

# OECD issues final paper on the transfer pricing aspects of financial transactions

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## In brief

The OECD on February 11 issued its final paper on the transfer pricing aspects of financial transactions (the OECD FT Paper), which will become Chapter X of the OECD Guidelines. This represents one of the last missing pieces of the OECD BEPS project. On July 3, 2018, the OECD had published a first discussion draft (Discussion Draft). The complexity of the topics and disparate regional approaches led to the publication of a non-consensus document, within which there were many areas where the OECD was seeking input from commentators.

The following outlines the key principles of each section of the document and highlights the key changes between the OECD FT Paper and the Discussion Draft.

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## In detail

### Accurate delineation of the transaction (Section B)

The OECD FT Paper starts by applying the guidance of Chapter I of the OECD TP Guidelines to related-party financial transactions in their “totality.” The paper outlines 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 (which needs to be read in line with the ongoing work being performed by Working Party 1 — see comments on key changes between the draft and final paper below).

The elements considered include evaluating debt capacity of a borrower, including specific terms and conditions applied, purpose of the loan, and ability of the borrower to repay the debt. The concept of options realistically available also is discussed as part of the evaluation of debt from the perspective of both the borrower and the lender. The OECD FT Paper acknowledges that the suggested economic principles do not preclude countries also applying domestic approaches to address capital structure and interest limitations.

In addition, the OECD FT Paper provides guidance on how the five comparability factors noted in the OECD Guidelines tie in with financial transactions and how the financing policies of the wider MNE group should be taken into account when delineating the intra-group financing arrangements. Specifically, with

reference to analyzing the functions performed by the lending party, the OECD refers to the concept of risk-free returns and where “the accurate delineation of the actual transaction shows that a funder lacks the capability, or does not perform the decision-making functions, to control the risk associated with investing in a financial asset, it will be entitled to no more than a risk-free return as an appropriate measure of the profits it is entitled to retain” (see more details below on risk-free/risk-adjusted returns).

The OECD FT Paper 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.

#### Key changes between the Discussion Draft and OECD FT Paper

Beyond some wording changes — for example, the modification of “capital structure” to “balance of debt and equity” — one key amendment to the Discussion Draft is reference to the work being performed by Working Party 1, specifically that “the guidance contained in this subsection is consistent with the Commentary on Article 9 of the 2017 OECD Model Tax Convention and also with the Commentary as it would read with proposed changes that have been agreed by Working Party 1. The guidance might be revised in the event that those proposals are materially changed at any stage.”

**Observation:** We understand that these ongoing discussions within Working Party 1 place greater focus on capital structure more generally in the context of treaties, which is why the OECD included the caveat that the interpretation of the OECD FT Paper must be read in line with the upcoming views arising from Working Party 1.

An additional example has been added to this section in order to highlight the need to examine at the financing behavior of the MNE group more generally when looking at the specific terms applied to the intercompany loan. The example indicates that where the MNE group policy and practices indicate that they would tend to borrow on a short-term basis using one-year revolving loan facilities to manage working capital, then it may be appropriate to delineate a 10-year loan provided between two group entities on the basis that the group entity “would not enter into a 10-year loan agreement to manage its short-term working capital needs and the transaction would be accurately delineated as a one-year revolving loan rather than a 10-year loan.”

**Observation:** This implies that a greater focus should be placed on the design of intragroup financing policies, in particular the terms and conditions applied with reference to the wider financing behavior of the group and group treasury functions.

Consistent with the Discussion Draft, the OECD FT Paper considers arm’s-length conditions of financial transactions, including the performance of businesses in the industry sector. What is new is the additional discussion of entities faced with recognized industry standards. Specifically, it is mentioned “where the relevant MNEs are regulated, such as financial services entities subject to regulations consistent with recognized industry standards (e.g., Basel requirements), due regard should be had to the constraints those regulations impose upon them.”

Finally, the additional commentary that was put forward by the OECD regarding the calculation of the risk-free and risk-adjusted return has been removed from this section and instead moved to its own section within the report “Section F,” albeit the majority of the commentary remains unchanged. The risk-free rate is relevant where a lender would be qualified as a so-called cash box, while the risk-adjusted return could be applied where a party providing funding exercises control over the financial risk associated with the provision of funding, without the assumption of, including the control over, any other specific risk, e.g., for some IP development.

