THE MCKESSON TRANSFER PRICING CASE

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BACKGROUND

The recently decided McKesson transfer pricing case in Canada, which dealt with the intercompany sale of receivables, has broad implications for other types of financial transactions, as well as risk shifting in general among related parties.

On December 13, 2013, the Tax Court of Canada ("the Court") rendered its judgment in the case of McKesson Canada Corporation ("McKesson Canada") v. Her Majesty the Queen, 2013 TCC 404. The issue was the appeal of a transfer pricing adjustment made by the Canada Revenue Agency ("C.R.A.") to McKesson Canada's income under paragraphs 247(2)(a) and (c) of the Income Tax Act, for the tax year 2003. Specifically, the relevant intercompany payments were compensation for a Receivables Sales Agreement ("R.S.A.") and a related Servicing Agreement between McKesson Canada and its parent company, McKesson International Holdings III ("MIH"), based in Luxembourg.

Essentially, the R.S.A. was a factoring agreement. Under the R.S.A., McKesson Canada sold C$460 million of trade receivables to MIH at a discount rate of 2.206%. Further, MIH committed to purchasing additional receivables over a five-year period, up to a maximum of C$900 million. Under the Servicing Agreement, MIH paid McKesson a fixed annual fee of C$9.6 million to continue servicing the receivables. MIH was granted the right to put receivables in default back to McKesson Canada at 75% of face value; MIH had no other recourse with respect to the purchased receivables. In addition, MIH held certain rights of termination of the R.S.A., including financial default of McKesson Canada or its affiliates, loss ratio of receivables beyond a set threshold, and any event materially adversely affecting the collectability of receivables. For example, the receivables potentially could have been reduced by payment defaults by customers, prompt payment discounts, and/or set-offs from rebates, discounts, and returns.

As mentioned above, the terms of the R.S.A. included a discount rate of 2.206% for the sale of the receivables, while the C.R.A. calculated the rate to be 1.013%, leading to a transfer pricing adjustment to McKesson of approximately C$26 million arising from an imputed increase in the price of the receivables sold. The Court

concluded that the C.R.A.'s arm's length range of discount rates, 0.959% to 1.17%, was indeed appropriate. McKesson Canada's appeal was rejected.[1]

ISSUES RAISED

Though the Court's decision focused on the discount rate applied in the R.S.A., wider issues were raised which could be important in other similar transactions or which could have been important in this case had they been raised by the C.R.A. Among the pertinent issues are:

- The economic substance of the parties involved;
- The business purpose of the transaction; and
- The impact of a non-arm's length relationship or transaction terms on a notional arm's length analysis.

Factoring of receivables is a means by which credit risk is transferred from the seller to the buyer. This is a common practice for a taxpayer selling products under terms that call for payment within a specified number of days. In the context of an unrelated seller and purchaser, it is expected that the purchaser will be required to manage the receivable pool to ensure payment. For that reason, factoring income is more than simply interest income for the purchaser. However, when a receivables sale takes place among related parties, questions arise as to whether the purchaser is willing and able to manage that risk – not just in terms of the needed capital, but also with regard to the capacity of the purchaser to manage the receivable pool in light of its employee headcount and the capability of the employee base.

Though the C.R.A. did not challenge the C$9.6 million Servicing Agreement between McKesson Canada and MIH, the fact that the Canadian operating company continued servicing the receivables after the sale is a red flag that should raise doubts about MIH's ability to assume and manage the related risk in the first place. The off-loading of the management function over some or all of a pool of receivables by one factor to an unrelated factor in light of an objective business reason of the seller – such as lack of capacity or the need for capital – is functionally different from a situation where the party whose sales have generated the receivable continues to service the entire receivable base after the sale, albeit for a fee. Consequently, the question remains whether the risk of collecting payment of receivables was effectively shifted from McKesson Canada to MIH. Stated differently, the question was whether McKesson Canada continued to bear a significant portion of the risk even after the transfer of receivables.

The context of the intercompany transaction raises a second issue related to the business purpose of the transaction. Given the relatively low level of risk observed

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[1] A secondary issue was McKesson Canada's failure to pay withholding tax on the disallowed portion of the purchase price, an appeal of which was also rejected.

historically with respect to McKesson Canada's portfolio of receivables, was there a believable business reason for selling the receivables to MIH other than as a means of shifting taxable income to Luxembourg? These questions were raised in the Court's decision, though not fully explored. However, they could be raised in future litigation or audits by Canadian and other tax authorities, and this case did little to establish meaningful precedent on this point. Stated in plain English, and using a before and after analysis regarding the servicing of a receivables pool, McKesson Canada performed all the same tasks and relatively the same risks before and after the transaction, yet a portion of its income was hived off to a low tax jurisdiction. Looked at in this light, it is not clear whether McKesson Canada would have entered the same transaction with an unrelated party in the absence of a need for capital.

