Current Issues in Transfer Pricing for the Financial Services Industry

Brian Schneiderman, *Borden Ladner Gervais LLP* (chair), Tom Tsiopoulos, *Ernst & Young LLP and* Tom Akin, *McCarthy Tétrault LLP*

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Current Issues in Transfer Pricing – the Role of Risk

- Canada’s transfer pricing regime
  - Analysis of risk – a legal perspective
- Revised OECD Transfer Pricing Guidelines
  - Increased emphasis on risk, especially re business restructuring
- Economic analysis of taking on, managing and pricing risk
- Understanding risk in a transfer pricing context
- Recent transfer pricing cases

1

Canada’s Transfer Pricing Regime

- Canada’s transfer pricing rule, s. 247, is found in Part XVI.1 of the *Income Tax Act*
  - This Part does not impose tax
  - Rather, any amounts that would be determined for purposes of the *Income Tax Act* are adjusted to those that would be determined if:
    - Terms and conditions had been those that would have been made between persons dealing at arm’s length; or
    - Transaction or series entered into had been those that would have been entered into between persons dealing at arm’s length

2

Canada’s Transfer Pricing Regime

- Income tax is imposed under Part I of the *Income Tax Act*
  - S. 9(1) provides that a taxpayer’s income from a business or property is the taxpayer’s profit from that business or property for the year
  - While there are provisions governing the inclusion or deduction of certain specific amounts in computing income from business or property, s. 9 authorizes the inclusion and deduction of most amounts in computing income from business or property
- In the companion cases *Toronto College Park Ltd*., *Canderel Ltd.* and *Ikea Ltd*., the Supreme Court of Canada held that the determination of profit under s. 9 is a question of law
  - Determinants are express provisions of the *Income Tax Act* and established rules of law
  - Well-accepted business principles and GAAP are interpretive aides

3

Canada’s Transfer Pricing Regime

- Canadian courts determine tax liability on the basis of the legal results of the taxpayer’s actions
  - Not based on accounting, economic or financial results or treatment under foreign tax laws
- *Shell Canada Ltd.* (Supreme Court of Canada):

  “[T]his Court has never held that the economic realities of a situation can be used to recharacterize a taxpayer's *bona fide* legal relationships. To the contrary, we have held that, absent a specific provision of the Act to the contrary or a finding that they are a sham, the taxpayer's legal relationships must be respected in tax cases. Recharacterization is only permissible if the label attached by the taxpayer to the particular transaction does not properly reflect its actual legal effect…”

4

Canada’s Transfer Pricing Regime

- Interpretation of s. 247 of the *Income Tax Act*:
  - Legislation is slim compared to other jurisdictions
  - Like computing profit, determination of arm’s length terms and conditions is a question of law
  - Economic realities only displace legal relationships where:
    - Legal relationships are not *bona fide* or are a sham
    - *Income Tax Act* expressly requires such an approach
  - OECD recognizes that legal relationships and contractual terms are the starting point to determine the functions carried out and risks assumed
    - Parties’ conduct can be examined to determine whether the contractual terms have not been followed or are a sham

5

Canada’s Transfer Pricing Regime

- What role do economists play?
  - Like well-accepted business principles and GAAP in determining profit, economists provide interpretive aids
  - Within the scope of the taxpayer’s legal relationships, determine the appropriate price for the functions carried out and risks assumed
  - Analysis and pricing of risk somewhat foreign to lawyers, but key to economists
  - Variety of products and strategies available to price risk

6

OECD – Increased Emphasis on Risk

- Revised OECD Transfer Pricing Guidelines
  - Increased emphasis on risk, especially re business restructuring
- Contractual terms are starting point, but:
  - Must be based on economic substance
  - Actual behaviour matters and must conform to contract terms
  - Must provide for arm’s length allocation of risks
  - Risk must be economically significant to justify material profit change
  - Expectation of written confirmation of risk allocation
- Control of risk is critical
  - Decision to take it on, and actively manage it
  - Requires people performing control and bearing cost of managing and possible loss if risk materialises
  - Financial capacity to bear the risks
  - Some ‘outsourcing’ possible – under control

