INSIGHT: A Closer Look at the OECD’s Draft Guidance on Financial Transactions

BY MONIQUE VAN HERKSEN, CLIVE JIE-A-JOEN, AND FAN BAI

The Organization for Economic Cooperation and Development (OECD) recently released a discussion draft that addresses issues related to the transfer pricing aspects of financial transactions, including intra-group loans.

THE SCOPE OF THE ARM’S-LENGTH PRINCIPLE

The OECD project on the transfer pricing aspects of financial transactions has been challenging because of different views among countries and the difficulty to find consensus on fundamental complex issues. One of those issues is whether there is a role for the arm’s-length principle to evaluate the capital structure of a related borrowing entity. The other issue regards whether applying a group credit rating as default rule, rather than a derived credit rating of the borrower including implicit support, is essentially arm’s-length.

The OECD released its discussion draft on the transfer pricing aspects of financial transactions for public comments on July 3, 2018. The discussion draft was not a consensus draft but represented a “majority consensus” document. It seeks to clarify the application of the “accurate delineation” analysis on financial transactions. It also deals with specific issues relating to the pricing of loans, cash pooling, financial guarantees, and captive insurance.

The OECD received comments from 78 organizations on the discussion draft, consisting of 965 pages in total. This illustrates how important multinational enterprises (MNEs) consider this issue. Taxpayers are rightfully concerned about the contents of the guidance, because previous updates of the OECD Transfer Pricing Guidelines (“OECD Guidelines” or “Guidelines”) foreshadow that they will need to substantiate and document their intra-group financial transactions currently in the master file and local file consistent with new guidance, although the financial transactions discussion draft is not yet finalized. Updates of the OECD Guidelines usually do not get a future effective date. They generally are deemed to only include clarifications and apply retroactively. In addition, intra-group financial transactions are often scrutinized in tax audits. It is therefore absolutely appropriate that the OECD seeks as broad consensus as possible on the new guidance, which can greatly contribute to consistency in the application of transfer pricing approaches and help avoid transfer pricing disputes and double taxation.

As indicated, there appear to be two substantive issues to be tackled:

1. Should the arm’s-length principle play a role in evaluating the capital structure of an MNE group entity, and

2. Should the MNE group credit rating be the default rating for pricing intra-group loans, financial guarantees, and other financial transactions.

The OECD has succeeded in decreasing the number of non-consensus issues from a list of about 25 to these two core issues. The OECD’s meeting of the first week of April 2019 served to achieve consensus on these two issues with the goal to complete the new guidance at the end of this year.
Below we discuss these two substantive issues.

**SHOULD THE ARM’S-LENGTH PRINCIPLE PLAY A ROLE IN EVALUATING CAPITAL STRUCTURE?**

One non-consensus issue regards the different views of countries on the role of the arm’s-length principle in evaluating the capital structure (i.e. debt-equity ratio) of a related borrowing entity (borrower). For the proponents of subjecting the capital structure of an associated enterprise to the arm’s-length analysis the relevance thereof lies in the consideration that a debtor that is too highly leveraged is eroding its tax base and—arguably—not “sufficiently” profitable. Opponents argue that a company’s management board should be at liberty to decide on what the leverage appetite is of the company, and that tax inspectors should not be able to impose their views of what would constitute proper business decisions.

Proponents of allowing the arm’s-length principle to consider the capital structure argue that the commentary to Paragraph 1 of Article 9 of the OECD Model Tax Convention (MTC) allows the arm’s-length principle to play a role not only in determining whether the interest of a loan is arm’s-length, but also whether an alleged loan is a loan for tax purposes or should be regarded as some other kind of payment, in particular a contribution to equity capital. The commentary to Paragraph 1 of Article 9 OECD MTC provides in relevant part that “the application of rules designed to deal with thin capitalisation should normally not have the effect of increasing the taxable profits of the relevant domestic enterprise to more than the arm’s-length profit, and that this principle should be followed in applying existing tax treaties.” This essentially seems to mean that the application of thin capitalization rules may have the result that taxable profits are not at arm’s-length, therefore, the conclusion would be that addressing base erosion by applying the arm’s-length principle makes more sense (than using thin cap or other rules).

