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INSIGHT: New OECD Guidance on Transfer Pricing Aspects of Financial Transactions—Part 2

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In this second part, they discuss the new transfer pricing guidance on 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 rates of return and risk-adjusted rates of return that will be included in section D.1.2.1 called Analysis of risks in commercial or financial relations in Chapter I.

Please refer to Part 1 of the authors' article, which discusses the guidance of Chapter X in relation to the accurate delineation of financial transactions, the application of the arm's-length principle to determine if a financial instrument qualifies as debt or equity, 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 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.

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 (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 widely made available.

2. Cash Pooling

Section C.2. of Chapter X provides transfer pricing guidance for cash pooling structures. A key guidance is

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that a cash pool leader in general is considered to perform no more than a co-ordination or agency function for which limited remuneration is applicable. This appears to deviate from a common observed position in practice, and taxpayers are recommended to prepare defence files to substantiate the more complex role of their cash pool leaders, if applicable. Alternatively, to reduce challenges, MNEs might want to consider outsourcing the cash pool leader function to financial institutions.

Chapter X considers cash pooling a short-term liquidity arrangement. Cash pooling is the pooling of debt and credit balances of the separate bank accounts of participating MNE group entities (i.e. cash pool members) to arrive at a net balance. Interest will then be paid to and received from the third-party bank depending on whether the overall balance is negative or positive, respectively. Through netting positive and negative bank accounts of the cash pool members, there will eventually be only an overall positive or negative balance. This prevents group entities with a negative balance from borrowing separately from the bank at a high interest rate, while the other group companies deposit their funds with the bank at a low interest rate. A main cash pool advantage is therefore to save on external borrowing costs.

A cash pool can be physical, notional, or another variation. Under a physical cash pool, surplus funds of cash pool members are physically transferred to the master account of the cash pool leader (CPL), while deficit accounts are covered by transfers of funds from the master account of the CPL to the respective cash pool members with a deficit account. Under a notional cash pool, no physical movement of cash takes place, but the bank balances of participating MNE group members accounts are theoretically aggregated for the purposes of interest optimization.

The accurate delineation of a cash pooling arrangements is important, and the following aspects should be considered in this respect:

- The facts and circumstances of the balances transferred as well as the wider context of the conditions of the cash pooling arrangement as a whole.
- A functional analysis should determine whether cash pool savings and efficiencies arise from group synergies caused by deliberate concerted group action. If so, Chapter X provides that these cash pool benefits should in general be shared between the cash pool members, provided that the CPL is provided with an arm's-length remuneration,
- To consider whether certain debit or credit positions of the cash pool members should be treated as long-term deposit or loan. We note that this issue often arises in transfer pricing audits of cash pooling arrangements and it is highly factual in nature, as cash pool balances tend to fluctuate.
- Chapter X provides that economically significant risks in relation to cash pooling structures include liquidity risk and credit risk. The assumption of liquidity risk, which arises from the mismatch between the maturity of the credit and debit balances of the cash pool members, may require the exercise of control functions beyond merely offsetting credit and debit positions. Credit risk is the risk of loss resulting from cash pool members with debit positions being unable to repay the money borrowed. The analysis of these risks should consider the short-term nature of cash pool arrangements.

A key transfer pricing issue regards determining an arm's-length remuneration for the CPL. Chapter X provides that a CPL should in general perform no more than a co-ordination or agency function. Such low functionality will result in a limited remuneration for the CPL. It is stated that minimum functions are conducted by the CPL under notional cash pooling.

However, if the role of the CPL goes beyond a coordination role, and the CPL controls the financial risks and has the financial capacity to assume these risks, the CPL may earn part or all the spread between the borrowing and lending positions.

Another key transfer pricing issue of a cash pooling arrangement regards the remuneration of the cash pool members. The guidance provides that the remuneration of the cash pool members will be calculated through the determination of the arm's-length interest rates applicable to the debit and credit positions. Such determination will allocate the synergy benefits resulting from the cash pool arrangements between the cash pool members after the remuneration of the CPL has been determined.

