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Alternative A: TP for financial transactions

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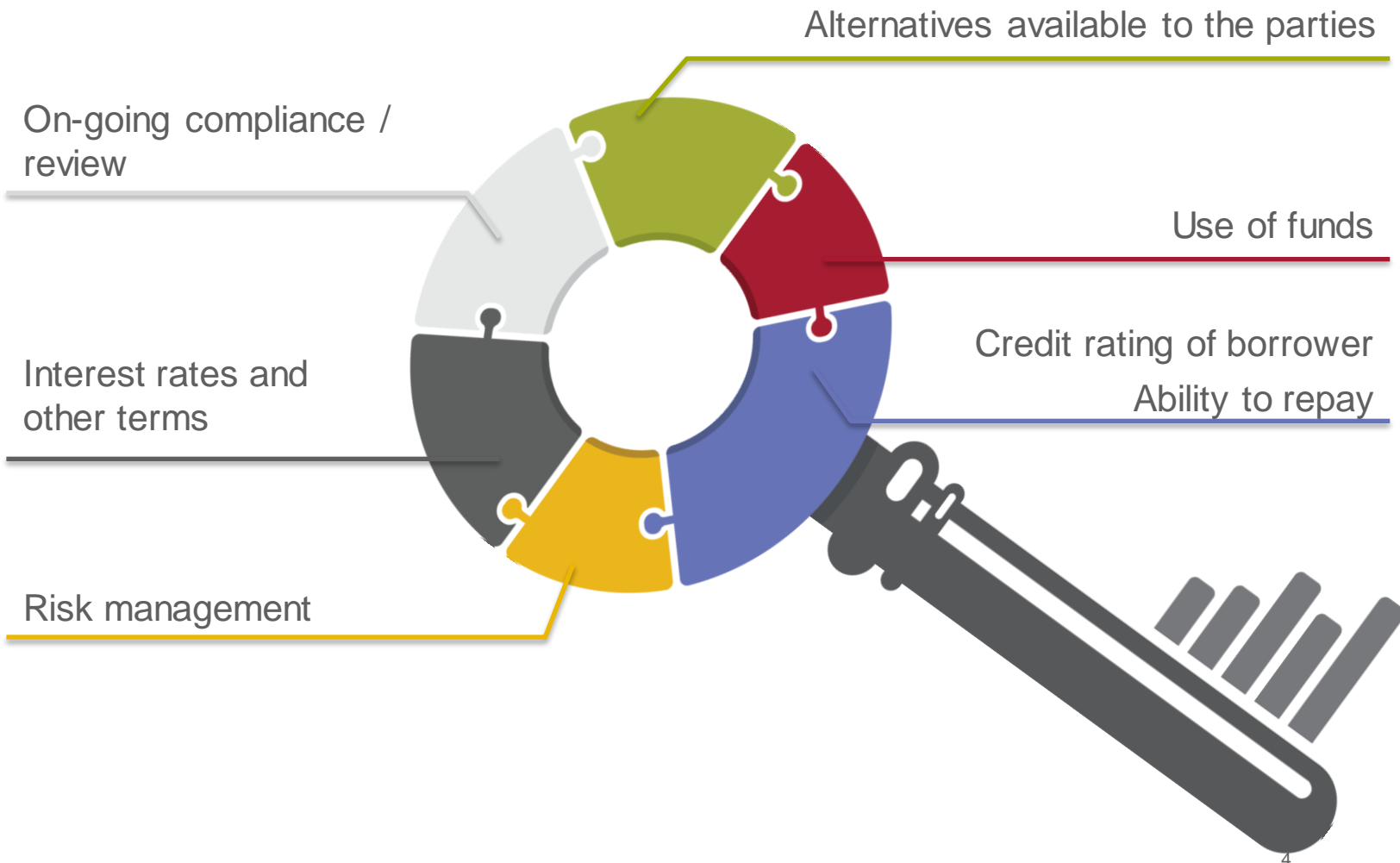
Sanjiv Malhotra, India

Michael Nixon, Singapore

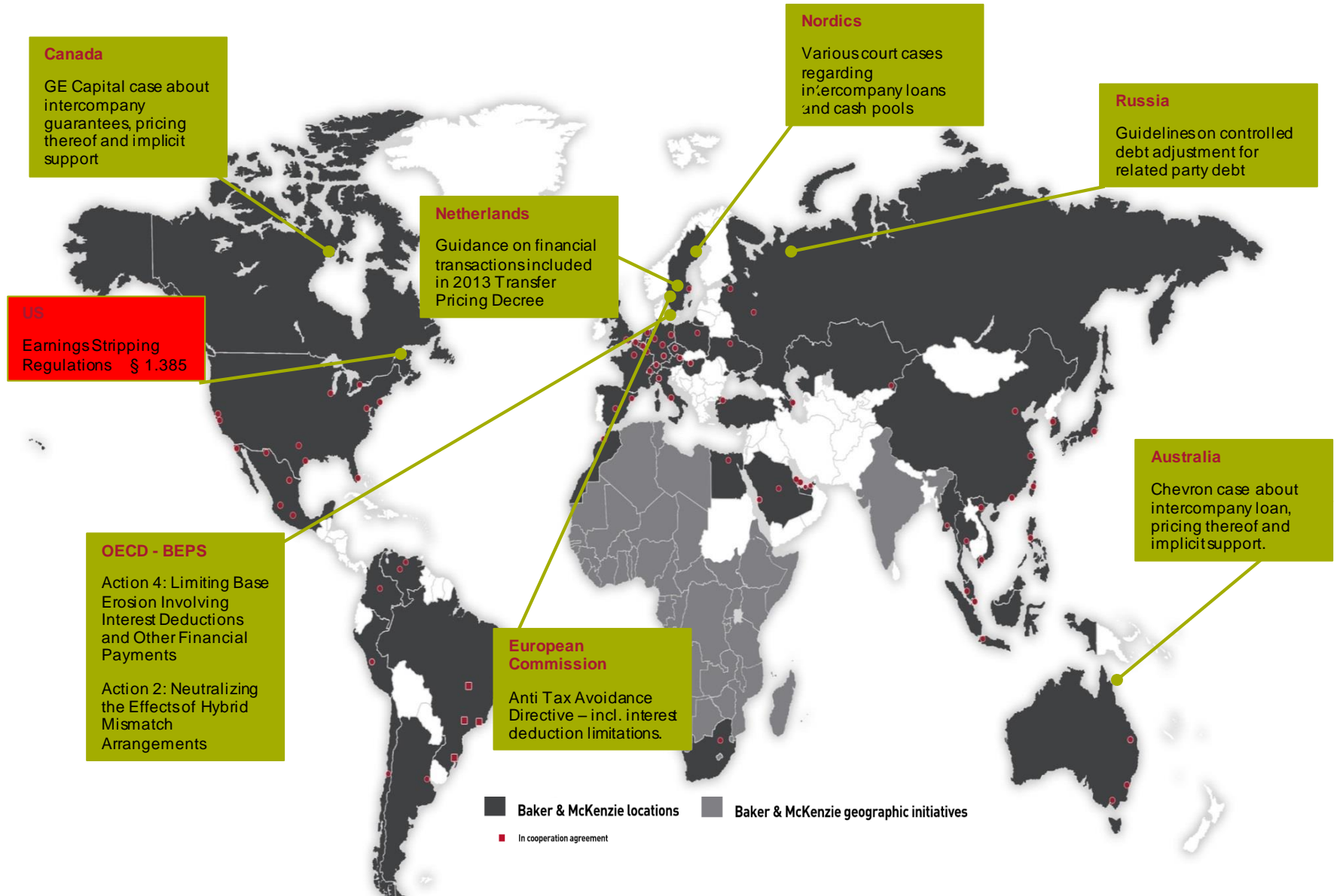
What do we mean by financial transactions?



