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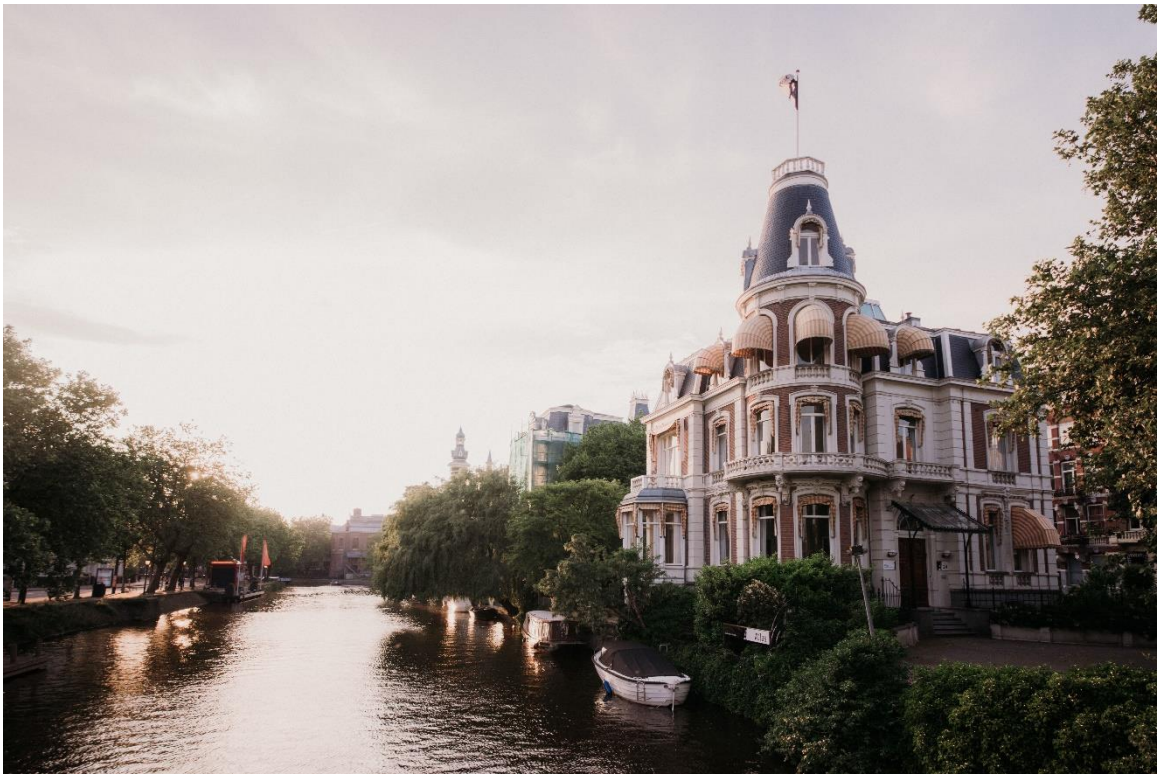
TECHNICAL MEMORANDUM ON THE OECD'S NON-CONSENSUS DISCUSSION DRAFT ON THE TRANSFER PRICING ASPECTS OF FINANCIAL TRANSACTIONS



On July 3, 2018 the OECD released the highly anticipated discussion draft on financial transactions ("discussion draft"), which deals with the follow-up work in relation to Actions 8-10 of the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project. Public comments are invited on the discussion draft and should be submitted by **September 7, 2018**.

The 2015 report on BEPS Actions 8-10

The 2015 report on BEPS Actions 8-10 mandated follow-up work on the transfer pricing aspects of financial transactions. Under that mandate, the discussion draft, which does not yet represent a consensus position of the Committee on Fiscal Affairs or its subsidiary bodies, aims to clarify the application of the principles included in the 2017 edition of the OECD Transfer Pricing Guidelines ("Transfer Pricing Guidelines").

