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In this article, the authors examine the options for companies managing risk and uncertainty regarding significant financial transactions in the current financial climate.

Introduction and Overview of Financial Transactions

Chapter X of the OECD transfer pricing guidelines provides direction on how to assess arm's-length prices for financial transactions, including intragroup loans, cash pooling, financial guarantees, and captive insurance.[1] Among these, intragroup loans are the most common type of transaction, raising not only the question of what the right interest rate is but also questions concerning the arm's-length quantum of supportable debt. The OECD guidelines conceive of this as a matter of accurately delineating the funding transaction, though countries' rules vary on debt/equity questions and the potential relevance of transfer pricing considerations to those determinations.

In the current environment, in which we are seeing a rapid evolution of tax legislative changes, companies are faced with unprecedented uncertainty in managing their tax obligations and business performance. Moreover, a prolonged period of higher interest rates has attracted increased tax authority attention to financial transactions. Competent authority procedures — specifically, the mutual agreement procedure for resolving double taxation arising from tax authorities' adjustments and the advance pricing agreement program for prospective certainty — are valuable tools for obtaining tax certainty on transfer pricing issues. Yet for financial transactions, taxpayers have historically been less

[1] OECD, "OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022" (2022).

likely to proactively seek certainty, partly because of the often brief lead time for implementation of these transactions (for example, an intercompany loan issued in connection with an acquisition).

This article discusses the various avenues open to companies with significant financial transactions for managing the associated risks and uncertainty.

A Closer Look at Intragroup Loans

In the United States, several sections of the Internal Revenue Code have a direct impact on the deductibility of interest on loans:

- section 385 covers the determination of the treatment of a funding transaction as equity as opposed to indebtedness;[2]
- section 163(j) and the regulations thereunder limit deductions for certain business interest expense, based on a percentage of a taxpayer's adjusted taxable income; and
- regulations under section 482 provide rules to determine whether the rate of interest charged on intragroup loans is arm's length.

Several jurisdictions include debt capacity considerations as an integral part of their transfer pricing rules. A debt capacity analysis provides support for a funding transaction being characterized as debt rather than equity.[3] For example, German legislation approved on March 22, 2024, and effective January 1, 2024, has made a debt capacity analysis mandatory in supporting the interest deduction on related-party financing.[4] In the Netherlands, there have been repeated challenges and court cases regarding the reclassification of debt as equity and regarding the pricing of intercompany loans.[5] Although not mandatory, a debt capacity analysis often is an integral part of the analysis supporting the interest rate on intercompany debt in Canada. In addition, several jurisdictions, such as the United Kingdom and Australia, have thin capitalization rules that are designed to prevent excessive debt.

Typical Challenges

The transfer pricing of intragroup loans can be challenging, with different countries imposing different requirements. Country-specific safe harbors, such as those that exist in the United States and Switzerland, are often useful but provide only partial protection from controversy because of their one-sided nature.

While many countries' guidance regarding transfer pricing for financial transactions generally aligns with Chapter X of the OECD guidelines, local transfer pricing regulations often apply idiosyncratic requirements. For example, the Australian Taxation Office's preferred benchmarking approach considers the interest rate on third-party debt of the multinational group as an appropriate comparable.[6] At the other extreme, French case law frowns on the use of the group's credit rating as a starting point and requires that a stand-alone credit rating be determined (though implicit support can be argued through a specific analysis).[7] Even in jurisdictions where the rules are broadly consistent with Chapter X, there remains a significant gray area when it comes to the local interpretation and implementation of that guidance.

Cash pools also represent an area with persistent challenges and successful adjustments by tax authorities. Drawing inspiration from Chapter X, tax authorities are insisting that a passive cash pool participant receive a portion of the profits generated in the pool because its deposits in the pool contribute to group synergies. The complexity inherent in cash pools, the frequent participation of affiliates in those kinds of financial hubs, and the recent interest rate environment all suggest that more audits are expected in this area. Often, a key consideration in these cases will be the sharing of synergy benefits among depositors and cash pool headers

[2] Sherif Assef, Sayantani Ghose, and Vinay Kapoor, "Current State and Trends in Intercompany Financial Transactions," 51(10) *Tax Mgmt. Int'l J.* (Oct. 7, 2022).

[3] *Id.*

[4] "Germany: New Transfer Pricing Regulations for Intra-Group Financial Transactions," KPMG TaxNewsFlash (Apr. 19, 2024).

