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# TRANSFER PRICING ASPECTS OF FINANCIAL TRANSACTIONS

## OECD GUIDANCE AND REAL-LIFE CASES

20 JANUARY 2021

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# OVERVIEW

1. Luxembourg's TP regime applicable to financing companies and its compatibility with the new Chapter X
2. Assessment of implicit support when evaluating the credit rating of a borrower
3. Remuneration of the corporate treasury function
4. Application to regulated entities considering the soft safe harbour introduced in the new Chapter X
5. New plans of the German Ministry of Finance to tighten intragroup financing rules and the practical impact on MNEs

# POLLING QUESTION

- Impact of new Chapter X: any change in financing TP policies after the publication?

Yes

No

We were already applying Chapter X principles

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# TP REGIME APPLICABLE TO FINANCING COMPANIES IN LUXEMBOURG

OLIVER HOOR

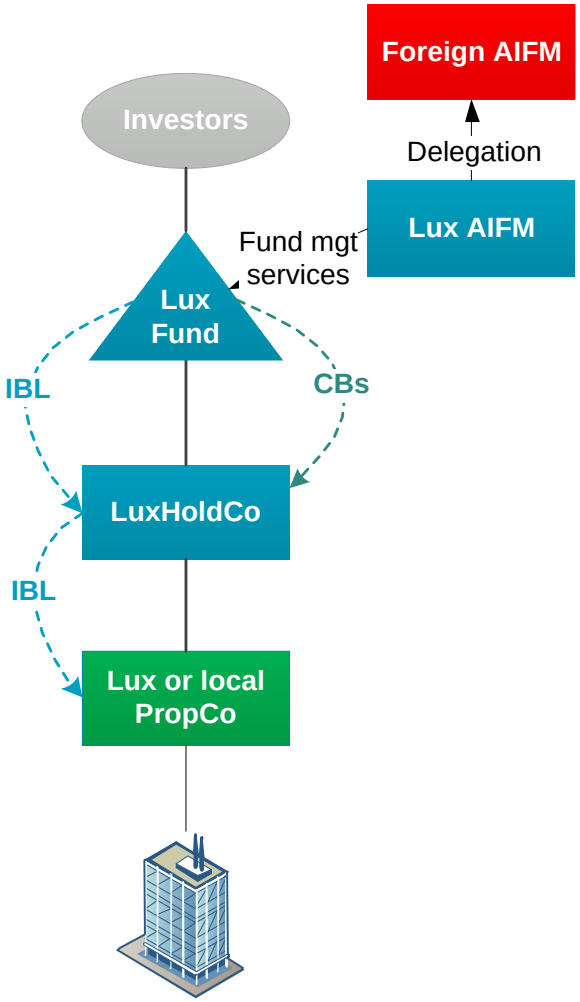
ATOZ, LUXEMBOURG

# TYPICAL FINANCIAL TRANSACTIONS

## Typical Real Estate Investments

Typical controlled transactions include:

- Financing activities and financial intermediation
- Various types of loans and debt instruments
- Intra-group services

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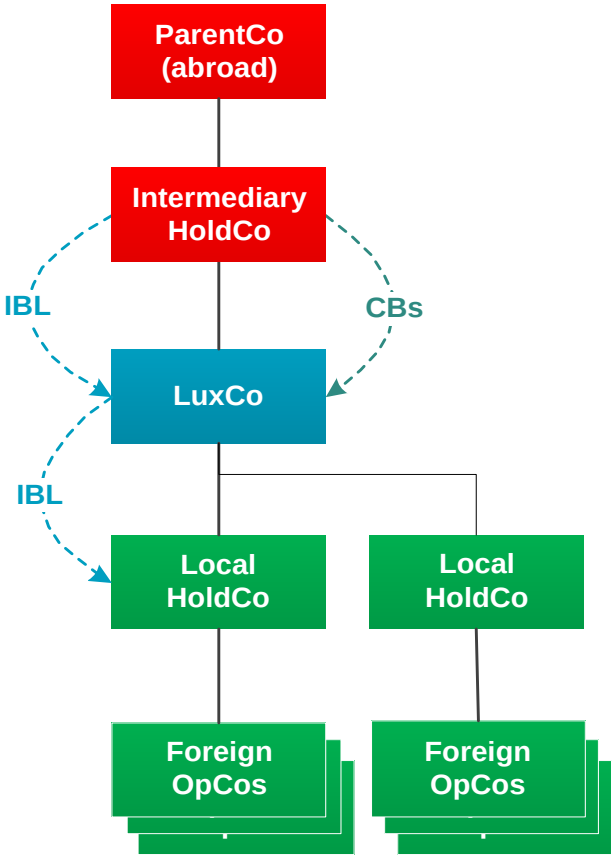
# TYPICAL FINANCIAL TRANSACTIONS