Status of the non-consensus discussion draft

The discussion draft, as presented by the OECD, is a non-consensus draft and subject to commentary. However, even though OECD countries obviously have different opinions regarding

the transfer pricing aspects of financing transactions, and even though it is not clear on which items consensus was reached – if any – the document does provide an overview of the transfer pricing (best) practices observed in the market.

Content of the discussion draft

Following the introduction, the discussion draft first focuses on the interaction with the guidance in section D.1 of Chapter I of the Transfer Pricing Guidelines, relating to the accurate delineation of controlled transactions. Subsequently, the discussion draft addresses the following specific issues related to the pricing of financial transactions:

(i) The **treasury function**, including:

   a. Intra-group loans;

   b. Cash pooling; and

   c. Hedging.

(ii) **Guarantees**; and

(iii) **Captive insurance**.

The issues listed above are discussed in detail, in the following sections. Throughout the discussion draft comment boxes have been inserted whereby commentators are invited to provide input on certain issues. In our document we shall, when deemed important, provide a summary of such comment boxes.

Section B: Interaction with the guidance in Section D.1 of Chapter I

After a short introduction, the discussion draft first addresses how the concepts of Chapter I of the Transfer Pricing Guidelines, concerning the accurate delineation of the actual transactions, may relate to the capital structure of an entity within a multinational enterprise group ("MNE group"). In this respect, according to the discussion draft, the following main items should be taken into account:

- In advance of an analysis of an arm's-length interest rate, it should first be determined up to which amount an unrelated lender would have been willing to lend to the borrower – and which amount an unrelated borrower would have been willing to borrow. Based on such an analysis, Tax Authorities might argue whether or not (part of) a loan can be recognized in relation to the determination of an arm's-length interest rate.

- Independent entities, when considering whether to enter into financial transactions, will consider all other options realistically available to them and will only enter into the transaction if they see no alternative that offers a clearly more attractive opportunity to meet their commercial objectives. In considering the options realistically available, the perspective of all parties to the transaction should be considered.

After the section on identification of the commercial or financial relations, the discussion draft focuses on the five comparability factors which, according to the Transfer Pricing Guidelines, need to be identified in order to accurately delineate the actual transactions. These five comparability factors consist of:

(i) **The contractual terms (Section B.2.1)**, which are the starting point of the accurate delineation of controlled transactions. If contractual arrangements do not provide information in sufficient detail or are inconsistent with the actual conduct, it is necessary to analyse other available documents and the actual conduct of the parties involved.

(ii) **The functional analysis (Section B.2.2)**, that identifies the functions performed, the assets used and the risks assumed by the parties to that controlled transactions (i.e. in case of an intra-group loan, the "lender" and the "borrower"). While this section of the discussion draft does not provide new information, it does provide some key functions that a lender or borrower would typically perform in case of an intra-group loan.

(iii) **The characteristics of (financial) products or services (Section B.2.3)**, concerns the wide variety of financial products and services in the open market, that present very different features and attributes, which might affect pricing. When pricing these financial products and services it is therefore important to document the transactions' features and attributes.

(iv) **The economic circumstances (Section B.2.4)**, should be analysed as - according to the discussion draft - in order to achieve comparability, the markets in which independent and associated enterprises operate must not have differences that have a material effect on the pricing (or unless appropriate adjustments can be made). For pricing financial instruments, this can be considered to be important, as the prices of financial instruments may vary substantially on the basis of underlying economic circumstances (i.e. currencies, geographic locations, business sector, timing etc.). As an example – with respect to the timing of transactions – the discussion draft states "it is not likely" that multiple year data on loan issuances will provide useful comparables.

(v) **The business strategies (Section B.2.5)**, As business strategies can have a significant effect on the terms and conditions which would be agreed between independent enterprises, these must also be examined in accurately delineating the controlled transaction. As an example, the discussion draft refers to the situation where independent lenders may be prepared to lend on terms and conditions to a company undertaking a merger or acquisition which might otherwise not be acceptable to the lender for the same business if it were in a steady state.