A common thread among transfer pricing analyses of financial transactions between related parties is the difficulty involved in attributing arm's length behavior and pricing to a situation which is inherently non-arm's length in character. In the case of the McKesson Canada transaction, for example, the Court noted that the five-year term of the R.S.A. is something that would likely not be observed among unrelated parties; factoring agreements tend to be of shorter duration. Consequently, the Court could have chosen to adjust the discount rate for a one-year term, particularly since the ruling included the observation that all relevant non-arm's length factors should be taken into account; otherwise the terms of a transaction could be open to manipulation.[2] Again, though this question was raised, the Court accepted the five-year term in the final analysis when calculating its arm's length discount rate range.

These types of issues are also raised by the Base Erosion and Profit Shifting ("B.E.P.S.") initiative of The Organization for Economic Co-operation and Development ("O.E.C.D."). In particular, the B.E.P.S. Action Plan (released July 2013) includes Action Item 9, which states that the O.E.C.D. will adopt "rules or special measures to ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital" and that returns are aligned with value creation.[3] This is not to say that risk cannot be transferred between related parties; however, any such transfer of risk must be consistent with the economic substance of the participants; the mere transfer of risk without corresponding employee functions may not be recognized. In this case, since the servicing of the receivables was retained by McKesson Canada while a portion of the risk was shifted to MIH, it seems the structure did not adhere to this O.E.C.D. principle.

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[2] The counterargument recommends a court or tax authority should respect the form of a transaction, assuming it is "commercially reasonable," and then attribute arm's length prices to the existing facts.

[3] OECD (2013), Action Plan on Base Erosion and Profit Shifting, OECD Publishing. http://dx.doi.org/10.1787/9789264202719-en

IMPLICATIONS FOR OTHER FINANCIAL TRANSACTIONS

Many of the concerns raised by the Court with respect to the sale of receivables, aside from the pricing of that sale, are echoed in analyses of and potential challenges to other types of intercompany financial transactions. This article explores three such transactions: loans, guarantees, and reinsurance.

Loans

Interest rates on related-party loans are often benchmarked by performing a credit analysis of the borrowing entity on a stand-alone basis. The resulting "synthetic" credit rating of a borrower that has not been issued a credit rating of its own by a public rating company along with the terms of the related-party loan are typically accepted as the right market benchmarks for the interest rate.

Questions of business purpose and economic substance can overshadow the traditional pricing exercise when loans are made between related parties. Even with a solid credit analysis and benchmarking of the borrower, a tax authority may suspect that the loan was put in place primarily to create interest deductions. Those suspicions can be heightened if the business purpose for the loan is not apparent. One example is a parent company that extends a loan to a subsidiary when at other times it made capital contributions to an affiliate in comparable circumstances but with no immediate need for the funds. Additional transfer pricing exposure may result from situations where the stand-alone credit quality of the borrowing entity is so low that it would not be able to borrow on its own from a third party, particularly if the intercompany loan is large. Some tax authorities might then re-characterize the transaction as an infusion of capital, not a loan, and disallow all of the interest deductions.

Non-arm's length behavior can further exacerbate the audit risk for a taxpayer. Often, intercompany loans are put in place, but interest is not actually paid by the borrower to the lender. Rather, it accrues on a cash basis and is deducted on the borrower's tax return, assuming accrued but unpaid interest expense is deducted on a current basis. This may look like a transaction that would never occur between third parties, particularly if the loan is renewed at the end of its term. Similarly, if a borrower has the right to refinance an intercompany loan and fails to do so in a falling interest rate environment, it could be taken as an indication of non-arm's length behavior and therefore jeopardize the taxpayer's characterization of the transaction.

Financial Guarantees

Financial guarantees are often provided by one party to a related party (*i.e.*, a borrower) in order to minimize external interest costs or to secure a loan that might otherwise not be offered. Typically, a bank will charge the borrower a higher interest rate without such a guarantee. In effect, the guarantor is lending its credit rating to the borrower.

Transfer pricing analysis of such guarantees is in many ways the flip side of benchmarking an intercompany loan. The difference in stand-alone credit ratings for the guarantor and the borrower implies a difference in the rates at which each

party could borrow on its own. Consequently, that difference in borrowing rates is the maximum that the borrower would be willing to pay for the guarantee. For example, if a parent company can borrow at a rate of 5% and its subsidiary can borrow only at 7%, the subsidiary can save 200 basis points by obtaining a guarantee from its parent and would be willing to pay up to that much as a fee for the guarantee. In most cases, the actual guarantee fee would be some fraction of that maximum, with the exact figure dependent on the relative bargaining position of the two parties.

