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INSIGHT: New OECD Guidance on Transfer Pricing Aspects of Financial Transactions—Part 1

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This first part of a two-part article discusses the importance of the final transfer pricing guidance on financial transactions, the role of accurate delineation as regards financial transactions, the application of the arm's-length principle to determine if a financial instrument qualifies as debt or equity, and treasury functions and the relevant considerations required when applying the arm's-length principle to intra-group loans.

1. Importance of the Final Guidance

The Organization for Economic Cooperation and Development (OECD) released new Chapter X of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (**OECD TPG**) on Feb. 11, 2020, a full 18 months after an initial non-consensus Discussion Draft was issued, and four years and two months after its initially intended deadline for publication. Chapter X contains specific guidance on the transfer pricing aspects of financial transactions and covers treasury functions, intra-group loans, hedging, cash pooling, financial guarantees, and captive insurance.

The length of time since the initially intended publication date and the first Discussion Draft reflects the challenges encountered in reaching consensus. Importantly, however, Chapter X acknowledges that countries may very well take an approach to address an MNEs capital structure (now referenced and reworded as ''the balance of debt and equity funding'') of an entity under domestic legislation that deviates from that laid out in Chapter X, and states that it does not mandate accurate delineation (i.e. ''the arm's-length principle'') as the only approach for determining whether purported debt should be respected as debt. This was one of two (re)main(ing) contentious issues holding up publication of Chapter X.

The second (re)main(ing) contentious issue was that of using the MNE group credit rating and under what circumstances, for pricing intra-group loans. Here, consensus was found in drafting vague wording in paragraph C.1.1.4 stating that in those cases where the individual/stand-alone credit rating—taking into account the effect of group membership—is ''not reliable,'' the MNE group credit rating may be used to price intercompany loans. There is no definition of what constitutes an 'unreliable'' outcome, so those countries favoring applying a group credit rating can set the reliability threshold high and force taxpayers into using an MNE group credit rating that way when assessing intra-group loans.

Separate and apart from these two issues, the Chapter X presents highly relevant guidance for intercompany financial transactions for at least three reasons:

- First, because the OECD TPG updates tend to not have an effective date and are usually presented as ''clarifications.'' The consequence is that these clarifications can be considered to apply retroactively to existing transactions, creating significant exposure to transfer pricing disputes and double taxation. This may be different where the OECD TPG updates are incorporated in domestic law by way of legislative action. Countries that may be bound by jurisprudence as to how to characterize a financial instrument, like the Netherlands is (witness its vast jurisprudence on characterizing intra-group loans and equity), may need to issue new legislation to incorporate the new guidance.

- Second, the guidance provides clarifications in areas where in practice, at least traditionally, functions were often described and considered as being entrepreneurial (for example the cash pool leader role) whereas the guidance indicates that absent special conditions and circumstances, those functions may very well only qualify as simple services, affecting the (level of the) return allocable to the relevant entity (and exposing them to audits and adjustments for open years). Similarly, the opportunity for guarantee fees seems to be downplayed in Chapter X, absent special conditions.
- Third, and obviously, Chapter X provides detailed guidance in clear wording to taxpayers and tax auditors alike on the pricing of more commonly observed intra-group financial transactions. This know-how was only accessible to persons specializing in this area of transfer pricing and taxation before and now is made available.

New Chapter X presents guidance on:

- The application of accurately delineation under Section D.1 of Chapter I of the OECD TPG to controlled financial transactions.
- How to use the arm's-length principle to characterize an instrument as debt or equity. The commentary to Article 9 of the OECD Model already mentions this option, but Chapter X now explicitly endorses this approach and provides guidance as to what that accurate delineation may look like.
- The fact that financial institutions are *not* exempted from the analysis presented in Chapter X, which we think is noteworthy. All that is mentioned is that due regard should be granted to the constraints that regulations put on entities subject to regulations consistent with recognized industry standards (e.g. Basel requirements). It would appear that as a result, further guidance may be required in this area as intercompany financial transactions of commercial banks would not necessarily seem equivalent to the treasury functions described in section C of Chapter X.
- The determination of arm's-length conditions for treasury functions including intra-group loans, cash pooling and hedging; financial guarantees and the pricing of such guarantees; captive insurance; and when and how to apply a risk-free and risk-adjusted rate of return. The relevant topics are accompanied by tailored accurate delineation guidance. This, we think, foreshadows the need for taxpayers with intra-group financial transactions to have detailed transfer pricing documentation supporting the accurate delineation of those transactions in case of audits.