Comment Box B.4. The Risk-free rate of return

Before section C, the discussion draft includes a comments box inviting commentators' views on guidance relating to the risk free rate of return.

- *In case a funder does not perform the decision-making functions to control the risk associated with investing in a financial asset, it should be entitled to no more than a*

risk-free rate of return. As proxy for determining the risk-free rate of return, government-issued securities are widely used in practice.

- *When there are multiple countries issuing bonds in the same currency, the reference point for the risk-free rate of return should be the government security with the lowest rate of return as any difference in rate must be due to differences in risk between the issuers.*

Section C. Treasury functions

In section C, the discussion draft addresses the treasury functions of MNE groups. The organization of the treasury function will depend on the structure of a given MNE group and the complexity of its operations. The treasury function can, according to the discussion draft, usually be viewed as a support service to the main value-creating functions of the MNE group. In this respect, it is important to note that, the activities of the treasury generally take into account issues at a group level and therefore will follow the vision, strategy and policy set out by group management. As a consequence, the higher strategic decisions will generally be the result of policy set at group level rather than determined by treasury itself.

In sections C.1. through C.3., the discussion draft deals with the following specific issues related to the determination of an arm's-length interest rate, which are described below:

(i) Intra-group loans (section C.1.);

(ii) Cash pooling (Section C.2.); and

(iii) Hedging (Section C.3.).

Section C.1. Intra-group loans

Section C.1. starts with the consideration that in an analysis of the economically relevant characteristics of a transaction, both the lender's and borrower's perspective should be taken into account.

- **The lender's perspective** as such, will involve an evaluation of the wider economic factors affecting the borrower. An independent lender will carry out a thorough credit risk assessment to evaluate the risks involved. According to the discussion draft, associated enterprises may not necessarily follow the same (credit risk assessment) processes as an independent lender. However, the same commercial considerations (creditworthiness, credit risk etc.) are important in a comparability analysis. Additionally, it is important to note that when evaluating the price of a loan between related parties, the absence of contractual right over the assets of the borrowing company does not necessarily reflect the economic reality of the risk inherent to the loan. This is for example the case when a parent entity provides a loan to a subsidiary – in which the parent entity already has control over and ownership of the assets of the subsidiary.

- From **the borrower's perspective**, the focus will be on the most cost-effective solution with regard to the business strategy it adopted. When, for example, a company has suitable collateral to offer, this would in circumstances be pledged in order to obtain a lower cost of funding. Furthermore, according to the discussion draft, borrowers will also consider the possibility to renegotiate loans to obtain better conditions taking into account the facts and circumstances of each case. The discussion draft specifically mentions the reduction of financing costs in the markets. It is therefore important to be aware of any possible pre-payment options in intra-group loan agreements.

After the section on the lender's and borrower's perspective, the discussion draft continues with a section on the use of credit ratings. After a short introduction on credit ratings the discussion draft addresses the following items, related to the use of credit ratings:

- The estimation of credit ratings may be particularly challenging for start-up companies, special purpose vehicles, or those which have recently been part of a merger or demerger. In these cases, independent lenders would usually conduct a due diligence process.

- Commercial tools to determine credit ratings are widely used in practice. According to the discussion draft it should be noted that the credit rating methodology used in commercial tools differs significantly from the credit rating methodologies applied by independent credit rating agencies to determine official credit ratings.

- Commercial tools that rate a specific debt borrowing can be compared to a market database in a search for comparables to arrive at a price or price range for the borrowing. When these commercial tools are used, there are some potential issues which need to be borne in mind, such as the accuracy of the parameters input and the tendency to rely more on quantitative inputs at the expense of qualitative factors.

- In performing credit rating analyses, thought should be given to the fact that the financials might be influenced by controlled transactions.

After the above paragraphs, which focus more on the stand-alone credit ratings of entities, the discussion draft addresses the effect of group membership. This section begins with the questions in the comment box below.

