Transfer Pricing Guidelines on Financial Transactions

February 2020

Content

Intra-group loans

Should purported loan be regarded as a loan?

- Substance-over-form
- Consequences
  - Article 9 of the OECD Model is relevant "*not only in determining whether the rate of interest provided for in a loan contract is an arm's length rate, but also whether a prima facie loan can be regarded as a loan or should be regarded as some other kind of payment, in particular a contribution to equity capital.*" (Commentary to Article 9 of the OECD Model).
    - Countries may have different views on the application of Article 9 to determine the balance of debt and equity. However, the purpose of the TPG is to provide guidance for countries that use the accurate delineation to determine whether a purported loan should be regarded as a loan for tax purposes.
  - A 10-year loan providing funding for short-term working capital may be regarded as a series of refreshed one-year revolver loans where the MNE group's policy and practices demonstrate that the MNE group uses a one-year revolving loan to manage short-term working capital.
- Indicators:
  - Fixed repayment date; interests payments; enforcements rights; status compared to creditors; financial covenants and security; source of interests; ability of recipient to obtain loans from unrelated parties; funds used to acquire capital assets; and failure to repay on due date or to seek a postponement.

Intra-group loans

Identifying the commercial/financial relations

- Factors affecting the performance of businesses, e.g. particular point of an economic, business or product cycle; effect of government regulations; or availability of financial resources in a given industry.
  - Account for industry-specific differences, e.g. different amounts or types of financing due to different capital intensity, different levels of short-term cash balances due to different commercial need or specific regulatory constraints.
- Use of MNE group’s policies in delineating, e.g. how the MNE group prioritizes funding needs among projects, the strategic significance of the particular entity, whether the MNE group is targeting a specific credit rating or debt-equity ratio, or whether the MNE group is adopting a different funding strategy than observed in its industry.

Intra-group loans

Economically relevant characteristics of the actual financial transaction

- Contractual terms
  - Written agreement, other documents, actual conduct of the parties, and economic principles generally governing independent parties.
- Functional analysis
  - Functions performed, assets used and risks assumed, i.e. exercising control over the risks and financial capacity to assume the risks.
- Characteristics of financial instruments
  - Amount, maturity, repayment schedule nature/purpose (e.g. trade credit, M&A or mortgage), seniority, geographical location of borrower, currency, collateral, presence/quality of guarantee, and fixed/floating interest rate.
    - A loan from ParentCo to SubCo, ParentCo already has control and ownership of SubCo, which would make security less relevant as a lender. Hence, it is important to consider whether absence of contractual rights over the (otherwise unpledged) assets of the borrowing entity reflect the economic reality of the risk inherent in the loan.

Intra-group loans

Economically relevant characteristics of the actual financial transaction (continued)

- Economic circumstances
  - Currencies (e.g. growth, inflation and volatility), geographic locations, local regulations (e.g. interest and exchange rate controls and FX restrictions), and business sector of the borrower.
  - Macroeconomic trends, (e.g. central bank lending rates or interbank reference rates, and financial market events like a credit crisis), can affect prices and the timing of the issue of a financial instrument in the primary market or the selection of comparable data in the secondary market can be significant in terms of comparability.

- Business strategies
  - M&A (e.g. borrower's business plans and forecasts), MNE group's global financing policy, and existing relationships between the related parties.

Intra-group loans

Options realistically available to lender and borrower

- When considering whether to enter into a particular financial transaction, all other options realistically available should be considered.
- Only if no alternative offers a clearly more attractive opportunity to meet commercial objectives, independent parties will enter into a transaction.
- Both the lender's and the borrower's perspective should be considered, and notably, the two perspectives may not align
  - Lender will carry on a credit assessment and consider methods to monitor and manage these risks.
    - It will not be necessary to follow *all* of the same processes as an independent lender, e.g. in respect of information gathering about the borrower's business.
    - However, the same commercial considerations, e.g. creditworthiness, credit risk and economic circumstances are relevant.
  - Borrower seeks to optimize WACC and to have the right amount of funding available to meet both short-term needs and long-term objectives.
    - Include broader considerations than the entity's ability to service debt, e.g. the funds it actually needs to meet its operational requirements.
    - Although an entity may have the capacity to borrow and service more debt, it may choose not to, e.g. to avoid negative pressure on credit rating, increasing its cost of capital, jeopardizing access to capital markets and market reputation.

