

# China Tax Alert

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## OECD: Transfer pricing guidance on financial transactions

### Regulations discussed in this issue:

- *Transfer Pricing Guidance on Financial Transactions: Inclusive Framework on BEPS: Actions 4, 8-10* issued by the OECD on 11 February, 2020
- 2017 edition of the *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* issued by the OECD on 10 July, 2017
- *Implementation Measures for Special Tax Adjustment (for Trial Implementation) issued by the State Taxation Administration ("Circular 2"), issued by STA on 8 January, 2009*
- *Announcement of the State Taxation Administration on Matters Relating to Improved Administration of Related Party Declarations and Contemporaneous Documentation, issued by State Taxation Administration on 29 June, 2016*
- *The judgment of Chevron Australia Holdings Pty Ltd (CAHPL) v Commissioner of Taxation [2017] FCAFC 62 handed down by the Full Federal Court in April 2017*

### Background

On 11 February 2020, the Organisation for Economic Cooperation and Development ("OECD") released its final report providing transfer pricing guidance on financial transactions, which will be incorporated as Chapter X of the OECD Transfer Pricing Guidelines.

The OECD report—Transfer Pricing Guidance on Financial Transactions: Inclusive Framework on BEPS: Actions 4, 8-10 ("the Report")—marks the first time that the OECD Transfer Pricing Guidelines has provided specific guidance on the transfer pricing aspects of financial transactions.

The aim of the Report is to help ensure consistency in the application of transfer pricing rules and avoid future transfer pricing disputes as well as double taxation issues. It is expected to have a large impact on local transfer pricing legislation and bilateral discussions going forward.

A comparison of the Discussion Draft published in the summer of 2018 and the final version of the Report shows that the document content is largely unchanged though a number of examples have been added to illustrate the principles discussed.

Overall, the Report outlines the economically relevant characteristics that guide the analysis of the terms and conditions of financial transactions, and addresses specific issues related to the pricing of financial transactions (including treasury functions, intra-group loans, cash pooling, hedging, guarantees and captive insurance). These are discussed in detail below.

### Overview of the Report

#### 1. Accurate Delineation Analysis

The Report first elaborates on how the accurate delineation analysis applies to the capital structure of a multinational enterprise ("MNE") within an MNE group.

##### a. *Loan versus Equity*

The first section of the Report deals, at a general level, with the application of the Chapter 1 "transaction delineation analysis" to determine whether a "purported loan" should be treated as a loan.

In particular, it sets out reference criteria to determine if a loan should be considered as a loan or as equity. It is noted that, for a full analysis, consideration needs to be given to the industry in question (e.g., different industries have different capital intensity and different accepted leverage levels), and factors specific to the MNE group in question (e.g., the stage that the borrowing entity is at in its business or product cycle; the MNE group's policy on prioritizing financing of certain projects). The analysis would also need to look at the options realistically available from both the lender and borrower perspectives.

The new OECD guidance on debt-equity characterization in the Report is not intended to be mandatory, as countries / jurisdictions may choose to continue to use any multifactor analysis that they already have in place in their domestic law (e.g., approaches to address capital structure and interest deductibility).

#### ***b. Lending Risk Control***

Even if a related party debt is not recharacterized as equity, if the lender does not control the risks and/or have the financial capacity to absorb loan losses, then the risks/returns should be allocated away to other MNE group companies. This leaves the lender with solely a risk-free return. The types of activity that the lender is expected to conduct to exercise control are listed, which include evaluating lending risks (using similar information to a bank or rating agency), determining loan terms and arranging the loan, as well as monitoring loan servicing.

There is also the possibility that considerations of commercial reality lead to a recharacterization of the loan (set out in the contract) as a different type of loan arrangement, with different pricing. For example, a 10-year loan is given by a parent to a subsidiary to finance working capital requirements. When borrowing externally for working capital, the MNE would normally get a one-year loan. The 10-year loan is then recharacterized as 1-year revolving loans, which are repeatedly rolled over. This is more in line with the commercial reality of the group's external financing policy. The factors to be considered in conducting the comparability analysis for pricing the loan are also spelled out in detail within the Report.

