Transfer Pricing Documentation and Compliance: ”Tick the Box”-exercise

Transfer Pricing webinar series: TP Lab

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pwc

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Transfer Pricing Documentation and Compliance: ”Tick the Box”-exercise

- Regulation, Exceptions, Submission & Typical issues
- Financial Transfer Pricing

Who we are

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An overview of Regulation, Exceptions, Submission & Typical issues

Regulation

Tax return requirements

- The taxpayer needs to state in the tax return if comprised by the transfer pricing documentation requirements (check-the-box); however
  - Exception for smaller groups (defined by the ultimate controlling entity)
    - A group with less than 250 employees and either a ”balance sheet” less than DKK 125m or turnover less than DKK 250m should only prepare TPD, if transactions with
      - Entities (including natural persons and PEs) in a foreign state that does not have a DTT with Denmark and is not part of the EU/EØS. Does also include PEs in Denmark.
        - A ”DTT” also covers international agreements that includes a section similar to the OECD Model tax treaty article 9
          - This includes Jersey, Guernsey, Bermuda, British Virgin Islands and Cayman Island where Denmark has an information exchange agreement with a ”TP clause”
  - Wrongful information in tax return– need for re-opening of the tax return – can lead to penalties

Exceptions

DK-DK transactions

- DK-DK transactions are not comprised by the Danish transfer pricing documentation requirements (the transactions still needs to adhere to the ALP)
- However, DK-DK transactions where one part is not taxed according to the ordinary corporate taxation regime as specifically mentioned in the Tax Control Act section 40 still needs to prepare documentation
  - Typically covers:
    - Tonnage taxation
    - Carbon taxation
    - Tax free entities (e.g. Municipalities etc.)
    - Cooperate taxation (”Andelsbeskatning”)

Exceptions

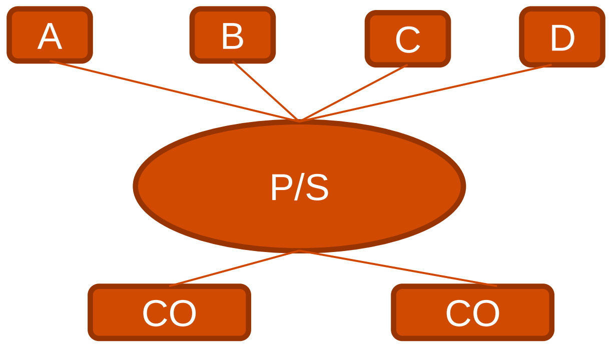
Immatarial transactions

- According to Tax Control Act section 39,2 there is no requirement to prepare documentation for controlled transactions, which are insignificant
- The DTAs position is that you need to prepare TPD even though you only have insignificant transactions, but the TPD can “just” include a description of the insignificant transactions
- No minimum threshold as such (example from DTA: one entity borrows a meeting room from another entity; lunch to an employee from another entity participating in a course….)
- **Dividends, capital contributions, capital increases etc. are also controlled transactions and therefore needs to be included in the TPD (if e.g. dividend is the only transaction the TPD requirement can be fulfilled by uploading an overview of the dividend distribution).**

Exceptions

Transactions with “limited” control

- Investments in transparent entities (I/S, K/S, P/S etc.) is typically “jointly controlled”; also if the taxpayer only has a limited ownership share



- Typically investments in Private Equity etc.
- The DTA has stated that a taxpayer (passively) investing in a tax transparent entity where jointly control exists, and where the tax payers only has a minority share (typically less than 1-3%) and therefore have no influence over the tax transparent entity (and the underlying investments) can fulfil the documentation requirement by just describing the investment.

Submission

Master file

- Still possible to submit a Master file for the previous year if the Master file (due to foreign local legislation) has not yet been prepared; however subsequent submission of the Master file is needed.