Key Issues



Recent Global Developments



Financial Transactions and Transfer Pricing

- How applicable are the existing OECD Guidelines when it comes to financial transactions?
- The OECD has flagged the need to develop further guidance on application of the arm's length principle in this area
- Does the output of the BEPS process to date provide us with any new insights?

“capital without functionality will generate no more than a risk-free return, assuring that no premium returns will be allocated to cash boxes without relevant substance”

(BEPS Action 8-10 Final Report, page 13)

Financial Transactions and Transfer Pricing

- How might tax authorities interpret such statements?
- What is substance when it comes to financial transactions?
- In what circumstances can the provision of capital only deserve a risk-free return?

Key Questions to Consider

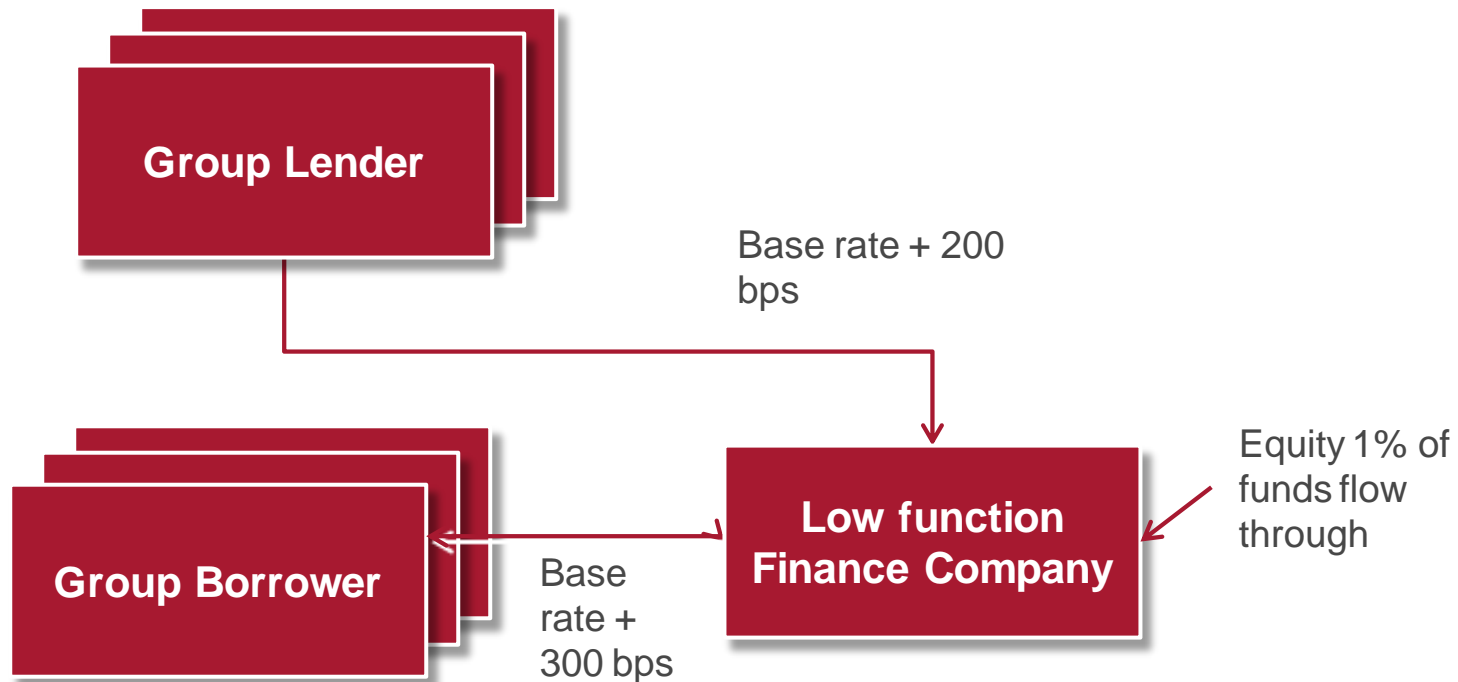
- What financial risk is assumed?
- Does the entity have the financial capacity to bear the risk?
- How is risk managed, and by whom?
- What is the arm's length anticipated compensation for assuming and/or managing the financial risk?

