Financial Services Transfer Pricing
Changing landscapes
October 2018
Contents

Welcome 2
Asset Management 3
Banking 10
Insurance 19
Brexit 25
OECD discussion draft on transfer pricing of financial transactions 29
Deloitte Member Firm Global Network 34
Welcome

A warm welcome to Deloitte’s Financial Services Transfer Pricing global publication. Our collection of articles is inspired by a range of topics including the ongoing implementation of the Organisation for Economic Cooperation and Development’s Base Erosion and Profit Shifting (“OECD BEPS”) initiative, Brexit, tax audit trends as well as key market and regulatory developments. With insights from our Financial Services Transfer Pricing teams from around the Deloitte global network of member firms, the aim is to extract the relevant trends and highlight their impact on transfer pricing for the banking, asset management and insurance sectors.

In this edition, the article series starts by exploring recent trends in the asset management sector covering transfer pricing methodologies/models for the sector as well as a discussion of the transfer pricing dimension of the unique role of regulated management companies under the Undertakings for the Collective Investment of Transferable Securities (“UCITS”) and the Alternative Investment Fund Managers Directive (“AIFMD”) regimes. The next two articles focus on the banking sector and examine two key issues related to branch capital attribution and funds transfer pricing which are both gaining more importance in light of a changing regulatory environment. Key trends in the insurance sector with respect to profit attribution and the developments on key entrepreneurial risk Taking (“KERT”) functions in light of BEPS is the focus of the next article. Given that the countdown has started to the departure of the UK from the European Union, an update on transfer pricing ramifications based on how the financial services sector is currently addressing this key event and related uncertainty is also included. Finally, we detail the key points covered in the OECD Discussion Draft on Transfer Pricing of financial transactions.

This publication is intended to be informative. Feel free to reach out to the listed Deloitte Financial Services Transfer Pricing team contacts for more information or in case of any questions.
Asset Management

Key transfer pricing issues of investment management businesses

The asset management industry is witnessing a series of changes that are increasing complexity from a regulatory and tax perspective and materially impacting the approach to transfer pricing. Key transfer pricing complexities that are more specific to investment managers are discussed in this article.

So what are the complexities faced by groups in the sector?

Adapting to business changes

The investment management sector is currently undergoing substantial change. Regulatory regime changes such as the Markets in Financial Instruments Directive ("MiFID II") and the Alternative Investment Fund Managers Directive ("AIFMD"), the UK’s exit from the EU and resulting changes to operating models, and greater reliance on technology and innovation regarding identification of investment opportunities, are just examples. Commercial changes are driving operational changes which will need to be reflected in groups’ transfer pricing flows.

With respect to MiFID II, one of the frequently discussed impacts is the recognition and treatment of research costs but the broader impact will also be on fee and distribution models themselves following the ban on inducement payments. The inducement ban could lead to changes in the operating models for distribution and fee arrangements with clients.

Taking technology as a further example, there is some discussion in the market currently as to whether the regulatory compliance responsibilities of lead management companies can be made more efficient (and less labour intensive) through the application of technology, specifically with regard to risk management and the oversight of portfolio management. Transfer pricing principles for multinational enterprises may attribute value to this technology asset and ensure that the owner (and potentially developer) of the relevant intellectual property is adequately remunerated. In many circumstances this may not be the lead management company whose skills may be more focused on regulatory risk than technology development. Removing a return from the lead manager may then have wider implications from a regulatory perspective, specifically with making sure that adequate income is retained to maintain any regulatory capital requirements.

Stronger focus on governance

In Europe, one area of recent attention is the focus of the European Securities and Markets Authority ("ESMA") on limiting financial market regulatory competition within Europe in the wake of Brexit. More intense scrutiny over governance arrangements is a clearly observed trend in the supervisory approach adopted by various European regulators. Although their primary focus is mitigating the risk arising from differing supervisory practices, a secondary focus on the role of tax in financial oversight has evolved more recently. Some regulators are starting to review transfer pricing policies, intercompany agreements and transfer pricing documentation as part of their on-site visits believing their existence to be an indicator of good governance and proper management. As such, it is more important to ensure consistency between the regulatory and tax positions, the management of regulatory and tax audits, as well as messaging to both tax authorities and regulators.

Identifying appropriate transfer pricing methodologies

Whilst the overall value chain of many businesses within the sector is similar, the choice of an appropriate method to remunerate activities such as the distribution or investment advisory function can be complex in practice. Common examples include:

- **Asset class** – How do different asset classes impact the structure of investment advisory activities and does that alter the remuneration? The work performed by portfolio managers or risk managers whose focus is on a distressed asset class will likely be more detailed and involved than a portfolio manager who is following an index through a passive strategy. This difference in level of involvement may need to be reflected in the remuneration due to the function, and the choice of any comparables used to determine pricing.
• **Investor type** – Whilst investor type may not have a direct impact on the nature of activities performed by portfolio managers, it will have a significant impact on distribution and the level of regulatory compliance. As commitments from retail investors will commonly be sourced through financial intermediaries and may require greater levels of regulatory disclosure, consideration needs to be given to the role of the distribution teams in building relationships with those intermediaries and securing the agreements to have their managed funds listed on fund platforms. Comparing those activities with those performed by individuals building relationships with institutions to secure segregated mandates, and the greater involvement in distribution of other individuals within the group, would likely result in material differences that need to be taken into consideration. It is also important to understand the underlying costs associated with distribution. If the distribution entity incurs the cost of commissions payable to intermediaries in a retail context, it requires compensation sufficient to cover not only this cost (which will likely be significant) but also to achieve an arm’s length return for the internal function itself. In an institutional context, the calculation of rebates and the entity who bears the responsibility for settling those, needs to retain sufficient income to do so.

• **Multiple functions** – Often individual portfolio managers performing the investment advisory activity will have some role in the capital raising process; typically institutional investors wanting to meet the people responsible for deploying their capital. When groups are using external prices (Comparable Uncontrolled Prices or “CUPs”) to determine a return for their in-house distribution function, consideration will need to be given as to whether the portfolio managers’ contributions to that process deserves a share of the distribution return.

These functional complexities mean that the identification of CUPs for benchmarking to determine their pricing can be challenging, as the fact patterns of the comparables may not be sufficiently comparable to those of the transacting group entities.

Structural, regulatory and tax changes are substantially increasing the complexity of what were once more straightforward transfer pricing analyses due to new business value drivers, greater interaction between functions, and additional cross border transactions.
Are there any practical solutions?

There are a number of practical actions that may assist with addressing some of the complexities outlined above. The most fundamental is to fully understanding the business, updating this understanding when operational changes arise.

Once the allocation of functions, assets and risks are properly understood, an assessment of appropriate legal entity transfer pricing methodologies can be made. The first consideration is often whether internal or external arrangements comparable to the intra-group ones are available and may be used to price the transaction (e.g., CUPs). Whilst it must be recognised that no two arrangements are identical, the use of CUPs (adjusted if necessary) may continue to provide the most reliable support.

CUPs can be one of the easier methods to implement by virtue of their direct application to a known factor to determine the price to be paid for the service performed. However, an indication that a CUP may not be appropriate might be if the implementation results in levels of profits (or losses) arising in legal entities that are obviously inconsistent with typical arm’s length circumstances.

An increasingly common approach within the sector is the use of revenue sharing type arrangements; the basis for splitting those revenues being based on either a CUP for one of the contributing roles, or alternatively the application of quantitative factors such as head count or compensation (sometimes referred to as the application of an “Other Method”). This type of approach can be helpful where CUPs are unavailable or there are significant differences for which reliable adjustments cannot be made. It may be a reasonable alternative approach if the implementation of a CUP results in the circumstance mentioned above (i.e., an anomalous recognition of profits/losses on a consistent basis).

Revenue sharing arrangements can however be complicated to implement. Even where appropriate factors can be identified, obtaining the data can be difficult. For example, data on remuneration (if that is an allocation factor) may only be available post year-end due to the timing of bonus calculations and payments. In these circumstances, practical approaches are necessary which might include using budgeted figures, or other similar estimates of the full year position.

If both CUPs and alternative revenue sharing arrangements applied in isolation create unexpected results, it may be appropriate to apply the two methods in combination; one being applied to either adjust or corroborate the application of the other. Corroborating approaches can be useful in order to refine what otherwise might present unusual results. Increasingly tax authorities are also considering corroborating approaches when testing the application of more established pricing methods as some form of broad test or risk assessment of the actual results achieved, although in many countries they are required to invalidate the taxpayers chosen method prior to asserting their new approach.

Summary

Whilst the business models of many investment managers may appear straight-forward, to follow the application of the OECD\(^1\) Guidelines to determine appropriate remuneration and/or profit is somewhat more complex. A practical approach to both the determination of appropriate pricing methodologies, and their implementation, is therefore essential if a technically robust and practical group policy is to be determined.

---

\(^1\) The Organisation for Economic Cooperation and Development’s Base Erosion and Profit Shifting project.
The unique transfer pricing dimension of regulated management companies in the asset management sector

Transfer pricing in the asset management sector continues to be one of the most complex topics in today’s financial services tax landscape. The complexity mainly arises from three areas:

1. The increasing interaction between the regulatory and tax dimension;
2. Operating models that are unique to the asset management sector; and
3. The impact of the Base Erosion and Profit Shifting ("BEPS") project, especially the new guidance on Actions 8-10 published by the Organisation for Economic Cooperation and Development ("OECD") that potentially affect the sustainability of sector-specific transfer pricing policies and methodologies.

This article provides an overview of the current state of transfer pricing for the asset management sector focusing on key developments surrounding the splitting of fees and how to consider the unique role of regulated management companies ("ManCos") in view of their delegation model.

Introduction

One of the key drivers of growth in the asset management sector has been the introduction of investment funds regulated under the Undertakings for the Collective Investment of Transferable Securities ("UCITS") regime. The European Commission introduced the UCITS regime in 1985 as a harmonised regulatory framework aimed at the cross-border distribution of mutual funds throughout Europe. The EU regulatory passport enables the marketing of shares to retail and institutional investors. While UCITS funds are domiciled in an EU member state and marketed to investors across Europe, they are also frequently sold to investors outside Europe based on the advantage of their consistent regulatory requirements.

Following the financial crisis in 2007-08, the European Commission also introduced the Alternative Investment Fund Managers Directive ("AIFMD") that – similar to UCITS – provides for a harmonised regime for the distribution of alternative funds (i.e. hedge funds, private equity and real estate) focused on professional investors.

What is the regulatory and operating model for ManCos?