Intra-group loans

Comparability analysis and adjustments

- With the many variables involved, it is likely that potential comparables will differ from the tested transaction.
- Where differences exist, it will be necessary to consider whether such differences will have a material impact on the price.
- Comparability adjustments is more likely to be achievable where the adjustment is based on a quantitative factor and there is good quality data easily available.
- Financing transactions with external lenders may be comparable for interest rates where the differences between the controlled and uncontrolled transactions do not materially affect the interest rate or accurately adjustments can be made.

Intra-group loans

Comparability analysis and adjustments (continued)

- Credit rating – based on quantitative and qualitative factors:
  - May be variances in creditworthiness between borrowers with same credit rating and variances in credit-rating despite same financial metric (debt-earnings or debt-equity ratio), especially if risky industry or less stable revenue streams.
  - "Special circumstances", e.g. start-ups or recently merged entities should be taken into account.
  - Issue rating would typically be more appropriate than issuer rating.
  - MNE group rating cannot *per se* be applied to specific entity.
  - Publicly available tools are, generally, too simple compared to rating agencies.

Intra-group loans

Comparability analysis and adjustments (continued)

- Effect of group membership – implicit support (passive association)
  - The relative status of the entity – either in its current form or in terms of future strategy – determines the impact of implicit support, i.e. if the entity is important credit rating will be more closely linked to that of the MNE group, e.g.:
    - *If* entity is part of core business or strategically important; operationally integrated and significant for the MNE group.
    - *If* consequences for the MNE group if not supporting the borrower, e.g. due to legal obligation/regulatory requirements, shared name or reputational impacts.
    - *If* general statement of policy/intent of support or history of support and common behavior of the MNE group with respect to third parties.

- Incurrence covenants and maintenance covenants
  - Less information asymmetry in intragroup, i.e. less need for covenants.
  - However, in the absence of covenants, it will be appropriate to consider whether there, in practice, is the equivalent of a maintenance covenant.

- Guarantees
  - For the lender to take a guarantee into account, it would need to be reasonably satisfied that the guarantor(s) would – and would be able to – meet any shortfall resulting from the borrower being unable to meet its obligations in full.

Intra-group loans

Determining arm's length interest rate

- CUP method
  - Generally, easier to apply to financial transactions as high frequency and availability of information.
  - Characteristics of loans affecting the lender's risk and borrower's interest rate:
    - Increasing: Long maturity dates, absence of security, subordination, or application of the loan to a risky project.
    - Decreasing: Strong collateral, a high quality guarantee, or restrictions on future behavior of the borrower.
  - In practice, a range of rates will be considered in accordance with the arm's length principle.
  - Arm's length interest rates can also be based on the return of realistic alternative transactions with comparable economic characteristics, e.g. bond issuances, uncontrolled loans, deposits, convertible debentures, commercial papers.
    - Comparability adjustments may be required, e.g. in respect of liquidity, maturity, existence of collateral or currency.
  - Internal CUPs may be identified and subject to appropriate comparability adjustments.

Intra-group loans

Determining arm's length interest rate (continued)

- CUP method (continued)
  - A comparable is not necessarily restricted to a stand-alone entity. In examining commercial loans, where the potentially comparable borrower is a member of an MNE group and has borrowed from an independent lender, provided all other economically relevant conditions are sufficiently similar, a loan to a member of a different MNE group or between members of different MNE groups could be a valid comparable.
  - Whereas it is unlikely that an MNE group's average interest rate paid on its external debt meets the comparability requirements to be considered as an internal CUP, it may be possible to identify potential comparable loans within the borrower's or its MNE group's financing with an independent lender as the counterparty. As with external CUPs, it may be necessary to make appropriate adjustments to improve comparability.
- Credit default swaps ("CDS") reflecting the credit risk linked to an underlying financial asset
  - In the absence of information regarding the underlying asset that could be used as a comparable transaction, the spreads of CDS may be used to calculate the risk premium.
  - High volatility may affect the reliability of CDS, as spreads may reflect not only risk of default but also the liquidity of the CDS or the volume of contracts negotiated.

