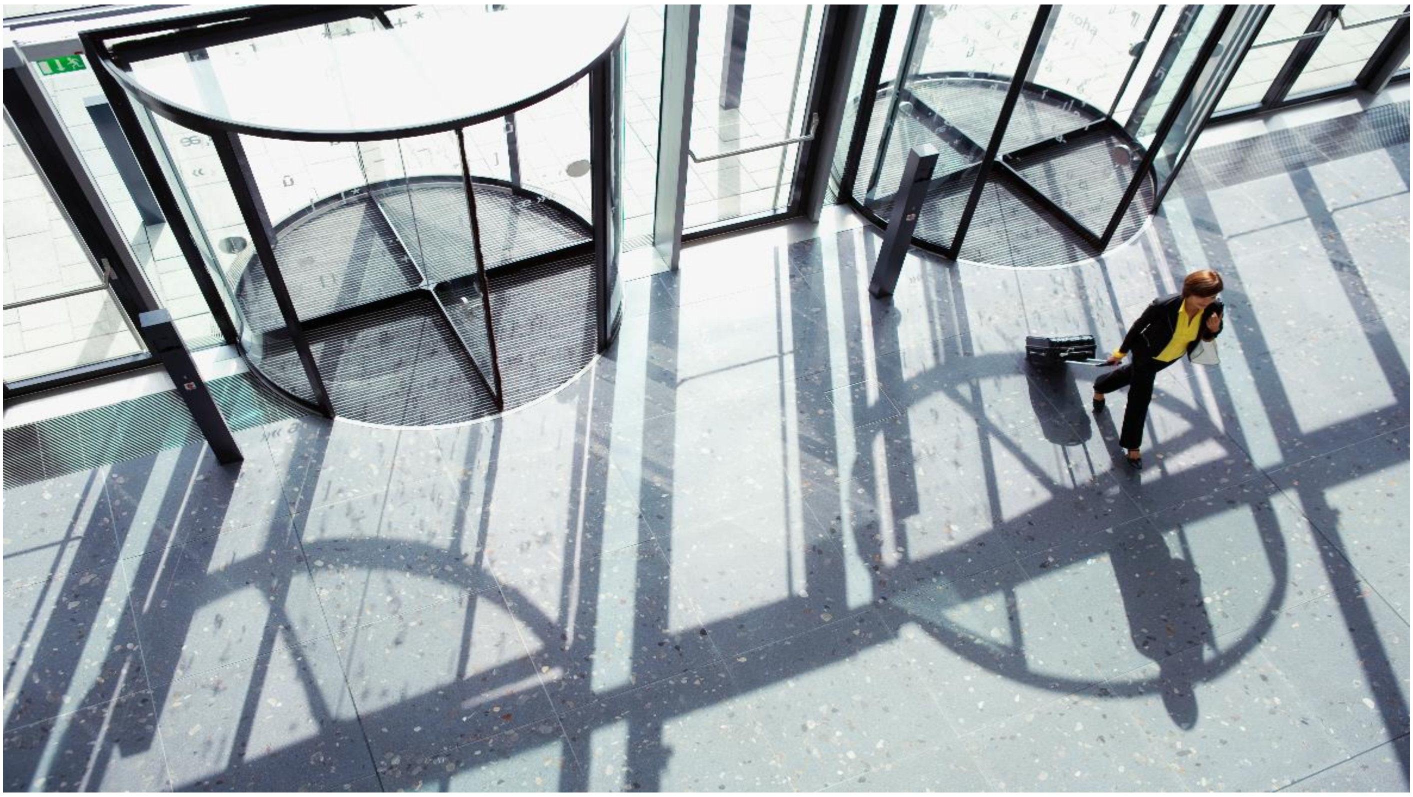
17 July 2018
Australia 2018/14



Tax Insights

OECD releases Discussion Draft on the transfer pricing of financial transactions: An Australian perspective

Snapshot

On 3 July 2018, the OECD released a Discussion Draft on the transfer pricing aspects of financial transactions.

The Discussion Draft follows the work previously undertaken by the G20/OECD in relation to Actions 8-10 of the Base Erosion & Profit Shifting (BEPS) Action Plan on aligning transfer pricing outcomes with value creation. The Discussion Draft does not, at this stage, reflect a consensus position of the governments involved but is designed to provide substantive proposals for further review and comment.

