Case SAC 2020:35 – Supreme Administrative Court Reasserts the Prohibition to Recharacterize Transactions, Now in a Case that Deals with Group Internal Financing

The Supreme Administrative Court (SAC) held in a previous case, SAC 2014:119, that the Finnish domestic arm’s length provision (section 31 of the Act on the Tax Assessment Procedure) does not give the Finnish tax administration legal competence to recharacterize transactions as meant in paragraphs 1.64 and 1.65 of the 2010 OECD Guidelines. Case SAC 2020:35 confirms the SAC’s earlier position: there are certain fundamental private law legal forms and structures that cannot be disregarded by applying section 31 of the AAP. The SAC found that the transfer pricing analysis must depart from the fact that the Belgian subsidiary company providing intra-group financing legally owns the intra-group receivables and, thus, it has acted in the capacity of a creditor. The tax administration had the obligation to set tax consequences accordingly.

1. Prohibition to Recharacterize Transactions in the Finnish Transfer Pricing Scene

Before turning to the details of case SAC 2020:35, a few more general remarks are in order. The question of to what extent the tax administration has the legal right to disregard a taxpayer’s transfer pricing documentation and their actual transactions has been one of the hot topics in the Finnish transfer pricing scene since 2014. There may be certain characteristics in the Finnish tax system that explain why the topic has been so prominent, particularly in Finland, but the authors believe that case SAC 2020:35 should be interesting to any international transfer pricing professional. The demarcation between recharacterization and recognizing/delineating transactions has great practical importance in tax audits and it is highly relevant for the legal protection of taxpayers. The topic has apparent links to how the role of general anti-avoidance rules (GAARs) has evolved within each tax system and to some of the more fundamental questions of tax law interpretation, especially the rule of law and substance-over-form doctrines. Also, the question arises concerning what is the normative status of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines) in domestic tax law interpretation.

Previously, in case SAC 2014:119, the Supreme Administrative Court (SAC) held that the Finnish domestic arm’s length provision (section 31 of the Act on the Tax Assessment Procedure, AAP) does not give the Finnish tax administration legal competence to recharacterize transactions as meant in paragraphs 1.64 and 1.65 of the 2010 OECD Guidelines. The Court also held that the OECD Guidelines can be used as a source for interpretation only within the legal scope of the domestic arm’s length provision. In case SAC 2014:119, the Court provided a generally applicable interpretation, but in a rather specific context. The case concerned a financial instrument, i.e. the recharacterization of debt to equity. The facts of case SAC 2014:119 are somewhat distant from many other transfer pricing issues with practical importance, e.g. business models or IP. This may have added to the confusion of what exactly amounts to prohibited recharacterization of transactions under Finnish domestic law and what does not.

Since 2014, the SAC has referred to case SAC 2014:119 and to the prohibition to recharacterize transactions in some of its subsequent transfer pricing judgments. However, case SAC 2020:35 is the first published SAC transfer pricing case since 2014 where the reasoning and outcome is based solely on the SAC’s conclusion that the tax administration has recharacterized transactions, thus exceeding its legal powers. Case SAC 2020:35 confirms the SAC’s earlier position, but it also demonstrates that it continues to be very challenging to give exact and generally applicable definitions as to what constitutes a prohibited recharacterization of transactions. This holds true even under the new terminology and renewed guidance of the 2017 OECD Guidelines.
2. Case SAC 2020:35

The SAC’s decisions are accompanied by short descriptions in which the Court summarizes what has been decided. For case SAC 2020:35, the description is as follows (freely translated):

In 2008, A Group had reorganized its internal financing function. For this purpose, the ultimate parent company for the group, A Oyj, had established a new company called A Finance NV in Belgium. A Oyj transferred its group-internal long-term receivables (EUR 223.5 million) to A Finance NV as capital contribution in exchange for A Finance NV’s shares. The loans that A Oyj transferred to A Finance NV were non-collateralized, and the right to collect interest for the loans was shifted to A Finance NV on the same date. A Finance NV booked the loan portfolio as assets in its financial statements. A Oyj and A Finance NV made an agreement concerning target return on equity. If the return on equity was above the target, A Finance NV would pay the excess to A Oyj. If the return on equity was below the target, A Finance NV would receive compensation from A Oyj.