One helpful clarification in this section is that, with regard to the calculation of risk-free returns, the OECD indicates that highly rated government-issued securities are not the only reference; other alternatives may be considered on prevailing facts and circumstances of each case (for instance interbank rates, interest rate swap rates or repurchase agreements of highly rated government issued securities).

**Observation:** It should be noted that the guidance included by the OECD with reference to risk-free and risk-adjusted returns will have broader applicability than in the context of solely intra-group funding (e.g., ownership of intellectual property), which is why the material in “Section F” will be introduced as amendments to Section D.1.2.1 of Chapter I of the OECD Transfer Pricing Guidelines.

## Treasury functions (Section C)

The OECD FT Paper initially draws the distinction between a decentralized versus a centralized treasury function (making reference to the levels of relative autonomy the subsidiaries have with respect to financing and liquidity management decisions). The OECD FT Paper then refers to the fact that treasury policymaking and strategy typically build from group strategy, and therefore treasury strategy actually may be determined — at least in part — at the group level. The OECD FT Paper also suggests that treasury functions usually will 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 in certain instances may be applicable.

The OECD FT Paper then steps through targeted activities performed by treasury functions on an intra-group basis and provides considerations as to: (1) what factors can influence the appropriate remuneration/sizing/pricing of these transactions and (2) what methods and sources are available to assist in the pricing mechanics.

### *Intra-group loans*

The OECD FT Paper refers to some of the content provided in the above-noted “Accurate delineation of the transaction” and draws the distinction between the lender and borrower perspectives and what needs to be taken into account under each. The OECD FT Paper also refers to the options realistically available, particularly regarding security/collateral and in the context of renegotiating the terms of a loan in cases of changing economic conditions.

This section then steps through other factors, set out in 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 generally are considered to be a helpful tool in assessing creditworthiness from a lender’s perspective. Compared to the Discussion Draft, the OECD FT Paper comments in more detail on the importance of analyzing both quantitative and qualitative factors influencing a credit rating.
- **Effect of group membership:** The OECD FT Paper explains that this concept is relevant for two reasons. First, the paper informs on the form and the terms and conditions under which the MNE would have borrowed (e.g., by reference to the group’s external funding policies). Second, it is important to determine the so-called implicit guarantee. For the latter, reference is made to the importance of a subsidiary relative to the group or parent, for the purposes of determining its credit rating.
- **Covenants:** The OECD FT Paper notes that covenants (e.g., incurrence, maintenance) which are present in third-party agreements often are 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 OECD FT Paper 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 OECD FT Paper looks at different pricing approaches, whereby it is acknowledged that one key difference between loans and other intra-group transactions is the fact that there is a wealth of potentially comparable market information available:
  - **Comparable uncontrolled price (CUP)** — The OECD FT Paper notes the need to identify suitable external comparables. This is not limited to loans, but extends to other potentially relevant transactions like bonds, deposits, convertible debentures, and commercial paper. If such instruments are used, the OECD FT Paper states that comparability adjustments may be required. The OECD FT Paper further 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 adjustments.

- Cost of funds — The OECD FT Paper notes that in the absence of comparable uncontrolled transactions, a potential approach to loan pricing is to look at the lender's cost of funding plus a profit margin that generally would include the lender's incremental cost of equity. The OECD FT Paper notes, however, that a related borrower would not enter into a transaction based on the cost of funding if it would be able to obtain more favorable conditions under an alternative transaction.
- Credit default swaps — The OECD FT Paper mentions such instruments as a potential comparable transaction to calculate the risk premium. At the same time, the document warns that a high degree of volatility may affect the comparability of such instruments.
- Economic modelling — Under such models, the OECD FT Paper refers to approaches whereby the interest rate is built-up of a risk-free interest rate plus a number of premiums (e.g., default risk, liquidity risk). The document acknowledges that such models may be representative tools to determine an arm's-length interest rate in cases where reliable comparable uncontrolled transactions cannot be identified.
- Bank letters/opinions — The OECD FT Paper 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.

This section also refers to the usage of the group's credit rating as a proxy for the rating of a subsidiary of that group. The OECD FT paper imposes three conditions to apply such proxy: the approach based on the afore-mentioned steps (stand-alone rating and implicit guarantee) would not lead to a reliable outcome, the subsidiary benefits from a very strong implicit group support, and the indicators of that subsidiary's creditworthiness do not differ significantly from the group's ones.

