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THE INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS OF CYPRUS

IP TRANSFERS AND TRANSFER PRICING OF INTANGIBLES

PRESENTATION BY
Christos Theophilou

September 2024

Your global tax partner

Agenda

1. Transfer Pricing and Intangibles: Introduction
2. Assessment of the Arm's Length Nature of Intangibles
3. Case Law Example
4. References

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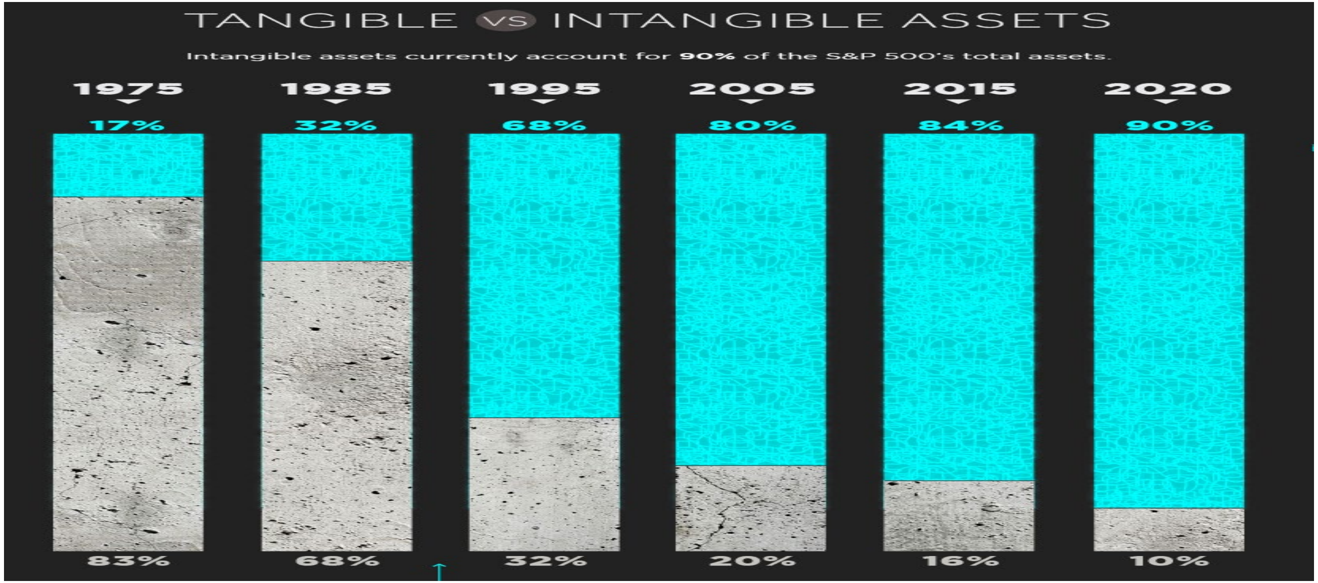
Transfer Pricing and Intangibles: Introduction

Christos Theophilou

Why Intangibles are Important (1)

The value of intangible assets soared from 17% of the value of the S&P 500 in 1975 to around 90% in 2020



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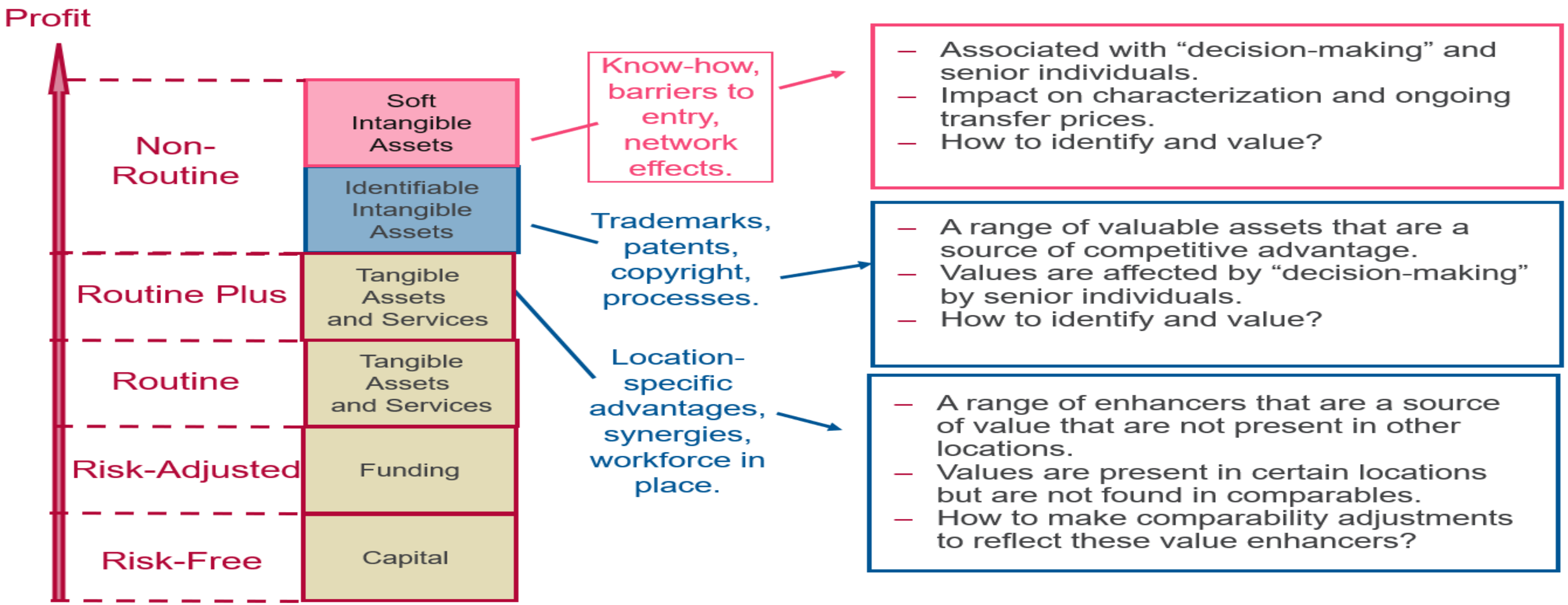
Why Intangibles are Important (2)

Post-BEPS Remuneration Spectrum*



* Source IBFD

Definition of Intangibles

[TPG § 6.6]

not a physical asset **or** a financial asset

capable of being owned or controlled for use in commercial activities

use or transfer would be compensated had it occurred between independent parties in comparable circumstances.

Definitions and characterisations for accounting, legal and tax purposes are not relevant [TPG § 6.7]

The existence of legal protection **and** separate transferability is not a necessary condition [TPG § 6.8]

Not every Intangible requires compensation

Transfer Pricing Challenges for Intangibles: Definitions: 2022 OECD TPG vs IAS 38

Transfer pricing

- Something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances
- Patents; Know-how and trade secret; Trademark, trade names and brand; Rights under contracts and government licences; Licences and similar limited rights in intangibles; and Goodwill and ongoing concern value.
- Specific local market advantages, group synergies and assembled workforce are not classified as intangibles.

IAS 38

- An identifiable non-monetary asset without physical substance, controlled by the entity and held for use in the production or supply of goods or services, for rental to others, or for administration purposes.
- *IAS 38 may require that intangible development be recorded as an expense and not capitalized and shown as an asset on the balance sheet. Yet, for TP purposes, there may be a valuable IP asset.*

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Transfer Pricing Challenges for Intangibles: Definitions: 2022 OECD TPG Vs. Tax Treaties

Transfer pricing

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Tax Treaties

- The term "royalties" as used in this Article means **[1]** payments of any kind received as a consideration **[2]** **<u>for the use of, or the right to use</u>**, any **[3]** copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or concerning industrial, commercial or scientific experience.

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Types of Intangibles: Illustrations

- Patents
- Trademarks, trade names and brands
- Licences and similar rights in intangibles
- Know-how and trade secrets
- Rights under contracts and government licenses
- Goodwill and ongoing concern value

- The following were **rejected** as intangibles because they are considered **comparability factors**:
  - Group synergies
  - Location savings and other local market specific characteristics
  - Assembled workforce

[TPG § 6.18-6.31]

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Categories of Intangibles

- IFA 2007 General Report, Intangibles can be classified into:
  - **marketing intangibles** (trademarks, trade names, brand names, copyright, franchises, licences, contracts, methods, systems, studies, forecasts, customer lists or technical data relating to marketing);
  - **manufacturing intangibles** (patents, inventions, formulae, processes, designs, patterns or knowhow); and
  - a third category that **does not fall neatly into either of the above two**, such as **efficient management systems** (e.g. inventory control systems and sales techniques)
- Manufacturing intangibles can be easily understood, and the **difficult areas** are marketing intangibles and efficient management systems.

Categories of Intangibles: OECD approach

- OECD provides for **two** commonly used terms,
  - **marketing intangibles** are defined as intangibles that relate to marketing activities, aid in the commercial exploitation of a product or service, and/ or have an important promotional value for the product concerned
  - **trade intangibles** are defined as “an intangible other than a marketing intangible”

- Yet distinctions are sometimes made between “**soft**” intangibles and “**hard**” intangibles, between **routine** and **non-routine** intangibles, and between other classes and categories of intangibles.