Below we present summary key takeaways of certain specific transfer pricing guidance in new Chapter X.

2. Determining whether a purported loan should be regarded as a loan

Chapter X provides guidance in applying the arm's-length principle to analyze the balance of debt and equity funding of a borrowing entity (i.e. borrowing MNE), although this guidance is not intended to prevent countries from implementing approaches under domestic legislation to deal with this issue.

The following economically relevant characteristics could serve as indicators of whether a purported debt should be regarded as debt: 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 failure of the purported debtor to repay on the due date or to seek a postponement.

The Discussion Draft listed an example meant to illustrate the lack of debt capacity on which commentator views were requested. In final Chapter X, this example is maintained in paragraph 10.13 and reflects on the situation where it is clear that debtor Company B does not have the projected financial income stream to service a 10-year loan provided by related creditor Company C. Based on that determination, the example concludes that Company C's loan for transfer pricing purposes would be a function of the maximum amount an unrelated lender would have been willing to advance to Company B, and the remainder of the financial instrument would not be delineated as a loan for tax and transfer pricing purposes.

The example presents a deceivingly simplified debt-capacity analysis however. In real life, conducting a reliable debt-capacity analysis based on projected financial income stream may not be that straightforward. In addition, there are alternative approaches to conduct such a debt capacity analysis for which no specific guidance is provided. So, if tax authorities want to resort to applying the arm's-length principle to characterize intra-group funding (partly) into debt or equity they ought to be able to produce (or at the very least competently analyze) an intricate debt-capacity analysis.

3. Application of accurately delineation analysis to financial transactions

The accurate delineation analysis is also important in understanding the financial transactions prior to pricing such transactions. As was already stated in analyzing the Discussion Draft, the accurate delineation of financial transactions will need to consider industry factors such as the particular point of an economic, business, or product cycle; the effect of government regulations; or the availability of financial resources in a given industry. Furthermore, it ought to be considered that MNE groups operating in different sectors may require different amounts and types of financing due to different capital intensity levels between industries or may require different levels of short-term cash balances due to different commercial needs between industries.

Chapter X leaves no uncertainty that the parties to a financial transaction should consider all other options realistically available to them when considering whether to enter into the transaction. For example, a lender may consider other investment opportunities, while the borrower may decide not to enter into the financial transaction because it will increase its cost of capital.

Delineation requires a detailed analysis of the functions performed, assets used, and risk assumed by the respective associated enterprises. For financial transactions, accurate delineation is expected to mirror the considerations of a commercial lender or ratings agency, according to Chapter X, including an analysis of the risks relating to the loan and the availability and quality of collateral. A DEMPE-like analysis is therefore also important for financial transactions. Delineation furthermore requires an analysis of the specific characteristics of the intercompany financial products or services, the contractual terms, the economic circumstances (bull or bear market, exchange rates, timing of the transaction, but also possible restrictions on financial market access) and business strategies (e.g., the MNE group's global financing policy).

In case accurate delineation discloses that the related funding entity lacks the capability to control risk associated with the intercompany funding, Chapter X now clarifies that a risk-free rate of return (or where appropriate, risk-adjusted rate of return) applies for those funding activities, and how that risk-free rate of return could be determined. While the related party debtor may be allowed to deduct an arm's-length interest on the debt instrument in full, only the risk-free return would accrue to a related entity issuing the funds, yet that lacks the capability to control the relevant risk. The enterprise that essentially has the control and the financial capacity to assume the risk associated with the transaction should be allocated a return commensurate with that risk.

Chapter X remains silent, however, as to how these split payments are to be handled or reported. Chapter X essentially applies a look-through rule here and concludes that delineation can have the result of changing an intercompany transaction between two associated enterprises into one where the arm's-length remuneration for the intercompany financial transaction ought to be allocated (partly) to more than one associated enterprise. This introduces challenges as regards transparency and possible mismatches (interest deductibility in full on one side but only partial taxation of interest earnings on the other side) but also complications for purposes of dispute resolution and avoidance of double taxation under Article 25 of the OECD Model Convention. While the Discussion draft asked for practical implementation comments in this respect, none appear provided in Chapter X.

4. Treasury function

Prior to discussing the transfer pricing aspects in relation to intra-group loans, cash pooling and hedging, Chapter X provides an overview of treasury functions, which include cash and liquidity management, corporate financial management, raising debt and equity, and managing the relationship with the MNE group's external bankers and with independent credit rating agencies. The organization of the treasury function within an MNE group may involve different degrees of centralization depending on the MNE group structure and complexity of operations.