[5] Clive Jie-A-Joen and Monique van Herksen, "The Newly Updated Dutch Transfer Pricing Guidance, Part 2: Treatment of Intercompany Financial Transactions," 51(8) *Tax Mgmt. Int'l J.* (Aug. 5, 2022).

[6] Assef, Ghose, and Kapoor, *supra* note 2.

[7] *Id.*

commensurate with the functions and risks of each party.

Controversy Background

Over the years, courts in various countries have issued notable rulings concerning intercompany financial transactions. For example:

- Dutch Supreme Court jurisprudence regarding non-market-price or non-arm's-length loans has treated the entire loan (not just a part of it) as a non-arm's-length loan and therefore denied interest deductions.[8] For example, on May 17, 2024, the Dutch Supreme Court ruled that a certain *obligation remboursable en actions* that had a term of 50 years and would be repaid in shares of the borrowing company must be regarded as capital under tax law.[9]
- In Canada, in 2010 *General Electric Capital Canada Inc. v. The Queen*[10] addressed the impact of implicit parental support on credit ratings — that is, the incidental benefit realized by a borrower by virtue of group affiliation.[11]
- The U.K. Court of Appeal in a 2024 decision concluded that the related-party interest costs were consistent with the arm's-length principle but should nonetheless be disallowed because they were fully attributable to an "unallowable purpose."[12]
- In April 2017 the Federal Court of Australia ruled in favor of the tax authority and disallowed hundreds of millions in deductions for interest paid by an Australian borrower to its affiliated U.S. lender leading to an additional tax bill of about AUD 340 million. The court rejected the stand-alone pricing argument and concluded that the ultimate parent would have provided security to support the Australian borrower if the latter had borrowed in the marketplace. The court accordingly found that the interest rate on the intercompany loan was too high under the arm's-length standard.[13]

In the United States no courts have yet addressed matters related to implicit support in transfer pricing cases. In December 2023 the IRS Office of Chief Counsel released a general legal advice memorandum[14] laying out the IRS's position on the effect of group membership in determining the arm's-length rate of interest chargeable for intragroup loans under section 482. The memo indicated that chief counsel interprets reg. section 1.482-2 as incorporating implicit support. However, the notion of implicit support is not contemplated in the U.S. regulations; the analogous concept of passive association exists only in the regulatory provision addressing intercompany services and is not applicable to financial transactions. Furthermore, U.S. jurisprudence under section 385 forecloses an implicit support approach when dealing with debt/equity characterization: A debt capacity analysis under section 385 is expected to be performed without consideration of any form of parental support or guarantee in order to establish the debt characterization of the funding transaction.[15] Nonetheless, the IRS does make implicit support arguments, although its history of bringing up the issue on audit has been inconsistent.[16]

Accordingly, in a cross-border intragroup loan transaction, it is often not easy to placate the tax authorities on both ends of the transaction. The difficulty originates from several sources:

- Tax authorities may take inconsistent positions on different transactions depending on what is a more favorable outcome for them. For example, they may argue for implicit support for inbound loans and against it for outbound loans.

[8] Jie-A-Joen and Van Herksen, *supra* note 5.

[9] "Important Judgment on Tax Classification of Financial Instrument," KPMG Meijburg & Co. (May 22, 2024).

[10] *General Electric Capital Canada Inc. v. The Queen*, 2010 FCA 344.

[11] Assef, Ghose, and Kapoor, *supra* note 2.

[12] Paul Freeman, "BlackRock: Transfer Pricing and Unallowable Purpose — Court of Appeal," KPMG (Apr. 25, 2024).

[13] Matthew Frank, "The Problem With Prediction in Transfer Pricing," Law360 Tax Authority (Oct. 23, 2018); *see also* Joanna Mather, "Chevron Loses Australia's Biggest Tax Case," *Financial Review*, Apr. 21, 2017.

[14] AM 2023-008.

[15] *See Plantation Patterns Inc. v. Commissioner*, T.C. Memo. 1970-182, *aff'd*, 462 F.2d 712 (5th Cir. 1972), *cert. denied*, 409 U.S. 1076 (1972).

[16] Assef, Ghose, and Kapoor, *supra* note 2.

- Perhaps more than in any other area of transfer pricing, the applicable rules differ significantly between jurisdictions. For example, courts in certain jurisdictions (such as France) have concluded that the burden of proof for implicit support is on the party arguing in favor of it, which will often be the tax authority. However, other jurisdictions place the onus on the taxpayer to prove otherwise if they have priced their loans based on a stand-alone credit rating.
- There is a lack of clarity and consistency in guidance on how to quantify implicit support (if any exists). Often, taxpayers have the option to rely on guidance issued by credit rating agencies. However, differing approaches from those agencies on measuring implicit support will not necessarily lead to the same end result for a company, creating more room for controversy and for opportunistic adjustments from tax authorities.