[TPG § 6.15]

Types of IP Tax Structuring

- Businesses often face **two crucial** considerations when organizing their intellectual property:

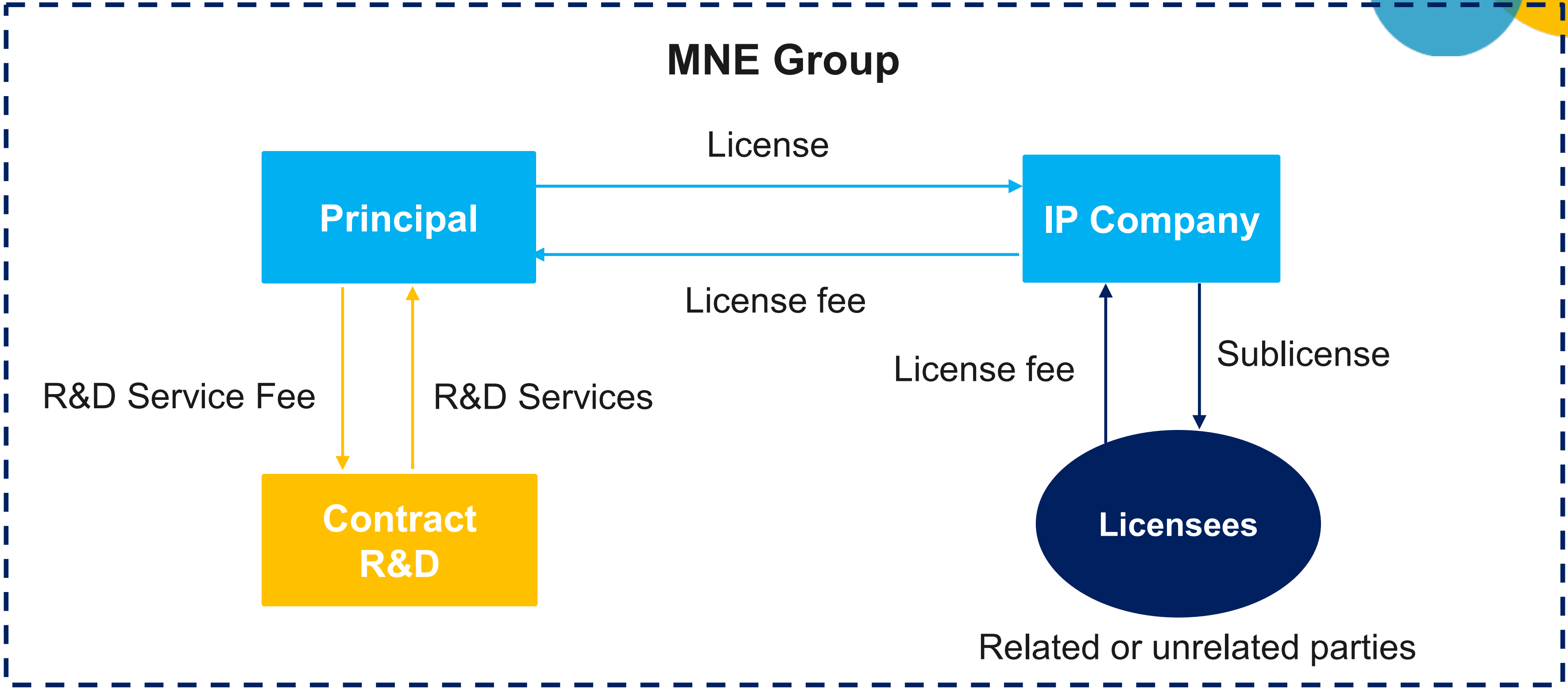
  1) Determining the location for IP development; and

  2) Deciding where to own the IP for exploitation.

IP Development
- Conventional Model
- Contract R&D Model
- Cost Contribution Model

IP Exploitation
- Conventional Royalty Model
- Principal Model
- Cost Contribution Model

Intangibles: Contract R&D Example



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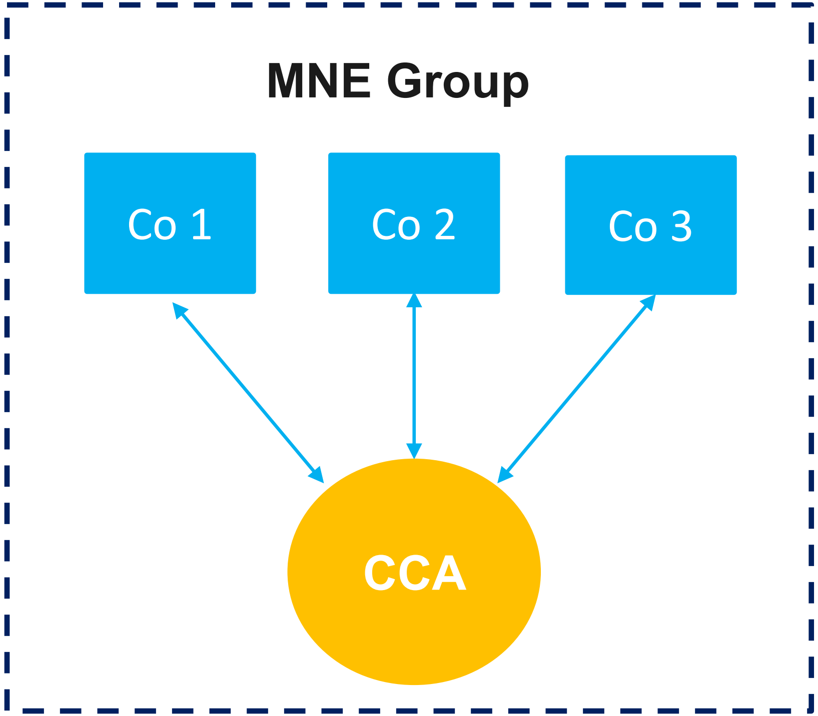
Intangibles: Cost Contribution Arrangements “CCAs” Example



- Separate legal entity not set up
- Developments costs shared by participants
- Cost sharing based on benefits to be received by each
- May require “buy-in” and “buy-out” payments if participants change

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Assessment of the Arm's Length Nature of Intangibles

Christos Theophilou

Practical Application of the ALP: 4 Step Approach

Step 1: Identification of the commercial or financial relations

Step 2: Recognition of the accurately delineated controlled transactions

Step 3: Selection of the most appropriate transfer pricing method

Step 4: Application of the selected transfer pricing method: Economic analysis (Benchmarking)

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Framework for analysing transactions involving intangibles: Six-step process

The allocation of returns from the exploitation of intangibles should especially be based on which parties perform the DEMPE functions, assume the risks and provide funds or other assets [OECD TPG 6.34]

1. **Identify** the **intangibles used** or transferred in the transaction with specificity, and the **economically significant risks** associated with the **Development, Enhancement, Maintenance, Protection and Exploitation** (**DEMPE**) of intangibles
2. **Identify** the full contractual arrangements, with special emphasis on determining **legal ownership** of intangibles
3. **Identify** the **parties** performing functions, using assets and managing **risks** related to the **DEMPE** of intangibles
4. **Confirm consistency** between the terms of the contractual arrangements and the conduct of the parties (allocation of risks)
5. **Delineate** the **actual** controlled transactions related to the DEMPE of intangibles
6. **Determine** arm's length prices for transactions consistent with each party's contribution of functions, assets and risks

[TPG § 6.35-6.72]

Going forward Legal Ownership becomes less important

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Ownership of Intangibles

- IFA 2007 General Report, the Ownership of an intangible can be classified under any of three tests:
  - Legal Ownership;
  - Ownership by agreement (may cover the partial transfer of rights, e.g. through a license agreement); and
  - Economic ownership.
- Under the OECD TPG:
  - Legal Ownership?
  - Contractual ownership?
  - Economic ownership?
  - Functional ownership?
  - Beneficial ownership?

Important Functions: Practical Examples

Intangibles: Self-developed or Acquired for Further Development	Other Functions of Intangibles Beyond Development
• Design and control of research and marketing programmes • Direction of and establishing priorities for creative undertakings including determining the course of "blue-sky" research, • Control over strategic decisions regarding intangible development programmes, management and control of budgets	• Important decisions regarding defence and protection of intangibles • Ongoing quality control over functions performed by independent or associated enterprises that may have a material effect on the value of the intangible

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[TPG § 6.56]

Important Risks: Practical Examples

Development Risk

- Including the risk that costly research and development or marketing activities will prove to be unsuccessful, and taking into account the timing of the investment (for example, whether the investment is made at an early stage, mid-way through the development process, or at a late stage will impact the level of the underlying investment risk);

Risk of product obsolescence

- Including the possibility that technological advances of competitors will adversely affect the value of the intangibles

Infringement risk

- Including the risk that defence of intangible rights or defence against other persons' claims of infringement may prove to be time consuming, costly and/or unavailing

Product Liability Risk

- Product liability and similar risks related to products and services based on the intangibles

Exploitation Risk

- Exploitation risks, uncertainties in relation to the returns to be generated by the intangible

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[TPG § 6.56]

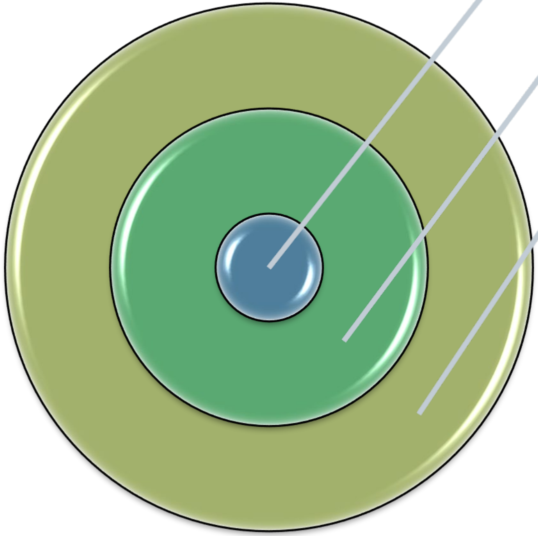
How is income allocated between related parties from exploiting the intangible?

The legal owner of intangibles does not, in and of itself, necessarily imply that the legal owner is entitled to any income generated by the business after compensating other members of the MNE group for their contributions in the form of functions performed, assets used, and risks assumed [TPG 6.47].

All members of the group receive appropriate compensation for any functions they perform, assets they use, and risks they assume in connection with the development, enhancement, maintenance, protection, and exploitation of intangibles [TPG 6.48].

- Which member(s) perform and exercise **control** over **DEMPE**;
- Which member(s) provide **funding** and other assets; and
- Which member(s) **assume the various risks** associated with the intangible.