## A Multinational Group

Controlled transactions in the context of multinational groups may involve a variety of intra-group transactions such as

- Financing activities and financial intermediation
- Various types of loans and debt instruments
- Cash pooling

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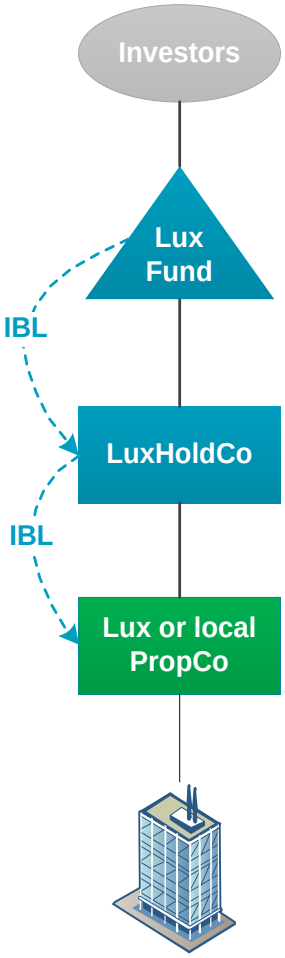
# LUXEMBOURG TRANSFER PRICING REGIME

- Luxembourg financing companies
  - Determination of the amount of equity at risk (expected loss method)
  - Determination of an arm's length return on equity (RoE)

- Points of attention
  - Substance requirements
  - Active management
  - Risk management

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# IMPLICIT SUPPORT IN CREDIT RATING ASSESSMENT

DEYAN MOLLOV

ALVAREZ AND MARSAL UK

# POLLING QUESTION

- Have you started considering including implicit support in pricing I/C transactions?

