OECD non-consensus discussion draft on the transfer pricing aspects of financial transactions: no longer just about contractual risk

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In brief

One of the last missing pieces of the OECD BEPS project, is the development of transfer pricing guidance on financial transactions. While the OECD had pushed back the publication several times, on 3 July it published a first discussion draft (the Draft), available at: http://www.oecd.org/tax/transfer-pricing/BEPS-actions-8-10-transfer-pricing-financial-transactions-discussion-draft-2018.pdf

The complexity of the topics and disparate regional approaches has led to the publication of a non-consensus document, within which there are many areas where the OECD is seeking input from commentators. The Draft sets outs various approaches that may be appropriate for the covered topics, without giving explicit guidance. This Tax Insight provides a brief summary of the Draft, while more detailed observations will follow shortly in a Tax Insight and Tax Policy Bulletin.

In detail

Accurate delineation of the transaction

The Draft starts by applying the guidance of Chapter 1 of the OECD TP Guidelines to related party financial transactions in their "totality". The Draft states that the process of "accurate delineation" begins with an informed view of a multinational enterprise's policies and strategies towards financial transactions. The Draft then develops how the "accurate delineation of transactions" can be used as a framework on whether and under what economically relevant conditions a related party funding transaction should be respected as debt. The elements considered include evaluating debt capacity of a borrower, including specific terms and conditions applied, purpose of the loan, ability of the borrower to repay the debt, etc. The concept of options realistically available is also discussed as part of the evaluation of debt from the perspective of the borrower. The Draft acknowledges that the suggested economic principles do not preclude countries to also apply domestic approaches to address capital structure and interest limitations.

Furthermore, the Draft provides guidance on how the 5 comparability factors noted in the OECD Guidelines tie in with financial transactions. For example, when considering the business strategies, terms and conditions linked to M&A funding may be different

from those of the same business in a steady state.

The Draft underscores that - besides interest rates - all terms and conditions of the financing transactions, including the volume of debt, should be tested against the arm's length principle.

Treasury functions

The Draft initially draws the distinction between a decentralised versus a centralised treasury function (making reference to the levels of relative autonomy the subsidiaries have with respect to financing and liquidity management decisions). The Draft then makes reference to the fact that treasury policy making and strategy typically builds from group strategy and therefore treasury strategy may actually be determined, in part at least, at the group level. The Draft also suggests that treasury functions will usually be a support service to the main value creation of the group, and therefore the guidance on intra-group services in Chapter VII of the Guidelines may in certain instances be applicable.

The Draft then steps through targeted activities performed by treasury functions on an intra-group basis and provides considerations as to a) what factors can influence the appropriate remuneration / sizing / pricing of these transactions and b) what methods and sources are available to assist in the pricing mechanics.

Intra-group loans

The Draft makes reference to some of the content provided in the above noted "Accurate delineation of the transaction" and also draws the distinction between the lender and borrower perspectives and what needs to be taken into account under each. The Draft makes reference to taking into account the options realistically available to borrowers, in particular regarding security/collateral, and also what can be learned from the group financial policy that has been adopted historically. More specifically, this section then steps through specific sub-sections (noted below) and how these should be taken into account with respect to intra-group loans:

- Use of credit ratings - multiple approaches are provided and estimated credit ratings are generally considered to be a helpful tool in assessing creditworthiness from a lender's perspective. The Draft notes that these may usefully contribute to the identification of appropriate comparables for determining arm's length interest rates using available market data, albeit noting that other characteristics, such as industry differences, are to be considered
- Effect of group membership - the Draft advocates consideration of the importance of a subsidiary relative to the group or parent, for the purposes of determining its credit rating and suggests several criteria to determine the subsidiary status, broadly consistent with existing rating agency guidance (also reasserting that implicit support should not require any payment to the wider group)
- Covenants - the Draft notes that covenants (e.g. incurrence, maintenance, etc.) which are present in third party agreements are often absent from intercompany agreements while acknowledging that this might be warranted because related parties typically do not suffer from information asymmetry. An accurate delineation of the transaction may be required to determine if, in practice, the equivalent of such covenants would have existed between unrelated parties and if that would impact pricing
- Guarantees - while referred to at a high level here (with reference to the later section on Guarantees, see below) the Draft notes that a guarantee should only be factored into the analysis if the lender would need to be satisfied that the guarantor would be able to meet any potential shortfall in the event of default
- Pricing approaches - the Draft looks at three specific pricing approaches, whereby it is acknowledged that one of the key differences between loans and other intra-group transactions is the fact that there is a wealth of potentially comparable market information available, including third party (loan and bond) agreements:
  - Comparable uncontrolled price (CUP) - the Draft notes the need to identify suitable external comparables (not limited to only loans but extending to other potentially relevant transactions; e.g., bonds) and also to analyse internal CUPs at greater length to determine if, through comparability adjustments, these could be potentially comparable. The Draft indicates that an MNE Group's average interest rate paid on external debt is unlikely to meet the comparability requirements to be considered as an internal CUP, without any adjustments.
  - Cost of funds - the Draft notes that a potential approach to loan pricing is to look at the

lender's cost of funding, including costs of servicing the loan and a premium associated with the underlying terms of the intercompany debt plus a profit margin. The Draft also states that a comparison should be drawn with the cost of funds of other lenders to determine if such a cost base could be considered to be arm's length

– Bank letters/opinions - the Draft makes clear that, in general, these would not be regarded as providing evidence of arm's length pricing and terms and conditions, given that they do not represent committed funds or executed transactions.

