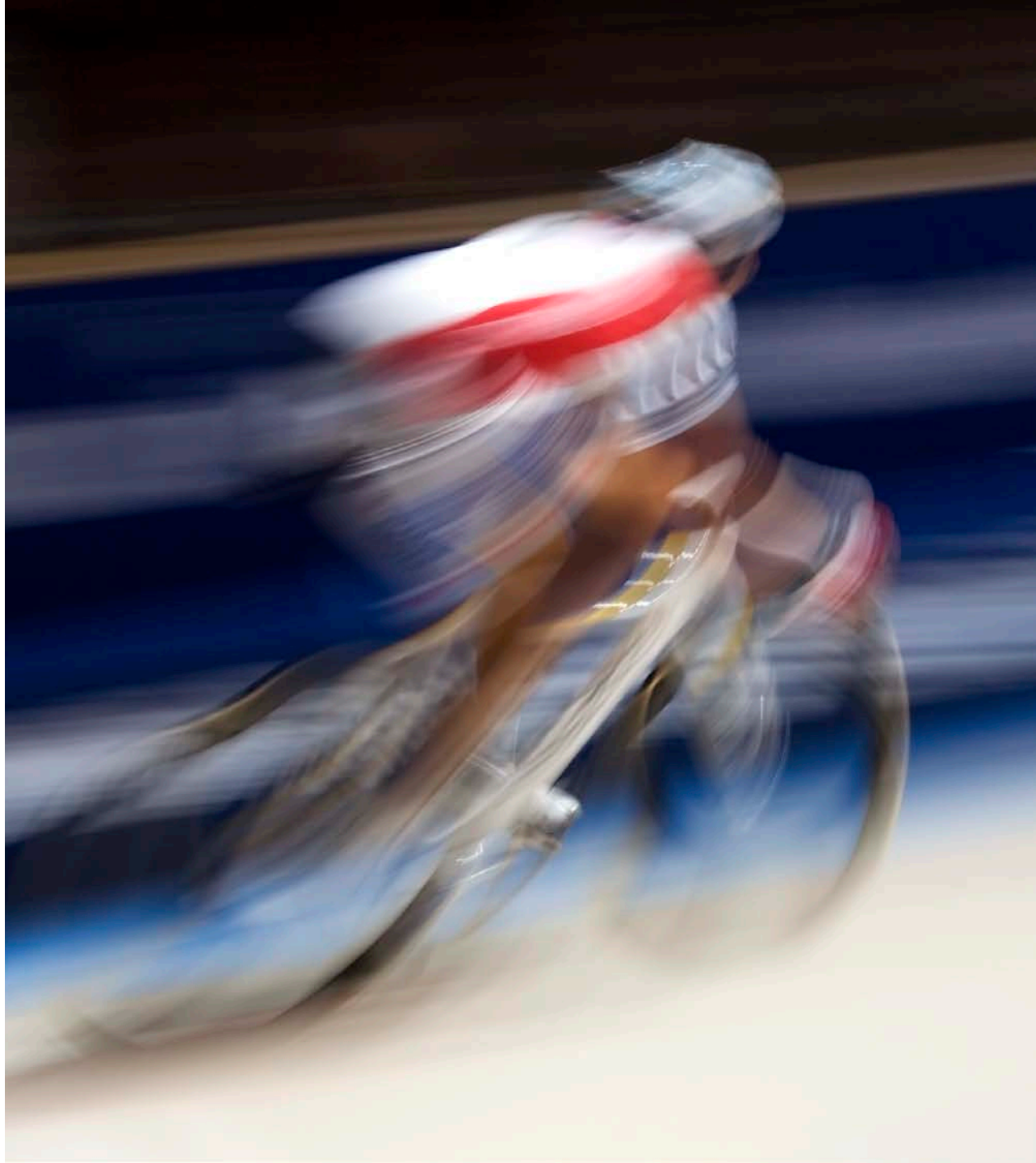




# Transfer Pricing of Financial Instruments

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March 1 - 4, 2015



# Agenda

Why is there a focus on financial transactions?