Managing Disputes

With tax authorities finding more reason to challenge financial transactions, it's important to think carefully about how to resolve — or better yet, avoid — those disputes. Although taking IRS financial transaction challenges to Appeals has long been common, in recent years we have seen the IRS examiners focus more on pricing (is the interest rate right?) and less on the debt/equity characterization issues that historically occupied much of their time.

Appeals isn't the only — and often isn't the best — forum for dealing with IRS disputes. Another option for controversies involving financial transactions between a U.S. entity and a counterparty located in a treaty jurisdiction is MAP, whereby the competent authorities of both concerned tax administrations negotiate with the aim of avoiding double taxation. Since 2015 IRS procedures have required taxpayers that wish to seek MAP relief to do so before taking their case to Appeals,[17] though they can avail themselves of Appeals input while in the MAP process via the simultaneous appeals procedure. Seldom used and somewhat cumbersome for ordinary transfer pricing issues, this procedure may actually be well suited to certain financial transaction adjustments that are informed by non-transfer-pricing issues that would benefit from Appeals consideration.

For taxpayers faced with a choice between Appeals and MAP, the statistics show MAP is the clear winner. According to a Government Accountability Office report, from 2013 to 2022, 59 percent of Appeals cases were fully resolved, with another 10 percent partially resolved.[18] That does not mean the resolutions were necessarily good resolutions; just that both the taxpayer and the IRS were able to live with them. By contrast, U.S. transfer pricing cases that are substantively resolved in MAP have historically resulted in 90 percent or greater success in eliminating double taxation.[19] To be sure, MAP is slower than Appeals: As of 2022, Appeals cases took 389 days on average; MAP cases typically take more than two years because of the need for both governments to understand the issues and negotiate a resolution.

It isn't just transfer pricing cases that are eligible for MAP under an applicable treaty: Treaties will generally also contain an article addressing the treatment of interest and whether it is subject to withholding tax. Significantly, in many treaties, the interest article supplies its own definition of what constitutes interest, of which a debt/equity adjustment under domestic law may run afoul, thereby entitling a taxpayer to competent authority relief via MAP. Debt-equity characterization issues can also result in double

[17] A limited exception applies if the taxpayer requests MAP no later than 60 days after its Appeals opening conference (and therefore without having had a practical chance to obtain substantive Appeals consideration). If the MAP process is unsuccessful, the taxpayer could then seek Appeals consideration.

[18] GAO, "IRS Could Better Manage Alternative Dispute Resolution Programs to Maximize Benefits," GAO-23-105552 (May 2023).

[19] *See* Mark R. Martin et al., "MAP: Past, Present, and Future," *Tax Notes Int'l*, Apr. 12, 2021, p. 175. The 2022 and 2023 statistics reflect lower success rates, apparently because of certain issues with India cases that are unlikely to be relevant in this context. Even those lower rates exceed Appeals' success statistics. *See* Phil Roper et al., "Transfer Pricing Takeaways From 2022's MAP Statistics," *Tax Mgmt. Int'l J.* (Nov. 22, 2023).

taxation (for example, when interest is included in income in one country where the underlying item is treated as debt but denied as a deduction in the counterparty country where it is recharacterized as equity). MAP is available to address these issues and has done so successfully.

Resolving disputes is all well and good; heading them off at the pass is better. Depending on the nature of the dispute and the desired outcomes, taxpayers should consider both the APA program — essentially MAP, but on a prospective basis, often with the ability to address prior years as well — and the IRS prefiling agreement (PFA) program, a domestic advance resolution program for non-transfer-pricing issues.

Advance Certainty

Although APAs have long been popular for financial services, which pioneered the use of multilateral as opposed to bilateral APAs, financial transactions have typically been addressed, if at all, as afterthoughts. The latest U.S. statistics break down the types of transactions covered by APAs entered into in 2023. Tangible property sales, services, and intangibles all loom large; financial transactions are not separately stated, but they apparently fall into the de minimis "all other" category amounting to only 2 percent of APA-covered transactions. Nonetheless, APAs have successfully been used for financial transactions, including via multilateral APAs covering funds transfer pricing policies.