Intra-group loans

Determining arm's length interest rate (continued)

- Cost of funds method
  - In the absence of CUP.
  - Reflects costs incurred by the lender in raising funds to lend, costs of arranging and servicing the loan, a risk premium, a profit margin generally including lender's incremental cost of the equity required to support the loan.
    - Should consider the lender's cost of funds relative to other lenders, i.e. in the commercial environment, lenders minimize operating costs and cost of obtaining funds to lend.
  - A borrowing MNE would not enter into a transaction priced under the cost of funds approach if it could obtain the funding under better conditions by entering into an alternative transaction.
  - May be used to price loans where capital is borrowed from an unrelated party which passes from the original borrower through associated intermediary enterprises, as a series of loans, until it reaches the ultimate borrower.
    - However, it may not be appropriate to determine the pricing as a mark-up on the costs of the services but rather on the costs of the agency function itself.

Intra-group loans

Determining arm's length interest rate (continued)

- Economic modelling
  - Generally, calculate an interest rate through a combination of a risk-free interest rate and a number of premiums associated with different aspects of the loan, e.g. default risk, liquidity risk, expected inflation or maturity and elements to compensate the lender's operational expenses.
  - Comparability adjustments would likely be required.
- Bank opinions or "bankability" opinion
  - Generally not regarded as evidence of arm's length terms and conditions.
- Loan fees and charges, e.g. arrangement fees or commitment fees on undrawn facility
  - Independent lenders' fees/charges will reflect costs incurred for raising capital and satisfying regulatory requirements, which associated enterprises might *not* incur.

Risk free and risk adjusted rates of return

Risk free rate of return

If 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.

Typically the interest rate on certain government issued securities:

- Functional currency of the investor. If multiple countries issue bonds in the same currency, the government security with the lowest rate of return should be referred to.
- Issued at the same time, or have a similar remaining maturity.
- Duration should match.

Alternatively, interbank rates, interest rate swap rates or repurchase agreements of highly rated government issued securities could be applied.

Risk adjusted rate of return

If funder exercises control over the financial risk associated with the provision of funding, without the assumption of, including the control over, any other specific risk, it could generally only expect a risk-adjusted rate of return on its funding.

- Financial risk vs. operational risk

Potential methods:

- CUP.
- Realistic alternative investment, e.g. bond issuances or third-party loans.
- Add a risk premium to the risk-free return, based on information available in the market on financial instruments issued under similar conditions and circumstances.

Treasury functions

Generally, part of the process of making the financing of the commercial business as efficient as possible, i.e. usually a support and coordinating service to the main value-creating operation.

- Usually the higher strategic decisions is the result of policy set at group level rather than determined by treasury itself.

In other situations, the treasury may be found to perform more complex functions.

Another key concern regarding treasury activities is the identification and allocation of the economically significant risks.

Decentralized treasury

Each entity within the MNE group has full autonomy over its financial transactions, e.g. if multiple operating divisions operating in discrete industries, regional hub structures, or specific local regulations.

Centralized treasury

Centralized treasury has full control over the financial transactions of the MNE group, with entities within the MNE group responsible for operational but not financial matters.

