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Treading Carefully through the Murky Labyrinth of Intra-Group Financial Derivatives

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1. Introduction

Intra-group financial transactions attract the attention of tax administrations, as they are increasingly perceived to lead to base erosion and profit shifting (BEPS), for example through the use of excessive interest payments on related-party or third-party debt. In recent years, many tax authorities have also expanded their scope of scrutiny and have begun to focus on other types of financial transactions and treasury operations, including cash pooling arrangements, financial and performance guarantees, factoring arrangements, derivatives, captive insurance and various types of treasury services.

The existing guidance on transfer pricing aspects of financial transactions is relatively limited. Generally, countries often use non-transfer pricing rules, for example (i) thin capitalization rules, (ii) debt-to-equity ratios and (iii) guidance on when capital should be regarded as debt or equity or when interest should be reclassified as a dividend. All of these kinds of rules are applied alongside the general or specific transfer pricing rules. In particular, it is acknowledged that a group-wide interest allocation rule together with effective controlled foreign corporation (CFC) rules, could complement transfer pricing rules in dealing with some of the issues surrounding intra-group financial transactions, such as the use of cash box companies with financial assets.

This article will address financial derivative transactions, including those used for managing foreign exchange risks. There are many instruments available to hedge financial risks, including over-the-counter (OTC) and exchange-traded products.

With regard to foreign exchange risks, the most common instruments are currency forwards and futures, cross-currency swaps and currency options. For example foreign exchange derivatives may be used in situations where it is not always efficient to borrow funds in certain territories and currencies due to foreign exchange restrictions, currency volatility or other factors. There may also be restrictions on repatriating cash out of specific countries. Finally, multinationals may also wish to have group-wide policies in place to allow for currency or interest rate hedging in order to access efficiencies for cash flow purposes.

On 5 October 2015, the OECD published its final reports on the 15 Actions under the OECD BEPS project. A number of these final reports relate directly or indirectly to transfer pricing. In addition, the OECD published a discussion draft in 2016 which deals with the...
design and operation of the group ratio rule under Action 4. One might actually wonder, when acting in the field of intra-group financing, and in particular financial derivatives, what the impact of these final reports is. Another question arises as to whether the other BEPS final reports, besides those on Actions 4, 8-10 and 13, do matter when assessing the impact of intra-group financial transactions.

This article provides a definition of financial derivatives (section 2.), an overview of the risks related to financial derivatives (section 3.) and the various operational/transactional models used by multinationals to hedge financial risk exposure in an intra-group context (section 4.). As the authors believe that in addition to understanding the treasury business and the applicable tax and transfer pricing rules, it is also relevant to consider the existing market regulations for purposes of the transfer pricing analysis and determining the arm’s length nature of transactions, this article highlights the regulatory aspects related to intra-group derivatives (section 5.). Subsequently, the article deals with the guidance included in the final reports related to Action 4(9) (section 6.1.) and Action 5(7) (section 6.2.), as preferential tax regimes may also affect the deductibility of interest or payments equivalent to interest, such as amounts equivalent to interest paid under derivative instruments or hedging arrangements related to an entity’s borrowings, as well as foreign exchange gains and losses on borrowings and instruments connected with the raising of debt.

Finally, the remainder of this article covers the OECD final reports on transfer pricing actions under the BEPS project, namely Actions 8-10(6) and 13. This guidance is critical for treasury departments that use financial instruments to limit financial risks. To this end, section 6.3. covers the OECD final reports on Actions 8-10, which address aligning transfer pricing outcomes with value creation, while section 6.4. deals with Action 13, which relates to the country-by-country reporting and transfer pricing documentation(9), (10)

2. Financial Derivatives

Financial derivatives are financial instruments that are linked to a specific financial instrument (asset), indicator or commodity, and through which specific financial risks can be traded on financial markets in their own right.[11] The value of such an instrument derives from the price of the underlying item, which usually fluctuates over time. Unlike debt instruments, no principal amount is advanced to be repaid and no investment income accrues. Financial derivatives are entered into as bilateral or multilateral contracts, where the most common underlying assets include stocks, bonds, commodities, interest rates, foreign exchange rates and market indices.

Financial derivatives represent a broad category of securities, and their usage and applications depend on the specific type of derivative in question. Market participants use derivatives for various purposes, including risk management (including hedging), speculation, investments and arbitrage strategies. With regard to risk management, derivatives enable companies and investors to transfer financial risks to a counterparty without trading the underlying asset.

In general, derivatives are either (i) traded on exchanges and electronic platforms or (ii) OTC. Exchange-traded derivatives are standardized contracts and traded anonymously between exchange members. OTC derivatives are negotiated and entered into directly between the parties. Whilst some OTC derivatives are also standardized, the majority of them are tailor made and entered into by a financial institution to meet the requirements of a particular client. Most financial derivatives are traded on OTC markets, which are less transparent and less regulated than exchanges. As such, OTC derivatives entail greater risks than exchange-traded derivatives.

Typically, standardized OTC derivatives are suitable for clearing, i.e. the process of establishing positions, including the calculation of net obligations, and ensuring that financial instruments, cash or both, are available to secure the exposures arising from those positions. Clearing is performed by a clearing house, i.e. a registered intermediary that becomes a buyer and seller in order to ensure smooth execution of the derivative transaction and to mitigate the credit counterparty risk. Specifically, the clearing house assumes the credit risk on the two parties, although each of the parties is required to put up and maintain a collateral deposit (margin) with the clearing house in order to limit its credit risk exposure.

The vast majority of OTC derivative transactions are governed by an ISDA Master Agreement, published by the International Swaps and Derivatives Association (ISDA). The ISDA Master Agreement is a document that outlines the terms and conditions of derivatives transactions agreed by two parties. Once the parties enter into such an agreement, they may subsequently negotiate each new transaction/trade of OTC derivatives verbally or electronically via any (multibank) platform.[12] The required paperwork, such as the confirmation, is

6. OECD, Action 4 Final Report, supra n. 3.
8. Particularly, Action 9 of the OECD BEPS project is designed to develop rules to prevent base erosion and profit shifting through the transfer of risks among, or the allocation of excessive capital to, group members.
9. The authors are aware of the EU developments for example in the field of tax transparency and the question as to how the OECD recommendation fits into the EU freedoms and ECJ case law. They do consider these developments as significant. However, a discussion of these developments is beyond the scope of this article. See E. Cencerrado Millán & M.T. Soler Roch, Limit Base Erosion via Interest Deduction and Others, 43 Intertax 1 (2015), at 58.
10. The authors are aware of Action 2 (hybrid mismatch arrangements), Action 6 (preventing the granting of treaty benefits in inappropriate circumstances), which prevents treaty abuse and makes it complicated to structure payments to the country where the cash box is tax resident in order to avoid withholding taxes, and Action 3 (designing effective controlled foreign company rules), which considers cash boxes with limited or no economic activities and which accordingly directs that any passive income – including interest – be taxed in the lender’s (parent) country, also influence the treatment of interest payments. However, these actions will not be dealt with in this article.
12. Multibank platforms, such as Bloomberg, 360T and FXAll, are software-based solutions that allow companies to trade various types of derivatives. The main benefit is that multiple price-makers can be asked for a quote simultaneously and, as such, they increase price transparency.
completed at a later stage, usually within 24 hours following the verbal agreement. The timeframe within which this paperwork is to be completed is set by regulation, such as EMIR, and is based on the client classification.\[13\]

In terms of activity in global OTC derivatives markets, volumes fell in the first half of 2015, when the notional amount of outstanding OTC derivative contracts decreased to USD 553 trillion at the end of June 2015 (from USD 629 trillion at the end of December 2014), and the gross market value declined even more sharply, to USD 15.5 trillion (from USD 20.9 trillion).\[14\]

The graphs below\[15\] illustrate the evolution and size of the global OTC derivatives markets:

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3. Risks Related to Financial Derivatives

Although financial derivatives are often used to manage various types of financial risks, financial derivatives themselves may trigger various types of risks, including market price risk, counterparty credit risk, liquidity risk and settlement risk.