Yes

No

We used implicit support principles prior to Chapter X

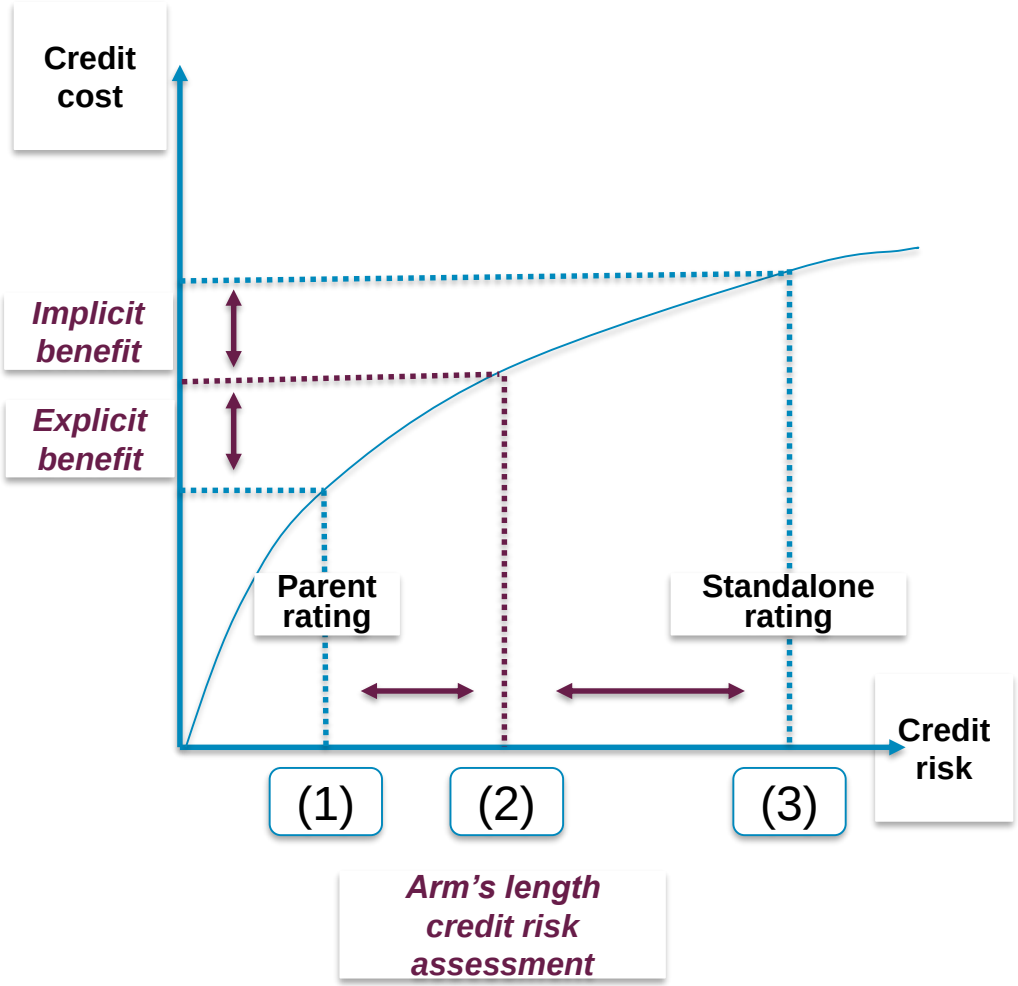
# AN ADDITIONAL FACTOR FURTHER COMPLICATING RATING ANALYSES

- Defined as *the incidental benefit that group entities receive solely on the basis of being part of an MNC.*

- Chapter X recognises that the effect of implicit support on an entity's credit rating, borrowing capacity or borrowing costs (interest rate) would not require any special payment or comparability adjustment (para 10.77).

- However, it is also recognised that implicit support will impact the credit rating of the borrower or the issue rating of any debt that borrower issues per the following factors:
  - Relative importance to the group / links to other entities
  - Regulatory requirements / legal obligations
  - Strategic importance [market, geography, sector]
  - Integration
  - Reputation
  - History of support and behaviour of the group vs. independent banks

# THE LINK BETWEEN CREDIT RISK AND COST




- Credit cost is determined as a function of how well integrated the entity is within the group
- The more *"core"* an entity is considered, the higher the implicit support or "halo effect" on its arm's length credit risk
- If links to rest of the group are weak, a standalone credit risk evaluation would be appropriate
- Approach closely follows the methodologies of credit rating agencies
- Use group rating if all of the above analyses / other methods are considered unreliable

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# CORPORATE TREASURY FUNCTION – KEY CONSIDERATIONS

DEYAN MOLLOV

ALVAREZ AND MARSAL UK

# POLLING QUESTION

- How do you treat your corporate treasury function – is it a profit or a cost centre?

