PLANNING IS THE KEY TO SUCCESS

IGNORE TAX ISSUES SURROUNDING INTRA-GROUP FINANCING AND THE PROVISION OF TREASURY SERVICES AT YOUR PERIL, SAYS **PAUL MINNESS** OF PRICEWATERHOUSECOOPERS LLP.

Over the five years since the enactment of the most recent transfer pricing legislation, most companies have, more or less, accepted the need to ensure that their cross-border, intra-group product flows, royalties and management charges are set on an arm's length basis and fully documented. However, the same cannot always be said with regard to intra-group financing and the provision of treasury services. This is despite the fact that the Inland Revenue has always maintained, quite correctly, that these transactions fall within the scope of the legislation. Indeed, the recent proposals for the reform of corporation tax in the UK suggest removing the existing thin capitalisation rules and policing the whole area by means of the transfer pricing rules.

This article examines what should be considered under the main headings of intra-group funding, guarantee fees and treasury services and shows how ignoring the issue could not only lead to problems with the Inland Revenue, but could also result in simple planning opportunities being missed.

INTRA-GROUP FUNDING. Often, the interest rate charged on intra-group funds is set at either the same rate as an external loan further up the structure, or a blended rate of the group's external borrowings (see *Figure 1*). While the simplicity of this approach is clear, one must question whether it is always appropriate.

Applying the basic tenet of transfer pricing to such a loan would require a company to set the interest rate equal to the rate at which the borrower could secure funds from a third party.

While, in certain circumstances, this may be at the same or at a lower rate than at which the group could borrow, in many cases it will be higher. Whether this is a potential benefit depends on the group's objectives. If the aim is to repatriate funds from overseas, a justifiable higher rate may be beneficial.

If, however, the subsidiary is experiencing trading problems, or the group wishes to retain cash in the overseas territory, the requirement to charge higher interest could create problems. Of course, there may be solutions to this, including rolling up interest to preserve cash, or the capitalisation of some of the debt, but, again, only if you can demonstrate that a third party could and would have done this.

FIGURE 1
INTRA-GROUP FUNDING

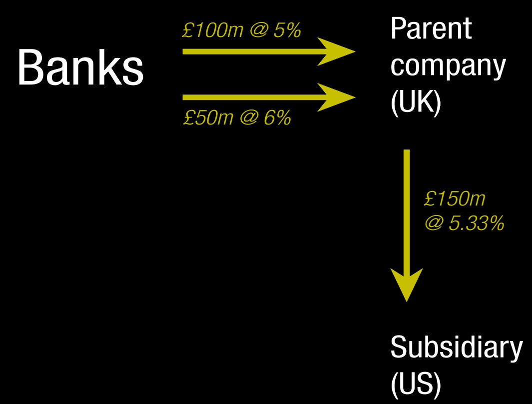


FIGURE 2
GUARANTEE FEES

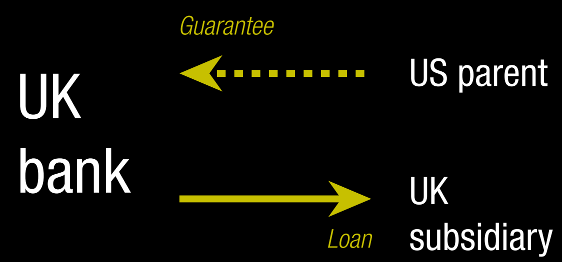
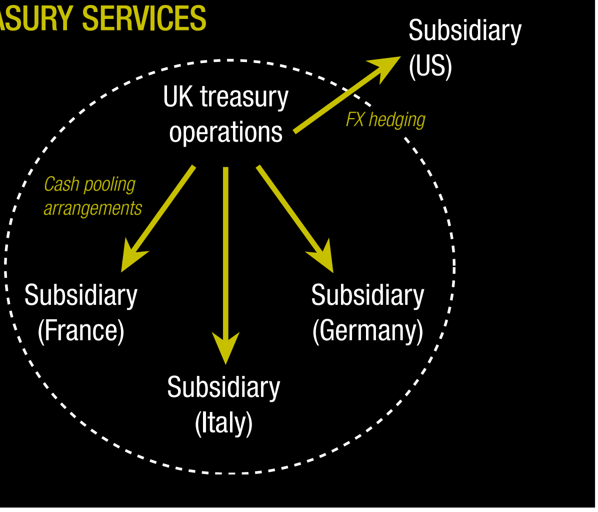


FIGURE 3
TREASURY SERVICES



In terms of setting an interest rate, it is likely that the group treasurer will be in a far better position to do this than the Inland Revenue, since treasurers are aware of the group's external banking arrangements and the trading position of the subsidiary. Ideally, though, the interest rate should be backed up by third-party evidence, which may be difficult to obtain. Some companies have approached their external bankers to provide an indicative quote. Although this would certainly be supporting evidence, some tax authorities, rightly or wrongly, do not place much faith in such quotes and suggest that a letter relating to a transaction that will not happen is of limited value.

It may be possible to benchmark the interest rates against other known third-party borrowings. In reality, though, this is likely to only be possible on very large loans, where the details of terms and rates are published in newspapers and publications such as *The Treasurer*.

If third-party supporting evidence is not available, any treasurer setting an intra-group rate should ensure that the basis upon which the rate is decided is fully documented and that the calculation forms part of the overall documentation supporting the transaction.