Local file

- Remember all required appendixes/information, e.g.:
    - Agreements
    - Benchmark
    - Financial statement
    - APAs
    - Data and allocation scheme

Typical Issues

Typical issues

- One day to late is one day to late…->penalty
- Lack of comparability analysis
  - Internal data / third party data
  - Benchmarks?
- Missing appendices…can lead to penalty evaluation
- Lack of reconciliation to tax return information

Solutions to data related compliance issues

PwC's digital capabilities can help with optimizing data processing related to TPD.

- IC transactional data – PwC tool for example: Intercompany transaction automation tool

Financial schedule requirement fulfillment

- Extracting ERP data and splitting P&L figures into functional P&L as required by OECD.
- Selecting appropriate allocation key, allocating the appropriate cost base for specific function's remuneration.

This not only helps to reduce potential manual errors, and ressource requirements but also increases data transparency, traceability of data usage and ensure a proactive approach to potential local transfer pricing audits.

02

Financial Transfer Pricing

Introduction

- We have over the years seen an increased focus on financial transactions from tax authorities all over the world.

- Companies typically regard financial transactions as immaterial or forget about them and don't remember to document them as all other IC transactions.

- Financial transactions can be theoretical and difficult

- They are typical "base eroding" transactions

- Essentially, the key areas of concern are as follows:
  - Debt vs. equity and the characterization
  - Intra-group funding; Short term vs. long term (and the appropriate rate)
  - Proper documentation

Why is this an issue for companies?

Historically very little guidance!
Inconsistency between territories!

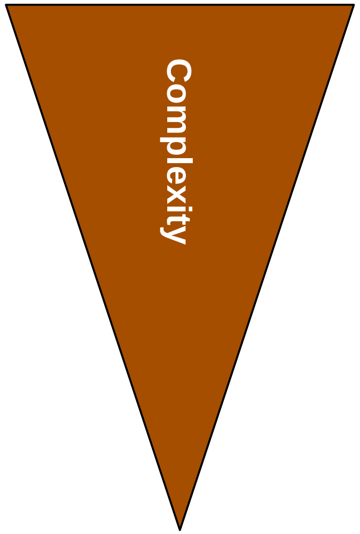
External funding is still more expensive
OECD Chapter 10 on Financial Transactions

"Our treasury team knows what to do"	Although treasurers may have an in-depth understanding of financial transactions, they may not be aware of or interested in transfer pricing risk and compliance.
"We have bank quotes supporting our pricing"	Bank quotes are typically not accepted by tax authorities as reliable comparable data, unless it is a binding offer from the bank.
"Of course, we rely on the average cost of funds for the group…"	The marginal cost of funding approach does not consider differences in creditworthiness of the borrower and in the terms and conditions applied.
"The parent company raises all third party debt – great comparable data"	Are the transactions really comparable (terms and conditions, volume, creditworthiness)?
"We have many examples of third party funding from 2015"	Times have changed!

Guidance: SKAT

- Legal Basis for ‘*Rentefiksering*’: section 2, subsection 1, of the Danish Tax Assessment Act.
- The Danish Minister for Taxation; Question 356, 2006.

    1. Should be based on characteristics (Benchmarking)
    2. Loan margin method
    3. Bank quote
    4. Discount rate + 4% ??



What is the underlying TP method?

What are the pros/cons for each method?

Documentation and risk
Developing a financial transactions policy

Documentation	Framework Questions
• A general policy describing how the company ensures that its inter-company financial transactions are carried out at arm's length. It typically describes the processes through which the important elements (credit rating, volume, terms and conditions etc.) are addressed in practice • Underlying legal documentation, i.e., the actual agreement concluded between both sides of the transaction (borrower/lender) • Information substantiating the economic rationale for the borrower and lender. e.g., local board minutes of the borrower and the lender explaining the reasons why to accept internal debt funding or participating in a cash pool • A file which contains information used to establish the arm's length interest rate (e.g., print screens from financial databases, information used to establish a stand-alone credit rating) • The policy also describes what documentation should be maintained by whom and for how long (e.g., in view of local statute of limitations)	• What TP rules to take as a basis: OECD Guidelines? • How to act in case local legislation deviates? • Who are the relevant stakeholders/the internal departments involved in the various steps (i.e., legal, tax, treasury accounting)? • What are the procedures regarding monitoring and adjustments? • Are the relevant financial information systems available? If not, where should one retrieve the relevant information from? • What are thresholds above which financial transactions will be dealt with on a more tailor-made basis