Comment Box C.2. regarding the effect of group membership on credit ratings

Commentators are invited to consider whether the following approaches would be useful for the purpose of tax certainty and tax compliance:

- *a rebuttable presumption that an independently derived credit rating at the group level may be taken as the credit rating for each group member, for the purposes of pricing the interest rate, subject to the right of the taxpayer or the tax administration to establish a different credit rating for a particular member; and*

- *a rebuttable presumption that tax administrations may consider to use the credit rating of the MNE group as the starting point, from which appropriate adjustments*

are made, to determine the credit rating of the borrower, for the purposes of pricing the interest rate, subject to the right of the taxpayer or the tax administration to establish a different credit rating for a particular member.

In short, this comment box invites comments on a simplification of the credit rating process, which comes down to either (i) use the credit rating of the group as the credit rating for each group member, or to (ii) use the credit rating of the group as the starting point, from which adjustments are. In our view, this comment box is not in line with the rest of this section (which is described below), which focuses more on a stand-alone credit rating that can – under circumstances – be adjusted due to implicit group support.

In deviation from the comment box above, the general wording of the section on the effect of group membership, addresses the following items:

- Even though a borrower - in pricing intra-group loans - is viewed as an independent enterprise, this does not mean that the presence of the rest of the group is necessarily ignored. The effect of passive association (implicit group support) should also be considered.

- Typically, group members are considered to be more, or less, likely to receive group support according to the relative importance of the entity to the group as a whole. In this respect a group member with stronger links, that is integral to the group's core identity or future strategy, typically operating in the group's core business, is more likely to be supported by the other group members.

- If the credit rating of a stand-alone entity is higher than the credit rating of the group, it may be appropriate to consider capping the credit rating for the entity at the group level, in circumstances where the parent would likely be able to impose requirements that would undermine the existing credit rating.

- In section D.1.2. on the arm's-length pricing of guarantees, the discussion draft states that if a borrower has its own independent credit rating from a commercial credit rater, this will usually reflect its membership of the group. Hence, ordinarily no adjustments would be needed to this credit rating to reflect implicit support.

Section C.1. furthermore shortly addresses covenants (Section C.1.4.), guarantees (Section C.1.5.) and Loan fees and charges (Section C.1.6.), before ending the section with the pricing approaches to determining an arm's-length interest rate in Section C.1.7., which will be described below.

Once the actual transaction has been accurately delineated, arm's-length interest rates can be determined based on consideration of the credit rating of the borrower and taking into account all of the terms and conditions of the loan and comparability factors. In this respect the CUP (comparable uncontrolled price) method is the preferred method to determine an arm's-length interest rate on intra-group loans. In applying the CUP method, internal CUPs should not be overlooked according to the discussion draft. In addition, arm's-length interest rates can also be

based on the return of realistic alternative transactions with comparable economic characteristics, such as bond issuances. As a final note on intra-group loans, the discussion draft explicitly states that bank opinions will generally not be regarded as providing evidence of arm's-length terms and conditions.

Section C.2. Cash pooling

Section C.2. of the discussion draft first focuses on the two basis types of cash pooling arrangements and their characteristics, followed by the accurate delineation of cash pooling transactions and their respective pricing. The described cash pooling arrangement are the following:

- **Physical pooling**, where bank account balances of all pool members are transferred daily to a single central bank account owned by the cash pool leader.

- **Notional pooling**, where some of the benefits of combining credit and debit balances of several accounts are achieved without any physical transfer of balances, although the bank will usually require cross-guarantees from participants to enable the right to set off between accounts if necessary. With minimal functions carried out by the cash pool leader (because functions are primarily performed by the bank), there will be limited value added by the cash pool leader to be reflected in the intra-group pricing.