Opponents argue that there already exist other approaches under domestic legislation addressing a company’s capital structure and interest deductibility, such as thin capitalization rules plus the implementation of base erosion and profit shifting (BEPS) Action 4 (the earnings stripping rules) into domestic legislation. The opponents argue that it would constitute “over-engineering” if the arm’s-length principle were to be applied as well to a borrower’s capital structure to determine whether there is a bona fide loan. The opponents prefer to leave this issue to be addressed by domestic legislation.

On a scale of complexity of substantiation, the following scenarios could be considered as starting positions for a transfer pricing analysis of a financial instrument:

<table>
<thead>
<tr>
<th>Assumption 1: The debt instrument is what it purports to be (i.e. a loan is a loan from a transfer pricing perspective).</th>
<th>Assumption 2: It needs to be determined if the purported debt instrument is what it purports to be (i.e. an analysis is required if the instrument needs relevant debt characteristics).</th>
<th>Assumption 3: It needs to be determined if part of the purported debt instrument constitutes a debt instrument (i.e. the assumption is that it needs to be tested if the debt instrument qualifies as such based on a debt capacity analysis of the borrower).</th>
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<tbody>
<tr>
<td>Domestic legislation and anti-avoidance rules will essentially address any capital structure issues.</td>
<td>Rational analysis of the debt instrument is concluded through accurate delineation.</td>
<td>Rational analysis of the debt instrument is concluded through accurate delineation and analysis of the options available to the parties. In addition, a debt capacity analysis is conducted to estimate the maximum amount of debt the borrower could take on, considering its cost of capital.</td>
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<tr>
<td>The financial transaction can in case it is commercially irrational.</td>
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**Other Approaches Under Domestic Legislation**

The discussion draft acknowledges that there are other approaches under domestic legislation to address the capital structure issue. Furthermore, domestic jurisprudence has historically also played a relevant role in how purported debt instruments are treated under domestic law in different countries. For example, in the Netherlands, a relevant Supreme Court case of Nov. 25, 2011 (BN3442), regarded the question of whether a purported loan could be labelled as being “not-at arm’s-length.” At stake was the deductibility of a loss resulting from a write-off on a loan receivable to a subsidiary.

To arrive at its conclusion, the Dutch Supreme Court took the position that the purported loan ought to be considered in its entirety and not be broken up in an arm’s-length part and a not-at-arm’s-length part. The Supreme Court concluded that in principle the legal form of the purported instrument is decisive for the characterization for tax purposes of the provision of financial means, but noted that there are three exceptions to this rule (each were specifically mentioned in previous jurisprudence):

i. In case the parties present the instrument as a loan but intended to provide equity capital. This is essentially a “fake loan.” In this scenario, the tax administration may disregard the parties’ characterization of the transaction and recharacterize it in accordance with the real intention of the parties;

ii. In case the purported loan is issued under conditions that essentially allow the creditor to participate in the business of the debtor, the loan is a so-called “participating loan.” Characteristics of a participating loan include that interest due is entirely or nearly entirely dependent on the profit of the debtor; the loan is subordinated; or the loan has no fixed maturity or a maturity of more than 50 years; and repayment of the principal amount of the loan can be claimed only in case of bankruptcy or liquidation.

iii. In case the loan was granted under such conditions that the creditor must have known that the principal (in part) will not be repaid in whole or in part. The debtor essentially is a bottomless pit and cannot meet its obligation to repay the (full) principal.
characteristics in this regard include that the loan is provided by the taxpayer solely in its capacity as shareholder. No or little value can be attributed to the receivable, since the principal amount will not be, or will be only partly, repaid.

Because of the above jurisprudence, and absent the three identified exceptions, the Netherlands acknowledges the existence of a so-called non-arm’s-length loan where the credit risk for the creditor essentially is not at arm’s-length, without recharacterizing the instrument in equity capital and essentially requires the calculation of interest in a case where arguably no comparables can be found. Although the case did not regard the determination of what the interest rate ought to be considering the facts, it was concluded that essentially the creditor, in its capacity as shareholder, had guaranteed the loan to the debtor. As a result, the write-off and potential loss on the loan were not tax deductible.

The above Supreme court case essentially accepts the purported instrument as is, with the observation that if any of the three exceptions existed it would have been commercially irrational to have issued a loan, but absent those exceptions, the instrument remains a loan (similar to the first approach in the columns listed above). The write-off was not tax deductible, however, because of the shareholder interest in granting the loan. From a transfer pricing viewpoint, the loan remained a loan (i.e., “it is what it is”).

