OECD discussion draft

Transfer pricing of financial transactions

July 2018

On 3 July 2018 the OECD published a discussion draft on the transfer pricing of financial transactions but does it pose more questions than answers?

The discussion draft, published under the Base Erosion and Profit Shifting (BEPS) Action Plan, provides additional transfer pricing guidance on several types of financial transactions but asks numerous questions of commentators. The draft guidance does not reflect a consensus view of OECD member states and this is evident in some of the questions posed to commentators. The OECD has invited comments on the paper to be provided by 7 September 2018.

Key topics discussed in the draft include:

- The application of the principles contained in the OECD Guidelines to transfer pricing of financial transactions;
- Economically relevant characteristics that should be considered when analysing the terms and conditions of financial transactions; and
- Specific transfer pricing issues related to treasury functions, intra-group loans, cash pooling, hedging, guarantees and captive insurance.

Key themes arising throughout the draft include:

- The importance of accurate delineation of the actual transaction in advance of considering the pricing;
- A focus on two sided analyses and consideration of options realistically available; and
- The concept of implicit group support needing to be taken into account in almost all cases.

The remainder of this article looks at the key topics covered by the discussion draft in more detail, the questions raised and our opinion on the proposed guidance.

Identifying commercial or financial relationships

The first section of the discussion draft focuses on the principles that apply with respect to the accurate delineation of a financial transaction, linking this in with Section D.1 of the OECD Guidelines.

Whilst the discussion draft acknowledges that accurate delineation of the actual transaction may also relate to the capital structure of an entity, the discussion draft specifically notes that the guidance is not intended to prevent countries from implementing other approaches to address capital structure and interest deductibility under domestic law. It is our view that, as a result, the discussion draft is missing meaningful guidance when it comes to assessing the arm's length quantum of debt from a transfer pricing perspective.

Further, it can be argued that the interest deductibility standard recommended by the OECD in BEPS Action 4 conflicts with the arm's length standard by applying a formulaic approach to determining the acceptable amount of interest rather than considering the terms that would have been agreed between independent parties. It would be useful to have had some commentary in the discussion draft that acknowledges and explains the rationale for this.

The discussion draft provides an example of economically relevant characteristics that may be useful in delineating an advance of funds. This goes on to note the importance of considering a two-sided analysis of the conditions that independent parties would have agreed to, i.e. what an unrelated lender would be willing to lend and what an unrelated borrower would be willing to borrow. Consistent with previous BEPS reports, the discussion draft advocates looking beyond the contractual terms of the transaction, and for consideration to be given to the full set of circumstances surrounding the transaction and the options realistically available to both parties.

Economically relevant characteristics

This section of the discussion draft closely follows the comparability factors outlined in Chapter I of the OECD Guidelines.

As touched upon in the previous section, the discussion draft reiterates the importance of considering the actual conduct of the parties to a transaction, rather than placing reliance on the contractual terms to appropriately delineate the actual transaction. That being said, we still see intra-group agreements as being important evidence to demonstrate the intentions of the parties at the time of the transaction. They provide a starting point from which to discuss the economic analysis, reducing the scope for tax authorities to jump straight to an alternative hypothesis without at least considering the actual terms of the arrangement entered into.

The discussion draft states that a functional analysis will be necessary to accurately delineate the actual financial transaction. It sets out some of the typical functions that might be performed by a lender and a borrower in a typical lending arrangement. It also outlines some of the key characteristics for loans and the economic circumstances that will be important when identifying comparables.For example, the timing of issue of a financial instrument, the geographic location and the currency. Specifically, the discussion draft notes that the most useful comparables might be those issued closest to the date of the tested transaction and that multiple year data might not therefore provide useful comparables.

Whilst this makes sense on a technical level, there can often be data limitations that make this more challenging in practice. The discussion draft doesn't provide a similar level of guidance on the economically relevant characteristics for other financial transactions outside of intra-group loans.

The draft explains that business strategies are important when undertaking a comparability analysis given that different strategies can have a significant effect on the terms agreed between independent enterprises. It also provides an example whereby independent lenders may agree terms with a borrower undertaking an acquisition which might not have been agreed had the purpose of the financing differed.

Risk-free rate of return

Commentators are asked to provide views on the whole section of the draft guidance considering the use and quantification of a risk-free rate of return. The discussion draft outlines the importance of choosing an appropriate reference rate that matches the characteristics of the tested transaction such as currency, term and issue date. Commentators are specifically asked to suggest realistic alternatives to government issued securities which the guidance views as being a commonly used measure of a risk-free rate.

The discussion draft sets out that, where a funder lacks the ability to control the risks associated with investing in a financial asset, then they 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. Could this then mean that a significant proportion of the financial return would be attributed to a potentially small number of risk management staff even if they have no capital at risk?

This section of the draft 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.