While the Discussion Draft is not exhaustive or instructive, reflecting the fact that it is a non-consensus document, it seeks to ventilate general principles that may be considered in the context of a range of possible financial transactions. Ultimately, as intra-group financing arrangements are such a hot topic globally and given the complexity involved in analysing and pricing financial transactions from a transfer pricing perspective, the

Discussion Draft is welcome additional guidance from the OECD as to how taxpayers may approach this exercise. Once finalised, it is likely that this guidance will form part of the OECD's *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (the OECD Guidelines).

This Tax Insight provides a summary of the Discussion Draft, and provides an Australian perspective in the context of intra-group financing being considered as one of, if not the, most significant risk to the Australian corporate tax base, as identified by senior Australian Taxation Office leadership. It also considers the Discussion Draft against the backdrop of Australia's transfer pricing provisions, the *Chevron* decision *([2017] FCAFC 62)*, and various materials issued by the ATO.

In detail

The first part of the Discussion Draft provides guidance on the application of the principles contained in Section D.1 of Chapter I of the OECD's *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (the OECD Guidelines) to financial transactions. The second part of the Discussion Draft addresses specific issues related to the pricing of financial transactions such as treasury functions, intra-group loans, cash pooling, hedging, guarantees and captive insurance. A few recurring themes surface throughout the Discussion Draft, for example the impact of implicit support, the need to accurately delineate the transaction, the importance of commercial considerations and commercial rationality and reconstruction.

Accurate delineation of financial transactions

The Discussion Draft includes guidance on the application of post-BEPS transfer pricing principles to financial transactions. This includes how to accurately delineate the capital structure (i.e. the mix and types of debt and equity) used to fund an entity within a multinational group. This accurate delineation is necessary before pricing a transaction to determine if adjustments are required, for tax purposes, to the legal form of the transaction. The Discussion Draft also confirms the standing view that Article 9 is relevant to determining the character of the financial instrument as well as pricing.

However, the Discussion Draft is not intended to prevent countries from implementing alternative approaches to address capital structure, and interest deductibility, under domestic legislation. This is important in an Australian context and is discussed further below, in particular the specific provisions governing the interaction of the thin capitalisation and transfer pricing provisions under Australian domestic law.

The Discussion Draft is not intended to prevent countries from implementing alternative approaches to address capital structure, and interest deductibility, under domestic legislation.

In relation to other intra-group financing transactions, delineation of financial transactions should begin with a thorough identification of economically relevant characteristics. This should include:

- an examination of the contractual terms;
- a functional analysis identifying the functions performed, the assets used, and the risks assumed by the parties;
- the characteristics of the financial products and services;
- the wider economic circumstances of the parties and the market; and
- the business strategies of the parties and the wider group.

Treasury functions, intra-group loans, cash pooling and hedging

The Discussion Draft recognises that treasury functions differ from one multinational group to another, including in respect of the degree of centralisation, autonomy, functionality and the risk profile of the treasury function. Differences also exist in groups' strategies relating to corporate financial management, including how costs of capital are optimised, and how investment returns are managed or maximised. Activities undertaken by the treasury team may, depending on facts and circumstances, be services that require remuneration from other group members.

The Discussion Draft recognises that treasury functions differ from one multinational group to another, including in respect of the degree of centralisation, autonomy, functionality and the risk profile of the treasury function.

The transfer pricing considerations for three particular treasury activities often performed within multinational groups are considered. Key issues include:

i) Determining an arm's length rate of interest on **intra-group loans** through:

- Consideration of both the lender's and borrower's perspectives
- Use of credit ratings to measure creditworthiness and identify potential comparables, including various methodologies for performing credit rating analyses and factors to be taken into account
- The effects of group membership and any associated implicit support
- Evaluation of covenants, loan fees and charges
- Summary of the transfer pricing approaches which may be used to determine arm's length interest rates, including internal and external Comparable Uncontrolled Prices (CUPs), and tracing the cost of funds incurred by the original lender in raising the funds to on-lend to related parties
- Reliance on written opinions from independent banks.

ii) **Cash pooling** enables a group to benefit from more efficient cash management by (notionally or physically) bringing together the balances on separate bank accounts. Considerations include:

- The appropriate basis upon which to reward the cash pool leader in various circumstances. Examples are provided where a cash pool leader (i) merely performs a co-ordination function and thus receives limited remuneration as a service provider; or (ii) performs additional functions, controls and bears the financial risks contractually allocated to it, and has the financial capacity to bear those risks, such that an enhanced reward may be appropriate

- Three approaches for allocating benefits of cash pooling to the participating members (which are not necessarily mutually exclusive) include:
    1. enhancing the interest rate for all participants (depositors and borrowers)
    2. applying the same interest rates for all participants (in situations where all members have the same or similar credit profile) regardless of whether they are depositors or borrowers
    3. allocating cash pooling benefits to depositors, and not borrowers, within the group (in situations where there is genuine credit risk to the depositors).