#### Key changes between the Discussion Draft and OECD FT Paper

The final OECD FT paper provides more guidance on the different steps to estimate the credit rating (including a discussion on issuer and issue ratings) and on specific circumstances that may influence the credit rating (e.g., start-ups and mergers). It furthermore put more emphasis on the importance of appropriately documenting the reasons and selection of the credit rating used.

#### **Cash pooling**

This section of the OECD FT Paper initially details the potential options for cash pooling structures (physical/notional). The document also outlines that cash pool related savings or 'synergies' result from 'deliberate concerted action' of all the members, and by doing so, the OECD FT Paper links the discussion to the guidance on Group synergies in Chapter I of the Guidelines. Contrary to the Discussion Draft, the OECD FT Paper also refers to benefits other than improved interest rates (like permanent source of financing, and reduced exposure to banks).

The document then emphasizes it is key to first determine the relevant economically significant risks linked to the cash pool — like liquidity and credit risk — and link them to the control over risk functions. The document further details that generally the remuneration of the cash pool leader will need to be calculated first before determining the debit and credit interest rates. The latter then will determine how the synergies are allocated among the pool members.

The OECD FT Paper steps through the potential remuneration mechanisms for the cash pool leader using 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).

Finally, the OECD FT Paper 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.

#### Key changes between the Draft and Final OECD FT papers

The final paper is no longer prescriptive on the remuneration of the cash pool members and removed the various approaches proposed in the Discussion Draft for splitting the cash pooling benefits. Besides enhanced interest rates on

debit and credit positions, the final document now also acknowledges that participants may have other drivers to participate in the cash pool (e.g., access to liquidity).

### *Hedging*

The OECD FT Paper makes brief reference to hedging, noting that some groups will seek to manage any risk exposures through targeted external hedging (either at the 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 OECD FT Paper 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 OECD FT Paper 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.

### Key changes between the Draft and Final OECD FT Papers

There are no substantive changes in this section.

### **Financial guarantees (Section D)**

The OECD FT Paper 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 OECD FT Paper indicates a number of business drivers for providing a financial guarantee. Where a guarantee results in more favorable interest conditions on debt funding (beyond the impact of implicit support), an arm’s-length guarantee fee would be payable. The more favorable interest conditions may be the result of a stronger credit rating of the guarantor and/or the guarantor’s asset pool. However, if the guarantee results in an increased debt capacity, the OECD FT Paper proposes a recharacterization of the incremental capacity by hypothesizing a loan to the guarantor followed by an equity contribution to the guarantee recipient.

The OECD FT Paper continues the ongoing theme around passive association (implicit support) and active promotion (explicit guarantee) of a group’s activities and that produces a benefit for which a fee would be payable. 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 OECD FT Paper 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 OECD FT Paper 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 guarantee fee cannot have as a consequence that the borrower is in no worse position. Taking into account this limitation, the OECD FT Paper lists the following pricing approaches:

- **CUP method:** The OECD FT Paper recognizes the difficulty in applying this method but notes that examples may exist.
- **Yield approach:** The OECD FT Paper 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 OECD FT Paper suggests the costs of the guarantor may suggest a floor, focusing on the risks borne by the guarantor.

- **Valuation of expected loss approach:** The OECD FT Paper notes that an alternative approach to price a guarantee would be to consider the expected default rates and recovery rates in the event of default that are available in the market. The guarantee then could be priced based on an expected return on this amount of capital based on commercial pricing models, such as the Capital Asset Pricing Model (CAPM).
- **Capital support method:** The OECD FT Paper also discusses the evaluation of a guarantee based on the capital enhancement/ capital substitution that it provides.

#### Key changes between the Draft and OECD FT Paper

The final paper provides a new subsection on the financial capacity of the guarantor. This capacity will not only depend on credit rating of the guarantor and borrower, but also on the business correlation between them whereby adverse market events could increase the risk of default of both parties simultaneously.

