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# Final OECD Guidance on Financial Transactions

## Introduction

On 11 February 2020 the OECD issued its final report *Transfer Pricing Guidance on Financial Transactions: Inclusive Framework on BEPS: Actions 4, 8–10* ("the Final FT Guidance" or "the Guidance"), which is now included as Chapter X in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("the OECD TP Guidelines"). The Final FT Guidance is important as this is the first time that the OECD has provided specific guidance on the transfer pricing aspects of financial transactions. This is an area where significant disputes have arisen (and there have been a number of high-profile court cases across a number of countries), and the aim of the guidance is to contribute to the interpretation of the arm's-length principle and help avoid transfer pricing disputes and double taxation.

The Final FT Guidance was published 18 months after the OECD's initial non-consensus discussion draft on financial transactions. The main areas addressed in the Guidance are:

- determining whether a loan should be regarded as a loan;
- accurate delineation of financial transactions;

- treasury functions:
  - intra-group loans,
  - cash pooling,
  - hedging;
- financial guarantees;
- captive insurance; and
- risk-free rate and risk-adjusted rate of return.

It is evident that some concessions were made to countries on difficult topics in order to reach consensus. Chiefly, it allows countries to take an approach to address an entity's capital structure (i.e. mix of debt and equity) under domestic legislation and does not oblige countries to follow the arm's-length principle as described in the Final FT Guidance. It also provides little clarity on the contentious issue of implicit support and the benefit to borrowers of being part of a group (discussed in more detail on the next page).

This article provides the details of the Final FT Guidance as well as some of the main considerations for taxpayers as a result of the guidance.

From an Irish perspective, the Final FT Guidance was released too late to be part of the update to Irish transfer pricing rules for accounting periods starting on or after 1 January 2020, whereby the 2017 Guidelines and other OECD updates were incorporated into Irish law. It will be necessary for the legislation to be updated by way of a statutory instrument to incorporate the Final FT Guidance into law. Taxpayers should be mindful of the requirements under the new guidance.

## Determining Whether a Loan Should Be Regarded as a Loan

The Final FT Guidance deals with the application of the arm's-length principle in analysing the mix of debt and equity of a borrower and whether an arrangement characterised as debt would and should be more appropriately considered equity. To distinguish debt, the Guidance lists a number of factors, which include, but are not limited to, the presence or absence of a fixed repayment date, the obligation to pay interest and the existence of covenants and security.

It is worth noting that the OECD considers that re-characterisation as equity is not "all or nothing" (i.e. it may be that only a portion of debt is considered equity). As mentioned, the Guidance also recognises that domestic legislation for capital structure and interest deductibility may prevail over this guidance. This is disappointing for taxpayers as it means that they will continue to face a number of different approaches to this issue, and it is more likely to lead to double taxation.

It is also important to note that, while the Guidance provides details on the issue of the characteristics of debt or equity, taxpayers are required to accurately delineate the actual transaction under the 2017 OECD Guidelines (which form part of Irish transfer pricing legislation for accounting periods starting on or after 1 January 2020). This means is that Irish taxpayers will need to consider the debt capacity of Irish borrowers who take on related-party debt and demonstrate its reasonableness going forward (irrespective of the fact that the Final FT Guidance is not yet part of Irish TP legislation).

## Economically Relevant Characteristics of the Actual Financial Transactions

The Final FT Guidance states that accurate delineation of financial transactions requires the identification and in-depth analysis of the economically relevant characteristics of the transaction. These include the contractual terms of the transaction; the functions performed, assets used and risks assumed; the characteristics of the financial products or services; the economic circumstances of both parties; and the market and business strategies pursued by both parties.

An accurate delineation analysis should also consider the group's global financing policy. In other words, it is necessary to take account of the broader group context – so, for example, if the group has publicly stated a desire to target a certain gearing ratio, any intra-group debt that generates higher levels of leverage would need to be carefully explained.

The Guidance also 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. (The issue of risk-free returns is broader than financial transactions, but the guidance was included in the same release as the Final FT Guidance. It is part of the OECD's efforts to target so-called cashbox entities that have no/minimal substance.)

## Treasury Functions

The Final FT Guidance provides an overview of treasury functions, which include cash and liquidity management, corporate financial management, raising debt and equity, and managing the relationship with the MNE group's external bankers and with independent credit rating agencies, and it recognises that the organisation of the treasury function within a group may involve different degrees of centralisation.

The OECD sees two alternative characterisations for treasury functions:

- The treasury function may often be a support service to the main value-creating operation.
- A treasury department may conduct more complex functions (and create value).

Therefore, where groups take the position that the treasury function generates value and is entitled to relatively significant profits (e.g. the spread between borrowing and lending), that view will need to be carefully explained and supported in the transfer pricing documentation.

