The arm’s length principle under pressure?

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Jo Myers examines the OECD’s ongoing work on BEPS Actions 8-10: Financial Transactions

Key Points

What is the issue?

The BEPS Inclusive Framework has published a discussion draft on the content of a new chapter of the OECD Transfer Pricing Guidelines on financial transactions.

What does it mean to me?

A key concern of some countries in this regard is the perceived complexity of applying the arm's length principle to financial transactions, with attendant compliance demands on taxpayers and tax authorities.

What can I take away?

Unless consensus can be reached on the final approach, the consequences could be wide reaching in terms of the approach to transfer pricing more generally.

Deep divisions

The BEPS Inclusive Framework has committed as part of the on-going work following BEPS to bring forward a new chapter of the OECD Transfer Pricing Guidelines providing guidance on financial transactions.

As a first step towards this end, in July the OECD secretariat published a 'non consensus' discussion draft for comment. The long delay in finalising the document and its many inconsistencies reflect deep divisions between members of the Inclusive Framework on key areas including:

- whether the arm's length principle can effectively address capital structure
- how intra-group loans should be priced and the relevance of a multinational group's credit rating and overall cost of debt
- how finance/treasury companies should be characterised and remunerated (whether as service providers or entrepreneurial risk takers)

Underlying all of these divisions is a question as to whether, and to what extent, the arm's length principle can or should be relied upon as a primary means of pricing intra-group financial transactions.

Given the divisions which currently exist on fundamental aspects of the discussion draft, the input from the initial public consultation is likely to be reflected in a further draft which will hopefully reflect a greater degree of consensus based on input received. Final guidance is not expected until at least 2019.

What is all the fuss about?

A key concern of some countries in this regard is the perceived complexity of applying the arm’s length principle to financial transactions, with attendant compliance demands on taxpayers and tax authorities. These differing perspectives are reflected in the draft which includes proposals for simplified approaches even though these may compromise the arm’s length principle.

Additionally, some countries consider, as was clear in the BEPS Action 4 discussions, that the arm’s length principle per se has proven ineffective against aggressive tax planning in the context of intra-group financial transactions.

Countries which support the continued application of the arm’s length principle in this area have concerns about the consequences of moving away from it, especially where this may limit access to relief from double taxation currently provided by double taxation agreements, and may have consequences for the application of the arm’s length principle more generally.

The main areas of contention are discussed below.

Capital structure considerations

The discussion draft raises the question as to how to ascertain whether an intra-group loan is in substance debt or equity. The current drafting suggests that countries can choose whether to apply the arm’s length principle or to apply non-transfer pricing rules such as safe harbours in this area.

This probably reflects an irreconcilable difference of opinion at Inclusive Framework in this area with many tax authorities having concluded (as was seen in the BEPS Action 4 discussions) that there is no such thing as an arm’s length capital structure, or alternatively that it is too difficult to apply this standard.

It appears that, whilst there is no overt softening of the BEPS Action 4 position, there is a concern about relieving double taxation if the question of debt/quasi equity cannot be effectively addressed under double taxation agreements. This may happen if some countries reject the relevance of the arm’s length principle in this area.

Treasury function

An illustration of the drive for greater simplification is the assertion at para 43 that the treasury function ‘will usually be a support service to the main value creating operations’. The inference is that treasury companies generally should receive a low, cost plus, reward and consequently should not be entitled even to retain a margin on any borrowing and lending activities.

This statement is however at variance with other statements in the draft, such as that treasury is an important and ‘potentially complex’ activity, and with some of the example scenarios in the draft which show such companies having complex functional and risk profiles, as is often the case in practice.

Pricing intra-group loans

The most controversial proposals in the draft relate to the pricing of intra-group loans.

Historically, the OECD has struggled to reach consensus on the appropriateness of reflecting group affiliation/halo effect when pricing intra-group debt, as opposed to using a completely stand-alone rating for a subsidiary. Although there is still not complete consensus between major countries on this, most countries now accept that it should be reflected in principle. However, rather than bridge the existing gaps on this issue, the discussion draft brings forward more radical proposals.