Loans

Intra-group loans
The impact of terms and conditions

Risk of challenge: Higher → Lower

Impact on interest rate: Higher ↓ Lower

	Higher	Lower
Repayment	Bullet	Capital & interest
Options	Pre-payment	Demand
Guarantee	Un-guaranteed	Guaranteed
Term	Long term	Short term
Seniority/rank	Mezzanine / Junior	Junior / Senior
Interest payment	On maturity	Quarterly (regular)
Security	Unsecured	Secured
Currency	Higher risk currency	Lower risk currency
Conversion	Non-convertible	Convertible

? Impact of covenants ?

? Commercial & economic rational ?

? Impact on fixed vs. floating loans ?

Approaches to evaluating creditworthiness

What is a credit rating?

“The creditworthiness of the borrower is one of the main factors that independent investors take into account in determining an interest rate to charge. Credit ratings can serve as a useful measure of creditworthiness and therefore help to identify potential comparables or to apply economic models in the context of related party transactions. Credit ratings can bedetermined for the overall creditworthiness of an MNE or MNE group or for a specific issuance of debt. The credit rating of an MNE or MNE group is an opinion about its creditworthiness. Such an opinion is usually premised on the MNE or MNE group´s capacity and willingness to meet its financial obligations in accordance with the terms of those obligations.”

STANDARD &POOR'S

Moody's

FitchRating KNOW YOUR RISK

modeFinance

Pricing a loan

We assume that we have first determined whether the purported loan should be regarded as a loan, identified the commercial or financial relations and lastly identified the economically relevant characteristics of the financial transaction

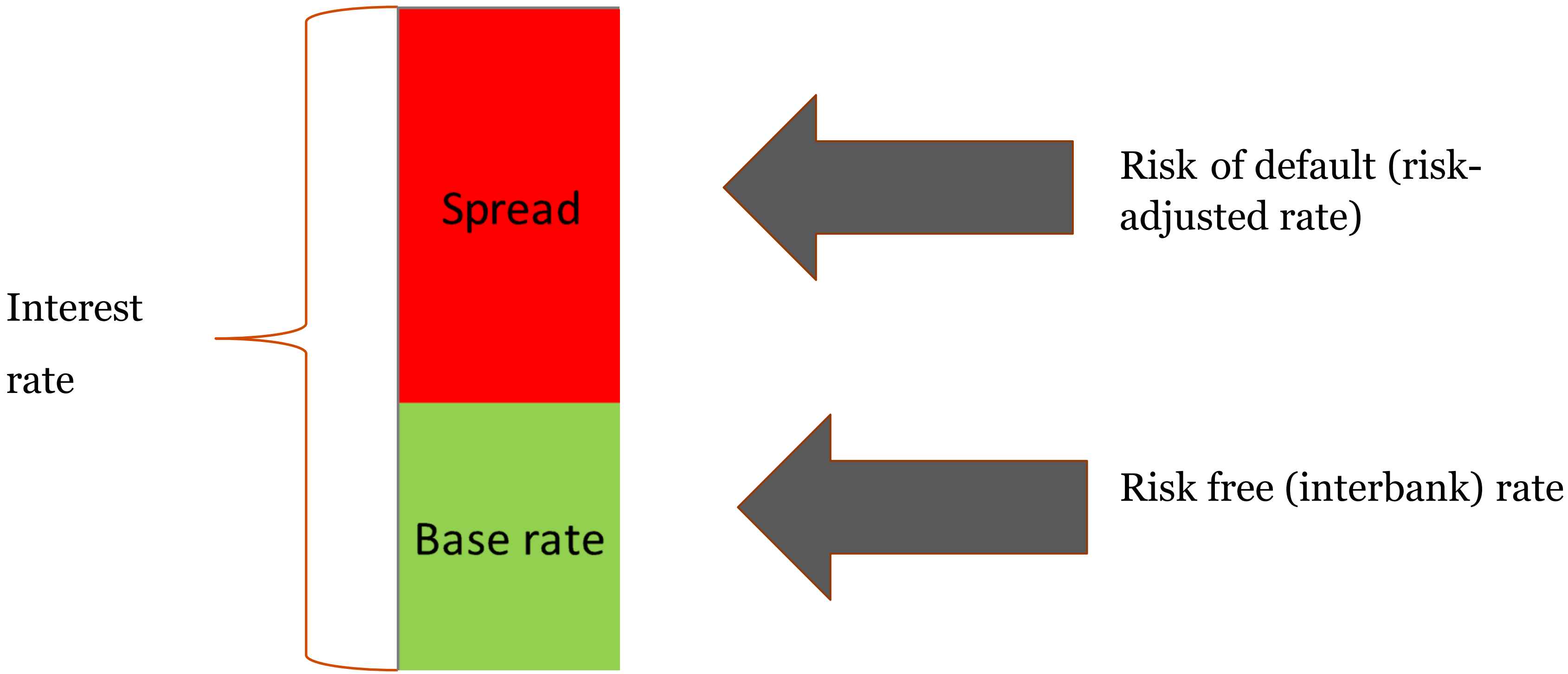
Step 1: Estimation of credit rating	Credit rating tool applied to determine synthetic (stand-alone) credit ratings of the Group entities.
Step 2: Qualitative assessment	Qualitative assessments of industry- and company specific risks are made.
Step 3: Comparables	Debt instruments with similar terms and credit ratings are identified using the CUP method.
Step 4: Loan term adjustment	Deviations in terms between the comparable debt instruments and the debt under review are accounted for.
Step 5: Assessment of interval	The interest rate interval is determined based on yields from comparable debt instruments adjusted for loan term deviations.