- Cross-guarantees and rights of set-off may be required between participants in the cash pool.

iii) Where a treasury function arranges a **hedging** contract that an operating company enters into, the treasury function can be seen as providing a service to the operating company and should be rewarded accordingly. More complex situations include where the contract instrument and the risks hedged arise in different entities within the group.

Financial guarantees

Draft guidance is given on how to accurately delineate and price financial guarantees in intra-group financial transactions, most typically where a guarantor provides a guarantee on a loan taken out by a fellow group member from an unrelated lender.

The Discussion Draft distinguishes between explicit guarantees (where the guarantor is legally committed to pay if the borrower defaults) and implicit guarantees (passive support, not backed up by a legally binding commitment, derived from the borrower's status as a member of a group). In general, the benefit of implicit support would arise from passive association and not from the provision of a service for which a fee would be payable. Consistent with the commentary and examples included in Chapter One of the OECD Guidelines, the Discussion Draft states that, in respect of an explicit guarantee, a borrower would not generally be prepared to pay for a guarantee if it did not expect to obtain an appropriate benefit beyond the implicit support of other group members.

The Discussion Draft suggests that, where the effect of a guarantee is to permit a borrower to borrow a greater amount of debt, it should be considered whether a portion of the loan from the external lender is accurately delineated as a loan from the external lender to the guarantor (e.g. the parent company), followed by an equity contribution from the guarantor to the borrower (i.e. the subsidiary). If this approach is adopted, it could have a material impact on the arm's length guarantee fees and interest payable by the borrower, noting again from an Australian perspective, the interaction of thin capitalisation and transfer pricing provisions under Australian domestic law.

The Discussion Draft suggests that, where the effect of a guarantee is to permit a borrower to borrow a greater amount of debt, it should be considered whether a portion of the loan from the external lender is accurately delineated as a loan from the external lender to the guarantor (e.g. the parent company), followed by an equity contribution from the guarantor to the borrower (i.e. the subsidiary).

For cases where the guarantee results in a lower interest rate payable to the external lender, five different approaches to pricing the guarantee fee are described: *comparable uncontrolled price* (although it is noted that finding sufficiently similar guarantees between unrelated parties is unlikely); *Yield approach; Cost approach; Valuation of expected loss approach; and Capital support method*.

Captive insurance

The Discussion Draft includes guidance on the application of the arm's length principle to captive insurance arrangements. A group may choose to pool certain risks through a group member, the 'captive' insurance company, for a number of commercial reasons (e.g. diversification of risk or volatility reduction on inherent material risks). The group member then provides insurance services exclusively or mainly to other members of the group. For regulatory reasons, risks are typically ceded by the operating company through a fronting company (usually an insurance broker or agent), which in turn reinsures the risk to the group captive. The Discussion Draft discusses the complexity of pricing the premium paid to the group captive given the participation of third parties that are indifferent to the levels of the price for insurance and reinsurance transactions.

A frequent concern is whether the transaction is genuinely one of insurance (i.e. a transfer of risk) and draft guidance on how to determine this through accurate delineation is provided. Further comments are provided on: the pricing of premiums, including arriving at a comparable uncontrolled price through considering the combined ratio of the classes of business insured - which can be difficult to benchmark given the lack of publicly available data and return on capital; group synergies; and the effect of agency sales.

Consultation questions highlight the need for significant further work

Questions highlighted in the Discussion Draft on which responses are specifically sought include:

- Proposed guidance on approximating risk free and risk-adjusted rates of return. The practical implementation of guidance in situations where funders lack the capability to control the risk associated with investing in a financial asset such that the excess over a risk free return is allocable to another party exercising control over the risk
- Whether as a simplification there should be a rebuttable presumption that the group credit rating should be used as a proxy for individual group members' credit ratings (or alternatively as a starting point from which adjustments are made)
- Views on the roles of credit default swaps and economic models on the pricing of intra-group loans
- The accurate delineation of hedging arrangements within multinational groups where exposures to risk and off-setting positions are booked in separate entities

Comments are invited by 7 September 2018. The working party intends to prepare a further Discussion Draft after considering input received.