Financial transactions: A simple example

Impact of 'passive association'

Summary of BEPS Guidance Impacting Financial Transactions

- OECD Guidelines and Financial Transactions
- BEPS Actions 8, 9 and 10
- BEPS Action 4
- Potential impact of BEPS guidance on financial transactions
- Some additional implications

# Why is there a focus on financial transactions?

## Financial transactions and tax planning

- The OECD perceives that financial transactions are “perhaps one of the most simple of the profit-shifting techniques available in international tax planning.”
- For many multinational groups, financial transactions can be complex and have a principal amount in the tens or even hundreds of billions of dollars; their impact on a firm’s financial condition can be material.
- Financial transactions extend beyond intra-group lending and cash pooling to include foreign exchange hedging agreements, interest rate and cross-currency swaps, credit guarantees, and factoring arrangements. These transactions can make financial transactions appear even more complex to taxation authorities.
- In 2013, financial and non-financial issuers raised USD 3.2 trillion through the corporate debt markets, according to Standard & Poor’s; banks extended USD 4.2 trillion in syndicated loans globally to corporate borrowers in 2013 according to Thomson Reuters.

# Why is there a focus on financial transactions?

Financial transactions and the comparable uncontrolled price method

- Financial transactions are generally priced based upon certain 'key comparability factors'. These include
  - The start date of the loan (reflects market conditions)
  - The time to maturity (reflects interest rate risk and credit risk)
  - The credit quality of the borrower (impacts credit risk/anticipated likelihood of default)
  - Seniority/Subordination/Collateral (impacts anticipated loss given default)
  - Interest rate basis (fixed/floating)
  - Call/Put provisions

# Why is there a focus on financial transactions?

While the factors that impact the determination of an arm's-length price are dictated by the market, applying these factors to private, related-party transactions is often a subjective process

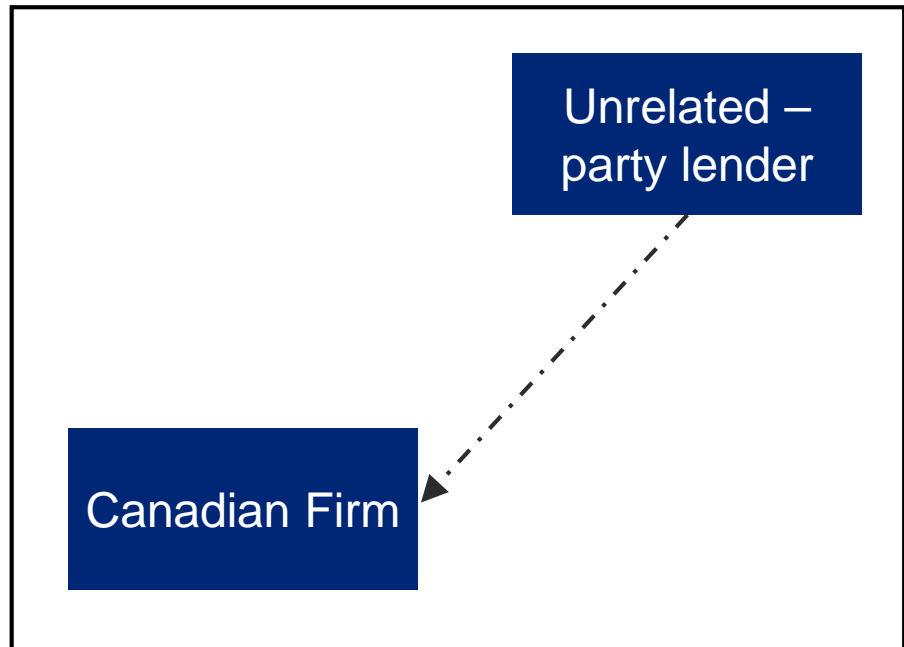
- Some areas of ambiguity include
  - Estimating the credit risk of subsidiaries
  - Evaluating the 'commercial realism' of transactions
  - Thin capitalization
    - Interaction with Treas. Reg. Sec. 1.163(j)
  - Identifying comparables