**Market price risk** is associated with the mark-to-market value, which is the fair value of a derivative and can change over time, depending on the prevailing market trends and parameters. In particular, if a company uses a derivative for speculative purposes or keeps an open position in a derivative (i.e. there is no opposite trade nor an offsetting position in the underlying asset which is being hedged by the particular derivative), the fluctuating mark-to-market value may result in losses for the company when the fair value of that trade is negative at maturity.

**Credit counterparty risk** is associated with a potential default of one of the counterparties to the derivative transaction (e.g. the buyer, the seller or the dealer). Such risk will materialize if the defaulted counterparty had a payment obligation towards the other party (e.g. due to the contract settlement). Modelling credit risk exposure for a derivative contract is more complex than in the case of debt. This is triggered by the fact that the mark-to-market value and/or the required settlement amount can be negative or positive for either party, depending on the prevailing market parameters at a given moment. The credit counterparty risk is particularly prevalent in the OTC markets, which – as opposed to exchanges – are often not subject to regulations and/or clearing.

The latest global financial crisis has highlighted the relevance of counterparty credit risk in the context of OTC derivative markets. For example the bankruptcies of some large financial institutions, including Lehman Brothers late in 2008 (which enjoyed the strongest credit ratings up until its collapse in the course of just one week), highlighted the importance of managing credit counterparty risk. In the aftermath of the financial markets turmoil, credit counterparty risk has become the key point on agendas of corporate treasurers. Currently, best practices entail careful and systematic evaluation and management of the credit risk with regard to derivative contracts and market investments, even if they are made with AAA/AA-rated institutions. For example many corporate treasury policies prohibit

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13. The EMIR uses three client classifications: Financial Counterparty (FC), Non-Financial Counterparty (NFC-), and Non-Financial Counterparty+ (NFC+). FC and NFC+ clients need to confirm the trade with one business day, whereas NFC- companies need to send confirmation within two business days after execution of the derivative.
dealing with only one external bank and require active management of the credit concentration risk. Typically, the credit counterparty risk is being managed by transacting with a few creditworthy banks, other financial institutions and market dealers.

**Liquidity risk** is another type of risk associated with financial derivatives and can materialize in two different ways. First, the liquidity risk applies in the sense that if one of the parties to the derivative transaction intends to close out the open trade prior to the maturity/settlement date, the party might not be able to do so immediately (for example if the market for the specific type of derivatives is illiquid) and/or the party may incur significant costs (for example in situations where bid-ask spreads are high). This is often also called “cash flow liquidity risk”. Second, there is also asset liquidity risk, which covers the liquidity in the market. This is the risk that one cannot exit a derivative positive due to bad market conditions.

Finally, **settlement risk** is associated with the probability of the failure by one counterparty to the trade to settle its obligations when due in a timely manner. Typically, this type of risk is associated with situations where payments between the two counterparties are not exchanged simultaneously. This risk is not necessarily related with the counterparty credit risk; it may for example stem from temporary liquidity problems of the counterparty to the trade.

As will be explained in this article, the final reports on BEPS Actions 8-10 introduce a new six-step analytical framework for the analysis of risks. This new framework should be an integral part of a functional analysis and should apply equally to non-financial and financial transactions, including financial derivatives. As such, to the extent that group companies enter into intercompany derivative transactions or transactions directly related to financial derivatives (for example hedging on behalf), the afore-mentioned risks will need to be considered when establishing the arm’s length terms and conditions of such transactions. Furthermore, if intra-group derivative trades are material (in monetary terms), such transactions should be explicitly addressed in the master file and local file, in accordance with the guidance in the final report on BEPS Action 13 (see section 6.4.).

## 4. Hedging and Use of Derivatives by Multinational Enterprises

### 4.1. Generally

In the course of ordinary business, multinational groups are exposed to financial risks in connection with fluctuations in interest rates, foreign exchange rates, inflation rates, commodity prices, cash flows, value of investments, etc. In order to reduce the risk exposure, companies employ a number of hedging and risk-mitigation strategies, some of them based on the use of financial derivatives.

Risk management strategies usually cover the whole spectrum of the supply chain, including research and development, manufacturing, sales, administration and investments. However, depending on the industry sector, business footprint, organizational structure, risk appetite, and business culture, companies may address hedging and risk management in different ways.

In recent years, many multinationals have been centralizing their treasury operations, including hedging and derivatives trading. This results in multiple benefits. First, companies gain a comprehensive view of the group's financial exposure and are able to employ internal hedging techniques, such as netting and matching. Second, centralization eliminates duplicative efforts across the firm, as it is no longer necessary for subsidiaries to have their own traders. In addition, multinationals are better positioned to monitor and manage counterparty credit risk, streamline external agreements and achieve economies of scale. Finally, the involvement of central treasury reduces operational burden and generates internal efficiencies.

While operating group companies are typically mandated not to assume unnecessary risks with regard to non-ordinary business activities, the treasury departments of the largest multinationals may be authorized to trade derivative contracts for speculative purposes, in anticipation of earning profits from changes in market parameters. For the majority of companies, this is allowed only if the underlying exposure is highly probable. Some treasury centres operate in a manner similar to banks/financial institutions, being involved in proprietary trading activities, i.e. using their own funds, as opposed to customers’ (i.e. subsidiaries’) funds.

On the other hand, it is acknowledged that not every multinational company requires a sophisticated and complex treasury model. In some cases, the functions of the corporate treasury with regard to hedging and risk management may be limited to routine/administrative activities. Corporate treasury may operate as a cost centre and not perform any hedging functions at all, or only to a limited extent.

Whenever the company does have to manage certain financial risks, the way to deal with such risks is often documented in a risk management, or even a treasury policy. Companies with a mature risk management policy not only document the process that governs the financial risks, but also update those risk policies periodically, have identified the risk owners, have defined the risk appetite by their board, and monitor and report on the adherence to such policies.

Irrespective of the maturity and complexity of the treasury and the risk management functions, hedging activities should be undertaken in line with a clearly defined policy and procedures. This is a critical element with regard to the execution of control over the financial risks. Typically, one can distinguish three types of intra-group transactional frameworks with regard to hedging techniques that involve derivative trades in the intercompany context, namely hedging on behalf, “back-to-back” hedging and internal hedging combined with macro/portfolio hedging.
4.2. Hedging on behalf

Group subsidiaries have separate ISDA master agreements\(^{[16]}\) with external parties, where obligations of group subsidiaries may be additionally guaranteed by the ultimate parent company. The group treasury (TreasuryCo)\(^{[17]}\) acts as an agent, and facilitates and enters into derivative contracts on behalf of its affiliates, in accordance with the hedging requirements provided by the subsidiaries. Effectively, from a legal perspective, each individual subsidiary – and not the treasury entity – is the counterparty to derivative transactions.

