G20/OECD Inclusive Framework publishes new Transfer Pricing Guidance on Financial Transactions

On 11 February 2020, as part of the G20/OECD Base Erosion and Profit Shifting (‘BEPS’) project, the Inclusive Framework on BEPS released its report Transfer Pricing Guidance on Financial Transactions, which includes new guidance be added to the OECD Transfer Pricing Guidelines for Multinationals and Tax Administrations (‘the OECD Guidelines’).

The new guidance follows on from an earlier Discussion Draft released in July 2018 and forms part of the G20/OECD’s follow-up work in relation to Action 4 (limiting base erosion involving interest deductions) and Actions 8-10 (aligning transfer pricing outcomes with value creation) of the 2015 BEPS Action Plan.

Deloitte comments

The long-awaited new chapter of the OECD Transfer Pricing Guidelines sets out guidance for businesses and tax authorities on how to determine whether financial transactions between associated enterprises are consistent with the arm’s length principle. This is the first time that specific guidance on pricing intra-group financing transactions has been included, and represents a big step forward in preventing and resolving disputes in this area. The focus is broadly on accurate delineation of the transactions being priced based on facts and circumstances, in line with the approach to other intra-group transactions. There remains, as anticipated, the option for countries to apply domestic rules in respect of when a loan should be considered to be equity for tax purposes, and the guidance is not prescriptive on how this should be approached. This will continue to be an area for potential double taxation if countries take different views, without recourse to resolution under double tax treaties.

Specific areas including the role and remit of treasury functions, intra-group loans, cash pooling, hedging, financial guarantees and captive insurance are covered. The new guidance follows many long-standing practices of applying the OECD Guidelines to financial transactions, but it is helpful to have these approaches set out and supported by examples.

For regulated financial service businesses, the guidance cross-refers (via the existing post-BEPS footnote in Chapter I of the OECD Guidelines) to the long-established guidance in the 2010 OECD Report on the Attribution of Profits to Permanent Establishments.

Cash pooling arrangements have seen increased scrutiny from tax authorities in recent years and therefore the OECD guidance in this area is particularly welcome.

Explicit statements that the pricing of intra-group loans should take into account the perspectives of both borrowers and lenders are useful – in practice, more focus has often been placed on the circumstances of borrowers. Other useful statements reinforcing existing practice include approaches to guarantee pricing, methodologies on performing benchmarking analyses, and the importance of identifying the features and attributes of transactions. Specifically, the 2018 draft of this guidance contained a ‘rebuttable presumption’ that a group credit rating should be used for individual entities, but this has been removed from the final guidance in favour of a fact-based approach taking into account both qualitative and quantitative factors for each entity.

The guidance also covers what is considered a risk free and risk-adjusted rate of return, including various approaches that are aligned with established practice, and potential methodologies that may be appropriate.

The report comprises six sections: Sections A to E will be added to the OECD Guidelines as a dedicated new chapter on financial transactions (Chapter X); and the guidance within Section F, on risk-free and risk-adjusted rates of return, will be added to the existing Chapter I.
Delineation of financial transactions

The report begins with guidance on how to accurately delineate financial transactions in line with the post-BEPS transfer pricing principles within Chapter I of the OECD Guidelines - necessary before pricing a financial transaction to determine if adjustments are required, for tax purposes, to its legal form.

The accurate delineation of the balance of debt and equity funding of a borrowing entity within a multinational group is addressed. However, the guidance does not mandate this as the only approach to determining whether debt should be respected as debt for transfer pricing purposes, nor is it intended to prevent other approaches to address debt/equity balance and interest deductibility under countries’ domestic legislation.

Delineation of financial transactions should begin with the thorough identification of economically relevant characteristics, including:

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

Where a multinational group is regulated and subject to recognised industry standards (e.g. Basel requirements for financial services), the guidance states that regard should be had to the constraints imposed. A cross reference to the existing footnote within Section D1.2.1 of the OECD Guidelines is included, highlighting the additional guidance on the application of transfer pricing principals to insurance, banking and other regulated financial services businesses found within the 2010 OECD Report on the Attribution of Profits to Permanent Establishments.

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

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

Three particular treasury activities are considered. Key issues include:

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

- Consideration of both the lender’s and borrower’s perspectives;
- Use of credit ratings of the entity, multinational group, or the debt issuance to measure creditworthiness and identify potential comparables, including various methodologies for performing credit rating analyses (e.g. using publically available tools or seeking to replicate the methodologies used by independent credit agencies), and the need to take both quantitative and qualitative factors into account;
- The effects of group membership and any associated implicit support;
- Evaluation of covenants;
- Summary of the transfer pricing approaches to determine arm’s length rates, including comparable uncontrolled price (CUP); internal CUPs; consideration of loan fees and charges; the cost of funds incurred by the lender in raising the funds to lend; the use of credit default swap prices; economic modelling, and the relevance, or otherwise, of bank opinions.