**Accurate Delineation**

The discussion draft serves to provide guidance in using the accurate delineation under Chapter I to determine whether a purported loan should be regarded as a loan for tax purposes (or should be regarded as some other kind of payment, for example as a contribution to equity capital). As part of the accurate delineation process, the discussion draft suggests analysing relevant economic characteristics of the loan instrument, such as:

- Is there a fixed repayment date?
- Are covenants/security present?
- What is the source of interest payments?
- What is the status of the lender versus other creditors?
- What is the ability of the debtor to obtain a loan from third party lenders?
- Is there an MNE group policy (e.g., aiming for certain debt-equity ratio)?
- The failure of the debtor to repay on the due date.

The above characteristics can be considered relevant indicators of a loan. The accurate delineation process of the financial transaction is essentially an assessment of evidence to determine what the transaction is. There is no arithmetic or mathematic predetermined level of “sufficient” evidence to conclude that the loan is a bona fide loan for tax purposes, however.

It should be noted, that if the arm’s-length principle does play a role in evaluating the capital structure, then not only will an accurate delineation analysis of the purported instrument be required but in addition a debt capacity analysis needs to be conducted to determine if the debtor can actually take on a certain amount of debt and it needs to be considered whether the debtor would have other options realistically available to obtain financial resources. Although these respective analyses are not simple “cut-and-paste” efforts but require considerable economic skill and access to relevant comparable data, the separate entity approach underlying the arm’s-length principle would seem to justify this approach.

Arguably the same analysis would be conducted between prudent unrelated parties, when making available and seeking financial resources. Yet at the same time, the OECD implies that MNE group dynamics need to be considered when delineating an intercompany financial transaction, such as whether there is a group policy that determines a certain debt-equity ratio for the associated enterprises. This indicates that MNE group conditions need to be considered while a separate entity analysis is the starting point of the analysis. The combination of these two approaches seems—at least theoretically—somewhat inconsistent, however.

Irrespective of whether the arm’s-length principle will play a role or not in evaluating the capital structure, tax authorities are cautioned to not substitute other transactions in place of those that have been accurately delineated and should not disregard those transactions undertaken other than in exceptional circumstances. (See paragraph 1.122 of the OECD Guidelines.) As already indicated, such an exceptional circumstance may exist where the arrangements viewed in their totality are not commercially rational thereby preventing the determination of an arm’s-length price for each party to the transaction (taking into account their own perspectives and the options realistically available to each of them). An example of a commercially irrational case could be where an intercompany loan is provided to a borrower which is already so leveraged that its standalone credit rating is very low. This indicates that the creditor may not be able to get repayment of the loan principal. The interest rate that would arguably be required to compensate the creditor for this risk of default would have to be very high and speculative and it may not be able to find comparables for this situation. Here one could maintain that this transaction, as delineated, qualifies to be disregarded.

**What Part of the Debt Instrument Is What It Is: The Debt Capacity Analysis**

The OECD requested comments on an example in which a group company B obtains a loan from a related company C with a maturity of 10 years. Based on financial projections of Company B for the next 10 years, Company B cannot service the loan. As a result, it can be concluded that an unrelated party would not be willing to provide such a loan to Company B. For transfer pricing purposes, the accurately delineated amount of the loan would therefore be a function of the maximum amount that an unrelated lender would have been prepared to advance to Company B; and the maximum amount that an unrelated borrower in comparable circumstances would have been willing to borrow from Company C. Consequently, the remainder of Company C’s loan to Company B should not be considered as a loan for the purposes of determining the amount of interest which Company B would have paid at arm’s-length. The OECD requested comments on whether this bifurcation approach should be used or an all-or-nothing approach, based on which essentially the entire amount of the loan would be equity. (See paragraph 17 of the OECD Discussion Draft.)