Hedging on behalf can be illustrated in a simplified manner as follows:

Under the hedging-on-behalf model, from a contractual perspective, each individual subsidiary is exposed to credit risk on the market counterparties,\(^{[18]}\) and the market counterparties are exposed to credit risk on individual subsidiaries and/or the parent company (in cases where parental guarantees are provided). In any event, the new six-step analytical framework to analyse risk proposed by the OECD (as explained in section 6.3.) should ultimately determine whether the contractual risk assumption should be respected for transfer pricing purposes. Specifically, there might be situations where the risks would need to be re-allocated to enterprises exercising control and having the financial capacity to assume the risk.

4.3. Back-to-back hedging

Within the group, TreasuryCo is specialized in dealing in derivatives and has entered into ISDA master agreements with external parties. Obligations of TreasuryCo towards external parties may be additionally guaranteed by the ultimate parent company. Under this scenario, either (i) subsidiaries are tasked with identifying exposures related to their business operations and subsequently request that TreasuryCo originate and execute hedges or (ii) TreasuryCo itself determines hedging requirements in accordance with the group’s risk management

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16. The ISDA Master Agreement is the most commonly used master service agreement for OTC derivatives transactions internationally. See http://www2.isda.org/, accessed 17 July 2017.
17. A separate TreasuryCo is not required, as the hedging activities can be performed by the central corporate treasury department at the parent level or a regional treasury department at an operating subsidiary. However, for the purpose of simplifying this example and the remaining ones, the authors use a transactional set-up involving TreasuryCo.
18. This is the case only if no margin is posted, as a margin reduces the counterparty credit risk. It is the experience of the authors that most investment grade companies do not need to post collateral, whereas subinvestment grade companies do have a margin requirement to cover any negative fair values of their derivatives. Without the margin requirements, those companies would not have access to the derivatives market.
and hedging policy, and initiates derivative transactions with external parties. Once the external trade is agreed upon, TreasuryCo replicates the opposite intercompany trade with its affiliate. The replicated intercompany trade has exactly the same (or very similar) details such as trade date, settlement date, price, etc. To the extent possible, the internal transaction will typically mirror a derivative contract concluded with the external party. Furthermore, TreasuryCo and each subsidiary enter into intercompany allocation agreements, which govern the allocation of costs and benefits of each derivative transaction to a group subsidiary. Under this hedging model, TreasuryCo is legally a counterparty to the transactions with external parties.

Back-to-back hedging can be illustrated as follows:

In the back-to-back hedging scenario, from a contractual and transactional flow perspective, TreasuryCo is interposed between individual subsidiaries and market counterparties. For example in the absence of a parental guarantee and any intercompany cross-guarantees by individual subsidiaries, it may arise that upon a default by one of the subsidiaries and its inability to settle the existing trades, ultimately TreasuryCo will incur losses specifically, and TreasuryCo would still be contractually obliged to settle the trades with the market counterparties, irrespective of the subsidiary’s default.

Again, a risk analysis under the OECD analytical framework is determinative as to which parties are to be deemed to assume risks for transfer pricing purposes. If the financial risks are contractually assumed by a party that cannot, in fact, exercise meaningful and specifically defined control over the risks, or does not have the financial capacity to assume the risks, in line with the OECD Guidelines such risks – along with both upside and downside consequences of risk outcomes – are to be allocated to the party that does exercise such control and does have the financial capacity to assume the risks.

4.4. Internal hedging combined with macro/portfolio hedging

In light of globalized treasury operations, another approach towards hedging is based on the combination of both internal and the external hedging techniques (including natural hedges and netting). In such a scenario, the Treasury department in the first instance applies internal hedging techniques in order to minimize the overall external position. Subsequently, the treasurer uses external hedging techniques (e.g. macro/portfolio level hedging, as opposed to single-transaction hedging) in order to control and (partially or entirely) mitigate the remaining risk. The use of internal hedging reduces transaction costs, as – from a consolidated group perspective – external hedging is more
expensive vis-à-vis internal techniques, and furthermore increases operational efficiencies. Portfolio hedging requires fewer derivative transactions as compared to hedging on behalf or back-to-back hedging.

However, integrating all the different cash flows and exposures, and hedging individual financial risks at a macro level become more complex and challenging. As such, it requires more sophisticated tools. The most mature risk management and hedging strategies are based on a portfolio-wide approach, which takes into account a combination of risk exposures, such as foreign exchange, interest rate and commodity price risks. Not only does this approach rely on internal offsetting of opposite positions within the same risk categories, but it also considers interdependencies and variations amongst different types of risk. Obviously, there are also limitations as to what degree the entire portfolio of risks can be hedged. As it is rarely possible that a perfect hedge is achievable and/or cost efficient, treasury centres may choose to hedge only part of the combined portfolio of various financial risks.

In some cases, treasury departments may intentionally keep open positions in order to take on a risk-bearing opportunity with anticipation of generating profits.

One of the most common internal hedging techniques entails intercompany netting, which typically involves a group of subsidiaries and a central treasury hub. Subsidiaries inform the treasury about their future intra-group cash flows (payables and receivables), which are then mutually offset, if and to the extent possible.

The following table provides an example of a decentralized and centralized hedging strategy, based on the netting concept:

<table>
<thead>
<tr>
<th>Exposure</th>
<th>Decentralized strategy</th>
<th>Centralized strategy/netting</th>
</tr>
</thead>
<tbody>
<tr>
<td>Subsidiary A</td>
<td>Receive EUR 10 million in 45 days</td>
<td>Short EUR FX forward</td>
</tr>
<tr>
<td>Subsidiary B</td>
<td>Pay EUR 10 million in 45 days</td>
<td>Long EUR FX forward</td>
</tr>
</tbody>
</table>

In the case of internal hedging combined with macro/portfolio hedging, similar to back-to-back hedging, there is a TreasuryCo, which is specialized in risk management and derivatives trading, and has entered into ISDA master agreements with external parties. Obligations of TreasuryCo towards external parties may be guaranteed by the ultimate parent company. TreasuryCo collects information on various risks exposures from the business and then uses such information to develop hedging programs. Contractual relations and terms and conditions between TreasuryCo and group companies may be agreed and evidenced, for example, in the form of a treasury management agreement. Typically, establishing a direct link between an external derivative trade and a specific intra-group transaction is not possible.
Transactional flows for the portfolio hedging strategy can be illustrated as follows:

Similar to the previous two cases, despite the presence of legal agreements and the contractual assumptions of risks, the OECD Guidelines require a functional analysis in relation to risks. Such an analysis should provide information about how the group companies operate in relation to the assumption and management of financial risks, and in particular about which companies perform risk-control functions and which companies have the financial capacity to assume the risks.

