# OECD transfer pricing (final) guidance on financial transactions: Initial impressions

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# Introduction

As part the base erosion and profit shifting (BEPS) project, Actions 8-10, the Organisation for Economic Cooperation and Development (OECD) on 11 February 2020 issued final recommendations ("OECD guidance" or "final guidance") regarding the arm's length treatment of various financial transactions among related parties. This follows release of proposed guidance in July of 2018 ("draft guidance"), and applies transfer pricing methods to intercompany loans, cash pools, financial guarantees, hedging transactions, and captive insurers.

Read about the February 2020 release of the OECD final guidance: ***TaxNewsFlash***

The following discussion provides initial impressions and observations, including notes about changes from the 2018 draft.

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# Accurate delineation of the transaction

The final guidance retains the accurate delineation analysis for financial transactions from the draft guidance. Under this approach, the mix of debt and equity can be challenged by a tax authority based on the economically relevant characteristics of a transaction—such as an enforceable obligation to pay interest; cash flow projections supporting a borrower's ability to meet its obligations; the ability of a borrower to obtain funds externally; contractual terms; industry factors; and alternatives realistically available to the lender and borrower. A functional analysis of the parties involved, particularly with respect to the lender's ability to bear and manage the risks inherent in the financing transaction, may be essential in accurately delineating the transaction, as well as relevant aspects of business strategy associated with the transaction.

Among the industry factors that may be taken into consideration in accurately delineating a transaction, including with regard to any of the specific areas discussed below, is the effect of government and other regulation. The financial services sector is specifically, if fleetingly, cited as an industry where "due regard" should be given to the constraints of regulations, such as capital requirements.

### KPMG observation

While far from a carve-out for financial services firms, this language appears to accept that financial transactions can be characterized and analyzed in ways which acknowledge the unique features of this industry.

The OECD guidance allows for the possibility that individual jurisdictions may eschew an accurate delineation analysis in favor of alternative approaches to determining the arm's length mix of debt and equity. Many countries currently have their own debt/equity characterization rules that do not depend on an accurate delineation approach.

## Treasury functions

Transactions involving centralized treasury operations also need to be accurately delineated, including with regard to the identification and allocation of the economically significant risks (in accordance with Chapter I of the OECD Transfer Pricing Guidelines). This allocation, as well as the characterization of the treasury functions in general, will largely depend on the structure under which the treasury organization is structured. The latter can range from a completely decentralized approach, under which each operating entity handles its own financial transactions and treasury plays a supporting role, to a fully centralized arrangement where treasury has full responsibility for funding and related functions.

### KPMG observation

Most real-world treasury functions fall somewhere in the middle of these extremes, while the complexity of the treasury function in multinational banks will usually be of a different order of magnitude.

## Loans

The OECD guidance reiterates the central role of a credit analysis of the borrower when pricing an intra-group loan, including through application of commercial "synthetic" credit rating tools and methodologies. The "implicit support" derived by an individual entity from its membership in a multinational group should be considered, with the entity's stand-alone credit rating adjusted up if the facts and circumstances support doing so.

## KPMG observation

However, there is no mention of a "rebuttable presumption" that an individual entity's credit rating should by default be viewed as equal to that of its parent or global group, as was floated in the draft guidance, although equivalence with the group rating is possible if supported by the facts (e.g., the importance of the entity to the overall business, regulatory obligations). The final guidance therefore hews closely to rating agency considerations of implicit support.

Loan covenants—such as limitations on a borrower's total allowable debt—are often included in agreements between unrelated parties, in part to alleviate the possible consequences of asymmetrical information between the parties. While such asymmetry will normally not be a factor in the case of related-party loans, the degree of interaction between the affiliates may mirror in many ways the protections provided by loan covenants. Consequently, the OECD guidance suggests that accurate delineation of the transaction could require taking into account the effects of such covenants in pricing an intra-group loan.

Finally, the OECD guidance discourages the use of credit default swaps to benchmark loan credit spreads (resolving a question left open in the draft guidance), and reiterates the unreliability of bank opinions as loan pricing indicators. (No differentiation is made as to potential distinctions in reliability among bank opinions, e.g., with respect to the depth of analysis that may support them.)

