Treasury and Tax: New Best Friends Forever?

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With the recent publication of new guidelines on transfer pricing for financial transactions, two experts examine the impact these will have on multinationals, their treasurers, and tax auditors.

For decades the business case for treasury has included the management of cash as a corporate asset. In-house banks are designed to use cash when it becomes available for funding business activities and thereby, like an external cash management bank, earning interest margin on simultaneous intercompany lending and depositing positions as well as buy-sell spread on intercompany derivatives.

Corporate income tax has always been a consideration when structuring treasury transactions but not so much when considering daily treasury operations. Under the influence of the professionalisation of mark-to market valuations and transfer pricing, as well as the Organisation for Economic Co-operation and Development (OECD) BEPS (Base Erosion and Profit Shifting[1]) Project, the relationship between tax and treasury has to evolve and become closer than ever before.

In February 2020, the OECD published guidelines on transfer pricing for financial transactions between related parties for the first time. While these guidelines were mostly

[1] https://www.oecd.org/tax/beps/

presented as a compendium of common practices, they incorporated jurisprudence from leading economies and evolving government insights and do not necessary fully reflect existing corporate practices. However, the OECD guidance has now become the reference point for tax authorities and tax auditors globally and has created a new 'normal' for companies to comply with, affecting both treasurers and tax directors.

Treasury and transfer pricing

Transfer pricing involves the pricing of transactions between entities within a multinational group. It is a sensitive topic because for decades governments competed on fiscal legislation, whereas multinational organisations at least explored the opportunities of lowering the effective tax rate of the group by arranging business processes and the legal structure in such a way as to benefit from discrepancies between local tax legislation. Depending on the perspective of the corporate executive, opinion maker or politician, this practice was labelled as 'the smart thing to do' or termed as 'tax avoidance'.

In the wake of the 2008 financial crisis the G20 and OECD started the BEPS Project. Within the OECD/G20 Inclusive Framework on BEPS, 141 countries[2] now work together to end the 'beggar they neighbour' policy resulting of many a fiscal strategy , including that of international tax havens that are non-members of the OECD.

The BEPS Project addresses three key areas of international taxes relevant for treasury transactions:

1. Guidelines for determining arm's length trading terms and conditions between related parties
2. The definition of local substance
3. Guidelines for transparency and reporting

Since the launch of the BEPS Project tax auditors have stepped up their focus on intercompany financial transactions and intensified the discussion around arm's length terms and conditions in a quest to protect the local tax base. In addition, new global and local tax filing requirements helped them to review and – if deemed necessary – to challenge the position of their tax clients. The result has been a rising number of disputes and court cases that urge a revision of corporate treasury practices worldwide.

Chevron and arm's length

The April 2017 judgement by the Federal Court of Australia regarding a USD$2.5bn intercompany loan within the Chevron Group goes straight to the heart of what transfer pricing is about.[3] Instead of just reviewing the loan pricing benchmark issue put in front of the court, the judges challenged the characteristics of the loan itself. They argued that a prudent and independent borrower would likely not have taken an unsecured bullet loan for the project in case. Instead, they would offer collateral, agree a repayment schedule and possibly also include conditions as a way to lower the risk profile of the lending position. Consequently, the court ruled that the terms of the loan were not consistent with the arm's length principle.

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[2] https://www.oecd.org/tax/beps/inclusive-framework-on-beps-composition.pdf
[3] https://www.taxinstitute.com.au/news/chevron-case-ato-wins-landmark-transfer-pricing-case

This Australian ruling has material implications for how intercompany lending is processed and will expand the business model of treasury to include a mirroring of bank credit and risk approval processes. Treasuries will need to analyse, evaluate, decide upon and document each funding request related to the purpose of the loan as though it were an external funding proposition and select the transfer pricing benchmark accordingly. If, for instance, an external bank were to provide funding as a collateralised loan only, treasury would also need to consider how to apply this to internal loans and possibly even set up a collateral management and conditions tracking process.

ConocoPhillips: splitting the spoils

Around the same time as the judgment in the Chevron case, in October 2016, the Supreme Court of Norway confirmed a ruling in favour of the Norwegian Tax Administration in a dispute regarding two Norwegian ConocoPhillips subsidiaries.[4] The entities participated in a multicurrency cash pool arrangement with more than 150 group companies. The entities in Norway were consistently in a net deposit position. The court ruled that, at arm's length, the Norwegian ConocoPhillips subsidiaries would have received a larger part of the overall benefit of the cash pool arrangement. The margin reported by the global cash pool leader was as a result partly allocated to the Norwegian entities, resulting in a higher interest income (for corporate income tax purposes) in Norway.

The implications of this ruling for treasury processes are that cash pool structures may need to deviate from mere legal relationships and should include additional layers in order to satisfy local fiscal requirements.

