Transfer pricing of treasury transactions

Navigating the complexities of intercompany financing

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Foreword

The corporate treasury is the department responsible for managing a company's liquidity and financial risks. Its primary goal is to ensure that the company has the right amount of money in the right place, at the right time and in the right currency, to meet its obligations and fund strategic goals. Specific intercompany financing transactions can be deployed by the corporate treasury to achieve core goals:

Liquidity and capital allocation ("right amount and right place"): A multinational enterprise (MNE) might have millions in surplus cash sitting in a Middle Eastern parent while an Asian subsidiary is struggling to pay its suppliers. Treasury transactions such as cash pooling, corporate guarantees and intercompany loans can be used to fix this imbalance.

Funding and cash flow management ("right time"): Cash flow is rarely synchronized, and expenses can often arise before revenues are collected. Short-term borrowings such as revolving credit facilities and short-term deposits and placements can help to ensure that periodic supply remains uninterrupted.

Foreign exchange management ("right currency"): MNEs operating globally may pay expenses in one currency and collect revenues in another. Using tools such as FX spot trades, forwards and swaps, the corporate treasury can help manage foreign exchange volatility risk and minimize costs of expensive external currency conversions.

When such treasury transactions take place between related parties, arm's length pricing considerations apply. Intercompany treasury transactions are among the most sensitive related party transactions and are closely scrutinized by tax authorities worldwide because they have a direct impact on interest deductibility, profit allocation, and cross-border cash flows, resulting in a high potential for Base Erosion and Profit Shifting (BEPS).

As a result, even routine or commercially driven funding arrangements are subject to increasing scrutiny, and tax authorities require rigorous documentation, economic modelling and alignment with contractual terms to demonstrate that the transaction was driven by commercial rationale rather than tax avoidance.

The structuring and pricing of intragroup treasury transactions can therefore have a direct and lasting impact on a group's effective tax rate (ETR). When financing arrangements are aligned with the arm's length principle and supported by commercial evidence, interest expense deductions may be accepted. Conversely, transfer pricing adjustments to transactions—such as the disallowance of interest, recharacterization of debt, or denial of treaty benefits—can result in permanent tax leakages —for a group. Accordingly, financing-related challenges are among the most significant drivers of long-term ETR volatility for multinational groups, rendering adherence to local and global standards of arm's length pricing a critical area of focus for group treasuries.

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Regulatory guidance around arm's length pricing

The definitive global standard for the arm's length pricing of treasury transactions is available in the OECD Transfer Pricing Guidelines, specifically Chapter X on Financial Transactions, which was formally integrated into the guidelines in 2022. Prior to the publication of Chapter X, guidance on the pricing of financial transactions was derived from general principles which often failed to capture the nuances of capital markets, credit risk spreads and group affiliation. Chapter X presents a fundamental recalibration of approach by mandating a two-stage analysis for any financial transaction: the accurate delineation of the transaction followed by the determination of an arm's length price.

The accurate delineation process enables tax authorities to recharacterize debt transactions for tax purposes where the borrower may lack the capacity to avail the loan or lack the capacity to repay the principal or where the terms are so favorable that no independent lender would have extended credit.

The financial capacity of the borrower to service the debt is often measured through quantitative indicators such as interest coverage ratio and debt to EBITDA ratio alongside other qualitative factors. If any entity's projected cash flows are insufficient to cover interest and principal repayments, tax authorities may recharacterize the funding as a capital contribution, which could lead to a disallowance of interest deductions, and, depending on domestic law and treaty application, give rise to potential withholding on payments reclassified as dividends.

For intercompany funding transactions that have been successfully delineated as debt, the next step is benchmarking of the interest rate. The comparable uncontrolled price (CUP) method is the preferred method, and all economically relevant characteristics must be analyzed to determine comparability, including contractual terms, market conditions and the risks borne by the borrower and lender. The currency, maturity and credit rating should be matched along with loan features and covenants in selecting comparables from publicly available databases. The rate resulting from the benchmarking analysis must be commercially acceptable from both the lender's and borrower's perspectives, and should incorporate the impact of covenants, guarantees, collateral, fees and timing.

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Intragroup financing in the UAE and Saudi Arabia

The UAE Transfer Pricing Guide (under Federal Decree Law No. 47 of 2022), specifically Transfer Pricing Bylaws (issued by ZATCA in 2019 and updated in 2023) supported by the KSA Transfer Pricing Guidelines, both reference the OECD Transfer Pricing Guidelines, particularly Chapter X, as the interpretive basis for pricing intragroup financial transactions.