Profit

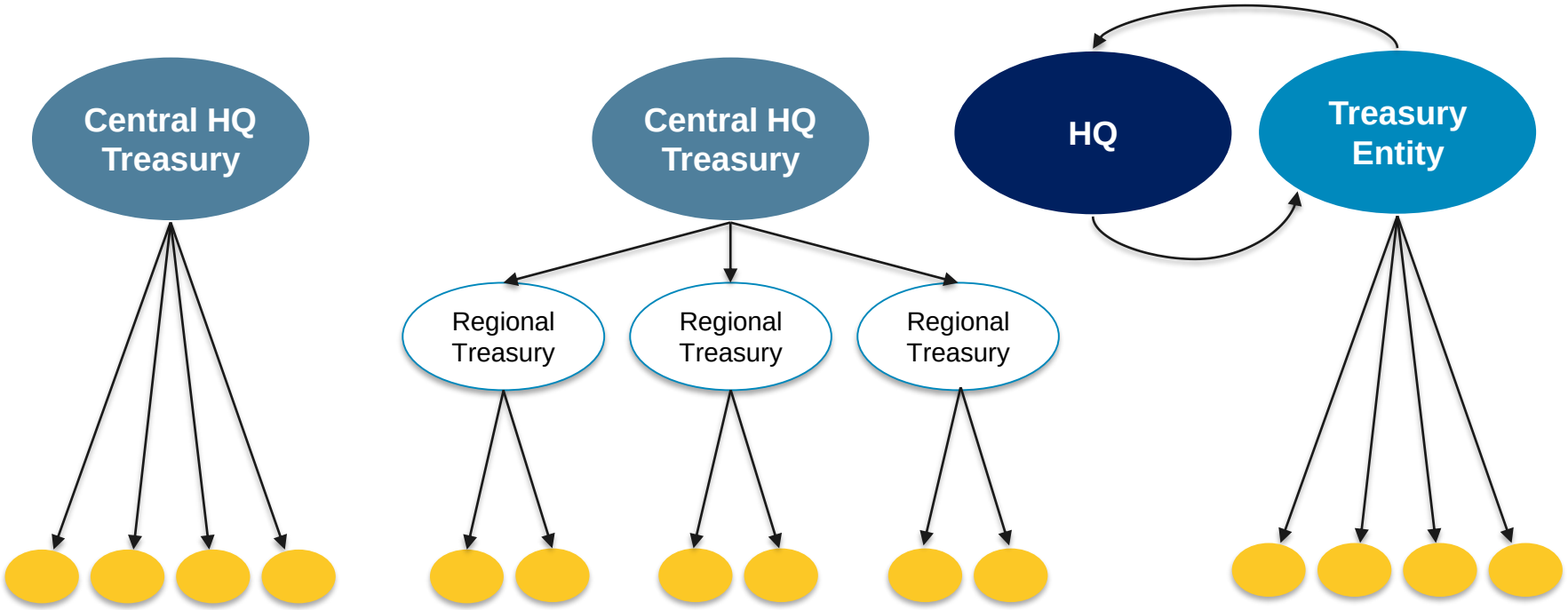
Cost

# HOW COMPLEX IS IT?

- The treasury function in a group encompasses a broad range of important and complex activities whose management is vital to the success of the business. These usually include:
  - Intercompany lending
  - Foreign exchange risk management
  - Guarantees to third parties [e.g. to third party counterparties]
  - Operating cash pools
  - Payment netting
  - Operating factoring arrangements
  - Investment management of available group funds /
  - Providing internal liquidity facilities

- By their nature, these activities can be split in two large groups:
  - Short-term / day-to-day / execution
  - Long-term / strategic / risk management

# TYPICAL TREASURY MODELS – DIFFERENT LEVELS OF CENTRALISATION

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# A PROFIT OR A COST CENTRE?

| | Head-office service provider | Inhouse financial intermediary |
|---|---|---|
| **Operating model** | Treasury described as provider of routine services, arranging financial transactions on behalf of affiliates, using internal or external sources, in essence coordinating the internal liquidity of the group<br>Primarily focussing on loan financing using financial markets to determine arm's length remuneration | Treasury characterised as an inhouse financial institution, servicing affiliates in a similar way of how a bank would<br>Treasury has specific expertise and is best qualified to bear and manage certain financial risks |
| **TP implications** | Appropriate return to the treasury entity likely to be based on a cost-plus basis (in line with the examples in Chapter I, para 1.168) | Managing economically significant risks is expected to result in a more significant level of compensation<br>The in-house financial intermediaries would be remunerated in a way commensurate with the risks managed and assets employed |

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# KEY TAKEAWAYS

A robust functional analysis and detailed understanding of the activities performed, and risks assumed and managed is key to appropriately remunerating the treasury function of an MNC.

A “full fledged” treasury function can easily make a profit or a loss in line with its functional profile; loss years are key to demonstrating to tax authorities on the other side of the border that the treasury entity is truly a risk taker, rather than a mere coordinating centre.