Considerations from an Australian transfer pricing perspective

Interaction between the thin capitalisation & transfer pricing provisions

As noted above, the Discussion Draft clarifies that the guidance does not prevent the implementation of other approaches to address capital structure and interest deductibility under countries' domestic legislation.

Under section 815-140, where the debt arrangements reflect a higher than arm's length level of debt, the capital structure of the taxpayer needs to be adjusted to reflect an arm's length level of debt *for the purposes of determining the arm's length interest rate*. However, the estimated arm's length interest rate is then still applied to the full *actual* amount of the debt. The quantum of debt is then separately addressed in the thin capitalisation provisions in Division 820. Therefore, the transfer pricing provisions only affect the interest rate, and the thin capitalisation provisions are preserved to address the quantum of debt.

In contrast, Paragraph 17 of the Discussion Draft suggests that if a related party lender is providing debt financing to a related party borrower in excess of what a third party lender would be willing to lend, then the excess portion of the funding would not be recognised as a loan for the purpose of determining the amount of interest the borrower would have paid at arm's length. That is, a lower amount of debt would be considered as being arm's length and, therefore, a lower amount of interest would be allowable. The outcome would be different in an Australian context in that, while part of the debt would still be recharacterised for the purposes of determining an arm's length interest rate, the arm's length interest rate would then be applied to the actual debt amount to determine allowable interest deductions, with the quantum of debt being separately considered under the thin capitalisation provisions.

Accordingly, the guidance in the Discussion Draft will not be directly relevant for the purposes of determining the allowable debt amount for Australian income tax purposes. However, when finalised, the approach for accurately delineating the transactions outlined in the Discussion Draft will be relevant to the transfer pricing analysis described above, i.e. determining the appropriate level of debt to be taken into account in determining the arm's length interest rate under section 815-140.

The guidance in the Discussion Draft will not be directly relevant for the purposes of determining the allowable debt amount for Australian income tax purposes.

Further, some of the concepts outlined in the Discussion Draft in relation to the amount of debt from the perspective of the borrower and the lender may also have some relevance to the application of the arm's length debt test (ALDT) in the thin capitalisation rules. Revised guidelines on the application of the ALDT are expected to be issued by the ATO in the second half of 2018.

Level of analysis required

The Discussion Draft also states that a functional analysis will be required to accurately delineate the financial transaction. Historically, the functional analysis included in transfer pricing documentation for intra-group loans typically included an overview of the borrower and the group, and a detailed description of the financial transaction being assessed. However, should the Discussion Draft be finalised and this approach be adopted by the ATO, a more detailed analysis of the functions performed, assets employed and risks assumed by both the borrower and the lender will be required (in addition to the detailed description of the financial transaction being assessed). This may include, for example, a detailed analysis of the decision-making processes of the entities involved, along with the functions performed by both the lender and the borrower in evaluating and mitigating the risks inherent to the loan arrangements.

Chevron decision

The focus on commercial rationality in the Discussion Draft is consistent with the views expressed in the OECD's final BEPS Action 8-10 reports. The Discussion Draft highlights the importance of correctly identifying the commercial and financial relations between parties and the conditions and economically relevant circumstances attaching to those relations. In doing so, the Discussion Draft emphasises the need to consider the conditions that independent parties would have agreed to in comparable circumstances.

While the Full Federal Court's (Full Court) decision in *Chevron* was based on Australia's former transfer pricing rules and did not take into account the reinterpretation of the arm's length principle due to BEPS, commerciality and reconstruction were central concepts in the decision, with the case ultimately turning on the Full Court's view that a borrower in the taxpayer's position would, had it been acting independently and dealing with a third party lender at arm's length, have been expected to have given security and operational and financial covenants to acquire funding at lower cost. This view is also reflected in the Discussion Draft.

In addition, the Full Court's view in *Chevron* was that a subsidiary should not be viewed as an 'orphan' from the multinational group, and this is further reflected in the Discussion Draft, which states that although the borrower is viewed as an independent enterprise in applying the arm's length principle, the presence of the rest of the group should not be ignored.

The Full Court's view in Chevron was that a subsidiary should not be viewed as an 'orphan' from the multinational group, and this is further reflected in the Discussion Draft.

PCG 2017/4

Separate to the work being done by the OECD's Working Party 6, the ATO released its own guidance on the transfer pricing aspects of financial transactions in the form of a Practical Compliance Guide (PCG 2017/4) in late 2017. Whereas the Discussion Draft provides interpretive guidance on the application of the arm's length principle in a financing context, PCG 2017/4 sets out the ATO's risk assessment framework for cross-border related party financing arrangements.