There are two important notes provided by Chapter X:

- First, the treasury function (e.g., the services rendered by a cash pool leader) will often be a support service to the main value-creating operation.
- Second, as the treasury policy and strategy may be determined at group level, the approach of the treasury to economically significant risks will depend on the MNE group policy rather than be determined by the treasury function itself.

A treasury department may very well conduct more complex functions in certain situations and sectors (e.g., the banking business), however. The Chapter X wording indicates that such should probably be carefully explained and corroborated in transfer pricing documentation, however, to be supported.

The Guidance provides that treasury should receive an arm's-length fee for performing coordination activities in case it serves as a contact point to centralize external borrowing of the MNE group.

5. Intra-group loans

One of the main financial transactions between MNE group entities consists of intra-group loans. Chapter X discusses general considerations in applying the arm's-length principle to intra-group loans and different approaches for determining the arm's-length interest rate. The main changes compared to the earlier Discussion Draft regard the more detailed guidance on the use of credit ratings and impact of group membership. In addition, credit default swaps and economic modeling have been added as additional approaches to price intra-group loans.

5.1. General considerations

Pursuant to the Chapter X, taxpayers should consider the following specific issues in applying the arm's-length principle to an intra-group loan:

—***Two-sided analysis***: *the analysis of the economically relevant characteristics of the intra-group loan should be performed from both the lender's and the borrower's perspectives:*

- It is important to consider the risks of the funding arrangement for the lender and the risks of acceptance and use of the funds for the borrower.
- Although a group lender will not follow all of the same processes as an independent lender in providing an intra-group loan (e.g., the information on the borrower's business is already available within the MNE group), the same commercial considerations, such as creditworthiness, credit rating, and economic circumstances, remain relevant when considering whether the conditions of an intra-group loan are at arm's-length.
- In case a parent entity of an MNE group provides a loan to a subsidiary, the parent entity essentially already has control over and ownership of the assets of the subsidiary. However, it will be appropriate to consider whether the assets of the subsidiary are available as collateral for an otherwise unsecured loan when those assets are not secured elsewhere, even when there are no contractual rights provided.
- Borrowers will strive to optimize their weighted average cost of capital when seeking funding.
- Changes in economic conditions, relevant local regulations, and macroeconomic circumstances are important factors for the TP analysis of an intra-group loan.

—***Use of credit ratings:*** *the creditworthiness of the borrower is a key factor in determining an interest rate. In this respect, credit ratings are a useful measure of creditworthiness and helpful for identifying potential comparables for estimating interest rates. Chapter X flags some special considerations regarding the use of credit ratings:*

■ Credit ratings can be estimated for the borrowing entity (referenced hereafter as borrowing MNE), the MNE group (based on the consolidated financial statements of the ultimate parent entity of the MNE group), or for a specific issuance of debt.

■ The credit rating of the MNE or the MNE group (also referred to as ''issuer credit rating'') is an opinion on the general creditworthiness of the MNE or the MNE group based on the capacity and willingness to satisfy financial obligations in line with the terms of those obligations.

■ Credit ratings should be determined based on quantitative factors (e.g., financial metrics such as debt-equity ratios) as well as qualitative factors (e.g., country and sector of the MNE or MNE group).

■ Borrowers with the same financial metrics may not have the same credit ratings because of other differences between the parties (e.g., they operate in different sectors).

■ The estimation of credit ratings for start-up companies or for companies that have recently been part of a merger needs to include the consideration of the special circumstances of such companies.

■ The reasons and choice of the credit rating should be properly documented.

■ The credit rating for a specific debt issuance regards an opinion on the creditworthiness of the issuer in relation to a specific financial instrument. This ''issue rating'' considers certain characteristics of the financial instrument, such as whether the loan regards a senior or subordinated loan, the presence of financial guarantees, and securities.

■ The issue rating can differ from the issuer credit rating, because the credit risk of a financial instrument is related to the risk profile of the borrowing MNE as well as the specific characteristics of the financial instrument. In practice, the issuer credit rating is determined first, after which the issue rating is estimated based on the characteristics of the financial instrument.

■ A publicly available credit rating of the borrowing MNE published by independent credit rating agencies may provide useful information for the credit rating determination for the intra-group loan. However, such a credit rating is usually often only available for the MNE group, if any, and not for an MNE group member. Therefore, in practice, the credit rating analysis is often based on using publicly available financial tools or methodologies of independent credit rating agencies to determine credit ratings. Such an analysis will also consider the impact on creditworthiness of being part of the MNE group.