When setting up treasury policies / entities, it is crucial to involve both tax and treasury teams when determining strategy and day-to-day responsibilities – the better the integration, the more sustainable and defendable the positions taken.

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# APPLICATION TO REGULATED ENTITIES OF THE SOFT SAFE HARBOR INTRODUCED IN THE NEW CHAPTER X

GIACINTO VALENTI

UNICREDIT

# PRELIMINARY REMARKS

- The unique nature of the financial services sector is already recognised by OECD through the guidance provided in its 2010 Report on Permanent Establishments.

- Paragraph 10.15 of Chapter X of the TP Guidelines reiterates the soft safe harbor contained in the footnote 1 to section D.1.2.1., Ch. I , "*Where the relevant MNEs are regulated, such as financial services entities subject to regulations consistent with recognised industry standards (e.g. Basel requirements), due regard should be had to the constraints those regulations impose upon them*".

- Such a sentence could be interpreted as some kind of carve out or special consideration of regulated entities for the purpose of the accurate delineation requirement.

# DEBT TO EQUITY ALLOCATION

- No consensus on debt/equity ratio in the WP6. Compromise solution to use both the accurate delineation of transactions methodology, according to sec. D1 Chapter 1 TP Guidelines, and the internal regulation. Possible double taxation issues in case of misalignment of the two methods.

- Due to the fact that the capital structure of banks is mostly determined by regulation, which is significantly more rigorous than the methodology proposed in the Chapter X, the debt/equity characterisation issues should not be relevant for banks.

- In detail the minimum capital for a Bank in the EU is defined in the Capital Requirements Regulation (CRR) Art. 92 et seqq. and in the Capital Requirements Directive (CRD IV) Art. 128 et seqq. Therefore, as long as banks fulfill these requirements, a loan from a related party should not be re-qualified as an equity investment.

# ACCURATE DELINEATION OF THE TRANSACTION

- The introduction of new parameters like duration, currency, level of subordination, covenants etc., better define the comparability in the context of the financial markets.

- However, since It is part of the banking business to earn money with maturity mismatched funding, the accurate delineation of financial transactions methodology may lead to inconsistent results in relation to the typical banking business.

- Therefore, also in this respect for banks it might be a good compromise to refer to regulatory rules: as long as a bank fulfills the CRR requirements on liquidity (Art 411 et seqq.) the maturity of loans from related parties should not be re-qualified at all.

# CREDITWORTHINESS AND CREDIT RATING

- According to point 28, section B-4, Part II of the OECD Report on the attribution of profits to permanent establishment, "*the creditworthiness is an important factor to take into account in any transfer pricing analysis of a bank as it affects both the bank's ability to borrow, the rate at which it can do so and the gross margin that can be earned*".

- Point 10.62 of the new chapter X of the TP Guidelines reiterates such statement also specifying that *"credit ratings can serve as a useful measure of creditworthiness".*

- According to point 10.73 official credit ratings published by independent credit rating agencies, deriving from a more rigorous analysis, are preferable respect to in house rating models.

# IN-HOUSE AND EXTERNAL CREDIT RATING MODELS

- The internal rating models adoption has been strongly supported since 2006 with the New Basel Committee Framework, so called Basel 2 with the explicit intention to overcome the Basel 1 simplistic approach and making the internal capital calculation fully risk sensitive, reducing the reliance on external rating agencies approach (still adopted for Standardised Approach).

- The new Basel IV framework released on 7 December 2017 confirmed the internal ratings approach for the Corporate and Retail business, although, particularly on US side, it has been made pressure for a removal of the internal ratings.

- In light of the above point 10.73 is not applicable to banking sector since internal rating models used by banking groups have to comply with prudential and regulatory requirements.

# EFFECT OF GROUP MEMBERSHIP AND IMPLICIT SUPPORT

- The issues of association and implicit support in a banking group are more complex than in non-banking groups. This is because banking groups generally will not wish (reputation) and may not be allowed (regulation) to let their banking subsidiaries go bankrupt, which implies that banking subsidiaries will generally be able to fully rely on their banking parent's capital and liquidity support in any event.

