identifying the legal issue that arises from the taxpayer's dispute with HMRC in order to consider whether that legal issue, and therefore any asserted advantage which relies on that issue, is determined by the judicial ruling on which a FN purports to rely. In this case, the legal issue that arose was whether the payment made by Mr Locke was to be treated as a payment to purchase a share in a partnership rather than solely as a contribution of capital. Although in Mr Locke's case this legal issue was evident from particular entries in an annex to his tax returns, the same legal issue may, as an objective matter, be one that arises in the dispute other taxpayers have with HMRC in relation to the same asserted advantage, whether or not they included similar wording in or with their tax returns. This means that Eclipse investors who, unlike Mr Locke, did not originally specify s 362(1)(a) as the basis of their interest relief claim in their tax return are not necessarily debarred from doing so in challenging the validity of an Eclipse FN. Judicial review actions on the part of many other Eclipse investors are already in train, as well as many Eclipse investors still awaiting a response from HMRC to their representations challenging their Eclipse FNs, and there is scope for others to consider their position in the light of *Locke*, whether or not FNs have already been complied with, and irrespective of other arguments that may be deployed in any further substantive litigation in the Tribunal in respect of the Eclipse partnerships.

Second, related to this point, the Court of Appeal considered what flexibility should be afforded to HMRC in forming its 'opinion' on the relevance of the judicial ruling in question. HMRC had argued that, in coming to that opinion, it is entitled to come to a view on 'the proper characterisation' of the facts of the arrangements. The court held that the flexibility afforded to HMRC in forming its opinion was of a different kind. Whilst HMRC might issue a FN in a situation where, for example, the arrangements chosen by the taxpayer are slightly different as a matter of fact from those that were considered in the earlier judicial ruling (but the legal issues are the same), it cannot do so where there are legal issues arising from the taxpayer's dispute with HMRC which have not been determined by the judicial ruling in question. It held that, even if HMRC views the taxpayer's position on that legal issue to be clearly unsustainable, without a prior judicial determination to that effect HMRC is not entitled to jump over the need for such a determination based on its own 'opinion'.

Third, as a more general point, the court confirmed (as it had in *R (Haworth) v HMRC* [2018] EWHC 1271) that the draconian nature of the FN/APN powers given to HMRC meant that those powers should be construed narrowly. The court noted that the legislation may have been enacted to deter litigation on points already decided, but its decision supports the view that taxpayers are entitled to seek a determination of other legal issues raised in their disputes with HMRC without the threat of a penalty being imposed if they turn out to be wrong and without having to pay the disputed tax upfront. ■

The author thanks his EY colleagues Boaz Goren, Dan White and Elyse Waller who also acted for the taxpayer in this case.

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Analysis

The transfer pricing of financing transactions: OECD guidance

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Speed read

Following a July 2018 consultation paper, the OECD will soon publish long-awaited guidance on how transfer pricing analysis of financing arrangements should be undertaken. Many principles will not be new to UK taxpayers given HMRC practice and guidance although the new OECD guidance concerning the recognition of guarantees could give rise to a change in UK legislation. Greater focus is expected on the risk management within, and economic rationale for, a finance structure that could cause some practical challenges with pricing. The likelihood of tax enquiries internationally in relation to this subject will increase as tax authorities are emboldened by the consensus implied by the adoption of the new guidance and the greater clarity to transfer pricing in this area that it brings in risk assessment. We speculate that there could also be guidance given on the comparison of secured and unsecured facilities, in particular where as a matter of fact no specific security is granted, or security has been issued in respect of a wider group facility, but where the structure might have looked different at arm's length.

Since the publication of the 'final' BEPS reports in 2015, two of the most difficult areas remained a work in progress with the initial reports concluding only that they should be addressed. One of these, the impact of the digital economy, has attracted significant attention. The other, guidance on the transfer pricing aspects of financing transactions (largely unaddressed by the current OECD transfer pricing guidelines, albeit an area where the OECD self-evidently see substantive tax risk), is less groundbreaking but still much needed.

The OECD finally issued a consultation paper on the transfer pricing of financial transactions in July 2018, but it was (unusually) a non-consensus one reflecting many areas of disagreement between the members of the OECD's Committee on Fiscal Affairs. It has taken more than a year, but the OECD has now substantively finalised its work and has a target to release the final paper before the end of this year.

In this article we explore the context to the new guidance, areas to look out for in the new guidance, and the tax environment and potential impact of new guidance on enquiry levels.