Financial Entity Characterization

- Remuneration of financing activities will increase in line with the functions performed and risks borne

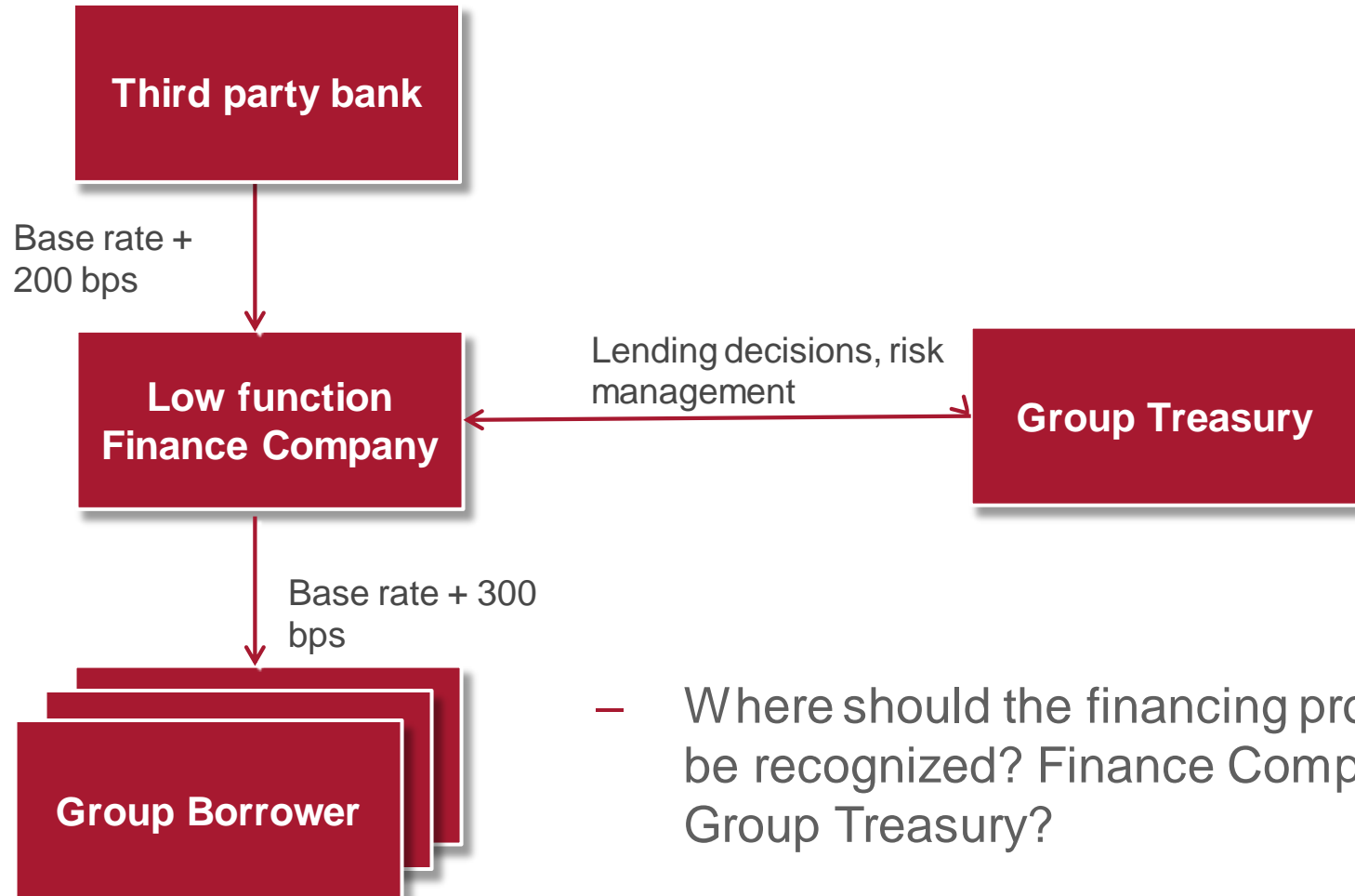
Characterization	Service Provider	In-House Finance/Treasury Entity
Description	- Provider of routine services, arranging financial transactions on behalf of affiliates, either with external financial institutions or internal sources	- Provider of potentially complex financial transactions, and operating as if an independent financial institution.
Functions	<ul style="list-style-type: none"> - Routine service provider - Transaction arrangement and facilitation - Loan documentation - Restrictive trading/hedging activities - Operates under pre-set guidelines - Finance/tax services 	<ul style="list-style-type: none"> - Institutional banking services - Deal sourcing and due diligence - Providing loans - Loan/Deal arrangement and negotiations - Full risk trading (i.e. determines strategy)
Assets	- Minimal capital required	<ul style="list-style-type: none"> - Highly skilled work force - Large capital requirements - Key industry networks
Risks	<ul style="list-style-type: none"> - Minimal capital at risk - No trading book 	<ul style="list-style-type: none"> - Capital risk - Forex risk - Hedging risk - Reputational risk

Low Function Financing Entity



- What is the appropriate reward for the Finance Company?

