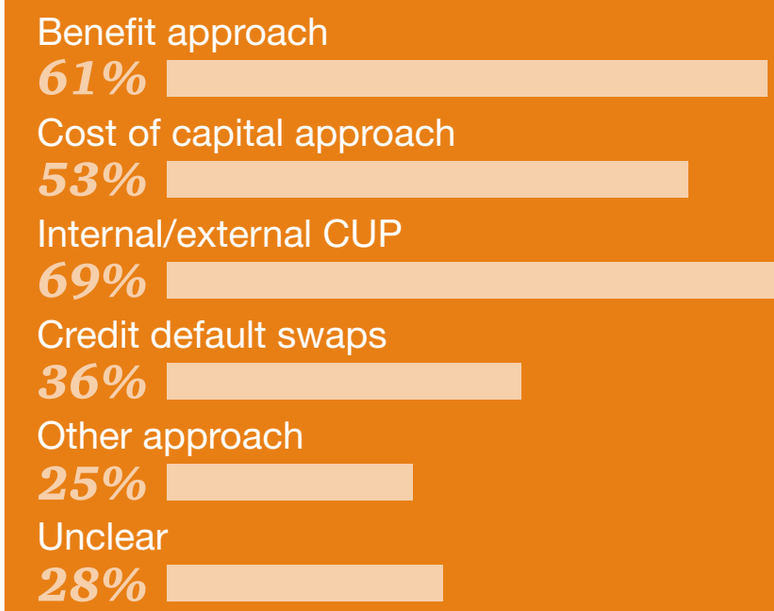
Progress, but no guarantees for the consistent treatment of intercompany financing transactions

The CUP method and the benefit method are the most commonly accepted methods to evaluate arm's length guarantee fees for intercompany guarantees. The benefit approach analyses the interest rate benefit obtained as a result of the guarantee and splits this between the guarantor and the guaranteed.

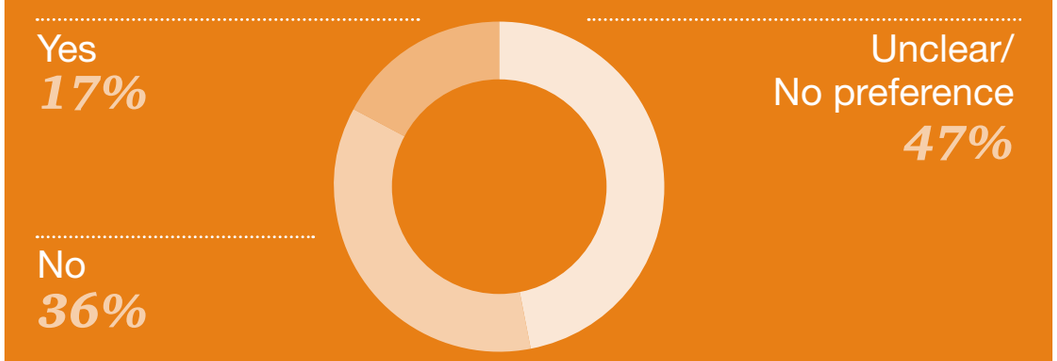
Other methods often accepted are the cost of capital approach, where the guarantee fee is determined based on the cost of the guarantee to the guarantor (typically determined by analysing expected loss on the guarantee and the cost of capital to be maintained in relation to the guarantee), and analysing the fees paid on credit default swaps on bonds with characteristics comparable to the guaranteed transaction (i.e. primarily the credit rating of the guaranteed). Other approaches include calculating the guarantee fee as (i) the value of a put option; and (ii) the multiplication of the expected default frequency, the underlying asset valuation, and the loss given default of the guaranteed asset.

As the results show, there is no common approach for accounting for passive association in substantiating the arm's length nature of interest rates and guarantee fees. Nonetheless, the OECD embraces the concept of implicit support in the Revised Discussion Draft on Transfer Pricing Aspects of Intangibles, which includes an example that recognises that implicit support is a synergistic benefit and not a compensable benefit.

Generally accepted methods to evaluate the arm's length nature of guarantee fees



Passive association/implicit support



Progress, but no guarantees for the consistent treatment of intercompany financing transactions

Conclusion: Challenges presented by inconsistency and unclear guidance

The PwC survey highlights the current inconsistency and lack of clear guidance in global transfer pricing rules and in the planning and management of intercompany financial transactions from a transfer pricing perspective. This collectively presents challenges in the global context, and the 2015 guidance anticipated from the OECD should be welcomed from a compliance perspective. In the interim, common practices can be identified to help ease some of the compliance burden. These practices can also be used as a basis for the master file and local country documentation discussed in the White Paper for Transfer Pricing Documentation when addressing an organisation's main financial transactions.

Progress, but no guarantees for the consistent treatment of intercompany financing transactions

Authors

Krishnan Chandrasekhar
PwC US
+1 312 298 2567
krishnan.chandrasekhar@us.pwc.com

Michel van der Breggen
PwC Netherlands
+31 0 88 792 75 23
michel.van.der.breggen@nl.pwc.com

Wout Moelands
PwC UK
+44 0 20 7213 8168
wout.y.moelands@uk.pwc.com

Jeff Rogers
PwC US
+1 416 815 5271
jeff.rogers@ca.pwc.com

This content is for general information purposes only, and should not be used as a substitute for consultation with professional advisors.

PwC helps organisations and individuals create the value they're looking for. We're a network of firms in 157 countries with more than 184,000 people who are committed to delivering quality in assurance, tax and advisory services. Tell us what matters to you and find out more by visiting us at www.pwc.com.

© 2013 PwC. All rights reserved

PwC refers to the PwC network and/or one or more of its member firms, each of which is a separate legal entity. Please see www.pwc.com/structure for further details.