The Finnish tax administration (FTA) conducted a transfer pricing audit on A Oyj. On the basis of its functional analysis, the FTA concluded that for group internal financing, effectively, it was A Oyj that had performed all key functions, carried key risks and utilized key assets and that, effectively, A Finance NV had not acted as group internal financing company. According to the FTA, A Finance NV was entitled to receive arm’s length compensation based on its costs. Consequently, the FTA made a transfer pricing adjustment to A Oyj’s taxable profits for 2011 and 2012. The FTA also levied also punitive tax increases on A Oyj. According to the FTA’s reasoning in the reassessment decisions, the authorities had not recharacterized the transactions between A Oyj and A Finance NV, but the reassessment was based on the actual transactions taken.

The SAC held that the FTA had disregarded the transactions between A Oyj and A Finance NV, and especially the fact that A Finance NV was the creditor of the relevant group companies. In its reassessment decisions, the FTA had recognized the transactions that A Oyj and A Finance NV had conducted after the capital contribution and concluded that in practice it was A Oyj that had performed all essential functions that were related to group internal financing, and that in reality A Finance NV had not acted in the capacity of a Group’s internal financing company. In so doing, the FTA had recharacterized the transactions between A Oyj and A Finance NV by applying section 31 of the AAP. Because section 31 did not provide the FTA with the legal competence to recharacterize transactions, and because the FTA had not claimed that the real purpose for reorganization of group internal financing was tax avoidance, the FTA had failed to provide valid legal grounds for its reassessment decisions and for levying punitive tax increases for the years 2011 and 2012.

3. The Facts of the Case

In transfer pricing cases, the reassessment is often based on a transfer pricing audit performed by the FTA and that is also true in the case at hand. The transfer pricing audit material is usually extensive and during the court proceedings a significant amount of written material is also provided to the courts. However, this material is not publicly available. The facts of the case described below are based on descriptions included in the decisions of the Helsinki Administrative Court and the SAC.

A Group’s business consisted of machinery and equipment rental services in various countries. The group parent company A Oyj performed head office functions related to the coordination and steering of the business activities carried out in the subsidiaries, and provided management services to the subsidiaries. A Oyj’s assets comprised shares in subsidiaries as well as in short- and long-term intra-group receivables. A Oyj was also responsible for acquiring external funding and all external debt (amounting to about EUR 0.6 billion in 2009-2011) was in A Oyj. The most significant risks of A Oyj were impairment risk related to the shares in subsidiaries as well as risks related to the financing, such as foreign exchange risk, interest rate risk and liquidity risk.

A Oyj restructured its financing functions in 2008 when it established a Belgian entity, A Finance NV. A Oyj transferred its long-term receivables from group companies worth EUR 223.5 million to A Finance NV against share issue. In 2011, A Finance NV’s receivable portfolio amounted to EUR 280.1 million. In addition to intra-group receivables, the company’s assets comprised cash. A Finance NV did not have any material external debt, and with an interest income of EUR 13.2-15.3 million, the company accrued a profit of EUR 9.9-12.5 million.

A Finance NV had a part-time managing director who worked for the company about 2.5 days per month. According to the FTA, the managing director provided expertise in local accounting and tax issues and he represented the company in compliance issues with the relevant authorities. In addition, A Finance NV employed one person, first as treasury project manager, and since April 2009 as finance officer. The employer mainly took care of the accounting and reporting and developed the treasury system and cash management. A Finance NV’s Board of Directors consisted of four members: the managing director and three people employed by A Oyj.

According to the clarification received during the tax audit, group companies estimated their need of financing during the budgeting process and applied for loans from A Finance NV. A Finance NV estimated the debtors’ ability to repay the loans based on historical accounts and budget forecasts and made the decisions to issue the loan taking into account the Treasury Committee’s recommendations for the capital structure of each subsidiary. All members of the Treasury Committee were employed by A Oyj.

According to A Oyj, A Finance NV made the decisions to issue the loans (as well as their terms) independently. The loan agreements were mostly adhesion contracts that differed from each other in relation to the loan type (long-term bullet or short-term credit line), currency (debtor’s currency), capital of the loan, reference rate (local 3-12 months’ inter-bank offered rate (IBOR)), marginal, maturity and interest payment dates. A Oyj and the FTA were in agreement that A Finance NV performed all administrative tasks related to the loans. However, the FTA did not accept A Oyj’s claim that A Finance NV also estimated the debtors’ ability to repay the loans and defined the interest rates. The FTA also claimed that A Oyj assumed all significant risks related to the financing.

At the end of 2010, A Oyj and A Finance NV had entered into a service agreement entitled the Mutual Agreement, on the partial division of functions, risks and profits.
related to the intra-group financing. Based on the Mutual Agreement, A Finance NV received a guaranteed return defined on the basis of A Finance NV’s target return on equity (ROE). If A Finance NV’s profit exceeded the target, the company paid the excess to A Oyj and if A Finance NV’s profit fell below the target, A Oyj compensated the difference to the company. The Belgian tax authorities had confirmed with an advance ruling that the Mutual Agreement resulted in an arm’s length result for A Finance NV.

