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# Transfer Pricing Alert

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# United Nations issues draft guidance on applying arm's length principle to financial transactions

## Introduction

On 8 April 2019, the Committee of Experts on International Cooperation in Tax Matters released a note (hereby referred to as '<u>the Note</u>'), providing an update to the United Nations ('UN') Practical Manual on Transfer Pricing for Developing Countries (UN TP Manual). Although the Note is still at draft stage, it gives us a preliminary view of the sub-committee's[1] work on Article 9: Associated Enterprises, offering consideration and guidance regarding certain topics.

The Note focusses on the arm's length principles ('ALP') outlined under Article 9 of the UN Model Convention and its subsequent application, whilst also dealing with circumstances related to the developing countries. It has given due consideration to the work performed by other international forums dealing with tax matters, particularly work performed by other international forums dealing with tax matters, particularly the project on BEPS[2] conducted by the OECD[3] and the G20 countries. To this effect, the Note focusses on three sections, including: (1) a new chapter on financial transactions, (2) a revised text concerning profit splits, and (3) administrative approaches towards risk assessments and transfer pricing audits.

Unlike the OECD's draft document on Financial Transactions ('FT') issued as part of BEPS Actions 8-10, the UN's draft Note is not open for public comments and is expected to be finalised by no later than 2021 alongside the OECD's final release on this topic. This news alert covers the key principles and guidelines embodied under the new chapter on FT.

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[1] The sub-committee (comprising of 27 participants) was formed during the committee's 15th session in 2017, with a mandate to review and update the UN TP Manual.

[2] BEPS - Base Erosion and Profit Shifting.

[3] OECD - Organisation for Economic Cooperation and Development.

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## Summary of the Note

This section provides an overview of the chapter on financial transactions.

### Section 1: Financing arrangements within MNE Groups

i. Multinational groups have an option to choose between internal and external funding options. Such options are available in various forms of financial instruments (i.e. debt financing, equity financing or financial derivatives), each with their own advantages, disadvantages and tax implications. The selection of any form of financial instrument entails, amongst other factors, tax implications for the group.

ii. The Note emphasises the need to treat inter-company financing transactions like any other form of inter-company transaction, subjecting it to the same available guidance on ALP and comparability analysis. However, such guidance is not applicable to inter-company financial transactions between regulated financial institutions because they are subject to a separate independent regulatory regime.

iii. The unique characteristics of financing transactions, which include mobility and fungibility of funds, allow for the shifting of debt from the group to high tax jurisdictions. Such movement leads to interest deductions and lower taxable profits, eroding the tax base of the group.

iv. The Note tersely refers to the various forms of intra-group financing options and arrangements,[4] but focusses largely on the most common forms of financing transactions, i.e. loans and guarantees. It also states that guidance emanating from such transactions could be applied to other forms of financing transactions.

v. Depending on the complexity of their operations, their overall structure, and their policies, multinational groups may choose to adopt either the centralised or non-centralised treasury approach. The treasury is defined by three capacities, functioning as either a cost centre, a value-added centre, or a profit centre. The varying degrees of control, decision making processes, functions, and risk bearing capacity help to indicate the most appropriate method to apply regarding the treasury's transfer pricing analysis.

vi. The Note refers to tax implications arising from debt and equity financing, and the impact of tax policy when choosing between different forms of financing. It also mentions some of the recent measures introduced in the international tax world (OECD BEPS Action 4) which address base erosion issues arising from financing arrangements conducted by the Multi-National Corporations (MNCs). The Note also considers the relevance of analysing the debt bearing capacity of the borrower for purposes of appropriate characterisation.

vii. It also highlights the interplay between domestic tax laws and transfer pricing rules, because the application of both could lead to contradictory approaches for a business, which could then lead-to double taxation.

[4] These include cash pooling, hybrid financing, hedging, derivatives and captive insurance

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## Section 2: Application of the ALP financing arrangements within MNE Groups

The ALP of intra-group financing arrangements requires identification of the commercial or financial relations, and an understanding of the significant economic characteristics of the controlled transactions.

i. The Note raises an interesting query regarding whether base erosion through excessive interest deductions can be tackled through the application of the ALP. This reinforces the views expressed in the UN commentary on Article 9, which suggests that while dealing with a loan transaction, transfer pricing analyses should not be limited to determination of the rate of interest, but also considers whether *prima facie* such a transaction ought to be treated as a loan.

ii. The UN has expressed its acceptance of the position taken in the UN Article 9 commentary, which could lead to a scenario whereby financial transactions are scrutinised for both peculiar characteristics and characterisation. The UN has acknowledged that domestic jurisprudence may exist for characterising a financial arrangement from a transfer pricing perspective, and defers to it as the starting point. It also acknowledges that the characterisation of financial transactions may differ when considered from an accounting / civil law and transfer pricing perspective.

iii. The application of the ALP requires analysis of a financial arrangement from the perspective of both the lender and the borrower, and must ensure that the financial instrument meets the underlying significant economic characteristics defined in the Note. Any conclusions drawn from transfer pricing analyses should be based on adequate information and analysis, avoiding any occurrences of double taxation, or circumstances affecting the position from an accounting or common law perspective.