The UCITS and AIFMD regulations outline various requirements that cover authorisation, organisational, substance/management, capital, risk and reporting/disclosure requirements ultimately aimed at ensuring investor protection.

One of the core principles of the regulation is the concept of a Management Company ("ManCo") that the fund(s) typically need to appoint. The ManCo is a legal entity whose business is the collective management of a fund. ManCos undertake a regulated financial activity that needs to be authorised by and under the supervision of local financial regulators. The authorisation/license can be limited to the management of funds either under the UCITS or AIFMD regime or cover both regimes (in which case the ManCo is referred to as a Super-ManCo).
The ManCo is formally responsible for all core and non-core activities defined under the UCITS/AIFMD regulations. The core functions are: investment management and risk management. Whereas non-core functions are distribution, fund administration and other support activities. The ManCo is able to delegate certain activities to either the promoter of the fund or third parties. Nonetheless, the ManCo can only delegate one of the core functions, i.e., either investment management or risk management. Regardless, the ManCo must retain oversight over any delegated functions and ensure that the delegate has sufficient resources, qualification and processes in place to perform these functions while retaining the key risks and liabilities towards the investors and regulators.

In practice, there is a broad range of operating models but frequently ManCos delegate investment management and distribution while retaining the minimum regulatory substance required for risk management, oversight and compliance.

Key transfer pricing aspects
The discussion of the regulatory and operating model highlights a critical issue from a transfer pricing perspective. In practice the functional profile of a ManCo may be limited, with only personnel dedicated to risk management, oversight and compliance and the necessary Conducting Officers and Responsible Persons. However, there are material commercial and financial risks retained by the ManCo, and the regulatory authorisation/license represents a key intangible asset.

Looking back at the development of transfer pricing in the asset management sector, there have typically been three general approaches to how fees are split and how regulated ManCos have been considered in the past.

Model 1 – one-sided approach with ManCo earning residual
Model 1 is a one-sided approach where each transaction between the ManCo and the different related parties are being tested individually. In a typical full delegation model, the ManCo would rely on related parties to perform investment management, distribution and other support activities while fund administration is often delegated to third parties.

The pricing of the transactions would be based or benchmarked against actual fee data that is obtained from benchmarking reports or based on internal comparables (comparable uncontrolled prices or "CUPs"). Under this model, the ManCo would retain any residual profits or losses. This model has become increasingly difficult to defend, especially where the ManCo is set up under a full delegation model. Tensions mainly arise from the lower economic contribution of the ManCo under this type of full delegation model and a view that i) investment management and distribution are typically the key value drivers with respect to generating excess returns and attracting assets under management ("AuM"), and ii) the availability of data from arrangements where funds rely...
on third party ManCos under similar delegation models where the third party ManCos typically earn a fee linked to AuM.

**Model 2 – two-sided approach with residual profits allocated to investment management and distribution**

Under Model 2, the ManCo is also set up under a full delegation model but its remuneration is based on a fee aligned with comparable third party ManCos. Residual profits are split between the key value drivers, i.e., the investment management and distribution functions. The fee split is typically performed based on databases such as Lipper, often supplemented with additional local sources; or may in some cases apply a contribution model. This approach has become common in practice but also leaves various questions to answer, especially how potential differences in the pricing derived from internal CUPs can be supported.

**Model 3 – two-sided approach with residual allocated to sponsor**

Under Model 3, the ManCo is remunerated based on the remuneration earned by third party ManCo service providers under a comparable delegation model (i.e. CUP) while the investment management and distribution functions are remunerated with a fee based on internal or external CUPs. Residual profits are retained by the sponsor for it’s role in establishing the fund. This model is more relevant where the sponsor only has a limited involvement overall across the key activities of the value chain.

There is no one-size-fits-all approach for transfer pricing in the asset management sector and the answer depends on various factors including:

1. the operating and delegation model of the ManCo;
2. the role of the sponsor; and
3. the availability of internal CUP data where activities on investment management or distribution are delegated to third parties.

The discussion of the regulatory and operating models also shows that ManCos play a unique role. Their functional profile can range from a concentrated profile where the ManCo focuses on risk management, oversight of delegated functions and compliance/reporting to a fully-fledged profile where the ManCo performs part or all of the investment management, distribution and fund administration related activities. In addition, ManCos also have a unique risk profile (mainly regulatory, investor and liquidity risks) and hold the authorisation/license as a key intangible asset.
How should the unique profile of a regulated ManCo be remunerated? Over the last couple of years, there has been a strong proliferation of service providers in the market that offer ManCo services to, often smaller, funds where the ManCo is not related to the sponsor of the fund.

This opens up the possibility of obtaining market data for in-depth benchmarking analyses to derive a range of arm’s length remuneration. Such data might consider the following key factors:

- Differentiation between the type of ManCo and its license;
- Functional comparability considering the type of delegation model and activities performed by the captive ManCo;
- Ability to analyse results on the basis of AuM and share of fees, including adjustments to differences in the definition of the fee base;
- Consideration of industry specific pricing aspects with respect to fee floors and caps;
- Adjustment capabilities for AuM volume effect via bucketing and extrapolation; and
- Consideration of differences due to investment strategy/fund type.

The issue does not end with identifying an appropriate ManCo fee. Applying this fee to the circumstances of the transaction can also be difficult. The determination of necessary data such as AuM and management fees, or taking into account any year-end adjustments must be considered. This is especially important where the fee base and determination of fee could change over time such as in Private Equity with switches from committed to invested capital. In addition, careful consideration needs to be given to potential adjustments to the transfer pricing policy to include floors (minimum compensation) to avoid loss situations at the ManCo which could be critical both from a regulatory and tax perspective.

**Conclusion**

The remuneration of captive regulated ManCos is a complex issue that needs to be carefully considered in the transfer pricing model, and regulatory developments have only increased this complexity. Further, the BEPS initiative has a major impact on the defensibility of certain historic transfer pricing approaches, especially in cases of one-sided and residual approaches where either the ManCo or sponsor are entitled to residual profits while their functional contribution during the year in question may be small relative to the other parties to the arrangement.

An increasing number of regulators are currently also looking into transfer pricing as an indicator of proper management of the ManCo

An increasing number of regulators are currently also looking into transfer pricing as an indicator of proper management of the ManCo

It is essential that any analysis is aligned with the regulatory position given the critical interaction and tension between both on aspects of substance and control over risk. An increasing number of regulators are currently also looking into transfer pricing as an indicator of proper management of the ManCo so the topic is not only relevant for tax professionals but also for management at the level of the sponsor and the Conducting Officers at the level of the ManCo itself.
Banking

Branch capital allocation – technical approach and practical considerations

The impact of Basel III has been felt since its implementation from 1 January 2014 on both sides of the Atlantic. In the US, the final US rules which codify the Basel III capital framework and relevant portions of the Dodd-Frank Act have resulted, chief amongst other developments, in more stringent Tier 1 capital requirements. The EU has ratified Basel III through the Capital Requirements Regulation ("CRR") and Capital Requirements Directive ("CRD"), culminating in CRD IV, which similarly tightened the regulatory capital requirements for EU regulated banks. These changes have intensified the pressures on banks to comply with a more rigorous and stricter regulatory capital regime, which are only expected to exacerbate following implementation of the EU's CRD V/CRR II reform on bank capital and risk. It is evident from the foregoing that the importance of capital for banks cannot be understated as banks are confronted by the timeworn issue of capital constraints and balance sheet allocation in order to maximise bottom line results.

Capital Allocation Approaches under the Authorised OECD Approach ("AOA")

The general principles and approaches governing the allocation of capital to permanent establishments ("PEs") are enshrined in Part I of the 2010 OECD Report on the Attribution of Profits to Permanent Establishment ("PE Report"). Part II of the PE Report prescribes the specific approaches to capital attribution for PEs of banks and global trading enterprises under the AOA:

1. **BIS ratio/Capital allocation approach**: This approach seeks to allocate capital to the branch on the basis of the proportion that the Risk Weighted Assets ("RWA") of the branch bear to the total RWA of the bank as a whole. In practice, this would mean if the branch has 10% of the bank's RWA, it will have attributed to it 10% of the “free” capital, or most commonly referred to as equity capital, retained profits or reserves. There are also variants within the capital allocation approach which do not entail risk-weighting the assets according to a standardised regulatory approach but rather rely on the bank’s internal risk models. These models are acceptable under the AOA, provided they are approved by the regulators, applied consistently and sufficiently documented. The economic capital allocation approach is one such variant by relying on the banks’ internal measure of risk and economic capital, but was determined not to be sufficiently well developed yet to be relied upon as an approach under the AOA.

2. **Thin capitalisation approach**: The thin capitalisation approach compares the branch’s debt and “free” capital with that of independent banking enterprises carrying on the same or similar activities under the same or similar conditions operating within the same jurisdiction.

3. **Quasi thin capitalisation/Regulatory minimum capital approach**: Otherwise referred to as the safe harbour approach, the quasi thin capitalisation approach requires the branch to have at least the same minimum amount of “free” capital as the domestic regulator would set for an independent banking enterprise operating in the same host country. The regulatory minimum “free” capital would be determined in accordance with the regulatory standards and tax characterisation rules of the host country.

Application and practical considerations

The common denominator of the three approaches authorised by the OECD described above is that they require the risks of the PE to be measured. In principle, the risk measurement models approved by the bank's regulator should also be acceptable from a tax transfer pricing perspective, if

- sufficient documentation on the models can be provided to the tax authorities; and
- data is available to determine the risk at a branch level.

---

3 Part I, Paragraph 105 of the PE Report defines “free” capital as an investment which does not give rise to an investment return in the nature of interest that is deductible for tax purposes in line with the rules of the host country of the branch.
Typically, the RWA of the branch and, in case of the capital allocation approach the bank as a whole, can determined in line with the internationally accepted regulatory requirements of the Basel Accords for credit risk and in some cases market risk. In practice, a regulatory approach is therefore often applied to measure the risks of a branch for tax transfer pricing purposes as well.

A simple example illustrates the interrelation of the three approaches authorised by the OECD: the bank has Tier 1 equity capital of 5,000 and RWA of 25,000, i.e. a Tier 1 capital ratio of 20%. Its foreign branch has RWA of 2,500. Similar independent banks in the host jurisdiction of the branch have a Tier 1 ratio of 15% while the regulatory minimum is 10%.