The interest rate charged on a loan is only one factor that should be reviewed. The transfer pricing rules operate when an intra-group provision "differs from the provision…which would have been made as between independent enterprises"[1]. As such, all of the terms of an intra-group loan need to be examined. For example:

- is interest payable under the loan (as opposed to being accrued)?;
- does the loan have standard default terms?; and
- are there any unusual terms or clauses in the loan?

While not advocating the requirement for every intra-group loan to be backed up by a 40-page loan agreement, an agreement in writing is important and it is essential to look at any agreements in place to ensure that all clauses that are regarded as standard provisions are present, such as repayment, interest, currency, default and termination. If a loan has non-standard terms, the Inland Revenue is being given an ideal opportunity to challenge the transaction.

When considering all intra-group funding, the transfer pricing position cannot be looked at in isolation. It is important to take into account any thin capitalisation rules that exist in the borrowing territory. The issue of thin capitalisation can be complicated but it relates to the ratio of debt to equity in the borrowing company. If the level of debt is perceived to be higher than the subsidiary could borrow on its own (the arm's length amount), then some of the debt may be reclassified as quasi-equity by the tax authorities, and some of the interest will be denied as a tax deduction.

GUARANTEE FEES. There has always been some discussion as to whether guarantees to third parties in support of group financing fall outside or within the remit of the transfer pricing legislation. However, the Inland Revenue has always considered that such guarantees are caught, so perhaps it is prudent to adopt the same view.

The actual detailed calculation of a guarantee fee would probably take up an article in its own right. The purpose of mentioning it here is to allow treasurers to identify possible transactions that fall within the transfer pricing rules and to suggest some possible methods of calculation.

It would, in fact, be prudent to look out for all uses of the parent company covenant. If you identify a parental guarantee (see *Figure 2*) or a cross-guarantee that is potentially within the transfer pricing rules, the next step would be to assess whether a fee should be payable and, if it is, how much it should be. A guarantee effectively removes the credit risk from a lender, leaving a remaining, lower, interest rate charged by the lender. As such, any guarantee fee charged will represent the compensation for the guarantor taking on the credit risk of the loan. There are a number of possible ways of valuing the benefit afforded by a guarantee, with the simplest being to ask a bank what rate it would be willing to lend at without the guarantee and comparing that with the guaranteed rate – the difference between the two is arguably the benefit that the guarantor should receive.

As noted above, however, there are some tax authorities that do not place significant reliance on evidence from group bankers. In these cases, it may be possible to estimate a benefit using historic information relating to credit defaults or some form of option pricing model.

TREASURY SERVICES. One further area that needs consideration under the transfer pricing rules is that of the provision of general treasury services, such as the operation of a cash pooling arrangement, or providing hedging advice (see *Figure 3*).

It may be that this activity is included within the general management expenses that are already recharged to subsidiaries at an appropriate price. However, many companies treat the treasury services as separate from the general management expenses and it is possible that they are not being recharged at all.

A further risk is that, even if the costs are being recharged, any mark-up applied in respect of general services would not necessarily be a mark-up based on the provision of treasury services. In these instances, it is beneficial to undertake a benchmarking exercise to calculate a third-party range of mark-ups that is earned by independent providers of treasury services, in order to provide evidence as to the appropriateness of the mark-up being applied. In our experience, the mark-up on treasury services tends to be higher than the average mark-up for general management services.

DOCUMENTATION. There have been many articles concerning what documentation is required to satisfy the transfer pricing legislation within the UK and the rules are the same for cross-border treasury transactions as they are for all intra-group cross-border transactions.

Although the comments below deal with documenting the UK position, it is important to check that the documentation also satisfies any local transfer pricing rules that may exist in the subsidiary's territory:

- details of the transactions within the scope of the legislation;
- the nature, terms and value of the transactions;
- the method of determining the terms of the transactions, including any benchmarking studies undertaken;
- an explanation of how the pricing results in an arm's length price; and
- details of any similar, comparable transactions with third parties.

Full documentation is not necessarily required for all financing transactions, but as the transactions increase in terms of materiality, then the greater the need for documentation.

If anybody believes the documentation can be left until requested by a tax inspector, it is worth noting that the legislation assumes that the documentation is prepared contemporaneously to the transactions taking place. Consequently, short turnaround times of 28 days are often given to reply to queries. While this may seem quite reasonable, any request is unlikely to appear during a quiet period.

At the very least, companies should review and document the transfer pricing position of their treasury operations in order to avoid being classified as negligent by the Inland Revenue. The benefit of this would be to avoid penalties, even if an adjustment is subsequently made to the taxable profits.

IDEAL TIME TO KEEP UP TO DATE. Despite the UK transfer pricing rules having been in place for a number of years, companies have often ignored transfer pricing for cross-border treasury transactions. This is despite the fact that a small adjustment to the interest rate on a large loan could lead to either a significant tax liability or a major planning opportunity. It is likely to be only a matter of time before the Inland Revenue concentrates its efforts on this area of intra-group activity, as opposed to the more traditional targets of royalties and management services. As such, it is an ideal time for treasurers to talk to their tax colleagues and ensure that all documentation is up to date.

One final thought to consider is the importance that the Inland Revenue places on transfer pricing as an area to investigate. In the recently published *Corporation Tax Reform: A Consultation Document* (August 2003), the Inland Revenue not only states that it will retain the transfer pricing rules cross-border and apply them to thin capitalisation cases, but suggests that it is considering the possibility of applying the same principles to intra-UK transactions as well.

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Note

[1] Income & Corporation Taxes Act, Schedule 28AA, Para 1(2).