Step by step approach to determine the interest rate on loans

Determining the interest rate consists of two parts:

- Risk free rate
- Risk premium

Components of interest rates



Group rating methodology

Summary Of Associating An Entity's Group Status With A Potential Long-Term ICR

Group status	Brief definition	Potential long-term ICR*
Core	Integral to the group's current identity and future strategy. The rest of the group is likely to support these entities under any foreseeable circumstances. (see ¶¶54-55)	Generally at GCP (see ¶74)§
Highly strategic	Almost integral to the group's current identity and future strategy. The rest of the group is likely to support these subsidiaries under almost all foreseeable circumstances. (see ¶57)	Generally one notch below GCP (but see ¶74)§
Strategically important	Less integral to the group than highly strategic subsidiaries. The rest of the group is likely to provide additional liquidity, capital, or risk transfer in most foreseeable circumstances. However, some factors raise doubts about the extent of group support. (see ¶59)	Generally three notches above SACP (but see ¶74)§
Moderately strategic	Not important enough to warrant additional liquidity, capital, or risk transfer support from the rest of the group in some foreseeable circumstances. Nevertheless, there is potential for some support from the group. (see ¶60)	Generally one notch above SACP (but see ¶74)§
Nonstrategic	No strategic importance to the group. These subsidiaries could be sold in the near to medium term. (see ¶61)	Generally at SACP (but see ¶74)§