Low Function Financing Entity



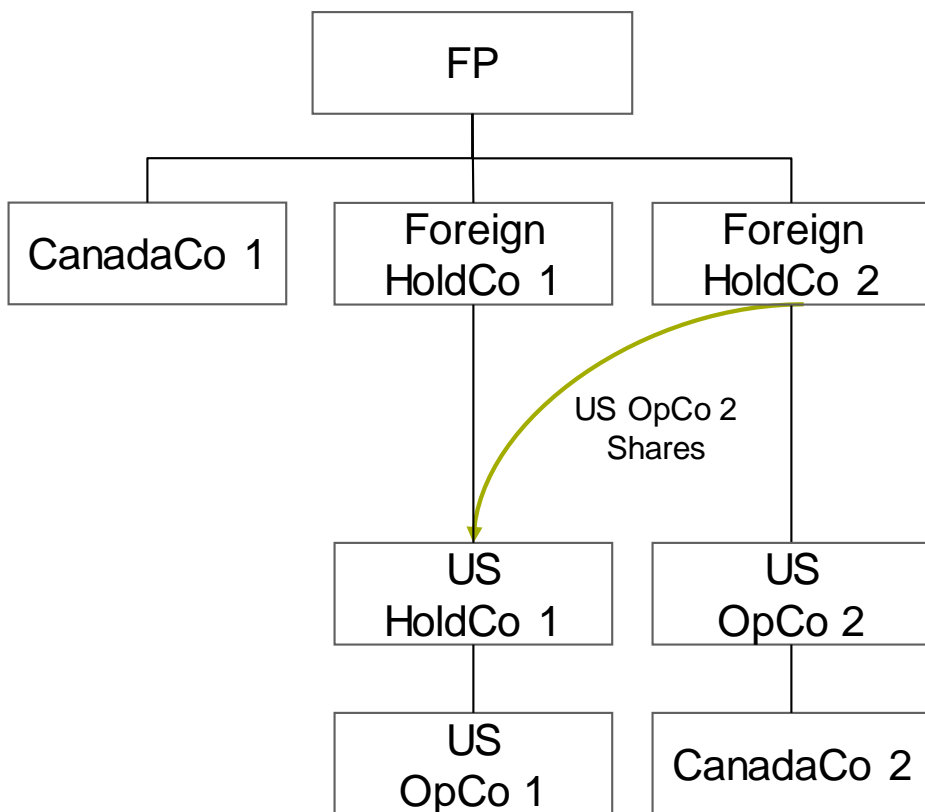
- Where should the financing profits be recognized? Finance Company or Group Treasury?

Final US Section 385 Regs

Section 385 Overview

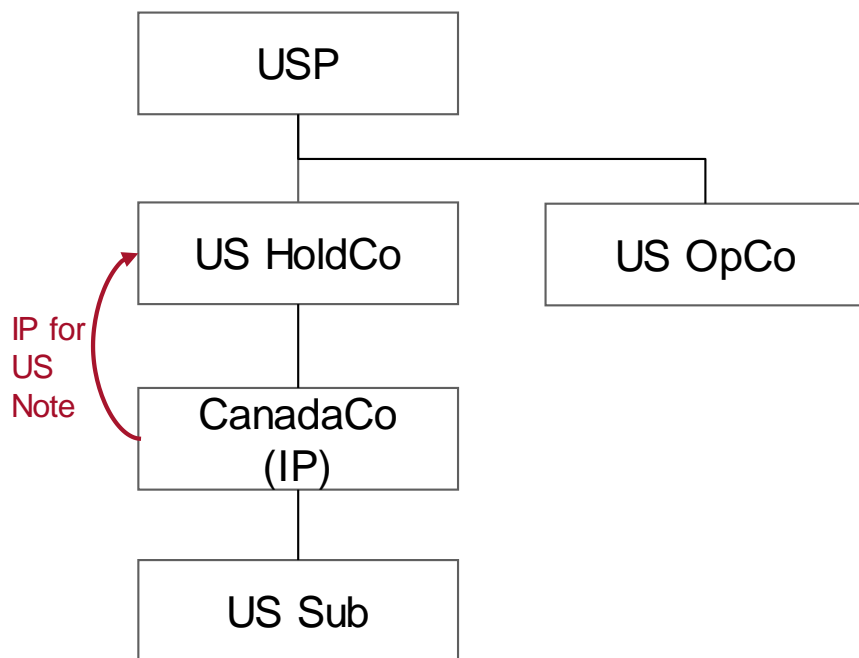
- Final and temporary related-party debt-equity regulations under Section 385 were released on 13 October 2016.
- Documentation Rule generally applies to debt instruments issued on or after 1 January 2018.
- Recharacterization Rules generally apply to debt instruments issued on or after 5 April 2016; a transition rule generally exempts debt settled within 90 days of the publication of the final regulations.

Impact on Post-Acquisition Integrations



- Assume FP recently acquired Foreign HoldCo 2 and wishes to form a single US consolidated group and integrate the business operations of US OpCo 1 and US OpCo 2
- Impact of general rule of Treas. Reg. § 1.385-3(b)(2) or the funding rule of Treas. Reg. § 1.385-3(b)(3) on various integration scenarios
 - If US HoldCo 1 (or US OpCo 1) borrows cash from a third party and uses the cash to purchase the shares of US OpCo 2 from Foreign HoldCo 2, neither the general rule nor the funding rule applies
 - If US HoldCo 1 (or US OpCo 1) issues a note (Note 1) to Foreign HoldCo 2 for the shares of US OpCo 2, the general rule dictates that Note 1 be treated as stock and payments of interest and principal be treated as distributions on that stock
 - If US HoldCo 1 (or US OpCo 1) borrows cash from Foreign HoldCo 1 in exchange for a note (Note 1) and uses the cash to purchase the shares of US OpCo 2 from Foreign HoldCo 2, the funding rule dictates that Note 1 be treated as stock and payments of interest and principal be treated as distributions on that stock
 - Impact of general rule of Treas. Reg. § 1.385-3(b)(2) and the funding rule of Treas. Reg. § 1.385-3(b)(3) on various integration scenarios is the same even if US OpCo 2 converts to a DRE or merges with US OpCo 1 after the sale
- What other integration scenarios could be pursued?