Treasury functions

Hedging

- Typically an MNE group will implement risk mitigation strategies to interest rate and currency risks in order to improve efficiency and effectiveness
  - Individual entities may not contractually enter into hedging arrangements although their risk is hedged from the perspective of the MNE group as a whole, e.g. by:
    - Delegation of responsibility to an MNE group treasury entity, with the hedging contracts arranged for and in the name of the relevant operating entities or hedging contracts made by and in the name of another MNE group entity; or
    - Identification of the existence of natural hedges within the MNE group, in which case no formal hedging contracts are made.
- A centralized treasury function that arranges a hedging contract that the operating entity enters into is providing a service and should receive arm's length compensation.
- But what if:
  - The contract instrument is entered into by the treasury entity or another MNE group entity, with the result that the positions are not matched within the same entity, although the MNE group position is protected?
  - Off-setting hedging contract instruments exist within the MNE group but not within the same entity, or where contract instruments do not exist within the MNE group but the MNE group position is protected?

Cash pools

A way of achieving more efficient cash management by bringing together the balances on a number of separate bank accounts, e.g. by:

- More effective liquidity management – reliance on external borrowing can be reduced or if surplus an enhanced return may be earned.
- Reduction in financing costs by eliminating the bank spread embedded in the interest which would be payable/receivable on a number of separate debit/credit account balances.

Physical pooling

The bank account balances of all the members are transferred daily to a single central bank account owned by the cash pool leader. Any account in deficit is brought to a target balance by a transfer from the master account to the relevant sub account. Depending on whether there is a surplus or a deficit after the members' accounts have been adjusted to the target balance, the cash pool leader may borrow from the bank to meet the net funding requirement or deposit any surplus.

Notional pooling

The bank notionally aggregates the various balances of members' accounts and pays or charges interest according to the net balance, either to a designated master account or to the members'. Typically, most functions are carried out by the bank and not the cash pool leader.

Cash pools

Accurate delineation of cash pooling transactions

- As cash pooling is not undertaken regularly, if at all, by independent enterprises, the application of TP-principles requires careful consideration.
- Options realistically available should be considered for each member.
- The cash pool member is likely to be participating in providing liquidity as part of a broader group strategy.
  - No member of a cash pool would expect to participate in the transaction if it made them worse off than their next best option. However, it should be taken into account that an MNE can obtain benefits as a member of the cash pool other than an improved interest rate.
- Savings and efficiencies achieved are a result of group synergies created through deliberate concerted action - necessary to determine:
  - The nature and amount of the advantage/disadvantage.
  - How to divide the benefit.
    - Generally, shared by the members (provided that cash pool leader is otherwise appropriately remunerated).
- If debit/credit positions are maintained – risk of treatment as longer term deposit/term loan instead of short-term cash pool balance.
  - Consider whether the same pattern is present year after year and potential group policies.

Cash pools

Accurate delineation of cash pooling transactions (continued)

- Economically significant risks associated to the cash pooling arrangement.
  - Liquidity risk: Mismatch between the maturity of the credit and debit balances.
    - Assuming the liquidity risk requires the exercise of control functions beyond the mere offsetting of credit/debit positions, i.e. decision-making process related to the amounts of debit/credit positions is required.
  - Credit risk: Inability of members with debit positions to repay cash withdrawals.
    - Cash pool leader only assumes the credit risk if there is a probability for it to incur losses derived from the default of members with debit positions.
- A potential difficulty for tax administrations in analyzing cash pools is that the various members may be resident across a number of jurisdictions
  - Difficult to access sufficient information to verify the position as set out by the taxpayer.
  - It would be of ***assistance*** to tax authorities if MNE groups would provide information on the structuring of the cash pool, the returns to the cash pool leader and the members in the cash pool as part of their transfer pricing documentation.
    - Likely, required to be part of the Master File.