■ The credit rating methodology used in publicly available financial tools may not be as rigorous as the methodologies applied by independent credit rating agencies. Nonetheless commercial tools are recognized as a solution for rating a specific intra-group loan in practice, particularly where the official credit rating from credit rating agencies is not available.

■ An important point made by Chapter X is that the credit rating analysis may be unreliable in case the financial metrics used in conducting such an analysis are affected by current and past controlled transactions that are inconsistent with the arm's-length principle.

–Effect of group membership:

■ Although a borrowing MNE is regarded as a separate independent enterprise in applying the arm's-length principle, there are two effects of it being part of an MNE group on evaluating the arm's-length conditions of the intra-group loan:

■ The external funding policies and practices of group management will provide information on the form and terms and conditions under which the borrowing MNE would have borrowed from an independent lender, including all economically relevant characteristics of the loan (e.g., the loan term, currency, security, and covenants). In this respect, we expect that tax administrations will pay increased attention to the terms and conditions of intra-group loans and whether these are in accordance with the arm's-length principle or not.

■ The borrowing MNE may receive support from the group to satisfy its financial obligations in case of financial difficulties. This incidental benefit received by the borrowing MNE as a result of group affiliation is referred to as ''implicit support'' in the context of intra-group loans. Implicit support may impact the issuer credit rating of the borrowing MNE or the issue rating. It is important to note that the subsequent impact on the interest rate is not subject to a fee being paid by the borrowing MNE for the support.

■ Such impact of implicit support on the credit rating depends on the relative status of the borrowing MNE within the MNE group. The likelihood of group members to receive group support will depend on the relative importance of the group entity to the MNE group as a whole and the linkages between the group entity and the rest of the MNE group. Based on Chapter X, the criteria used to determine the status of a group entity are generally consistent with existing guidance of rating agencies, including legal obligations (e.g., regulatory requirements), strategic importance, operational integration and significance, shared name, potential reputational impacts, general statement of policy or intent, and any history of support. The relative weight of these various criteria may differ depending on the industry.

■ The stand-alone credit rating of the borrowing MNE may be used in case there is evidence to substantiate that no support will be provided by the MNE group.

■ Chapter X notes that the impact of implicit support is a matter of judgment and tax administrations may not have the information available to judge implicit support. In our experience, it does happen that parent companies will not support the local MNE in case of financial difficulties, however.

–Use of MNE group credit rating:

■ One of the long-debated issues regarded whether credit rating determinations should be based on the credit rating of the borrowing MNE taking into account the impact of implicit support (this is considered the traditional approach) or on using the MNE group credit rating. Certain countries suggested to use the MNE group rating as a default rule. We discussed this in an earlier article on April 22, 2019.

■ Chapter X provides that in case the traditional approach results in unreliable outcomes, the MNE group credit rating may be used for pricing the intra-group loan if consistent with the facts, in particular in cases where the borrowing MNE is important to the MNE group and where the creditworthiness of the borrowing MNE does not deviate remarkably from the MNE group.

■ Whether the traditional approach results in an unreliable outcome can be a matter of judgment, so we expect significant controversy in this area, in particular in countries which are proponents of the MNE group credit rating approach, such as Germany.

–Covenants: To protect the lender, covenants in a loan agreement will normally be in the form of incurrence covenants or maintenance covenants. As related parties will encounter less information asymmetry than unrelated parties, the intra-group lender may choose not to have covenants in the loan agreements. Despite this, it will be appropriate to consider whether there is a maintenance covenant between the group entities and the potential impact on loan pricing, according to Chapter X.

–Guarantees: *In case there is a guarantee from another party to support the borrower's loan, the lender should evaluate the guarantor in a similar way as the original borrower in order to assess whether the guarantor would be able to meet its obligations.*

5.2 Determining the arm's-length interest rate of intra-group loans

After accurate delineation of the intra-group loan transaction, the arm's-length interest rate can be determined based on the estimated credit rating of the borrowing MNE or the issue credit rating considering terms and conditions of the loan. Chapter X presents various common approaches to determine arm's-length interest rates:

■ *External CUP*: due to the widespread existence of loan markets together with the availability of information and analysis of loan markets, the comparable uncontrolled price (CUP) method may be the easier method to apply. Considering the credit rating for the loan, terms and conditions, and other comparability factors, the arm's-length interest rate can be estimated by benchmarking the tested loan against publicly available data for other borrowers with the same credit rating for loans with sufficiently comparable terms and conditions. Chapter X recognizes that arm's-length interest rates can also be based on bond issuances or the return of other realistic alternatives to intra-group loans, such as loans, deposits, convertible debentures, or commercial papers.