# A simple example

# Financial transactions: A simple example

## Independent enterprise

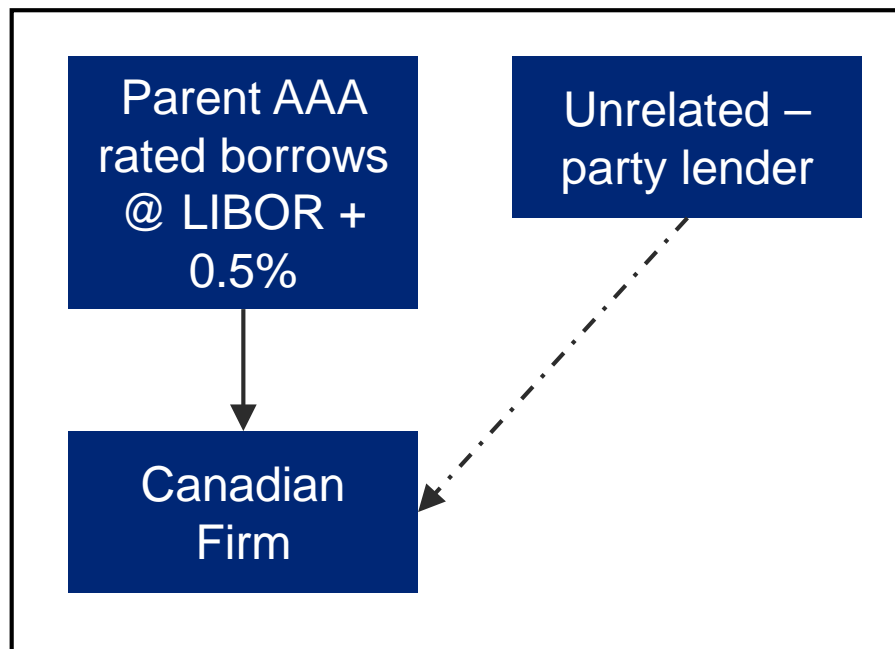
- Canadian industrial firm
- Debt:equity ratio of 1:1
- Credit quality of Ba/BB
- Funds at LIBOR + 3.00%
  - At what rate?
  - On which terms?
  - At what debt/equity ratio?



# Financial transactions: A simple example

## Foreign-controlled enterprise

- AAA-rated foreign parent
- Canadian subsidiary
- Stand-alone credit quality of Ba/BB
  - At what rate?
  - On which terms?
  - At what debt/equity ratio





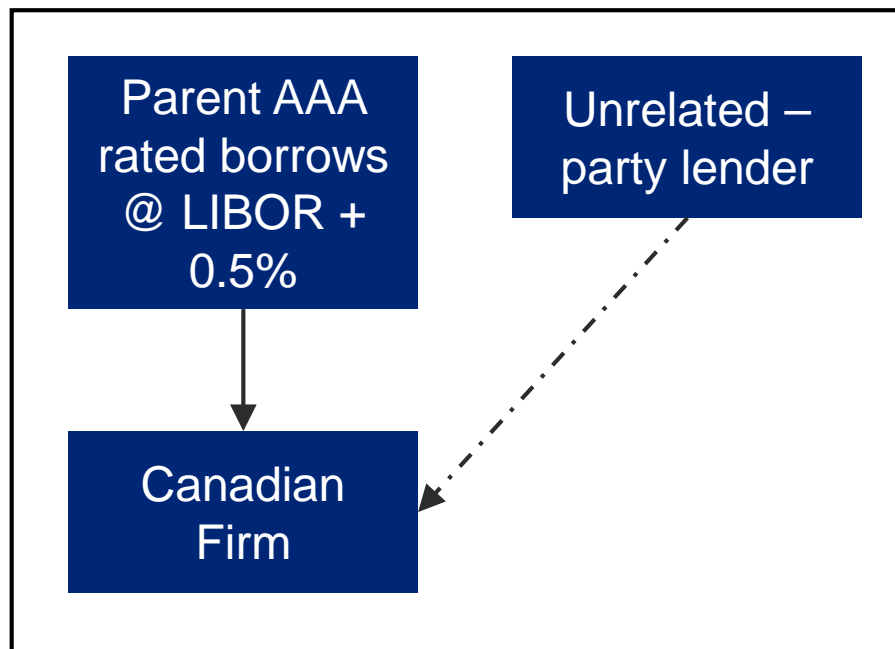
# Financial transactions: A simple example

- In both the third-party and the related-party case, the lender is assuming the risk that the borrower may default or otherwise be unable to perform on its obligations as agreed
- Hence, in the related party case, the lender is assuming real risk, a fact often overlooked by taxation authorities
- Some taxation authorities have argued that the fact the lender can control the borrower's debt/equity ratio and can inject additional equity into the borrower, makes the transaction somehow artificial

# Financial transactions: A simple example

Traditional perspective:  
'Functionally separate enterprise principle'