US HoldCo Issues US Note to CanadaCo in Exchange for IP

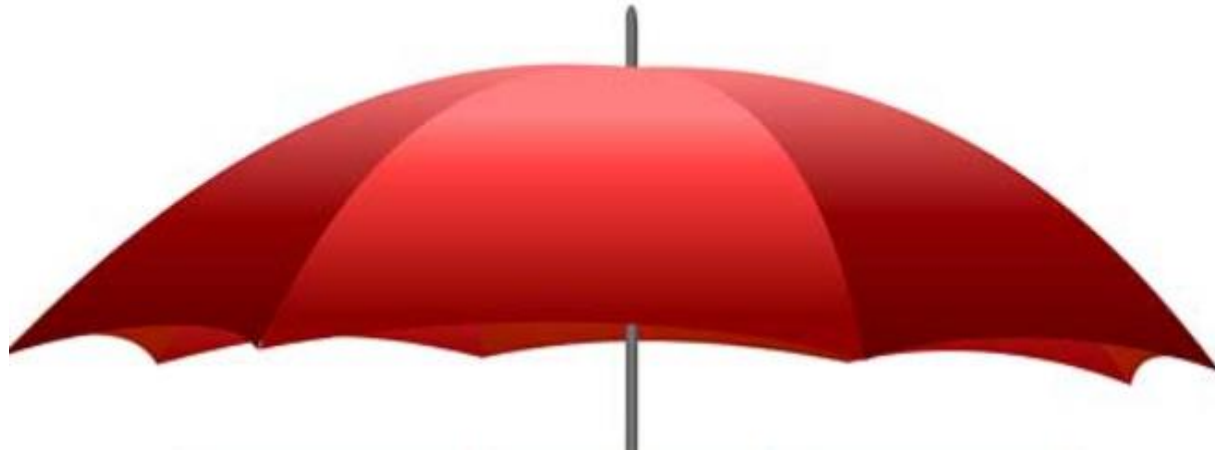


- US Note is a covered instrument
- Section 956 issue arises whether the note is recast or not
- US Note is not yet deemed equity, but US HoldCo is funded
- Assume US HoldCo purchases the stock of US Sub or the assets of US Sub and US Sub liquidates into CanadaCo
 - The stock sale fits within the subsidiary exception in Treas. Reg. § 1.385-3(c)(2)
 - The asset purchase and liquidation of US Sub is not a D reorg because the transaction fails the control requirement
- Alternatively, assume US OpCo purchases the stock of US Sub or the assets of US Sub in an all-cash D reorg
 - US Note is recast as equity because the subsidiary exception does not apply
 - The subsidiary exception requires 50% direct or indirect control, but not attribution under § 318
 - Partial payment of the debt is a dividend subject to US withholding tax
 - A lump sum payment (or a series of related payments) cannot qualify as a complete termination of interest due to attribution under § 318
 - US dividend withholding tax still applies

Documentation Rules & Requirements








- **Implementation Date:** Instruments issued on or after January 1, 2018
- **Purpose:** Provide IRS with documentation / information necessary to properly exam / audit debt instruments
- **Scope:**
 - EGIs issued by certain “large” Expanded Groups (publicly-traded group, \$100M in assets, or \$50M in revenues)
 - Covered members (domestic)
- **Excluded Instruments Include:**
 - Intra-consolidated group instruments
 - Certain instruments issued by regulated entities
 - Rev. Proc. 99-32 receivables
 - Receivables deemed created under Code / regulations
- **Timing** for documentation – filing of tax return for “relevant date”