Chapter X states that the determination of the arm's-length interest rates for cash pool intra-group transactions is difficult because of unavailability of comparable arrangements between third parties. However, banking arrangement involving the cash pool leader and options available to the cash pool members may provide helpful information for the transfer pricing analysis.

Chapter X remarks that cash pool members should expect to be better off as compared to a situation in which there is no cash pool arrangement. This means that the cash pool members should benefit from enhanced interest rates for debit and credit positions within the cash pool arrangement in comparison with the interest rates applicable in absence of a cash pool arrangement. However, it is important to consider that cash pool members may be interested to participate in a cash pool arrangement for other reasons, such as less exposure to banks and access to liquidity.

Finally, Chapter X provides that in case cross-guarantees are part of a cash pool arrangement, no guarantee fee is due if the guaranteed borrower does not benefit beyond the level of credit enhancement attributable to the implicit support of other group members.

3. Hedging

Chapter X notes that intra-group financial transactions may include the use of hedging arrangements to mitigate exposure to risks, such as foreign exchange or commodity price movements. An independent enterprise may choose to assume such a risk or hedge against the risk exposure. In the context of an MNE group, this may be affected by the MNE group's approach to risk management and hedging.

In an MNE group, individual group entities may not contractually enter into hedging arrangements, although their risk is hedged from the MNE group perspective, because of a centralized treasury function.

Taxpayers should expect that the centralized treasury function is seen as rendering a service for which an arm's-length remuneration should be received in

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case central treasury arranges for a hedging contract entered into by the operating group entity.

More complex transfer pricing issues arise in case the contract instrument is entered into by the treasury company or another group entity, with the result that the positions are not matched within the same company, although the group situation is protected. Chapter X indicates that in this latter situation, a comprehensive analysis of the delineation of the actual transactions is required before a hedging service (and fee) are to be recognized, absent written contracts.

4. Financial guarantees

Section D of Chapter X presents transfer pricing guidance related to financial guarantees. A financial guarantee is defined as a legally binding commitment on the part of guarantor to assume a specified obligation of the guaranteed debtor if the debtor defaults on that obligation. A typical situation regards where an associated enterprise (the guarantor) provides a financial guarantee for a loan provided to another associated enterprise (the borrowing MNE or guaranteed party) by a third-party lender (e.g., a bank).

Accurate delineation of a financial guarantee should consider the economic benefit arising to the borrower beyond the benefit derived from passive association. Chapter X identifies the following two effects of financial guarantees:

- Obtaining more favourable terms for borrowing (e.g. a more favourable interest rate). In case the financial guarantee results in lower cost of debt-funding for the borrowing MNE, a guarantee fee is expected to be paid by the borrowing MNE provided it is not worse off from an overall financial position (considering the cost of the guarantee as well as the costs of obtaining the guarantee). However, a financial guarantee may not provide any benefit to the borrowing MNE beyond the benefit of being part of the MNE group.
- Access to a larger amount of borrowing. A financial guarantee could allow the borrowing MNE to increase its borrowing capacity (i.e. borrowing a greater debt amount) and reduce the interest rate. In such a case, the issue arises whether a part of the loan provided by the lender to the borrowing MNE should be accurately delineated as a loan from the lender to the guarantor followed by an equity contribution from the guarantor to the borrowing MNE. For the other part of the loan that is accurately delineated as a loan from the lender to the borrowing MNE, the issue is what constitute an arm's-length guarantee fee.

Chapter X also provides guidance on the impact of group membership on determining an arm's-length guarantee fee. Anything less than a legally binding agreement (e.g., letter of comfort) involves no explicit assumption of risk, therefore the benefit of such support would be regarded as arising from passive association and not as a service provision for which a fee is due. Whether a commitment from one MNE group entity to another to provide funding to satisfy its debt obligations constitutes a financial guarantee or a letter of comfort depends amongst others on whether the commitment provides the lender with relevant legal rights to enforce the commitment.