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Domestic thin capitalization or debt-equity rules may prescribe what amount of debt will be recognized under domestic law. However, such rules need not necessarily be consistent with the arm’s-length principle. Can the arm’s-length principle then serve to determine that (only) part of the funding provided in an intercompany financial transaction constitutes a loan and the remainder does not, i.e. constitutes equity? There is no universal agreement on whether the transfer pricing rules provide that authority, because such a determination is likely to include multiple assumptions. Furthermore, in case thin cap rules and debt equity ratios are to be combined with transfer pricing rules, it will need to be established what rules trump other rules and how inconsistent treatment is to be dealt with in cross-border settings. This is where the guidance in the OECD Model Convention’s Commentary comes in relevant and (at the very least bilateral) agreement on the interpretation and application thereof is required to avoid double taxation.

Conducting a debt capacity analysis is a standard requirement in certain countries. Based on HMRC guidance, for example, determining an arm’s-length level of debt requires consideration of what you could borrow (debt-serving capacity) and what you would borrow (optimal D/E ratio):

- Application of a “could” argument—what a lender would have lent and therefore what a borrower could have borrowed, and
- Application of a “would” argument—what a borrower acting in the best interests of their own business would have borrowed.

In a transfer pricing decree of 2018 (See paragraph 11, Loan Transactions, of Decree of May 11, 2018, published in the Official Gazette # 26874 of 2018), The Netherlands already indicated the need for applying a two-sided perspective. The Decree provides in relevant part:

- That an affiliated lender that grants a loan to a borrowing company that is insufficient creditworthy (after the loan the rating < BBB-) should make it plausible that there is a loan agreed under arm’s-length terms.
- That if an intra-group financing transaction leads to a capital structure and interest charges such that the borrowing company is insufficient creditworthy (a rating < BBB-), the borrowing company should make it plausible that there is a loan agreed under arm’s-length terms.

Conducting a debt capacity analysis consists of a cash flow analysis of the borrower to demonstrate that the borrower would be able to service the interest payments and repay or refinance the loan. In addition, market evidence will need to be gathered to demonstrate that an independent borrower with the same credit rating as the borrower can obtain a loan from a third party lender on a stand-alone basis. As stated earlier above, performing these analyses is not a simple cut-and-paste effort but requires considerable economic skill and access to relevant (comparable) data.

**USE OF MNE GROUP CREDIT RATING TO PRICE FINANCIAL TRANSACTIONS**

The credit rating of the borrower is a key factor in determining an arm’s-length interest rate for an intra-group loan. The discussion draft provides that credit ratings are a useful measure of creditworthiness of the borrowing entity and helpful for identifying potential comparables for estimating interest rates.

**The Traditional Credit Rating Approach**

In the absence of an explicit guarantee, capital markets would lend to a borrowing group entity (borrower) based on a so-called “derived” credit rating. Such a derived credit rating is not only based on the relevant indicators of the borrower as an independent enterprise, but also on the relevant indicators of the MNE group to which the borrower belongs, and the relative importance of the borrowing entity within the MNE group. The derived credit rating is to be distinguished from the stand-alone credit rating of the borrowing entity. The latter assumes that the borrower is not part of an MNE group.

The traditional approach for estimating the credit rating of a borrower is to first estimate the stand-alone credit rating of the borrower and subsequently adjust that rating depending on an analysis of the potential impact of implicit support on its creditworthiness.

The element of implicit support is generally considered a relevant economic factor to consider in pricing intra-group loans and financial guarantees. In the context of an intra-group loan, for example, implicit support is the benefit that may arise from passive association when an MNE member attains a better credit rating and correspondingly a reduced interest rate from an independent lender due to its membership of the MNE group while there is no contractual obligation of any MNE group member to provide de facto support.

Implicit support generally does not require any payment. Paragraph 7.13 of the OECD Guidelines suggests that “an associated enterprise should not be considered to receive an intra-group service or be required to make any payment when it obtains incidental benefits attributable solely to its being part of a larger MNE group. In this context, the term incidental refers to benefits arising solely by virtue of group affiliation and in the absence of deliberate concerted actions or transactions leading to that benefit.” Chapter I of the OECD Guidelines provides examples to illustrate the impact of implicit support. The discussion draft invited commentators’ views on the effect of implicit support, and how that effect could be measured.

Under the concept of implicit support, there is an expectation that the parent will support the related borrowing entity in case it encounters financial distress or performance disruption. The likelihood of group members to receive group support is assumed to depend on the relative importance of the group entity to the MNE group and the linkages between the group entity and the rest of the MNE group. Based on the discussion draft, the criteria used to determine the status of a group entity are generally consistent with existing guidance of independent commercial rating agencies, including strategic importance, operational integration and significance, shared name, potential reputational impacts, and any history of support.

