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TRANSFER PRICING AND FINANCIAL TRANSACTIONS

CURRENT DEVELOPMENTS, RELEVANT ISSUES AND POSSIBLE SOLUTIONS

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Transfer Pricing and Financial Transactions

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Transfer Pricing and Financial Transactions

Current Developments, Relevant Issues and Possible Solutions

edited by

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Preface

In previous years, issues related to transfer pricing and intra-group financing are prominent in the agendas of both taxpayers and governments. The relevance of these issues is due to numerous factors. The first is the fact that money is a highly movable asset that can often be shifted around the world without significant effort. Second, the complexity of these issues requires comprehensive knowledge not only of the applicable tax codes but also of corporate finance, corporate law, and other subjects. The third is the debt-equity conundrum that has historically generated important discussions among tax experts. Consequently, according to the outcomes of a recent study, approximately 40% of MNEs have indicated transfer pricing issues related to intra-group financing as the most relevant issue in tax controversies.[1]

The extreme relevance of these topics and the need to address them has attracted the interest of various international organizations for a long time. Already in 1972, the OECD Committee on Fiscal Affairs emphasized that these topics required further attention. As a result, the 1979 OECD Transfer Pricing Report dedicated an entire chapter to issues concerning loans and, in 1986, the OECD Report on Thin Capitalization addressed a number of related issues. However, the first OECD Transfer Pricing Guidelines issued in 1995 did not include a chapter on these issues, and the reasons for this exclusion are unknown.

Twenty-five years later, in February 2020, the OECD finally released its Transfer Pricing Guidance on Financial Transactions that became Chapter X of the OECD Transfer Pricing Guidelines. Shortly later, in 2021, the United Nations included these topics in Chapter 9 of its Practical Manual for Developing Countries.

The guidance provided by both international organizations aligned with the best practices developed on the topic around the world clearly highlights that, when analysing the transfer pricing aspects of intra-group financial transactions, the accurate delineation and recognition of the actual transactions are of vital importance. As already confirmed by some relevant case law that will be explored in this book, these will be at the core of the discussions between taxpayers and tax administrations in the upcoming years.

Moreover, regarding pricing, various methodologies have been proposed, and they are all very beneficial in practice. However, the manner in which they should be implemented remains a controversial issue, as the following chapters will illustrate.

This book is based on the outcomes of the presentations and discussions held during the WU Transfer Pricing Symposium "Transfer Pricing and Financial Trans-

1 EY, 2019 Transfer Pricing and International Tax Survey, p 18.

actions: Current Developments, Relevant Issues and Possible Solutions" that occurred in October 2021 at the WU Vienna University of Economics and Business. The symposium was organized by the WU Transfer Pricing Center at the Institute for Austrian and International Tax Law which is conducting research projects on various transfer pricing topics and their global impacts, including the application of transfer pricing rules to intra-group financing. During the symposium, four renowned international experts presented their papers on various issues associated with transfer pricing and financial transactions that were accompanied by practical case studies and followed by panel discussions; all are part of this book that also includes an introduction chapter.

This book is aimed at academics, practitioners (including the business community and advisory firms), international organizations, and government officials who are tax and transfer pricing experts. It is also directed at C-level executives who are interested in the transfer pricing issues related to financial transactions. The book provides an in-depth analysis of the topics described above and suggestions for potential future solutions to any issues that are raised.

The editors would like to express their sincere appreciation to the authors of the four chapters and the introduction section who made it possible to provide this book. Many thanks are forwarded to Linde Verlag GmbH for supporting and cooperating with this publication project. Last, but not least, the editor would like to thank *Christina Sudrat*, *Marcelo Henrique Barbosa Moura* and *Nina Klauß* for the overall supervision and *Jenny Hill* for providing linguistic support to the authors during the publishing process.

Vienna, January 2022

Michael Lang
Raffaele Petruzzi

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She has experience negotiating advance pricing agreements ("APAs") and defending complex transfer pricing audits. Most recently, she has acted as expert witness supporting tax litigation in several European countries. Ágata is frequent speaker at international tax events (IBFD, BNA training courses, OECD consultations) and is invited as guest lecturer at the University of Leiden (Adv. LLM International Tax), University of Amsterdam and Vienna University of Economics and Business.

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Contents

Figures

Tables

Introduction

Introduction to Financial Transactions

Marcelo Henrique Barbosa Moura

1. General Remarks

1.1. Importance of the issue

Among the classical areas of distribution, selling of goods, and exploitation of intangibles, the number of intra-group financial transactions performed by multinational enterprises (MNEs) has increased in the last decades in both importance and magnitude with no signs of this trend diminishing.[1] For no other reason this theme is being currently focused by companies as a critical area for tax controversy[2] whereby tax administrations have since the implementation of the base erosion profit shifting (BEPS) measures easy access to the financial structure of MNEs throughout either the master file or country-by-country reporting.