As with loans, economic substance arguments can be used to challenge intercompany guarantee arrangements. A number of tax authorities have disputed the payment of guarantee fees among related parties – particularly, if a parent company is guaranteeing a subsidiary – on the principle that there is implied support by a parent for its subsidiary, and thus, no explicit guarantee agreement, or fee, is needed. Whether that approach by tax authorities is justifiable is an open question in light of the financial crisis that began in 2008 and left the holders of non-guaranteed debt in a perilous situation.

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On the other hand, under the arm's length standard, are we not required to view each party on a stand-alone basis? Under this consideration, the impact of group affiliations should not be taken into account in a transfer pricing analysis. This is especially true if a bank requires an explicit guarantee agreement to make a loan or, at least, differentiates its pricing dependent upon whether or not such a guarantee exists. However, even if the bank has no such requirement or makes no such distinction, many would still argue that the benefits of implicit support within a controlled group should be ignored for transfer pricing, and a guarantee fee should be benchmarked on an arm's length basis.

Other issues may arise with respect to pricing for a guarantee fee. If the treasury department of a multinational group maintains a policy for borrowers to always pay the full value of interest savings as a guarantee fee, this could be evidence of non-arm's length behavior because the group does not differentiate between borrowing with or without the guarantee. The borrower's total costs are the same either way.

In a competitive market, a company that is in the business of extending financial guarantees might at times be able to extract full value from its customers – say, when the demand for loans is high relative to supply of loanable funds and credit capacity. At other times, however, when economic growth and demand for funds are low, a guarantee company may prefer to put its capital to work, even at lower fees, rather than incur the higher opportunity costs. Consequently, a related-party situation where full value of the guarantee is always reflected in the fee paid would not be consistent with market behavior.[4] A rule of thumb for pricing the guarantee

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4 Of course, in situations where an entity cannot borrow on its own at any interest rate and a guarantee is necessary to access capital markets rather than merely to reduce its costs, the entity might be willing to pay top-dollar guarantee fees. However, the taxpayer might be in danger of having the entire fee disallowed under audit, since no third party would provide a guarantee under such circumstances. Similarly, a performance guarantee, such as to assure a subsidiary's ability to fulfill the terms of a customer or vendor contract, could command a high fee, since the subsidiary might not be able to conduct any

fee (*e.g.*, 80% to 90% of the savings) might be preferred. Alternatively, more advanced quantitative approaches for pricing the guarantee, such as real-option theory or statistical simulation, could be applied.

Reinsurance

Reinsurance agreements with related parties are very common and always vulnerable to challenge by tax authorities because the objective of reinsurance is by definition to shift risk. Moreover, related reinsurance companies often have minimal or even no substance in terms of employees to manage the risk and make accompanying strategic decisions. They are often pure risk-holding entities and located in unregulated low-tax jurisdictions. Captive insurance and reinsurance companies are common examples of such arrangements.

The challenge in analyzing and benchmarking related-party reinsurance transactions, therefore, is that there are often no third-party arrangements against which they can be compared. Setting up a captive insurer or reinsurer whose only function is to assume risk from a parent company, with the management of such risk remaining with the parent, is by definition non-arm's length behavior and further complicates benchmarking for the resulting transactions. This difficulty is not relieved by the common practice of using an unrelated "fronting company" as an intermediary in the transaction. For example, an insurance company with a related reinsurer in a low-tax jurisdiction can enlist an unrelated insurer to write policies on behalf of its customers, then reinsure with the captive reinsurer. The unrelated insurer will only achieve a market return for its administrative role, as well as the small amount of risk it bears, but it could pay above-market premiums to the reinsurer while overcharging the primary insurance company. The result is the potential for a non-arm's length shift of income from the primary insurance company to its related reinsurer, disguised as a third-party arrangement with another insurance company.

CONCLUSION

As demonstrated by the McKesson Canada case, as well as a number of cases before it (*e.g.*, the GE Capital Canada guarantee fee case of a few years ago[5]), intercompany financial transactions are vulnerable to a variety of challenges, of which actual benchmarking for the payments may be the least worrisome to taxpayers. More daunting perils may come in the form of business purpose and economic substance tests, which could question the bases and characterizations of such transactions. Uncertainty in the transfer pricing analyses of such transactions, for taxpayers certainly but also for tax authorities, will likely persist until more specific guidance is provided.

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business without it. Identifying comparable third-party arrangements could be difficult, however.

[5] GE Capital v. Her Majesty the Queen, 2009 TCC 563.

Such guidance may come in the form of specific recommendations from the O.E.C.D. regarding Action Item 9 of its B.E.P.S. Action Plan, expected as early as December of this year, and any ensuing changes to national transfer pricing rules. Alternatively, the U.S. Global Dealing regulations, when re-proposed, may include specific guidance on financial transactions such as guarantees. No one should hold their breath, however; these regulations were first released by the Internal Revenue Service in 1998, with not a peep of follow-up since.