DEMPE and Income Attribution



Risk-free return [TPG § 6.59] → Entity with limited functions (i.e., funder not controlling financial risk, e.g., Cash Box)

Risk-adjusted return [TPG § 6.61] → Entity with funding and financial risk (i.e., funder controlling financial risks)

Full intangible related return → Entity with full DEMPE* functions (see examples 14, 15 annex to Chapter VI)

*D**A**EMPE (UN TPM), **A**cquisition
DEMPE**P** (China) **P**romotion

Non-Recognition

- An exception to the general principle of the recognition of the actual transactions, the tax authorities may depart from accepting a transaction when:
  - The **economic substance** of a transaction differs from its form; **or**

  - while the form and substance of the transaction are consistent, the arrangements made in relation to the transaction **viewed in their totality** nevertheless differ from those that would have been adopted by independent enterprises behaving in a **commercially rational manner** and the actual structure practically impedes the tax authorities from determining an appropriate transfer price

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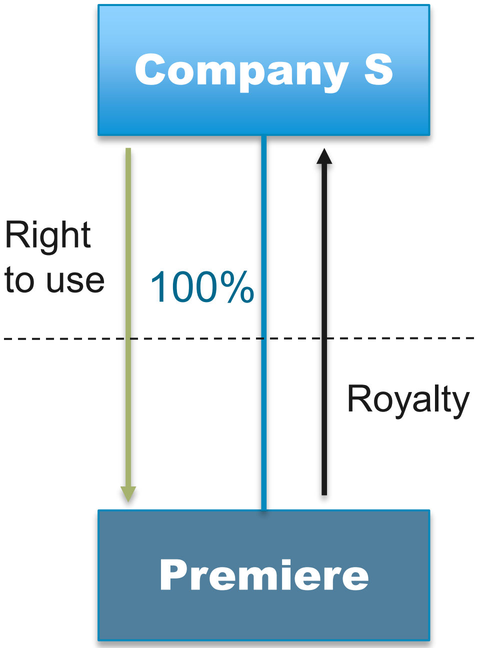
[TPG § 1.142]

Practical Example: Holding intangible and simply performing a patent administration function is not entitled to intangible related returns



- Company S employs **three lawyers** to perform its **patent administration** work and has no other employees
- Company S **does not conduct or control** any of the R&D activities of the Premiere group

- Premiere **funds R&D** and performs ongoing R&D functions in support of its business operations.
- Premiere **performs all DEMPE functions** except for patent administration services.
- Premiere contributes and uses **all assets** associated with the development and exploitation of the intangible, and
- Premiere **assumes** all or substantially all of the **risks** associated with the intangibles.

OECD Conclusion

S is entitled to an arm's length price for the patent administration services and is **not entitled to any intangible related returns**

[OECD TPG Annex I Chapter VI]

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Poland vs “K.P.”, October 2023, Provincial Administrative Court, Case No I SA/Po 475/23

Case Law Example

Facts of the Case

- In December 2013, K.P., a Polish company (the **Parent** or **Licensee** or **Taxpayer**) engaged in retail sales of computers, peripheral equipment, and software, transferred valuable trademarks (the **IP Asset**) to its subsidiary (the **Subsidiary** or **Licensor**) in exchange for shares (i.e. contribution in kind). Parent incurred license fees for using these trademarks.

- In valuing the license fee to the Subsidiary for the use of the trademarks by the Parent, relied on formal legal ownership in granting a share of the revenue generated by the Parent despite the fact that the Subsidiary did not take any part in the creation of these revenues. As a result, almost all of Parent's profits were transferred as royalties to the Subsidiary

Polish tax authorities arguments (1)

- Parent reported a lower income than what would have been expected in the absence of such a relationship and therefore considered that the Parent had overstated its cost (i.e. by incurring excessive license fees).

- Deemed this arrangement commercially irrational and recharacterized it because, from the facts viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner in comparable circumstances.

- Relied on the 2017 OECD Guidelines example 1 of the Annex to Chapter VI

Polish tax authorities arguments (2)

- The business case lacks economic rationality because an independent entity wouldn't dispose of essential assets, finance their acquisition by another company, exchange shares for significantly lower value assets without compensation, and incur extra costs for licensing trademarks previously owned.

- The license agreement was, in substance, a contract for the provision of trademark administration services and therefore priced the controlled transaction using a mark-up on the total operating costs of the Licensee (median value of 6.91%).

- The Polish tax authorities rejected the taxpayer approach from using the comparable uncontrolled price method in pricing the license agreement in calculating the arm’s length intra-group royalties.

Taxpayer arguments

- Taxpayer won the case by arguing against the Polish tax authorities use of recharacterisation, introduced in 2019, for a tax year that started in April 2016 and ended in March 2017

- OECD Guidelines are not a binding law and should be treated as a “set of good practices”

- At the time of the license agreement, the 2010 OECD Guidelines was in force. The DEMPE concept, introduced in July 2017, couldn't be considered by the Taxpayer for the tax year spanning April 1, 2016, to March 31, 2017

Conclusion and Planning Points (1)

- Had the transactions occurred post-2019 anti-avoidance provision and significant OECD Guidelines amendments, the outcome might have differed, with the tax authorities having stronger grounds to challenge the economic substance of the transaction

- If the European Commission's transfer pricing Council Directives proposal, announced on September 12, 2023, were enforced, tax authorities could use it to challenge transactions.

Conclusion and Planning Points (2)

- The proposal aims to harmonise transfer pricing rules, incorporate the arm's length principle into Union law, clarify the role of OECD Guidelines, and create the possibility of establishing common binding rules within the Union.

- 2022 similar cases that tax authorities are more inclined to challenge the economic substance of the transaction:
  - Poland vs “Fertilizer Licence SA”, April 2022, Provincial Administrative Court, Case No I SA/Po 788/21
  - Poland vs “X-TM” sp. z o.o., March 2022, Administrative Court, SA/PO 1058/21

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References

- OECD/G20 BEPS Project, the 15 actions, click here.
- OECD Model Tax Convention on Income and on Capital: Condensed Version 2017, click here
- ATAD Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, click here.
- OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022, click here.
- Proposal for harmonised transfer pricing rules in the EU click here
- Poland vs "K.P.", October 2023, Provincial Administrative Court, Case No I SA/Po 475/23click here
- Poland vs "Fertilizer Licence SA", April 2022, Provincial Administrative Court, Case No I SA/Po 788/21 click here
- Poland vs "X-TM" sp. z o.o., March 2022, Administrative Court, SA/PO 1058/21 click here
- Toshio Miyatake 'Transfer Pricing and Intangibles' (2007) 92A Cahiers de droit fiscal international, General Report to the IFA Congress

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TRANSFER PRICING AND SERVICES

PRESENTATION BY
Costas Savva

September 2024

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Agenda

I. Introduction

II. Identification of the commercial or financial relations

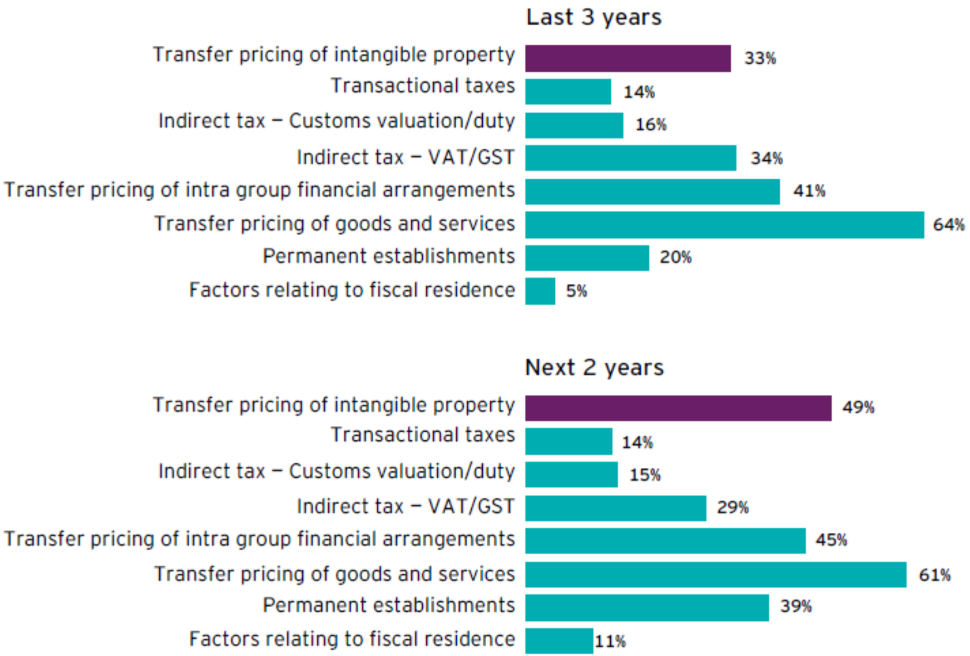
III. Recognition of the most appropriate transfer pricing method

IV. Selection of the most appropriate transfer pricing method

V. Application of the most appropriate transfer pricing method case study

Introduction

Important of services



See EY Transfer Pricing and International Tax Survey 2019

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Biggest source of risk facing transfer pricing in the next 3 years

- Double taxation in Pillar II — 84%
- Executing operational transfer pricing — 78%
- Intellectual Property — 74%
- Limitation of deductibility of costs based on domestic Rules being applied — 70%

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Classic intra - group services