### Bank Balance Sheet

<table>
<thead>
<tr>
<th></th>
<th>RWA</th>
<th>Tier 1 Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>25,000</td>
<td></td>
</tr>
<tr>
<td>Other assets</td>
<td>5,000</td>
<td>Debt 25,000</td>
</tr>
<tr>
<td></td>
<td>30,000</td>
<td></td>
</tr>
</tbody>
</table>

### Applying the BIS Ratio/Capital Allocation Approach

The BIS ratio for the capital allocation approach would therefore be 10% and the PE would need to be attributed 10% of the bank’s Tier 1 capital. As a result, the branch would have the same Tier 1 capital ratio of 20% as the bank as a whole, i.e. 500.

### Branch Balance Sheet

<table>
<thead>
<tr>
<th></th>
<th>RWA</th>
<th>Capital attributed</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2,500</td>
<td>500</td>
</tr>
<tr>
<td>Other assets</td>
<td>500</td>
<td>Debt 2,500</td>
</tr>
<tr>
<td></td>
<td>3,000</td>
<td></td>
</tr>
</tbody>
</table>

### Applying the thin capitalisation or regulatory minimum capital approach

Under the thin capitalisation approach, however, in this case the branch would have equity capital of 375, i.e. a Tier 1 ratio of 15% in line with independent banks carrying on similar activities in the branch host country. The regulatory minimum Tier 1 capital ratio is generally also the floor for tax purposes in the branch’ host country, in this simple example 250.

As can be seen from this example, depending on local regulatory requirements and the capitalisation of independent banks in the branch’ host country, it is possible that either more or less capital than the bank’s actual total tier 1 capital is attributed to the PEs versus head office where the thin capitalisation or regulatory minimum capital approach are applied. Where the BIS/Capital allocation approach is acceptable to both home and branch host countries, this is not generally an issue unless a local capital waiver is in place.

### What are the potential implications of a capital waiver?

A waiver may be granted by local regulators, e.g. because of significant amounts of capital held in another group entity in the same country. If the bank in the above example had been granted a waiver and held Tier 1 Equity of 2,000 the capital attributed to the branch based on the BIS ratio approach of 10% would be 200 rather than 500. A Tier 1 ratio of 8% is in this example both below the ratio of 15% derived from the thin capitalisation approach and 10% regulatory minimum requirement and therefore likely to lead to adjustments in the branch’ host country. Due to inherent risk of double taxation, the implications of a capital waiver for a banking entity with foreign branches should be analysed and addressed in the way capital allocation is dealt with early on.

---

The implications of a capital waiver for a banking entity with foreign branches should be analysed and addressed in the way capital allocation is dealt with early on.
How does the capital attribution impact the interest expense of the branch?

Once the attributable capital has been determined for a branch for tax purposes, it needs to be compared with the amount of the “free” capital that has actually been booked in the branch balance sheet for financial accounting purposes. If the “free” capital booked in the branch accounts is less than the capital attributable to the branch, an adjustment will likely have to be made to the amount of interest expense allowed in the branch in the host country in order to reflect the “free” capital that it actually needs to support the RWA on its balance sheet. In the example above, if the branch had capital of only 400 on its balance sheet instead of the 500 attributable to it, an adjustment would likely have to be made to the interest expense relating to the delta of 100 in line with the rules of the branch host country.

A practical example is the recent UK regulations which prescribed that additional Tier 1 (“AT1”) capital be deductible for UK tax purposes with effect from 1 January 2014. The new legislation impacts the breadth of regulatory capital that falls under the EU CRD IV (2013/36/EU), but does not expressly deal with non-EU regulated banks. Whilst the HMRC technical note does not distinguish between EU regulated and non-EU regulated banks, it would be reasonable to assume a similar position should be taken to ensure an equitable outcome, subject to the requirements under the Capital Attribution Tax Adjustment (“CATA”) rules (i.e. attribution of the AT1 capital to the UK branch should result in a capitalisation position achieved by comparable banks).

Country Insights

United Kingdom

The UK tax authorities have adopted the ‘thin capitalisation’ approach, which has taken effect since enacted in 2003 and requires that the attribution of capital to the UK branch of a foreign bank should be analogous to that which it could reasonably be expected to have were the UK branch operating as a “distinct and separate enterprise” and engaged in the same or similar activities. Whilst the legislation does not require the physical allotment of capital to the UK branch, where it is established that the UK branch’s business is not supported, or is inadequately supported, by capital, an adjustment to the UK tax computations, otherwise known as CATA, will be made to align the taxable profits more closely with what would be achieved by similar banking activities performed by a UK bank under similar circumstances. From a branch capitalisation perspective, this requires in effect a level of equity and debt capital for the UK branch that is comparable to that of a separate entity engaged in similar activities under the same or similar circumstances. HMRC Guidance accepts that it may be difficult to find appropriate comparables in practice so alternative approaches including attributing capital are also discussed. Whilst the technically correct approach would be to identify a sample of comparable banks for the UK branch, the usual stumbling block is that a UK Branch often has a very different business to that of a UK bank or building society of a similar scale. So there may be no comparable enterprises within the UK. The default position adopted by HMRC has therefore tended to be to adopt the capital ratios and composition of the foreign bank as a proxy for what would be available to the UK Branch if it were a separate enterprise. This does not however impact on how banks conduct or fund their actual branch operations, rather the CATA is only relevant from a tax computation standpoint. We are seeing increased scrutiny and challenge of foreign banks’ CATA calculations by HMRC. The principle is also of importance in branch profit exemption calculations for UK headquartered banks that have elected into the regime, although in such circumstances a capital allocation approach is prescribed under statute (subject to a treaty override).

4 This should be read in conjunction with the HMRC technical note published in December 2013.
The 2017 decision reached by the First-Tier Tribunal in the case of Irish-Bank Resolution Corporation Limited (In Special Liquidation) vs The Commissioners for Her Majesty’s Revenue and Customs, concerned the issue around whether the attribution of notional capital to a PE is incompatible with Article 8 (Business Profits) of the UK and Republic of Ireland Double Tax Convention (“DTC”) is relevant when considering the application to UK PEs in any jurisdictions whereby the UK has a DTC based on the pre-2010 OECD PE Report. HMRC was successful in the contention that the PE is trading “under the same or similar conditions” and that it “has such equity and loan capital as it could reasonably be expected to have”, reflecting the Article 8(2) assumption that it is a “distinct and separate enterprise” which affirms the principle underpinning the CATA rule. The case is currently on appeal by the taxpayer.

Germany
The German Branch Profit Attribution Regulation which stipulates the principles of asset attribution, branch capital allocation, as well as the recognition of internal dealings in line with the AOA, took effect from 1 January 2015. The Regulation sets out the rules on determining capital allocation to German branches of foreign banks as well as foreign branches of German banks. These rules designate the BIS ratio/capital allocation approach as the preferred method for branches of foreign branches in Germany. A lower capital attribution is permissible, if the bank can demonstrate that this better reflects the arm’s length principle and the capital attributed to the branch meets the regulatory minimum capital requirements plus a “buffer” of 0.5% to allow for new business, as appropriate. For foreign branches of German banks, the regulatory minimum capital approach is designated as the preferred method. German banks can attribute more capital to their foreign branches, if that better reflects the arm’s length principle and is in line with the BIS ratio/capital allocation approach.

Japan
As part of Japan’s BEPS initiatives, Japanese domestic law was amended by the 2014 tax reforms to adopt the principles reflected in the OECD Report on the Attribution of Profits to Permanent Establishments. The new law takes effect for the fiscal years commencing 1 April 2016 for PEs of corporations and mandates that a PE should have sufficient capital (including free capital) to support the functions it undertakes, the assets it economically owns, and the risks it assumes. Attribution of free capital is important in determining the arm’s length amount of debt capital and interest expense deduction for the PE. Japanese tax law focuses on two approaches to allocate capital to bank branches:

1. BIS ratio/Capital allocation approach

\[
\text{Foreign enterprise regulatory capital} \times \frac{\text{Assets attributed to the PE taking into account risks at year end}}{\text{Total assets of the enterprise taking into account risks at year end}}
\]

2. Thin capitalisation approach

\[
\frac{\text{Assets attributed to the PE taking into account risk at year end}}{\text{Regulatory capital for a comparable Japanese bank for the last 3 years}} \times \frac{\text{Total assets of the enterprise taking into account risk at year end}}{\text{Total assets of the enterprise taking into account risk at year end}}
\]

However, only the BIS/Capital allocation approach is permitted for Japanese branches of foreign banks (where both approaches above are available to foreign branches of Japanese banks). As part of the review of the draft reforms and guidance foreign banks largely determined that they were very unlikely to find comparable Japanese banks that had the same or similar business model and mix which effectively would eliminate the thin capitalisation approach from their consideration.

Related to the determination of capital is the interest deduction on debt capital. Prior to the introduction of AOA into domestic law, Japanese branches of foreign banks had their interest deductions limited to LIBOR rate level interest amount based on a precedent widely applied by tax examiners. With the introduction of the AOA into domestic law Japanese branches of foreign banks are seeing both the determination of notional debt (now aligned with the arm’s length standard for AOA purposes) change considerably.

As the domestic rules have only been effective for one fiscal year end for December year end branches and two years for March year end branches, there are very few observations from tax examinations or controversy in this area however it is an area industry and practitioners are keeping a close eye on for developments.

\[5\] This is the equivalent of Article 7 of the OECD Model Tax Convention.
Conclusion

Against an evolving backdrop of global tax reforms that are largely driven by the BEPS initiatives, it is recommended that adequate focus is accorded to branch capitalisation to ensure continued compliance with the arm’s length principle as prescribed under domestic tax legislation and the OECD PE Report. Appropriate monitoring and a consistent global approach (to the extent possible) in this respect will help in achieving optimum capitalisation for banking PEs and mitigating the potential for double taxation whilst taking into consideration prevailing local domestic requirements governing branch capital attribution. This in turn should help provide a level of assurance and certainty with regards to interest deductibility for the branches to the extent possible.
Key developments in funds transfer pricing and the interaction between the tax and regulatory dimension

This article focuses on recent key trends in the area of funds transfer pricing (FTP) and the interaction between the tax and regulatory dimensions. FTP is not a new concept – it is relevant for most banking institutions but so far has often been addressed differently across banks based upon their business model, their funding profile and other criteria. Nonetheless, there are important recent regulatory developments that put FTP back into the spotlight and requires banks to revisit their FTP approach both from a regulatory and transfer pricing perspective.