Cash pooling

This section of the Draft initially details the potential options for cash pooling structures (physical / notional) and then goes on to discuss how a cash pooling arrangement should be delineated (e.g., in light of limited cash pool leader involvement in relation to a notional pool) along with commenting on some of the inherent risk areas associated with cash pooling setups (e.g., short term deposits in place for greater than a year). The Draft outlines that cash pool related savings or 'synergies' result from 'deliberate concerted action' of all the members, and by doing so, the Draft links the discussion to the guidance on Group synergies in Chapter I of the Guidelines.

The Draft then steps through the potential remuneration mechanisms for the cash pool leader through the use of two examples to emphasize the importance of accurately delineating the role of the cash pool leader (based on either a service-based return or a spread-based return for lower and higher risk activities, respectively). The Draft then discusses the appropriate remuneration for cash pool members (in particular, how to share cash pool benefits such as liquidity pooling, netting benefits and volume discounts) with three potential suggestions:

1. Enhance the interest rate for all participants - which would provide those members with more sizeable balances in the pool (positive or negative) with more favourable rates

2. Apply the same interest rate for all participants - debit and credit balances would receive the same interest rate

3. Allocating the benefit to the depositors - where there is genuine default risk to the depositors, apportioning the pool benefit across the depositors given their capital at risk

Finally the Draft notes that as cross-guarantees are a required feature of cash pooling arrangements, and would not exist between independent parties, there may be no incremental credit enhancement to the creditworthiness of the participants and, consequently, no compensation may be due for such cross-guarantees.

Hedging

The Draft makes brief reference to hedging, noting that some groups will seek to manage any risk exposures through targeted external hedging (either at subsidiary level, or group level) or through natural hedges, and that difficulties can arise where the treasury company is the counterparty to the external hedge but not party to the underlying affiliate hedging transaction.

For each type of the above treasury transactions, the Draft applies the 'accurate delineation' framework to assess the relevant factors and how these should be priced. Again, a central theme is the consideration of options realistically available to both borrower and lender, linking this to the terms and conditions (either specifically included within the legal agreements or otherwise that might be expected at arm's length). The Draft also notes the importance of understanding what the group financial/ treasury policy has been and how this compares with decisions being made by individual subsidiaries within the group.

Guarantees

The Draft defines a financial guarantee as a legally binding commitment on the part of the guarantor to assume a specified obligation of the guaranteed debtor if the latter were to default on that obligation. The report indicates that anything less than a legally binding commitment (e.g. a "letter of comfort") involves no explicit assumption of risk and, generally, the benefit of any support resulting therefrom would be attributable to group member status.

The Draft indicates a number of business drivers for providing a financial guarantee. Where a guarantee results in a credit enhancement beyond the impact of implicit support, an arm's length guarantee fee would be compensable. If the guarantee results in an increased debt capacity, the Draft proposes a recharacterization of the incremental capacity by hypothesizing a loan to the guarantor followed by an equity contribution to the guarantee recipient. The Draft does not consider the uncertainty that

results from the scenario where a guarantee was required by an arm's length lender to provide the financing as part of its own policies.

The Draft continues the ongoing theme around passive association (implicit support) and active promotion (explicit guarantee) of a group's activities and which produces a compensable benefit. Where there is an explicit guarantee, it is necessary to further evaluate the benefits conferred by that guarantee by reviewing third party banking agreements for covenants that may reduce or offset the value of that guarantee.

The Draft recognizes the complexities of cross guarantees, noting the possibility that it may be practically impossible to identify the benefits conferred by the parties to the arrangement. The Draft states that it is possible that an analysis of the facts and circumstances may lead to the conclusion that group member contributions may amount to passive association.

If an explicit guarantee provides value to the recipient of the guarantee, the Draft lists the following pricing approaches:

- CUP method: the Draft recognises the difficulty in applying this method but notes that examples may exist.
- Yield approach: the Draft suggests the interest-savings from a guarantee (after considering implicit support) as a potential cap, focusing on the benefit provided to the guaranteed party.
- Cost approach: the Draft suggests the costs of the guarantor may suggest a floor, focusing on the risks borne by the guarantor.
- Valuation of expected loss approach: the Draft notes that an alternative approach to price a guarantee would be to consider the expected default rates and loss data that is available in the market to evaluate the potential expected loss related to the guarantee.
- Capital support method: the Draft also discusses the evaluation of a guarantee based on the capital enhancement/ capital substitution that it provides.