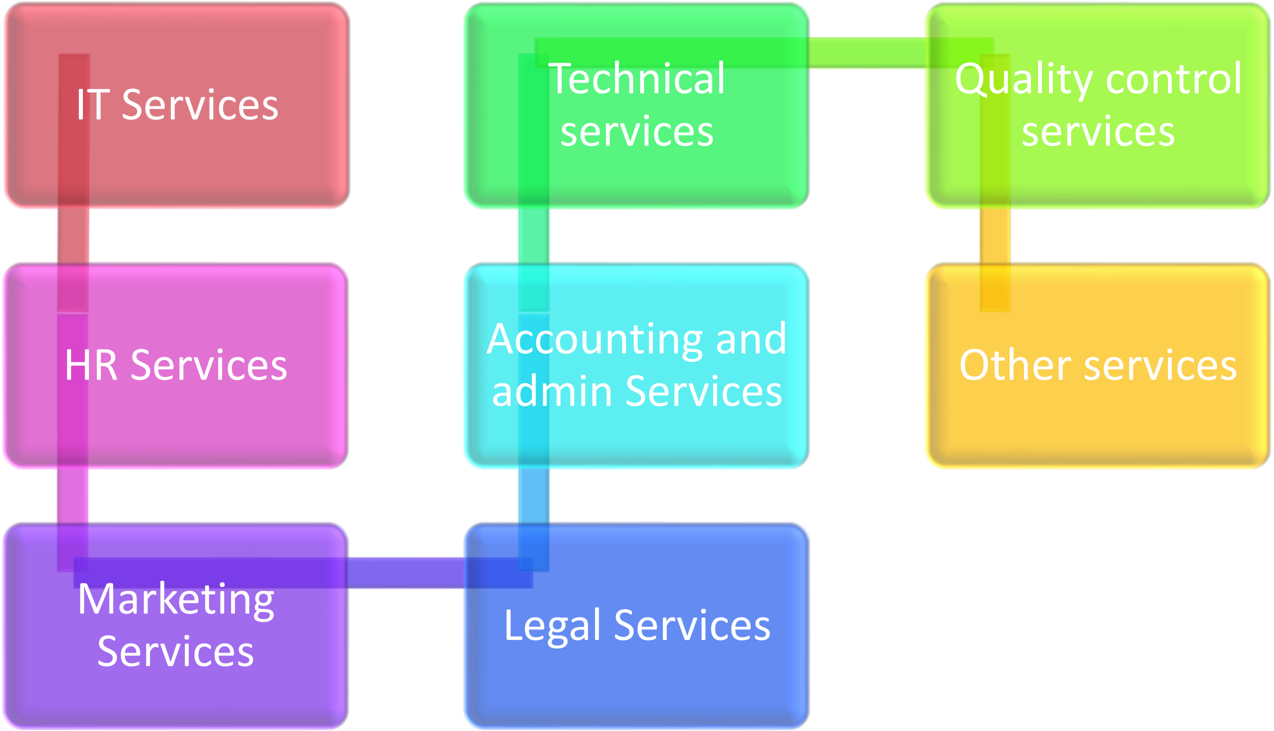

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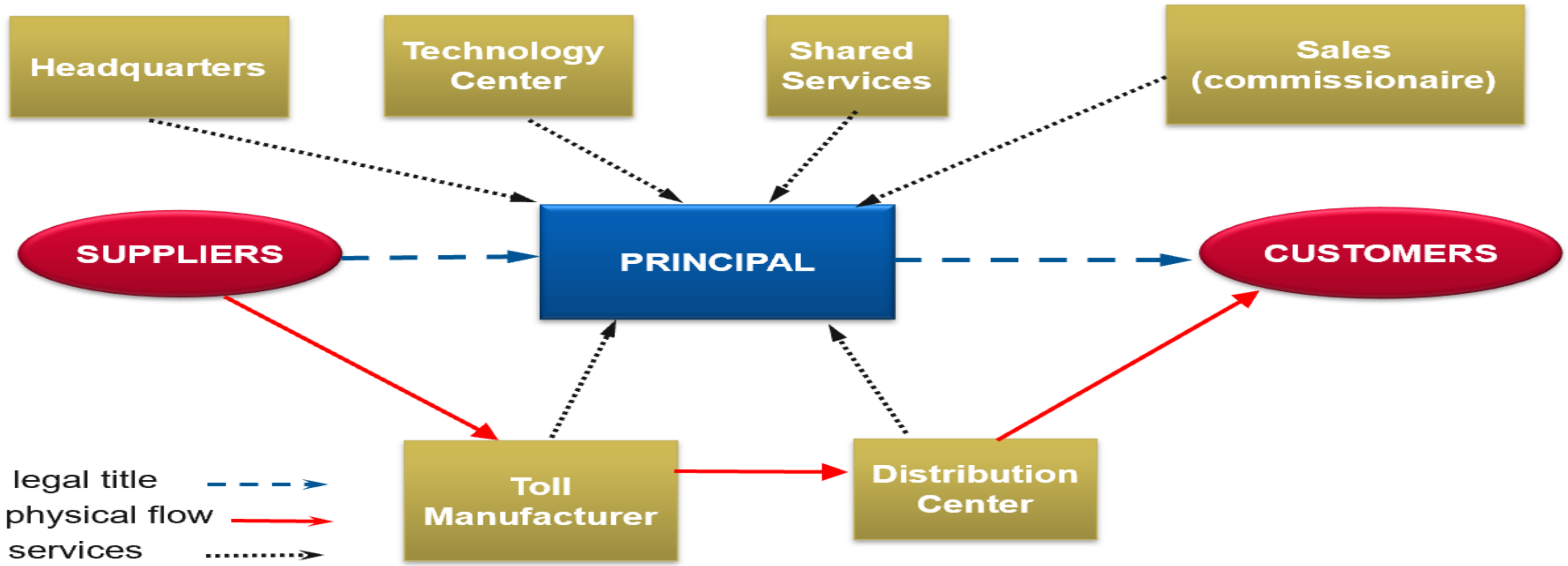
Illustration: Global Supply Chain Model



[1]Source IBFD

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What is transfer pricing?

Transfer pricing	Transfer pricing legislation
The price at which related parties transact with each other.	Arm’s length – MNE’s should carry out controlled transactions at arm’s length prices. The description of an agreement made by two parties freely and independently of each other. Its application is based on a **comparison** of the conditions that would have been made between independent parties.

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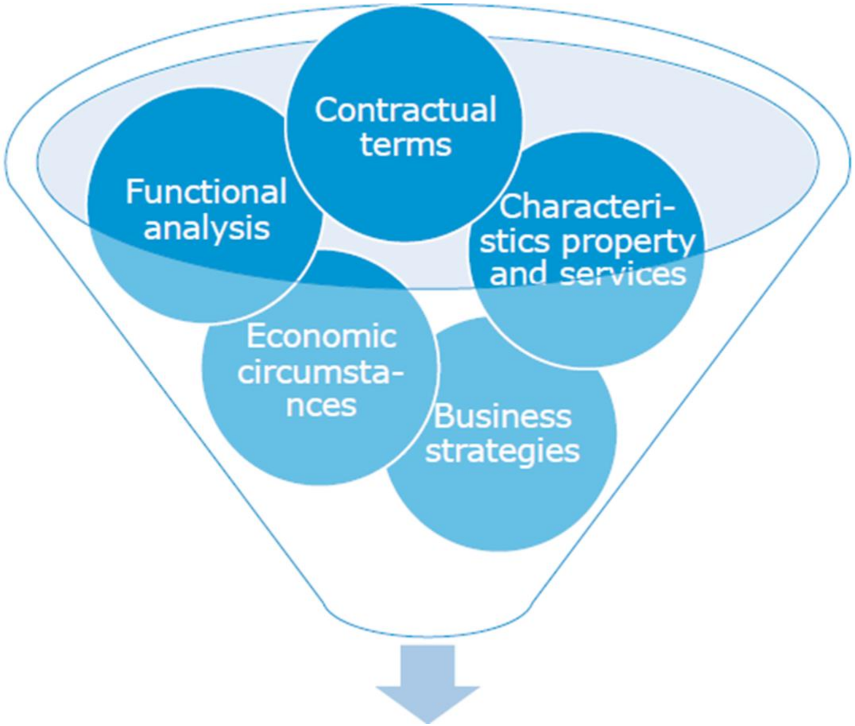
The process of apply the arm’s length principle

1. Identification of the **commercial or financial relations**
2. Recognition of the **accurately delineated transaction**
3. **Selection** of the **most appropriate transfer pricing method**
4. **Application** of the **most appropriate transfer pricing method**

Identification of the commercial or financial relations

Identification of the commercial or financial relations



Accurate delineation of the **actual transaction** undertaken
(by means of the above **economically relevant characteristics** or **comparability factors**)

Identify the commercial or financial relations

- Overview of the group – business strategies, markets, products

- Analysis of what each MNE does (e.g. a production company, distributor) and identifies its commercial or financial relations with associated enterprises

- The economically relevant characteristics or comparability factors that need to be identified in the commercial or financial relations are:
  - The contractual terms
  - The Functions performed, Assets used and risks assumed (VCA)
  - The characteristics of services provided
  - The economic circumstances
  - The business strategies

Identification of the commercial or financial relations

- **Review the contracts** – division of responsibilities, obligations and rights, risks and pricing arrangements.

- **Functional analysis** – compensation usually reflects the functions that each enterprise performs (taking into account assets used and risks assumed).