■ *Internal CUP*: comparable loan transactions between an MNE group member and independent enterprises should be considered. However, without conducting comparability adjustments, applying the MNE group's average interest rate paid on its external debts will not qualify as an internal CUP by itself.

■ *Loan fees and charges*: In case separate loan fees are charged (e.g., arrangement fees or commitment fees) in an intra-group loan, these charges should be analyzed as any other intra-group transaction. However, Chapter X notes that independent lenders may incur costs (e.g., in raising capital and in meeting regulatory requirements), which MNE group entities may not incur.

■ *Cost of funds*: the pricing is based on the lender's cost of raising funds, plus expenses in arranging and servicing the loan, a risk premium reflecting various economic factors, and a profit margin. Such an approach may be used in cases whereby the loan is borrowed from an unrelated party and will pass through one or more associated intermediary companies to the ultimate borrower.

■ *Credit default swaps*: More detailed guidance is provided on using credit default swaps (CDS) for pricing intra-group loans. The spreads of CDS may be used to compute the risk premium related to intra-group loans in case the CUP method cannot be applied. However, Chapter X provides that the spreads of CDS may fluctuate because CDS are traded on the market. Thus, a CDS spread may not only reflect the risk of default but also other irrelevant factors (e.g., volume of contracts negotiated).

■ *Economic modeling*: it is noted that certain industries make use of economic models to price intra-group loans. Such models determine an interest rate based on a risk-free rate plus a number of premiums to consider for e.g. default risk, liquidity risk, expected inflation, or maturity. Such models can be considered in case the CUP method cannot be used.

■ *Bank opinions*: according to Chapter X, bank opinions are not viewed as providing evidence of arm's-length interest rates, because they do not constitute actual transactions.

6. Key takeaways

Our first key takeaways of new Chapter X include:

■ While Chapter X explicitly endorses the use of the arm's-length principle to determine whether (parts of a) debt instrument can be regarded as a loan or as some other kind of payment (e.g., contribution to equity capital) for tax purposes, as a sort of anti-base erosion tool on top of countries' individual domestic anti-avoidance rules and thin cap rules (although the effect of any interaction between those rules is not currently addressed), it does not clarify that conducting an accurate delineation analysis and debt-capacity analysis, which together are essentially the correct ways to assess the true nature of the debt instrument if the arm's-length principle would apply is not straight forward and a highly complex exercise.

■ As expected, it is important to accurately delineate each intra-group financial transaction not only on the basis of contractual terms, but also on functions performed (including assets used and risks assumed), characteristics of financial products or services, economic circumstances, and business strategies.

■ We expect that tax administrations will pay increased attention to whether the terms and conditions of intra-group loans are in accordance with the arm's-length principle through considering for instance the MNE group's external funding policies and practices.

■ The substance of financial transactions is important. For example, whether a lender assumes the bad debt risk that is contractually allocated to it depends on whether it controls the risk in substance and has the financial capacity to assume the risk. If the lender does not assume the risk, then it is entitled to merely a risk-free rate of return.

■ Implicit support may impact the issuer credit rating of the borrowing MNE or the issue rating. It is important to note that the subsequent impact on the interest rate is not subject to a fee being paid by the borrowing MNE for the support.

■ One of the long-debated issues regarded whether credit rating determinations should be based on the credit rating of the borrowing MNE taking into account the impact of implicit support (this is considered the traditional approach) or on using the MNE group credit rating. Chapter X provides that in case the traditional approach results in unreliable outcomes, the MNE group credit rating may be used for pricing the intra-group loan if consistent with the facts. We expect significant controversy in this area, in particular in countries which are proponents of the MNE group credit rating approach, such as Germany.

Chapter X foreshadows audits of intra-group financial transactions that may only be successfully handled if intercompany funding (template) agreements are up to date and transfer pricing documentation is in order. We therefore strongly recommend that all intra-group financial transactions are cataloged, screened for common commercial lender tests and requirements and adjusted as economic conditions or individual conditions of the debtor change.

Part 2, which will appear in the next issue of this publication, and will discuss the new OECD guidance on the transfer pricing aspects of financial transactions as it applies to cash pooling, hedging, financial guarantees, and captive insurance—which are all part of new Chapter X—and the new guidance on risk-free rate of return and risk-adjusted rate of return that will be included in section D.1.2.1 (Analysis of risks in commercial or financial relations) of Chapter I OECD TPG.

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