Section 385-2 Documentation Requirements

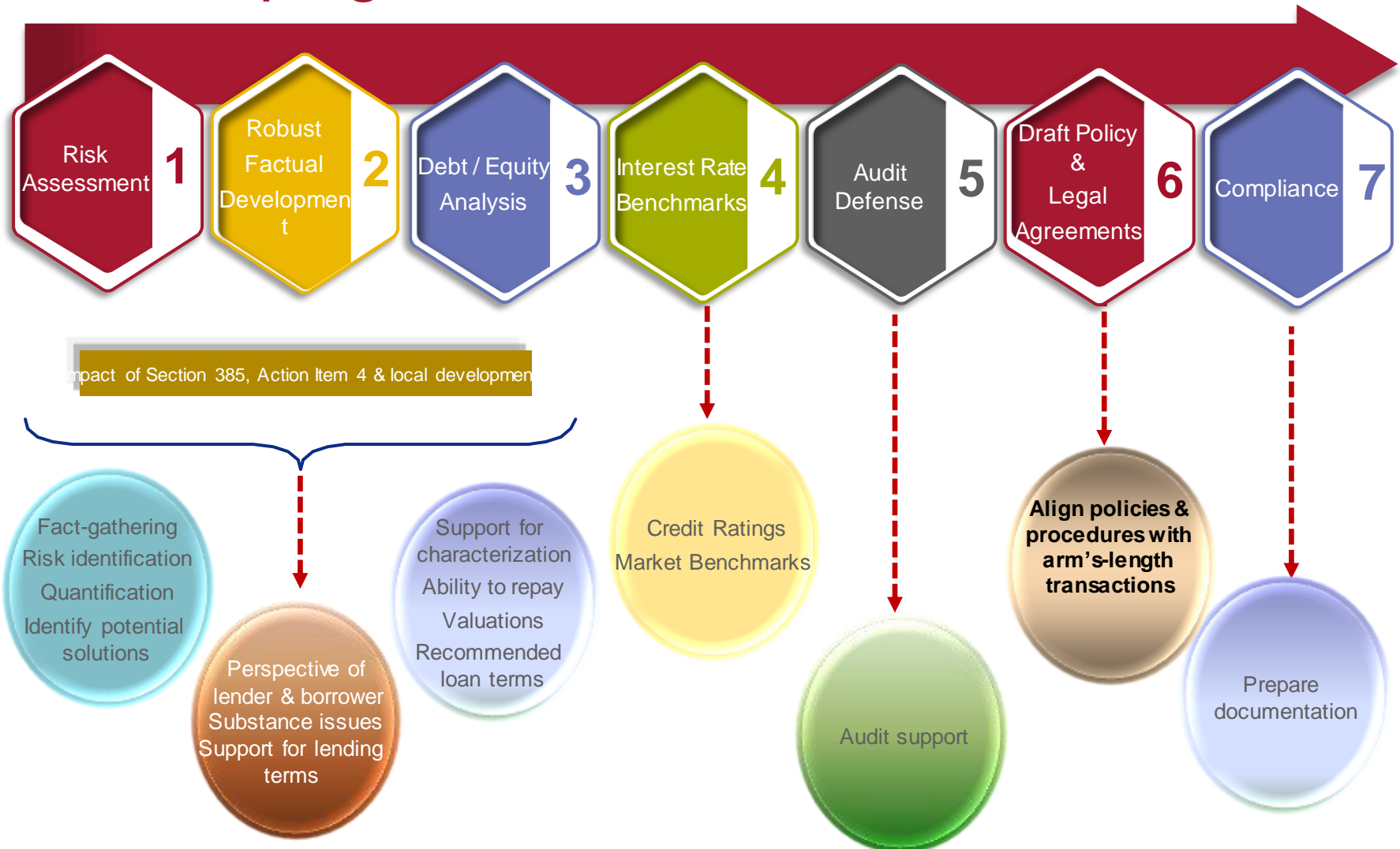


Obligation to repay funds	Creditor's rights to enforce terms of debt	Reasonable expectation of repayment of funds advanced	Evidence of on-going debtor creditor relationship
Interco Agreements	Interco Agreements & Policy	Documentation	Policy & documentation

How to deal with requirements in practice

		Current State	Future State
Loan Agreements	Instrument Name		+ Naming convention generally consistent
	Maturity Date		+ Stated maturity date in agreements
	Payment Sch.		+ Compounding schedule in agreements
	Creditor's Rights		+ Senior vs. subordinated + Security for loan performance (collateral) + Covenants + Dealing with delayed or non-payment
Policy / Procedures	Debt / Equity		+ Process led by TP group + Analytical framework/process in place + Combine with TP analysis
	In-Take Process		+ Lack of central oversight + Dealing with non-routine debt transactions + Further refine policy & procedures + Revamp reporting/oversight process
	On-Going Review		+ Setup process for TP or Treasury to monitor on-going compliance
Doc.	Compliant w/ local requirements		+ Robust documentation analyzing both D/E and interest rate + Ability to repay + Financial templates/tools for implementation + On-going compliance

Developing an Action Plan



Cash Pooling

Cash Pooling – What is it?



- Cash management exercise by a corporate group
- Companies combine their credit/debit positions into one central account and interest is earned and distributed based on each company's contribution to that account
- Parent corporation or group treasury monitors cash needs of companies within the group
- Engages services of a bank for management of the cash management

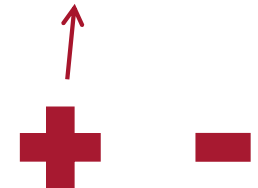
Cash Pooling – Why Cash Pool



- Addresses imbalances within the group of some subsidiaries having excess cash while other subsidiaries may be in need of cash
- Benefits from combined group strength to earn interest or obtain better loan rates compared to subsidiaries going singly
- Negates the need for a subsidiary to go for external borrowings if other subsidiaries have excess cash

Cash Pooling – How it works

- Group Finance & Treasury Centre has a Central Account
- Sweeping concept - cash from subsidiaries with positive cash balances may be swept to the Central Account which then sweeps balances to debits in the subsidiary account
- Notional concept - subsidiaries keep cash in own account and the Cash Pool operator calculates the notional balances with interest accruing in the Central Account or subsidiaries' individual accounts



Why Does Cash Pooling Matter?

- Planning opportunities
- Controversy
 - Cash pooling is becoming a major issue in repatriation and interest stripping controversies
 - Misunderstood by many tax authorities
 - Practical issues around establishing, implementing and monitoring appropriate transfer pricing policies

Economic Need for Cash Pooling

— Sample Interest-Rate Spread

- Assume a depositor receives 2% from a bank.
- Assume the bank charges 5% to a borrower.

— Rather than borrowing from banks, intercompany borrowing lowers the cost of financing.

- Using external financing would cost \$20.
- Using internal cash, the financing cost is lowered to \$5.

Sub 2
\$200 cash

Sub 1
(\$600 cash)

Sub 3
\$300 cash

	Cash Need	Income/Costs
Sub1	(\$600)	$(\$600) \times 5\% = (\$30)$
Sub2	\$200	$\$200 \times 2\% = \4
Sub3	\$300	$\$300 \times 1\% = \6
Total		(\$20)

Cash Pooling – Alternative methods

Physical cash pooling

- Zero cash pooling, also called sweeping or cash concentration
- Cash is swept into a Central Account
- Calculates interest on combined credit and debit balances that are put together

Notional cash pooling

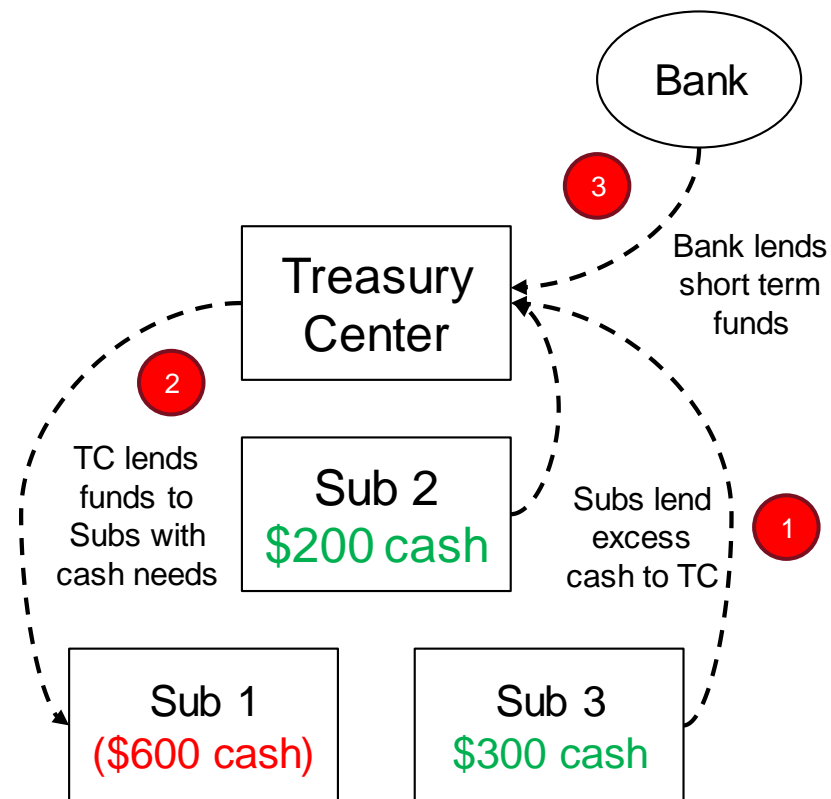
- Notional pooling manages interest only through Central Account
- No physical funds movement in this instance
- Calculates interest on combined credit and debit balances that are put together

Type 1: Physical Cash Pooling

- The Treasury Center (“TC”) acts as an internal bank for the company.