According to S&P’s group rating methodology, one would determine the derived credit rating either based on a bottom-up approach (starting from the stand-alone
credit rating of the borrower and improving the rating) or the top-down approach (starting from the MNE group credit rating and reducing that rating). It is assumed that the gap between the standalone credit rating of an entity and that of the MNE group is closely linked to the relative significance of that entity within the group. Depending on the status of the group entity, the derived credit rating is based on the standalone credit rating plus some notches up, if any, or on the group credit rating reduced by downward adjustments, if any.

<table>
<thead>
<tr>
<th>Group Status</th>
<th>Definition</th>
<th>Potential Rating</th>
</tr>
</thead>
<tbody>
<tr>
<td>Core</td>
<td>Integral to the group's current identity and future strategy. The rest of the group is likely to support these entities under any foreseeable circumstances.</td>
<td>Generally at group credit profile (GCP)</td>
</tr>
<tr>
<td>Highly strategic</td>
<td>Almost integral to the group’s current identity and future strategy. The rest of the group is likely to support these subsidiaries under almost all foreseeable circumstances.</td>
<td>Generally one notch below GCP</td>
</tr>
<tr>
<td>Strategically important</td>
<td>Less integral to the group than highly strategic subsidiaries. The rest of the group is likely to provide additional liquidity, capital, or risk transfer in most foreseeable circumstances. However, some factors raise doubts about the extent of group support.</td>
<td>Generally three notches above standalone credit profile (SACP); but for the purpose of this analysis two notches below GCP</td>
</tr>
<tr>
<td>Moderately strategic</td>
<td>Not important enough to warrant additional liquidity, capital, or risk transfer support from the rest of the group in some foreseeable circumstances. Nevertheless, there is potential for some support from the group.</td>
<td>Generally on notch above SACP, but for the purpose of this analysis three notches below GCP</td>
</tr>
<tr>
<td>Nonstrategic</td>
<td>No strategic importance to the group. These subsidiaries could be sold in the near to medium term.</td>
<td>Generally at SACP; for the purpose of this analysis all entities assumed to be at least moderately strategic</td>
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Under S&P methodology, the effect of implicit support depends on an analysis of certain criteria, such as:

- the probability that the borrowing entity will be sold in the future;
- the borrowing entity operates in lines of business or functions (which may include group risk management and financing) integral to the overall group strategy;
- The borrowing entity has a strong, long-term support commitment from senior group management in good times and under stressful conditions, or incentives exist to induce such support; and
- Whether the subsidiary shares the same name or brand with the main group.

In estimating the MNE group credit rating or the borrower’s stand-alone credit rating, the first question to ask is whether there is an “official” issuer credit rating assigned by any independent credit rating agencies (e.g., Standard & Poor’s rating services (S&P), Moody’s investors services (Moody) and/or Fitch Ratings). An issuer rating is a credit rating agency’s opinion of an obligor’s overall capacity to meet its financial obligations. Normally, such an official credit rating is not available for a separate MNE group entity. In such a case, commercial tools are available to approximate creditworthiness of a borrower. For example, credit rating tools are offered by credit rating agencies, such as S&P Capital IQ Credit Analytics and Moody’s RiskCalc.

The discussion draft provides that the credit rating methodology used in commercial tools is not as rigorous as the methodologies applied by independent credit rating agencies. Nonetheless, commercial tools are recognized as a solution for rating a specific intra-group loan, particularly where no official credit rating from rating agencies is available. Certain commercial tools recognize business risks as well as financial risks in estimating the credit rating. But banks may also have developed in-house credit rating models and consider the impact of implicit support.

Opponents of the above traditional credit rating approach argue that estimating a stand-alone credit rating and conducting an implicit support analysis for each intra-group loan leads to a great compliance burden for taxpayers, an administrative burden for tax authorities and requires careful and expert judgment.

**Using the Group Credit Rating as Default Rule**

Certain countries argue that the traditional credit rating approach suffers from subjective estimates of the impact of implicit support and results in significant compliance burden / administrative burden for taxpayers / tax administrations. The discussion draft requested comments on using the MNE group credit rating as a rebuttable assumption, to which many commentators commented that a rebuttable assumption would not provide tax certainty.