Captive Insurance

Characteristics of insurance

The Draft defines insurance via reference to Part IV of the Report on the Attribution of Profits to Permanent Establishments, as well as a listing of some key features including presence of diversification and pooling of risks, evidence of external insurance market for the covered risks, existence of requisite skills (including underwriting skills) at the insurer, and the possibility of losses. In discussing the rationale for captives, the Draft notes cost mitigation, access to reinsurance, and even the potential to insure against low frequency risks with limited commercial insurance. On the latter, the Draft raises the question of subsequent ability to identify arm's length pricing. The Draft also addresses the case of 'fronting' in the case of reinsurance captives, wherein the initial insurance contract may be with a third-party insurer who then reinsures the risk to an affiliated captive insurer.

In laying out the framework for evaluating such transactions, the Draft notes that for an insurance business to exist, there has to be both the initial assumption of risk and risk distribution/ pooling, as well as other indicators expected to be present at an insurer. In the event that a captive does not demonstrate the latter (or such indicators), there could be a case where the business does not rise to being a true insurance business.

Approach to arm's length pricing

The Draft outlines the potential to use third-party pricing evidence for pricing premiums, but notes that significant comparability adjustments may be required. The use of actuarial approaches is also discussed, with the litmus test being around ensuring that the captive covers anticipated losses, underwriting and administrative costs, and a return on capital (after considering investment returns). The latter is explained in terms of a two stage approach: (a) starting with a 'combined ratio' (premiums less claims and losses), and (b) adding to it an investment return on its capital, based on investments it is making and its capital cushion. The discussion also covers required capital for a captive, noting that it may be lower than what is required for commercial insurers due to less regulatory constraints/ requirements.

Similar to the discussion on cash pooling, the discussion notes that there is an element of group synergy benefit in a captive (where the concerted action of the MNE's participants leads to reduced insurance costs) and such benefit should be distributed to the affiliates, after paying the captive for its 'basic services', in proportion to the premiums paid.

Finally, there is a brief discussion around Agency Sales, which focuses on a unique fact pattern around highly profitable insurance contracts that are tied to access to certain customer sales. The key point in this discussion centers around the Draft's view on the source of margins on such insurance contracts, wherein '…the ability to achieve the very high level of profit on the sale of the insurance policies arises from the advantage of customer

contact at the point of sale.' Here, the Draft notes that the captive should earn benchmarked returns as observed for comparable insurers, and the residual profit should be earned by the affiliate having access to customers.

Generally speaking, the discussion on captives provides a description of the relevant profile of affiliate captive insurance transactions, and centers around methods that consider both costs and considerations around appropriate capitalization. The examples indicate that there is recognition around unique types of low frequency and potentially non-commercial risks that are hard to price, a need for a clear understanding of the control around risk and true underwriting profit, and the need to demarcate potential additional sources of profit such as those related to group synergy benefits and connection to customers.

The takeaway

The Draft represents a non-consensus document and raises questions for comments which need to be submitted to the OECD by September 7th, 2018. It lays out a summary of the key issues surrounding intercompany financial transactions and helpful commentary is provided around the use of credit ratings, the availability of market data and the importance of data available at the time of the transaction, the uniqueness of cash pools to multinational groups, and proposed methods applicable to relevant transactions. The Draft also raises questions and proposes novel approaches around allocation of risk-related returns, bringing in concepts that consider a two-sided analysis of both borrower and lender/ guarantor, and goes beyond contractual terms to considerations around reasonable alternatives and the actual management of risks.

PwC will provide more detailed insight on a number of these issues over the coming weeks. Whether the Draft can be developed into a consensus document will determine the true value of the guidance but, irrespective of the final outcome, the Draft highlights the heightened scrutiny that taxpayers are facing around intercompany financial transactions and reflect the needed diligence and analysis that is recommended around the transactions addressed in the Draft.

Let's talk

For a deeper discussion of how this might affect your business, please contact:

Transfer Pricing

David Ledure, PwC Belgium
+32 (0)2 710 73 26
david.ledure@pwc.com

Michel van der Breggen, PwC Netherlands
+31 (0)88 792 75 23
michel.van.der.breggen@nl.pwc.com

Daniel Pybus, PwC UK
+44 (0)20 7213 1359
daniel.j.pybus@pwc.com

Jeff Rogers, PwC Canada
+1 (416) 815 5271
jeff.rogers@pwc.com

Nick Houseman, PwC Australia
+61 2 8266 4647
nick.p.houseman@pwc.com

Krishnan Chandrasekhar, PwC US
+1 (312) 298-2567
krishnan.chandrasekhar@pwc.com