Defining FTP: the components of an FTP rate

Let us start with a definition of FTP and why it is relevant for tax purposes. FTP is a strategic management tool and process that enables banks to achieve the following four goals:

1. Appropriately establish a cost structure for internal funding based on the external funding profile of the bank (i.e., capital markets, interbank/wholesale and retail funding) and transfer the funding costs from the treasury function to the products and business lines (either within a legal entity or across legal entities) based upon their risk and maturity profile;
2. Properly manage its balance sheet structure and maturity;
3. Measure risk-adjusted profitability by taking into account (and pricing) the term liquidity risk, interest rate risk and other risks (such as pre-payment risks) and include the costs of regulation, the bank’s operations and profit elements into its product pricing; and
4. Potentially incentivise or dis-incentivise the sales and distribution side to sell certain products via adjustments to the transfer price.

FTP gained heightened focus following the 2007-2008 financial crisis where it became clear to regulators that banks had not properly priced funding costs, time to maturity and interest risks/term liquidity risks into their products. Pre-financial crisis, the differential between what banks had to pay for long-term funding and the risk free rate was often negligible. Post-financial crisis, the world was very different – liquidity was a scarce resource and credit spreads increased significantly, particularly for financial institutions. Such pricing approach led to increased focus by regulators, such as the Bank for International Settlements, the United States Federal Reserve and the Committee of European Banking Supervision, on FTP which was followed by the publication of various position papers and guidance. Nonetheless, with the extended implementation period of Basel III, FTP did not seem high on the agenda for some banks.
The regulatory environment is, however, changing. European regulators for banks supervised under the Single Supervisory Mechanism (SSM) are putting new emphasis on FTP. Since 2016, the European Central Bank (ECB), and as such also local country regulators, are focusing on creating a more stable banking sector through harmonised rules at the EU level and stricter risk and capital requirements. To achieve this goal, the ECB and local regulators launched the Business Model Analysis (BMA) in 2016 where as part of the supervisory reviews the ECB and local regulators assess a range of criteria including strategy, risk management, financial performance and regulatory compliance to determine the viability of a bank’s business model and operations. Among other areas, BMA now explicitly focuses on FTP as part of the review of the management of the banking operations, funding structure/management and profitability management. As such, it will be essential for banks that are under the SSM to prepare for BMA and improve their FTP framework to be aligned with current market practice.

It is important to keep in mind that FTP covers both the pricing of funding provided to affiliates (e.g. in the form of an interbank loan between the parent and one of its subsidiaries), also referred to as *intercompany funding*, as well as the pricing the use of funding by a banking branch when relying on the capital of its head office, also referred to as *intracompany funding*.

**Where are the gaps?**

Common FTP gaps often occur in the following areas:

- Banks (mainly medium and smaller-sized players) that currently do not yet employ FTP but only rely on external market prices;
- Banks that employ FTP but with overly simplified approaches (e.g. using an average cost of funding or single rate FTP system that does not consider the existence of a sloped yield curve) in view of their business model, balance sheet structure, funding profile and risk characteristics;
- Methodological gaps with respect to not appropriately considering maturity mismatches and liquidity premia;
- Structural gaps with respect to the level of funding costs and pricing of funding in a product; and
- Inconsistencies in the cost of funding incurred from external providers vis-à-vis the cost of funding to/from internal lenders.

As such, it is essential that banks address FTP and any gaps to meet both regulatory requirements as well as transfer pricing requirements to ensure that the interest on intercompany and intracompany funding is respected for tax purposes.

**Finding the right interest rate/spread**

The funding profile of any bank typically consists of equity, debt capital markets, interbank (consisting of either intercompany loans from related parties or funding obtained from the interbank market) and retail funding. Factoring in the issuance of Total Loss Absorbing Capital (“T-LAC”) is also relevant. Considering the broad spectrum of funding with different maturities and costs, sophisticated FTP frameworks rely on a multi-rate/matched maturity approach to create multiple pools of funds with different characteristics.

FTP methodologies usually vary greatly among banks. Usually, the methodology starts with a base rate (often swap rate). The term liquidity premium is typically assessed by isolating the spread between the bank’s actual funding costs vis-à-vis the selected base rate.

The inclusion of other risk components (such as pre-payment risks) often varies depending on market, products, and other factors. It is also important to consider other costs such as regulatory costs with respect to meeting liquidity requirements. Some banks have started to incorporate such costs into their FTP frameworks as well.

Many banks have historically not included cost elements (related to the ongoing operation of the bank) and profit elements into their FTP framework, allowing the bank to earn a return on its operation/infrastructure and ensure that the product also generates sufficient profits.
Regulatory drivers

The ongoing implementation of Basel III across various jurisdictions has produced a higher level of intercompany funding between banking groups to ensure that affiliates meet increasingly stricter liquidity requirements. The aim of the Basel III liquidity measures are to address concerns where banks show a relatively high reliance on wholesale funding or hold large amounts of short-term assets. One of the liquidity measures introduced is the so-called Net Stable Funding Ratio (NSFR). The NSFR is defined as the amount of available stable funding (ASF) relative to the amount of required stable funding. The ASF is defined as the portion of capital and liabilities expected to be reliable over the time horizon considered by the NSFR, which extends to one year. As such, various banks are currently already in the process of entering into medium and long-term loans to their banking affiliates to meet liquidity requirements in cases where funding is overly concentrated on short-term maturities below one year. The obvious challenge is to price such intercompany loans appropriately from a transfer pricing perspective and consider additional costs in the FTP framework. Recently, some banks have started looking at incorporating NSFR costs into their FTP frameworks and to pass on costs related to meeting liquidity requirements as a cost of carry that is then allocated.

FTP – Why it matters to the tax department

Challenge of pricing intercompany loans

Having a consistent approach between funds transfer pricing and tax transfer pricing policies for intercompany financing would simplify the establishment and maintenance of such policies. While there is typically considerable overlap between transfer pricing regulations and the regulatory standards of major bank regulators, key differences exist that make the application of transfer pricing logic to regulatory requirements (or vice versa) potentially problematic. For example, in the U.S., differences exist between the tax and regulatory treatment of shareholder costs. However, it may be possible to develop a tax transfer pricing framework that is broadly consistent with regulatory requirements, though potentially at the expense of deviating from funds transfer pricing principles.

In the U.S., for example, Section 23 B. of the Federal Reserve Act requires regulated banks to transact with affiliates ‘on terms and under circumstances, including credit standards, that are substantially the same, or at least as favorable to the member bank, as those prevailing at the time for comparable transactions with or involving non-affiliates.’ Such a requirement might make it difficult to charge differing costs of funding to a given business based upon the risk of its businesses, particularly when the legal entity as a whole could fund less expensively. Similarly, a taxation authority might challenge increases in credit cost based upon modeled evaluations of risk, particularly when the same legal entity can raise funds less expensively from third parties (i.e., internal comparable uncontrolled transactions). At the same time, while a bank might avoid regulatory scrutiny by providing its regulated affiliate in the U.S. credit at below-market rates, such an approach might receive less approval from the taxation authority in the lending jurisdiction (and indeed potentially the regulator in this jurisdiction as well).

On the transfer pricing front, the Organisation for Economic Cooperation and Development (OECD) is currently evaluating the transfer pricing implications of intra-group financial transactions as part of Base Erosion and Profit Shifting (“BEPS”) Action 4 and Actions 8-10; they released a discussion paper on 3 July 2018 – see our article “OECD discussion draft on transfer pricing of financial transactions”. The revised 2017 OECD Transfer Pricing Guidelines already recognise the concept of passive association, where the interest rate charged on an intercompany loan to an affiliate can recognise the benefit of implicit group support to the extent this would be recognised by a third party finance provider. This is discussed further in the 3 July paper. In the meantime, taxation authorities are taking disparate approaches towards evaluating the pricing and indeed terms of financial transactions. As global financial institutions tend to have material cross-border funding flows, this emerging area of tax controversy is likely to impact financial institutions. Furthermore, developing tax case law globally is also a factor to consider in pricing loan transactions on an arm’s length basis. For example, the principles established in Chevron Australia Holdings Pty Ltd (CAHPL) v Commissioner of Taxation [2017] FCAFC 62 (the Chevron case) in Australia are an important part of any transfer pricing analysis of the terms and conditions of loan transactions, not just the price of the loan. Indeed, the accurate delineation of the financial transaction is a key discussion area in the 3 July paper and draws on Chevron to some degree.

Following the passive association approach, certain taxation authorities are using such ‘group affiliation’ arguments to argue that attributing a significant credit differential between a subsidiary and its parent is both artificial and inappropriate.
One key area of ambiguity arises from the requirement under OECD guidance that transactions be evaluated as if the parties were 'independent'. Certain taxation authorities have argued that an 'independent' transaction includes transactions between subsidiaries of multinationals and third parties — and therefore the credit risk of a subsidiary needs to be evaluated in light of the fact that it is part of a broader group and therefore might receive contingent credit support from other members of the group (even though such support would not be consistent with it being independent from these other members). In practice, following the passive association approach, certain taxation authorities are using such 'group affiliation' arguments to argue that attributing a significant credit differential between a subsidiary and its parent is both artificial and inappropriate, regardless of the subsidiary’s actual credit profile. Some taxation authorities have also argued that certain transactions, as structured by the taxpayer, would not have occurred – and subsequently propose to restructure (and reprice) transactions, potentially in ways that make little sense to industry participants.

**Intrabank transactions**

The OECD notes in its Report on the Attribution of Profits to Permanent Establishments (2010) that it is not appropriate, absent extraordinary circumstances, to assign a different credit quality to a branch of a bank than that of the head office, given the two are parts of the same legal entity (paragraph 31). Hence, even if a branch has significantly different activities that, if the branch were evaluated on a stand-alone basis were to increase the credit risk of the branch, it is not appropriate to reflect that differential in credit risk in the branch’s cost of funding. There are therefore typically separate rules for branches applying for tax purposes, which may adopt the Authorised OECD Approach, subject to application of Article 7 and 9 of the OECD Model Tax Convention.

**Conclusion**

Increased scrutiny from regulators and tax authorities across the globe is pushing banks to address FTP policy and consistency between regulatory and tax approaches. It is also driving a focus on pricing to consider whether it unduly favours one party over the other e.g. the business/product line versus the treasury unit (the borrower and lender perspectives), and if so, approaches to resolve any mismatches or consistent losses in one entity or unit in this respect.
Evolving issues around branch profit allocation in a post Brexit world

Following the implementation of the Solvency II Directive, many multi-national insurance groups in the European Economic Area ("EEA") operate with a “hub and branch” structure to manage capital and compliance demands more effectively. This leads to a number of potential tax implications, and from a transfer pricing perspective the key consideration is the attribution of profits to a permanent establishment ("PE") for tax purposes, encompassing both underwriting profit and investment income. In the current environment, two issues remain paramount in the context of branch profit attribution:

- Application of the Authorised OECD Approach ("AOA"); and
- Impact of Brexit.