Nevertheless, certain countries proposed to use the MNE group credit rating as the default rule in pricing financial transactions arguing that this would be consistent with the arm’s-length principle for the following reason:

a) If it is accepted that the ultimate commercial motive of a company is to maximize profits and thus to reduce costs, this includes reducing interest costs. Applying the group credit rating will generally lead to lower cost of financing for the borrower and may better represent how MNE groups obtain debt financing in the market—obtain financing at the lowest possible cost.

b) An added benefit would be that the group rating approach presents a simplification measure because only one group credit rating needs to be estimated for all intra-group loans rather than a separate stand-alone credit rating analysis for each individual intra-group loan.

c) When evaluating the potential impact of implicit support on the creditworthiness of an MNE group entity, tax authorities face information asymmetry.

d) Using the group rating eliminates controversy regarding estimating the stand-alone credit rating and calculating the impact of implicit support.

e) Arguably, applying an MNE group rating approach will reduce BEPS opportunities, because pricing will be based on the group credit rating irrespective of the debt capacity of the borrower.

Another effect of using the MNE group rating approach will likely be that it eliminates the need to determine an intercompany financial guarantee fee, because...
the pricing of the financial instrument, i.e. interest, is (already) based on the group credit rating.

Opponents of using the group credit rating as default mention that:

a) It is not consistent with the arm’s-length principle to use the group credit rating for pricing each intra-group loan. The arm’s-length principle follows the approach of treating the MNE group members as “operating as separate entities rather than as inseparable parts of a single unified business” (Paragraph 1.6 of the OECD Guidelines). Using a group rating approach is not consistent with the separate entity approach. The traditional credit rating approach regards the borrower as a separate independent enterprise but does not ignore the influence of being part of the MNE group by considering the potential impact of implicit support;

b) In certain jurisdictions (including, The Netherlands), local transfer pricing rules already prescribe the traditional credit rating approach;

c) In certain multinational enterprises the credit ratings of certain subsidiaries can be higher than that of the MNE group;

d) Implicit support may or may not exist in real life. There have been situations where parent companies decided to not support a subsidiary when the subsidiary faced financial distress, for various reasons;

e) In providing funding, banks do consider the stand-alone credit rating of borrowers based on internal models considering the potential impact of implicit support. To consider for the subjective nature of implicit support, the stand-alone credit rating will be adjusted upwards with a maximum number of—for example—two notches. Banks will only consider the group credit rating in case there is an explicit parental guarantee. Applying the group credit rating as a default is therefore not in line with third party behaviour.

f) By eliminating the stand-alone credit rating, treasury entities or cash pool leaders which assume risks (e.g., credit risk and liquidity risk) and perform functions exceeding an administrative function will not be able to earn a credit spread.

g) Taxpayers are likely to face controversy in jurisdictions where the related lending entity (creditor) is located if the group rating approach is not consistently applied globally. The group rating approach is detrimental for those creditor jurisdictions, as they will receive less taxable income.

Proponents of using the MNE group rating, on the other hand, may argue that:

b) The group rating approach is consistent with Section D.8 of Chapter I of the OECD Guidelines (MNE group synergies), which provides that synergistic benefits of group membership need not be separately compensated or specifically allocated among members of the MNE group.

CONCLUDING REMARKS

Underlying both issues discussed above is the question whether the arm’s-length principle will be applied or whether a simplification will be preferred.

If the MNE group credit rating becomes a default rule to price intra-group financial transactions it essentially undermines the arm’s-length principle. This would not be the first time, however, as other OECD solutions have also principally extended beyond the arm’s-length principle to get to the “right” result (e.g., hard to value intangibles approach) or for pragmatic reasons (e.g., low value adding services). We would hope that the arm’s-length standard will not be unnecessarily eroded, however, and that the significant and valuable work done to update the Guidelines in 2017, based on the vast BEPS Action 8-10 efforts will largely be respected.

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Monique van Herksen, Clive Jie-A-Joen and Fan Bai work in the Financial Markets practice group of Simmons & Simmons LLP with a focus on transfer pricing. Any errors or admissions are those of the authors, and this article is written in their personal capacity. They can be reached at Monique.vanHerksen@simmons-simmons.com; Clive.Jie-A-Joen@simmons-simmons.com; and Fan.Bai@simmons-simmons.com.