In its reassessment decision, the FTA concluded that A Finance NV did not perform any core activities related to the intra-group financing and that A Oyj was responsible for the key functions and assumed all significant risks related to the intra-group financing. On the other hand, A Finance NV provided certain routine administrative services to A Oyj. The service fee was defined based on the TNMM with a cost-based profit-level indicator.

In its decision, the Adjustment Board (who handled the appeal in the first instance) found that in addition to the service fee, A Finance NV should earn a risk-free return on its intra-group receivables. The risk-free return was defined based on information in Bloomberg’s database on Germany’s 10 years’ government bonds.

4. Analysis of the Case: Delineating or Disregarding Transactions

It has been clear since 2014, based on the decision in case SAC 2014:119, that the FTA is not authorized to disregard and recharacterize transactions on the basis of the domestic arm’s length provision in section 31 of the AAP. However, the FTA has regularly claimed, in this case also, that it has not disregarded the taxpayer’s transactions but simply adjusted the transfer price of the transaction actually performed and as structured by the parties. The SAC did not accept the FTA’s position.

The SAC’s juridical reasoning is concise and tailor-made for the case at hand. Therefore, the Court does not describe in any generally applicable language what must be regarded as non-permissible recharacterization of transactions within the scope of section 31 of the AAP. The SAC’s reasoning focuses on the fact that due to the capital contribution that A Oyj has made, A Finance NV legally owns the assets received and consequently, A Finance NV has legally acted in the capacity of creditor. The SAC explicitly states that the FTA had the legal obligation to set tax consequences for A Oyj accordingly.

Effectively, the SAC states that juridical ownership of receivables is beyond the reach of normal transfer pricing analysis – it cannot be sidelined by applying section 31 of the AAP. It should be noted that if the FTA had been allowed to treat A Oyj as the actual group internal financing company instead of A Finance NV, this would have meant de facto that the capital contribution that A Oyj had made to A Finance NV would have been disregarded. The SAC’s reasoning is reminiscent of recent GAAR cases, where it has held that shareholders’ decisions to pay dividends, as well as to not pay dividends, cannot constitute tax avoidance. This means that the FTA should not challenge those decisions by claiming that they are not based on sufficient business reasons, for example, but it has to take them as a basis for taxation as they are.

The authors believe that the SAC’s position in both types of cases – TP and GAARs – is based on the same underlying consideration: private law rules set certain legal structure or “legal fundamentals” that must not be sidelined in the application of tax law rules. There are also strong practical reasons that support this position. If the FTA had the right to consider whether a company should or should not pay dividends, or whether a parent company should or should not have made a capital contribution to its subsidiary, predictability of taxation would be seriously undermined and most of all, it would be very difficult for the courts to exercise rational legal control over such analyses.

The SAC notes that the FTA had not claimed that the purpose for reorganization of internal financing in A Group was to avoid taxes and that this was one factor that demonstrates that the FTA’s reassessment decisions lacked valid legal grounds. The SAC’s reasoning relates to the fact that although it is not possible for the FTA to recharacterize transactions by applying the domestic arm’s length provision (section 31 of the AAP), it may nevertheless be possible to recharacterize transactions by applying section 28 of the AAP, which contains the GAAR. However, this should not be taken as a hint that the outcome would have been different had the FTA also invoked the GAAR of section 28 of the AAP. Considering previous SAC case law, there is no reason to believe that the FTA could have successfully invoked a GAAR in this case. The reason for this is that a claim that the establishment of a subsidiary could be regarded as tax avoidance – and therefore that this action should not have been taken by the taxpayer – clearly goes beyond what the SAC has been willing to accept in the application of a GAAR. Thus, the SAC’s reasoning merely indicates that the kind of measures that the FTA was aiming at – recharacterization – belongs generally within the scope of a GAAR (and not that of the arm’s length principle).