## Captive Insurance (Section E)

### Overview

The OECD FT Paper outlines that MNE groups may look to consolidate risks using captive insurance and notes that captive insurance may be subject to regulation in the same way as other insurance and reinsurance companies. The paper then outlines a variety of reasons why an MNE group may look to utilize a captive insurer:

- stabilizing premiums paid by entities within the MNE group;
- benefiting from tax and regulatory arbitrage;
- gaining access to reinsurance markets;
- mitigating the volatility of market capacity; or
- because the MNE group considers that retaining the risk within the group is more cost effective.

The OECD FT Paper then points to arrangements whereby a captive insurer may be used to insure risks that otherwise could not be insured in the marketplace and raises the question of commerciality and the ability to determine an arm's-length price for such an arrangement.

In laying out the framework for evaluating such captive insurance transactions (including the analysis of fronting in a captive reinsurance scenario), the OECD FT Paper notes that for an insurance business to exist, there must be both the initial assumption of risk and risk diversification, as well as other indicators. If a captive does not demonstrate the latter (or such indicators), there could be a case where the transaction does constitute real insurance business. The paper further addresses whether a transaction is indeed insurance at all and points to factors (e.g., risk diversification, potential to suffer losses) which may indicate that the activities undertaken by the captive can be considered as a genuine insurance business. The paper goes on to outline that the captive insurer must exhibit the financial capacity to bear the associated insurance risks in order to satisfy any claims which potentially materialize.

There is a discussion about the assumption of economically significant risks and, in this context, the activities that can be considered 'control functions,' with references to Part IV of the Report on the Attribution of Profits to Permanent Establishments. The paper indicates that if the captive is not found to exercise such control on the assumption of underwriting risk, the return derived from the investment of the premiums would be allocated to the members of the group exercising such control.

### Approach to arm's-length pricing

The OECD FT Paper 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 also is 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). It is noted, however, that actuarial analyses do not represent third-party transactions and therefore comparability adjustments would also be required.



Recognizing the limitations associated with both approaches, the paper presents a different, two-staged approach: (1) starting with a 'combined ratio' (the ratio of claims plus expenses to premiums), which is compared to a (potentially adjusted) benchmark; and (2) adding to that an investment return on its capital, which is compared against an arm's-length return. The second stage leads to the question of the captive's capital adequacy. In this regard, the paper notes that capital may be lower than what is required for commercial insurers due to (1) less regulatory constraints/requirements, and (2) no driver to achieve a certain credit rating (which is often a driver for an insurer to hold capital above minimum requirements).

Similar to the discussion on cash pooling, the paper notes that there may be 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 in proportion to the premiums paid. The return retained by the captive will depend on risk retention activities — e.g., where the captive reinsures the risk into the market, it should receive a reward for the services provided.

Finally, there is a brief discussion around agency sales, which focuses on a relatively uncommon 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 OECD FT Paper'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 OECD FT Paper notes that the captive should earn benchmarked returns as observed for comparable insurers, and the residual profit should be earned by the affiliate as recompense for providing access to its customers.

Generally speaking, the discussion on captives provides a description of the relevant profile of affiliate captive insurance transactions, and centers on 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.

#### Key changes between the Discussion Draft and OECD FT Paper

The OECD FT Paper exhibits significant rewrites to the opening section on captives, with greater emphasis being placed on the commercial drivers for having a captive insurer within an MNE group, the regulatory requirements to which captive insurers are subject, and the indicators of genuine insurance business/activity, which provide helpful context to the remainder of the section. In addition, the newly introduced guidance regarding risk diversification, the role of capital, and the economic assumption of risk (with the corresponding consequences in terms of allocation of investment income), along with the additional narrative regarding outsourcing, pick up on many of the clarifications requested by commentators to the Discussion Draft.

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### The takeaway

The OECD FT Paper reflects the consensus position of the OECD members and will be codified in Chapter X of the OECD Guidelines. It summarizes key issues surrounding intercompany financial transactions and provides helpful commentary 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 OECD FT Paper also provides guidance regarding the allocation of risk-related returns, bringing in concepts that consider a two-sided analysis of both borrower and lender/guarantor, and capacity to bear risk, and goes beyond contractual terms to considerations around reasonable alternatives and the actual management of risks. The introduction of the paper is likely to shape the international environment for domestic and bilateral disputes in the context of financial transactions; therefore, it is important that companies assess the impact of the paper against their existing intra-group financial transaction pricing policies.

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## Let's talk

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

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