iv. Similar to the OECD's draft document concerning FT, the significant economic characteristics of a financial transaction would include:

   a. Contractual terms (such as terms being open ended or close ended).
   b. Functional analysis (debt capacity assessment, internal vs. external facilities).
   c. Characteristics of financial products or services (including party conduct, presence of covenants, flexibility of payment).
   d. Economic circumstances (rationale).
   e. Business strategies (purpose or utilisation of funds).

v. Whilst the topic of the creditworthiness of the borrower and financial instruments has been dealt with in detail, it has not been considered by the committee. The Note suggests that the standalone credit rating for a subsidiary company can be arrived at through the use of credit rating tools. It also suggests that the support provided by the parent company of an MNE group to its affiliates should be factored as "implicit support" from the group, thus improving the borrower's credit rating. The amount of this improvement will depend on the level of strategic influence that the subsidiary has within the group. The Note also recognises the concept of *"stewardship functions"* in cases where the MNE group considers the subsidiary company as a core affiliate and provision of financial transactions. This should be considered part of the overall scheme of things as opposed to having an independent analysis.

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vi. The Note also raises questions on establishing credit ratings when taking into account economic and financial characteristics before the financial transaction is put in place. The Note highlights a debatable point in its consideration of issuer vis-à-vis issuance rating. It suggests that, in practice, the credit rating of the issuance could be made lower than its issuer rating based on methodologies provided by credit rating agencies.

vii. The selection of transfer pricing methods for benchmarking intragroup financing transactions and treasury transactions is dependent on several factors. The CUP method is recommended for intragroup financing transactions (via use of internal or external comparables), while the cost-plus, transactional net profit margin, or even the profit split method comprise the recommended methods for treasury functions. Such selection is dependent on the risk bearing capacity, control, and decision-making ability of the treasurer.

viii. Simpler measures such as safe harbours or official interest rates are available to taxpayers as options for benchmarking financial transactions. Such options provide certainty, reduce administrative burden, and are efficient from a cost and time perspective. However, they are limited to certain forms of financing transactions and are merely a proxy to the arm's length price for limited purposes because they do not allow accurate delineation of a transaction.

## Section 3: Application of the ALP to intra-group loans and guarantees

i. The Note deals with the relevant characteristics for loan and guarantee transaction, requiring accurate delineation of a loan transaction in order to arrive at the loan and guarantee price. This involves identifying the relevant characteristics (including terms); functional, risk and economic analysis; identification of business strategies; along with a review of party's conduct.

ii. The Note provides some practical illustrations in order to demonstrate the impact of accurate delineation of loan and guarantee transactions. Examples include the provision and treatment of an early repayment option, the characterisation of the funding as debt or equity, and the strong or weak position of the borrower and lender, etc.

iii. The illustrations focus on the application of internal/external CUP, or other approaches such as the "other method"[5] (as in the case of commodity transactions for loans and guarantees). Based on the structure of a transaction, a cost of funds approach or a cost-based method may be applied for pricing the intercompany loan transactions.

iv. In the Note, various types of financial guarantees[6] and the concept of implicit/explicit support are discussed in detail. Typical conditions warranting a charge for financial guarantees include reduction in interest rates and favourable lending options etc. Letters of comfort/letters of intent and keep well agreements that generally do not transfer risk are not considered as financial guarantee. Similar to the OECD's draft document on FT, the illustrations also acknowledged using a yield approach and a cost-based approach for pricing guarantees.

[5] The Note refers to the use of LIBOR, or the interest rate on bonds issuing such loans. Other approaches mentioned include credit default swaps, economic modelling or written opinions provided by banks.

[6] The Note refers to explicit credit guarantees, upstream/downstream guarantees, and cross guarantees, along with a brief on each of their characteristics.

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v. The Note also acknowledges that guarantees do not provide benefit to a borrower when the recipient has no debt bearing capacity or credit status. In such scenarios, the tax authority could recharacterise the transaction as a shareholder service.

vi. Interestingly, the interplay between financing arrangements and other forms of transactions are also discussed and explained by way of a descriptive case study. The case study demonstrates that funding arrangements cannot be scrutinised in isolation, and that its purpose ought to be analysed in the overall scheme of things, focussing on party conduct.

## Dhruva comments

The UN's draft Note provides clear procedures for arriving at an arm's length remuneration for loans and guarantees. It is quite clear that transfer pricing analysis is not restricted to determining arm's length rate of interest or guarantee fee, and includes careful consideration of its characterisation, i.e. a loan could be considered as quasi-equity and could guarantee a shareholder service.[7]

Furthermore, one should also take note that the UN calls for thorough consideration of factors involving financial transactions such as credit ratings, terms of financing arrangements, interplay with other inter-company transactions, and economic circumstances before arriving at an arm's length price. A generic approach may not be considered as adequate compliance.

[7] Tega Industries Limited [TS-780-ITAT-2016(Kol)-TP].

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