### **2. Treasury Function**

#### ***a. Intra-Group Lending***

The Report calls for an assessment of whether the treasury centre activities are considered 'low' or 'high' functions. At the lower end of the spectrum is simple cash and liquidity management (i.e., ensuring operating companies have enough cash when they need it), including cash pooling. The higher end may include corporate financial management (i.e., planning to finance investments over the long term, optimizing group cost of capital, strategic responses to group financial risks, etc.). The conducting of higher value adding activities for the group (with real control) will justify a higher profit allocation to the treasury centre versus a more basic coordination fee for lower value activities.

The Report delves into many complex issues, including the issue raised in the Chevron court case (i.e., Chevron versus Australian Taxation Office). The guidance discusses the circumstances in which the MNE group's credit rating will be the more relevant guide for determining the borrowing costs of a group entity in a related party loan than a particular group entity's standalone credit rating (i.e., the importance of 'passive association' of a group entity with the MNE as a whole). If the MNE entity is highly likely to be supported (i.e., implicit support) then the entity would not be expected to pay other group entities for loan guarantees. Consequently, contracts for any guarantee payments would need to be disregarded.

Further guidance is provided in the Report on the use of financial tools to determine credit ratings for an MNE or specific entity, and on interpreting the significance of particular financial metrics for creditworthiness in industries with different features. Guidance is also provided on the choice of transfer pricing method for pricing a loan, on the use of information on credit default swaps to determine the risk premium on a loan, and on the use of economic modelling.

***b. Cash Pooling***

The Report explains how to use the Chapter 1 guidance to determine whether the treasury centre, as cash pool leader, controls the economically significant risks of the cash pool. It also explains how the synergy benefits of the cash pool are to be allocated amongst pool members, and how to deal with cash pool cross-guarantees.

***c. Hedging***

The Report explores how to deal with a number of complex scenarios, involving foreign exchange, commodity price movements and interest rate hedging. It looks at cases where the hedging contracts (while arranged by the treasury centre) are entered into by the group operating company where the hedged risk exists. It also looks at cases where the treasury centre finds 'natural hedges' at group level (e.g., the risks at the level of one operating entity cancel out those at the level of another group entity). It further examines where the treasury centre enters into hedging contracts that counteract risks when viewed at the group level (already taking into account the natural hedges).

**3. Financial Guarantees**

A number of complex issues around guarantee are dealt with in the Report. For example, where the 'implicit support' of an MNE group for a particular group entity is high (e.g., it is strategically crucial), then contracts for intra-group guarantees may need to be disregarded, as they have no economic justification (e.g., these would not be commercially rational for the borrower to enter into in view of its "options realistically available").

Another scenario looked at is where a bank lends money to a financially weak MNE group entity, which is guaranteed by a financially strong group entity. In this case, as no bank would have found it commercially logical to lend to the weak entity, the transaction may be recharacterized as a loan from the bank to the financially sound entity, and an equity injection from the financially sound entity to the weak entity (resulting in part or all of the guarantee fee being disregarded). Extensive guidance on different transfer pricing methods for pricing guarantees are set out.

**4. Captive Insurance and Reinsurance**

In applying the Chapter 1 guidance, the Report highlights that the captive insurance MNE entity needs to be shown to control the risks, and to conduct a commercially rational business, in a way that it can be seen to undertake a 'genuine' insurance business. Relevant factors are set out, including that there is genuine risk diversification, that the entity has the requisite skills, and that the insured risk could be insurable outside the MNE. If the captive insurance entity business makes no commercial sense, and if it does not fully control the relevant risks, the economic benefits of MNE group risk aggregation and management may simply be allocated out to group entities.

**5. Risk-Free and Risk-Adjusted Rates of Return**

The Report also provides guidance where a funder lacks the capability to control the risks associated with investing in a financial asset, then it will only be entitled to a risk-free return. The balance of the financial return may then in turn be allocated to the party exercising control over the investment risk.

It then outlines the importance of choosing an appropriate reference rate that matches the characteristics of the tested transaction such as currency, term and issue date.

