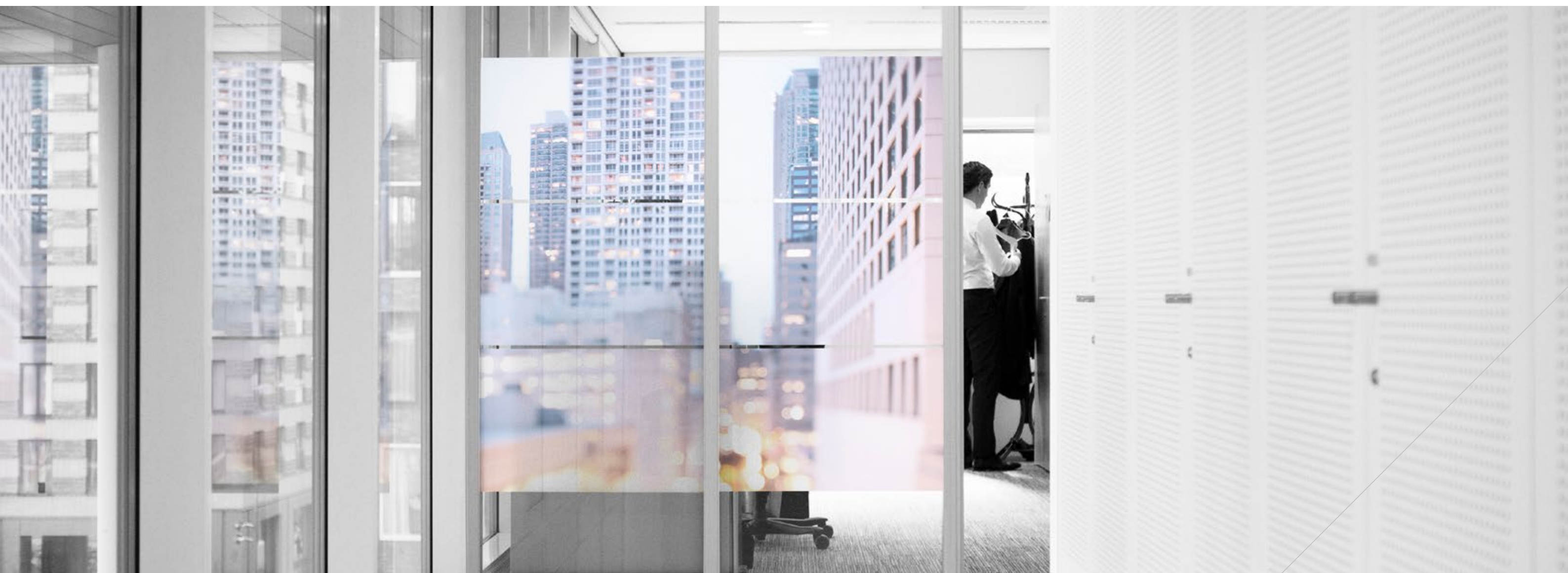

TRANSFER PRICING GUIDANCE ON FINANCIAL TRANSACTIONS

On 11 February 2020, the OECD released its long-awaited transfer pricing guidance on financial transactions (the "**Report**"). This guidance, which follows the public discussion draft of July 2018, marks the first time that the OECD's Transfer Pricing Guidelines ("**TP Guidelines**") will include detailed guidance on financial transactions. The Report is expected to contribute to consistency in interpreting the arm's length principle and avoiding transfer pricing disputes and double taxation issues.

The Report serves as a sequel to the OECD BEPS Action Points 8-10 (*Aligning Transfer Pricing Outcomes with Value Creation*) and specifically Action Point 4. The latter aims to limit base erosion and profit shifting through the pricing of related party financial transactions, including financial and performance guarantees, derivatives, and captive and other insurance arrangements.

The Report provides new guidance on the following topics:

- Accurate delineation of financial transactions;
- Treasury functions including intra-group loans, cash pools and hedging;
- Financial guarantees;
- Captive insurance; and
- Risk-free and risk-adjusted rates of return.

ACCURATE DELINEATION OF FINANCIAL TRANSACTIONS

The Report elaborates on how the accurate delineation of the transaction (currently adopted in Chapter I of the TP Guidelines dated July 2017) relates to the capital structure (i.e. debt serving capacity) of an entity that is part of an MNE

group, on debt pricing, and, specifically, offers guidance to determine whether a purported loan should be considered a loan for tax purposes.