## Intra-group Loans

The Guidance states that, in applying the arm's-length principle to an intra-group loan, the following issues will need to be considered.

### Two-sided analysis

The analysis should be performed from both the lender's and the borrower's perspective, considering the risks of the arrangement, the creditworthiness, the economic circumstances, any assets available for collateral and any changes in the economic conditions.

### Credit ratings

Credit ratings can generally be determined for the overall creditworthiness of the issuer or a specific issuance of debt and would require the consideration of qualitative and quantitative data. When both an issuer and issue ratings are available, the issue rating of the particular debt issuance would be more appropriate to use. The reasons and choice of the credit rating should be properly documented.

### Group membership effect

When the borrower is part of a group, there are two effects to consider.

The first is the third-party funding policies of the group, which potentially provides an indication of the terms and conditions under which the borrower would have borrowed from an independent lender.

The second is the fact that the borrower may receive group support to meet its financial obligations in case of financial difficulty. This benefit is referred to as "implicit support" and may affect the borrower's credit rating. Whether a group company is considered to receive implicit report requires an analysis of the entity's strategic importance to the group and the group's policy around supporting subsidiaries. This is consistent with how credit rating agencies assess the impact of group membership.

Where a borrowing entity is said to receive implicit support, the credit rating of the group (potentially with some adjustments to align with credit rating agency approaches) should be used. In other words, the benefit of group membership should accrue to the borrower.

If a borrowing entity is not considered to receive implicit support then it would be more appropriate to consider its standalone credit rating and price the interest rate accordingly.

### Covenants

Recognising there is less information asymmetry within a group, a lender may choose to not have covenants. However, the Final FT Guidance states that the impact of any covenant should be carefully considered.

### Guarantees

Where a guarantee exists, the guarantor should be evaluated in a similar way to the original borrower to ensure that its obligations would be met (i.e., the guarantor is good for the guarantee).

### Determining the arm's-length interest rate

The Guidance outlines the transfer pricing approaches to determine the arm's-length rates, including the comparable uncontrolled price (CUP) method, a cost of funds approach, credit default swaps and economic modelling. However, it is indicated that credit default swaps and economic modelling should be used only in the absence of reliable CUP. Further, it is stated that relying on bank opinions instead of actual comparable transactions would not be regarded as providing evidence of arm's-length pricing.

### Key impact for taxpayers

Much of the guidance on intra-group loans has been developed from jurisprudence across OECD Member States. In the authors' view, of the various items covered by the OECD, the two most significant ones (and where taxpayers may need to review their arrangements in light of the guidance) are:

- the requirement for a two-sided analysis to show the commerciality of the arrangement from the perspective of both the lender and the borrower; and
- the impact of implicit support and the expectation in the Guidance that the credit rating of a borrower will generally be closely linked to the group's credit rating.

## 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 Final FT Guidance indicates that accurate delineation of a cash pooling arrangement is particularly important and, therefore, the following should be considered:

- The facts and circumstances of the balances transferred, as well as the wider context of the conditions of the arrangement.
- A functional analysis should determine whether the cash pool leader's role goes beyond that of a mere coordinator. Also, it should determine whether any cash pool savings and efficiencies arising from group synergies are caused by deliberate group action.
- Cash pooling is considered a short-term arrangement. Therefore careful consideration should be given to whether debit or credit positions of the cash pool members should be treated as longer-term deposits or loans instead, where they remain in place over time.
- Cash pool members are expected to be in a more beneficial position as compared to a situation in which there is no cash pool arrangement.

The Guidance discusses two broad pricing schemes for cash pooling transactions: rewarding the cash pool leader and rewarding the cash pool members (not mutually exclusive). The appropriate basis on which to reward the cash pool leader/members would depend on the above considerations.

Overall, the Guidance is helpful is explaining what activities a cash pool leader might be expected to undertake. However, it can be expected that arrangements where the cash pool leader earns significant returns (e.g. the entire spread between borrowing and lending rates) will come under pressure, and taxpayers will need to be ready to demonstrate that the cash pool leader is performing activities that go beyond coordination. In addition, groups would be wise to carefully monitor cash pool positions to ensure that the characterisation of balances as cash pool arrangements remains valid. This is already a significant area of focus for tax authorities, i.e. where balances or loans are contractually characterised as short-term but in substance are more likely to be medium/long-term arrangements. The guidance in the Final FT Guidance is only likely to increase tax authority scrutiny of this issue.

## Financial Guarantees

The Final FT Guidance also discusses accurately delineating and pricing financial guarantees. A typical situation is where a guarantor provides a financial guarantee to a third-party lender, such as a bank, for a loan provided to a related party. In order to accurately delineate a financial guarantee, the economic benefit arising for the borrower beyond any passive association benefit should be considered.