This Report also discusses the risk-adjusted rate of return, which the draft guidance notes would be relevant where the party providing funding exercises control over the financial risk but not over any other specific risks. In this case, the funder should only receive a financial return, rather than a return from the wider operations of the business being funded.

## Potential Impact on China Transfer Pricing Environment

The Report explains how accurate delineation analysis applies for financial transaction arrangements. Accurate delineation analysis was a key addition to the OECD Transfer Pricing Guidelines, made in the 2017 update following the 2015 BEPS Actions 8-10 Report [For 2015 BEPS Deliverables, See China Tax Alert [Issue 28](#) (October 2015)]. The extent to which the Chinese tax authorities will adopt the new OECD guidance on financial transactions is yet to be seen. It is inherently challenging to determine how the guidance might be applied, given the absence of detailed guidance on "accurate delineation analysis" in China's existing transfer pricing regulations.

Potentially, we could see China apply some of the guidance in the Report in its administration of financial transactions transfer pricing in the future, such as in the context of bilateral discussions and negotiations with overseas competent authorities. Discussed below are key issues which Chinese taxpayers face in relation to financial transactions.

### 1. Approach to Financial Transactions Transfer Pricing

Per the new accurate delineation guidance, the arm's length mix of debt and equity may be determined based on the economically relevant characteristics of a transaction.

The Report does not mandate accurate delineation analysis as the only approach. It allows for the possibility that countries continue to use domestic legislation and approaches to address the balance of debt and equity funding of an entity and interest deductibility.

In China's thin capitalization administration, interest deductions for intercompany lending may be restricted if the debt to equity ratio of related parties ("DE ratio") exceeds the statutory limit (5:1 for financial institutions, 2:1 for other enterprises). The restriction may be applied unless sufficient documentation to demonstrate the arm's length nature of the intercompany lending is in place.

China's transfer pricing regulations do not preclude the recharacterization of debt in an audit. When determining whether a loan can be regarded as a bona fide loan or should be regarded as some other kinds of payment, Article 17 of *Announcement of the State Taxation Administration on Matters Relating to Improved Administration of Related Party Declarations and Contemporaneous Documentation* ("Announcement 42"), lists the factors taxpayers should consider. These include the solvency and borrowing capacity of the borrower and the group it is associated with, the nature and objectives of debt investments and market conditions, changes in equity investments, etc. [See China Tax Alert [Issue 23](#) (July 2016)] Such requirements focus on the commercial rationality of the intra-group loan, and mirrors the approach in accurate delineation analysis when determining the balance of debt and equity funding.

In practice, the recharacterization of debt has rarely been seen in China, if not entirely unseen, when the DE ratio is within the statutory limit. It remains to be seen if China will introduce further rules regarding the recharacterization of a purported loan for tax purposes as the Chinese tax authorities continue to tighten their administration of intercompany financing arrangements.

Further, many aspects of the Report are geared towards large scale, more complex cross-border financial transactions. Although there are no specific materiality criteria specified in the Report, the application of the Report may be more relevant to a small number of enterprises which have sizeable borrowing capacity, and to the limited number of cross-border transactions that are not restricted by China's regulations on cross-border capital flows.

## **2. Arm's Length Pricing of Intra-group Loans**

According to the Report, the selection of the most appropriate method to price the intra-group loan should be consistent with the actual transaction as accurately delineated through a functional analysis.

Despite the widely used and OECD endorsed approach to establish interest rate through comparable analysis (e.g., performing credit rating analysis, benchmarking comparable loans, and making appropriate adjustments to comparable issuances), in practice, many Chinese taxpayers simply take a rudimentary approach by using the People's Bank of China ("PBOC") benchmark rates (or the Loan Prime Rate in recent instances) in pricing their intercompany financing transactions.

As local Chinese tax authorities generally view PBOC benchmark rates as an acceptable rate, it remains to be seen whether the new guidance would have any practical impact on Chinese taxpayers' approach to pricing intragroup financing transactions, unless it is accompanied by Chinese tax authorities tightening of administration in this area.