- Focus on borrower and its functions, assets, risks and credit quality
- Price transaction on stand-alone basis, using factors that market participants would consider

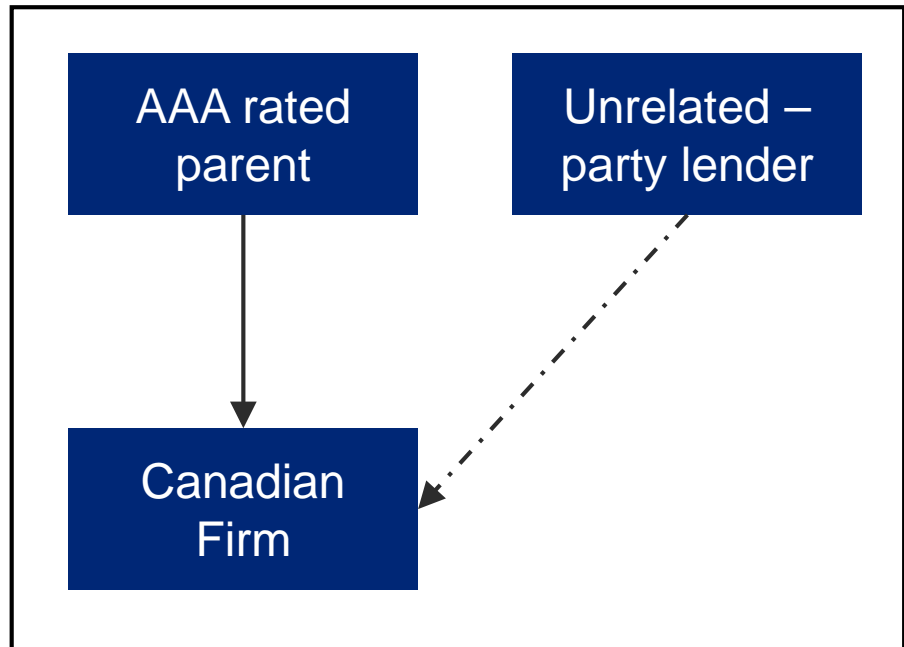


# Financial transactions: A simple example

Alternative perspective:

‘Member of a group/passive association’

- Focus on the rate at which a third-party lender would extend credit without a parental guarantee, but in light of group affiliation



# Impact of passive association

## The grey area.....

- Additional OECD guidance, including the definition of the arm's length principle from Article 7(2) of the OECD Model Tax Convention, potentially provides support for both a pure stand-alone and a 'member of a group' approach to credit evaluation
- Specifically, when determining “the profits which might be expected to make if [a related-party subsidiary] were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions” can be interpreted to support a stand-alone basis (focusing on 'distinct and separate enterprise') or a 'member of a group' approach (focusing on 'same or similar conditions')

# Impact of passive association

## The case for 'stand-alone'

- This concept is important as the arm's length standard states
  - Paragraphs 1.6 and 1.7 of the OECD Guidelines state that the members of the MNE group should be treated as 'separate entities' rather than inseparable parts of a single unified business
  - That attention is focused on the dealings between these members as if they were independent entities
- The logical conclusion could be argued that dealings within an MNE should be considered without the impact of being 'a member of a group'

# Impact of passive association

## OECD commentary on 'incidental benefit'

- 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
- No service would be received where an associated enterprise by reason of its affiliation alone has a credit-rating higher than it would if it were unaffiliated, but an intra-group service would usually exist where the higher credit rating were due to a guarantee by another group member, or where the enterprise benefited from the group's reputation deriving from global marketing and public relations campaigns
- Passive association should be distinguished from active promotion of the MNE group's attributes that positively enhance the profit-making potential of particular members of the group
- Each case must be determined according to its own facts and circumstances

# Summary of BEPS guidance impacting financial transactions

# OECD guidelines and financial transactions

## 2010 version

The current OECD Guidelines provide only broad guidance regarding the application of the arm's-length principle to financial transactions

- Reference to 'arm's-length conditions'
- Definition of a comparable uncontrolled price, but not in the context of financial transactions or financial services
- Recharacterization imbedded in an example on a loan that is, in substance, a contribution of equity
- Passive association, without any consideration of how it interacts with risk in an intra-group context