The OECD emphasises that examining the commercial rationale for accurately delineating the transaction (for instance a ten-year term loan could be delineated as series of ten one-year revolving loans or vice versa) is a prerequisite to pricing intra-group transactions. In this regard, it is essential to take into account both the debtor's and creditor's perspectives when assessing the financial transaction's economically relevant characteristics (two-sided approach). The Report also highlights that independent parties, when considering whether to enter into a financial transaction, typically would consider all other options realistically available (ORA) to them which implies that the bargaining position of the parties could be considered relevant for transfer pricing purposes.

It is surprising that the OECD leaves room for different (unilateral) approaches to the balance of the debt and equity and interest deductibility under domestic legislation and does not demonstrate full support for the 'accurate delineation' approach.

Lastly, five well-known comparability factors (i.e. contractual terms, functional analysis, characteristics of financial transactions, economic circumstances and business strategies) that should be considered in any transfer pricing analysis are explained with specificity in the context of financial transactions. While the practical use of this guidance should be considered on a case-by-case basis, it provides useful commonly observed examples.

TREASURY FUNCTIONS

The Report provides guidance on treasury activities, namely, intra-group loans, cash pooling and hedging arrangements.

INTRA-GROUP LOANS

- The Report acknowledges that the borrower's creditworthiness is one of the most important aspects which investors consider when determining an interest rate. However, the OECD's new guidance is not considered groundbreaking and in fact, does not provide any new aspects to what was already applied by practitioners. The OECD, in this respect, confirms the following:
- For intra-group loans, an individual credit rating approach should be followed taking into account the effect of group membership.
- The effect of group membership (implicit support) should be determined on the basis of how important the relevant entity is for the group and this can vary by industry.
- Creditworthiness should be determined based on both quantitative and qualitative information that takes into account the borrower's individual characteristics.
- The use of publicly available credit scoring tools may be helpful to approximate credit ratings, one should be aware that there is a lack of clarity in the processes (underlying algorithms).
- The use of group credit ratings can be relied on only in exceptional cases (e.g. when there is information asymmetry resulting in unreliable outcomes) and particularly in situations where the relevant legal entity is important to the group.

To select the most appropriate method, the Report states that the comparable uncontrolled price (CUP) method is typically the preferred method of determining an arm's length interest rate, given the widespread existence of markets for borrowing and lending funds between independent parties. However, in the absence of comparable uncontrolled transactions, other

methods, such as the cost of funds approach or the use of credit default swaps (CDS) may be used as an alternative to determine an arm's length interest rate. Bank opinions, however, represent a departure from an arm's length approach, according to the Report, since those opinions are not based on a comparison of actual transactions (i.e. not an actual offer to lend funds).

CASH POOLING

Like other financial transactions, cash pooling arrangements should be analysed in two steps for transfer pricing purposes. The first step is to assess the commercial rationale of the cash pooling transaction and second step is determine an arm's length remuneration.

The two key aspects for assessing the arrangement's commercial rationale are to consider (i) the wider context of the conditions of the arrangement as a whole (multi-sided analysis) and (ii) whether it is functioning as a short-term liquidity arrangement.

On pricing, the OECD's default view is that the cash pool leader performs no more than a coordination or agency function and thus its remuneration should be limited. Allocating higher remuneration to the cash pool leader should only be considered if it can be proven otherwise.

In this respect, the OECD seems to recommend a residual type of analysis for remunerating cash pooling arrangements. The first step is to remunerate the cash pool leader (i.e. routine remuneration unless proven otherwise). In the second step, all cash pool participants should be made better off by using more favourable interest rates. The ORA concept is also recommended for pricing cash pooling. This could be interpreted as an argument to use the bargaining power for pricing purposes. This means that as a third step of pricing, any remaining residual profits (after having remunerated the cash pool leader and made all participants better off) should be allocated to the participants with positive cash balances (arguably for assuming additional credit risk).

For cross-guarantees, a practical approach is recommended by the OECD whereby no guarantee fee should generally apply. However, if this approach is followed, a default from another group member should be regarded as a capital contribution. This guidance is in line with Dutch Supreme Court's judgment of 1 March 2013 no. 11/01985 as well as the Dutch transfer pricing Decree of 22 April 2018.

Overall, the OECD's guidance on the transfer pricing aspects of cash pooling arrangements seems to be broadly in line with the HMRC guidance from 2016 and the leading decisions in ConocoPhillips and Bombardier cases. However, the OECD, as usual, refrained from providing detailed guidance and restricted its guidance to providing general principles.

HEDGING

If a centralised treasury function arranges hedging for the operating companies, this function can be seen as a service, most likely, attracting a routine remuneration.

The OECD highlights cases where the risk and the benefit of the hedging can occur at different entity levels, for instance, the group position is protected, while positions are not matched within the same entity.