This article will explore both of these in detail.

Application of the AOA: Survey

Eight years ago, the Organisation for Economic Cooperation and Development ("OECD") published the 2010 Report on the Attribution of Profits to Permanent Establishments ("the PE Report"), the purpose of which was to address considerable variation in the interpretation of the general principles which govern the attribution of profits to a PE under Article 7 of the OECD Model Tax Convention. The OECD specifically sought input from the insurance industry to address how the AOA could apply to situations commonly found in enterprises carrying on an insurance business through a PE. The broad consensus was that:

- The concept of the key entrepreneurial risk taking function(s) ("KERTs") of an insurance enterprise is the guiding principle for allocating underwriting profits and investment income to a PE of an insurance enterprise; and
- In an insurance context, the designation of the KERT function equates to the assumption of insurance risk as a result of the underwriting function.\(^7\)

The PE Report defines the underwriting function to include the following activities:

- Setting the underwriting policy;
- Risk classification and selection;
- Pricing;
- Risk retention; and
- The acceptance of the insured risk.

However, the PE Report does recognise that there may be exceptions depending on the line of business where active risk management of insurance risk can also be categorised as a KERT function. For example, in the life assurance industry, the decision to take on risks may have less influence on the risk profile than how they are managed.\(^8\)

---

\(^6\) Per paragraph 8, Part I of the PE Report, “The authorised OECD approach is that the profits to be attributed to a PE are the profits that the PE would have earned at arm’s length, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.”

\(^7\) Paragraph 68, Part IV of the PE Report.

\(^8\) Examples include unit-linked funds and investment bonds, in which the active risk management of investment risk and asset/liability matching are more important than where and how the risks are assumed given the long tail nature of the policies.
Nevertheless, the question still remains are tax authorities consistent in their application of the AOA, or are there varying interpretations of the AOA which create another transfer pricing dilemma for insurance groups, and therefore could lead to double taxation?

To assess the acceptance of the AOA and understand the differences by jurisdictions, Deloitte conducted a survey of its global network member firms to identify the acceptability of the AOA in certain countries which included:

- An indication of the preferred methodology by tax authorities to attribute investment income: capital allocation ("top down") versus thin capitalisation ("bottom up");
- The most commonly applied allocation keys to allocate investment income (e.g. premiums, technical reserves, which includes incurred but not yet reported, incurred but not enough reported, case reserves, outstanding loss reserves or an internal economic capital measure); and
- The preferred accounting approach: head office generally accepted accounting principles ("GAAP") versus local GAAP and the use of safe harbour exemptions.

Based on the results of the survey, as set out in the table below, whilst the PE Report provides a common framework for attributing profits to a PE of an insurance enterprise, there remains a wide range of interpretations which can result in double taxation in certain circumstances.

<table>
<thead>
<tr>
<th>Country</th>
<th>Does your country accept the Authorised OECD approach (AOA)?</th>
<th>Does your local tax authority prefer capital allocation vs thin capitalisation as a basis for allocating notional investment income?</th>
<th>Would the tax authorities accept technical reserves using Head office GAAP (e.g. IFRS) measure of reserves as an allocation key rather than local GAAP?</th>
<th>Would tax authorities accept a notional allocation of assets? (Or would they require actual allocation of assets given there is no requirement to hold assets locally?)</th>
<th>Would tax authorities accept a regulatory safe harbour approach?</th>
<th>Would tax authorities be open to an APA (e.g. bi-lateral)?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>AOA only applies in limited cases</td>
<td>Both methods accepted</td>
<td>No</td>
<td>Yes, may require local GAAP testing</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Belgium</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes, provided a reconciliation exercise is prepared which is available upon request</td>
<td>Yes, may require local GAAP testing</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Denmark</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes, provided results are similar under local GAAP</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>France</td>
<td>Yes</td>
<td>Both methods accepted</td>
<td>Yes, provided results are similar under local GAAP</td>
<td>No</td>
<td>No</td>
<td>Yes, but a unilateral APA is more difficult to obtain</td>
</tr>
<tr>
<td>Germany</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes, provided it does not lead to double taxation</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Ireland</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Italy</td>
<td>Yes</td>
<td>Both methods accepted</td>
<td>Yes, provided results are similar under local GAAP</td>
<td>Yes</td>
<td>Potentially</td>
<td>Yes</td>
</tr>
<tr>
<td>Japan</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes, provided results are similar under local GAAP</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>Yes</td>
<td>Both methods accepted</td>
<td>Yes, provided results are similar under local GAAP</td>
<td>Depends on the case</td>
<td>Potentially</td>
<td>Yes</td>
</tr>
<tr>
<td>Netherlands</td>
<td>Yes</td>
<td>Yes, provided results are similar under local GAAP</td>
<td>Depends on the case</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Singapore</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes, provided results are similar under local GAAP</td>
<td>Depends on the case</td>
<td>Depends on the case</td>
<td>Yes</td>
</tr>
<tr>
<td>Spain</td>
<td>Yes, however, the AOA is not formally incorporated into domestic legislation</td>
<td>Both methods are accepted</td>
<td>Yes, provided results are similar under local GAAP</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Switzerland</td>
<td>Yes</td>
<td>Both methods accepted</td>
<td>Yes, provided it does not lead to double taxation</td>
<td>Depends on the case</td>
<td>Depends on the case</td>
<td>Yes</td>
</tr>
<tr>
<td>UK</td>
<td>Yes</td>
<td>Both methods accepted</td>
<td>Yes, provided it does not lead to double taxation</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>US</td>
<td>Yes, where there is an AOA treaty</td>
<td>Depends on the case</td>
<td>No official guidance, but in our experience the approach is reasonable</td>
<td>Yes, where the AOA is applicable</td>
<td>Depends on the case</td>
<td>Yes</td>
</tr>
</tbody>
</table>

Source: Responses provided by Deloitte global network member firms in the above countries as at June 2018.
For example, some groups use the head office GAAP measure of technical reserves as an allocation key to allocate investment income to the branches. In certain cases there can be significant differences between head office GAAP and local GAAP, this can cause issues with certain tax authorities. Certain countries (e.g. UK) will accept the head office GAAP measure of technical reserves on the basis that it provides a consistent basis for allocating income, and that the sum of the investment income booked in the branches is no more or less than the total investment income of the enterprise. However, other countries would only accept head office GAAP on the basis that the allocation is not significantly different under local GAAP (e.g. Spain). Other countries such as France and Germany prefer the local GAAP measure of technical reserves (which includes Claims Equalisation Reserves (“CER”)) as a basis for allocating investment income. This can be problematic if the head office uses IFRS as the basis for allocating investment income given IFRS does not take into account CER as part of the calculation. This may potentially lead to an over allocation of investment income to Germany and France and therefore exacerbate double taxation.

Insurance groups therefore should consider how this mismatch could be addressed. One way is through an Advance Pricing Agreement ("APA") which is becoming an increasingly powerful tool in giving taxpayers certainty on their transfer pricing position, particularly as tax authorities become more coordinated in their approach to audits, as evidenced by cross-border multi-jurisdictional transfer pricing audits. In this environment, securing a bilateral APA is one way to demonstrate to a third fiscal authority (who will not be a party to the APA) that the profit attribution methodology is:

- Applied consistently across all of the PEs; and
- That the sum of the underwriting profits and investment income is no more or no less than the total income of the enterprise.

Therefore, this reduces the risk of double taxation.

**Impact of Brexit**

The other key consideration currently is Brexit and the possible impact this will have on operating structures for insurance groups across Europe.

Many insurance groups, whether headquartered in the UK or for which the UK serves as a regional centre, currently rely on EU passporting rules to write business in 27 member states under either:

- A "freedom of services" basis – business written in the UK for EU customers; or
- A "freedom of establishment" basis – business written by an EU branch of a UK insurance company for EU customers.

Following the Brexit vote in June 2016 and as Brexit negotiations have unfolded, many insurance groups are anticipating the loss of these passporting rights under Brexit, which would expose UK insurance companies to legal and regulatory barriers if they wish to continue to serve their existing EU customer bases.

Specifically, UK-based insurers that follow a hub and branch approach will need to restructure in one of two ways:

- Retain the UK-based insurance carrier alongside a new EU-based insurance carrier with branches across the EU, with the UK-based insurance carrier potentially as a subsidiary of the new EU-based insurance carrier;
- Establish a UK branch of a new EU-based carrier, otherwise known as a “third country” branch.

In responding to Brexit, many insurance groups have already reviewed their operating structure from a regulatory perspective and conducted an exercise to determine the new jurisdiction of choice. Whilst many EU member states are seeking to attract business by providing a more regulatory friendly regime or setting favourable substance thresholds, there is one key business question to answer – **how does one maintain the underlying economics of the business, from a transfer pricing perspective, albeit under a different operating model?** The case study below considers certain potential options post-Brexit.
Case Study

Pre-Brexit Scenario

Pre-Brexit, a UK-based insurance carrier, otherwise referred to as UK InsurCo, operates with branches across the EU, notably France and Germany, on a freedom of establishment basis writing mainly Casualty business. The Prudential Regulatory Authority ("PRA") regulates UK InsurCo and its branches, with all the assets required to support the technical liabilities of UK InsurCo and its branches held centrally in the UK as there is no regulatory requirement to hold assets locally.

The business operates with a flexible delegated underwriting authority model whereby:

- The Head of Casualty works in the UK on behalf of UK InsurCo and sets the underwriting guidelines and associated parameters within which the EU branch underwriters are permitted to operate;
- The underwriters in the German and French Branch can accept business within their pre-defined authority limits, which vary depending on their experience and expertise; and
- If an attractive opportunity arises which is outside the underwriting authority limits of the German and French Branch casualty underwriters, the opportunity is submitted to the Head of Casualty in the UK for consideration and approval.

Diagram 1: Likely Pre-Brexit Operating Structure

From a transfer pricing standpoint, UK InsurCo would be entitled to a share of the underwriting profits and investment income associated with the referred business as it is deemed to perform the KERT function leading to the assumption of insurance risk.

When the UK officially leaves the EU, and if the loss of passporting rights is confirmed, how does UK InsurCo respond?

There is the current expectation that post-Brexit, UK InsurCo will no longer be able write business on a freedom of services or freedom of establishment basis. Whilst some staff may be willing to relocate elsewhere in the EU, others may not be.