The companies' justification for their focus is quite clear. Financial transactions between related parties may frequently involve substantial amounts of capital that, as such, are volatile so that the taxpayer might easily allocate financial resources to other jurisdictions, which is contrary to the settlement of physical premises. In addition to that, complex situations occur in which the mispricing of the financial functions may arise. Moreover, planning and conducting financial transactions do not necessarily underlie operational activities. Stated differently, if an MNE, for instance, intends to implement another type of cash pooling structure, its operational set-up will not be directly affected by this decision. Thus, the establishment of financial arrangements is more flexible and easier to implement than the operational functions of an MNE.[3] From the tax authorities' perspective, it is also interesting to focus on financial transactions within tax audits. These transactions are easily discerned from the taxpayer's financial statements and their transfer pricing documentation, and their assessment also does not involve an in depth investigation into the often complex functional analysis of the related parties.[4] In that context, tax authorities might prefer to scrutinize intra-group financial transactions on a cost-benefit basis rather than other intra-group transactions concerning the production and delivery of goods, provision of services, or the highly controversial use of intangibles. This has resulted in several court cases worldwide that have been dealing with inter-group financial transactions. The relevant case law will be mentioned in the next sections and in the following chapters of this book.

1 EY, 2019 Transfer Pricing and International Tax Survey, p 19.

2 EY, 2019 Transfer Pricing and International Tax Survey, p 18.

3 Take the example of an automotive MNE for which industrial facilities cannot be allocated to another jurisdiction without a well-based and long-term business plan. In contrast, establishing a financial structure of an intercompany loan is feasible on a short-term basis.

4 Although a functional analysis should also be taken into account by assessing intra-group financial transactions, as will be shown below and in this book.

1.2. Historical development

Although the arm's length principle-based Article 9 of the OECD[5] Model Tax Convention on Income and on Capital nor its commentary directly mention financial transactions,[6] the characterization of intra-group financing as an issue for transfer pricing purposes was recognized by the OECD already in 1972.[7] A report followed in 1974 that focused on the transfer pricing aspects of intra-group loans and pointed out what would constitute an arm's length remuneration for those purposes.[8] Accordingly, the OECD developed this issue further within Chapter V of the 1979 Transfer Pricing Report[9] by means of a two-step approach in order to reach an arm's length outcome:

(1) distinguish an equity contribution from a loan;[10] and
(2) determine the arm's length interest remuneration that represents the rate of interest that would be charged in an unrelated party transaction within similar circumstances.[11]

As already noted in the 1979 Transfer Pricing Report, the ongoing work developed by the Committee on Fiscal Affairs (CFA) at the OECD level on intra-group financing focused primarily on thin capitalization issues which led to the OECD issuing the Report on Thin Capitalization in 1986.[12] In this context, the comprehensive 1979 Transfer Pricing Report has been subject to a global revision that included the discussion of its Chapter V (Loans).[13] Albeit the continuous development of this theme within the OECD and its CFA, the 1995 guidelines did not contain a specific section on intra-group financing nor on loans. Thus, this focus point remained as future work to be carried out by the OECD.

This theme again returned in 1998 in an OECD discussion paper regarding the tax treatment of global trading[14] and in part III of the 2010 OECD report on the

5 Organisation for Economic Co-operation and Development.

6 The same absence of guidance to financial transactions applies for the UN Model, s Art 11 para 6 and Art 9 para 1 UN Model.

7 OECD Committee on Fiscal Affairs, Taxation Aspects of the Activities of International Companies (Note by the Secretariat), CFA(72)7, Paris, 15 Jun. 1972, para 30 et seq. See also *Petruzzi*, Transfer Aspects of Intra-Group Financing, 87 et seq.

8 OECD Committee on Fiscal Affairs, Taxation of Multinational Enterprises: Transfer Prices (Note by the Secretariat), DAF/CFA/WP6/74.1, Paris, 1 Feb. 1974.

9 OECD, Transfer Pricing and Multinational Enterprises (Paris: OECD, 1979) ('Transfer Pricing Report').

10 OECD, Transfer Pricing and Multinational Enterprises (Paris: OECD, 1979), Chapter V, Section I, para 183–191.

11 OECD, Transfer Pricing and Multinational Enterprises (Paris: OECD, 1979), Chapter V, Sections II and III, para 198–201. As elements of comparability, the transfer pricing report refers to amounts and maturities, nature or purpose of the loan, currency(ies), exchange risks, security involved, and credit-standing of the borrower; see para 199.

12 OECD, OECD Report on Thin Capitalization, adopted by the OECD Council on 26 Nov 1986.

13 OECD Committee on Fiscal Affairs, Working Party No 6 on the Taxation of Multinational Enterprises of the Committee on Fiscal Affairs – Revision of the 1979 Report on Transfer Pricing: Organisation of Future Work (Note by the Secretariat), DAFFE/CFA/WP6(92)3, Paris, 18 Mar 1992, para 2f.

14 OECD, The Taxation of Global Trading of Financial Instruments, 1998.