Foreword

Paul Samuelson once said, “What we know about the global financial crisis is that we don’t know very much.” Reading IBFD’s new book, Transfer Pricing and Intra-Group Financing, suggests to me that Samuelson’s quote could easily be rephrased as, “What we know about transfer pricing of intra-group financing is that we don’t know enough.” What we do know is brought together in this book in a clear, well-organized format that should be mandatory reading for all transfer pricing (TP) professionals. IBFD has done the TP community a real service by asking well-known professionals to summarize existing theory, policy and court cases related to intra-group financing. The introductory chapter by Russo and Moerer is a particularly useful overview of the current status of the field and the individual country chapters provide helpful details as to how different governments are handling particular types of intra-group financing.

Transfer pricing regulation is a story of shifting to progressively more and more difficult pricing problems as governments grapple with implementing the arm’s length standard for pricing intra-firm transactions between subunits of a multinational enterprise (MNE). Early work focused on related-party transactions in tangible products. The original triad of TP methods developed by Charles Berry for tangibles (CUP, resale price and cost-plus) became the core of the 1968 US Internal Revenue Code section 482 regulations and later, in 1979, of the OECD’s first Transfer Pricing Guidelines.

In the 1980s, Congressional concerns over super-royalty payments for “crown jewel” intangibles led the US government to amend IRC section 482 with the addition of the commensurate with income standard. As a result, the IRS revamped its TP regulations, developing rules for intangibles to parallel its revamped tangibles rules (e.g. CUT for CUP). These changes (which seemed radical at the time) are now standard components of not only the US regulations, but also the 1996 OECD TP Guidelines and most national TP regimes (e.g. CPM/TNMM, the best method rule, the arm’s length range, functional analysis, contemporaneous documentation). Tax authorities in most countries now apply the arm’s length standard by asking multinationals for the “most reliable measure of an arm’s length result”, taking into account each entity’s “functions, assets and risks” and all the relevant “facts and circumstances”.

With the basic rules in place for tangibles and intangibles, intra-group services were next in line, again with the idea of ensuring that the MNE’s transfer prices for goods, intangibles and services would meet the arm’s
length standard test by being commensurate with income earned. In 2009, the IRS finalized services regulations that developed new, parallel methods (e.g. CUSP for CUP and CUT) to those for tangibles and intangibles. While there are still huge areas of controversy – and big differences across countries – in terms of the specifics of the rules and their application in practice, the TP community now has a basic, consistent core of transfer pricing methods for the three best-known forms of intra-firm transactions.

In 2012, we are looking at what I believe will be the next frontier in transfer pricing regulation: interest, loans and other forms of intra-group financing, or more simply, the transfer pricing of finance or financial transfer pricing. The writing has been on the wall for a few years now, but has accelerated since the 2008 financial crisis because financial transfer pricing, for a variety of reasons, has become more contentious.

Early work on financial transfer pricing (e.g. IRC section 482-2) dealt with related-party loans and advances, in terms of three areas: the arm’s length interest rate (including safe harbours), debt-equity characterization and thin capitalization rules. All three areas have become more controversial. Determining an arm’s length interest rate for an intra-corporate loan, as Russo and Moerer’s introductory chapter well documents, can be a minefield for MNEs where “the devil is in the details”. Moreover, governments (e.g. see the Australia chapter) are adopting a more holistic approach to funding arrangements, taking into account issues such as parent affiliation, financial independence and commercial realism.

MNEs have been setting up international financial centres in low-tax locations for many years, locating in tax havens or countries that offer tax preferences (e.g. Belgium’s coordination centre regime was set up 30 years ago, in 1982). Financial centres allow MNEs to reap economies of scale and scope by centralizing their treasury department operations. Centralized cash management (e.g. cash pooling) raises a variety of transfer pricing issues, such as the functions, risks and remuneration of the centre, and the allocation of risks and synergy proceeds among the MNE group members. Not surprisingly, managing international financial centres has become a growing area for TP practitioners; for example, in 2007, PwC began publishing Financial Services Transfer Pricing specifically aimed at two groups: intra-group financial services within MNEs and the financial services industry.