The possible responses include establishing:

- A new EU-resident insurance carrier, EU InsurCo, with EU branches, to continue serving the existing EU client base only. UK InsurCo would continue to serve the UK domestic market;
- A new EU-resident insurance carrier, EU InsurCo, with EU branches and a UK branch, to continue serving the existing EU and UK client base respectively.
The diagram below sets out the two possible options with the key operating features summarised in the table below.

### Diagram 2: Possible Post-Brexit Operating Structure

<table>
<thead>
<tr>
<th>Key features</th>
<th>Option A: Retain the UK-based insurance carrier and establish a new EU-based insurance carrier with branches across Europe</th>
<th>Option B: Establish a UK branch of the new EU-based carrier, otherwise known as a “third country” branch</th>
</tr>
</thead>
</table>
| **Overview of the operating model** | Head of Casualty, who works for UK InsurCo, is responsible for:  
  - Setting underwriting guidelines and limits; and  
  - Providing strategic underwriting services to EU InsurCo when local underwriting authority limits are exceeded. | Head of Casualty, who works for the UK Branch, is responsible for:  
  - Setting underwriting guidelines and limits; and  
  - Making decisions when local underwriting authority limits are exceeded. |
| **Regulatory permissions** | Assuming the EU branches identify opportunities which exceed their underwriting limits, UK InsurCo is unlikely to have the requisite regulatory permissions to make underwriting decisions on behalf of EU InsurCo. However, one potential option is for UK InsurCo to provide strategic underwriting services and recommendations to EU InsurCo such that EU InsurCo makes the final underwriting decision. | Similar to Option A, the UK Branch will not have the requisite regulatory permissions to write EU-business and will therefore write UK business only. |
| **Other factors to consider** | As UK InsurCo will be a separate legal entity from EU InsurCo, this could result in different capital requirements compared to Option B given capital diversification under Option B. | If the UK Branch is a significant operation (by reference to, say, premium volume), a question could arise as to whether the UK Branch could be viewed as supervising the overall activities of the EU InsurCo. |

Whilst the table above sets out an overview of the operating model and the relevant regulatory permissions, a key question from a transfer pricing perspective is how one rewards UK InsurCo and the UK Branch for their input into the underwriting activities of EU InsurCo. Under Option A, one may consider rewarding UK InsurCo for the provision of strategic underwriting activities on a cost plus basis. However, the question would remain whether the new transfer pricing model appropriately rewards the locations where value creation occurs, principally in the UK. Alternatively, would a different transfer pricing model, such as a profit split, or a fundamentally different transaction, such as reinsurance, be a more appropriate answer?

---

9 The UK Branch is treated as a “third country” branch.
For Option B, if the underwriting experience and expertise remain in the UK, how does one remunerate UK Branch for the underwriting services performed? It is likely that Option B will require a review of where the KERT functions are performed and the associated attribution methodology of underwriting profits and investment income between EU InsurCo and the UK Branch.

**Conclusion**

In a fast-paced environment where political uncertainty and an evolving regulatory framework are causing headaches for businesses, the tax overlay is increasingly important, particularly as transparency and disclosure requirements, including Country-by-Country Reporting, provide tax authorities with more information. Given insurance groups’ reliance on branch structures in Europe, branch profit attribution in a post-Brexit world is key, and taking time to consider the tax implications alongside the operational considerations has never been more important.
Brexit

Brexit uncertainty and TP considerations in the financial services sector

The UK has committed to withdrawing from the European Union (“EU”) on 29 March, 2019, subject to a potential transitional period. Consequently many UK-based financial services groups are well advanced in terms of their Brexit contingency planning. The key driver for any changes, including group re-structuring, is the loss of regulatory passporting rights, but the knock-on effects for tax generally, and transfer pricing specifically, need to be considered.

Loss of passporting

Under EU Directives, UK companies currently have the right to “passport” financial services to European Economic Area (“EEA”) countries by either establishing a branch/agents in an EEA country or through the provision of cross-border services.

The UK is negotiating a potential 21-month transitional period post-Brexit until December 2020. While there is political agreement on a transition period, the draft Withdrawal Agreement which contains the terms of the transition period is yet to be fully agreed, and will need to be ratified before there is legal certainty. The Chancellor of the Exchequer, in his HSBC speech in March 2018, challenged the assertion that Financial Services cannot be part of a free trade agreement. However, there is still the question of the extent of market access for financial services in any agreement on the future UK-EU relationship.

The potential alternatives to passporting are somewhat limited. The next best option is regulatory “equivalence” granted under the EU’s third country regime, although this can be rescinded at short notice and many financial services groups are reluctant to rely upon it. World Trade Organisation (“WTO”) rules are generally perceived as being less favourable than equivalence; and other potential alternatives are limited in scope (e.g. use of “reverse solicitation” for distribution activities).
As such, many UK financial services groups are making structural changes to ensure they can continue to operate in the EU post-Brexit. Consideration in your transfer pricing arrangements will need to be given to (i) people performing regulatory services and where they are located, (ii) the risks associated with the regulated activities and where these are borne, (iii) the capital associated with these regulated functions and the balance sheet on which it sits, and the (iv) assets relating to the new functions, both as part of the restructure and post-restructuring.

**Restructuring**

The movement of people, risks, capital and assets as a result of Brexit will necessarily lead to changes in where the functions, assets and risks – the key drivers of value from a transfer pricing ("TP") perspective – are located. Typically we consider where Significant People Functions ("SPFs"), or in a Banking or Insurance context where the Key Entrepreneurial Risk Taking Functions ("KERTs") are performed when attributing value in transfer pricing analyses, but also where a business’s key assets are located and where the risks of the business are borne in a Permanent Establishment ("PE") profit attribution exercise.

**People**

With the loss of passporting, people performing regulated functions for EEA clients will need to be located within the EEA. From a business perspective this throws up several immediate issues (e.g. the need for staff to move, potentially creating duplication of roles between the UK and EEA and the need to meet minimum substance requirements in multiple jurisdictions).

The kind of substance required will need to be agreed with the local regulator in the new jurisdiction but will most certainly lead to more local roles and infrastructure within the EEA. This may mean greater disruption to the existing business structure. A re-alignment of where these functions are performed will therefore pose significant TP questions.

In asset managers it is possible we will see portfolio managers and/or distributors based in different jurisdictions; underwriters in insurance may also need to move to EU carriers; and the level of trading staff at banks, if any, required to relocate will need to be determined.

**Risks**

Changes to where regulated activities are performed will potentially lead to a re-alignment of risk within the corporate structure. The scale of this risk will vary by industry and by the exact nature of the operating model adopted on a case-by-case basis.

The new local EU regulators may have specific requirements with respect to management of risk, but restructuring will also be driven by business concerns. As a rule of thumb, de-centralisation of risk leads to a reduction in benefits from e.g. diversification of risk, and often this business motive will heavily influence the new transfer pricing operating model.

Risk may come in the form of contracts, such as contracts with fund vehicles in the asset management industry, insurance risk, or in the form of capital at risk for banks. Transfer pricing will need to consider the implications of the risk transfer both from a regulatory and practical perspective. There is substantial scope for disruption to the fact pattern; for example, an EU insurance carrier may reinsure into the UK, but the type of reinsurance and the terms of this contract could mean that one EU carrier has a significantly different risk profile to another.

Risks typically need capital to support them.

**Capital**

Financial services groups are required to hold capital in the jurisdictions where their regulated activities are performed e.g. Tier 1 capital, Solvency II Capital etc., subject to local branch exemptions. This capital is, in many cases, required to underwrite the inherent risks of the business.

Many UK headquartered financial services groups currently conduct activities through branches (for example banking operations, fund managers distributing through a network, or insurers operating the "hub and spoke" model). The potential challenges of revising these models can be acute, particularly for insurers, who stand to lose significant diversification benefits as a result of balance sheet fragmentation.
Any restructuring will therefore need to consider how capital is allocated.

Transfer pricing comes into play here when we consider the return to capital (an asset in the typical transfer pricing consideration of functions, assets and risks) and the changes to capital at risk.

For asset managers, management companies are required to hold a certain level of capital; in the case of insurers, there will in all likelihood be a need for increased capital within the group to ensure that any new carriers are sufficiently capitalised; whilst banks will potentially need to maintain higher levels of regulated capital as a result of operating multiple regulated entities.

Assets

Many financial services groups have been focussing on whether an "exit" charge will arise on the transfer of an asset. Management agreements in the case of asset managers and renewal rights in the case of insurers are good examples of this. Other examples of assets that may need to be transferred include customer relationships, distribution rights or technological IP (e.g. for underwriting or trading strategies).

The obvious question that this raises is how should the assets transferred be valued? UK tax rules (for example the Capital Gains and Intangible Fixed Assets regimes) can in some cases deem that the transfer take place at the higher of the Arm’s Length Price and market value. UK tax on a market value disposal is a potential cost of moving activity out of the UK: an exit charge. Considering the nature of the assets being transferred, the transaction being undertaken, the market value and any available statutory reliefs will need to be considered.

There is an inevitable transfer pricing element to determining a correct market value. A good case in point would be the transfer of contracts for the provision of regulated services; robust benchmarking support and understanding of the local tax regulations to determine the correct price will be critical when determining the value transferred.

In asset management we are seeing the most activity in relation to the movement of management contracts to entities based in EEA states; in the case of insurers contractual renewal rights may need to transfer; trading books for banks may also move. This is regardless of whether the risk is ultimately transferred back to the UK via, say, reinsurance or derivatives.

A value chain analysis of the post-restructuring transactions will need to be performed. This should take into account the latest OECD guidance provided as part of the Base Erosion and Profit Shifting ("BEPS") project as well as the OECD guidance on Permanent Establishments ("PEs"). Certain SPFs and KERTs may be located in new/different jurisdictions as a result of the restructure.

Post-Restructuring

Any post-restructuring changes will also need to be cognisant of transfer pricing. Two new groups of transactions will emerge: (i) transactions that previously did not exist at all (e.g. between UK entities and new EEA entities) and (ii) transactions that were previously UK-UK now being cross-border.
TP should not be considered in isolation; with changes to transactions, particularly cross-border, VAT will be of increased significance. Issues such as the provision of composite supplies, understanding the TP covered transactions and their impact on irrecoverable VAT and understanding which services/products are VAT-exempt should all be assessed as part of the new TP operating model.