5. Regulatory Requirements Regarding Intercompany Derivatives

The global financial crisis has resulted in additional regulations and stricter control mechanisms around OTC derivatives which apply not only to financial institutions, but also to non-financial counterparties, including trading in an intra-group context.[19] For example in Europe the European Market Infrastructure Regulation (EMIR) has been in place since 16 August 2012.[20] Implementation of the EMIR entails obligations for both financial and non-financial institutions, and has an impact on several main areas, namely clearing, risk mitigation and reporting. As the EMIR directly addresses risk-related aspects (including clearing and risk mitigation), while at the same time risk analysis is one of the most significant steps in establishing arm’s length terms and conditions of financial transactions, a brief overview of the main EMIR considerations with regard to intra-group derivatives is provided below.

The need for additional market regulations with regard to financial derivatives was summarized in the EMIR text as follows:

The OTC derivative contracts lack transparency as they are privately negotiated contracts and any information concerning them is usually only available to the contracting parties. They create a complex web of interdependence which can make it difficult to

19. The EMIR regulations impact all derivatives trades in which at least one party to the trade is registered in the European Economic Area.

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identify the nature and level of risks involved. The financial crisis has demonstrated that such characteristics increase uncertainty in times of market stress and, accordingly, pose risks to financial stability. This regulation lays down conditions for mitigating those risks and improving the transparency of derivative contracts.[21]

In particular, the EMIR also recognized a need to substantially improve the mitigation of counterparty credit risk.

Intercompany derivative transactions (even under the back-to-back model) trigger various types of risks (including counterparty credit risk) and, as such, fall within the scope of the EMIR. Depending on the specific facts and circumstances of the case, intercompany derivatives entered into by non-financial companies may be subject to mandatory clearing. Specifically, if the non-financial counterparty takes positions in OTC derivative contracts and those positions exceed the clearing threshold specified by EMIR, that non-financial counterparty becomes subject to the clearing obligations for future contracts (in accordance with the other relevant provisions of the EMIR). The clearing obligation applies not only to the specific asset class the clearing threshold of which has been breached, but also to all asset classes in scope under the EMIR. In other words: breach one, clear all. However, if the two group counterparties can demonstrate to the relevant competent authorities that (i) their risk-management procedures with regard to intra-group derivative transactions are adequately sound, robust and consistent with the level of complexity of the derivative transaction and (ii) there is no current or foreseen practical or legal impediment to the prompt transfer of own funds or repayment of liabilities between these counterparties, they should be exempt, wholly or partially, from the clearing requirement.[22]

In addition, the applicability of the EMIR may differ depending on whether an intra-group derivative transaction is entered into for hedging purposes. In this regard, it is to be determined whether an OTC derivative contract reduces risks directly relating to the commercial activities and treasury activities of the subject non-financial counterparty. Such an analysis would require analysing that non-financial counterparty’s overall hedging and risk-mitigation strategies. In particular, consideration should be given to whether an OTC derivative contract is economically appropriate for the reduction of risks in the conduct and management of a non-financial counterparty, where the risks relate to fluctuations in interest rates, foreign exchange rates, inflation rates or commodity prices.[23]

Effectively, having a clear understanding of the purpose of respective intercompany derivative transactions is critical with regard to the EMIR. However, it is also a key element in the transfer pricing and tax analysis. The above also clearly demonstrates that risk-management procedures in the context of financial transactions (including derivative contracts) not only are becoming more relevant for transfer pricing purposes under the amended OECD Guidelines (reflecting the BEPS final reports),[24] but also play a critical role with regard to existing regulations.

6. The OECD BEPS Project

6.1. Action 4

6.1.1. Introduction

Action 4 of the BEPS Action Plan calls for the design of rules to prevent erosion through the use of interest expenses and other financial payments. One of the areas where guidance was supposed to be given is the area of transfer pricing of financial transactions. However, such transfer pricing guidance has not been provided in the BEPS Action 4 Final Report that was published on 5 October 2015, nor in the Action 4 Discussion Draft published on 11 July 2016.[25] Transfer pricing guidance on financial transactions is expected to follow in 2016 and 2017.[26] The banking and insurance sectors are considered sectors with special features, and the OECD has indicated that it will issue tailored rules in 2016.[27] Treasury companies do not fall under this exclusion.

The OECD made an inventory of rules that are used in various countries to limit interest expense deduction. These rules include withholding tax on interest, fixed ratio, fixed ratio in combination with a group ratio, and specific anti-avoidance rules and arm’s length tests.[28] With regard to the arm’s length test, the entity’s circumstances, the amount of debt that the entity would be able to raise from third-party lenders and the terms under which that debt could be borrowed should be taken into account. However, the OECD notes in paragraph 12 of the Action 4 Final Report that, although the arm’s length test allows a tax administration to focus on the particular commercial circumstances of an entity or a group, it can be resource intensive and time consuming for both taxpayers and tax administrations to apply.

21. EMIR, supra n. 19.
22. EMIR, supra n. 19, art. 11.
23. EMIR, supra n. 19, art. 11.
24. This point is further elaborated on in the remainder of this article.
25. OECD, Action 4 Final Report, supra n. 3; OECD, Action 4 Discussion Draft (2016), supra n. 5. In the Action 4 Final Report, the OECD explicitly states that the arm’s length principle, as such, is not considered a best practice “in tackling base erosion and profit shifting involving interest and payments economically equivalent to interest if they are not strengthened with other interest limitation rules”. Action 4 Final Report, para. 22. According to the OECD, the arm’s length principle is generally found to be too resource intensive and time consuming for both taxpayers and tax administrations to apply. Further, the arm’s length principle is no longer found to be an effective measure to tackle artificially high interest and similar payments. See J. Hülshorst et al., Transfer Pricing Implications of Action 4 under the OECD’s BEPS Initiative, 23 Ind. Transfer Pricing J. 2 (2016), at 129. The authors note that in their opinion the ratios do not take into account the specific circumstances of a company and the transaction, as the arm’s length principle would do. Hülshorst et al., at 130.
27. OECD, Action 4 Final Report, supra n. 3, Executive Summary, at 12.
28. OECD, Action 4 Final Report, supra n. 3, para. 11.
The OECD concludes that some countries doubt whether transfer pricing rules are sufficient to combat base erosion and profit shifting. The OECD concluded that transfer pricing rules may be useful to complement other rules limiting the deduction of interest expense.

The OECD sets out a best-practice approach[29] in the Action 4 Final Report which is based on a set combination of some or all of the rules which (i) limit the level of interest expense or debt in an entity with reference to a fixed ratio, (ii) limit the level of interest expense or debt in an entity with reference to the group’s overall position and (iii) use targeted anti-avoidance rules that disallow interest expense on specific transactions.[30]

6.1.2. Definition of interest

The OECD indicates in the Action 4 Final Report that the definition of interest should not be limited to the cost of borrowing money, as such an approach would pave the way for BEPS. The interest limitation rules should apply to interest on all forms of debt, as well as to other financial payments that are economically equivalent to interest. Payments are economically equivalent to interest when they:

- are linked to the financing of an entity and are determined by applying a fixed or variable percentage to an actual or notional principal over time. A rule should also apply to other expenses incurred in connection with the raising of finance, including arrangement fees and guarantee fees.[31]

The OECD provides a non-exhaustive list of expenses that should be considered interest expenses for interest limitation rules, namely:

1. payments under profit participating loans;
2. imputed interest on instruments such as convertible bonds and zero-coupon bonds;
3. amounts under alternative financing arrangements, such as Islamic finance;
4. the finance cost element of finance lease payments;
5. capitalized interest included on the balance sheet value of a related asset, or the amortization of capitalized interest;
6. amounts measured by reference to a funding return under transfer pricing rules, where applicable;
7. notional interest amounts under derivative instruments or hedging arrangements related to an entity’s borrowings;
8. certain foreign exchange gains and losses on borrowings and instruments connected with the raising of finance;
9. guarantee fees with regard to financing arrangements,[32] and
10. arrangement fees and similar costs related to the borrowing of funds.[33]

With regard to derivative contracts, the expenses mentioned under (7) and (8) are noteworthy. Referencing section 5., gaining a clear understanding of the purpose of the derivative contract will be a critical element in determining the deductibility of financial payments.