Analysis of Risks

  - **Assume** the risk (taking the upside and the downside consequences of the risk)
  - **Financial capacity** to assume the risk – access to funding to take on the risk
  - **Control over the risk** (capability to make decisions (i) take on/decline (ii) how to respond to the risks i.e mitigation)

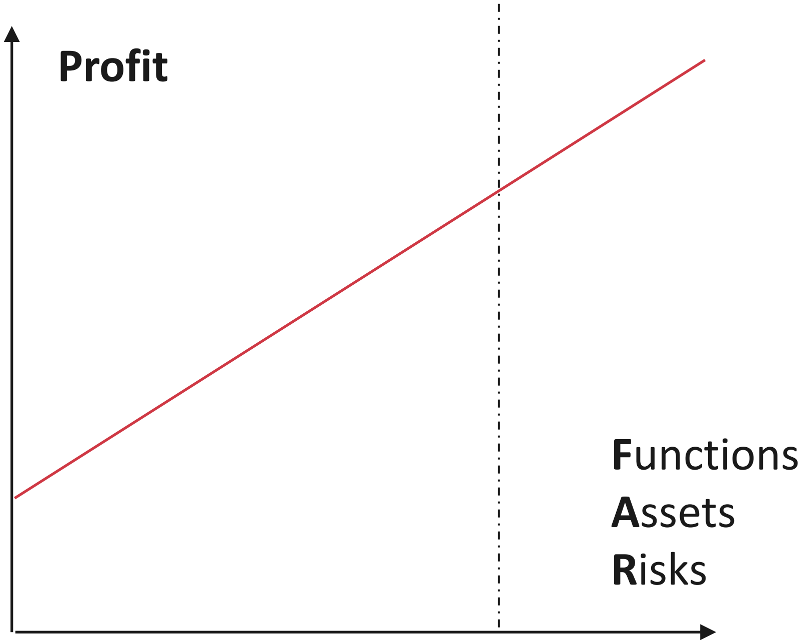
Identification of the commercial or financial relations

- **Characteristics of services** provided – i.e the nature and the extend of the services
  - CUP method – any material differences in the characteristics can have an effect on the price
  - Resale price or cost-plus method – less likely to have material effect

- **Economic Circumstances**
  - Markets in which the enterprises operate do not have differences that have a material effect on price

- **Business strategies**
  - i.e. innovation, new product development, difercification, political changes, labour laws, duration of arrangements

Types of Service Providers



- Manufacturers
  - Contract Manufacturer
  - Toll Manufacturer
  - Fully fledged Manufacturer
- Distributors
  - Limited Risk Distributor
  - Fully fledged Distributor
  - Agent
  - Commissionaire
- R&D
  - Contract R&D
  - Cost sharing
  - fully fledged

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Recognition of the accurately delineated transaction

Recognition of the accurately delineated transaction

Benefit test

The service provides the recipient with **economic or commercial value**?

Would an independent enterprise be **willing to pay** for the service?

Service is not:

- **Shareholder activity**
- Mere **duplication** of service
- Provision of **incidental benefits**

Service **can** be charged

Service **cannot** be charged

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Recognition of the accurately delineated transaction

Shareholders activities

- Costs relating to the **juridical structure** of the parent company itself, such as meetings of shareholders of the parent, issuing of shares in the parent company, stock exchange listing of the parent company and costs of the supervisory board.

- Costs relating to **reporting requirements** (including financial reporting and audit) of the parent company including the consolidation of reports, costs relating to the parent company’s audit of the subsidiary’s accounts carried out exclusively in the interest of the parent company.

- Costs of raising funds for the acquisition of its participations and costs relating to the parent company’s investor relations such as communication strategy with shareholders of the parent company, financial analysts, funds and other stakeholders in the parent company.

- Costs relating to compliance of the parent company with the relevant tax laws

- Costs which are ancillary to the corporate governance of the MNE as a whole

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Selection of the Most appropriate TP Method

Selection of the Most appropriate TP Method

- CUP Method
- Cost Plus Method
- Cost-based TNMM method
- Transactional profit split method

Traditional Methods

Transactional Methods

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Application of the Most appropriate TP Method

Application of the most appropriate Method

No value adding

E.g. pass-through costs

No mark-up can be applied

Low value adding

- Have a **supportive** nature
- Are **not** part of the **core business** of the group
- Do not require the use of **unique and valuable intangibles** (nor create any)
- Do not involve the assumption or control of **substantial or significant risks** by the service provider (nor create any)

Only a low mark-up can be applied

High value adding

- Services constituting the **core business** of the group
- **Research and development** services
- **Manufacturing** and **production** services
- **Purchasing activities** relating to raw materials or other materials are used in the manufacturing/production process
- **Sales**, **marketing** and **distribution** activities
- **Financial transactions**
- Extraction, exploration, or processing of **natural resources**
- **Insurance** and **reinsurance**

High mark-up should be applied

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Application of the most appropriate Method

Direct Charge

- Assessment costs related to services
- Elimination costs for non-chargeable services i.e. Shareholder services
- Application of Mark - UP

Indirect Charge

- Assessment costs related to services
- Elimination costs for non-chargeable services
- Determination of appropriate allocation keys (PLI)
- Application of Mark - UP

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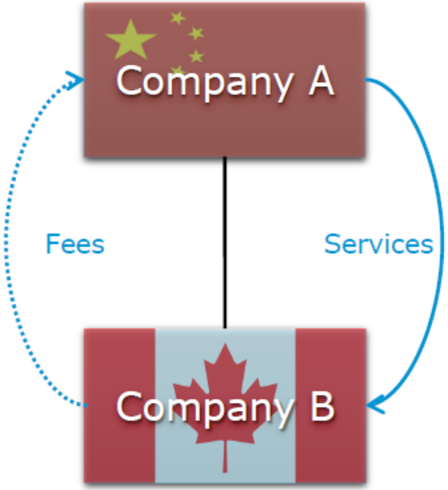
LVAS examples



Source: 2017 UN Manual, B.4.4.12

- Company A, located in China, is the parent of the group
- Company B, located in Canada, is a subsidiary of the group
- Company A provides centralized marketing services for the group.
- Company A is requested by Company B to design a marketing program for a new product.
- Following research, Company A has concluded that the CUP method is not applicable. In applying the cost plus method, the costs are known. The unknown variable is the total arm's length charge for the intra-group service.
- A comparability analysis is then carried out to determine the appropriate arm's length net profit margin for Company A (net cost plus method). This is decided to be 5%.
- Ex-ante: If we assume that the cost of providing the service is EUR 80,000 and the operating expenses are EUR 20,000, the total direct and indirect costs of providing the services are EUR 100,000. The total charge would then be EUR 105,000.
- Ex-post testing: A search of comparable independent marketing enterprises has revealed they are making a net profit to costs (TNMM) of providing services of 3-8%. Canada accepts the range of indicative comparables, therefore the cost plus 5% charge is arm's length.

Simplified Studies

- These methods simplify certain aspects of the price setting but still rely on an assessment of facts and circumstances to determine the final price, allowing for a greater degree of discretion on behalf of taxpayers.

- In this group of methods, we find
  - safe harbour rules
  - Sector-specific rules
  - Commodities sector (i.e. Argentina)
  - Alternative methods (i.e. Brazil/India)

- In Cyprus we rely on the OECD TPG, where is in line with ALP.

Simplified Studies

<u>Circular 6/2023</u>

- Brief description of the functional analysis (functions performed, assets used, risks assumed)

- Company characterisation based on the functional analysis performed

- An indication of the most appropriate transfer pricing method with regard to the transaction category and the reasons for selecting that method

- Determination of the arm's-length price based on the internal or external comparability search results, or any other relevant analysis performed in accordance with the OECD TP Guidelines.

Recent Case law

- July 2024 - Czech Republic vs BEAS SUN s.r.o. – most appropriate method
- July 2024 - Italy vs Convergys Italy S.R.L, - comparables (loss making companies)
- June 2024 - France vs SA Engie, - incidental benefit
- June 2024 - Norway vs Eni Norge AS, - aggregate services
- March 2024 - India vs Mercer Consulting India Pvt Ltd – Cost Plus method (expenses to be included)

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INTRA-GROUP LOANS AT ARM'S LENGTH?

Gaspar Lopes Dias

26-27 September 2024

Your global tax partner

AGENDA

1. TP Guidance for Intra-Group Loans (OECD TPG 2022)
2. Case study: Treasury Company
3. Discussion
4. Q&A

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TP Guidance for Intra-Group Loans

(OECD TPG 2022)

TP Guidance for Intra-Group Loans (OECD TPG 2022)

Accurate delineation of the controlled transaction under Chapter I

- Alignment of the actual conduct of the parties (FAR analysis) and the contractual terms
- Characteristics of the financial instruments
- Economic circumstances (of the parties involved in the transaction and the market)
- Business strategies (purpose of the loan, MNE group's global financing strategy/policy)
- Options realistically available

Multi-factor analysis of the characteristics of the instrument and the issuer

- Quantitative methods (debt capacity analyses)

Consider domestic legislation

- Thin capitalization rules
- Limitation on interest deductibility measures
- Safe harbours

A two-sided perspective

Typical key functions performed by a lender

- decide whether and under which terms (including amount) to advance funds
- evaluate of the risks inherent under the loan
- asses the capability of the borrower to attract funds in light of the borrower's availability of own capital (financial capacity)
- supporting and documenting the loan
- ongoing monitoring and periodic review of the loan
- evaluate (investment) options realistically available

Typical key functions performed by a borrower

- ensuring the availability of funds to repay the principal and the interest on the loan in due time
- providing collateral
- monitoring and fulfilling any other obligations resulting from the loan
- evaluate (funding) options realistically available

Functional Analysis

For intra-group loans it is important to ensure the functional analysis examines/includes

- Intra-group loan agreements
- Business plans for the borrower
- Forecast financial statements
- Financial modelling of loan servicing
- External loan agreements (of any group companies)
- Reports to external lenders
- Board papers
- Prospectuses issued by the group
- Interviews with the group treasurer, CFO, operational manager

May need to use specialist for the functional analysis

Approaches to price intercompany loans

Different approaches based on the application of the CUP method

- Internal CUP
- External CUP
- Returns of realistic alternative transactions (economically cognate instruments; such as bonds, commercial papers, deposits, etc.)
- Cost of funds approach (lender's perspective)
- Economic modelling (build-up approach)
- Bank opinions – 'generally not relevant for purposes of pricing intercompany loans

Intra-Group Loans Comparability

Group loans from external parties (must be comparable)

Commercial databases

Ask a bank to indicate the interest rate it would have charged

Ask a bank for a formal loan review and the issue of a loan offer

Get a credit rating for the borrower (expensive)

Determining Interest Rates

%

Interest rate is determined by:
amount to reflect use of money
amount to reflect risk

If there is no risk of default there is still a charge for the use of the money – often referred to as the base rate