- In this respect par. 10.79 clearly points out that one of the criteria for determining the weight of the implicit support could be the regulatory requirements.

- Concerning systemically important banks the recovery and resolution plans requirements can significantly influence the relationship between parent and subsidiaries.

# MNE GROUP CREDIT RATING

The new paragraph related to use of the MNE Group credit rating is in line with the MREL discipline (minimum required eligible liabilities), introduced by Recovery Resolution Directive (BRRD), which provides for two different recovery resolution strategies:

The Multiple Point of Entry which provides the resolution of different operating subsidiaries in different jurisdictions separately, by the local resolution Authorities, with the bail-in of local liabilities.

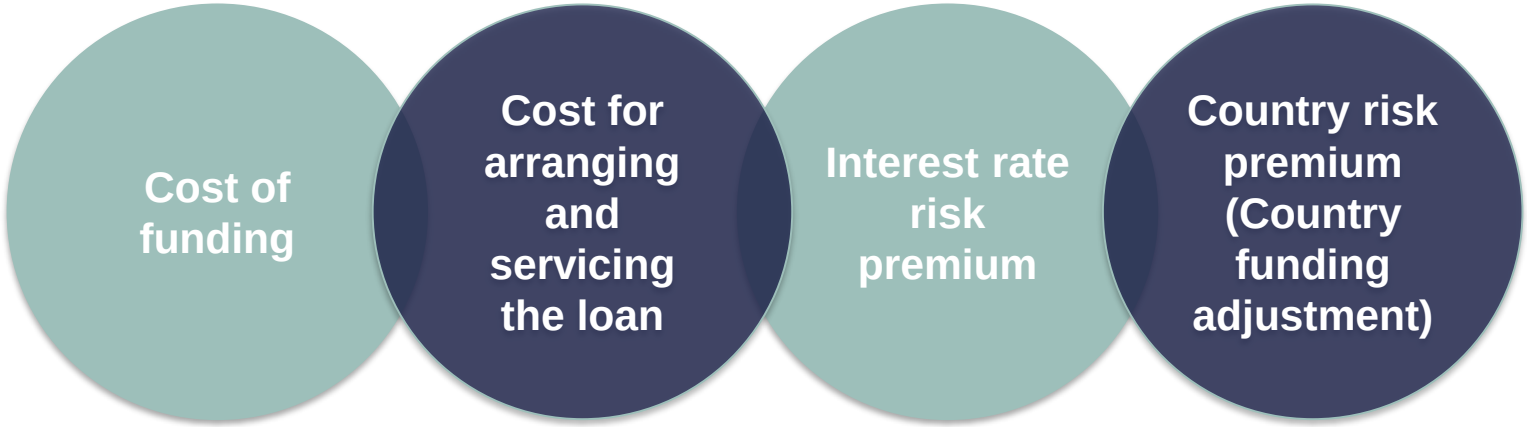
The Single Point of Entry which provides the resolution of the Parent Company on behalf of its subsidiaries which continue to operate unaffected.

In the case that the SPE strategy is adopted, creditworthiness of subsidiaries of a banking group can generally be assimilated with that of the parent company and therefore it will generally be very similar to that of foreign permanent establishments of banking parents.

# COFA METHODOLOGY

COFA methodology, based on cost borne by the lender in raising the funds on the market, is in line with SPE strategy within MREL framework.

"Build-up" logic through the following components:




Point of attention in case of subsidiaries with better rating of the Head Office.

In line with the recognition of the accurate delineated transaction, dual side approach should apply and therefore considerations would be required on the options realistically available for the borrower.

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# NEW PLANS OF THE GERMAN MINISTRY OF FINANCE TO TIGHTEN INTRAGROUP FINANCING RULES

DR. MICHAEL PULS

ERIK MEINERT

FLICK GOCKE SCHAUMBURG, GERMANY

# NEW GERMAN RULES ON INTRA-GROUP FINANCING

**Draft Sec. 1a para 1 FTA ("financial relations")**

(1) Notwithstanding any double taxation treaty, **it is not in line with the arm's length principle if** […]

1. the taxpayer cannot credibly demonstrate that
   (a) **it could have provided the capital service for the entire period** […], and
   (b) the **financing is economically necessary** and used for the purpose of the company;

or

2. […] the **interest rate** payable […] **exceeds the interest rate at which the multinational group** […] **could finance itself** vis-à-vis third parties, unless […] a different value is in line with the arm's length principle.