There are some financial transactions that are not good fits for the APA program: APAs typically take three years or longer and are thus ill suited to shorter-term arrangements. Yet many financial transactions fare well under APAs, and the program represents a largely untapped source of tax certainty in an audit environment that is increasingly uncertain. What it comes down to is whether the effort and expense (including an IRS user fee of $121,600) are commensurate with the benefits of certainty and simplified compliance.

Financial transactions with a material impact, and those that involve recurring or ongoing issues, stand to benefit most from APA coverage. For example, the following categories of transactions all present opportunities to seek certainty through an APA:

- Large strategic loans: Some taxpayers enter into intercompany loans in connection with material business transactions, which can involve billions of dollars in transaction volume and hundreds of millions of dollars in interest expense, and can last for lengthy periods (for example, seven to 10 years) that would benefit from APA coverage. In addition, taxpayers that enter into back-to-back arrangements, such as an inbound loan followed by an outbound loan of a portion of the proceeds, may benefit from proactively addressing and explaining the business purpose of those arrangements through the APA program rather than reactively responding to tax authority concerns in an examination.
- Guarantees on public bond issuances: Like large strategic loans, these can involve material amounts over a long duration. Taxpayers that guarantee an affiliate's issuance of bonds may therefore wish to proactively seek certainty.
- High-volume lending in accordance with a centralized policy: Many taxpayers apply a centralized policy to all intercompany lending, which in the aggregate may be of substantial importance even if no single loan covers a material amount. APAs covering a selection of loans subject to the centralized policy can give broader comfort regarding the appropriateness of the policy, even beyond the transactions directly covered.
- Cash pooling: Cash pooling arrangements frequently cover material amounts, involve numerous jurisdictions, and remain in place indefinitely. Bilateral APAs between two of the relevant jurisdictions can provide certainty in those jurisdictions as well as practical comfort in others.
- Funds transfer pricing process: For global banks, funds transfer pricing is a centralized process that governs the internal charges and compensation for the sources and uses of the universe of their secured, unsecured, and deposit funding. It is primarily a process governed by financial regulations and has transfer pricing implications.

> Global banks can benefit, and historically have benefited, from entering into APAs and reaching agreement on the funds transfer pricing process.

APAs are, as the name suggests, agreements on pricing. While the U.S. APA program has sometimes been willing to cover nonpricing issues for which transfer pricing principles are relevant, debt/equity issues under section 385 would generally be outside the formal scope of an APA from a U.S. perspective, although they might be the subject of some due diligence and might be formally covered by a foreign competent authority. Outside the United States, many countries (for example, Belgium, the Netherlands, and the United Kingdom) offer rulings for financial transactions that can provide invaluable certainty.

Even without formal coverage, an APA should provide comfort on debt/equity issues as well as pricing. The APA that results from the process is a contract between the taxpayer and the IRS that would typically address the covered transaction using terms (such as "loan" and "interest") that are probative of the debt/equity question. For additional certainty, taxpayers could simultaneously seek an APA alongside a thin capitalization ruling in the foreign jurisdiction (e.g., an advance thin capitalization agreement in the United Kingdom).

When a quicker resolution is hoped for or certainty in the counterparty jurisdiction is less important, the IRS PFA program provides an underappreciated means of obtaining up-front certainty on issues other than transfer pricing. For taxpayers that are accepted into the PFA process, the IRS assembles a team (typically based around the taxpayer's own examination team) to review the issues and conduct due diligence, all with the aim of reaching agreement with the taxpayer before the filing of the return for the relevant year.

Although PFAs require a completed transaction, they can also be used to achieve agreement on a method to be applied in up to four future years, making them particularly well suited to financial transaction issues that are recurring in nature (for example, a method for debt capacity determinations that will be applied to all of a taxpayer's intercompany loans). PFAs, like APAs, come with a user fee — $181,500 — and require a similar weighing of expected costs and benefits. It is therefore not surprising that they have typically been used for significant issues such as large worthless stock deductions, research credit issues, and debt/equity characterization.

Conclusion

In light of the prolonged period with relatively low interest rates prior to the recent spike, it perhaps stands to reason that appetite for proactively achieving certainty on financial transactions has historically been low. Yet as taxpayers encounter increasing audit activity worldwide, and as examiners weaponize the more sophisticated concepts promulgated in the OECD's 2020 guidance on financial transactions (now incorporated into the OECD guidelines as Chapter X), effectively resolving disputes — including by eliminating double taxation in MAP — is increasingly important. So is up-front certainty, when available: APAs in particular offer a hitherto underappreciated means of achieving certainty, which in practice can provide comfort for the underlying transactions that goes beyond the pricing issues directly addressed by the APA.[20] ■

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