The discussion draft furthermore states that the practical result of the cross-guaranteeing arrangement is such that the formal guarantee may represent nothing more than an acknowledgement that it would be detrimental to the interest of the group not to support the performance of the cash pool leader and so, by extension, the borrower. In such circumstances the guaranteed borrower may not be benefitting beyond the level of credit enhancement attributable to the implicit support of other group members. If this is the case, no guarantee fee would be due.

As cash pooling is generally not undertaken by independent enterprises, according to the discussion draft, application of transfer pricing principles requires careful consideration, such as:

- No member of the pooling arrangement would expect to participate in the transaction if it made them any worse off than their next best option; and

- Whether or not a cash pool should be treated as something other than a short-term liquidity arrangement (such as a longer-term deposit or a loan). In this consideration, it may be appropriate to analyse (i) whether or not the same pattern is present year on year and (ii) what policies the financial management has in place.

With respect to the pricing of cash pooling transactions the discussion draft notes that in general, a cash pool leader performs no more than a co-ordination or agency function. Given this low level of functionality, the cash pool leader's remuneration as a service provider will generally be similarly limited.

Furthermore, with respect to rewarding the cash pool members, three approaches can be envisaged:

(i) Enhancing the interest rate for all participants, where there are both debit and credit balances in the pool;

(ii) Applying the same interest rate for all participants, in a situation where all cash pool members have the same or a similar credit profile; or

(iii) Allocation the cash pooling benefits to the depositors, where there is a genuine credit risk to the depositors.

Section C.3. Hedging

Section C ends with a paragraph on hedging arrangements. The discussion draft states the following possible mechanisms by which an MNE group may centralize hedging of risk:

- Delegation of responsibility for hedging to a group treasury company, with the hedging contracts arranged for and in the name of the relevant operating companies;
- Delegation of responsibility for hedging to a group treasury company, with the hedging contracts made by and in the name of another group company; or
- Identification of the existence of natural hedges within the group, in which case no formal hedging contacts are made (in case an MNE group centralizes treasury functions and implements risk mitigation strategies, with the result that individual entities may not contractually enter into hedging arrangements, although their risk is hedged from the perspective of the MNE group as a whole).

In case the centralized treasury function arranges a hedging contact, where operating companies enter into, for this service the treasury function should receive an arm's-length remuneration.

Section D. Guarantees

Section D.1. Financial guarantees

Guarantees within the context of intercompany financing mostly occur in situations whereby a related party provides a guarantee to a related party who wants to borrow funds from an unrelated party, allowing the lending party to borrow funds against more favourable terms and conditions or allowing it to be able to borrow funds at all.

The discussion draft states that, where the effect of a guarantee is to permit a borrower to borrow a greater amount of debt, a guarantee could be considered not to only support the credit rating of a borrower but to also increase the borrowing capacity and to reduce the interest rate. In such cases two potential issues arise:

- Part of the loan could be considered being delineated as a loan from the lender to the guarantor (followed by an equity contribution from the guarantor to the borrower); and

- The question if the guarantee fee paid with respect to the portion of the loan that is respected as a loan from the lender to the borrower is arm's length.

When a guarantee is provided to reduce the cost of funding of a borrower, such a borrower could be prepared to pay a guarantee fee.

Section D.1.1 Explicit guarantees, implicit guarantees and cross-guarantees

An **explicit guarantee** can only be provided by means of a legally binding commitment. Letters of comfort or other documents that do not explicitly involve any assumption of risk are not considered being such legally binding commitments. According to the discussion draft, guarantee fees for explicit guarantees are only appropriate if a borrower expects an advantage, which is not necessary the case when explicit guarantees are provided. Legal, financial or operational ties could mean that group companies are financially interdependent, even without a formal guarantee. Providing a formal guarantee in such cases would not be more than "*an acknowledgement that it would be detrimental to the interests of the group not to support the performance of the borrower"*. In such cases (i.e. in cases of an **implicit guarantee**), a guarantee fee should not be applied as the borrower does not benefit from such a guarantee.