7

Defining Risk & Uncertainty

- Broad, complex, and impacts virtually all aspects of corporate operations
- Many definitions of risk and uncertainty
- Frank Knight – defined uncertainty as not measurable and risk as a quantity susceptible to measurement
- Doug Hubbard distinguishes uncertainty from risk as follow:
  - Uncertainty is the lack of complete certainty where more than one probability exists and the true outcome is not known
  - Measurement of uncertainty is represented by a set of probabilities that are assigned to possible outcomes
  - Risk is a state of uncertainty where some of the possible outcomes involve negative outcomes
  - The measurement of risk involves applying a set of possible outcomes with quantified probabilities and quantified consequences

8

Risk Management: Rationale and Strategies

- Why do corporations manage risk?
  - Risk management and loss mitigation is a consistent practice that is aligned with a key corporate goal of enterprise (share value) maximization

$$Corp_{Value} = \sum_{i=0}^{n} \frac{Net\ Cash\ Flows_t}{(1+i)^t}$$

  - Net Cash Flows (generated by projects that yield returns greater than the firm's cost of capital) are impacted by: size, timing, and volatility
  - Risk affects all the above three elements that impact Net Cash Flows by improving liquidity positions, reducing potential for underinvestment
  - Value is created as long as the marginal cost of risk reduction is less than the marginal benefit of expected loss reduction

9

Risk in a Transfer Pricing Context

- Risk can either be isolated or it can be bundled into other transactions such a tangible goods, services, financial transactions, and intangibles transfers
- Pure inter-company risk transfers include:
  - Reinsurance
    - Increases underwriting capacity and profit stability
    - Portfolio diversification
    - Protection against low frequency but highly material events
  - Tranches of insurance risks
    - Arbitrage on insurance life cycle and asymmetric information
  - Financial guarantee
    - Reduces the guaranteed entity's cost of borrowing and potentially enhances the MNE's consolidated profits
  - Performance guarantees (surety bonds)
    - Allows guaranteed entity to undertake activity by benefiting from the parent company experience and strength
  - Treasury (hedging activities)
    - Centralized treasury groups can create natural hedges providing benefits to insurer and the insured

10

Risk in a Transfer Pricing Context (cont.)

- Operational risks
  - Market risks: examples include macro economic fluctuations and changes to input and output costs
  - Financial risks – examples include changes to interest rates and foreign exchange
  - General operational risks – inventory, accounts receivable, capacity utilization and other short term fixed costs
  - Research and development risks
  - Product liability and warranty risks

11

Economics & Pricing of Risk

- Products and strategies commonly used to price risk
  - Actuarial models
    - Applied to determine ceding commissions on reinsurance transactions and for self insurance captive structures
  - Derivatives (swaps, futures, options)
    - Credit default swaps can be used to estimate the value of credit default risk on loans
    - Put options can be used to estimate capacity risk to adjust for differences between contract and toll manufacturing arrangements
  - Securitization strategies
    - Hedging risks, such as loans or credit risks, through pooling arrangements
  - Performance bonds
    - Guarantees issued, usually by the parent company to a subsidiary, to secure contracts
  - Other hybrid models and approaches

12

The Role of Risk in Transfer Pricing

- Risk and risk transfer – differences between financial institutions and other businesses

- Associated enterprises may transfer risk in ways that independent enterprises would not

13

The Role of Risk in Transfer Pricing

- Tax consequences of risk transfers in business restructuring
- Transfer of risk between entities in different jurisdictions
- Current debates with the CRA on risk transfers

14

Recent Transfer Pricing Cases

- *General Electric Capital Canada Inc.* (FCA)
- *Glaxosmithkline Inc.* (FCA, SCC granted leave)
- *DSG Retail Ltd.* (UK First Tier Tax Tribunal)

15