It took almost 6 years after the first SAC case on recharacterization (case SAC 2014:119) for the SAC to renew its earlier position in case SAC 2020:35. The earlier case concerned tax year 2009 and the latter tax years 2011 and 2012, so both cases were considered by the SAC in light of earlier versions of the OECD Guidelines. However, during the 6 years between the two cases, it was not altogether clear whether the changes in terminology around “recharacterization” and other BEPS-related changes in the 2017 OECD Guidelines, and even the related academic discussion, could somehow impact the SAC’s position. Because case SAC 2014:119 did not provide clear definition of “recharacterization”, one possibility was that the FTA would be able to go around it by selecting the right terminology, i.e. by stating that it is merely recognizing the actual transactions, not disregarding them. It should be noted that this was precisely the justification strategy that the FTA followed in case SAC 2020:35. However, case SAC

2020-35 demonstrates that prohibiting the recharacterization of transactions is indeed a permanent requirement in the application of the Finnish domestic arm’s length rule. This conclusion is the same under the 2017 OECD Guidelines and irrespective of the terminology, because the SAC’s position is not based on an interpretation of the Guidelines but rather on the idea that the Guidelines – no matter what their content – do not extend the scope of application of section 31 of the AAP.

5. Has the BEPS Project Clarified the Issue of Recharacterization?

One of the mandates to address base erosion and profit shifting under Action 10 in the OECD’s Action Plan on Base Erosion and Profit Shifting in 2013 was to “clarify the circumstances in which transactions can be recharacterized.” As a consequence, the OECD introduced the new concept of “accurate delineation of the actual transaction” in its public discussion draft on revisions to Chapter I of the OECD Guidelines in December 2014. In addition, the OECD term “recharacterization” was replaced with the term “non-recognition” although the intention was that the new term “non-recognition” would convey the same meaning as the original term (according to paragraph 83 of the discussion draft).

However, as a consequence of the BEPS Project, one form of recharacterization was considered as delineation of the actual transaction in the new OECD transfer pricing guidance: the previous substance-over-form type recharacterization was included in the delineation of the actual transaction. Accordingly, under the 2017 OECD Guidelines, the tax administrations are able to disregard the legal form of the taxpayer’s transaction and delineate the actual transaction in accordance with the conduct of the parties, the functions they perform, the risks they assume and the assets they employ as the first step of the transfer pricing analysis and not only in exceptional cases as stated in the 2010 OECD Guidelines. The authors consider that this important change in the OECD Guidelines has largely remained unnoticed.

Case SAC 2020:35 covered tax years 2011 and 2012, and consequently the FTA and the courts applied the 2010 OECD Guidelines. With the terminology used in the 2010 OECD Guidelines, the FTA was not allowed to disregard the legal form of A Finance NV’s transactions and replace them with another type of transactions (i.e. a provision of administrative services from A Finance NV to A Oyj). The fact that this type of recharacterization is included in the concept of delineation of the actual transaction in the 2017 OECD Guidelines seems to have caused some confusion within the FTA and the Administrative Courts. Nevertheless, regardless of the label one puts on the FTAs interference in the taxpayer’s choices to arrange their operations and structure their transactions, it is not allowed.

In case SAC 2020:35, the FTA and the taxpayer were in disagreement concerning A Finance NV’s power to make relevant decisions and whether A Oyj or A Finance NV assumed the significant risks related to the intra-group financing. This turned out to be irrelevant since the FTA was not allowed to deviate from the fact that A Finance NV was the owner of the funds and provided the loans to the group companies. However, it may be interesting to note that the case resembles the example provided in paragraph 10.25 of the OECD’s Transfer Pricing Guidance on Financial Transactions.

Paragraph 10.25 reads as follows:

10.25. When, under accurate delineation, the lender is not exercising control over the risks associated to an advance of funds, or does not have the financial capacity to assume the risks, such risks should be allocated to the enterprise exercising control and having the financial capacity to assume the risk (see paragraph 1.98 of Chapter I). For instance, consider a situation where Company A advances funds to Company B. Consider further that the accurate delineation of the actual transaction indicates that Company A does not exercise control functions related to the advance of funds but that Company P, the parent company of the MNE group, is exercising control over those risks, and has the financial capacity to assume such risks. Under Chapter I analysis, Company P will bear the consequences of the playing out of such risks and Company A will be entitled to no more than a risk-free return (see Section D12.1 in Chapter I).

In its decision, the Adjustment Board considered that in addition to the service fee for administrative services provided to A Oyj, A Finance NV should have earned a risk-free rate on its intra-group lending. In this regard, the Adjustment Board recognized that A Finance NV was the legal and factual owner of the funds that had been lent to the A Group subsidiaries. However, as the FTA had exceeded its powers in the reassessment decision, the SAC did not consider or comment on the Adjustment Board’s approach.