In accurately delineating a financial guarantee, the financial capacity of the guarantor to satisfy its obligations in case of default of the borrowing MNE should also be considered. In this respect, a high level of correlation between the guarantor's and the borrowing MNE's businesses (e.g., similar market conditions) will impact the capacity of the guarantor to fulfil its obligation.

Finally, Chapter X discusses the methodologies to price financial guarantees, including:

- The comparable uncontrolled prices (CUP) method: the difficulty of finding comparables is recognized given that unrelated party guarantees of bank loans are uncommon;
- The yield approach: estimates the savings in interest (lower interest rates) for the guaranteed party resulting from the financial guarantee, which set the maximum guarantee fee; and
- The cost approach: focuses on quantifying the risk borne by the guarantor through estimating the value of the expected loss that the guarantee incurs (loss given default). The cost approach will lead to a minimum guarantee fee.

5. Captive insurance

Section E of Chapter X provides guidance on captive insurance, which is an insurance undertaking or entity substantially all of whose insurance business is to provide insurance policies for risks of entities of the MNE group to which it belongs. Guidance is also provided on reinsurance captives (also referred to as "fronting"). For defining insurance and reinsurance undertakings Chapter X refers to insurance and reinsurance business as defined in Part IV of the Report on the Attribution of profits to Permanent Establishments (Part IV).

Chapter X recognizes several reasons for using captive insurance by an MNE group, such as stabilizing premiums paid by MNE group entities and gaining access to reinsurance markets. However, the guidance in Chapter X also makes clear that in case captive insurance is used to insure risks for which it is difficult to obtain insurance coverage from unrelated insurers, the commercial rationality of such an arrangement should be questioned.

Chapter X appears quite sceptical about captive insurance. The main concern regards whether the transaction actually relates to insurance. In other words, whether a risk exists and whether the captive is allocated the risk contractually transferred to it. Chapter X provides the following elements for evaluating whether the captive insurance is a genuine insurance business:

- Six indicators of which all or substantially all are found to be present: (i) there is diversification and pooling of risk in the captive insurance, (ii) the economic capital position of the MNE group has improved as a result of diversification, (iii) the application of a regulatory regime governed by a regulator that requires evidence of risk assumption and appropriate capital levels, (iv) it is possible to insure the insured risk outside the MNE group, (v) the captive insurer has the requisite skills and experience, and (vi) there is real possibility of incurring losses by the captive insurance.
- Accurate delineation should evaluate whether the captive insurer assumes the risks in relation to issuing insurance policies (i.e. underwriting), which may include insurance risk, commercial risk, or investment risk, in line with paragraph 1.65 of Chapter I of the OECD Guidelines. This means that the captive insurer

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should exercise control functions with respect to the risks. In addition, the captive insurance entity or division should have the financial capacity to assume the risks.

- Chapter X refers to Part IV for a description of what activities constitute the underwriting function. In case the captive insurance outsources certain activities of the underwriting function, and this is allowed under the minimum regulatory standards, it should be considered whether the captive insurance entity or division conducts the required control functions to determine whether the risk is allocated to it.
- Chapter X elaborates on the significance of risk diversification in the insurance business, which is the pooling of a portfolio of risks through which an efficient use of capital can be obtained, and how this can be achieved. Independent insurers depend on sufficiently large numbers of policies with similar probabilities of loss and non-correlated risk to result in an efficient use of capital. Having insufficient scale to achieve risk diversification or reserves to cover additional risks may indicate that the captive insurance entity or division is not operating in the insurance business. In this respect, the lack of external, non-group risks being covered by the captive insurance entity may indicate that risk diversification will not be achieved.
- Re-insurance captives: there are cases in which an MNE group involves an unrelated regulated insurer (a.k.a. the ''fronter'') to issue insurance policies to related insured entities or to the MNE group's customers, which subsequently re-insures all or a part of the risk to the re-insurance captive. Chapter X is clear that such fronting arrangements will involve controlled transactions that are complex to price.
- A distinction is being made between the specific risk being insured (that is controlled by the insured party) and the risk taken on by the insurer.

