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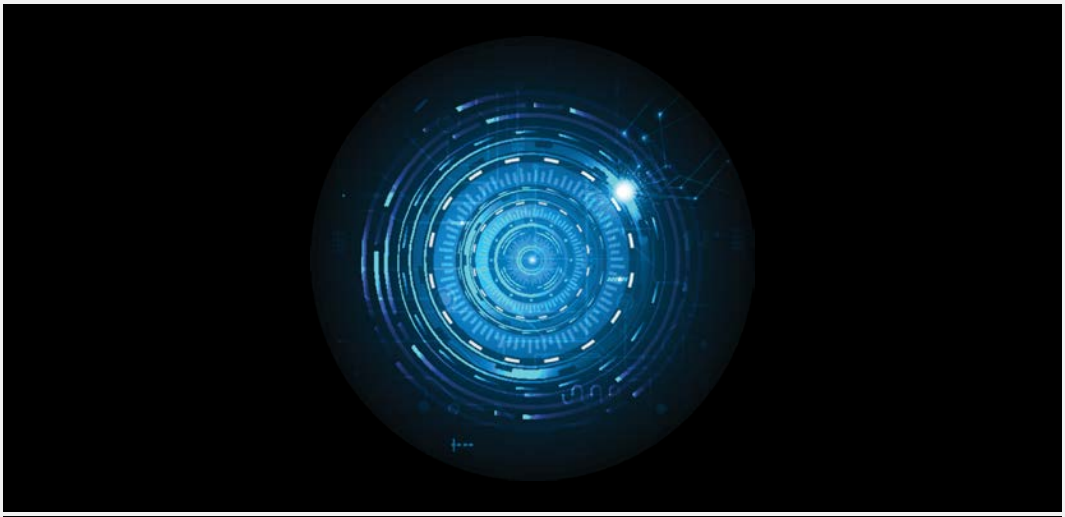

OECD releases discussion draft on transfer pricing of financial transactions

The Organisation for Economic Co-operation and Development (OECD) on 3 July released a non-consensus discussion draft on the transfer pricing aspects of financial transactions. This discussion draft is part of Actions 8-10 of the base erosion and profit shifting (BEPS) project, which began in 2013.

The 2015 final report on BEPS Actions 8-10 mandated follow-up work on this topic. Pursuant to that mandate, the discussion draft aims to clarify the application of the OECD transfer pricing guidelines (TPG) to financial transactions, in particular, the accurate delineation analysis under Chapter I.[1] The discussion draft addresses debt-versus-equity determinations as well as specific issues related to financial transactions such as rates of return, intragroup loans, cash pooling, hedging, guarantees, and captive insurance companies.

The OECD has invited interested parties to submit comments on the discussion draft by 7 September 2018.

Debt versus equity determinations

The discussion draft includes guidance that reflects an approach of accurate delineation of the actual transaction to determine the capital structure (the mix and types of debt and equity) used to fund an entity within a multinational enterprise (MNE) group. The draft guidance indicates that an approach of accurate delineation, which may include a multifactor analysis, is necessary before pricing a loan to determine whether the purported loan is regarded correctly, or should be

[1] All references to the OECD TPG are references to the 2017 version of the TPG.

recharacterized as equity for tax purposes.[2] Furthermore, the draft guidance suggests that the recharacterization as equity of a purported loan is not an all-or-nothing consideration; rather, the draft guidance appears to allow a bifurcation of a purported loan between debt and equity as part of the accurate delineation analysis.[3]

As stated in the discussion draft, accurate delineation of financial transactions should begin with the thorough identification of economically relevant characteristics of the transaction, consistent with the application to other transactions. These include:

- An examination of the contractual terms of the transaction;
- The functions performed, the assets used, and the risks assumed;
- The characteristics of the financial products or services;
- The economic circumstances of the parties and the market; and
- The business strategies pursued by the parties.