Financial guarantees would generally have two effects:

- Obtaining more favourable terms for the borrower, e.g. a lower interest rate. In such a case, a guarantee fee would be expected to be paid by the borrower (provided, however, that this will not worsen its financial position due to guarantee-related costs).
- Accessing a larger amount of borrowing. In such a case, it is necessary to consider whether a portion of the loan from the lender to the borrower 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). In addition, it would need to be considered whether a guarantee fee paid with respect to the loan portion is arm's length.

The Guidance also discusses explicit guarantees (i.e. legally binding contracts) versus implicit guarantees. As previously discussed, the benefit of implicit support would arise from passive association itself and therefore no fee should be payable. In the case of explicit guarantees (where the guarantor legally assumes the risk of default of the borrower), it is appropriate to consider if a fee would be payable but a borrower would generally pay only to obtain an appropriate benefit in return.

In accurately delineating a financial guarantee, the financial capacity of the guarantor to meet its obligations if the borrower defaults also needs to be considered. In other words, does the guarantor have the financial capacity to take on the potential liability in the event of a default by the borrower?

Finally, the Guidance discusses the methodologies to price financial guarantees, including:

- the CUP method (even though the difficulty of finding comparables is recognised, as unrelated-party guarantees of bank loans are quite uncommon);
- 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, whereas the cost, valuation of expected loss, and capital support methods price the guarantee based on the cost to the guarantor. With the exception of the CUP method, these pricing approaches address only the maximum or minimum amounts that an unrelated borrower or lender may be willing to pay or receive for a financial guarantee, and they do not address how to consider prices above or below these limits.

## Captive Insurance

The Final FT Guidance also discusses captive insurance. Many tax authorities have an inherent suspicion of captive insurers within groups, and the Guidance provides certain indicators that need to be present in an independent genuine insurance business. These include the following:

- There is diversification and pooling of risk in the captive insurance.
- The economic capital position of the entities within the group has improved as a result of diversification and there is therefore a real economic impact for the group as a whole.
- Both the insurer and any reinsurer are regulated entities with broadly similar regulatory regimes that required evidence of risk assumption and appropriate capital levels.
- The insured risk would otherwise be insurable outside the group.

- The captive insurer has the requisite skills, including investment skills, and experience at its disposal, including employees with senior underwriting expertise.
- The captive insurer has a real possibility of suffering losses.

Accurate delineation should also evaluate whether the captive insurer assumes the risks in relation to issuing insurance policies and exercises control functions. In addition, the captive insurer should have the financial capacity to assume the risks. Where the captive insurer is not found to exercise control functions related to the insurance risk, it may be concluded that the captive insurer does not assume the risk or that another MNE group member is exercising these control functions. In the latter case, the Guidance states that the return derived from the investment of the premiums would be allocated to the member(s) of the group that are assuming the risk.

The Guidance discusses two methods as appropriate for pricing intra-group transactions that involve captive insurance and reinsurance premiums:

- CUPs and
- actuarial analysis.

It 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, it provides guidance on the pricing of agency sales and arrangements whereby a captive insurer is used to achieve synergies for the group.

## Risk-Free and Risk-Adjusted Rates of Return

The Final FT Guidance discusses how to determine a risk-free rate of return and a risk-adjusted rate of return in circumstances where an associated enterprise is entitled to such returns under the guidance of Chapters I and VI of the OECD TP Guidelines.

Where an entity cannot/does not conduct the decision-making functions to control the risk associated with investing in a (financial) asset, it should receive only a risk-free return as remuneration. The Guidance states that government-issued securities serve as one reference for estimating risk-free rates, although other alternatives may be considered based on the facts and circumstances of each case. Alternatives may include interbank rates, interest rate swaps or repurchase agreements of highly rated government-issued securities.

In addition, in situations where a related-party funder exercises control over the financial risk of the funding (without assuming any other risks), its remuneration should be based on a risk-adjusted rate of return, i.e. the risk-free rate plus a premium reflecting the risks assumed by the funder.

Several approaches for estimating a risk-adjusted return are suggested. These include approaches based on the return of a realistic alternative investment with comparable economic characteristics, a cost of funds approach, or a risk premium to the risk-free return based on the information available in the market.

## Conclusion

The long awaited Final FT Guidance marks a major milestone in transfer pricing. For the first time, the OECD has set out a consensus approach to a complex area of transfer pricing, where there have been significant disputes and court cases internationally. Some of the guidance validates general practice, whilst other areas will require groups to consider their approach to and/or level of effort in pricing financial transactions.

Irish taxpayers would be advised to revisit existing financial transactions and consider how their historical pricing analysis reconciles to the Final FT Guidance as well as taking it into account for new transactions. This will be particularly important in light of the new Irish TP rules, which require many taxpayers to prepare Irish transfer pricing documentation in 2020 too.