Bloomberg Tax

bloombergbna.com

INSIGHT: 2020 Transfer Pricing Controversy Forecast: What, Who, and How?



By Clive Jie-A-Joen, Monique van Herksen, and Fan Bai

Clive Jie-A-Joen, Monique van Herksen, and Fan Bai look back at some transfer pricing developments to foreshadow what issues are likely to cause controversy in 2020 and who will be targeted. They conclude with how these controversy issues may best be tackled.

While pragmatically side-stepping the European state aid discussion for this overview, they note three areas as likely or possible candidates for future transfer pricing controversy: (1) Intra-group financial transactions; (2) Business restructuring; and (3) Digital business.

Intra-Group Financial Transactions

Intra-group financial transactions (and deemed excessive interest deductions) have attracted many audits and resulted in several court cases. New Chapter X of the Organization for Economic Cooperation and Development (OECD) Transfer Pricing Guidelines on the transfer pricing aspects of intra-group financial transactions are expected to be published in the first quarter of 2020. The UN Subcommittee on Article 9 also finalized a new chapter on financial transactions, which will be part of the updated UN Practical Manual on Transfer Pricing for Developing Countries. Nevertheless, different views on how to analyze transfer pricing of financial transactions will most certainly remain. Key issues will be:

- Should the arm's-length principle play a role in evaluating the capital structure (i.e. debt–equity ratio) of a related borrowing entity; and
- Should the derived credit rating of the borrower considering implicit support (rather than the multinational enterprise (MNE) group credit rating) be the default rating for pricing intra-group loans, financial guarantees, and other financial transactions.

As to the capital structure, many countries apply domestic legislative approaches and anti-avoidance rules, like thin capitalization rules and earnings stripping rules. While the new OECD guidance will permit applying the arm's-length principle to the borrower's capital structure to determine whether there is a bona fide loan, it will also offer a flexible approach regarding the extent of the role of the arm's-length principle (accurate delineation, debt capacity analysis). However, having different approaches available will likely lead to controversy (and double tax).

Credit rating is the basis for benchmarking financial transactions. While implicit support should be considered, using a group credit rating may be useful under certain conditions. Credit rating and implicit support will undoubtedly continue to be heavily scrutinized in practice.

The new OECD (and UN) guidance has been shaped by (international) court cases like the General Electric Capital Canada Inc. case (2010) on financial guarantees and the impact of implicit support on credit rating and the Chevron Australia Holdings Pty Ltd. (2017) case on whether loan terms and conditions are arm's-length. Other court cases on cash pooling (Bombardier v. Denmark (2013) and ConocoPhillips v. Norway (2010)) addressed whether the interest rate on funds deposited with a bank constituted a comparable uncontrolled price (CUP) for intra-group deposits on the remuneration of the cash pool leader; whether cash pool posi-

tions constituted long-term rather than short-term arrangements; and the allocation of cash pool benefits to participants.

Since OECD Guideline updates traditionally are not assigned an effective date and generally are interpreted as clarifications, they may be applied retroactively. This practice will cause ample controversy exposure for intra-group financial transactions.

MNE groups likely to be targeted are those that heavily rely on intra-group financing, either because their business is too risky for external funding by banks or because they show hefty interest charges for intercompany financing in a market where interest rates are low, stagnant, or even negative. Also in focus is intra-group financing of related-party borrowers with a credit rating below investment grade (i.e. below BBB-).

Business Restructuring

Business restructurings will undoubtedly remain the most fertile field for transfer pricing audits and adjustments in the coming years. The Base Erosion and Profit Shifting (BEPS) initiatives have made many existing tax structures ineffective, leading to the need for entity minimizations. Brexit is leading to many new registrations in Europe for MNEs engaged in the capital markets business that might be seen as business restructurings. Key issues here usually are:

■ Is there compensation due for business transferred? That remains to be seen and requires a careful analysis of whether ''something of value'' has been transferred and a valuation thereof, or whether existing arrangements have been terminated or substantially renegotiated. This may not be easy. In a Danish court case of 2018, however, a compensation charge required by the Danish authorities was successfully rejected at the national tax tribunal level largely based on procedural grounds, but also because there was no direct transaction and transfer of assets or customer lists.

■ Is the remuneration of post-restructuring controlled transactions arm's-length, and is there a relationship with the compensation mentioned above?

■ R&D restructuring and related (often large figure) buy-out assertions by authorities, and close analysis of (remaining) development, enhancement, maintenance, protection and exploitation (DEMPE) functions will be issues. This latter area is one where lead and high-level DEMPE functions by few employees may be considered leading, yet in other cases substantive low-level DEMPE functions by many employees are considered more relevant, depending on the perspective of the tax authorities of the country where those DEMPE functions are performed.