The knock-on effects of the restructuring must also be considered; in the event that assets, for example, have moved, we would expect the revised value attributed to them under the new structure to broadly align with the valuation assigned as part of the restructuring exercise. Where new inbound transactions are created (e.g. where a contractual relationship has moved from the UK to the EU, but functionality is delegated back to the UK) there is also the question of how these are regulated in the UK – for example, will the Prudential Regulatory Authority and the Financial Conduct Authority continue to regulate most activities?

Chapter IX of the Organisation for Economic Cooperation and Development’s Transfer Pricing Guidelines deals with restructurings, and any analysis will need to give consideration to the provisions set out therein.

Summary

The business changes being forced by Brexit are regulatory driven and to some degree are still being discussed with local regulators. Consideration of the tax, and transfer pricing in particular, consequences of both the transition and the subsequent post-Brexit operating model, will however be a critical stage in both the planning and implementation process.
OECD discussion draft on transfer pricing of financial transactions

The Organisation for Economic Co-operation and Development (OECD) on 3 July 2018 released a non-consensus discussion draft on the transfer pricing aspects of financial transactions. This discussion draft is part of Actions 8-10 of the base erosion and profit shifting (BEPS) project, which began in 2013. The OECD invited interested parties to submit comments on the discussion draft by 7 September 2018.

The 2015 final report on BEPS Actions 8-10 mandated follow-up work on this topic. Pursuant to that mandate, the discussion draft aims to clarify the application of the OECD transfer pricing guidelines (TPG) to financial transactions, in particular, the accurate delineation analysis under Chapter I.10 The discussion draft addresses debt-versus-equity determinations as well as specific issues related to financial transactions such as rates of return, intragroup loans, cash pooling, hedging, guarantees, and captive insurance companies.

A lot of the discussion is aimed more at corporate groups outside the financial services sector (e.g. the discussion around captives), however the principles discussed within the draft are also in many cases equally applicable to financial services groups, for example the approach to intra-group loans. We also have to bear in mind the footnote to D.1.2.1. (Analysis of risks in commercial or financial relations) in the Transfer Pricing Guidelines, noting that the regulatory approach for insurance, banking and other financial services business needs to be taken into account, and reference made as appropriate to the transfer pricing guidance in Parts II-IV of the 2010 OECD Report on the Attribution of Profits to Permanent Establishments.

Debt versus equity determinations

The discussion draft includes guidance that reflects an approach of accurate delineation of the actual transaction to determine the capital structure (the mix and types of debt and equity) used to fund an entity within a multinational enterprise (MNE) group. The draft guidance indicates that an approach of accurate delineation, which may include a multifactor analysis, is necessary before pricing a loan to determine whether the purported loan is regarded correctly, or should be recharacterised as equity for tax purposes.11 Furthermore, the draft guidance suggests that the recharacterisation as equity of a purported loan is not an all-or-nothing consideration; rather, the draft guidance appears to allow a bifurcation of a purported loan between debt and equity as part of the accurate delineation analysis.12

As stated in the discussion draft, accurate delineation of financial transactions should begin with the thorough identification of economically relevant characteristics of the transaction, consistent with the application to other transactions. These include:

- An examination of the contractual terms of the transaction;
- The functions performed, the assets used, and the risks assumed;
- The characteristics of the financial products or services;
- The economic circumstances of the parties and the market; and
- The business strategies pursued by the parties.

---

10 All references to the OECD TPG are references to the 2017 version of the TPG.
11 This approach of accurate delineation applies to certain financial transactions mentioned in the discussion draft including intragroup loans, cash pooling, hedging, guarantees, and captive insurance arrangements.
12 The bifurcation approach is consistent regarding the United States with the draft Treas. Reg. §1.385, although the final regulations moved away from this methodology.
The discussion draft specifically mentions factors that may be useful indicators in accurately delineating a loan. While it clearly states that the draft guidance is not intended to prevent countries from implementing other approaches to address capital structure and interest deductibility, it lists a number of factors that can be used to distinguish intercompany debt from other forms of funding such as equity, including the following:

- The presence or absence of a fixed repayment date;
- The obligation to pay interest;
- The right to enforce payment of principal and interest;
- The status of the funder in comparison to regular corporate creditors;
- The existence of financial covenants and security;
- The source of interest payments;
- The ability of the recipient of the funds to obtain loans from unrelated lending institutions;
- The extent to which the advance is used to acquire capital assets; and
- The purported debtor's failure to repay on the due date or to seek a postponement.

In applying the arm's length principle to a financial transaction, the guidance advocates for consideration of the conditions that independent parties would have agreed to in comparable circumstances. Further, it is necessary to consider the options realistically available to each of the parties to the transaction.\(^\text{13}\)

Considering that many jurisdictions follow a fixed-ratio thin capitalisation approach and others, including the United States, have issued specific regulations that govern the debt-equity characterisation that may go beyond a transfer pricing analysis, a key issue going forward will be how individual countries adopt this portion of the OECD draft guidance.

**Risk-free and risk-adjusted rates of return**

The discussion draft states that when the accurate delineation analysis shows that a funder lacks the capability, or does not perform the decision-making functions, to control the risk associated with investing in a financial asset, it will be entitled to no more than a risk-free return as an appropriate measure of the profits it is entitled to retain.\(^\text{14}\)

The discussion draft discusses the approach to use the interest rate on certain government-issued securities as a reference rate for a risk-free return. The guidance also mentions that government-issued securities are not the only reference for estimating risk-free rates, and other alternatives may be considered based on the prevailing facts and circumstances of each case.

The draft guidance states that in a situation in which a party providing funding exercises control over the financial risk associated with the provision of funding, without the assumption of or control over any other specific risk, it could generally expect only a risk-adjusted rate of return on its funding (that is, it would not be entitled to a return on its funding beyond fixed, risk-adjusted interest income). The discussion draft indicates that a risk-adjusted rate of return can be determined under different approaches, for example: comparable uncontrolled transactions, the addition of a risk premium to the risk-free return, or a cost of funds approach.

**Treasury functions: Intragroup loans, cash pooling, and hedging**

The discussion draft states that the organisation of the treasury function will depend on the structure of the MNE group and the complexity of its operations. Differences in the treasury function may flow from variations in the function’s degree of autonomy and the range of activities it performs. The draft guidance sets out transfer pricing considerations that arise from treasury activities such as intragroup loans, cash pooling, and hedging activities.

\(^{13}\) For example, in the case of an entity that advances funds, other investment opportunities may be contemplated.

\(^{14}\) The funded party would still be entitled to a deduction up to an arm’s length amount in respect of the funding. The difference between those amounts would be allocable to the party exercising control over the investment risk in accordance with the guidance in Chapter I of the TPG.
**Intragroup loans**

In determining the arm’s length interest rate on intragroup loans, a number of factors should be considered, including:

- The lender’s and borrower’s perspectives;
- The borrower’s credit rating;
- The effects of group membership (and associated implicit support);
- Incurrence and maintenance covenants;
- Guarantees; and
- Loan fees and charges associated with the transaction.

In considering the lender’s perspective, the discussion draft suggests an evaluation of the lender’s ability to bear the risks associated with the borrower’s potential default on the loan. A similar concept is also seen in the section of the discussion draft on guarantees and the guarantor’s ability to bear the financial risk associated with providing a contractual guarantee. Such an analysis is likely to be an important aspect of the accurate delineation of the transaction. However, the discussion draft does not offer any guidance or examples as to how the financial ability to bear the risk should be measured or evaluated.

Specific guidance is provided on considerations for conducting credit rating analyses and performing comparability adjustments to account for influences of controlled transactions and potential impact of passive association. The discussion draft acknowledges that credit ratings can serve as a useful measure of creditworthiness and to help identify potential comparables. Furthermore, the discussion draft highlights that in performing a credit rating analysis, it is important to note that the financial metrics of the borrower may be influenced by other controlled transactions. However, no guidance or examples are provided as to how these situations should be best addressed.

The guidance emphasizes the importance of both quantitative and qualitative factors in determining arm’s length pricing. Qualitative factors include both the effects of group membership, as discussed above, and also qualitative aspects of the borrower’s business. The draft guidance also looks beyond contractual terms to consider that the lender and borrower are related parties, that the funding is in fact intercompany and not third-party debt, and that the borrower is a member of a larger MNE. For example, consideration is given to the fact that intercompany loans are frequently subordinated to third-party loans in many jurisdictions. This suggests that there may be a need to perform a legal analysis with respect to bankruptcy laws and seniority. The guidance also highlights that covenants may be less important in a related-party context and that intragroup loans may effectively be secured lending even if no security is contractually given. Finally, consistent with paragraphs 1.164 through 1.167 of the TPG, the draft guidance considers the effects of group membership via implicit support, even in the absence of a contractual guarantee.

The discussion draft covers the issue of implicit support throughout, and the guidance on performing credit rating analyses is no exception. In line with, for example, the Standard & Poor’s approach, the discussion draft suggests that in cases in which the borrower would be more likely to receive support from other group members than a less integral member, the borrower’s credit rating is likely to be more closely linked to the group rating. Conversely, when a borrower is determined to be less likely to receive group support in more limited circumstances, it may be appropriate to first consider a stand-alone credit rating of the entity and then modify the rating upward to account for implicit support. In this context, the discussion draft asks for comments on the appropriateness (or otherwise) of adopting a rebuttable presumption to follow either the group credit rating or notching down from the group credit rating.

The discussion draft outlines the transfer pricing approaches to determine arm’s length interest rates, including the comparable uncontrolled price (CUP) method, a cost of funds approach, and reliance on bank opinions. The guidelines indicate that the last item – reliance on bank opinions – generally would not be regarded as providing evidence of arm’s length pricing.
Cash pooling

Cash pooling enables a group to benefit from more efficient cash management by (notionally or physically) bringing together the balances on separate bank accounts. The draft guidance indicates that accurate delineation of cash pooling arrangements would need to take into account the facts and circumstances of the balances transferred, but also the wider context of the conditions of the pooling arrangement as a whole.\(^\text{15}\) The discussion draft mentions two broad pricing schemes for cash pooling transactions: rewarding the cash pool leader and rewarding the cash pool members. The appropriate basis on which to reward the cash pool leader depends on the specific facts and circumstances of the arrangement.\(^\text{16}\)

The draft guidance discusses three approaches to allocating the benefits of cash pooling to the participating members (that are not necessarily mutually exclusive):

- Enhancing the interest rate for depositors and borrowers;
- Applying the same interest rates for depositors and borrowers;\(^\text{17}\) and
- Allocating cash pooling benefits to depositors, and not borrowers, within the group (in situations in which there is genuine credit risk to the depositors).

