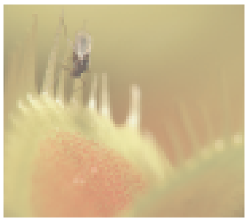


Don't trip the transfer trap

UNLESS TREASURERS RESOLVE TRANSFER PRICING ISSUES CORRECTLY, A BUSINESS CAN END UP SADDLED WITH A BIGGER TAX BILL THAN NECESSARY. **MARTIN O'DONOVAN** EXPLAINS.

Executive summary

Many standard treasury operations can throw up transfer pricing issues. The application of the arm's length principle and the amassing of documentation and supporting evidence are crucial to protect cashflow and the balance sheet.

Transfer pricing issues arise whenever a treasurer arranges a transaction between group companies, in particular when the transaction crosses national borders. A straightforward intercompany loan at an agreed rate of interest is a typical example: the tax authorities in each country involved will want to ensure that the correct rate of interest is being applied to avoid an artificial movement of taxable profits from one country to the other. Many other everyday operations performed regularly by corporate treasurers, such as support services, provision of guarantees, risk management, debt factoring, asset management, cash management, leasing, and so on, can trigger transfer pricing issues.

In 1999, only six countries had transfer pricing regulations; in 2008, more than 50 have regulations that could affect group treasury operations. Getting transfer pricing wrong can trigger a tax audit, creating legal uncertainty for businesses and generating tax assessments that impact the company's cashflow, P&L and balance sheet.

EXAMPLE 1 A parent company in country A lends to its subsidiary in country B at, say, 6% pa. The tax authority in country B determines that this rate of interest is too high and denies the subsidiary a tax deduction for any amounts paid over 5%. In country A the taxman welcomes the additional income and is only too pleased to tax it as profit. The group overall therefore ends up paying tax on that extra 1% interest with no corresponding tax deduction.

EXAMPLE 2 The same loan is made but in country B the authorities say the loan is not one any commercial bank would make and is in reality quasi-equity; they accordingly deny tax relief on the 6% paid. The result: the loan is taxed at the full 6% with no corresponding adjustment.

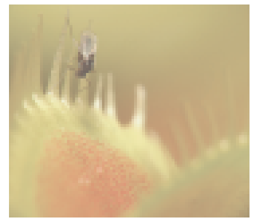
If the tax rates in the two countries are different, the downside can be exacerbated.

OECD GUIDANCE Outside of national legislation the main sources of reference for transfer pricing have been produced by the Organisation for Economic Co-operation and Development (OECD). The OECD is a forum for member countries to discuss policy approaches to a range of issues, including international taxation and transfer pricing, and it has developed a number of key international standards:

- the Model Tax Convention on Income and Capital (last updated, May 2005), which forms a basis for double taxation agreements between member countries;
- the Transfer Pricing Guidelines (from 1979, last updated in 1995) for Multinational Enterprises and Tax Administrations, which cover transfer pricing issues from the point of view of a company trying to devise or improve its own transfer pricing policy and for tax administrations; and
- a number of authoritative documents, including Attribution of Profits to Permanent Establishments and Guidance on Comparability.

ARM'S LENGTH PRINCIPLE In its transfer pricing guidelines, the OECD adopted the arm's length principle: when group companies deal with each other they should transact as if they are third parties. If transactions are not undertaken at arm's length, tax authorities may adjust the taxable profits of the companies.

A lack of economic substance may also mean the borrower has its intercompany loan reclassified as capital. This would remove the positive impact of interest deduction on the taxable income of the borrowing company.



The running of a subsidiary with an unrealistically low level of equity is termed thin capitalisation. Thin capitalisation tends to be driven by local tax rules interacting with international taxation treaties and there is little guidance in the OECD guidelines. Nevertheless it is a very important topic for corporate treasurers looking to capitalise subsidiaries, and in some jurisdictions where there is no safe harbour legislation it is very much a transfer pricing issue.