# BEPS Actions 8, 9 and 10

## Risk, recharacterization and special measures

### Application of the arm's-length principle – comparability analysis

- Comparison of *conditions* of controlled transaction and transactions between independent parties
- First step: Identify commercial or financial relations between associated enterprises and its conditions
- Second step: Compare conditions of controlled transaction with those of comparable transactions between independent enterprises
- Role of contractual terms, other written guidance (e-mails) and actual actions
  - Transaction may include services not identified by the taxpayer
  - Need to determine “the conditions that independent parties would have agreed in comparable circumstances, and those circumstances need to take into account economically relevant characteristics”

# BEPS Actions 8, 9 and 10

## Risk, recharacterization and special measures

(cont'd)

Application of the arm's-length principle – comparability analysis

- Also need to consider “functions performed, risks assumed and assets used” by the parties
- Independent enterprises will compare transaction to “options realistically available to them” and will “only enter into the transaction if they see no alternative that offers a better opportunity”
- The CUP method “becomes a less reliable substitute for arm's length transactions if not all characteristics of these uncontrolled transactions that significantly affect the price charged between independent enterprises are comparable”
  - Is being part of a multinational group an affiliation factor?

# BEPS Actions 8, 9 and 10

## Risk, recharacterization and special measures

(cont'd)

Application of the arm's-length principle – comparability analysis

- “Controlled and uncontrolled transactions and entities are not comparable if there are significant differences in the risks assumed for which appropriate adjustments cannot be made”
- “Usually, in the open market, the assumption of increased risk would also be compensated by an increase in the expected return”

# BEPS Actions 8, 9 and 10

## Assumption of risk

- “In arm’s-length transactions it generally makes sense for the parties to be allocated a greater share of those risks over which they have relatively more control”
- “Should transactions between associated enterprises be recognized where the sole effect is to shift risk?”
- How should this thinking be applied to the FS sector?
- Is the allocation of risk consistent with the conduct of the parties?
- In a group context, risk management may be carried out at multiple levels
- Risks and opportunities do not “derive from asset ownership alone”
- When risks are transferred, consequences are allocated “in accordance with the terms of the trade”

# BEPS Actions 8, 9 and 10

## Assumption of risk (cont'd)

- OECD appears to characterize centralized treasury and similar functions as service providers (and, by implication, potentially worthy of only a 'routine' return)
- Just because a risk can be transferred, does not mean it would be done at arm's length
- Risk transfer "likely to happen only if the transferee is well placed or better placed to manage risk than the transferor"
- If a transaction lacks the fundamental economic attributes of arrangements between unrelated parties, the transaction may not be recognized for transfer pricing purposes
- "The mere fact that a transaction may not be seen between independent parties does not mean that it does not have the characteristics of an arm's-length arrangement." (para 82) The fundamental underlying basis matters

# BEPS Actions 8, 9 and 10

## Disregarded transactions

- Non-recognition (or recharacterization) should not be used by taxation authorities because arriving at an arm's length price is difficult
- “Where the same transaction can be seen between independent parties in comparable circumstances, non-recognition would not apply”
- However, “the mere fact that the transaction may not be seen between independent parties does not mean that it should not be recognized”
- The key test is “whether the actual transaction possesses the fundamental economic attributes of arrangements between unrelated parties”
- The OECD notes that the “consequences of the allocation of assets, function and risks to separate legal entities is overridden by control”

# BEPS Actions 8, 9 and 10

## Disregarded transactions (cont'd)

- Transactions that do not “offer each of the parties a reasonable expectation to enhance or protect their commercial or financial positions on a risk-adjusted basis, compared to other opportunities realistically available to them at the time” are subject to non-recognition for transfer pricing purposes.

# BEPS Action 4: Interest

## Limitations on debt

- Multinationals should be “able to obtain tax relief for an amount equivalent to their actual third party interest cost”
- External cost of raising debt and hedging costs may be included in calculation of total cost of debt
- The OECD believes that by tying the amount of allowable debt deductions for related-party debt to actual third-party interest expense, it will minimize the potential for profit shifting through intra-group debt transactions (and hence potentially the need for transfer pricing measures)
- The OECD recognizes that commercial banks, insurers, asset managers and others may require separate guidance
- Debt amounts may also be limited through “targeted rules”
- Double taxation potentially mitigated through carryforward provisions for disallowed interest expense, as well as the carryforward of any unused capacity to deduct interest