(ii) Cash pooling whereby a group benefits from more efficient cash management by (notionally or physically) bringing together the balances on separate bank accounts. Considerations include:
• The appropriate basis upon which to reward the cash pool leader in various circumstances. Examples are provided where a cash pool leader (i) merely performs a co-ordination function and thus receives limited remuneration as a service provider; or (ii) performs additional functions, controls and bears the financial risks contractually allocated to it, and has the financial capacity to bear those risks, such that an enhanced reward would be appropriate.

• The principles that should guide the allocation of the benefits of cash pooling to the participating members, including evaluating risks borne by the cash pool leader (e.g. liquidity and credit risks), the presence of cross-guarantees, and the contributions of the other participants to the cash pool.

• Cross-guarantees and rights of set-off that may be required between participants in the cash pool. To the extent that this represents only credit enhancement attributable to the implicit support of other group members, no guarantee fee would be due. Any support given in the event of a default from another group member should be regarded as a capital contribution.

(iii) Where a centralised treasury function arranges a hedging contract that an operating company enters into, the treasury function should be rewarded accordingly for the service to the operating company.

Financial guarantees

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

The effect of group membership on determining the arm’s length price of guarantees is discussed. Situations involving explicit guarantees (an indicator of which would be whether a commitment provides a lender legal rights of enforcement) are distinguished from the implicit support arising from non-binding commitments e.g. attributable to the borrower’s group member status. In general, the benefit of any such implicit support would not arise from the provision of a service for which a fee would be payable. Even in respect of an explicit guarantee, a borrower would not generally be prepared to pay for a guarantee if it did not expect to obtain an appropriate benefit beyond the implicit support of other group members, and examples are provided showing how implicit support is taken into account before determining the impact and pricing of an explicit guarantee.

Where the effect of a guarantee is to permit a borrower to borrow a greater amount of debt, it is necessary to consider: (i) whether a portion of the loan should be accurately delineated as a loan from the lender to the guarantor (followed by an equity contribution from the guarantor to the borrower); and (ii) whether the guarantee fee paid with respect to the remaining portion of the loan is arm’s length. The financial capacity of the guarantor to fulfil its obligations in case of default would also need to be examined.

Five different approaches to pricing guarantee fees are described: the CUP method (although it’s noted that it can be difficult to find sufficiently similar guarantees between unrelated parties); the yield approach; the cost approach; the valuation of expected loss approach; and the capital support method.

Captive insurance

The report includes guidance on the application of the arm’s length principle to captive insurance and reinsurance arrangements. It notes that a group may choose to pool certain risks through a group member, the captive insurance company, for a number of commercial reasons e.g. to stabilise premiums paid by group entities; gaining access to reinsurance markets; mitigating the volatility in the group’s operating results due to unforeseen insurance events; because the group considers that retaining the risk within the group is more cost effective; or the difficulty or impossibility of getting insurance coverage for certain risks.
A frequent question is whether an intra-group transaction results in a real transfer of insurance risk. Guidance on how to determine this through accurate delineation of the transaction is provided, including: setting out a number of indicators of a genuine insurance business; indicators that a group captive has assumed insurance risk, and has achieved the necessary diversification of risk resulting in an improvement in the net economic capital position of group entities; whether the captive insurer or another entity is performing the risk control functions associated with its underwriting; the effects of outsourcing certain underwriting activities to unconnected parties; and the applicability of the guidance to reinsurance ‘fronting’ arrangements - where risks are typically ceded by the operating company through a fronting company (usually an insurance broker or agent) which in turn reinsures the risk to the group captive.

Further comments are provided on: the pricing of premiums, including arriving at a comparable uncontrolled price through considering the combined ratio of the classes of business insured - which can be difficult given the lack of publicly available data - and return on capital; possible use of actuarial analysis as an appropriate method to independently determine an arm’s length premium; group synergies; and the effect of agency sales.

Risk-free and risk-adjusted rates of return

When a lender is not exercising control of the risks associated with an advance of funds, or does not have the financial capacity to assume the risks, the risks should be allocated to the entity exercising control and with financial capacity. In such circumstances, the lender will be entitled to no more than a risk-free return.

Additional general guidance is provided, for insertion in Chapter I of the OECD Guidelines, on how to determine risk-free rates. The approach widely used is to treat the interest rate on certain government-issued securities as a reference rate for risk-free returns. Key considerations include: comparing instruments with the same currency and maturity, and ideally issued at the same time; and the use of the reference security with the lowest rate of return where there are multiple governments issuing bonds in the same currency.

Approaches to calculating risk-adjusted rates of returns – applicable where an entity provides funding and exercises control of the associated financial risks, but does not assume any other specific risks – are also included, such as adding a risk premium to a risk-free return based on similar financial instruments issued in the market.

Deloitte EMEA Dbriefs webcast

Deloitte’s EMEA Dbriefs webcast programme will cover the new guidance on Wednesday 19 February 2020 at 12.00 GMT (13.00 CET). To register for the webcast please go to deloit.tt/2STCpt2 or www.emeadbriefs.com.

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