The above issues were raised in the Israeli cases Gteko Ltd. (2017) and Broadcom Semiconductor Ltd. (2019), the US Amazon.com case (2017), and a Dutch court case (court of Zeeland - West Brabant, Sept. 19, 2017, number BRE 15/5683) in which a Dutch entity that initially performed all the necessary functions in the total value chain of zinc smelting restructured its business. The Dutch tax inspector challenged the compensation payment as well as the transfer pricing method for the post-restructuring transactions. While the lower court ruled in favor of the taxpayer, the Dutch tax authorities have appealed the case. The cases all underscore the importance of well-prepared and considered transfer pricing documentation regarding the restructuring.

Digital Tax

In the absence of common international consensus, countries are implementing unilateral tax levies on digital business of MNEs, to capture revenue resulting from local consumers while the headquarters and offices of the MNEs often remain overseas.

While the OECD Secretariat Proposal for a ''Unified Approach'' under Pillar One presented a big step toward development of consensus, the comments submitted disclosed little unity and many demands for exclusion from the rules. That said, essentially, we expect that the cat is out of the bag in the digital business field, and controversy is likely to result based on the following aspects:

■ New nexus concept: how should (taxable) revenue in a jurisdiction be determined, considering there is no presence; and

■ Amount of taxable profit: The Unified Approach presented a definition of baseline or routine marketing and distribution activities and returns. As these figures may differ per industry sector and per country, and likely will trigger unreasonable revenue expectations, challenges arise. The Unified Approach assumes a hierarchy between amounts A, B, and C that will be impacted by the above (unreasonable) revenue expectations. But more importantly, the Unified Approach has inevitably opened the door to justifying a ''standardized'' industry margin perspective. Audits and adjustments of margins falling short of standardized margins will be a given. Loss allocations, on the other hand, are not clearly considered under the available and expected digital tax proposals.

There are not many court cases yet that can indicate where the taxation of digital income will go, but maybe Uber BV v. Aslam (2018) foreshadows what can happen. In the Court of Appeals, Uber lost the argument that drivers who use platforms are independent contractors rather than employees. Therefore Uber is facing a potential value-added tax on all bookings. Uber is awaiting a U.K. Supreme Court decision, but the result could mean that Uber must reconsider income and cost allocations in jurisdictions and may have a more substantive presence due to the deemed employees everywhere that use its platform to connect with customers.

MNE groups with platform-based revenue and no or limited physical presence may be measured along the same lines. Alternatively, possibly simple cost-based returns for stripped or limited company presence will be rejected and some form of market- or location-specific advantage-like return will be allocated to that presence, defying traditional transfer pricing rules.

Concluding Remarks

With great transparency due to international standards for transfer pricing documentation, exchange of country-by-country reports, exchange of tax rulings, and the upcoming DAC 6 reporting, tax inspectors (will) have a clear view of corporate structuring. This is leading to more controversy but it also impacts how controversy should be managed to be resolved. There are several constructive avenues to consider, however:

■ Well-considered transfer pricing documentation for high-risk transactions (like those in this overview's identified areas) ahead of time, provides an invaluable

basis and improves the taxpayer's position going into controversy.

■ Cooperative relationships with tax authorities can be very constructive. However, not all taxpayers fit into such programs. This also applies to Advance Pricing Agreements: they can be constructive but can also lead to undesirable audits and being strong-armed into undesirable positions.

■ Thanks to the OECD and the BEPS Action 14 initiative, Mutual Agreement Procedures (MAP) are more in sight and working better than before and should certainly be considered and invoked where possible.

■ Being alert and protecting procedural rights is paramount in any controversy matter. As the Denmark High Court Western Division case on the application of the Arbitration Convention of 2016 indicated: diligently protecting statutes of limitation and, where necessary, challenging tax authorities that deny access to a treaty may be required as well.

This column does not necessarily reflect the opinion of The Bureau of National Affairs, Inc. or its owners.

Author Information

Monique van Herksen, Clive Jie-A-Joen and Fan Bai work in the Financial Markets practice group of Simmons & Simmons LLP with a focus on transfer pricing controversy. Any errors or admissions are those of the authors, and this article is written in their personal capacity. They can be reached at Monique.vanHerksen@simmons-simmons.com; Clive.Jie-A-Joen@simmons-simmons.com; and Fan.Bai@simmons-simmons.com.