However, the OECD does note that some expenses in foreign exchange gains and losses on instruments to hedge or take on a currency exposure connected with the raising of finance are not generally economically equivalent to interest. Payments are economically equivalent to interest when they:

- for foreign exchange gains and losses on monetary items that are not connected with the raising of finance;[34]
- amounts under derivative instruments or hedging arrangements that are not related to borrowings (e.g. commodity derivatives);
- discounts on provisions not related to borrowings;
- operating lease payments;
- royalties;

29. A discussion of whether this is really the best approach to limit the deduction of interest falls is beyond the scope of this article.
30. OECD, Action 4 Final Report, supra n. 3, para. 16.
31. OECD, Action 4 Final Report, supra n. 3, para. 35.
32. Performance guarantees do not fall within the bracket of all interest on a debt, payments economically equivalent to interest or expenses incurred in connection with the raising of finance. OECD, Action 4 Final Report, supra n. 3, paras. 241, 242.
33. OECD, Action 4 Final Report, supra n. 3, para. 36.
34. It looks like costs or foreign exchange gains/losses associated with export or import transactions (e.g. through hedging or a currency swap on the sale/purchase price within the ordinary course of business) is not considered interest. It is also common that parent companies within international groups like to protect themselves against losses on assets (including shares in subsidiaries) and obligations in the business due to currency fluctuations, which is why they enter into currency derivatives (usually index based) in order to protect the group balance sheet. The authors assume that these hedging costs will also not be considered interest. See also OECD, Comments Received on Public Discussion Draft, BEPS Action 4: Interest Deductions and Other Financial Payments – Part 1 (OECD 11 Feb. 2015), comments by AstraZeneca.
accrued interest with regard to a defined benefit pension plan.[35]

As mentioned in section 1. of this article, the authors focus here is primarily on financial derivatives. According to the OECD, these either may or may not fall within the scope of the interest limitation rules, depending on whether such derivative instruments are related to an entity's borrowings/raising of finance. For centralized treasury functions where hedging is undertaken by a treasury function, the above means that the treasury departments of MNEs need to make a distinction between contracts which are involved in hedging arrangements related to debt and those which are not, in order to determine the amount of financial payments subject to the deductibility limitations.

6.1.3. Fixed ratio rule

The OECD recommends an approach based on a fixed ratio rule. A fixed ratio test would restrict the net interest expense to a specified proportion of EBITDA (earnings before interest, tax, depreciation and amortization), assets or equity of a company. The OECD recommends a primary interest limitation rule, based on a "net interest/EBITDA" cap.[36] The fixed ratio test involves the following steps:

- Step 1: an entity's EBITDA is calculated by adding back to its taxable income, the tax values for (i) net interest expense and net payments equivalent to interest payments (see section 6.1.3.) and (ii) depreciation and amortization;
- Step 2: the statutory benchmark fixed ratio is applied to the EBITDA figure; and
- Step 3: the maximum amount that the entity is allowed to deduct for tax purposes is then compared with the entity's actual net interest expense.

Based on the above calculations, any net interest expense in excess of the maximum allowable amount is disallowed as a deduction.

Consider the following example:[37]

<table>
<thead>
<tr>
<th></th>
<th>Single entity taxation</th>
<th>Group taxation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>A1 Co USD</td>
<td>A2 Co USD</td>
</tr>
<tr>
<td>Taxable income/(losses) before applying the fixed ratio rule</td>
<td>70m</td>
<td>10m</td>
</tr>
<tr>
<td>+ net interest expense</td>
<td>+ 10m</td>
<td>+ 50m</td>
</tr>
<tr>
<td>+ depreciation and amortisation</td>
<td>+ 20m</td>
<td>+ 40m</td>
</tr>
<tr>
<td>= tax-EBITDA</td>
<td>= 100m</td>
<td>= 100m</td>
</tr>
<tr>
<td>x benchmark fixed ratio</td>
<td>x 15%</td>
<td>x 15%</td>
</tr>
<tr>
<td>= maximum allowable deduction</td>
<td>= 15m</td>
<td>= 15m</td>
</tr>
<tr>
<td>Disallowed interest expense</td>
<td>0</td>
<td>35m</td>
</tr>
</tbody>
</table>

The benchmark corridor for a fixed ratio could be between 10-30%.[38] In the Action 4 Final Report, the OECD discusses various approaches that countries could take to manage volatility. Disallowed interest or unused interest capacity could also be carried forward (or back). Countries might also choose to apply a fixed ratio on an average over a number of periods. There could also be a de minimis rule (e.g. interest remains fully deductible up to EUR 3 million).

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37. OECD, Action 4 Final Report, supra n. 3, para. 98.
38. The OECD recommends a threshold between 10% and 30%, indicating that countries will have some flexibility when adopting Action 4 in their domestic legislation. OECD, Action 4 Final Report, supra n. 3, para. 98. The range of 10% to 30% may be revised following an initial review of the best practice, to be completed by no later than the end of 2020.
In the authors’ opinion, a fixed ratio seems rather simple to administer. A very low fixed ratio would be a bit unfair to capital intensive industries. This ratio could be supplemented with a group ratio. This group ratio would allow an entity that exceeds the benchmark fixed ratio to deduct interest expense up to the net third-party interest/EBITDA ratio of its group, where this is higher.

### 6.1.4. Group ratio rule

In the Action 4 Final Report, the OECD states that a fixed ratio rule does not take into account that groups in different sectors may be leveraged differently, and – even without a sector bias – some groups are simply more highly leveraged. Therefore, if a fixed ratio rule were to be introduced in isolation, groups which have a net third-party interest/EBITDA ratio above the benchmark fixed ratio would be unable to deduct all of their net third-party interest expense. To reduce the impact on more highly leveraged groups, the OECD recommends that countries consider combining a fixed ratio rule with a group ratio rule.[43] In order to determine the net interest expense at a group level, group level information is required. The OECD recommends that, as a minimum, countries accept consolidated financial statements prepared under local generally accepted accounting principles (GAAP) and the most common accounting standards used by large listed multinational groups (i.e. International Financial Reporting Standards (IFRS), Japanese GAAP and US GAAP).[40]

In addition, the OECD also provides a definition of a group. For purposes of applying a group ratio rule, a group includes a parent company and all entities that are fully consolidated on a line-by-line basis in the parent’s consolidated financial statements.[41]

The OECD distinguishes two stages when determining the amount of net interest expense deductible under a group ratio rule, namely:

- Stage 1: determine the group’s net third-party interest/EBITDA ratio:
- Stage 2: apply the group’s ratio to an entity’s EBITDA:

As mentioned in section 1. of this article, the OECD published a Discussion Draft in 2016 in which more guidance is given with regard to the group ratio rule.[42] In the Discussion Draft, the OECD states that, when calculating the group’s net third-party interest expense, some adjustments should be made to the group’s consolidated financial statements. The OECD suggests that adjustments be made to the aforementioned financial statements to make sure that foreign exchange gains or losses (to the extent these are not economically equivalent to interest) are excluded from net third-party interest expense.[43]

### 6.2. Action 5

On 5 October 2015, the OECD published its final report on Action 5, Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance (the Action 5 Final Report).[44] This Final Report establishes a substantial activity requirement and minimum standards with regard transparency in relation to rulings.[45] To fall within the scope, there must be a so-called “preferential regime”. According to paragraph 13 of the Action 5 Final Report, a regime is considered preferential when it offers some form of tax preference in comparison with the general principle of taxation in that country. This could be a decrease in tax rate, tax exemptions, or preferential terms for the payment or repayment of taxes. Whether a regime is potentially harmful is determined by the following four key factors:

- the regime imposes no or low effective tax rates on income from geographically mobile financial and other service activities;
- the regime is ring-fenced from the domestic economy;
- the regime lacks transparency (for example the details of the regime or its application are not apparent, or there is inadequate regulatory supervision or financial disclosure); and
- there is no effective exchange of information with regard to the regime,[46] In order for a potentially harmful regime to be considered actually harmful the regime should create harmful effects.[47] The OECD reviewed several non-IP regimes. None of them was considered actually harmful. The OECD will continue to review preferential regimes.

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40. OECD, Action 4 Final Report, supra n. 3, para. 123.
41. OECD, Action 4 Final Report, supra n. 3, para. 125.
42. The authors are aware that the OECD – in both the OECD Action 4 Final Report and the Discussion Draft – provided guidance on the impact of loss making entities on the group ratio rule, calculation of the group EBITDA and how to calculate a group’s net third-party interest expense. A discussion of this is beyond the scope of the article.
43. OECD, Action 4 Discussion Draft, supra n. 5, para. 14.
44. OECD, Action 5 Final Report, supra n. 7.
45. It also sets a minimum standard for domestic law provisions in respect of intellectual property (IP) regimes, such as patent box regimes. A discussion of this is beyond the scope of this article.
46. OECD, Action 5 Final Report, supra n. 7, para. 15. There are also eight other factors included in paragraph 16 of the report, namely: (i) an artificial definition of the tax base, (ii) failure to adhere to international transfer pricing principles, (iii) foreign-source income exempt from residence country taxation, (iv) negotiable tax rate or tax base, (v) existence of secrecy provisions, (vi) access to a wide network of tax treaties, (vii) promotion of the regime as a tax minimization vehicle and (viii) encouragement of operations or arrangements that are purely tax driven and involve no substantial activities by the regime.
47. For criteria, see OECD, Action 5 Final Report, supra n. 7, para. 20.
The substantial activity requirement requires a link between the income qualifying for benefits and the core activities necessary to earn the income. The Action 5 Final Report lists types of activities that could be used to establish a link with different types of financial and other service activities, including financing and leasing regimes and banking and insurance regimes.

The Action 5 Final Report also includes an exchange of information framework to increase transparency with regard to rulings. This framework applies to taxpayer-specific rulings, namely (i) rulings on preferential regimes, (ii) unilateral advance pricing agreements (APAs) or other cross-border unilateral rulings in respect of transfer pricing, (iii) cross-border rulings providing for a downward adjustment of taxable profits (in particular, excess profit and informal capital rulings), (iv) permanent establishment (PE) rulings and (v) related-party conduit rulings.

The exchange of information will take place with regard to existing rulings which have been issued on or after 1 January 2010 and which were still in effect as from 1 January 2014. In addition, information with regard to future rulings will be exchanged. Rulings are considered future rulings when they are issued on or after 1 April 2016. Further, information on past rulings that were issued on or after 1 January 2010 and were still in effect as from 1 January 2014 will also need to be exchanged. This also applies to rulings that were modified during this period.

A financing and leasing or banking and insurance regime could apply to companies that use financial derivatives. If the applicable regime is considered actually harmful, information with regard to the ruling will be exchanged. Based on the above, it is expected that countries will adjust their preferential regimes. It is also expected that tax authorities will have more information and will challenge more certain positions taken – and, as a consequence, disputes will increase. Financing companies residing in third countries may not be safe in the future, as the OECD has asked the Forum on Harmful Tax Practices to develop a strategy to engage non-OECD/non-G20 countries into the work on harmful tax practices.

### 6.3. Actions 8-10

Actions 8, 9 and 10 of the BEPS project seek to ensure that transfer pricing outcomes be in line with value creation. As part of these actions, the OECD published the Final Report on BEPS Actions 8-10, which provide for changes to Chapter I of the OECD Guidelines related to risk, recharacterization and special measures. The OECD also provided more guidance on comparability analysis and risk in the Actions 8-10 Final Reports.

In the discussion here, the primary focus is on risks, although the authors are aware that paragraph 1.33 of the Actions 8-10 Final Reports emphasizes the significance of understanding the importance of all the economically relevant characteristics of the transactions and the comparability analysis thereof. Paragraph 1.36 of these Final Reports states the comparability factors that are to be taken into account when performing a comparability analysis, namely (i) contractual terms, (ii) functional analysis, (iii) the characteristics of property transferred or services provided, (iv) the economic circumstances of the parties and of the market in which the parties operate and (v) the business strategies pursued by the parties. Part of the functional analysis is an analysis of the risks in the commercial and financial relations.

The OECD introduces several definitions with regard to risk. The OECD provides a six-step approach with regard to risk, specifically determining whether the associated enterprise contractually assuming the risk, does not exercise control over:

1. Identification of economically significant risks with specificity;
2. Determination of contractual assumption of the specific risk;
3. Functional analysis in relation to risk;
4. Interpreting Steps 1 through 3;
5. Allocation of risk;
6. Pricing the transactions, taking into account the allocation of risks.

Step 1 concerns the identification of economically significant risks. Entrepreneurship means running risks. While risk is often thought of as a downside, de facto there could also be upside consequences of risk assumption. The significance of a risk depends on the likelihood and size of the potential profits or loss arising from the risk. Paragraph 1.72 of the Actions 8-10 Final Reports contains a non-exclusive list of risks, namely: strategic risks or marketplace risks, infrastructure or operational risks, financial risks, transactional risks and hazard risks.

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49. OECD, Action 5 Final Report, supra n. 7, paras. 82-83.
50. OECD, Action 5 Final Report, supra n. 7, paras. 95-119.
52. OECD, Action 5 Final Report, supra n. 7, paras. 128-129.
54. OECD, Actions 8-10 Final Reports, supra n. 4.
55. Also here the value chain analysis comes back. The functional analysis should indicate how the functions of the parties involved in the transaction relate to the wider generation of value by the MNE group to which the parties belong, the circumstances surrounding the transaction and industry practices
56. OECD, Actions 8-10 Final Reports, supra n. 4, para. 1.60.
57. OECD, Actions 8-10 Final Reports, supra n. 4, para. 1.71.