Lenders want to be competitive; they also want to make a profit

Key factors

- Credit worthiness of the borrower
- Macro economic conditions

Factors affecting Credit Worthiness

Main Factors

- Collateral (Assets pledged for the loan)/Security given
- Asset backing
- Level of other loans
- The ranking of the debt
- Gearing/leverage
- Interest cover
- Cash flow
- Covenants
- Guarantees
- Business risk
- Track record
- Purpose of the debt
- Industry prospects

Evaluation of the risks – Credit rating

Group credit rating
View of the consolidated creditworthiness of the group

MNE credit rating
stand-alone credit capacity of the subsidiary plus the effect of implicit support

Specific issuance rating
considers additional factors such as ranking, security, or the existence of guarantees

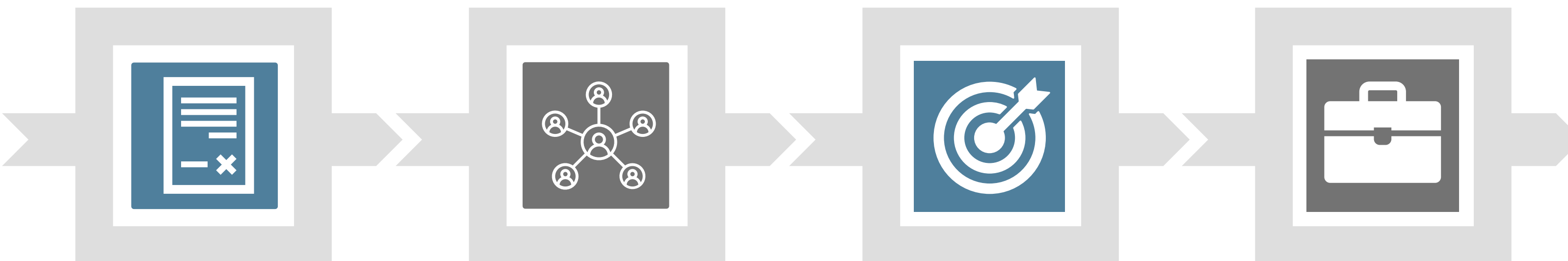
Credit rating analysis

- Understanding of the business
- Purpose of the loan
- Borrower's cash flow forecasts
- Strength of borrower's balance sheet

Points of attention:

- No specific guidance on the calculation of appropriate adjustments (e.g. ranking, security, implicit support etc.)
- The Guidance emphasizes the use of specific issuance rates where possible

Implicit support and the relative status of an entity



Strength of linkage to the group

operational integration,
legal obligations

Integration to the group's identity

shared name,
reputational impacts

Importance to the groups future strategy

effects to the MNE group

Closeness to the group core business

strategic importance

Other important factors to consider

Other Factors

- Comparability analysis. Consider the proximity in time of the analyzed transaction and the comparables
- How market circumstances affect refinancing options and when should those be revisited (ORAs).
- Disclosure of information, to be included in the master file re MNE group's global financing strategy/policy, CbCR re people and assets per jurisdiction, TP hallmarks for DAC6, etc.
- Industry-specific factors

Debt Capacity Analysis: Amount Borrowed

Analysis

- Can be tested by ratios such as Debt to EBITDA and Debt to Equity
- The company's ratios would then be compared to those of other companies operating in the same sector and with the same economic circumstances

Examples

Example: lender and borrower perspectives

A 10 year loan is provided to a member of the MNE group, which is known to be unable to serve the loan

- An unrelated party would not be willing to provide such loan
- The accurately delineated amount of the loan, for transfer pricing purposes, is a function of:
  - the maximum amount that an unrelated lender would have been willing to advance
  - the maximum amount that an unrelated borrower would have been willing to borrow
- Possibility of not lending or borrowing any amount, or doing so under certain terms and conditions
- The remainder funds advanced would not be delineated as a loan

Example: Intercompany loans

A 10 year loan is provided to a member of the MNE group, which will use the funding for short-term working capital purposes

- The Group's policy and practices demonstrate that the MNE group uses a one-year revolving loan to manage short-term working capital (business strategies)
- An unrelated borrower would not enter into a 10-year loan agreement to manage its short-term working capital needs (economic circumstances)
- The transaction would be accurately delineated as a one-year revolving loan (options realistically available)

Case study: Treasury Company

Functional profiles of a treasury company – example per transaction

	Agent	Risk-bearing	Strategic Treasury Company
Intra-Group Loans		X	
Cash Pooling			X
Hedging		X	
Financial Guarantees	X		
Other financial services	X		

Case study:
Treasury Company Location

Choice of location considerations

- Reliable legal system
- Privileged access to financial institutions and capital markets
- Country credit rating
- No interest withholding tax
- Interest deductions not restricted
- Broad tax treaty network
- Access to finance professionals
- Corporation tax rate
- Availability of APAs, relationship with the authorities
- Cost level
- Need to manage tax and TP compliance obligations and requirements
- Indirect taxes (e.g. VAT treatment), transactional taxes, wage taxes
- Uncertainty factors, (e.g. Covid19 pandemic)

Case Study

Group treasury company

Scenario – Bond issuance

The treasury Co issues USD 500m of bonds to third-party investors, with a maturity term of 5 years and a 5.00% fixed interest rate p.a.

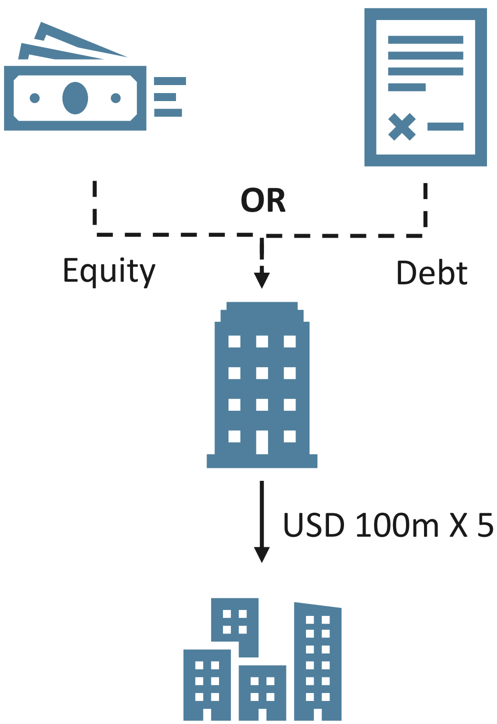
The group parent guarantees the bonds issuance. The group parent has an A+ / A1 rating.

The treasury Co uses the proceeds of the bond issuance to grant 5 loans of USD 100m to group affiliates with a 5 year maturity and a 5.25% fixed interest rate p.a.

Functional analysis?
TP method and approach?
Remuneration?

Case Study

Group Financing company



The Group financing Company needs to provide loan of USD 100m to 5 of its subsidiaries in different part of the world.

Therefore, it needs to raise capital of USD 500m
It can do so by way of:

- Equity - Issuing new shares;
- Debt- Issuing Bonds to third party persons;
- Debt-Equity: Issuing convertible notes

Functional analysis?
TP method and approach?
Remuneration?

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Discussion

Discussion points

- In which area of financial transactions can we expect audits from tax authorities following the guidance as presented in Ch. X?

- Do we need to adjust our way of testing / documenting financial transactions? If so, how?

- What are the main (commercial) opportunities taking into account the guidance of the OECD?

- How do periods of crisis affect financial transactions TP? (e.g. sanctions, pandemics, value chain disruptions)

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Q&A

Key Takeaways

- Chapter X provides a comprehensive overview of key intra-group Financial Transaction topics
- Broad implications on financial transactions which impact all multinationals
- Limited guidance on practical implementation – room for discussion?
- Some of the guidance raises practical issues
- Tax authorities worldwide are expected to use the new guidance to actively audit financial transactions operated by MNEs
- Going forward, more extensive transfer pricing analyses and (legal) documentation may be required with respect to intercompany financial transactions

ABOUT TAXAND

Taxand is the world's largest independent tax organisation with more than 550 tax partners and over 2,500 tax advisors in 50 countries. Taxand focuses on delivering high quality, integrated tax advice, free from conflict creating audit work. Taxand advisors work together to deliver global tax services for clients.

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Intra-group guarantees

If there's time…

Intra-group Guarantees at Arm's Length

Pressing questions

- *Guarantees: intra-group service or capital contribution?*
- *No compensation for incidental group benefits?*
- *Is the ALP to require deemed financial guarantees?*
- *How to deal with implicit support in the context of a shareholder loan?*

Classification of Guarantees

Important distinctions:

- **Guarantee:** An undertaking to answer for the payment or performance of another's debt or obligation in the event of default by the primarily responsible person. / A formal assurance (typically in writing) that certain conditions will be fulfilled.

- **Other types of secured obligations (e.g. pledges, collaterals, mortgages):** [Typically] an asset to be forfeited in the event of default [of a given obligation].

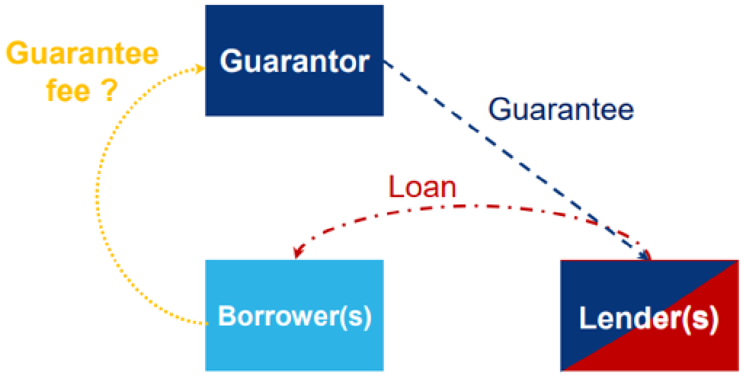
Ordinary meaning (Oxford Dictionary)

- **Financial guarantees:** the guarantor agrees to be legally responsible for the financial obligations of the borrower in case of default. E.g. the MNE parent guarantees debt attracted by a subsidiary.