Another matter of relevance is interest-free loans. The Report illustrate that a debt can carry the characteristics of equity. A case-by-case analysis is merited to evaluate the arm's length nature of interest-free debt arrangements, i.e. whether it is to be accurately delineated as quasi-equity or debt.

## **3. Cash Pooling**

The Report directs that the appropriate reward of the cash pool leader should be determined based on its functions and risks undertaken. This could range from co-ordination or agency functions to a more comprehensive in-house bank function and risk profile (e.g. assumption of credit risk, liquidity risk and currency risk for intra-group finance). In the case that the cash pool leader only performs co-ordination functions, it should only receive a reward commensurate with its service function, as opposed to retaining the interest spread between deposits and loans. Any synergy benefits arising from the cash pool arrangement after the remuneration of the cash pool leaders should be allocated among the pool members.

This could be very different from the usual practice observed in China, where the cash pool leader generally keeps the rate differentials. This approach inherently assumes that the leader is acting as the in-house bank which is not a light assumption to be made. Whether Chinese taxpayers' behavior will change, to align with the new guidance, again depends on the evolution of the Chinese tax authorities' administrative practices in this area. If applied, comprehensive transfer pricing documentation will also be called on to provide details on the cash pool structure and the returns attributed to the cash pool leader and members.

## **4. Outbound MNEs**

The Report has a potentially significant impact on China's outbound MNEs. As their global footprint has expanded, China outbound MNEs need to navigate through different countries' transfer pricing regimes. These countries may or may not adopt the new guidance prescribed in the Report. This adds an additional level of complexity to group transfer pricing risk management.

For example, it is not uncommon that Chinese group headquarters extend interest free loans to overseas subsidiaries. Whether such arrangements are viewed as arm's length needs to be carefully analyzed based on the local transfer pricing legislation.

Another example is transactions involving treasury operations. Under the new guidance, treasury functions need to be accurately delineated to allow for arm's length remuneration for the treasurer under different structures, based on different degrees of centralization. The current pricing for treasury functions may need to be (re)examined to assess whether it is compliant.

Given the challenges brought by the ever-evolving transfer pricing environment, and the complexities of local legislation, the Report provides a good basis for countries to consider a more unified and consistent approach for the examination and administration of intra-group financing transactions. For instance, the Belt and Road Initiative Tax Administration Cooperation Mechanism ("BRITACOM") might consider leveraging the guidance in the Report for discussion amongst BRI countries, including China, on the potential for greater alignment to alleviate issues faced by BRI cross-border investment. Tax treatment for many financial transactions varies widely amongst these countries. Greater consideration could lead to more consistent tax treatment for MNE global operations.

## 5. KPMG Observations

In recent times we have noted that the Chinese tax authorities have been taking a more assertive stance on intra-group financing transactions. We expect this to intensify going forward against the backdrop of the evolving global transfer pricing environment. The new guidance will provide the tax authorities with an additional tool in performing tax audits, particularly in areas where different interpretations and disagreements exist. We have already seen challenges arising in the areas of thin capitalization, cash pooling arrangements, intra-group loans, etc. in China. With more audits targeting such transactions, we expect that the Chinese tax authorities will gradually sharpen their understanding of financial transaction arrangements, and Chinese taxpayers will have more precedents to follow. Chinese taxpayers will need to stand ready to defend their related party financing arrangements when audit activity increases.

As noted above, while many types of financial arrangements dealt with under the new guidance are limited in China due to regulatory restrictions (e.g. certain more bespoke financial instruments), this could change in the future as Chinese regulations on cross-border financial arrangements are further liberalized.

Taxpayers are recommended to proactively review their existing and planned financial transactions and consider mitigating actions to address the gap. Consideration should also be given to documentation preparation. Though the Report does not specify any documentation requirements, it does call for careful preparation of documentation to support the transfer pricing for the financial arrangements. This includes analysis on the commercial rationality of loans, functional analysis for cash pooling and treasury functions and return allocation, direct/ indirect benefits for pricing guarantees, etc. Where required, taxpayers should seek professional support to carefully formulate the pricing policy and documentation strategy.

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