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For example with regard to foreign exchange, the following three risks subcategories can be identified:  

- transaction risk: the risk of variations of the value of committed future cash flows;
- economic risk: takes into account the impact of exchange rate variations on competitiveness; and
- translation risk: the risk of variations in the value of assets and liabilities denominated in foreign currency.

Part of Step 1 under the OECD analytical risk framework is also the identification of the magnitude of foreign exchange exposure, where, for example, the amount or value at risk should be measured.  

This issue has been clouded by the fact that financial results for an enterprise tend to be compiled by methods based on the principles of accrual accounting. In other words, identifying what is at risk, and in what way.

With regard to financial derivatives, the following risks (as mentioned in section 3.) are applicable and therefore ideally should be analysed: market price risk, counterparty credit risk, liquidity risk and settlement risk. Otherwise, the functional and risks analysis might prove to be incomplete.

Step 2 relates to the contractual assumption of risks. The party or parties assuming the risks involved in a transaction, as well as the types of risk they assume would typically be laid down in a contract. This must be aligned with the relevant substance and people functions. For example, from an efficiency perspective, it makes sense to centralize the management of foreign exchange risk results.  

Treasury can minimize its external market transactions by netting offsetting exposures within the global enterprise and write internal hedging contracts when necessary. In addition to netting of currencies across many different transactions globally, a centralized treasury group could also take advantage of other hedging techniques with resort to external financial market transactions.

As Moerer, Agarwal and Respess note, the intercompany contracts that treasury enters into with affiliated entities should provide the relevant details to this arrangement and how foreign exchange risk is managed and mitigated by treasury and for the local entity, potentially in combination with agreements with other related or unrelated parties.

Given the various risk management models and techniques, as introduced in section 4., first, companies should ideally ensure that intra-group contractual arrangements with regard to financial derivatives are properly aligned with the applicable intra-group transactional framework (e.g. hedging on behalf, back-to-back hedging or internal hedging combined with macro/portfolio hedging). Most critically, the legal agreements need to reflect both the actual intent and actual conduct of the parties to financial derivatives transactions.

Step 3 concerns the functional analysis with regard to risk. This analysis provides information about how the associated enterprises operate in relation to the assumption and management of the specific, economically significant risks. It also provides insight into which enterprise or enterprises perform control functions and risk mitigation functions, which enterprise or enterprises encounter upside or downside consequences of risk outcomes, and which enterprise or enterprises have the financial capacity to assume the risk.

The OECD provides a couple of examples to illustrate what control and risk mitigation functions means. According to paragraph 1.65 of the Actions 8-10 Final Reports, control over a risk means that a company has the (i) the capability to make decisions to take on, lay off or decline a risk-bearing opportunity, together with the actual performance of that decision-making function and (ii) the capability to make decisions as to whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision making. If one speaks of foreign exchange risks, this would mean the following. If Company A, residing in the Netherlands and having the euro as its functional currency, buys a huge volume of goods from group Company B residing in the United States and the pricing is in US dollars, Company A runs a foreign exchange risk. In Company A, one fully sees the risk involved and the implications that it has when the risk materializes, having a background in finance. In Company A, one can decide to take on this risk or to hedge this risk. But if Company B sells the goods in euro in order to protect Company A from foreign exchange risk, Company B should be remunerated for this. Control over risk does not mean that the company needs to perform the day-to-day mitigation. Indeed, the day-to-day mitigation may be outsourced.

In addition, the OECD states that a company has the financial capacity to assume risk when it

58. This is a non-exhaustive list. It also is not the purpose of the OECD to rank the risks (i.e. to give them some hierarchical order).
61. Moerer, Agarwal & Respess III, supra n. 59.
63. OECD, Actions 8-10 Final Reports, supra n. 4, para. 1.62.
64. OECD, Actions 8-10 Final Reports, supra n. 4, para. 1.63.
65. OECD, Actions 8-10 Final Reports, supra n. 4, paras. 1.83-1.85.
66. The OECD points out: “Neither a mere formalisation of the outcome of decision-making in the form of, for example, meetings organised for formal approval of decisions that were made in other locations, minutes of a board meeting and signing of the documents relating to the decision, nor the setting of the policy environment relevant for the risk (see paragraph 1.76), qualifies as the exercise of a decision-making function sufficient to demonstrate control over a risk”, OECD, Actions 8-10 Final Reports, supra n. 4, para. 1.66.
68. OECD, Actions 8-10 Final Reports, supra n. 4, para. 1.65.
has access to funding to take on the risk or to lay off the risk, to pay for the risk mitigation functions and to bear the consequences of the risk if the risk materializes. Access to funding refers to the available assets and the options realistically available to access additional liquidity, if needed, to cover the costs anticipated to arise should the risk materialize.\(^{69}\)

With regard to the intra-group transactional frameworks pertaining to financial derivatives, as introduced in section 4., in Step 3 of the OECD analytical risk framework it is critical to understand the roles and people functions undertaken at the level of the parent, the subsidiaries and the treasury company, in particular as they relate to control over risks. Also, the financial capacity to assume the risks identified in Step 1 (which may include market price risk, counterparty credit risk, liquidity risk, and settlement risk) should be examined.

Step 4 involves an analysis of whether the conduct of the parties to the transaction is in line with the contract. If this is not the case, the conduct of parties will prevail over the contract. In a second step (i.e. once the party assuming the risk has been identified), one must determine whether the party assuming the risk does exercise control over the risk and has the financial capacity to assume the risk. If so, the transfer pricing analysis can skip directly to Step 6 (pricing). If not, an additional Step 5 is required. Paragraph 1.98 of the Actions 8-10 Final Reports states what needs to happen when the enterprise assuming the risk does not exercise control over the risk or does not have the financial capacity to assume the risk. In such case, the risk should be allocated to the enterprise exercising control and having the financial capacity to assume the risk. Paragraph 1.98 further states as follows:

> If multiple associated enterprises are identified that both exercise control and have the financial capacity to assume the risk, then the risk should be allocated to the associated enterprise or group of associated enterprises exercising the most control. The other parties performing control activities should be remunerated appropriately, taking into account the importance of the control activities performed.

Also noteworthy in this regard is paragraph 1.94 of the Actions 8-10 Final Reports which deals with the situation when there is more than one party to the transaction exercising control over a specific risk. This paragraph states that where the associated enterprise assuming risk (as analysed under Step 4(i)) controls that risk in accordance with the requirements set out in paragraphs 1.65-1.66, all that remains under Step 4(ii) is to consider whether the enterprise has the financial capacity to assume the risk. If the enterprise has the financial capacity to assume the risk, the fact that other associated enterprises also exercise control over the same risk does not affect the assumption of that risk by the first-mentioned enterprise, and Step 5 need not be considered.

### 6.4. Action 13 and its impact on financial instruments\(^{70}\)

On 5 October 2015, the OECD published its final report under Action 13 on transfer pricing documentation and country-by-country reporting (the Action 13 Final Report). Many countries\(^{71}\) have already begun to adopt a number of the new requirements in various forms.