- **Performance guarantees:** the guarantor agrees to be legally responsible for the fulfilment of the (non-financial) obligations of a party under a contract. E.g. the MNE parent of a local construction company ensured deliverance of the project in accordance with set agreements, with a view to win a public tender.

Intra-group Financial Guarantees:

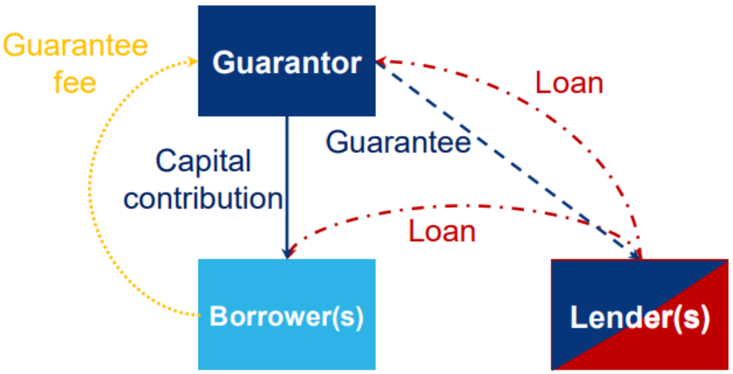
- Is the guarantee an intra-group service?
- Is there any value to the borrower in the guarantee?
- If so => guarantee fee.



- **Benefit Test:**
  - Is there "economic or commercial value to enhance or maintain [the taxpayer's] business position" ?
  - Third-parties would be willing to pay for [the intra-group guarantee] or to perform in-house?
  - **No shareholder activity:** if performed by the Parent also for the benefit of the subsidiary.
- ***But first:*** is the controlled transaction accurately delineated?

Intra-group Financial Guarantees: No borrowing capacity

- Accurately delineating the intra-group guarantee may involve recognising capital contributions



- The Borrower(s) attract a loan (from a related or third party / market).
- A guarantee is granted by a group entity (e.g. MNE Parent) to the Lender(s), when the Borrower(s) have no borrowing capacity / to expand the borrowing capacity.
- Lender(s) are deemed to lend, in part, also to the Guarantor.
- The Guarantor is deemed to have used the cash to make a capital contriobution to the Borrower(s).

TP consequences:

- Any guarantee fee is due only in relation to the portion of the loan that is respected as having been granted by the Lender(s) to the Borrower(s).

Pricing Guarantee fees: What to price?

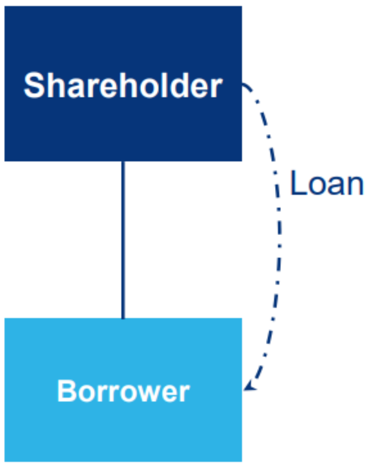
IMPLICIT SUPPOT: benefits of mere group affiliation

- OECD TPG, §7.13: “an associated enterprise should not be considered to receive an intra-group service when it obtains incidental benefits attributable solely to its being part of a larger concern, and not to any specific activity being performed
- **Measuring implicit support**: strategic importance of the subsidiary for the group. See => Rating agencies subjective methodologies

EXPLICIT SUPPORT: intra-group guarantee

- Legally binding commitment for a party to assume a specified obligation of the guaranteed debtor should it default on that obligation.

Pricing Guarantee fees: Diligentia Sweden



- Credit rating analysis is a key comparability factor to pricing both loans and guarantee fees.

Facts

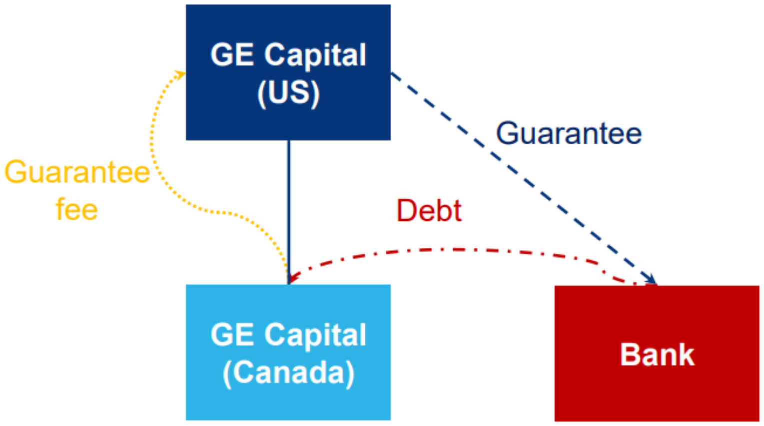
- Loan from shareholder deemed unsecured / subordinated
- The interest rate on the loan was determined by the Borrower on the basis of its stand-alone credit rating.

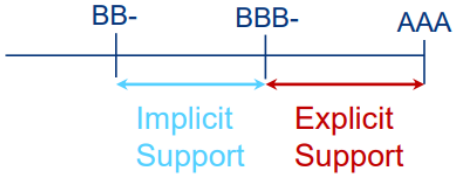
Decision:

- ➢ The court considered that third party lenders would take into account a higher rating, considering (but not paying for) group affiliation (i.e. likelyhood of group support in case of financial distress).

- ➢ Therefore, the interest rate was reduced, reflecting a higher rating.

Pricing Guarantee fees: GE Canada





How to measure the value of the guarantee?

Facts:

- Stand-alone rating of GE Canada: BB-
- Implied rating on existign debt without the guarantee: BBB-
- Group rating / debt rating with the guarantee: AAA

Decision:

- correct pricing of the intra-group guarantee fee takes into account the difference between the factual situation prior to and after the unconditional explicit guarantee.
- i.e. Difference between BBB- (with implicit support) and AAA (with explicit support). **NOT**: between BB- (stand-alone) and AAA (with explicit support).
- Therefore, *implicit support* should not be remunerated (i.e. not an intra-group service), but taken into account as a fact. (Synergy? – depends, if concerted group action).

Implicit support → ~~No guarantee fees~~

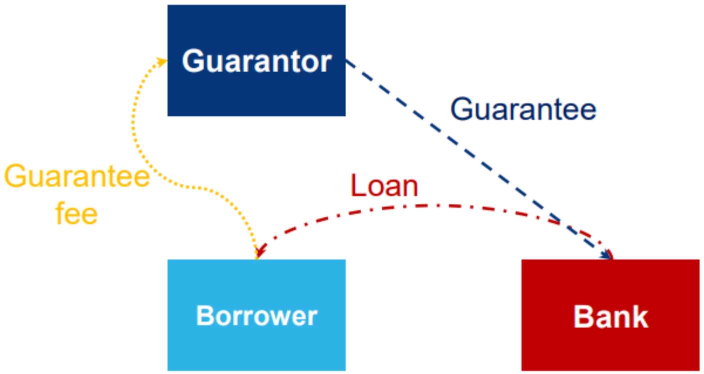
Cross guarantees → ~~No guarantee fees~~

Support regarded as a capital contribution

Explicit guarantees if beneficial to the borrower → Guarantee fees

TP Methods

Pricing Guarantee fees: Methodologies

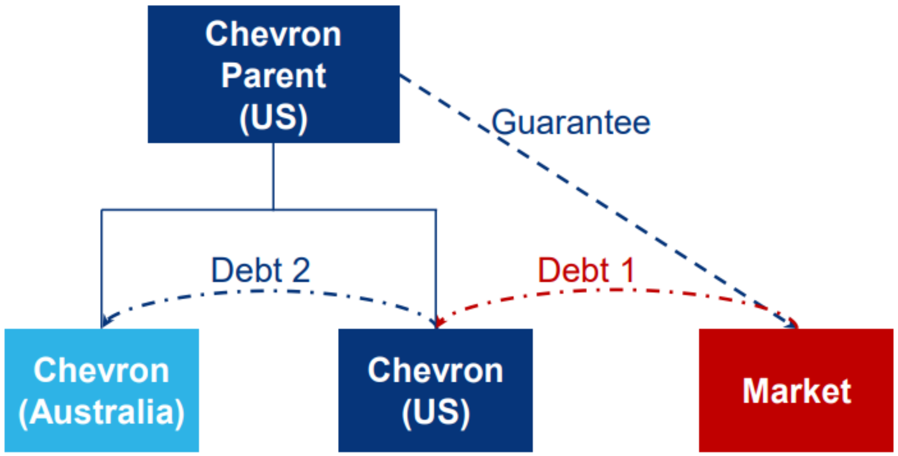


➢ Guarantee fee? If so, *quantum*?

Pricing methodologies:

- CUP Method
- Cost Approach
- Benefit or Yield Approach
- Contingent Put Option, where the Guarantee fee can be compared with the right of the Lender, in case of default, to sell the loan to the Guarantor at face value.
- Capital Support Method
- Valuation of Expected Loss Approach

Pricing Guarantee fees: Chevron Australia



Facts

- Debt 1 is granted by third parties, guaranteed by the Chevron Parent, and bears a low interest rate.
- Debt 2 is an intra-group loan, unguaranteed / unsecured, and bears a high interest rate.

Decision:

- Third parties would have guaranteed Debt 2. Therefore, Debt 2 should be priced as if a guarantee had been provided (**Deemed guarantee**).

Impact for MNEs: Two-fold re-assessment of the facts

Primary line of defence: **accurate delineation of transactions**

Secondary line: **non-recognition of transactions (§1.122 TPG)**

- Consequence: *disregard or replace the transaction or parts thereof*

- Cummulative conditions – *exceptional circumstances*, where:

  - (i) Accurately delineated transactions would differ from what third parties would have done, behaving in a commercially rational manner (**Hypothetical Requirement**);
  - (ii) Preventing pricing that would be acceptable to all parties, considering their ORAs (**Prevention Requirement**).