Cash pooling: the devil is in the detail

Over the past few years, local tax auditors have been scrutinising cash pool structures and intercompany bank account balances more than ever before. Intercompany cash positions are typically not disputed when supporting fluctuating working capital requirements. More often than not, however, structural balances, are challenged as being economically not prudent and thus as a case of tax base erosion.

An analysis of leading and lagging of intercompany obligations and inventory management has become part of the process employed by a tax inspector to determine the actual liquidity balance of a local subsidiary in a cash pool or internal bank account. An important issue in this respect is that the local and global tax files typically do not include sufficient detail for the proper assessment of the daily fluctuation of these intercompany cash positions. For example, a tax auditor assessing a local subsidiary of a highly seasonal agro-business, and based on the opening and closing balances in the financial statements, may conclude that the cash pool balance is structural, whereas throughout the year the subsidiary depleted is cash resources for its business investments in sowing seed and farmers only to collect outstanding balances after the harvest season when farmers have sold their crops. In short, the cash pool position in the balance sheet may not be representative of the working capital needs of the business during the year.

Treasury substance: who is doing what?

Substance issues have not (yet) triggered many high-profile disputes involving corporate treasury. However, the BEPS Project laid the foundation for a shift in focus away from legal

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[4] https://tpguidelines.com/norway-vs-conocophillips-october-2016-supreme-court-hr-2016-988-case-no-20151044-2/

relationships towards economic substance and management reality. This shift may prove to be a game-changer because tax auditors may challenge, for example, the adequacy of staffing or the independent decision-making power of an international treasury hub or finance centre.

Treasury operating model: taking a fresh look

The cases discussed above, together with increased focus from tax authorities on financial transactions, should provide compelling arguments for taking a fresh look at the treasury organisation and processes under the corporate treasury's responsibility. Arguably, more than ever before, the treasury operating model now has to mirror that of an external bank.

The Chevron case suggests that treasury will need an intercompany credit and risk review process very similar to that of an external bank. This intercompany credit review process 2.0 should include a discussion about the purpose of each funding requirement as well as an analysis/benchmark of (risk mitigating) terms and conditions. For example, if funding is required for investment in machinery, a repayment schedule and collateral would likely have to be the norm for that new intercompany loan.

Repayment requirements make the debt/equity ratio of the borrowing affiliate a more volatile number. This volatility may impact capitalisation planning, (implied) credit rating and thus also influence transfer pricing for intercompany working capital lines and future borrowings. Consequently, and to an extent not done today, the intercompany credit review process 2.0 will also have to include a periodic review of the balance sheets and business outlooks/cash flow projections of all affiliated companies obtaining intercompany financing.

The implementation of the intercompany credit review process 2.0 also requires a careful assessment of potential substance issues. The expertise and authority required for the analysis and approval lies typically at head office, whereas the finance company that is the designated lender might be located elsewhere. Tax authorities in the head office location might want to challenge the justification for allocating the interest earned on the loan to the finance company when that company relies on the risk management expertise and decision power at head office.

The cash pool examples suggest that the utilisation of internal bank account solutions will need to be different from how companies are typically managing cash balances externally. Treasury will need to pro-actively monitor the evolution of structural intercompany cash and overdraft positions and feed this information into the intercompany credit review 2.0 process for resolution. Adequate monitoring may require additional system reporting capabilities such as dashboards that include trend analysis and escalation key performance indicators (KPIs).

Another common theme across the cases discussed that reinforces the parallel drawn is outside expectation regarding client care: treasury is expected to act and decide in the best interest of their (internal) clients. This implies that in addition to considerations of group interest, operational benefit and, for instance, hedge accounting, treasury will need to assess for each of its treasury transactions and processes, whether they are in the best interest of the affiliate involved. This may require a new type of cash manager operating as internal treasury consultant and the definition of an internal client account role.

The processes described above may in part already be performed in practice, but is often not documented with the detail that may be required when dealing with tax authorities. For example, the daily closing balances of the internal bank accounts may need to be readily available as evidence in case a tax auditor challenges the role of the internal bank account as part of the intercompany funding strategy. Existing treasury systems may be used to gather and store the required information, but changes to internal processes may need to be made.

Key takeaways

The BEPS Project, the 2020 OECD transfer pricing guidance on financial transactions, as well as the court rulings, may shape prudent treasury operations going forward. These developments add requirements to the treasury organisation, processes and information management or expose the organisation to additional tax risk. Key considerations that treasurers need to take into account include:

1. Align or merge the treasury and tax policies
2. Operate in accordance with the pre-defined treasury/tax policy
3. Arm's length conditions do not apply only to pricing, but also to other terms and conditions that would be included in similar funding propositions between unrelated parties (such as repayment schedules, collateral and ratios)
4. Maintain detailed records on the decisions and upfront analysis used to determine the applied terms, conditions and pricing
5. Make sure that treasury is staffed adequately and given the proper mandate in the location where treasury activity reported
6. Make detailed transactional data is available for local and global tax reporting as well as for on-demand analysis and reporting

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