Chapter X discusses the following approaches for pricing intra-group transactions involving captive insurance and reinsurance:

5.1. Pricing of premiums:

a. Using CUPs from comparable arrangements to price insurance premiums, but comparability adjustments may be needed (e.g. a captive insurance entity will perform less functions—for instance no distribution and sales functions—as compared to an independent insurer).

We note that the difficulty of using CUPs was discussed in a Dutch court case involving a mutual insurance company that reinsured most of the risks it underwrote initially with external re-insurers. It restructured its business model by establishing a Swiss captive and subsequently entered into reinsurance agreements with the captive (rather than with the external re-insurers) in exchange for insurance premiums. In this case, it was considered that the premiums paid to the external re-insurers could be the starting point for evaluating the premiums paid to the captive.

b. Using actuarial analyses to price insurance premiums should cover the insurer's expected losses on claims, its underwriting and administrative costs and claims handling, plus a return on capital taking into account any investment income. Chapter X notes that such an actuarial analysis is complex and does not represent actual transactions between independent parties.

5.2. Remuneration of the captive insurance entity:

The arm's-length profitability of the captive insurance entity can be based on a two-step approach: (i) determining the profitability of claims through identifying the captive's combined ratio (premiums receivable less claims and expenses), and (ii) determining the investment return on its capital considering the capital of the captive and investments made by the captive in related party investments (e.g., intra-group loans). Chapter X also notes that the capital required for a captive is lower than required for an unrelated insurer because of regulatory and commercial factors.

Chapter X then discusses pricing approaches relating to the scenarios of group synergy benefits and agency sales:

- In case group synergy benefits are achieved by concerted actions of MNE policyholders and the captive through pooling risks within the MNE group at the captive, which is reinsured with independent reinsurers (thereby achieving lower premiums through collective negotiations), the synergy benefits should be allocated to MNE policyholders after providing the captive with an arm's-length remuneration for basic services rendered (in line with the guidance on group synergies in Chapter I of the Guidelines).
- Agency Sales—under this scenario, insurance contracts are not sold directly between the insurer and the insured, but a sales agent arranges the sale at the point of sale of the products (e.g., at a retail company). The insurance contracts are concluded between the captive (or the fronting company) with third-party customers at the point of sale of the products. In addition, there is an active market for insurance of the particular insured risk. In such a scenario, Chapter X takes the position that the high profit is due to the advantage of the sales agent to intervene at the point of sale. The group company with the point of sale can involve an alternative provider that can provide insurance policies. Chapter X concludes that the captive should earn an arm's-length return consistent with the benchmarked return for insurers, while the remainder of the profit should be allocated to the group company with the point of sale advantage. That this is relevant guidance is underscored by the fact that the transfer pricing aspects of the agency sales scenario was litigated in the DSG Retail Ltd. case and in a Dutch court cases involving a holiday and leisure resort group.

6. Risk-free rate and risk adjusted rate of return

Section F of the new Transfer Pricing Guidance on Financial Transactions elaborates on how to determine a risk-free rate of return and a risk-adjusted rate of return in circumstances where an associated enterprise is entitled to such returns under the guidance of Chapter I and Chapter VI of the OECD Guidelines. Section F will be part of Section D.1.2.1 (Analysis of risks in commercial or financial relations) of Chapter I OECD Guidelines and not of Chapter X on financial transactions.

6.1 Risk-free rate of return

Section F states that a funder lacking the capability or that does not conduct the decision-making functions

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to control the risk in relation to investing in a financial asset should receive no more than a risk-free return as remuneration.