The guidance mentions that cross-guarantees and set-off rights may be required between participants in the cash pool. The guidance also mentions that, in some circumstances, the guaranteed borrower may not be benefitting beyond the level of credit enhancement attributable to the implicit support of other group members. In such cases, the discussion draft suggests, no guarantee fee would be due, and support in case of a default from another group member should be regarded as a capital contribution.

When a centralised treasury function arranges a hedging contract that an operating company enters into, the draft guidance indicates that the centralised function can be seen as providing a service to the operating company and should be rewarded accordingly. When hedging positions are not matched within the same company, although the group position is protected, more difficult transfer pricing issues may arise.

Guarantees

The discussion draft provides guidance on how to accurately delineate and price financial guarantees.

As stated in the guidance, when the effect of a guarantee is to permit a borrower to borrow a greater amount of debt than it could in the absence of the guarantee, it is necessary to consider whether a portion (incremental borrowing capacity) of the loan from the lender should be more accurately delineated as a loan from the lender to the guarantor (followed by an equity contribution from the guarantor to the borrower),\(^\text{18}\) and whether the guarantee fee paid with respect to the loan portion is arm’s length.

The draft guidance discusses both explicit guarantees (legally binding contracts) and implicit guarantees (anything less than a legally binding commitment). In general, the benefit of any such implicit support would arise from passive association and not from the provision of a service for which a fee would be payable. In an explicit guarantee, a borrower generally would not be prepared to pay for a guarantee if it did not expect to obtain an appropriate benefit in return (that is, a cost of debt-funding lower than its non-guaranteed borrowing costs adjusted for implicit support and costs associated with the guarantee).

The draft guidance describes five pricing approaches for circumstances in which a guarantee fee is found to be appropriate:

- The CUP method (although finding sufficiently similar guarantees between unrelated parties may be unlikely);
- The yield (differential) approach;
- The cost approach;
- The yield (differential) approach;
- The cost approach;
The yield approach prices the guarantee based on the benefit provided to the borrower (that is, from the borrower’s perspective), whereas the cost, valuation of expected loss, and capital support methods price the guarantee based on the cost to the guarantor (that is, from the guarantor’s perspective). It is worth noting that a capital support approach appears to presume that an improvement in the borrower’s credit rating can be accomplished solely through a capital infusion, without regard to the myriad of other inputs typically considered in a credit rating analysis.

**Captive insurance companies**

Some MNE groups manage risks within the group through a captive insurance company, a group member that provides insurance-type services exclusively or primarily to members of the group. The discussion draft provides guidance on applying the arm’s length principle to these transactions. A frequent concern when considering the transfer pricing of captive insurance transactions is whether the transaction is accurately delineated as such. The draft guidance provides indicators, all or substantially all of which would typically be expected in an independent insurer:

- Diversification and pooling of risk in the captive insurer;
- The group’s economic capital position has improved as a result of diversification and there is therefore a real economic impact for the group as a whole (that is, the captive insurer either: (i) does not only insure group risks but diversifies those group risks by inclusion within its portfolio of a significant proportion of non-group risks, or (ii) it reinsures a significant portion of the risks it insures outside of the MNE group);
- Both the insurer and any reinsurer are regulated entities with broadly similar regulatory regimes and regulators that require evidence of risk transfer and appropriate capital levels;
- The insured risk would otherwise be insurable outside the group;
- The captive has the requisite skills, including investment skills, and experience at its disposal, including employees with senior underwriting expertise; and
- The captive has a real possibility of suffering losses.

Two methods are discussed that may be appropriate for the pricing of premiums: CUPs from available comparable arrangements between unrelated parties (or internal comparables) and actuarial analysis. The draft guidance also provides for a method that builds to an arm’s length level of profitability as the sum of underwriting profit plus investment income. Further, the draft discussion provides guidance on the pricing of agency sales and arrangements whereby a captive is used to achieve synergies for the MNE group.

**Conclusion and key takeaways**

The discussion draft provides guidance on the transfer pricing aspects of financial transactions including treasury functions, intragroup loans, hedging, cash pooling, financial guarantees, and captive insurance. The principles discussed in the pricing of intra-group loans and guarantees should be equally relevant to financial transactions in financial services groups. Furthermore, the principles around hedging and cash pooling benefit and how these might read across to central treasury functions and alignment to funds transfer pricing in a banking context are worth consideration. Equally, there is currently no exception for Insurance groups, so the section on captives may read across to intra-group reinsurance companies.

Not only does the guidance provide methods for determining the arm’s length compensation for financial transactions, it also indicates that an accurate delineation is necessary before pricing a financial transaction to determine whether the transaction is characterised correctly, or should be recharacterised for tax purposes. To accurately delineate financial transactions, the discussion draft indicates it is necessary to perform an examination of the contractual terms of the transaction (and conduct of the parties); the functions performed, the assets used, and the risks assumed, the characteristics of the financial products or services; the economic circumstances of the parties and the market; and the business strategies pursued by the parties.

Overall, the guidance provided in the discussion draft highlights a potential need for MNEs to revisit and develop intragroup policies (and revisit associated funding agreements) to address any ambiguity regarding how tax authorities might interpret their intragroup financing transactions. For financial services groups, alignment with the regulatory position and the 2010 PE report will also be relevant.
# Deloitte Member Firm Global Network

## Financial Services Transfer Pricing contacts

<table>
<thead>
<tr>
<th>UK</th>
<th></th>
</tr>
</thead>
</table>
| Stephen Weston | Partner  
Tel: +44 20 7007 4568  
sjweston@deloitte.co.uk |
| Greg Martin | Partner  
Tel: +44 20 7007 6715  
gjmartin@deloitte.co.uk |
| Giles Hillman | Partner  
Tel: +44 (0) 20 7007 3750  
ghillman@deloitte.co.uk |
| Sebastian Ma‘ilei | Partner  
Tel: +44 (0) 20 7007 1596  
smailei@deloitte.co.uk |

<table>
<thead>
<tr>
<th>US</th>
<th></th>
</tr>
</thead>
</table>
| Rob Plunkett | Tax Principal  
Tel: +1 212 436 5261  
tplunkett@deloitte.com |
| Ivan Mullinax | Tax Managing Director  
Tel: +1 212 436 2275  
imullinax@deloitte.com |
| Bill Yohana | Tax Managing Director  
Tel: +1 212 436 5578  
bjyohana@deloitte.com |
| Darrin Litsky | Tax Managing Director  
Tel: +1 212 436 5760  
dlitsky@deloitte.com |

<table>
<thead>
<tr>
<th>Japan</th>
<th>Germany</th>
</tr>
</thead>
</table>
| Sam Gordon | Partner  
Tel: +81 362 133 760  
samuel.gordon@tohmatsu.co.jp |
| Ken Takahashi | Partner  
Tel: +81 804 183 7314  
takahashi@tohmatsu.co.jp |
| Oliver Busch | Partner  
Tel: +49 69 75695 6906  
obusch@deloitte.de |
| Silke Imig | Director  
Tel: +49 69 75695 7266  
simig@deloitte.de |

<table>
<thead>
<tr>
<th>Germany</th>
<th>France</th>
</tr>
</thead>
</table>
| Jobst Wilmanns | Partner  
Tel: +49 697 5695 6243  
jwilmanns@deloitte.de |
| Greigore de Vogue | Partner  
Tel: +33 1 40 88 22 20  
ogdevogue@deloitte.fr |
| Ralf Heusssner | Partner  
Tel: +352 45145 3313  
rheusssner@deloitte.lu |
| Muris Dujuc | Partner  
Tel: +371 2612 4303  
mdujuc@deloitte.lv |

<table>
<thead>
<tr>
<th>Netherlands</th>
<th>Italy</th>
</tr>
</thead>
</table>
| Pim Gerritsen van der Hoop | Director  
Tel: +31 882 883 880  
gerritsenvanderhoop@deloitte.nl |
| Rasmus Steiness | Senior Manager  
Tel: +31 882 883 264  
rsteiness@deloitte.nl |
| Marco Mazzetti | Partner  
Tel: +39 064 899 0910  
mazzetti@deloitte.it |
| Aldo Castoldi | Partner  
Tel: +39 028 332 4036  
acastoldi@deloitte.it |

<table>
<thead>
<tr>
<th>Spain</th>
<th>Switzerland</th>
</tr>
</thead>
</table>
| Josep Serrano Torres | Partner  
Tel: +34 932 304 984  
tjessanaotorres@deloitte.es |
| Juan Ignacio de Molina | Partner  
Tel: +34 932 304 804  
tdemolina@deloitte.es |
| Salim Damji | Partner  
Tel: +41 58 279 6217  
sdamji@deloitte.ch |
| Georgy Galumov | Director  
Tel: +41 58 279 8142  
ggaliomov@deloitte.ch |

<table>
<thead>
<tr>
<th>Belgium</th>
<th>Ireland</th>
</tr>
</thead>
</table>
| Mourad Chatar | Director  
Tel: +32 2 600 67 34  
mchatar@deloitte.com |
| Gerard Feeney | Director  
Tel: +353 1417 2403  
gfeeney@deloitte.ie |
| Jesper Skovhus | Partner  
Tel: +45 20 74 28 04  
jskovhus@deloitte.dk |
| David Godin | Partner  
Tel: +46 70 080 30 51  
ggodin@deloitte.se |

<table>
<thead>
<tr>
<th>Denmark</th>
<th>Sweden</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>South Africa</th>
<th>India</th>
</tr>
</thead>
</table>
| Billy Joubert | Partner  
Tel: +27 118 065 352  
bjoubert@deloitte.co.za |
| Anis Chakravarty | Partner  
Tel: +91 22 6185 4265  
anis@deloitte.com |
| Natalie Yu | Partner  
Tel: +86 1085 207 567  
natYu@deloitte.com.cn |

<table>
<thead>
<tr>
<th>China</th>
<th>Singapore</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Australia</th>
<th>Indonesia</th>
</tr>
</thead>
</table>
| Geoff Gill | Partner  
Tel: +61 2 9322 5358  
geff@deloitte.com.au |
| Stan Hales | Partner  
Tel: +61 2 9322 5500  
sthales@deloitte.com.au |
|  |  |
|  |  |
|  |  |
|  |  |
|  |  |
|  |  |
|  |  |

<table>
<thead>
<tr>
<th>Russia</th>
<th></th>
</tr>
</thead>
</table>
| Vladimir Elizarov | Partner  
Tel: +7 4957 870 600  
velizarov@deloitte.ru |

---

Back to Contents