The most significant recent development in Saudi Arabia is the extension of the applicability of the Saudi Transfer Pricing Bylaws to Zakat payers effective for financial years 1 January 2024 onwards. The tax authority in Saudi Arabia now requires Zakat paying entities to demonstrate that their intercompany dealings are at arm's length to prevent the artificial reduction of the Zakat base. This integration of transfer pricing and Zakat creates a unique challenge from the perspective of financial transactions - the characterization of the transaction as debt or equity has direct implications for the Zakat base. Loans from related parties are generally treated as debt but if they lack commercial terms or fixed payment schedules, they may be reclassified as equity which gets added back to the Zakat base, potentially increasing the Zakat payer's liability.

In the UAE, transfer pricing is a critical determinant for free zone entities to maintain a zero percent (0%) corporate tax rate on qualifying income. A qualifying free zone person (QFZP) must comply with the arm's length pricing requirement for all its related party transactions, both domestic and international. If a QFZP fails to price its intercompany loan at market rates, it risks losing its qualifying status on material and repeated non-compliance and being subject to the standard nine percent (9%) tax rate on all income. This creates a high stakes environment for treasury centers located in the UAE free zones necessitating rigorous benchmarking of interest rates and guarantee fees.

Both the UAE and Saudi transfer pricing guidelines closely mirror the OECD's Chapter X by requiring a robust and economically accurate delineation of all intercompany financial transactions. Each jurisdiction mandates that taxpayers go beyond the legal form and examine the real substance of the arrangements, including a detailed analysis of the borrower's creditworthiness, the lender's perspective and options realistically available to both parties. On pricing methodology, the CUP method is considered the most appropriate for intragroup loans, and both regimes follow the OECD's credit rating methodology, requiring both instrument-level and borrower rating that starts from the stand-alone profile and is adjusted for implicit group support based on strategic importance to the MNE.

The alignment extends seamlessly into the treatment of more complex financial arrangements. Both sets of rules adopt the OECD's detailed guidance on guarantee fee benchmarking, including the analysis of the financial capacity of the guarantor, the pricing of the guarantee fee using the yield or cost approaches, and computation of benefit conferred to the borrower, notwithstanding implicit support which is non-chargeable.

For cash pooling structures, the UAE and Saudi guidelines follow Chapter X by demanding a functional analysis of the pool leader and participants, ensuring that the treatment distinguishes physical from notional cash pools and rewards the leader according to actual functions performed and risks borne, allocating synergy benefits to participants, and re-characterizes long-term balances as term loans.

This comprehensive adoption of the OECD's principles confirms that the UAE and Saudi frameworks are not merely inspired by Chapter X but are integrated with its substance, providing a consistent and internationally accepted basis for pricing financial transactions within multinational groups.

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Key areas of focus for tax authorities

Although Saudi Arabia, the UAE and other Middle Eastern jurisdictions have largely aligned their transfer pricing framework to global standards, the practical application of the arm's length principle to intragroup pricing remains inconsistent across the region. This is partly because transfer pricing regimes are still relatively new in the region and many family-owned groups, holding companies and MNEs have historically taken an informal approach to the management of intragroup funding. At the same time, tax authorities across the Middle East have increased their scrutiny of intragroup financing arrangements, and the audits and assessments tend to focus on a defined set of high-risk areas where regional groups are routinely falling short. Some areas of focus are:

- **Excessive leverage:** this is the first and most fundamental area of scrutiny. Authorities examine whether the level of indebtedness is commercially sustainable. Some of the key indicators tested are the borrower's ability to service the debt from operating cash flows, the purpose of funding, and repayment dates. For loans that are perpetually rolled over, or have no security or covenants, or where interest is accrued but never paid, the authorities may form a view that the borrower had no realistic prospect of entering such an arrangement with an independent lender and could recharacterize the debt to equity.
- **Interest-free loans:** This is a particularly high-focus area in the region given the prevalence of such loans in family groups and holding company structures. Tax authorities will typically challenge interest free shareholder loans or intragroup loans that are not supported by commercial rationales and adjustments may typically impute an arm's length income to make the lender whole for their opportunity cost of capital, with potential downstream withholding and corporate tax consequences.
- **Inaccurate determination of credit worthiness:** Reliance on the stand-alone credit rating of the borrower, ignoring the "halo effect" of implicit support from group affiliation and failure to consider the instrument level rating accounting for seniority, security and covenants, are all areas of challenge that tax authorities worldwide have focused on with regards to financing transactions. Some of these have also resulted in landmark court cases and decisions which have shaped the current thinking and framework for credit scoring methods and processes.
- **Explicit guarantees without fees:** In the Middle East, parent companies often guarantee loans for local entities with weak credit to lower borrowing costs, without charging a guarantee fee. Tax authorities treat these guarantees as intragroup services requiring arm's length compensation and may impute a fee. The absence of an explicit guarantee fee becomes even more contentious if the borrower defaults and the guarantor absorbs the loss, as authorities will argue the guarantor assumed uncompensated risk. Consequently, this exposes poor documentation and often leads to denied loss deductibility, recharacterization of financial support as capital contributions, and retrospective pricing adjustments.
- **Informal cash pooling arrangements:** Regional groups may operate informal cash pooling arrangements with no agreements leading to gaps where regional treasury centers act as cash pool leaders but synergy benefits are allocated to participants. Cash pool arrangements also come under scrutiny where the rewards to the leader are not accurately reflective of the functions and risk-bearing activities performed. Long term balances held in cash pool can also be recharacterized as term loans and deposits and interest rates adjusted accordingly.

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How can KPMG help?

The transfer pricing of financial transactions has evolved from a peripheral compliance exercise into a highly scrutinized discipline demanding the same rigor applied by independent lenders in the capital markets. The approach to benchmarking financial transactions can therefore no longer be ad hoc or reactive. Organizations should adopt a proactive, strategic and systematic framework for pricing and managing intercompany financing arrangements.

A strategic approach to financial benchmarking tailors the methodology to the transaction profile. For groups with high-volume, multi-directional intercompany loans, a standardized funding grid offers a highly efficient and economical solution. In contrast, standalone, one-off transactions require bespoke benchmarking to reflect their unique characteristics. For the most material and complex arrangements, advance pricing agreements (APAs) remain the best avenue to achieve certainty and proactively manage tax risk.

Organizations navigating complex intragroup funding, guarantees, or treasury structures may benefit from engaging with practitioners who operate at the intersection of capital markets insight and transfer pricing rigor. Ultimately, achieving an arm's length outcome requires more than rule compliance. It demands a practical understanding of how financing is originated, structured, and priced in the real world. As scrutiny of financial transactions intensifies, the question is no longer whether intercompany financing will be challenged, but whether your pricing methodology can withstand it.

At KPMG, our team of experts leverages specialized experience across banking, mature tax jurisdictions, and regulatory authorities to bridge the gap between commercial financing practice and transfer pricing expectations. Through lender-grade credit analysis, market-based pricing methodologies, and rigorous transaction-level documentation, we help clients build intercompany financing structures that are both commercially coherent and defensible before tax authorities.

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KPMG serves the diverse needs of businesses, governments, public-sector agencies, not-for-profit organizations, and the capital markets.

Our commitment to quality and service excellence underpins everything we do. We strive to deliver to the highest standards for our stakeholders, building trust through our actions and behaviors, both professionally and personally.

Our values guide our day-to-day behavior, informing how we act, the decisions we make, and how we work with each other, our clients, and all our stakeholders.

Integrity
We do what is right

Excellence
We never stop learning and improving

Courage
We think and act boldly

Together
We respect each other and draw strength from our differences

For Better
We do what matters.

Our purpose is to inspire confidence and empower change. By inspiring confidence in our people, clients and society, we help empower the change needed to solve the toughest challenges and lead the way forward.

KPMG's Impact Plan guides our commitments to serving our clients, people and communities across four categories: Planet, People, Prosperity, and Governance. These four priority areas assist us in defining and managing our environmental, social, economic and governance impacts to create a more sustainable future. We unite the best of KPMG to help our clients fulfil their purpose and deliver against the United Nations Sustainable Development Goals, so all our communities can thrive and prosper.

We are dedicated to helping our clients achieve their goals, and advancing sustainable progress to ensure that all our communities thrive. Empowered by our values, and committed to our purpose, our people are our greatest strength. Together, we are building a values-led organization of the future. For better.

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