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OECD Final Paper on Transfer Pricing Aspects of Financial Transactions



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OECD Final Paper on Transfer Pricing Aspects of Financial Transactions

The OECD issued its final paper on the transfer pricing aspects of financial transactions (the OECD FT Paper) on 11 February 2020, which will form Chapter X of the OECD Guidelines.

The new Chapter X will provide additional guidance to taxpayers on the treatment of advances obtained from (or provided to) domestic and foreign related parties. The key principles in the OECD FT Paper are outlined in this document.



Section B - Accurate delineation of the transaction

The OECD FT Paper starts by applying the guidance of Chapter 1 of the OECD TP Guidelines to related-party financial transactions in their 'totality'. It 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 arrangement 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 and the ability of the borrower to repay the debt.

It is important to ensure that besides interest rates, all other terms and conditions of the financing transactions, including debt capacity of the borrower, is tested against the arm's-length principle.

The OECD FT Paper also emphasises that where the funding party does not have the capability, or does not perform the decision-making functions in controlling the risk associated with investing in the financial asset, it will be entitled to no more than a risk-free return.

Another item included in the Paper is the need to examine the financing behaviour of the MNE Group when looking at the specific terms applied to the intercompany loan. If the practice of the borrower indicates that it tends to obtain one-year revolvers to fund short-term working capitals, then it may be appropriate to delineate a 10-year intercompany term loan as a one-year revolver.



The OECD FT Paper emphasises the importance of accurately delineating a financial transaction, and draws the distinction between lender and borrower perspectives and what needs to be taken into account under both.

Section C - Treasury functions

The OECD FT Paper refers to the fact that treasury policy making and strategy are typically built from group strategy i.e. determined at group level. As a result, treasury functions will usually be a support service to the main value creation of the group, and guidance on intra-group services in Chapter VII of the OECD Guidelines may be applicable in certain instances.

Intra-group loans

The OECD FT Paper sets out in specific subsections how certain salient factors should be taken into account with respect to intra-group loans:

- **Use of credit ratings** - It is important to analyse both quantitative and qualitative factors influencing a credit rating. The Paper also cautions against over-reliance on credit rating tools; potential issues may include a tendency to rely more on quantitative inputs at the expense of qualitative factors, and a lack of clarity in the rating processes.
- **Effects of group membership** - 1. The form as well as terms and conditions under which a group company would have borrowed would be informed by the group's funding policies; and 2. The need to determine any implicit guarantees, which would depend on the importance of the subsidiary relative to the group for the purposes of determining its credit rating.
- **Covenants** - Related party agreements generally do not contain covenants which are often present in third party arrangements. This could be because related parties do not suffer from information asymmetry, and are unlikely to take the same kind of action as a third party lender in the event of breach. As such, in the absence of written covenants, it is necessary to assess if there is, in substance, the equivalent of a maintenance covenant between the related parties, and whether this would have an impact on pricing.
- **Guarantees** - 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 the key difference between loans and other intra-group transactions is that there is potentially comparable market information available for the former.
 1. *Comparable uncontrolled price (CUP)* - External comparables are not limited to loans, but extend to other potentially relevant alternative transactions like bonds, deposits, convertible debentures, and commercial papers. When evaluating alternatives as comparables, it is necessary to bear in mind that comparability adjustments may be required to eliminate material differences. The paper also indicates that a group's average interest rate is unlikely to meet comparability requirements without adjustments.
 2. *Cost of funds* - 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. It is important, however, to note that a borrower would not enter into a transaction based on cost of funding if it was able to obtain more favourable conditions under an alternative transaction.
 3. *Credit default swaps* - Although credit default swaps may be potentially useful to calculate the risk premium, the high degree of volatility may affect the comparability of these instruments.
 4. *Economic modelling* - Where reliable comparable uncontrolled transactions cannot be identified, economic models (i.e. interest rate built up from a risk-free interest rate plus a number of premiums (e.g. default risk, liquidity risk) may be considered in determining the arm's length interest rate.
 5. *Bank letters / opinions* - 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 of executed transactions.
- **Notching approach in determining credit rating** - The OECD FT Paper imposes three conditions to apply the group's credit rating as a proxy for the rating of a subsidiary of that group: (1) the stand-alone rating and implicit guarantee approach would not lead to a reliable outcome; (2) the subsidiary benefits from very strong group support; and (3) the indicators of the subsidiary's creditworthiness do not differ significantly from the group's.

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Bank opinions / quotations do not generally represent the arm's length rate, as these are not actual transactions entered into between independent parties.



A cash pool leader's remuneration depends on its characterisation - whether the cash pool leader is a routine service provider, or undertakes higher level treasury functions.



Cash pooling

The OECD FT Paper refers to various reasons entities may decide to enter into a related party cash pooling arrangement, other than obtaining favourable rates. These include having ready access to a permanent source of financing and reduced exposure to banks.

It is necessary to first determine the economically significant risks in the cash pool (e.g. liquidity and credit risk) and link them to control over risk functions. The remuneration of the cash pool leader will need to be calculated first before determining the debit and credit interest rates.