Basic Operating Structure:

1. A company’s subsidiaries actually transfer their excess cash to the TC.
2. The TC then lends the excess cash to the subsidiaries that need cash.
3. The TC may borrow externally to meet intercompany cash needs.

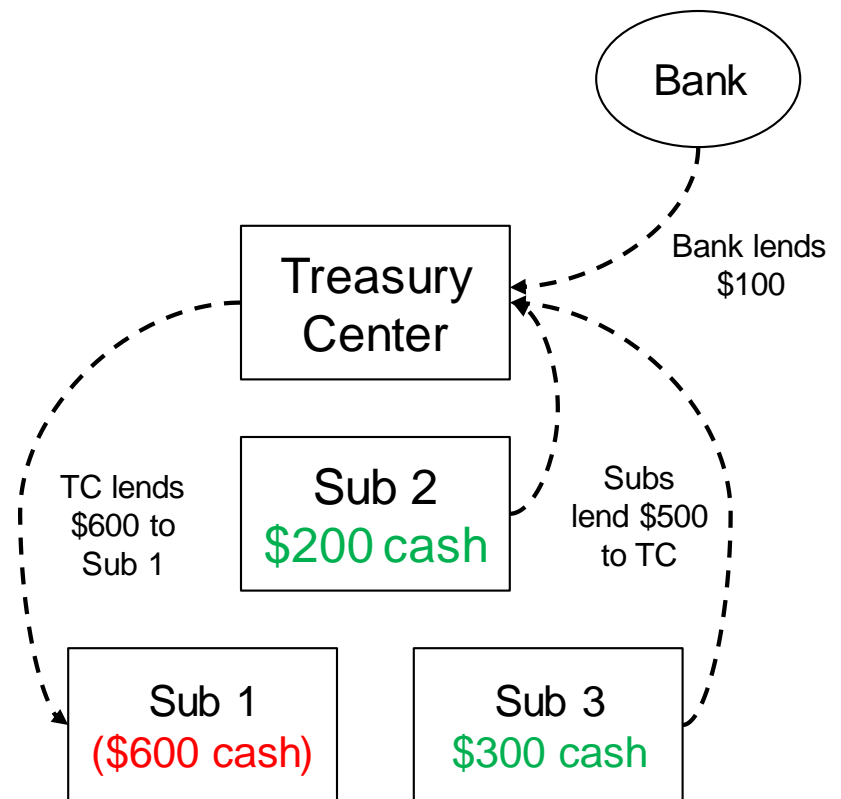


Type 1: Physical Cash Pooling

- Financing Costs with no cash pooling: \$20.

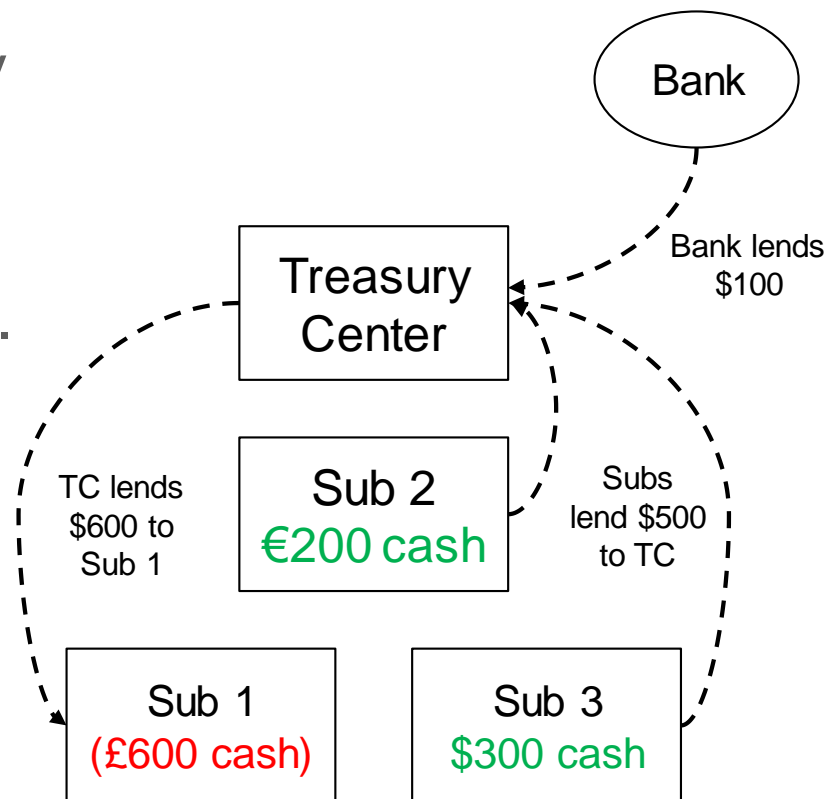
	Cash Need	Income/Costs
Sub1	(\$600)	$(\$600) \times 5\% = (\$30)$
Sub2	\$200	$\$200 \times 2\% = \4
Sub3	\$300	$\$300 \times 1\% = \6
Total		(\$20)