This is in line with the guidance previously set out in respect of developing intellectual property.

Treasury function

Whilst the discussion draft starts by talking about the management of group finances being an important and potentially complex activity, it goes on to say that *"the treasury function will usually be a support service to the main value-creating operation"* and suggests that it might then be relevant to refer to the guidance on transfer pricing of intra-group services.

Clearly in a number of organisations, the treasury function does not simply act as a service provider but may instead act in the capacity of an in-house bank, having complex functionality, making strategic risk decisions and managing significant assets for the group. The discussion draft does not acknowledge this type of model, nor does it attempt to provide any commentary in respect of how the pricing of individual financial transactions interacts with the return due to the treasury function.

Intra-group loans

This section of the discussion draft is centred on assessing both the lender's and borrower's perspectives and the importance of a two-sided analysis. There is a discussion around the typical considerations and business strategies that might apply from a lender's and borrower's perspective. The discussion draft indicates that these factors should be considered when delineating the actual transaction and the terms that would have been agreed in an independent transaction.

An interesting point is raised around how consideration would be required where there is an intra-group loan from a parent company and the assets of the subsidiary have not already been pledged elsewhere. The question taxpayers will need to consider is whether those assets should be expected to serve as collateral and therefore be taken into account when considering the pricing.

Credit ratings

The discussion draft introduces the concept of credit ratings and acknowledges that tools are available to rate specific debt borrowings where a formal credit rating is not available.

The discussion draft notes the key differences between a formal credit rating and the principally quantitative analysis that many tools employ, correctly pointing out that the appropriateness of the analysis when using these tools is largely dependent on the accuracy of the inputs.

Whilst not explicitly stated, our view is that the guidance suggests a general acceptance of the use of these tools where formal credit ratings are not available and where you can demonstrate the inputs are appropriate.

Effect of group membership

This section of the discussion draft opens with a question to commentators, asking whether it would be useful for the purpose of tax certainty and tax compliance to either presume that the credit rating of group members is the same as that of the group, or whether the group rating can serve as a starting point from which adjustments can be made to arrive at the credit rating of the group members.

The discussion draft is clear that the OECD believes that an independent lender would usually take into account the implicit support that might be present from elsewhere in the multinational entity (MNE) group and that this would then in turn impact on the credit profile of the borrower.

It notes that, where there is strong implicit support, then the credit rating of the borrower would be more closely linked to the group rating, and that only in cases where the borrower is of no strategic importance to the group and has weak linkage might it be appropriate to consider its own stand-alone rating. Whilst the discussion draft advocates the consideration of implicit support, we note that this would represent a significant shift in approach should it be adopted by those tax authorities who to date have strictly followed a 'stand-alone' approach when considering the creditworthiness of a borrower. We expect this to be one of the key points of contention when trying to reach consensus across the member states.

The remainder of this section considers the characteristics that might indicate how strong the implicit support might be and follows similar logic to the principles outlined in Standard & Poor's Group Rating Methodology.

However the draft guidance stops short of providing meaningful suggestions on how to quantify the implicit support being provided.

Covenants

The discussion draft includes four paragraphs in respect of covenants, yet it is only the final sentence that provides us with any guidance. It reads *"Where there is an absence of covenants in any written agreement between the parties, it will be appropriate to consider under Chapter I guidance whether there is, in practice, the equivalent of a maintenance covenant between the parties and the consequential impact upon the pricing of the loan."*

Interestingly this single point of guidance only mentions the consequential impact upon the pricing of the loan, but doesn't mention whether a breach of an equivalent maintenance covenant would be expected to lead to a more fundamental review of the quantum of debt that is then considered to be arm's length.

Banking options

The discussion draft notes that written opinions or quotes from independent banks would not generally be regarded as providing evidence of arm's length terms and conditions. Whilst we acknowledge that quotes or opinions do not represent an actual price, some quotes might have significant analysis supporting them and may include references and consideration of actual prices in the market. When considering whether reliance can be placed on quotes/opinions we feel that rather than dismiss them entirely, consideration should instead be given to the reliability of alternative evidence available to determine the arm's length pricing. It would be helpful if the guidance explored possible situations where it could still be appropriate to use this data to help determine an arm's length price and what might constitute a meaningful quote/opinion.

Cash pooling

Based on our experience, cash pooling is an area of common tax authority scrutiny. With several elements to consider, such as what return to give the cash pool leader, how to share the benefits and the appropriate use of a cash pool vs term funding, it is also an area where taxpayers would benefit from clear guidance.

The discussion draft starts with a question to commentators that seeks to explore situations under which the cash pool leader is allocated risks rather than simply performing a coordination/service provider role.

The questions posed explore the circumstances under which the proposed approaches to rewarding cash pool participants might be most appropriate, as well as inviting suggestions for other ways to determine the pricing of cash pooling arrangements. The discussion draft does not provide clear guidance, but rather poses a number of approaches for consideration.