A risk-free return is defined as ''the hypothetical return which would be expected on an investment with no risk of loss.'' in determining such a return, Section F notes that the funder's costs of funding should be considered. Subject to other constraints, the funded party would be entitled to deduction of an arm's-length amount in relation to the funding, while the difference between the risk-free return and the arm's-length amount allocable to the party exercising control over the investment risk. In the context of a loan transaction, this means that the lender is entitled to a risk-free return (assuming the lender does not control the risk based on the accurate delineation analysis), the borrower pays an arm's-length interest rate, while the party that controls the risk is entitled to the residual interest. Section F is silent about how such a situation should be implemented in practice, for instance, whether the risk control party receives the residual interest from the borrower or the lender. We believe that the issue of substance at the level of the lender and Section F's guidance will result in controversy in practice.

Section F confirms that the interest rate on certain (highly rated) government issued securities with the same functional currency as the investor, similar maturity and timing can be a reference rate for a risk-free return. The example that was presented in the Discussion Draft is maintained in which different governments issue bonds denoted in the same currency (e.g. €) with the result that the government bond with the lowest rate of return is selected, albeit that a minimum credit rating can be specified for the issuing government. Considering the current macro-economic circumstances, the question arises what to do with negative interest rates in relation to certain currencies (e.g., €), however, which is not addressed.

In addition to highly rated government issued securities, other alternatives such as interbank rates, interest rate swap rates, or repurchase agreements of highly rated government issued securities can be considered to determine the risk-free return.

6.2 Risk-adjusted rate of return

In situations where a related party providing funding exercises control over the financial risk in relation to the funding (without it assuming any other risks), its remuneration should be based on a risk-adjusted rate of return on its funding. It is important to distinguish between the financial risk assumed by the funder and the operational risk assumed by the funded party.

Section F provides that a risk-adjusted rate of return will consist of a risk-free rate and a premium reflecting the risks assumed by the funder.

A risk-adjusted rate of return can be determined based on various approaches, including comparable uncontrolled transactions, the return of a realistically available alternative investment (e.g., bond issuances or loans), adding a risk premium on the risk-free return, or the cost of funds.

7. Key takeaways

Our second set of key takeaways of the Chapter include:

- Chapter X indicates that a cash pool leader should generally perform no more than a coordination or agency function for which it should earn a limited remuneration.
- The element of implicit support will remain a relevant and often audited economic factor to consider in pricing intra-group loans and financial guarantees. In the context of an intra-group loan, for example, a related borrower may obtain a better credit rating (and hence lower interest rates) because of being part of an MNE group. Such implicit support is the benefit resulting from passive association that should be considered in estimating the credit rating of the related borrower. In the context of a financial guarantee, no guarantee fee would be due for implicit support resulting from passive association.
- The accurate delineation of a financial guarantee should consider whether a legally binding commitment is in place and should analyze whether the borrower enjoys economic benefit from the guarantee beyond the benefit derived from passive association. A financial guarantee that merely acts to increase the borrowing capacity of the borrowing MNE may not give rise to a guarantee fee.
- Chapter X appears quite sceptical about captive insurance. The main concern regards whether the captive insurance transactions actually relates to insurance. In other words, whether a risk exists and whether the captive is allocated the risk contractually transferred to it.
- Chapter X clarifies that a risk-free rate of return may be appropriate if accurate delineation discloses that the funding entity lacks the capability or does not conduct the decision-making functions to control the risk in relation to investing in a financial asset, and that the remainder of the remuneration ought to be allocated to the entity controlling the risk. We believe that the issue of substance at the level of the lender and Chapter X's guidance will result in controversy in practice.
- Chapter X confirms that the interest rate on certain (highly rated) government issued securities with the same functional currency as the investor, similar maturity and timing can be a reference rate for a risk-free return. The question arises what to do with negative interest rates in relation to certain currencies (e.g., €) in the current macroeconomic circumstances.
- The remuneration of a related party that provides funding and exercises control over the financial risk in relation to the funding (without it assuming any other risks) should be based on a risk-adjusted rate of return on its funding (consisting of a risk-free rate and a premium reflecting the risks assumed by the funder).

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 catalogued, screened for common commercial lender tests and requirements, and adjusted as economic conditions or individual conditions of the debtor change.

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