The discussion draft specifically mentions factors that may be useful indicators in accurately delineating a loan. While it clearly states that the draft guidance is not intended to prevent countries from implementing other approaches to address capital structure and interest deductibility, it lists a number of factors that can be used to distinguish intercompany debt from other forms of funding such as equity, including the following:

- The presence or absence of a fixed repayment date;
- The obligation to pay interest;
- The right to enforce payment of principal and interest;
- The status of the funder in comparison to regular corporate creditors;
- The existence of financial covenants and security;
- The source of interest payments;
- The ability of the recipient of the funds to obtain loans from unrelated lending institutions;
- The extent to which the advance is used to acquire capital assets; and
- The purported debtor’s failure to repay on the due date or to seek a postponement.

In applying the arm's length principle to a financial transaction, the guidance advocates for consideration of the conditions that independent parties would have agreed to in comparable circumstances. Further, it is necessary to consider the options realistically available to each of the parties to the transaction.[4]

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[2] This approach of accurate delineation applies to certain financial transactions mentioned in the discussion draft including intragroup loans, cash pooling, hedging, guarantees, and captive insurance arrangements.
[3] The bifurcation approach is consistent with the draft Treas. Reg. §1.385, although the final regulations moved away from this methodology.
[4] For example, in the case of an entity that advances funds, other investment opportunities may be contemplated.

Considering that many jurisdictions follow a fixed-ratio thin capitalization approach and others, including the United States, have issued specific regulations that govern the debt-equity characterization that may go beyond a transfer pricing analysis, a key issue going forward will be how individual countries adopt this portion of the OECD draft guidance.

Risk-free and risk-adjusted rates of return

The discussion draft states that when the accurate delineation analysis shows that a funder lacks the capability, or does not perform the decision-making functions, to control the risk associated with investing in a financial asset, it will be entitled to no more than a risk-free return as an appropriate measure of the profits it is entitled to retain.[5]

The discussion draft discusses the approach to use the interest rate on certain government-issued securities as a reference rate for a risk-free return. The guidance also mentions that government-issued securities are not the only reference for estimating risk-free rates, and other alternatives may be considered based on the prevailing facts and circumstances of each case.

The draft guidance states that in a situation in which a party providing funding exercises control over the financial risk associated with the provision of funding, without the assumption of or control over any other specific risk, it could generally expect only a risk-adjusted rate of return on its funding (that is, it would not be entitled to a return on its funding beyond fixed, risk-adjusted interest income). The discussion draft indicates that a risk-adjusted rate of return can be determined under different approaches, for example: comparable uncontrolled transactions, the addition of a risk premium to the risk-free return, or a cost of funds approach.

Treasury functions: Intragroup loans, cash pooling, and hedging

The discussion draft states that the organization of the treasury function will depend on the structure of the MNE group and the complexity of its operations. Differences in the treasury function may flow from variations in the function's degree of autonomy and the range of activities it performs. The draft guidance sets out transfer pricing considerations that arise from treasury activities such as intragroup loans, cash pooling, and hedging activities.

Intragroup loans

In determining the arm's length interest rate on intragroup loans, a number of factors should be considered, including:

- The lender's and borrower's perspectives;
- The borrower's credit rating;
- The effects of group membership (and associated implicit support);
- Incurrence and maintenance covenants;

[5] The funded party would still be entitled to a deduction up to an arm's length amount in respect of the funding. The difference between those amounts would be allocable to the party exercising control over the investment risk in accordance with the guidance in Chapter I of the TPG.

- Guarantees; and
- Loan fees and charges associated with the transaction.

In considering the lender's perspective, the discussion draft suggests an evaluation of the lender's ability to bear the risks associated with the borrower's potential default on the loan. A similar concept is also seen in the section of the discussion draft on guarantees and the guarantor's ability to bear the financial risk associated with providing a contractual guarantee. Such an analysis is likely to be an important aspect of the accurate delineation of the transaction. However, the discussion draft does not offer any guidance or examples as to how the financial ability to bear the risk should be measured or evaluated.

Specific guidance is provided on considerations for conducting credit rating analyses and performing comparability adjustments to account for influences of controlled transactions and potential impact of passive association. The discussion draft acknowledges that credit ratings can serve as a useful measure of creditworthiness and to help identify potential comparables. Furthermore, the discussion draft highlights that in performing a credit rating analysis, it is important to note that the financial metrics of the borrower may be influenced by other controlled transactions. However, no guidance or examples are provided as to how these situations should be best addressed.