OECD COMMENT BOX D.1

What to do when an unrelated lender insist on a guarantee and how do such guarantees affect the credit rating of a borrower and the pricing of a guarantee.

In case of **cross-guarantees**, whereby several related parties provide a guarantee to a borrower, a lender gains greater comfort as it has access to the assets of every cross-guaranteeing entity in the event of a default by a guaranteed borrower. According to the discussion draft, evaluating the effect of a cross-guarantee arrangement is difficult and as the number of parties involved increases, may be practically impossible, as stated by the discussion draft. It could be concluded that the effect of cross-guarantees is that they have no influence on the credit rating of a borrower beyond the level of passive association. In such cases, the advantage should be regarded as a capital contribution.

Section D.1.2. Determining the arm's length price of guarantees

When, through accurate delineation a guarantee fee is considered appropriate, the question arises how such a guarantee fee should be determined. The discussion draft provides several approaches:

- **CUP-Method:** The discussion draft states that the CUP-method could be used but that practical difficulties exist due to the high-level of comparability required to apply the CUP-method. However, when available, comparable guarantees are the most reliable method to determine arm's-length guarantee fees.

- **Yield-approach:** The yield-approach determines the benefit of the borrower resulting from a lower interest rate. The method calculates the spread (i.e. the difference) between the interest rate that would have been payable by the borrower *without* the guarantee and the interest rate payable *with* the guarantee. In this respect, careful consideration is required to the impact of either an explicit or an implicit guarantee. "*The* benefit *to be priced is not the difference between the cost to the unguaranteed borrower on a standalone basis and the cost with the explicit guarantee but the difference between cost to the borrower after taking into account the benefit of any implicit support and the cost with the benefit of the explicit guarantee."* The result of the analysis determines a maximum guarantee fee. However, a borrower would not enter into a guarantee arrangement if it would not be more advantageous than without a guarantee fee. Therefore, the yield-approach merely determines the maximum guarantee fee.

- **Cost-approach**: This method aims to quantify the additional risk borne by a guarantor by estimating the value of the expected loss that the guarantor incurs by providing the guarantee (*loss given default*). The expected loss can be determined by analysing the capital required by the guarantor to assume additional risks it assumes when providing a guarantee. In contrast to the yield-approach, the cost-approach determines a minimum guarantee fee (i.e. the minimum amount that a guarantor would be willing to accept).

- **Valuation of expected loss approach:** This method estimates the value of a guarantee on the basis of calculating the probability of default and making adjustments to account for the expected recovery rate in the event of default in order to derive the cost of providing a guarantee. The guarantee fee could then be determined by calculating the expected return on this capital.

- **Capital support method:** This method can be used when the risk profile of the guarantor and the borrower can be addressed by adding more capital to the balance sheet of the borrower. To utilise this method it is required to determine the capital required by the borrower to realize a credit rating comparable to the guarantor. The guarantee fee could then be determined by calculating the expected return on this additional capital.

The discussion draft provides, in par. 158 through 161, examples of the above described methods.

Section E. Captive Insurance

Section E.1.-E.4. Accurate delineation of the transaction

In the discussion draft reference is made to Part IV of the 2010 Report on the Attribution of Profits to Permanent Establishments, to describe a general insurance scheme. However, to accurately delineate a captive insurance, the same principles apply as for other intra-group transactions. Furthermore it is stated that, when talking about insurance from a transfer pricing perspective, it should be determined whether a transaction actually concerns insurance (i.e. if a risks actually exists and whether it is allocated to the captive). In any case, as stated in par. 166, the following indicators would typically be expected by an independent insurer:

- *"there is diversification and pooling of risk in the captive insurer;*

- *the economic capital position of the group has improved as a result of diversification and there is therefore a real economic impact for the group as a whole (i.e. the captive insurer either: (i) does not only insure group risks but diversifies those group risks by inclusion within its portfolio of a significant proportion of non-group risks, or (ii) it reinsures a significant proportion of the risks it insures outside of the MNE group);*