Country-by-country reporting encompasses a three-tiered approach to transfer pricing documentation that should consist of:\(^{72}\)

- a master transfer pricing file containing standardized information relevant for all MNE group members;
- a local transfer pricing file referring specifically to material transactions of the local taxpayer; and
- a country-by-country report containing certain information relating to the global allocation of the MNE’s income and taxes paid, together with certain indicators of the location of economic activity within the MNE group. This applies only for MNEs with a global turnover over EUR 750 million.\(^{73}\)

The master transfer pricing file should provide the following:\(^{74}\)

- the MNE group’s organizational structure;
- a description of the MNE’s business or businesses (including the so-called “important drivers of business profits”);
- the MNE’s intangibles;
- the MNE’s intercompany financial activities; and
- the MNE’s financial and tax positions. This includes a list of advance pricing agreements and advance tax rulings.

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69. OECD, Actions 8-10 Final Reports, supra n. 4, para. 1.64.
71. For example Argentina, Australia, Canada, China, Denmark, Ireland, Mexico, the Netherlands, South Korea, Spain and the United Kingdom.
72. OECD, Action 13 Final Report, supra n. 4, para. 16.
73. OECD, Action 13 Final Report, supra n. 4, para. 52.
74. OECD, Action 13 Final Report, supra n. 4, para. 19.
Based on Annex 1 to the Action 13 Final Report, the following information should be provided in the master file with regard to financial transactions:

1. A general description of how the group is financed, including significant financing arrangements with unrelated lenders;
2. The identification of any members of the MNE group that provide a central financing function for the group, including the country under the laws of which the entity is organized and the place of effective management of such entities; and
3. A general description of the MNE’s general transfer pricing policies related to financing arrangements between associated enterprises.

The question concerns what should be considered significant financing arrangement for these purposes. This is not limited to loans, but can also include sale and lease-back arrangements, short-term credit facilities and bridge loans. The authors believe that point (1) is not directly applicable to instruments covered in this article. Point (2) concerns the obligation to provide a list of MNE members that perform a central financing function for the group. Central financing functions could include cash pooling, treasury management, working capital finance and risk management/hedging. Consequently, companies engaged in centralized intra-group activities related to financial derivatives are likely to fall within the scope of point (2). However, historically, financial derivatives transactions have not been extensively covered in transfer pricing documentation.

Furthermore, companies need to provide a general description of the MNE’s general transfer pricing policies related to financing arrangements between associated enterprises. While the OECD does not further elaborate as to what is exactly meant by the relatively broad term “transfer pricing policies”, the authors believe that in the case of financial derivatives a master file should at least describe (on a high-level basis) the general pricing approach for intra-group financial derivative trades (e.g. in reference to the market prices). However, remains to be seen what the best practices will be in this regard.

The local transfer pricing file should provide more detailed information relating to specific intercompany transactions. The specific information is listed in Annex 2 of the country-by-country report. Financial derivatives, provided that they are considered material (in monetary terms), should be documented in the local file. This would typically also require documentation of terms and conditions, the comparability and functional and risk analysis, as well as supporting analysis (including relevant benchmarks) with regard to the arm’s length nature of such transactions (including the transaction price and, where applicable, remuneration for a company engaged in intra-group financial derivatives activities at a central/regional level). Furthermore, the relevant intercompany agreements should be provided as part of the local file for material intra-group transactions. Per the authors’ understanding, this requirement applies equally to intra-group financial derivatives transactions.

Also, companies that derive profits for example solely from hedging activities will be included in the country-by-country report (provided that the group meets the threshold to prepare the country-by-country report). The Action 13 Final Report requires aggregate tax-jurisdiction-wide information relating to the global allocation of income, taxes paid and certain indicators of the location of economic activity among tax countries in which the MNE group operates. The country-by-country report also requires a listing of all the constituent entities for which financial information is reported, including the country of incorporation (where different from the country of residence) and the nature of the main business activities carried out by that constituent entity. An MNE should make sure that the companies mentioned in the master file that are performing a central financing function are included in the country-by-country report.

It is essential that the information provided in the master file, local files and country-by-country file be aligned. If information provided in a local file deviates from the information in the country-by-country report or another file, this may be a red flag for the authorities. As mentioned, legal agreements should also be part of the documentation related to financial derivatives. However, it is essential that the risks laid down in these agreements, the division of the risks, the assumption of the risks, the control over the risks and the financial capacity to assume the risks reflect the actual intent and conduct of parties. Companies that derive their profits from hedging/derivatives-trading activities should also take into account the changes laid down in Chapter 1, part D of the OECD Guidelines, as explained in section 6.3.

7. Conclusion

The analysis of intra-group financial derivatives in light of the more stringent international and local transfer pricing and tax regulations, which have resulted from the BEPS project, may often prove to be complex and both resource and time consuming. Given that, in the past, such transactions received limited attention from both the tax administration and multinationals, the authors are of the opinion that the forthcoming period will be a challenging one for tax and treasury departments of MNEs.

The new developments require a new approach. Where in the past financial derivatives were often addressed only within the treasury domain, the OECD guidance under the BEPS project requires companies to address intra-group financial derivatives and centralized risk management (including hedging) from a tax and transfer pricing perspective. Thus, tax and transfer pricing departments need to closely liaise with treasury, and take actions to ensure compliance with the stricter regulations and manage tax controversy risks. Not taking any action might lead to, for example, disallowed deductions of payments under financial derivatives, transfer pricing adjustments and even damages.

76. OECD, Action 13 Final Report, supra n. 4; Annex III to chapter 5. For purposes of completing Annex III, a constituent entity of an MNE group is any separate business unit of the MNE group (company, corporation, trust, partnership etc.) that is included in the consolidated group for financial reporting purposes. Entities excluded from financial statements only on size or materiality grounds should be included in the country-by-country report as constituent entities.


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recharacterization of the transactions, namely if such transactions lack commercial rationality or the contractual terms are not aligned with the actual conduct of the parties (e.g. where the control over risks and/or financial capacity to assume risks are not performed by the specific entity).

However, there is a way out of this labyrinth. Specifically, in the authors’ opinion, the following actions should enhance taxpayers’ positions, help in articulating consistent transfer pricing policies towards tax administrations and reduce a number of potential transfer pricing controversies in the area of financial derivatives:

- Developing a transfer pricing policy for financial derivatives to ensure a global and consistent transfer pricing approach and pricing across jurisdictions, or if such transfer pricing policy is already in place, ensuring the transfer pricing policy is updated to reflect the guidance under the BEPS final reports. Ideally, a transfer pricing policy would address the overall business purpose/commercial rationality of financial derivatives transactions, the arm’s length nature of terms and conditions of derivative trades and the arm’s length pricing.

- Preparing and/or updating legal agreements. This way it can be clearly proven to local management and tax authorities what the terms and conditions of the transactions are, in particular with regard to the intended assumption of the financial risks.

- Performing an Action 4 analysis, taking into account financial derivative and foreign exchange gains and losses, to determine what is the current capacity to deduct such payments and whether there is some need to optimize financing, including risk management/hedging strategies. In this context, a distinction is required between the financial derivatives used in relation to raising finance and those used for other purposes.

- Covering financial derivatives in transfer pricing documentation, both in the master file and local files (in the case of material financial derivatives transactions). With regard to benchmarking analyses, having proper procedures in place is essential, especially for those cases where financial derivatives are frequently traded in the intra-group context. For example, it would be relevant that the Treasury department collects, maintains and provides to the tax department sufficient market evidence (market prices) to demonstrate the arm’s length pricing of individual derivative trades (as such information is now required in local files).
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