FINANCIAL GUARANTEES

The Report elaborates on how to accurately delineate financial guarantees and determine an arm's remuneration for guarantees. The Report stipulates that for accurate delineation of financial guarantees, consideration needs to be given to

three aspects: (i) economic benefit derived from a financial guarantee by a borrower, (ii) effect of group membership and (iii) financial capacity of the guarantor

The economic benefit of the explicit guarantee for a borrower is considered to be two-fold: it (i) enhancing the terms of the borrowing from the borrower's perspective (e.g. improved credit rating and reduced borrowing costs), and (ii) providing the borrower access to an increased amount of debt. In assessing the impact of group membership, the Report starts by stating that there must be a legally binding commitment through an explicit guarantee arguing that letter of comforts types of documents not automatically qualifying as guarantees and there should only be guarantee payment if the economic benefit exceeds the benefit that arises through an implicit guarantee. The Report goes further by saying that even an explicit guarantee may not require a payment for transfer pricing purposes, if, for instance, the facts and circumstances of the case demonstrate that the borrower would not be abandoned if it encountered financial difficulties because there would be adverse consequences for the MNE group. Furthermore, just like in the case of cash pooling, the value of cross-guarantees can be considered similar to the effect of group membership. This does not justify a separate remuneration and such arrangements should be regarded as a capital contribution. Lastly, the Report introduces financial capacity of the guarantor as a consideration (i.e. an evaluation of the credit rating of the guarantor and the borrower and business correlations between them) for accurate delineation. However, the OECD has not provided clear guidance on how to make this assessment and this lack of clear guidance could add further complexity to analysing these arrangements.

For determining arm's length price of guarantees, the Report acknowledges that there are various approaches such as the CUP method, the yield approach, the cost approach, the valuation of expected loss approach and the capital support method.

CAPTIVE INSURANCE

The OECD states that the initial question to consider is whether the transaction under review is genuinely one of insurance (i.e. whether a risk exists). For such analysis, it is required to consider whether the insurer assumes the risk and whether the relevant facts and circumstances result in actual risk diversification.

With this, the OECD takes a clear position that a remuneration beyond what is routine can be allocated to captive insurance companies when the relevant facts and circumstances of the case support such conclusion. This approach may come as a surprise to tax authorities who have been challenging captive insurance structures for a number of years and who generally argue that these are routine activities for transfer pricing purposes. In fact, following a case decided by District Court of the Hague (11 July 2011) re-characterising a group reinsurance company into an administrative services provider, a similar approach has then been adopted in the Dutch TP Decree of 22 April 2018 whereby a distinction is made between two types of insurance companies; being passive poolers and captive insurer offering insurance as by-product; both entitled to a routine returns.

The Report notes that applying the CUP method to price captive insurance might be practically difficult, e.g. due to the fact that the captive insurer performs fewer functions than a commercial insurer. Alternatively, an actuarial analysis may be more suitable to determine an arm's length insurance premium for a particular risk. Furthermore, in relation to outsourcing the underwriting functions, the Report states that a captive insurance that outsources all aspects of the underwriting process without performing control functions would not assume the insurance risk.

RISK-FREE AND RISK-ADJUSTED RATES OF RETURN

Finally, the Report provides guidance on determining a risk-free return if the funder does not perform the key decision-making functions to control the risk relating to the financial asset. The approach followed by the OECD in this respect is

fully in line with so-called 'control over risk' notion that was introduced in the 2010 version of the TP Guidelines and further developed in the 2017 version.

This risk-free return is the hypothetical return that is assumed to result from an investment with no risk of loss (e.g. securities issued by certain governments). To eliminate currency risk, the reference security for determining the risk-free rate needs to be a security issued in the same currency as the investor's functional currency. Other relevant aspects in this regard relate to the temporal proximity of the reference security (preferably issued at the same time) and the maturity of the financial instrument.

However, if the funder exercises control over the associated financial risk, without controlling any other specific risk, it could generally only expect a risk-adjusted rate of return on its funding. In this regard, the Report states that the expected risk-adjusted rate of return on a funding transaction has two components, the risk-free rate and a premium reflecting the risks assumed by the funder. The determination of the risk-adjusted rate of return can be based on the return of a realistic alternative investment which reflects the same risk, or based on other approaches, for example by adding a risk premium to the risk-free return based on the information available in the market. Taking into account the current market conditions in which negative interest rates play an important role, one could however question the practical implications of this approach.

A copy of the Report can be found here. For more information, please contact the Houthoff Transfer Pricing Team.

ABOUT HOUTHOFF

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