The cash pool leader's remuneration depends on the characterisation of the cash pool leader (whether the cash pool leader is entitled only to a service-based return or a spread-based return for higher risk activities e.g. hedging, liquidity management, etc.).

Cross-guarantees are typically required in a cash pool and do not generally lead to incremental credit enhancement of the cash pool participants. As such, there is no separate remuneration due for such cross guarantees.

Hedging

When a treasury centre arranges a hedging contract that the operating entity enters into, this may be seen as a service, for which a service return may be determined.

Issues arise when the hedging contract is entered into by the treasury centre, or where separate contracts do not exist but the position of group entities are protected (e.g. via a natural hedge). Under such circumstances, a comprehensive analysis of the accurate delineation of the actual transactions is required to determine whether a separate hedging transaction should be recognised in the absence of a written contract.



Where a borrower would not be able to obtain the loan in the absence of a related party guarantee, the transaction might more accurately be delineated as a loan secured by the guarantor, and subsequently injected by the guarantor as equity into the borrower.

Section D - Financial guarantees

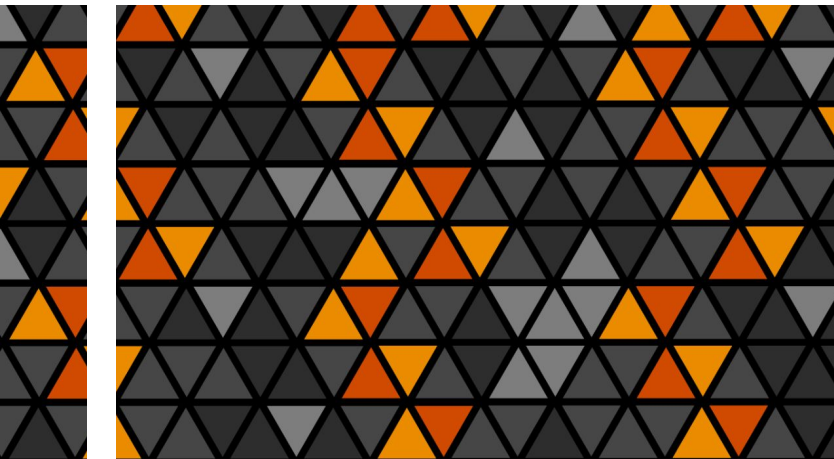
The OECD FT Paper indicates that anything less than a legally binding commitment involves no assumption of risk, and, as a result, the benefit of any support resulting therefrom would be attributable to group member status.

Where a guarantee results in savings on funding costs (beyond the impact of implicit support), an arm's length guarantee fee would be payable. However, where a guarantee results in additional debt capacity, recharacterisation of the transaction by hypothesising a loan to the guarantor, followed by equity contribution to the guarantee recipient may be required.

If an explicit guarantee provides value to the guarantee recipient, the guarantee fee cannot leave the recipient in a worse position than if it had borrowed without a guarantee. The OECD FT Paper lists the following pricing approaches:

- CUP method;
- Yield approach;
- Cost approach;
- Valuation of expected loss; and
- Capital support method.

The OECD FT Paper also makes reference to the financial capacity of the guarantor to fulfil its obligations in the event of default. A guarantee may provide benefit to a borrower that has the same or higher credit rating than the guarantor, if the guarantee effectively allows the lender to access wider recourse and, as a result, reduces the interest rate.



Section E - Captive insurance

Multinational enterprise groups may want to utilise a captive reinsurer for a variety of reasons, including:

- Stabilising premiums paid by entities in the group;
- Benefitting from tax and regulatory arbitrage;
- Gaining access to reinsurance markets;
- Mitigating the volatility of market capacity; or
- It is more cost effective to retain risk within the group.

The OECD FT Paper emphasises that in captive insurance transactions, there must first be the assumption of risk, followed by risk diversification. If these factors do not exist, then the transaction would not constitute a genuine insurance business. A captive insurer must also have the financial capacity to bear risks if they do materialise.

The paper outlines the potential to use third party pricing evidence for pricing premiums, or an actuarial approach. However, both approaches have their limitations, and may require significant comparability adjustments.

The paper then presents a two-staged approach: (1) starting with a combined ratio, which is compared to a benchmark; and (2) adding to that an investment return on capital, which is compared against an arm's length return.

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For an insurance business to exist, there must first be the assumption of risk and subsequent risk diversification. When these indicators do not exist, the captive may be undertaking activities other than a genuine insurance business (e.g. provision of intra-group services).



Takeaways

Financial transactions are increasingly becoming a key area of focus for the Malaysian Inland Revenue Board. Key questions raised include:

- Is there a requirement to charge interest on long outstanding related party balances;
- Is there a need to impose a guarantee fee for corporate guarantees;
- Should intra-group financing transaction be recharacterised as equity, particularly where the borrower is unable to demonstrate the necessary level of debt capacity, on the face of its balance sheet.

It is important to ensure that transactions are accurately delineated upon their inception, and that documentation is in place to support the group's position on financial transactions.

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It is important to document the commercial rationale for entering into intra-group financial transactions, and accurately delineate the transaction at the point of entry.



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