Why do we need new guidance?

HMRC has several sections of its *International Manual* dedicated to the transfer pricing of financing arrangements. However, challenges arise frequently from international differences in their treatment and the potential for differing views taken in international courts.

It is also evident that some tax authorities currently display a lack of willingness to engage fully with the arm's length standard in respect of financing, instead aggressively policing the boundaries of safe harbours.

The OECD's new guidance on financial transactions seeks to enhance international consistency and will help promote a set of common standards, making it easier for groups to operate without high risk of double taxation through transfer pricing.

While having a well-developed view on the appropriate measures for dealing with financing arrangements, the UK will not be immune to changes from the upcoming guidance. There may be technical areas that change (such as guarantees, see below) and areas such as substance and decision-making roles where the OECD may seek to provide further clarity over what these entail in the context of financial transactions.

Limited interest?

While the transfer pricing of financing arrangements is finally gaining common OECD guidance, some of its potency has arguably been lost in recent years due to the shifting sands of policy.

The introduction of other rules through the BEPS programme, in particular interest limitation (by virtue of BEPS Action 4), give a separate set of mechanical tests that can conflict with transfer pricing. This can potentially give rise to situations where a company in one country will be taxed on arm's length interest income but the borrower in another country will not be able to deduct interest due to a mechanical interest limit.

Whilst this remains the case, there *will* be a continuing place for transfer pricing at the table.

In general, interest limits are set using the higher end of the OECD's recommended range for BEPS Action 4, at 30% of taxable profits. This is intended to not be a punitive level and therefore the interest deduction of many companies could still be limited primarily by transfer pricing. On smaller debt amounts, the interest rate – something generally only varifiable using arm's length principles – will be the key factor to assess. In other cases, transfer pricing could be the only mechanism available to tax authorities to curtail perceived tax abuse through aggressive financing arrangements.

Content of the guidance

Whilst the OECD guidance on financing transactions has yet to be published, the areas covered are likely to closely follow those of the public discussion draft released last year. The draft guidance is intended to provide for the more accurate delineation of financial transactions and their analysis under chapter 1 of the 2017 OECD guidelines. It also addresses specific issues related to the pricing of financial transactions such as treasury function, intra-group loans, cash pooling, hedging, guarantees and captive insurance. Capital, cash flow and managing financial risk are core issues.

It is possible that there will be a wholesale change in direction but, as it is highly unlikely that all parties would agree to shift entirely to a mechanical or formula driven basis, it seems likely that changes will be confined to the areas with most questions raised for consultation.

Relatively uncontentious aspects	Aspects more liable to change
Pricing guidance: relevant considerations and methods to be used in pricing a loan.	Assessment of capital structure.
Treasury functions and hedging management: appropriate remuneration for treasury teams managing a group's finances internationally.	Risk-free returns for lenders with insufficient substance.
Cash-pooling: we are likely to see distinction between situations when a cash pool leader should and should not attain a pricing margin and where benefit should be shared between pool members, either to depositors (if at risk) or to all members through reduced margins between borrowing and lending.	Guarantees and the impact on pricing.

The previous discussion draft also featured a section covering captive insurance. Given that this manner of insurance arrangement is quite distinct from those associated with making and receiving loans, we do not consider it further here.

We discuss below the areas we consider most likely to see or to cause change.

Assessment of capital structure

While there were no detailed questions on consultations over alternative routes, there is some concern over the degree to which the capital structure can or should be subjected to an arm's length test.

The UK has a long history of formally requiring both the arm's length quantum of debt and interest rate to be considered; other countries have not always mirrored this approach. The tests set out in the consultation draft mentioned determining the true character of an advance (akin to the 'quasi-equity' term, i.e. an amount shown as a liability but with technical features more like a capital contribution) and the level of debt that might be agreed at arm's length.

We expect that these tests will remain and would hope that greater detail and guidance would be given in relation to these matters; however it is possible that if consensus was not reached we could end up with either a position with reservations (and so unhelpful for consistently avoiding double tax) or a very light touch acknowledgement that these tests could be carried out.

In either case, UK practice seems unlikely to change materially, making this of greater interest internationally.

Risk and substance

A section in the consultation draft addressed risk-free and risk-adjusted returns and raised general and specific questions.

This area for discussion originally arose in respect of intangibles, where the role of limited function cash-boxes was considered with the conclusion that merely providing funding should provide a financing return rather than an automatic entitlement to a share of future revenues.