In assessing appropriate levels of capital, tax authorities have historically looked at balance sheet ratios such as debt to equity, but with the growth of fully leveraged private equity deals there is now more focus on interest coverage.

Tax authorities may analyse the transaction using arm's length principles (in other words, working out the maximum loan a subsidiary could borrow from a third party and the rate of interest the subsidiary could borrow it at). The maximum amount would not be defined by reference to the subsidiary's balance sheet but by reference to market data.

A second approach would be to apply the maximum debt/equity or interest cover ratios set in legislation (called safe harbours).

DOCUMENTATION In justifying the terms of a transaction it is crucial to have good internal documentation and supporting evidence in place that can be made available to the tax authorities in any enquiry. In many countries there is a penalty regime for not doing so. The documentation not only consists of the details of the terms of the transaction but also the economic circumstances and justifications. Components that could be maintained on file include:

- details of intra group transactions;
- company and group information (history, products, markets, legal entity chart, organisation, strategy);
- industry analysis (markets, trends, threats, opportunities);
- a functional analysis covering the group transactions;
- the transfer pricing setting and testing policy/methods;
- economic support for the prices;
- financial analysis of the results of the group transactions; and
- explanation of results in the context of the industry and/or company analysis.

The documentation must be created before the transactions start, and not retrospectively. This is particularly vital for comparative pricing information, which in any case is often easier to obtain at the time of the transaction.

Transfer pricing penalties can be avoided by keeping documentation, in particular if it shows the taxpayer acted in good faith with the arm's length principle when determining prices in intercompany transactions. Even if there is no penalty regime, keeping good documentation can leave the burden of proof on the tax authority.

PRICING METHODOLOGIES The OECD guidelines describe the two types of transfer pricing methods:

- traditional transaction methods (direct methods), of which there are three: comparable uncontrolled price (CUP), resale price (or resale minus), and cost-plus; and
- transactional profit methods (indirect methods), of which there are two: profit-split and transactional net margin, both of which also satisfy the arm's length principle.

Box 1: Further guidance

The ACT and EACT have issued a joint guidance note on transfer pricing and treasury operations. It looks at the rules and practices, and explains how to turn the OECD guidance into a practical way of operating for treasury activities across a group. The guidance can be downloaded from: **www.treasurers.org/transferpricing**

Comparable uncontrolled price CUP prices a transaction by reference to third-party external prices such as interbank lending rates, or to prices between the group and third parties such as internal cost of credit. The OECD guidelines outline five key comparability factors: characteristics of the goods or services; functions performed, assets used and risks assumed; contractual clauses; economic circumstances; and company strategy. In general, all are relevant. For example, when setting a loan rate, the treasury group will look at which party is taking the market risk. It will also look at the terms of the loan as the duration can affect the rate. It might also look at the location of the subsidiary (economic circumstances). In terms of company strategy, the group gearing ratios may be relevant in setting rates.

Resale price This method is not usually relevant to treasury.

Cost-plus This method starts by computing the cost of providing the goods or services and adds an appropriate markup. Cost-plus is often used where a group treasury function performs routine functions.

Profit-split This method is often used where there is a third-party transaction generating a group profit created by routine and value-added functions, properly performed by a number of group companies, and is most relevant in manufacturing and selling operations. Profit-split works first by allocating a reward for routine functions, usually calculated on a cost-plus basis. The residual is split by reference to the respective contributions of the parties. This method is typically used in banking transactions where the loan originator is a separate entity from the provider of capital and administration takes place in a third entity.

Transactional net margin This method is used to justify a level of net operating profit. It examines the net margin achieved on a transaction or group of similar transactions relative to a base such as turnover, costs or capital employed. This is compared with the result achieved by independent entities on a similar transaction. The method can only be used when either CUP, resale price or cost-plus cannot.

Martin O'Donovan is assistant director, policy and technical, at the ACT.
modonovan@treasurers.org