Cash pool

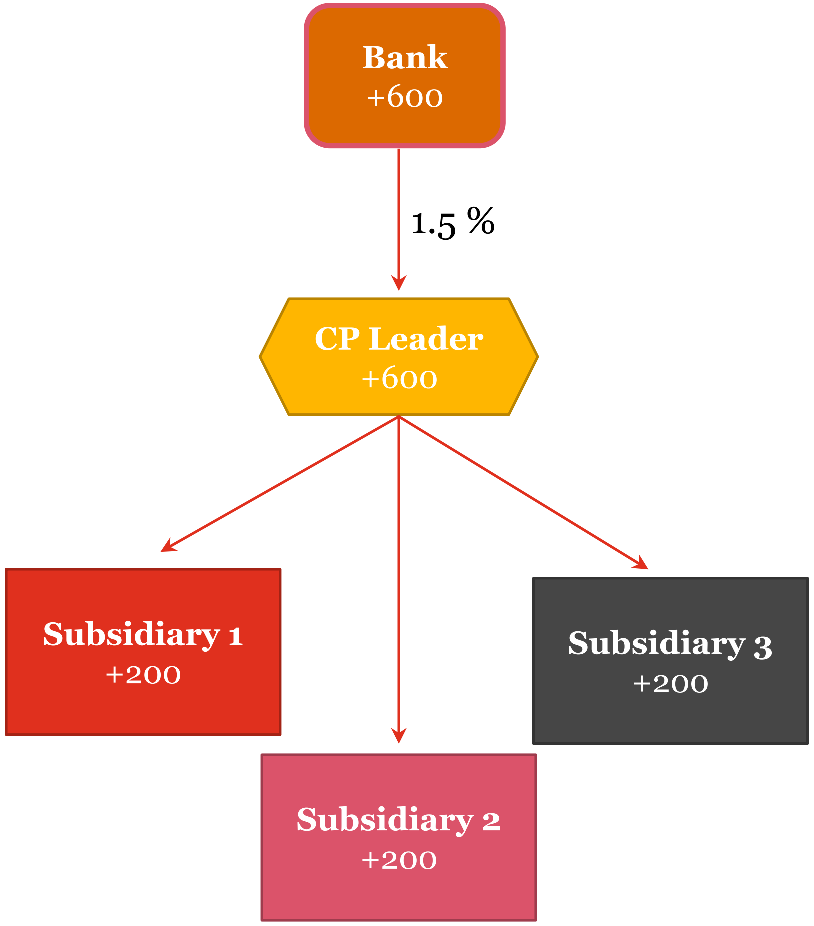
Benefits of Cash Pools

1. Netting:
   - Maximization of interest returns and minimization of interest expense by offsetting cash shortages and surpluses within the pooling system (thereby avoiding a banking spread);
   - Efficient allocation of capital from those with surplus cash to those with cash deficiencies;
2. Increased treasury efficiency through treasury economies of scale;
3. Reduction of banking charges (fees) depending on structure;
4. Management of volatility of the group's liquid cash resources on a daily, monthly or annual basis;
5. Increased credit line - also due to asymmetrical information