Amongst these is the proposal for a ‘rebuttable presumption’ that each group member has the same credit rating as the global group. This may have been proposed partly in the spirit of simplifying the process of pricing intra-group loans, which would be a good thing for tax authorities and taxpayers alike.

However, the proposal is effectively not to apply the arm’s length principle to intra-group loans, since it cannot be argued, in the absence of explicit parental guarantees (which would involve the need to consider guarantee fees), that any reasonable application of the arm’s length principle would result in all subsidiaries having the rating of the group. This is the case even with adjustments for implicit support, since different subsidiaries will have varying degrees of importance to the wider group.

Furthermore, even where taxpayers have the right to ‘rebut’ the presumption, the process could be overly onerous/difficult and/or could meet with tax authority resistance such that, in practice, very few intra-group loans may end up being priced on an arm’s length basis.

A similar proposal in the draft is to use a group’s average interest rate on its external debt as a benchmark for internal loans. This is conceptually not an arm’s length approach given the major differences which often exist between a group’s borrowing capacity and that of any individual group entity. Also, in practice, it is often very difficult, where multinational groups have multiple debt tranches, to work out such an ‘average’ cost.

Alongside the proposals for the approach to pricing intra-group loans based on the group’s credit rating/interest rates is a great deal of discussion regarding how to apply an arm’s length approach in this area absent such group benchmarks.

The draft sets out a range of factors which it is proposed need to be considered in order accurately to price an intra-group loan, including the need to consider both the lender’s and borrower’s perspectives. The need to consider multiple factors for all intra-group loans could increase the level of complexity and the compliance burden on multinational groups. This may lead to much time-consuming discussion in tax audits about hypothetical alternative scenarios.

Based on the current draft, especially regarding the making of comparability adjustments, there is a potential requirement for an unrealistic level of precision in the selection of comparables. In this context it is not just ‘likely’ that potential comparables will differ from tested transaction, but ‘certain’ they will, and the making of comparability adjustments to individual comparables is often difficult or impossible in practice.

Conclusions

The arm’s length principle remains the basis of the OECD’s approach to pricing transactions between associated enterprises, according to the latest version of the Transfer Pricing Guidelines. This is endorsed in section A of the draft on financial transactions.

If the BEPS Inclusive Framework wishes to maintain an approach based on the arm’s length principle, with associated processes for obtaining relief of double taxation under double taxation treaties, it should as a minimum take action on the points set out below.

If some countries cannot accept that capital structure matters can be addressed by reference to the arm’s length principle, it is clear that there needs to be a new/alternative/supplementary mechanism available to multinational groups, such as some form of arbitration, to resolve disputes and prevent double taxation.

Countries should seek to resolve the ambiguities in the current draft on group treasury companies and formally recognise that there is a spectrum of functional and risk profiles with some companies being purely service providers but others bearing and controlling complex risks (credit/FX/liquidity) and employing skilled/qualified personnel. Therefore there should be no ‘one size fits all’ approach.

With regard to pricing intra-group loans, the suggested approaches based on use of the group’s credit rating/interest rate should be rejected but equally the concerns about the complexity of applying the arm’s length principle in this area should be addressed. There is no reference in the discussion draft to materiality in terms of the work that should be needed to demonstrate an arm’s length outcome, and it would be most helpful if further commentary and ideally some practical guidance could be added. APAs should be widely available for financial transactions.

The consequences if the BEPS Inclusive Framework is not able to reach a consensus position based on the arm’s length principle include increased tax audits, MAP referrals and unrelieved double taxation. Not to be able to reach agreement would not be in the spirit of creating earlier and greater certainty which was one of the key BEPS objectives (BEPS Action 14) and which is part of the on-going work on an amended Chapter IV to the OECD Transfer Pricing Guidelines on Transfer Pricing Dispute Resolution.

The objective should be a comprehensive set of guidelines for financial transactions based on the arm’s length principle with an approach to demonstrating compliance with this based on materiality of individual transactions. This should reduce the number of tax audits on financial transactions and facilitate relief from double taxation via either MAP or alternative dispute resolution mechanisms.