As with other sections of the discussion draft, a significant amount of the content serves as a primer, defining what a cash pool is, the typical types of cash pools and why they commonly exist in MNEs. The discussion draft considers the concept of sharing the netting benefit across cash pool members provided that an appropriate reward is allocated to the functions performed by the cash pool leader. There is a recognition that cash pooling arrangements should be used for short term liquidity and that balances that are more appropriately delineated as longer term balances should be defined and priced as such.

The draft notes that "*It would be of assistance to tax authorities if MNE groups would provide information on the structuring of the pool and the returns to the cash pool leader and the members in the cash pool as part of their transfer pricing documentation".* There is then a reference to Annex I to Chapter V of the OECD Guidelines, which covers the content of the Master File. The information noted above goes beyond the level of detail currently required for a Master File. This raises the question of whether more detailed disclosures with respect to financial transactions are going to be expected in the future.

The discussion draft sets out some draft guidance for rewarding the cash pool leader and the cash pool members. It notes that, in general, a cash pool leader performs no more than a coordination or agency function. As such, the remuneration would be as a service provider and similarly limited. Where there are activities or risks beyond this role, the discussion draft suggests following the approaches included in other sections and makes particular reference to the draft guidance on loan pricing.

With respect to rewarding the cash pool members, three suggestions are provided, although very little guidance is provided to indicate when each of these approaches might be most appropriate. More specifically, one option suggests applying the same interest rate for all participants, regardless of whether they are a borrower or depositor. However, this could ultimately result in a net profit or loss in the cash pool leader. This would appear to conflict with the guidance that indicates that the cash pool leader should generally earn a limited services-type remuneration, rather than be exposed to profit or loss volatility.

The discussion draft states that it is common within cash pooling arrangements for cross-guarantees to exist, but it notes that the practical result of the cross-guaranteeing is often that the formal guarantee may represent nothing more than the enhancement attributable to the implicit support of other group members. To this extent, the draft guidance suggests that no guarantee fee would be due.

Hedging

The discussion draft outlines some examples of how hedging might occur within an MNE. It notes that, where a centralised treasury function arranges a hedging contract on behalf of an operating company, then it should be seen as providing a service for which it should receive arm's length compensation.

The draft does note that more complicated issues may arise where the positions and hedges are not matched within the same company.

However, little guidance is provided on how this type of arrangement might be managed, apart from mentioning that a comprehensive analysis of the actual delineation of the transactions would be required. The discussion draft asks commentators how the delineation of the actual transaction might affect the profits and losses in the relevant entities, and whether the risk associated with an unhedged position in an entity should be treated as being assumed by the unhedged MNE or instead by the entity which sets the group policy.

Guarantees

The discussion draft considers the transfer pricing consequences of financial guarantees and, as might be expected given the title, does not provide any comments on other forms of guarantees, such as performance guarantees.

The draft reiterates the fact that implicit support arising from being part of a group should be factored into any analysis when considering what the non-guaranteed cost of borrowing might be. The discussion draft goes on to note that generally the absence of an explicit guarantee means that any implicit guarantee arises from passive association with the group, hence a fee would not be payable. It also notes that the existence of an explicit guarantee does not necessarily mean a fee would be payable. Rather, a fee would only be payable to the extent a benefit is provided over and above the benefit arising as a result of being part of a group.

The draft discusses several approaches to pricing a guarantee. It acknowledges that credit enhancing guarantees are unlikely to be found between unrelated parties and hence application of the comparable uncontrolled price (CUP) method can be difficult.

It also outlines the yield and cost approaches, as well as the valuation of expected loss approach and the capital support method. Whilst the discussion draft acknowledges that these might provide upper and lower bounds for the fee that might be payable, there is no discussion around which methods might be most appropriate under different circumstances. There is also no guidance around how to substantiate an arm's length fee within the upper and lower bounds, for example as derived under the cost and yield approaches.

The examples included in this section are particularly simplistic, illustrating where a guarantee has or hasn't provided a benefit. The examples do not seek to illustrate how any of the suggested approaches could then be used to determine an arm's length guarantee fee.

Captive insurance

The discussion draft sets out to deal with the consolidation of risks within a group through a so-called 'captive' insurance company, defined as a group member that provides "insurance-type services." As this definition suggests, much of what follows challenges whether such transactions should be recognised at all, whether they are actually insurance, or whether they should be disregarded.

Of the four initial questions to commentators, three are around substance and whether a captive of this kind can satisfy the requirements regarding control of risk in Chapter I of the OECD Guidelines.

The fourth question invites comments on the consequences for premiums, claims and investment income of a captive failing to satisfy the control of risk requirements. Unsurprisingly, what follows seems primarily to concern ways for tax authorities to disregard the entire arrangement.