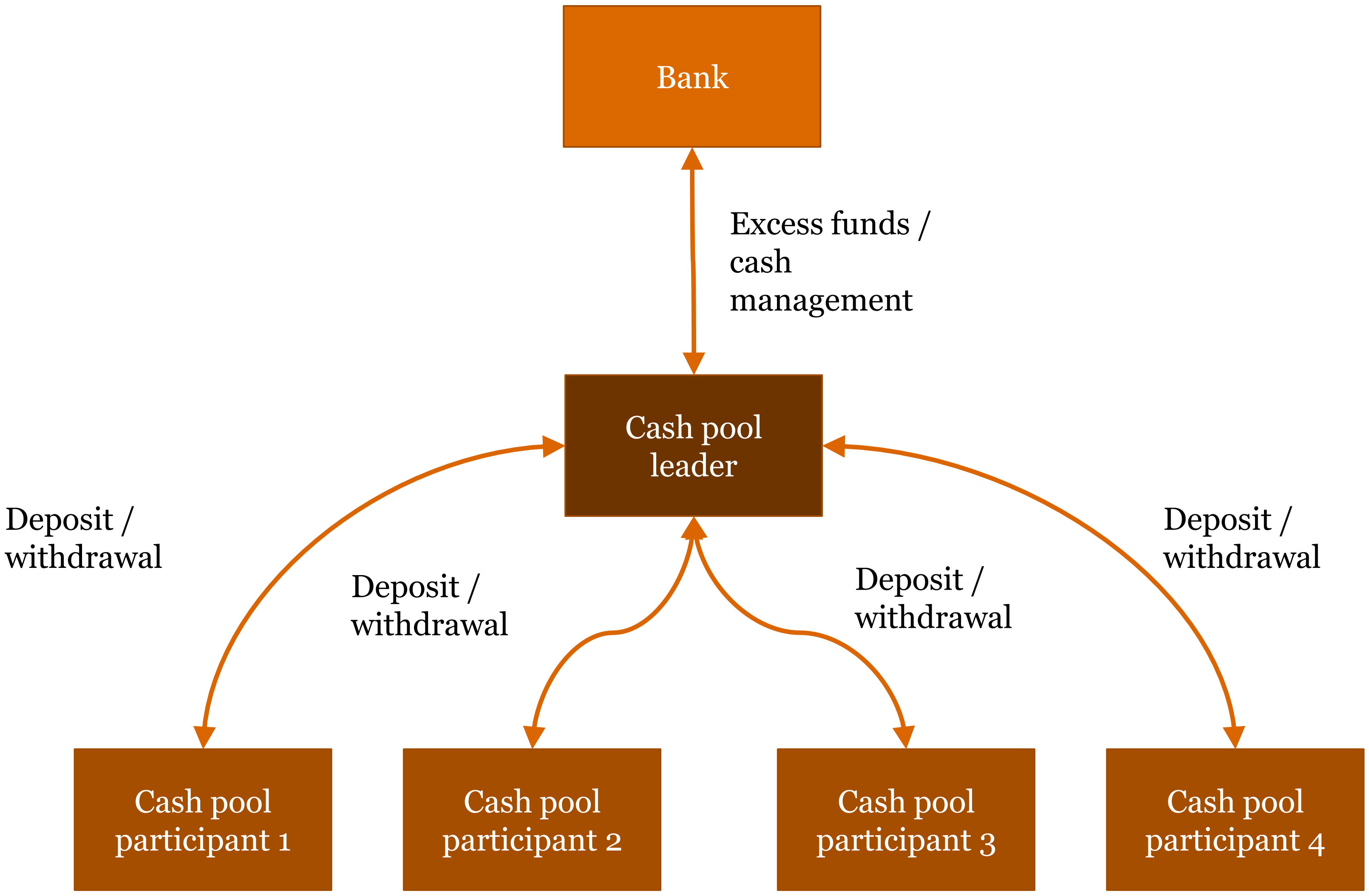
Economic benefits of cash pooling

- The main issue is the allocation of the **economic profit** generated by the CP.
- The major focus of the tax authorities is on the allocation of economic profit between the CPL and the group entities participating in the cash pool.
- ...the allocation between CP members has had less focus but, especially, differences in creditworthiness may trigger allocation issues.
- No specific TP rules on CP - **Arm's length terms** are generally applicable.
- Credit and debit rates and charged pool costs must be on arm's length terms.
- CP members should have an **incentive to participate** – should receive better or same interest rate in CP as in a stand-alone situation.

Cash Pool



Cash pool account structure



What we see

What we have seen based on recent tax audits

TP documentations sent for penalty evaluation

We have now seen Skattestyrelsen sending TP documentations for penalty evaluation due to lack of documentation (according to the Tax Authority) of how intercompany loans were priced.

Discussions around adjustments to the initial credit ratings: Group affiliation/implicit support, priority of the debt (senior, junior, subordinated etc.)

We have seen several cases with Skattestyrelsen where they have started to challenge the priority of the individual debt instrument and whether the terms and conditions does in fact imply that the credit rating should be adjusted upwards or downwards – e.g. subordinated intercompany debt without any other debt in the company.

Re-characterisation of cash pool deposits into long-term loan to the Cash Pool Leader

We have seen several cases where companies have set up a cash pool and then increased the amount deposited every year. In such situations Skattestyrelsen have re-characterised the deposits with a low interest rate into long-term loans with the Cash Pool Leader

Q&A

Join our next TP Lab webinars

6 December 2023
Transfer pricing and year-end: keep your checklist ready

- Transfer pricing adjustments
- Benchmarking studies
- Impact of VAT and custom duties

7 February 2024
Updates to the OECD Guidelines that stem from Pillar I – Amount B

- Pricing of in-country baseline marketing and distribution activities

Thank you!