# Potential impact of BEPS guidance on financial transactions

# OECD guidance vs. local legislation

- Timing of finalization of OECD BEPS guidance unclear
- Degree to which current draft guidance will make it to final form also not clear
- Individual countries may not adopt OECD BEPS guidance or may interpret it in different ways
- This may produce both a potential for increased double taxation as well as new transfer pricing planning opportunities

# Some additional implications

# OECD guidelines

## 2015 draft version

- Potential increase in standard required to use a CUP
- Fundamental purpose of intra-group risk transfers questioned
- Risk management capability required for recognition of ownership of risk
  - Booking, absent risk management, potentially challenged
- Increased scope for recharacterization of transactions, to the extent that they do not reflect what actually has happened or if they involve a transfer that would not happen between third parties, based upon its fundamental economic attributes

# Some additional implications

Impact of test examining “the conditions that independent parties would have agreed in comparable circumstances”

- Ability of taxation authorities to hypothecate what independent parties might do in a given situation may be limited
- Potential for re-hypothecation of the allocation of risk based upon ability to manage that risk (if indeed intra-group risk transfer is respected at all)
- Possibility of non-recognition of transactions that lack “the fundamental economic attributes of arrangements between unrelated parties”

Please remember  
to complete your  
evaluation

# Speaker bios

**Tom Butera** is a tax principal in Deloitte Tax LLP's International Tax Services group in New York City. Tom has over 17 years of experience assisting clients with various international tax matters. His industry specialization is in the financial services area and his client base includes investment banks, hedge fund managers, asset management companies, private equity firms and companies that provide services to the financial services industry. He has extensive experience advising clients on cross-border M&A transactions, internal restructurings and reorganizations and on matters related to subpart F income and the US foreign tax credit system.

Tom has a LL.M. in Taxation from New York University School of Law, a JD cum laude from St. John's University School of Law and a BBA in Public Accounting from Hofstra University. He is a member of the New York State Bar Association and the international tax committee of the New York State Society of CPAs.

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**Rob Plunkett** is a Principal in the New York office of Deloitte Tax LLP, and the leader of Deloitte Tax's Financial Services Transfer Pricing Group. He has provided services to some of the firm's largest clients, including banks, investment banks, insurance companies, and investment advisors.

Rob's banking projects have involved income and expense allocation among branches for activities ranging from global trading to provision of ancillary/support services. His investment banking experience includes analysis of global trading of derivatives, merger & acquisition activity, and loan syndication. In global trading transactions, Rob has helped to price the assumption of market risk, the assumption of credit risk, the performance of trading functions, and the provision of sales/marketing services. He has assisted insurance companies in pricing the transfer of risk among entities, and has worked on a number of investment advisory projects including the pricing of advisory functions, sub-advisory functions, custody functions, and brokerage functions.

In addition, Rob devotes a considerable amount of time to assisting clients with the pricing of intercompany lending, the provision of guarantees, and to transactions that transfer credit risk from one legal entity to another.

Rob received his graduate training in Economics at the University of California, Los Angeles, where he specialized in Industrial Organization and Market Microstructure. His dissertation was "NYSE Specialist Merger and Economies of Scale and Scope." His undergraduate degree in Economics is from Harvard University.

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# Speaker bios

**Bill Yohana** is Director in Deloitte Tax LLP's Transfer Pricing Practice in New York. Bill has been providing clients with transfer pricing advice for the past 17 years, with a focus on addressing financial services transfer pricing issues as an advisor to commercial and investment banks, asset managers, finance companies and insurers. He also has extensive experience in financial transactions transfer pricing issues across industries, including the pricing of related-party loans, credit guarantees, the development of global loan and guarantee pricing policies and the evaluation of capital structure and thin capitalization issues.

Bill also has considerable experience in tax controversy matters arising from financial transactions, including responding to taxation authority position papers and creating strategies in taxation authority audits. Bill has worked with clients in the energy sector, particularly in relation to the funding of their businesses, the establishment of 'commercially realistic' capital structures and developing models for cross-border energy trading.

Before beginning work in transfer pricing, Bill worked for four years in US and international equity investment management and for four years in interest rate derivative structuring. He also worked at the Federal Reserve, where he held a payment system policy role.

Bill has an AB degree in Economics from the University of Chicago, studied Philosophy and Economics as a visiting student at Jesus College, University of Oxford, and has an MBA degree from Cornell University. He is also a Chartered Financial Analyst.

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