Cash pools

Determining arm's length price of cash pooling transactions

- Rewarding the cash pool leader function
  - Typically, a cash pool leader performs no more than a coordination or agency function, i.e. generally limited remuneration.
- Rewarding the cash pool members
  - Interest rates on debit/credit positions - this should allocate the synergy benefits arising from the cash pool amongst the members.
    - Banking arrangements involving the cash pool leader and the options realistically available may provide comparable interest rates.
    - It is expected that all members will be better off than in the absence of the cash pool, e.g. enhanced interest rates, access to permanent source of financing, reduced exposure to external banks, and/or access to liquidity otherwise not available.
- Cash pooling guarantees
  - Cross-guarantees and rights of set-off between members may be required.
    - Complex and may be practically impossible.
      - Numerous members, entities with debit positions and credit positions, different stand-alone credit rating, each guarantor is providing a guarantee for all members and is also guaranteed, etc.
    - Could be regarded as implicit support.

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Financial guarantees

Accurate delineation of financial guarantees

"A legally binding commitment on the part of the guarantor to assume a specified obligation of the guaranteed debtor if the debtor defaults on that obligation."

- Economic benefit derived beyond passive association
  - Enhancement of the terms - the borrower can borrow on the terms that would be applicable if it had the credit rating of the guarantor.
  - Access to a larger amount of borrowing.
    - Risk that a portion of the loan from the lender to the borrower is accurately delineated as a loan from the lender to the guarantor followed by an equity contribution from the guarantor to the borrower.
- Effect of group membership (passive association)
  - Letter of comfort/other lesser form of credit support (no explicit risk assumption).
  - Explicit guarantee will not necessarily confer a benefit on the borrower, e.g. due to interdependence between guarantor and guarantee.
  - Cross-guarantees, i.e. each party providing a guarantee may in turn be guaranteed by the party for whom it is now acting as guarantor.
- Financial capacity of the guarantor to fulfill (potential) obligations
  - Evaluation of the credit ratings of lender and borrower (incl. asset pool of guarantor) and of the business correlations between them (adverse market conditions could affect both the borrower and the lender's capacity).

Financial guarantees

Determining arm’s length price of financial guarantees

- CUP method
  - Independent guarantors’ charges reflect costs of raising capital and satisfying regulatory requirements, which associated enterprises might *not* incur.
- Yield approach (max fee)
  - Quantifies the benefit that the guaranteed party receives in terms of lower interest rates, i.e. the interest rate spread, accounting for implicit support.
  - Maximum fee for the guarantee, i.e. the difference between the interest rate with the guarantee and the interest rate without the guarantee but with the benefit of implicit support (and taking into account any costs).
    - The borrower would have no incentive to enter into the guarantee arrangement if, in total, it pays the same to the bank in interest and to the guarantor in fees as it would have paid to the bank in interest without the guarantee → does not necessarily reflect the outcome of a bargain made at arm’s length.
- Valuation of expected loss approach
  - Calculating the probability of default and accounting for expected recovery rate applied to the nominal amount guaranteed to arrive at a cost of providing the guarantee. The guarantee could be priced based on an expected return on this amount of capital based on commercial pricing models e.g. CAPM.

Financial guarantees

Determining arm's length price of financial guarantees (continued)

- Cost approach (min fee)
  - Quantifies the value of the expected loss of the guarantor or the cost of capital required to support the risks assumed by the guarantor, e.g. using option or CDS pricing models.
  - Pricing under each model will be sensitive to the assumptions made in the modelling process.
  - Sets a minimum fee for the guarantee (that the provider of the guarantee will be willing to accept) and does not of itself necessarily reflect the outcome of a bargain made at arm's length.

- Capital support method
  - Identifying the amount of additional notional capital required to bring the borrower up to the credit rating of the guarantor. The guarantee may be priced based on an expected return on this amount of capital.

Captive insurance

- An MNE group may use captive insurance to stabilize premiums paid, benefit from tax and regulatory arbitrage, gaining access to reinsurance markets, mitigating volatility of market capacity, because it considers it more cost effective, or because it is difficult/impossible to insure certain risks.
- Captive insurances may be subject to regulation in the same way as other insurance and reinsurance companies.
  - Typically include certain actuarial, accounting and capital requirements.
  - Local regulators may impose a lighter regulatory regime where the captive insurance provides insurance exclusively to members of the MNE group.