The discussion draft covers the issue of implicit support throughout, and the guidance on performing credit rating analyses is no exception. Rather than adopting a single top-down approach (starting with a parental credit rating and notching down) or bottom-up approach (starting with a stand-alone borrower credit rating and notching up) to implicit support consideration, the discussion draft suggests a facts- and circumstances-driven approach based on the entity's relative importance to the group. The discussion draft suggests that in cases in which the borrower would be more likely to receive support from other group members than a less integral member, the borrower's credit rating is likely to be more closely linked to the group rating. Conversely, when a borrower is determined to be less likely to receive group support in more limited circumstances, it may be appropriate to first consider a stand-alone credit rating of the entity and then modify the rating upward to account for implicit support.

The guidance emphasizes the importance of both quantitative and qualitative factors in determining arm's length pricing. Qualitative factors include both the effects of group membership, as discussed above, and also qualitative aspects of the borrower's business. While the draft guidance takes a separate entity approach to pricing, it looks beyond contractual terms to consider that the lender and borrower are related parties, that the funding is in fact intercompany and not third-party debt, and that the borrower is a member of a larger MNE. For example, consideration is given to the fact that intercompany loans are frequently subordinated to third-party loans in many jurisdictions. This suggests that there may be a need to perform a legal analysis with respect to bankruptcy laws and seniority. The guidance also highlights that covenants may be less important in a related-party context and that intragroup loans may effectively be secured lending even if no security is contractually given. Finally, consistent with paragraphs 1.164 through 1.167 of the TPG, the draft guidance considers the effects of group membership via implicit support, even in the absence of a contractual guarantee.

The discussion draft outlines the transfer pricing approaches to determine arm's length rates, including the comparable uncontrolled price (CUP) method, a cost of funds approach, and reliance on bank opinions. The guidelines indicate that the last item – reliance on bank opinions -- generally would not be regarded as providing evidence of arm's length pricing.

Cash pooling

Cash pooling enables a group to benefit from more efficient cash management by (notionally or physically) bringing together the balances on separate bank accounts. The draft guidance indicates that accurate delineation of cash pooling arrangements would need to take into account the facts and circumstances of the balances transferred, but also the wider context of the conditions of the pooling arrangement as a whole.[6] The discussion draft mentions two broad pricing schemes for cash pooling transactions: rewarding the cash pool leader and rewarding the cash pool members. The appropriate basis on which to reward the cash pool leader depends on the specific facts and circumstances of the arrangement.[7]

The draft guidance discusses three approaches to allocating the benefits of cash pooling to the participating members (that are not necessarily mutually exclusive):

- Enhancing the interest rate for depositors and borrowers;
- Applying the same interest rates for depositors and borrowers;[8] and
- Allocating cash pooling benefits to depositors, and not borrowers, within the group (in situations in which there is genuine credit risk to the depositors).

The guidance mentions that cross-guarantees and set-off rights may be required between participants in the cash pool. The guidance also mentions that, in some circumstances, the guaranteed borrower may not be benefitting beyond the level of credit enhancement attributable to the implicit support of other group members. In such cases, the discussion draft suggests, no guarantee fee would be due, and support in case of a default from another group member should be regarded as a capital contribution.

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[6] It is necessary to determine (i) the nature of the advantage or disadvantage, (ii) the amount of the benefit or detriment provided, and (ii) how that benefit should be divided among members of the MNE group.
[7] An example is provided whereby the cash pool leader performs coordination services, but bears no credit risk and accordingly should earn rewards commensurate with a service provider. In a second example, the cash pool leader performs additional functions, controls and bears the financial risks contractually allocated to it, and has the financial capacity to bear those risks, and should be compensated commensurately.
[8] This applies in a situation in which all cash pool members have the same or similar credit profile.

When a centralized treasury function arranges a hedging contract that an operating company enters into, the draft guidance indicates that the centralized function can be seen as providing a service to the operating company and should be rewarded accordingly. When hedging positions are not matched within the same company, although the group position is protected, more difficult transfer pricing issues may arise.

Guarantees

The discussion draft provides guidance on how to accurately delineate and price financial guarantees.