[…]

**Background**

- On December 11, 2019, the German Ministry of Finance ("MoF") released a first draft bill on the implementation of the Anti-Tax Avoidance Directive into German statutory law [in the meantime superseded by a new draft bill issued on March 24, 2020].
- With a new section 1a German Foreign Tax Act ("FTA"), the draft bill also includes new provisions on intra-group financing activities.
- Note that changes must be read in the context of Chapter X of the OECD Transfer Pricing Guidelines; however new rules proposed deviate in some important instances and contain a treaty override.

**Para 1 of Sec. 1a FTA: Key Takeaways**

- Without proof of both (i) **debt capacity**, and (ii) **business purpose**, interest expenses shall no longer be recognised for tax purposes.
- In addition, applicable interest rates shall be **capped** at the rate at which the group could finance itself on the external capital market.

**Para 1 of Sec. 1a FTA: Practical Impact and Challenges**

- What are the criteria for the debt capacity/business purpose test?
- What are the methods or rules that shall be used to determine the reference group interest rate, i.e.
  - Focus on actual refinancing rates or hypothetical financing costs?
  - Focus on the group credit profile only for pricing exercise, or consideration of the *stand-alone rating* of the financing entity?
  - Acceptance of non-binding bank quotes? Full scope benchmarking?

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# NEW GERMAN RULES ON INTRA-GROUP FINANCING

**Draft Sec. 1a para 2 FTA ("financial relations")**

(2) A service is **usually low-function** and low-risk if

1. **a financial relationship is arranged** […], or
2. **a financial relationship is passed on** […]

within a multinational group of companies.

This is **also** regularly the case **if** a group company assumes […] the **management of financial resources**, such as liquidity management, financial risk management or currency risk management, or performs the activities of a financing company.

Sent. 1 and 2 **shall not apply if** the taxpayer proves on the basis of a **functional and risk analysis** that it is not a low-function and low-risk service.

**Para 2 of Sec. 1a FTA: Key Takeaways**

- The management of financial resources shall generally be deemed a *routine function* entitled to a mere routine profit only, regardless of the nature/scope of the underlying treasury activities.
- Proof shall be on the taxpayer who may demonstrate otherwise by performing a functional and risk analysis.

**Para 2 of Sec. 1a FTA: Practical Implications and Challenges**

- What are the criteria to delineate routine functions from strategic functions within corporate treasury?
- What level of evidence is required to demonstrate a particular i/c FinCo to have a functional profile greater than that of a service provider?
- How is the routine profit calculated? Cost+ ?
- What options exist to achieve legal certainty about tax consequences?

**Remarks on Further Proceedings**

- The draft bill is widely discussed among academia and public; whether the new rules will actually come into force is yet to decide.
- Note that the first draft bill contained even stricter rules reg. para 2:
  - Functions should always be deemed routine, without providing any escape rule for the taxpayer, and
  - The remuneration should generally be capped at the risk-free rate, i.e., yields from AAA-rated T-bonds with equivalent maturity (?).
- A consensus between MoF and the chancellery on final scope and timeline is still not reached.

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# ABOUT TAXAND

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# SPEAKER PROFILE

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Erik Meinert is an Economist with Flick Gocke Schaumburg in Düsseldorf with many years of professional experience in international tax and transfer pricing advisory.

Erik obtained both a masters' degree in Finance & Accounting (M.Sc.) as well as in Business and Tax Law (LL.M.). He started his career in 2012 with a Big Four accounting firm. He joined Flick Gocke Schaumburg in 2020 after gaining experience as an Economist in a major US law firm as well as in public administration.