- Financing Costs with cash pooling: \$5.
 - $\$100 \times 5\% = \5



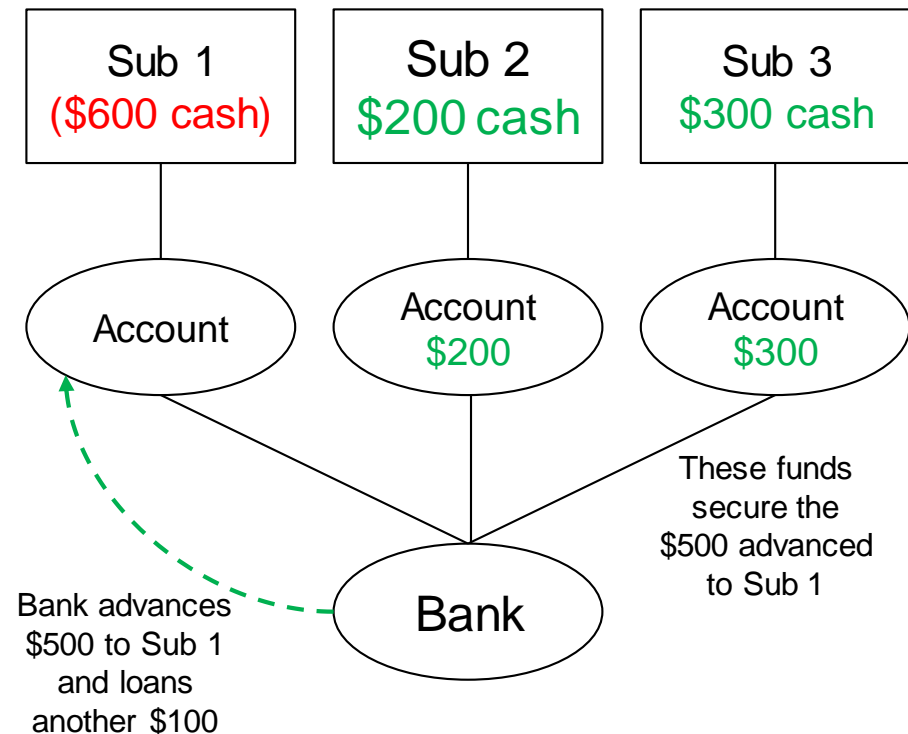
Type 1: Physical Cash Pooling

- Usually, TC “sweeps” the excess cash from each entity on a daily basis.
 - TC also normally bears the foreign exchange risk.
- For tax purposes, Sub 2 and Sub 3 are treated as lending directly to TC, and TC is treated as lending to Sub 1.
 - Physical cash pools create withholding issues in the international context.



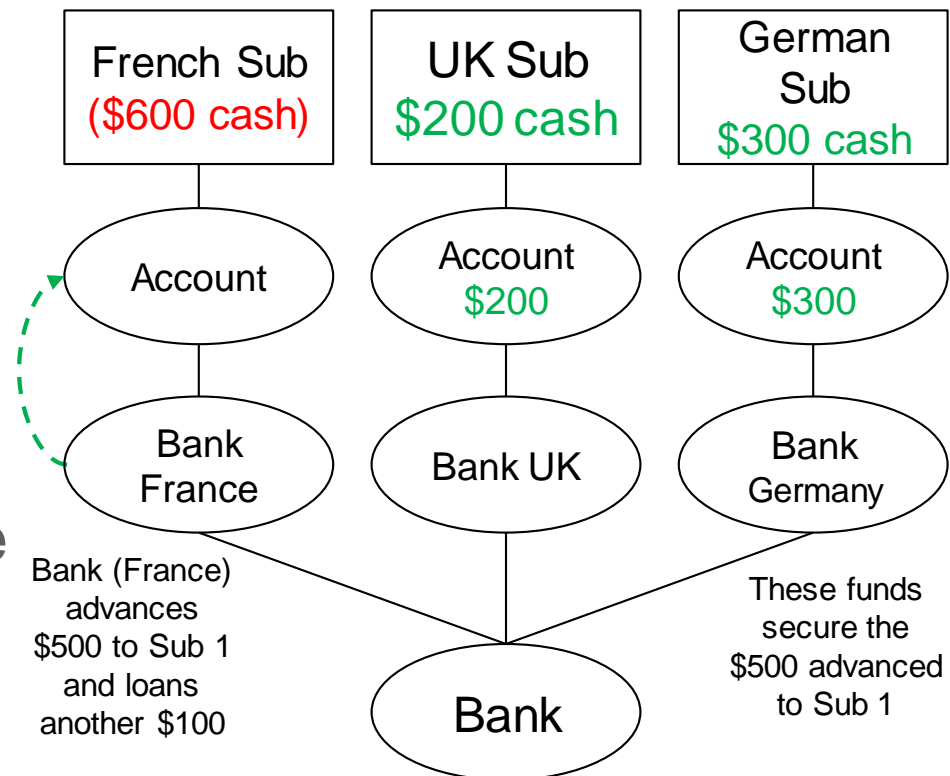
Type 2: Notional Cash Pooling

- Each subsidiary keeps its excess cash in its own bank account.
- All the bank accounts are kept with the same bank.
- This excess cash serves as collateral for advances made by the bank to related subsidiaries.
- To the extent that the amount of cash needed exceeds the aggregate amount in the bank accounts, the bank will treat the extra amount as a loan.



Type 2: Notional Cash Pooling

- Notional pooling is normally cheaper.
 - Fewer withholding issues because funds are not physically transferred.
 - No bank fees for daily “sweeps.”
- However, there are greater restrictions on when companies can use notional pooling.
- May generate cross-guarantee fees.



Cash Pooling – Transfer pricing

- Intra-group interest income / charge
- Remunerating the cash pool leader
 - Interest spread v Service fee
- Directors' duty to act in best interest of the company
 - need to ensure the company does not lose out by participating in cash pooling?
 - increased credit risk through any guarantees?
- Documentation requirements

Cash Pooling – Some practical issues

- Withholding taxes?
- Operational substance needed?
- Regulatory issues – licenses required?
- Exchange control – restrictive?
- Experience of tax bureaus?

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