There is a section of the discussion draft focused on pricing transactions with a captive insurer, in cases where these transactions are nonetheless recognised. The OECD recognises that reliable external CUPs may not be available (in practice, as insurance is a private contract between insurer and insured it seems unlikely that in most countries there would be public data on premiums for individual transactions).

The use of actuarial methods to arrive at a price is then discussed, but with a question to commentators as to the practical application of such an approach.

The draft suggests a CUP can be arrived at by combining two methods better described as a transactional net margin method (TNMM): the combined ratio for the underwriting result and the investment return of the captive.

The combined ratio compares premiums to claims plus expenses, but there is no guidance on identifying appropriate comparables or making comparability adjustments for differences in the cost base of captives and independent insurance or reinsurance companies. The investment return on capital should be limited to the return on the regulatory capital requirement plus a reasonable buffer, and the focus is on whether the capital is invested in connected party investments such as loans. It is unclear whether the investment return on premiums is to be included; presumably it is meant to be included, but only to the extent the premiums themselves have been shown to be arm's length.

The discussion draft suggests that the pricing of premiums must also take group synergies into account. If group risks are pooled in the captive and then reinsured, savings may arise from the reinsurance of a diversified pool of risk compared with the sum of the premiums each group member would otherwise have paid to a third party. These savings should be allocated amongst the insured. In this respect, the captive is treated in a similar manner to a procurement company under the OECD Guidelines.

The final part of this section deals with 'agency sales' and effectively describes the UK *DSG Retail* First-tier Tribunal decision.

An example is included of an insurer wholly-owned by a retail group that sells high-value new technology consumer goods. The insurer provides accidental damage and theft cover to the group's customers, sold at the point of sale of the consumer goods. The insurance contracts are very profitable, but the retailer receives a commission benchmarked against independent agents selling similar (less profitable) insurance products. The paper suggests that, instead, the insurer should receive a benchmarked return and the excess profit should go to the high-street retailer, who has the advantage of intervening at the point of sale which provides the opportunity to charge higher premiums.

Two further issues need highlighting which are not immediately apparent from the captives section of the draft. The first is that there is no discussion in the pricing section of the use of broker quotes, a very common method of establishing arm's length pricing for captives. The earlier section on intra-group loans, however, states clearly that banker's quotes are not acceptable for establishing arm's length rates of interest, on the grounds that such quotes are not transactions. The same argument could easily apply to broker quotes used by captives to set premiums, however detailed they may be.

The second issue is one of scope. The entire discussion draft, including the section on captives, refers consistently to MNE groups and their members. A financial services group operating in more than one jurisdiction falls within this definition. As drafted, therefore, the material in the captive insurance section could apply equally to intra-group reinsurance between members of an insurance group (or intra-group retrocession in a reinsurance group).

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In summary, few captives will be unaffected if their business model currently gives rise to profits:

- A captive that cedes risk into the reinsurance market, but that charges premiums based on the arm's length price each group member would pay for direct insurance as a stand-alone entity, must pass on all the benefits of group synergy: effectively simply allocating the reinsurance premium among the insured.
- A captive that retains risk and sets the premiums by reference to broker quotes, however detailed, must replace these with premiums set by reference to benchmarked combined ratios, effectively passing on to the insured the benefit of its low cost base and zero acquisition costs. There is no recognition that, in some lines of insurance, one year's claims can be so severe they cancel out the profits earned in the previous years. If underwriting is outsourced, as day-to-day underwriting for captives often is, this may indicate capital in the captive should not earn an underwriting return and therefore the premium based on the benchmarked combined ratio should be further reduced to eliminate reward for insurance risk.
- Finally, if risks are retained because cover is not available in the market, that is described as an indicator that there is no commercial rationale for the transaction and it should be disregarded.

It seems captives, and perhaps some intra-group reinsurance arrangements within insurance groups, are squarely under attack.

Conclusion

Whilst the discussion draft is a step in the right direction and covers a number of important topics, it falls short of providing meaningful guidance or best practice when it comes to practically demonstrating compliance with the arm's length principle for financial transactions. While there is some useful recognition of the economic characteristics that should be considered in delineating financial transactions and there are some suggestions on how to arrive at an arm's length price, these are largely speculative and incomplete in areas.

We hope the OECD embraces responses to the discussion draft to help expand the guidance, so that once finalised (and if consensus can be reached) it can serve as a useful reference point for taxpayers and tax authorities alike.

Transfer pricing for financial transactions continues to be a high-focus area. Regardless of achieving consensus on the content of this discussion draft, its publication will undoubtedly prompt some form of response from a number of tax authorities. Taxpayers should consider how their pricing policies might be viewed in light of this latest guidance and should ensure that they have sufficient evidence to demonstrate the arm's length nature of their intra-group financial transactions.

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