- *both the insurer and any reinsurer are regulated entities with broadly similar regulatory regimes and regulators that require evidence of risk transfer and appropriate capital levels;*

- *the insured risk would otherwise be insurable outside the group;*

- *the captive has the requisite skills, including investment skills, and experience at its disposal, including employees with senior underwriting expertise; and*

- *the captive has a real possibility of suffering losses."*

When talking about insurance, the insurer should assume risk, which it can only do if the insurer has a realistic prospect of being able to satisfy claims in the event of the risk materializing. Furthermore, insurance also requires risk distribution, which is defined as "*the pooling of a portfolio of risks by which the insurer reduces the impact of individual claims".* Commercial insurers generally have a very diversified portfolio that allows them to reduce the impact of such claims. An MNE group providing insurance services generally does not have such a diversified portfolio. In such cases, the discussion draft states that "*the outcome of the accurate delineation of the transactions could be that an MNE group is providing a business rather than actually performing an insurance service*".

In some situations, legal requirements prescribe that insurance risks must be placed with a regulated insurer. For these situation, fronting arrangements -in which the first contract of insurance is between the insured member of an MNE group and an unrelated insurer (the fronter) - have been developed. As stated by the discussion draft, such transactions are particularly hard to price.

Section E.5. Arm's-length pricing of captives

The discussion draft states that the use of the CUP-method could be an appropriate method to determine an insurance premium. However, in such cases comparability adjustments should be considered. As an alternative method an actuarial analysis is mentioned.

A CUP can be determined by considering the arm's-length profitability of a captive considering a two-step method (which takes the profitability of claims and the return on capital into account):

(i) Identifying the captive's combined ratios (i.e. insurance premium less claims or losses); and

(ii) Deriving the investment return achieved by the captive against an arm's-length return.

The sum of the derived profit from step one and the investment income from step two, subsequently provide a total operating profit.

In case of captives, synergy advantages can also be important as it could lead to an overall decrease of insurance costs. In such cases, as goes with other synergy advantages, this benefit should be allocated to each individual member of the group that has its insurance costs reduced due to group synergies.

Key takeaways

In summary, it is in our view worthwhile to at least take note of the following points included in the discussion draft.

- In advance of an analysis of an arm's-length interest rate, it should first be determined up to which amount an unrelated lender would have been willing to lend to the borrower – and which amount an unrelated borrower would have been willing to borrow. Based on such an analysis, Tax Authorities might argue whether or not (part of) a loan can be recognized in relation to the determination of an arm's-length interest rate.

- In case a funder does not perform the decision-making functions to control the risk associated with investing in a financial asset, it should be entitled to no more than a risk-free rate of return. As proxy for determining the risk-free rate of return, government-issued securities are widely used in practice.

- The discussion draft invites commentators to consider whether the following rebuttable presumptions would be useful for the purpose of tax certainty and tax compliance:

    - A rebuttable presumption to use the credit rating at the group level as the credit rating for each group member; and

    - A rebuttable presumption to use the credit rating at the group level as a starting point, from which appropriate adjustments are made.

- The CUP-method is the preferred method to determine an arm's-length interest rate on intra-group loans. In applying the CUP method, internal CUPs should not be overlooked.

    - In addition, arm's-length interest rates can also be based on the return of realistic alternative transactions with comparable economic characteristics, such as bond issuances.

- A key consideration in analysing cash pool arrangements is whether or not a cash pool should be treated as something other than a short-term liquidity arrangement (such as a longer term deposit or a loan). In this consideration it may be appropriate to analyse (i) whether or not the same pattern is present year on year and (ii) what policies the financial management has in place.

- In case group members are financially interdependent, quite apart from any formal guarantee agreement, the economic risk of a guarantor may not change materially on it giving an explicit guarantee. As in such cases the guaranteed borrower may not be benefitting beyond the level of credit enhancement attributable to the implicit support of other group members, it can be considered appropriate to not charge a guarantee fee.