As stated in the guidance, when the effect of a guarantee is to permit a borrower to borrow a greater amount of debt than it could in the absence of the guarantee, it is necessary to consider whether a portion (incremental borrowing capacity) of the loan from the lender should be more accurately delineated as a loan from the lender to the guarantor (followed by an equity contribution from the guarantor to the borrower),[9] and whether the guarantee fee paid with respect to the loan portion is arm's length.

The draft guidance discusses both explicit guarantees (legally binding contracts) and implicit guarantees (anything less than a legally binding commitment). In general, the benefit of any such implicit support would arise from passive association and not from the provision of a service for which a fee would be payable. In an explicit guarantee, a borrower generally would not be prepared to pay for a guarantee if it did not expect to obtain an appropriate benefit in return (that is, a cost of debt-funding lower than its non-guaranteed borrowing costs adjusted for implicit support and costs associated with the guarantee).

The draft guidance describes five pricing approaches for circumstances in which a guarantee fee is found to be appropriate:

- The CUP method (although finding sufficiently similar guarantees between unrelated parties may be unlikely);
- The yield (differential) approach;
- The cost approach;
- The valuation of expected loss approach; and
- The capital support method.

The yield approach prices the guarantee based on the benefit provided to the borrower (that is, from the borrower's perspective), whereas the cost, valuation of expected loss, and capital support methods price the guarantee based on the cost to the guarantor (that is, from the guarantor's perspective). It is worth noting that a capital support approach appears to presume that an improvement in the borrower's credit rating can be accomplished solely through a capital infusion, without regard to the myriad of other inputs typically considered in a credit rating analysis.

[9] A similar question was not posed with regards to implicit support.

Captive insurance companies

Some MNE groups manage risks within the group through a captive insurance company, a group member that provides insurance-type services exclusively or primarily to members of the group. The discussion draft provides guidance on applying the arm's length principle to these transactions. A frequent concern when considering the transfer pricing of captive insurance transactions is whether the transaction is accurately delineated as such. The draft guidance provides indicators, all or substantially all of which would typically be expected in an independent insurer:

- Diversification and pooling of risk in the captive insurer;
- The group's economic capital position has improved as a result of diversification and there is therefore a real economic impact for the group as a whole (that is, the captive insurer either: (i) does not only insure group risks but diversifies those group risks by inclusion within its portfolio of a significant proportion of non-group risks, or (ii) it reinsures a significant portion of the risks it insures outside of the MNE group);
- Both the insurer and any reinsurer are regulated entities with broadly similar regulatory regimes and regulators that require evidence of risk transfer and appropriate capital levels;
- The insured risk would otherwise be insurable outside the group;
- The captive has the requisite skills, including investment skills, and experience at its disposal, including employees with senior underwriting expertise; and
- The captive has a real possibility of suffering losses.

Two methods are discussed that may be appropriate for the pricing of premiums: CUPs from available comparable arrangements between unrelated parties (or internal comparables) and actuarial analysis. The draft guidance also provides for a method that builds to an arm's length level of profitability as the sum of underwriting profit plus investment income. Further, the draft discussion provides guidance on the pricing of agency sales and arrangements whereby a captive is used to achieve synergies for the MNE group.

Conclusion and key takeaways

The discussion draft provides guidance on the transfer pricing aspects of financial transactions including treasury functions, intragroup loans, hedging, cash pooling, financial guarantees, and captive insurance.

Not only does the guidance provide methods for determining the arm's length compensation for financial transactions, it also indicates that an accurate delineation is necessary before pricing a financial transaction to determine whether the transaction is characterized correctly, or should be recharacterized for tax purposes. To accurately delineate financial transactions, the discussion draft indicates it is necessary to perform an examination of the contractual terms of the transaction; the functions performed, the assets used, and the risks assumed, the characteristics of the financial products or services; the economic circumstances of the parties and the market; and the business strategies pursued by the parties.

Overall, the guidance provided in the discussion draft highlights a potential need for MNEs to revisit and develop intragroup policies (and revisit associated funding agreements) to address any ambiguity regarding how tax authorities might interpret their intragroup financing transactions.

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