Discussion was set out on how a risk-free rate could be tested, for instance based on an appropriate base rate (see below regarding LIBOR use) or sovereign debt, and how this might apply for lenders not undertaking sufficient decision-making roles with additional profits attributed elsewhere.

Further discussion then covered the mechanics of how risk adjusted returns are to be calculated, with detail on how these returns can be attributed.

The aim of the section appears to target both notional financing (as discussed for 'aggressive' intangible development structures) and also loans where an equity advance is made to a low-tax jurisdiction that then on-lends to a high-tax jurisdiction.

Turning to substance and the people functions performed in a lending business, the EU Commission decision of 2 April 2019 on state aid and the UK's CFC group financing exemption highlighted the importance of the analysis of profits attributable to UK significant people functions and key entrepreneurial risk takers. There needs to be clear delineation of decision making where business is being conducted cross border. The absence of a clear operating model being supported by the underlying facts can create permanent establishment risk and a potentially significant tax cost.

However, we regard the direct implementation of the principles highlighted in the EU decision to intragroup lending to be fraught with potential difficulty. At this stage the financial transactions guidance is unlikely to go into this level of complexity. Contentious issues such as the following require more thought:

- Tax authorities might need to accept both potential losses for loans made in other countries with no contractual liability or loss in their country. This seems unlikely to proceed without high risk of taxpayers being challenged.
- The main target might be avoidance structures, but in practice many groups apply little rigour, i.e. no one is making some of the 'necessary' decisions, which makes positions hard to defend clearly.
- Longer-term lending arrangements may not need significant on-going activity making it relatively easy for low-tax lending companies to step through any hoops set out, unlike an overstretched treasury team 'innocently' shuffling cash within a group.
- The interplay with other guidance on treasury functions and cash-pooling may not be clear.
- There was no clear reference in the consultation draft to financing conduit structures, or to the substance required to justify margins. Even if not specifically covered, any business using back-to-back finance structures seeking efficient financing structures under tax-treaties may need to take increased care in the light of substance discussions.

Guarantees

The UK's transfer pricing legislation specifically excludes both implicit and explicit financial guarantees from being taken into account for the purposes of considering their capitalisations.

The guidance seems likely to require that implicit guarantees from a group can and should be taken into account when pricing loans, something that has often been seen internationally. The *Australian Chevron* case (*Chevron Australia Holdings Pty Ltd (CAHPL) v Commissioner of Taxation* [2017] FCAFC 62) is an example, resulting in a significant adjustment, where the local borrower was treated as having access to the group's borrowing credentials, potentially going beyond a standard 'implicit support' argument.

Wider factors relating to tax authority attitude

Tax authorities are expected to feel emboldened following the publication of OECD guidance specifically on financing transactions to increasingly challenge financial arrangements (supported by big wins by tax authorities in challenging financial transactions transfer pricing, such as in *Australian Chevron*).

HMRC's recently published statistics on its pipeline of 'tax potentially due' from its current compliance activities in the Large Business Directorate show a total approaching £30bn (of which the most significant area is transfer pricing and thin cap at £6bn). With increasing yields on transfer pricing enquiries, additional tax authority resource (including HMRC's team focused on 'diverted profits') and revisions to the business risk review process, there is every indication of the potential for increased scrutiny of the transfer pricing of financial arrangements. Business will need to ensure that it is appropriately prepared for this.

A first step for many will be an assessment of transfer pricing risk in this regard. In response to the behavioural changes of tax authorities around the world, it is important that groups are aware of the principles and procedures governing tax risk assessments to appropriately prepare themselves from a compliance perspective.

A detailed examination of this is beyond the scope of this article, but a good starting point would be HMRC's transfer pricing risk assessment framework (and specifically its two principal HMRC policies which provide the framework governance for HMRC's conduct of TP risk assessments: the TP risk assessment guidance in INTM482010 et seq. and its litigation and settlement strategy), and the OECD April 2013 *Draft handbook on transfer pricing risk assessment* and its September 2017 *CBCR handbook on effective tax risk assessment*.

On a final point, in an article on the transfer pricing of financial transactions it would seem apposite to at least make passing reference to the demise of LIBOR as the base rate for lending in sterling (and other currencies) and the impending adoption of alternative reference rates such as 'SONIA'. If any related party loan agreements are novated, it will be a trigger for fresh transfer pricing assessment and critical to align the policy and documentation update to the revised OECD guidance. ■

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- Transfer pricing of financing arrangements (Anton Hume & Andrew Stewart, 5.7.18)