Captive insurance

Refers to an insurance undertaking or entity, substantially all of whose insurance business is to provide insurance policies for risks of entities of the MNE group to which it belongs.

Reinsurance

Refers to a reinsurance undertaking or entity, the purpose of which is to provide reinsurance policies for risks of unrelated parties that are in the first instance insured by entities of the MNE group to which it belongs.

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Captive insurance

Accurate delineation of captive insurance and reinsurance

- The carrying on of risk mitigation functions falls within the wider concept of risk management but not within that of control of risk.
- Difference between the specific risk being insured and the risk taken on by the insurer in providing insurance to the insured party.
- Indications that captive insurance is found to undertake a genuine insurance business:
  - Diversification and pooling of risk, e.g. by also insuring external non-group risks or if the breadth and depth of the MNE group allows the captive insurance to cover non-correlated/less than fully correlated risks and varied geographical exposures;
  - The captive insurance has a real possibility of suffering losses and has the financial capacity to bear the losses, i.e. capital readily available.
  - The economic capital position of the entities within the MNE group has improved.
  - Both the captive insurer and reinsurer are regulated entities with requirement of evidence of risk assumption and appropriate capital levels.
  - The insured risk would otherwise be insurable outside the MNE group.
  - The captive insurance has the requisite skills, including investment skills, and experience at its disposal.

Captive insurance

Accurate delineation of captive insurance and reinsurance (continued)

- The assumption of the economically significant risks, i.e. underwriting
  - Part IV of the Report on the Attribution of Profits to Permanent Establishments is applicable when identifying relevant risks e.g. insurance risk, commercial risk or investment risk.
  - Control functions = underwriting functions, e.g. setting underwriting policies, classifying and selecting insured risk, setting premiums, analyzing risk retention and acceptance of insured risk.
    - The mere setting of parameters would not qualify as control functions.
- Outsourcing the underwriting function will generally be inconsistent with the minimum regulatory standards to operate an insurance business.
  - A captive insurance may be allowed to outsource the acceptance of insurance risk to an associated enterprise that acts as a broker. Special consideration of the retention by the captive insurance of the control functions would be required in order to conclude whether the risk is allocated to the captive insurance.
- Reinsurance captives – Fronting
  - The principles for captive insurance apply. The key issues are whether the transactions involved amount to genuine insurance or reinsurance and, if there is genuine insurance, whether the premiums payable are on arm’s length terms.

Captive insurance

Determining arm's length price of captive insurance and reinsurance

- Pricing of premiums
  - CUPs may be available.
    - Comparability adjustments, e.g. due to lack of distribution and sales functions in captive insurances that only insure internal risks within MNE group, or differences in business volume, or in the level of capital.
  - Actuarial analysis.
    - An insurer seeks to cover expected losses on claims, costs associated with writing and administering policies and dealing with claims, plus a profit to provide a return on capital taking into account any investment income.
- Remuneration of the captive insurance
  - Combined ratio and return on capital.
    - Step 1: Claims and expenses payable as a percentage of premiums receivable and benchmarked.
    - Step 2: Assessing the investment return achieved by the captive insurance against an arm's length return, i.e. (a) the amount of capital held by the captive insurance, and (b) to the extent to which the captive insurance invests in controlled investments, the rate of investment return achieved by the captive insurance on those investments.
  - The capital adequacy requirements of a captive insurance are likely to be significantly lower than an insurer writing policies for unrelated parties.

Captive insurance

Determining arm's length price of captive insurance and reinsurance (continued)

- Group synergy
  - Where captive insurance is reinsured in the open market, the captive insurer should receive an appropriate reward for the basic services it provides. The remaining group synergy benefit should be allocated among the insured participants by means of discounted premiums.

- Agency sales
  - Where an insurance contract is not sold directly from insurer to insured, recompense will usually be due to the party who arranges the original sale. In certain circumstances a higher rate of profit might be earned on the third party sale than would otherwise be expected from comparison with similar transactions.
    - The higher profit should be allocated between the parties by means of contribution to value creation.

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