1 In intra-group financing, I include what Russo and Moerger refer to as the “usual suspects”, e.g. intercompany loans and advances, hybrid financing, intercompany guarantees, cash management structures and treasury services such as foreign exchange risk management, factoring, captive insurance, etc.
Another reason for the increased attention to financial transfer pricing has been the global financial crisis in 2008 (referenced in the Samuelson quote above) which brought public and regulatory attention to the instabilities of the international financial system and the roles played by its core private actors (banks, other financial intermediaries and multinationals). Financial regulatory reforms such as Sarbanes-Oxley and Dodd Frank have affected MNEs’ TP policies and risks. In addition, the crisis spurred many MNEs to massive rounds of downsizing and business restructurings, creating new transfer pricing problems as firms turned to in-house funding sources and ramped up the functions of their international financial centres. (These issues are well captured in IBFD’s 2009 book, Transfer Pricing and Business Restructurings: Streamlining all the way.)

Growing attention by national tax authorities to MNE intra-group financing is documented, for example, in Ernst & Young’s 2010 Global Transfer Pricing Survey, where 42% of survey respondents that underwent a TP examination in 2010 had their intercompany financing examined, compared with 7% in 2006. The E&Y survey argues that more tax audits of MNE intra-group financial transactions are likely. Since financial transactions are driven primarily by value and not by cost, transfer pricing can generate significant tax adjustments, attracting the interest of revenue-seeking tax authorities. Moreover, third-party comparables may be less readily available for financial transactions than for tangibles or services, again making this area more contentious. Lastly, determining an arm’s length price requires specialized knowledge of corporate financial instruments, which is often not part of standard economics training.

Tax courts have also played a role in bringing financial transactions to the forefront of transfer pricing issues. For example, guarantee fees, whereby one unit of an MNE (usually the parent) provides either a financial or performance guarantee for another unit of the MNE, raise difficult TP issues. These issues, illustrated in the General Electric Capital Canada Inc. v. the Queen case, are thoroughly reviewed here in the introductory and Canada chapters. Another interesting example of financial transfer pricing is captive insurance (see Russo and Moerer’s discussion of the recent UK transfer pricing case, DSG Retail Ltd & Others v. HMRC, which they argue is “the most important transfer pricing case discussed in a European court”, partly because of its application of bargaining power theory to intra-group financing).

Regulatory guidance has lagged behind MNE practice, however (as it often does). Recent OECD work on permanent establishments and updates to the
Foreword

OECD Model Tax Convention and Transfer Pricing Guidelines have provided some additional guidance, but only a few national tax authorities to date have developed new regulations specifically aimed at financial transfer pricing. I searched through the most recent annual country-level summaries of TP regulations, published by Ernst & Young, PwC and Deloitte; the terms “financial transactions”, “thin capitalization” and “guarantees” were typically mentioned by about a dozen of the approximately 60 country reports; terms such as “cash pooling”, “insurance”, “debt” and “safe harbor”, on the other hand, were mentioned by less than half a dozen countries. The paucity of tax legislation is a double-edge sword: it provides more opportunities for MNEs to engage in cross-border integration and arbitrage, but differences in regulatory treatment across countries also raise the tax risk for MNEs.

The IBFD’s new book is therefore all the more valuable for gathering together in one place current thinking and tax practice on intra-group financing. My conclusion is that more TP regulation is on the horizon. Transfer Pricing and Intra-Group Financing provides us with an excellent and timely exploration of that frontier.

Lorraine Eden  
Professor of Management, Texas A&M University  
College Station, TX, USA  
June 2012
Transfer Pricing and Intra-Group Financing

The entangled worlds of financial markets and transfer pricing

Edited by
Anuschka Bakker
and
Marc M. Levey