The McKesson case

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Key transfer pricing principles in the context of debt factoring

The trial of *McKesson Canada Corporation v. The Queen* commenced in the Tax Court of Canada in Toronto on October 17, 2011 and is expected to take six to seven weeks. The case concerns a related party debt factoring arrangement between McKesson Canada Corporation (*McKesson*) and McKesson International Holdings III S.a.r.l. (*factor*) resident in Luxembourg. Certain important details of the transfer pricing arrangements and the transfer pricing arguments are not apparent from the Notice of Appeal[1] and the Reply,[2] but already it appears that certain key techniques and assumptions used in this common tax planning arrangement have been called into question and in this respect McKesson will surely join *GE Capital Canada,*[3] *GlaxoSmithKline*[4] and *Alberta Printed Circuits*[5] as another key source of transfer pricing case law and precedent originating from Canada.

I. General features of a debt factoring arrangement

It is worth recapping first of all the standard features of an invoicing discounting arrangement. A good source is the US Internal Revenue Service "Factoring of Receivables Audit Techniques Guide" dated June 2006 (LMSB-04-0606-004).[6] This advises that

> "the factor typically charges interest on the advance plus a commission.[7] The price paid for the receivables is discounted from their face amount to take into account the likelihood of uncollectability of some of the receivables. . .a factor may provide any of the following services:[8]
> 1. Investigation of the credit risk of the client
> 2. Assumption of the credit risk of the customers
> 3. Collection of the client's accounts receivable from the customers
> 4. Bookkeeping and reporting services related to accounts receivable
> 5. Provision of expertise related to disputes, returns and adjustments
> 6. Advancing or financing. . .
> the taxpayer pays the foreign factor the following fees: a discount; administration fees; commission; and interest[9]. . .however, the foreign [related party] factor does not perform any of the typical services of a factor, including collection of the taxpayer's accounts receivable. Instead, the taxpayer agrees to continue doing all or most of its own collection work on its accounts receivable."

The Guide notes that in arm's length arrangements the factor is normally allowed to decide whether it wishes to accept the accounts receivable – what it terms *"the selective assumption of risk"*. Finally, the Guide refers to Treasury Reg. section 6050P regulations which in its preamble opines that

> "for typical transactions with unrelated parties factoring fees range between 0.35 percent of the face value of the accounts receivable (if the client retains the collection function) and 0.70 percent of the face value (if the factor undertakes the collection function)".[10]

In the 2011 online UK Business Link article "Debt Factoring and Invoice Discounting: the Basics",[11] two types of debt factoring costs are identified: interest and fees.[12] Typical interest charges are said to range from 1.5 percent to 3 percent p.a. over the base rate (calculated on a daily basis) – *"roughly equivalent to bank overdraft rates and can be even more advantageous"* (sic). The article states that the fee for *"credit management and administration"* will depend on turnover, the volume of invoices and the number of customers but typically will range from 0.75 percent to 2.5 percent of turnover (reduced to only 0.2 percent to 0.5 percent for pure invoice discounting where the company retains responsibility for debt collection and credit control elements). Finally, the Business Link article notes that *"credit protection charges"* will be levied in non-recourse (see next paragraph) factoring arrangements; they will depend largely on the factor's assessment of the level of risk but typically range from 0.5 percent to 2 percent of turnover.[13]

On the latter credit protection point, it is important to note that the figures quoted above from Treasury Reg, section 6050P relate to arm's length factoring arrangements in which the factor does not purchase the highest risk component of the accounts receivable. As Dr John Young explains in "Using Option Pricing Models for Transfer Pricing",

> "factoring receivables from a cross-border entity at 100 percent non-recourse is unusual, especially if the volume of receivables is large, because factors are not likely to take on the risk of having no recourse to the cross-border seller for any uncollectable receivables. Therefore, it may be difficult to obtain interest rates (even quoted rates) from uncontrolled factors for large transactions at 100 percent non-recourse. . . .when the factor is denied this option to sell back, or recover, a defaulted receivable, it takes on risk that is equal to the value of the put option that is no longer embedded in factoring at 100 percent non-recourse."[14]

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Young suggests that this theoretical "put option" can be valued using a Black-Scholes type option pricing model:

> "valuing this put option using an option pricing model, such as the Black Scholes model, involves estimating the exercise price and expected life of the option, the current price of the underlying receivable and its expected volatility, as well as the expected term of the option. . .once the option is valued, it will result in some risk premium that may be added to the. . .rate observable in the market."

It is interesting that in Young's example he calculates a 100 percent non-recourse adjustment of 0.83 percent, which happens to be consistent with the range of 0.5 percent to 2 percent referred to in the UK Business Link article.