# Cash pools

There is not much change in the discussion of cash pooling arrangements in the final compared to the draft OECD guidance. Application of an accurate delineation analysis can lead to re-characterization of debit and credit balances in the pool, which are meant to be short-term arrangements, into long-term loans or deposits if they are left outstanding for a long period of time. How long is too long may vary in different situations, with consideration possibly given to patterns over multiple years and the context of the group's overall funding policies.

Also consistent with the draft guidance, the final guidance directs that any synergies accruing to the multinational group from the operation of a cash pool, such as aggregate savings on external borrowing, should be allocated to the pool participants. The final guidance recognizes that identifying and collecting the data required to implement such an allocation is a challenge, as well as for tax administrations evaluating the arrangements. Consequently, taxpayers are called on to prepare comprehensive documentation of the pool structure as well as the returns to the cash pool leader and pool participants.

As with an in-house treasury operation, arm's length remuneration for a cash pool leader should be determined based on its functions and incurrence of economically significant risks (e.g., liquidity risk, credit risk).

# Hedging

A multinational group may centralize the hedging of risk in a treasury entity. If hedges are executed in the name of specific operating companies, traditional transfer pricing analyses should reflect arm's length dealings and returns for the operating companies on a stand-alone basis. However, if hedges are entered into in the name of the treasury entity, or that of another group entity, specific operating company results will not reflect the protection of the relevant positions at the group level. The same would be true in case there exist natural hedges within the multinational group, but not within the same entity that bears the initial risk. In these situations, the OECD guidance does not endorse attributing hedges to individual entities unless a comprehensive accurate delineation analysis indicates that it would be appropriate to do so.

# Guarantees

The OECD guidance reiterates that financial guarantees are compensable if they provide measurable benefits, such as a reduction in the borrower's interest costs. Consistent with the draft guidance, if a guarantee from a related party has at least the partial effect of increasing the beneficiary's borrowing capacity, an accurate delineation analysis may split the transaction into two parts: (1) a loan from the lender to the borrower, based on the latter's capacity without the guarantee; and (2) a loan from the lender to the guarantor, followed by a capital contribution to the borrower. The guarantee fee should be calculated only on (1).

Similar to intra-group loans, implicit support should be considered when pricing a guarantee, such as when applying a yield-differential approach. As with the draft guidance, performance guarantees are not addressed; only financial guarantees.

# Captive insurance

Captives are defined as companies whose primary, and perhaps only, function is to insure risks of entities belonging to the same multinational group. The final guidance tones down some of the language on possible re-characterization of captive insurance transactions, as compared to the draft guidance, but such arrangements are still subject to multiple challenges, including:

- Is there sufficient diversification to justify delineating the transaction as insurance?
- Is there an economic capital benefit to both the group and its members?
- Does that benefit arise from group synergies (in which case it should be shared with insured members through lower premiums)?
- Does the captive or another group member exercise control of risk?
- Are the risks insurable?

Some of the potential challenges to captive arrangements stem from a less-than-full appreciation in the OECD guidance of the similarities between captive and "traditional" insurers, including with regard to the level of regulation, diversification of risk, and commercial aspects of captive insurance. It seems prudent for taxpayers to focus on these and similar factors in carefully documenting the arm's length nature of their captive programs.

When the captive is accurately characterized as an insurance company, a method is then proposed (consistent with the draft guidance) to establish an arm's return as the sum of a benchmarked return over claims and expenses plus an arm's length investment return. In practice, this will give rise to many challenges relating to comparability, and will often result in premiums below those available in the open market.

## KPMG observation

While the OECD guidance also covers intra-group reinsurance within insurance groups, it focuses heavily on captives and there is little additional guidance on reinsurance companies. There is, however, a clear statement that the principles of Chapter I regarding accurate delineation and allocation of risk apply equally to intra-group reinsurance. With both captive insurance and reinsurance, a transfer pricing analysis may be helpfully informed by a careful distinction between the control of risk (attributed to the insured) and the transfer/assumption of risk (by the captive or the reinsurer). In both cases, transferring risk, or some portion of it, does not cede control.

Finally, similar to cash pooling, any synergies created by a captive program may need to be shared among the group companies.

Expect more in-depth analysis of the key provisions of the final OECD guidance in the coming days and weeks.

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