6. Implications for Transfer Pricing Approaches in Finland?

Back in 2014, case SAC 2014:119 initiated a lively academic and professional discussion on what kind of FTAs reassessment decisions should be regarded as prohibited recharacterization. Because the number of published SAC transfer pricing precedents were limited and many different interpretations could be taken from the SAC’s reasoning in case SAC 2014:119, for some tax specialists the concept of “recharacterization” became very broad. In retrospect, it can be said that the concept did not turn out to have such fundamental importance for the Finnish transfer pricing scene as some predicted back in 2014. Not everything constitutes recharacterization – since

3. OECD, Action Plan on Base Erosion and Profit Shifting (OECD 2013), Primary Sources IBFD.
4. See OECD, Public Discussion Draft, BEPS Actions 8, 9 and 10: Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (including risk, recharacterisation, and special measures) (OECD 1 Dec. 2014-6 Feb. 2015), Primary Sources IBFD.
5. OECD/DG20, Aligning Transfer Pricing Outcomes with Value Creation – Action 8-20- 15 Final Reports, (OECD 2015), Primary Sources IBFD, and included in the 2017 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Primary Sources IBFD.
7. OECD, Transfer Pricing Guidance on Financial Transactions: Inclusive Framework on BEPS Actions 4, 8-10 (OECD 2020), Primary Sources IBFD.
2014, the Finnish courts have found the FTA’s reassessment decisions to be either correct or not on several legal and factual grounds and the concept of “recharacterization” has had only a rather limited role to play. Because the concept is of a fundamental nature – it demarcates the transfer pricing analysis and reassessment that the FTA is allowed to make from the analysis the FTA is not allowed to make – it is of course relevant to ask following case SAC 2020:35 what exactly falls under prohibited recharacterization. However, it seems that the case does not bring us significantly closer to clear-cut definitions.

Both cases SAC 2014:119 and SAC 2020:35 deal with financing transactions, but there is no reason to think that the concept of recharacterization would be relevant only to certain financing transactions. And as explained above, the concept is relevant also under newer versions of the OECD Guidelines – the passage of time does not solve the problem for the FTA. However, in practice, in over 6 years, the concept has so far been decisive only in the facts and circumstances of these two published SAC cases. From this perspective, a “renaissance” of the concept in the wake of case SAC 2020:35 does not seem very likely. Much depends on what kind of tax audit cases the FTA decides to pursue in the future. From a strategic standpoint, it seems that it does not make much sense for the FTA to pursue cases that it loses, also because it may be difficult to predict in advance how each lost case weakens the FTA’s legal powers in this field. After case SAC 2020:35, it is clear that the FTA cannot go around the concept of recharacterization with terminological explanations.

It should also be noted that recently the SAC has taken a more formalistic stance towards the FTA’s transfer pricing analyses. In a typical transfer pricing case, facts are complex and the tax authority may, practically speaking, choose to accept or challenge almost any of the basic elements of pricing (functions, risks, assets, comparables, methods, etc.). If the FTA decides to challenge the taxpayer’s view and if it chooses an approach that is not correct under domestic law and/or under the OECD Guidelines, in its recent case law, the SAC has plainly overturned the FTA’s reassessment decisions, without considering further whether the facts actually confirm that the pricing has been at arm’s length and without giving the FTA a “second chance” by returning the case back to the FTA’s desk for new consideration. Case SAC 2020:35 follows this new policy along with cases SAC 2018:173° and SAC 2020:34. The authors believe that this is also an important aspect of case SAC 2020:35.

In case SAC 2020:35, the SAC found that recharacterization of transactions is not allowed under the Finnish domestic arm’s length rule, although it may be permissible under the OECD Guidelines. The question therefore arises whether there is a need to “fix” section 31 of the AAP so that in the future Finnish domestic law would facilitate the kind of recharacterization that the SAC rejected in case SAC 2020:35. The authors believe that it may be an acceptable policy choice to amend the wording of section 31 in order to clarify that its scope extends generally to the transfer pricing methods and approaches that are described in the OECD Guidelines. However, there seems little point in tailor-made amendments to facilitate such far-reaching recharacterization that the FTA was after in case SAC 2020:35. It must be noted that the SAC has recognized in its case law that there are certain fundamental private law legal forms/structures that limit even the application of GAARs, causing the authors to believe that it would be difficult to justify disregarding these forms/structures (e.g. capital contribution or ownership of assets as in case SAC 2020:35) in transfer pricing assessments. From this perspective, the problem of recharacterization does not concern only the (technical) scope of section 31 in relation to the OECD Guidelines, but the more fundamental question of what kind of powers the tax authorities should or should not have under domestic law.

8. This case is commented on by the authors in M. Raunio & M. Urpilainen, Landmark Ruling on the Tax Administration’s Duty to Respect the Taxpayers’ Choices, 26 Intl. Transfer Pricing J. 2 (2019), Journal Articles & Papers IBFD.