II. Features of the McKesson invoice discounting arrangement

Returning to the *McKesson* case itself, there are important facts which are not yet in the public domain, as follows:

- the mathematical formula(e) used to determine the discount rates;
- the credit terms and average debtor days for the customers;
- the bad debt history and the bad debt profile (including any high risk tail from customers, delays and defaults);
- the breakdown of the discount between its possible constituent elements; and
- the payment from the factor to McKesson for servicing the accounts receivable on a subcontractor basis (on behalf of the factor).

However, the following facts are already in the public domain:

- the arrangement involved non-recourse factoring (that is, having purchased the accounts receivable, the factor could not sell them back to McKesson);
- the factor was obliged to buy 100 percent of the accounts receivable;
- the accounts receivable were sold to the factor on a daily basis (suggesting that they may have been sold on, on the same day they were generated, possibly well before they were due and payable[15]);
- there was no single discount rate but rather formula(e) producing a discount rate of 2.20 percent for that portion of the 2003 tax year preceding March 1, 2003 and 2.22 percent for the rest of the 2003 tax year;[16]
- the discount appears to have included an element of 0.4564 percent which was designed to compensate the factor for incurring capital costs.[17] (It should be noted that neither this figure and certainly not the total "discount rates" above are annualised and so do not correspond to and cannot be compared directly at all with annual interest rates);
- there was no other charge to McKesson;
- McKesson received a fixed payment from the factor for servicing the accounts receivable (on a subcontracted basis for the factor), whereas the discount enjoyed by the factor included an element of charge for servicing the accounts receivable expressed as a percentage of those accounts receivable;
- the Minister of National Revenue has assumed and asserted that the discount rate that would have been agreed to had the parties dealt at arm's length would have been no greater than 1.0127 percent; and
- the initial amount paid by the factor to McKesson was funded by a series of loans and cash contributions from other non-resident related companies and ultimately financed by McKesson Corporation of the USA.

The following arguments have been made by the Minister of National Revenue:

- the actual discount rate used would not have been agreed upon between parties dealing at arm's length;
- McKesson and the factor fixed certain attributes of the discount rate whereas arm's length parties would have provided for reserves and periodic adjustments in respect of those attributes to reflect changes in the risk of the transaction[18];
- McKesson and the factor did not use the actual prompt payment discounts granted by McKesson to its customers in the indemnification mechanism in the factoring agreement, whereas arm's length parties typically agree on an indemnification reimbursement feature based on the actual dilutions[19];
- the factor paid a fixed servicing fee to McKesson but the servicing component of the discount rate is applied to net sales, creating (except in very unlikely circumstances) a "wedge" (i.e. an additional profit) in favour of the factor. Moreover, the servicing component was calculated taking into account contingent and commercially irrational replacement services fees. Arm's length parties would not have agreed to such provisions[20];
- the factor was bound by an Intercreditor Agreement under which part of McKesson's accounts receivable were pledged as collateral for other loans, whereas arm's length parties would not have agreed on provisions of that kind[21]; and
- a discount was allowed to the factor in order to compensate the factor on account of its capital costs, whereas, in the Minister's view (which is not explained in the case documents that are currently in the public domain) the cost of capital of a purchaser of accounts receivable is generally not relevant in arm's length transactions to determine a market price of comparables[22]. Even if considered, an arm's length interest discount with respect to a purchaser's cost of capital would be significantly lower than the element of the discount linked to the cost of capital of 0.4564 percent p.a. retained under the factoring agreement.

III. Key issues to be resolved

It appears at this stage that the following key issues may need to be resolved by the Court:

- have comparable uncontrolled prices been referred to?
- to what degree do the accounts receivable by McKesson already include risk and credit related mark-ups in the form of interest on overdue balances?[23]
- has a 100 percent non-recourse risk adjustment been made to the comparable uncontrolled prices?

- how much of the accounts receivable were pledged as collateral in the Intercreditor Agreement and what were the associated conditions?[24]
- did the discount formula(e) reflect in an arm's length manner the profile of McKesson's accounts receivable?
- was each element of the discount priced on an arm's length basis?
- was the subcontractor fee paid to McKesson for servicing the accounts receivable on behalf of the factor consistent with arm's length pricing?
- has appropriate allowance (if any) been made for the special relationship between McKesson and its factor (in that a larger discount might be extracted by a factor which is known to have a good record in collecting debts quickly and efficiently, has procedures which are known in detail by its counterparty, is known to handle disputes and queries well, will become an "insider" and be in frequent contact with the company and sees eye-to-eye with the company on issues which are key the company's business, has experience of the company's industry, is known to communicate well with customers/debtors, is known to respond effectively if a customer/debtor goes over the credit limit and requires only a short notice period to end the agreement[25] and a smaller discount might be extracted if McKesson was known to the factor to be an efficient (subcontracted) servicer of the accounts receivable)?
- was it in McKesson's commercial interests to enter into the agreement (i.e. would the transaction have taken place at all at arm's length)[26]?
- if not, was there a different agreement which it would have entered into and if so should this be imputed?
- potentially, how could an option pricing or insurance type model be used to value the risks assumed by the factor in a mark to model comparison?[27]

We will follow the case with interest and expect to analyse the decision in the New Year.