The ATO's risk framework identifies several 'Pricing' and 'Motivational' risk factors which, when combined, yield a risk rating for related party financing arrangements. One of the key pricing risk indicators outlined in PCG 2017/4 is the price of the intercompany debt funding relative to (i) traceable third party debt, (ii) relevant third party debt of the group, or (iii) the global group cost of funds. While the PCG and Discussion Draft serve different purposes, it is noted that in the Discussion Draft the OECD also discusses the 'cost of funds' approach as an option that can be used for determining an arm's length interest rate and raises the need for borrowers to consider the lender's costs of funds relative to other lenders' operating in the market (particularly if there is a potential competitor who can obtain funds more cheaply).

However, it is noted that the ATO's view in relation to the cost of funds approach appears to be at odds with the views expressed in the OECD Discussion Draft. The ATO states in PCG 2017/4 that they expect "*in most cases, the cost of financing to align with the costs that could be achieved, on an arm's length basis, by the parent of the global group to* *which the borrower and lender both belong'*[1]. That is, in the ATO's view, if an overseas parent is lending to an Australian subsidiary, it is expected that the parent should charge the same interest rate to its subsidiary as the rate it pays to its external lenders. In contrast, in referring to the cost of funds approach, the Discussion Draft states that while the lender's external costs may be an appropriate basis for pricing an interest rate, adjustments should be made to add the expenses of arranging the loan, a risk premium and a profit margin. (In cases where the lender is only performing an agency function, these adjustments may not be required).

Unsurprisingly, both the PCG and the Discussion Draft urge taxpayers to ensure their inter-company loan agreements include the key terms and conditions that borrowers and lenders would require to enter into the arrangements.

Additional schedules to PCG 2017/4 for related party derivative arrangements and interest-free loans are expected to be released in draft in the coming months. It is anticipated that the draft derivatives schedule will include the ATO's view on group treasury functions, and intercompany hedging arrangements.

Concluding comments and next steps

Financial transactions have long been an area of uncertainty due to a lack of specific guidance from the OECD, and with the ATO's current focus on this area, this draft guidance is welcome.

The Discussion Draft follows many long-standing practices of applying the OECD Guidelines to financial transactions, but it will nevertheless be helpful to have these approaches set out in detail and supported by examples. Explicit statements that the pricing of intra-group loans should take into account the perspectives of both borrowers and lenders are also useful. In practice, more focus has often been placed on the circumstances of borrowers only. Other useful statements reinforcing existing practices include approaches to guarantee pricing, methodologies on performing benchmarking analyses, and the importance of documenting the features and attributes of transactions.

However, given the delays in publishing this Discussion Draft, and the many key sections that remain subject to broad consultation questions, it is clear that differences in opinion currently exist between members of the BEPS Inclusive Framework. It will be important that a single international framework is established in order to minimise disputes and double taxation. Moreover, differences between the current Australian legislation/ ATO approaches and the guidance in the Discussion Draft will need to be addressed.

The draft guidance discusses both the risk free and risk-adjusted rates of return, including various potential approaches that are aligned with established practice, and potential methodologies that may be appropriate. However, this is almost entirely posed as a question for consultation such that changes may be needed in future drafts to reach consensus agreement. Guidance in this regard is particularly important for the application of post-BEPS transfer pricing principles to 'capital rich' entities with limited functionality that provide funding to related parties. The new OECD approach specifically requires the determination of risk free and/or risk-adjusted returns in these circumstances.

Given that the Discussion Draft is a non-consensus document and since there are a number of critical key areas on which the OECD has specifically requested responses, there will still be some way to go before this guidance will be finalised.

[1] PCG 2017/4, paragraph 52

Contacts

Geoff Gill

Partner
Tel: +61 2 9322 5358
gegill@deloitte.com.au

Ockie Olivier

Partner
Tel: +61 8 9365 7158
oolivier@deloitte.com.au

Soulla McFall

Partner
Tel: +61 3 9671 7814
smcfall@deloitte.com.au

Paul Riley

Partner
Tel: +61 3 9671 7850
pbriley@deloitte.com.au

Jacques Van Rhyn

Partner
Tel: +61 7 3308 7226
jvanrhyn@deloitte.com.au

John Bland

Principal
Tel: +61 7 3308 7275
jbland@deloitte.com.au