- **Simple test (§1.122 TPG):** is the MNE worse-off on a pre-tax basis?

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TRANSFER PRICING MISAPPLICATION

PRESENTATION BY
Demis Ioannou

September 2024

Your global tax partner

Transfer Pricing misapplication

1. Big picture view
2. What is transfer pricing?
3. Practical applications
4. Conclusions

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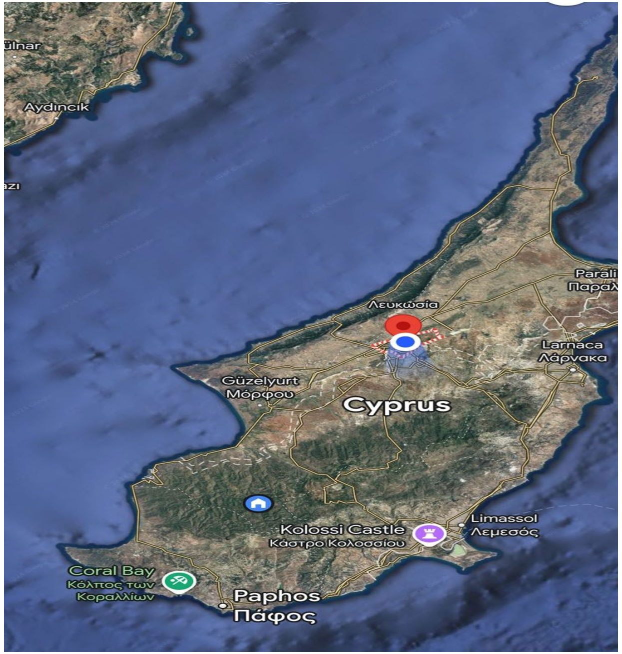
Big picture view



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What is Transfer Pricing?

P

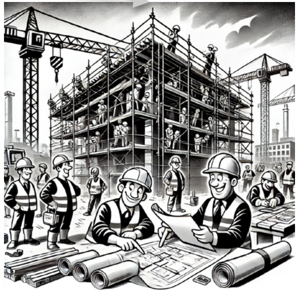
PE — 20 people & assets

S1 — 1 person & assets

S2 — 100 person & assets

~~S3~~ — 500 person & assets

Construction



1000 people and assets

Transfer pricing : - It is not about economics, is not about benchmarking etc

- It is the method we allocate income to source and resident

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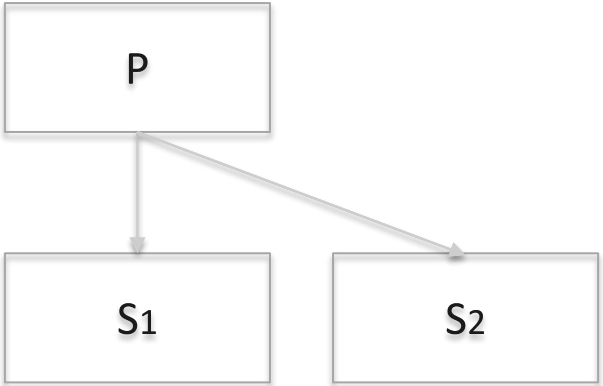
What is Transfer Pricing?

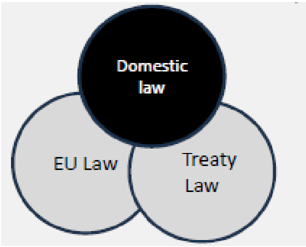


1 person
& assets

100 people
and assets

We have established that.. Transfer pricing : Is the method we allocate income to source and resident

1. Source and resident rules



But…

2. How do we allocate income to S&R(based on what)?

Formula

Economics

Hybrid system:
-People decision function
-Economics

What is Transfer Pricing?

- It is about: Income allocation to S&R

- Step 1: What are you (economics)
  - -Distributor
  - -Manufacturer
  - -Financing
  - -IP Company
  - -Service company
- Step 2: Find 3rd party prices (comparables)

- BEPS: people (decision) function

Summary:
Work as a
Hybrid model

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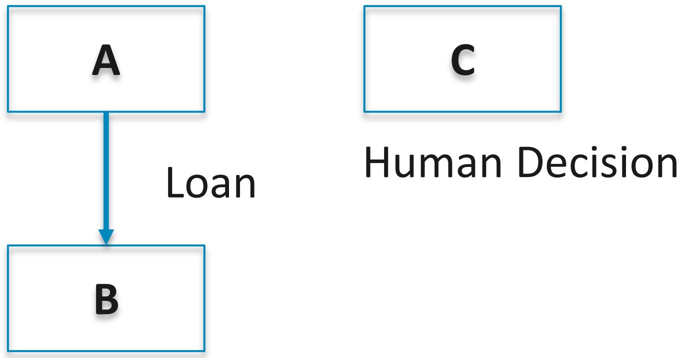
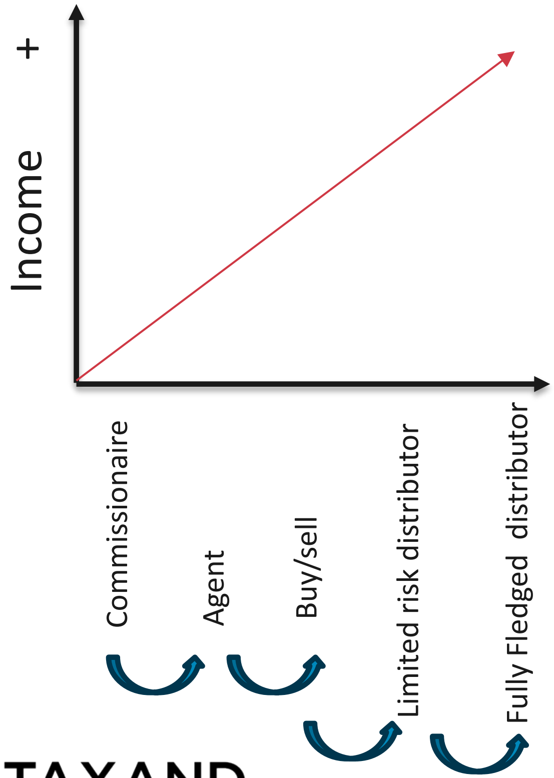
Examples of misapplication: Loans



- Step 1: What are you (economics)
  - Finance company
- Step 2: Find 3rd party prices (comparables)
- Step 3: People function

Examples of misapplication : Distributors



- Step 1: What are you (economics)
  Full risk distributor
- Step 2: Find 3rd party prices (comparables)
- Step 3: People function

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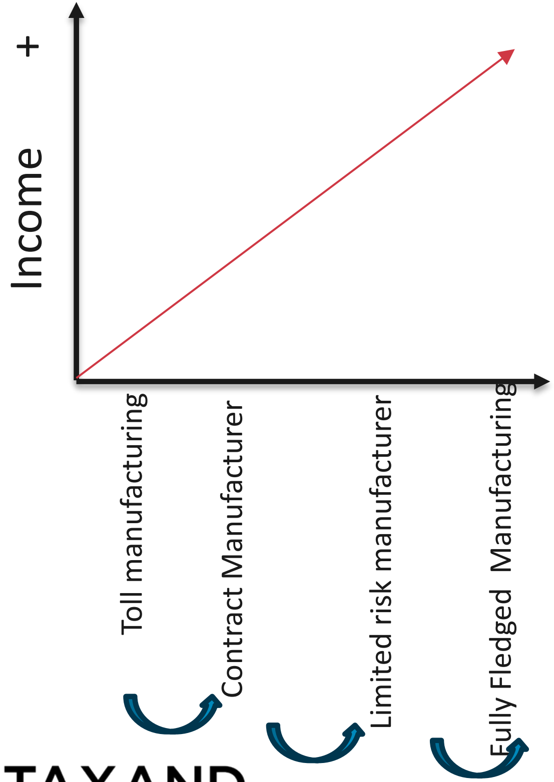
Examples of misapplication: Manufacturing



- Step 1: What are you (economics)
  Full risk distributor
- Step 2: Find 3rd party prices (comparables)
- Step 3: People function

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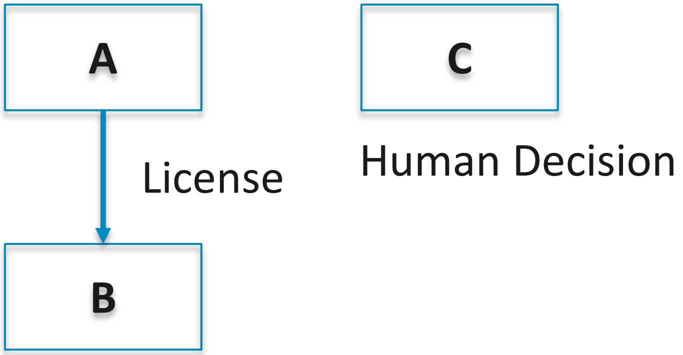
Examples of misapplication: Intangibles



- Step 1: What are you (economics)
  Finance company
- Step 2: Find 3rd party prices (comparables)
- Step 3: People function (DEMPE)

Conclusion: What is Transfer Pricing?

P

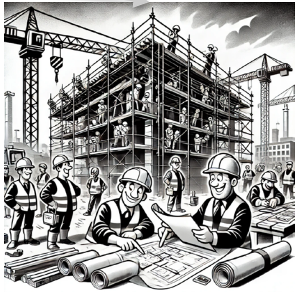
PE — 20 people & assets

S1 — 1 person & assets

S2 — 100 person & assets

~~S3~~ — 500 person & assets

Construction



1000 people and assets

Transfer Pricing – Some Conclusions:

(1) It is the method by which we allocate income to source and resident tests

(2) It is based on an unclear hybrid approach (economic and people functions).

(3) We expect significant litigation and controversies.

(4) Strong documentation is essential.

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