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This article constitutes professional academic comment not legal or economics advice.

NOTES

[1] *McKesson Canada Corporation v The Queen*, Notice of Appeal (Part 1 Reassessment), Court File No 2008-2949(IT)G, 18 September 2008 and Amended Notice of Appeal, 17 December 2010.
[2] *McKesson Canada Corporation v The Queen*, Amended Reply to Notice of Appeal, Court File No 2008-2949(IT)G, 12 January 2011 and Reply to Amended Notice of Appeal (Part XIII) dated 12 January 2011.
[3] 2010, Canadian Federal Court of Appeal.
[4] 2010, Canadian Federal Court of Appeal.
[5] 2011, Tax Court of Canada.
[6] N.B. This guide appears to be current as of 17 March 2011 - see IRS website page: www.irs.gov/businesses/article/0,,id=159770,00.html
[7] While the economics of factoring are somewhat akin to lending, so that the price of the receivable will include an interest-like component to compensate that factor for the time it is out of funds (i.e. the period between the purchase and the maturity date of the receivable), that is built into the discount applied by the factor in determining the purchase price - there is actually no loan or advance as such in a factoring arrangement, only the purchase of an asset (i.e. the receivable).
[8] "Managing Factoring in Banking Groups", Discussion Paper 1/2006, Credifact April 2006, pp 5-6, observes that factoring involves a combination of receivables financing, insurance and services.
[9] See footnote 8; in practice all services are paid for through the discount.
[10] N.B. The original version of this guidance contains the following disclaimer: *"This material was designed specifically for training purposes only. Under no circumstances should the contents be used or cited as sustaining a technical position"* (see www.irs.gov/pub/irs-utl/factoring_of_receivables_atg_final.pdf).
[11] www.businesslink.gov.uk/bdotg/action/detail?itemId=1073791096&type=RESOURCES.
[12] See footnotes 8 and 10.
[13] These credit protection charges for non-recourse factoring could be interpreted as risk premia charged by the factor for assuming default risk per average factoring transaction.
[14] *Tax Management Transfer Pricing Report*, vol.8, no.15, November 24, 1999
[15] Given the normal practice of public sector hospitals, the sale of the accounts receivable may have taken place even much further still from the eventual date of receipt of payments.
[16] See para 3 in the original Notice of Appeal dated 18 September 2008.
[17] See e.g. para 34A (e) in the Reply to the Amended Notice of Appeal (Part X111) of the Crown, dated 12 January 2011.
[18] Of course from a pure pricing point of view either periodic adjustments or no periodic adjustments are equally feasible and priceable, analogous with a long term credit default swap versus a sequence of back to back short term credit default swaps.
Para 34A (q) of the Reply to the Amended Notice of Appeal (Part X111) of the Crown, dated 12 January 2011, indicates that the associated RSA (Receivables Sale Agreement) was for a $900m 5 year facility. This might be compared with a 5 year revolving credit linked swap facility, based on the credit-worthiness of McKesson, the factor and the receivables customers (including Canadian hospitals and health service suppliers).
[19] Same argument applies as footnote above.
[20] N.B. Irrationality in this context is potentially hard to prove. Replacement service fees (as observed for independent service providers) could be very important in establishing contestable market comparators.
[21] Presumably the accounts receivable in the hands of the factor were pledged as collateral for the factor's related party loans (as noted above). The factor might then find itself in a position in which it could not use the receivables to meets it contractual obligation to purchase subsequent receivables from McKesson. This would be expected to increase the risk to the factor and hence the size of the discount which it would require.
[22] N.B. Many banks have vociferously argued otherwise in the context of Basel III and UK Vickers Commission proposals and likely effects on their cost of capital and pass-through costs to consumers. The factor's cost of capital would determine where in a feasible range of discount rates it could profitably bid.
[23] The size of the factor's discount would be expected to reflect the extent to which it could earn late payment interest from customers.
[24] See para 34A (d) in the Reply to the Amended Notice of Appeal (Part X111) of the Crown, dated 12 January 2011.
[25] Business Link online article, "Debt Factoring and Invoice Discounting: the Basics" www.businesslink.gov.uk/bdotg/action/detail?itemId=1073791096&type=RESOURCES.
[26] It can be assumed that the agreement could have been in McKesson's commercial interests if, for example, either the factor enjoyed a lower cost of capital, or was more efficient at those aspects of servicing the accounts receivable that were not subcontracted back to McKesson (lower service costs), or was more effective at collecting accounts receivable (lower risk in practice).
[27] Mark to model means establishing the fair net present value by reference to one or more computer/mathematical models. This approach is typically used for complex instruments where there is no liquid market or liquid quotes.

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