Erik’s expertise is focussed on designing tax efficient supply chains with a strong focus on related economic questions. He is regularly engaged to help clients solve complex transfer pricing issues that involve pricing, evaluation and value contribution exercises with intragroup financing being one his special fields of interest.

He is a lecturer for Public Finance and Taxation at the University of Applied Sciences for Police and Public Administration NRW.

# SPEAKER PROFILE

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Stefano Bognandi has a Degree in Economics (Università Cattolica del Sacro Cuore in Milan). He started his career in 1995 as a financial advisor at German boutique firm and subsequently joined Ernst & Young in 2001. He founded an independent advisory firm in 2008 and, starting from 2010, he set up a transfer pricing team to exploit his economic background and his experience in cross border transactions, valuation and corporate reorganisations. He started to work with Fantozzi & Associati, where he was a partner, from 2016 until December 2017. He joined Led Taxand in January 2018.

Stefano has been advising domestic and international corporate clients and investors for more than 20 years. He has a significant expertise in the area of transfer pricing covering business reorganisations, IP and business valuation, documentation, tax disputes, APA, MAP and Patent Box.

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Oliver Hoor is a Partner in the International and Corporate Tax department at ATOZ.

A tax professional since 2003, Oliver has experience in Luxembourg and international taxation with a focus on alternative Investments (private equity, real estate, sovereign wealth funds, hedge funds), mergers & acquisitions and multinational groups. Oliver advises clients on all direct tax aspects regarding deal structuring, maintenance, reorganisations and exit planning. He is further Head of Transfer Pricing and the German Desk.

Oliver is the author of more than 200 articles and books on Luxembourg and international taxation including Transfer Pricing and related documentation requirements, the OECD Base Erosion and Profit Shifting ("BEPS") Project and the EU Anti-Tax Avoidance Directives (ATAD 1/ATAD 2), reporting obligations of tax intermediaries (DAC 6), the OECD Model Tax Convention and Tax Treaties, EU Law and the State Aid investigations of the EU Commission (see www.atoz.lu/media-room). He is also a regular speaker at conferences as well as a lecturer with LPEA, ILA and Legitech.

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Deyan Mollov is a Senior Director with Alvarez & Marsal Taxand UK, LLP with more than 15 years of experience in transfer pricing. He supports clients across a wide range of industries including oil and gas, commodities trading, energy, real estate, specialty chemicals, pharmaceuticals, financial services, consumer business, and automotive sectors.

Deyan has assisted clients on a wide range of complex transfer pricing issues including planning and implementation of business restructurings, debt pricing and thin capitalisation analyses, valuation of intangible assets, analysis and implementation of inter-company management charges, risk pricing, and the preparation of three-tier transfer pricing documentation.

Prior to joining A&M Taxand, Deyan spent twelve years with Deloitte in London and Paris, where he specialised on all aspects of thin capitalisation and debt pricing arrangements, in the context of UK, French and pan-European transfer pricing projects. He has also led the audit defence in a number of tax controversy cases specifically focused on debt pricing arrangements for real estate funds and industrial companies.

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Dr. Michael Puls is a partner with Flick Gocke Schaumburg in Düsseldorf. He has more than 20 years professional experience in international tax and transfer pricing advisory work.

Michael's expertise covers international tax law and transfer pricing, with a strong focus on tax audit defence work, global documentation, tax planning and structuring projects (including relocation of functions), and mutual agreements and arbitration proceedings as well as APA.

Michael has been a lawyer since 2003 and a certified tax adviser since 2006. He studied law and business administration in Osnabrück and Bonn (2004 Dr iur). He is a lecturer at the University of Augsburg as well as a frequent seminar speaker in the field of international tax law and transfer pricing.

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Giacinto Valenti serves in the UniCredit Spa Tax Department as Head of Transfer Pricing. He joined the UniCredit Group in 2006. He previously gained experience in the legal department of an American joint venture, and practiced law in various law firms.

In 2008 he obtained a Master's Degree in International Tax Law at the Catholic University of Piacenza.

He graduated in Law at the University of Messina in 2001 and has been qualified as a lawyer since 2006.

He participates as a speaker at conferences on the subject of international taxation.