Executive summary

On 11 February 2020, the Organisation for Economic Co-operation and Development (OECD) released its final report with transfer pricing guidance on financial transactions (the Report). The Report has been published as follow up guidance in relation to Base Erosion and Profit Shifting (BEPS) Action 4 and Actions 8-10. It aims to clarify the application of the principles included in the 2017 edition of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD TPG), in particular the accurate delineation analysis under Chapter I, to financial transactions. The Report represents the first time that guidance on financial transactions is included in the OECD TPG, which should contribute to consistency in the application of transfer pricing and help reduce transfer pricing disputes and double taxation.

The Report covers the accurate delineation of financial transactions, in particular with respect to multinational enterprises’ (MNEs) capital structures. The Report also addresses specific issues related to the pricing of financial transactions such as treasury functions, intra-group loans, cash pooling, hedging, guarantees, and captive insurance. It also provides guidance on the determination of risk-free rates of return and risk-adjusted rates of return where an associated enterprise is entitled to such return under the guidance in Chapter I and Chapter VI of the OECD TPG. The Report also includes a number of examples to illustrate the principles discussed.
Key items discussed in the Report include:

- **Intra-group lenders without functional substance**: companies should evaluate whether they have any profit from intra-group lending in countries that don’t have the people functions needed to manage and control the financial risks. Such a lender would be entitled to no more than a risk-free return, and the remainder would be allocable to the party exercising control over the investment risk.

- **Actual delineation of guaranteed loans**: companies should evaluate whether any loans were made to a group company that could only borrow due to a guarantee by another group company and could not have raised the funds on its own. Such a transaction can be delineated as a loan to the guarantor followed by a capital contribution from the guarantor to the borrower.

- **Actual delineation of the terms of funding**: the Report emphasizes the importance of the actual delineation of the transaction; for example, a 10-year term loan could be delineated as a series of ten 1-year revolving loans, or vice versa. Companies should evaluate all the terms of their intra-group funding and consider how to document that the terms and conditions - not merely the interest rate - are at arm’s length.

- **Cash pools**: the Report indicates that, in general, a cash pool leader performs no more than a coordination or agency function. Given such a low level of functionality, the cash pool leader’s remuneration as a service provider will generally be similarly limited, although it acknowledges that cash pool leaders with more functionality can exist. Any company with material income in a cash pool leader should be prepared to substantiate that allocation of income based on the performance of control functions over credit, liquidity and other risks by employees of the cash pool leader. Thorough documentation is recommended.

- **Credit rating**: the Report provides extensive guidance about both determining the stand-alone rating of group companies, and about taking into account the benefit of group membership (“implicit support,” also known as the “halo effect”). Companies should consider their group’s policies for determining credit ratings of subsidiaries in light of the Report, and in particular consider the group’s view on willingness and ability to support troubled group companies.

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### Detailed discussion

#### Background

As part of the OECD’s and G20’s BEPS Action Plan, initiated in 2013, a specific work stream was focused on developing detailed guidance on the most frequent transfer pricing issues in the area of financial transactions. The final reports on BEPS Action 4 and BEPS Actions 8-10 mandated follow-up work on the transfer pricing aspects of financial transactions. Under this mandate, a non-consensus discussion draft (Discussion Draft) was released on 3 July 2018. Unlike the Discussion Draft, this Report is issued as a final report of the Inclusive Framework, which currently includes 137 jurisdictions. This likely indicates it is a consensus document, approved by the Inclusive Framework members. The Report mentions that its content is added to the OECD TPG. This would typically take place through an OECD Council Recommendation, but the Report doesn’t describe the procedure nor the date as of which the new guidance would be applicable. Sections A-E of the Report will be added as a new Chapter X of the OECD TPG, whereas the guidance on the determination of risk-free and risk-adjusted rates of return (Section F) will be included in Chapter I of the OECD TPG. This is the first time that specific guidance on the transfer pricing aspects of financial transactions will be included in the OECD TPG.

#### Structure of the Report

The Report is divided into five main sections, including:

- Interaction with the guidance provided in section D.1 of the OECD TPG (i.e., accurate delineation of the transaction)
- Treasury function, including related transactions such as intra-group loans, cash pooling and hedging
- Guarantees
- Captive insurance
- Risk-free and risk-adjusted rates of return

#### Accurate delineation of the transaction

Section B of the Report sets out the principles that should be followed with respect to the accurate delineation of a financial transaction.

Determining whether a purported loan should be regarded as a loan

The guidance elaborates on how the concepts of Chapter I, in particular the accurate delineation of the actual transaction under Section D.1, may relate to the balance of debt and equity funding of an entity within an MNE group. Similar to the
previous Discussion Draft, the final guidance lends support to the notion that it is possible to determine an arm's-length capital structure. The final guidance refers to the “balance of debt and equity funding of an entity” rather than “capital structure,” but this does not appear to reflect a substantive modification. Furthermore, the guidance of Section D.2. (Recognition of the accurately delineated transactions) of the OECD TPG may be relevant, where it is considered that the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner in comparable circumstances.

The Report reflects an approach to determine the amount of debt to be priced. It acknowledges that other approaches may be taken to address the issue of the balance of debt and equity funding as well as interest deductibility of an entity under domestic legislation. The guidance is therefore not intended to prevent countries from implementing such approaches under domestic legislation, nor should the accurate delineation under Chapter I be considered a mandate as the only approach for determining whether purported debt should be respected as debt. The Report provides various examples of economically relevant characteristics that may be used as indicators for accurately delineating an advance of funds and addressing the capital structure.

The Report mentions that Working Party No. 1 of the OECD, the working party that is responsible for drafting changes to the Commentary to the OECD Model Tax Convention, has agreed on changes to the commentary on Article 9 of the OECD Model Tax Convention. The Report mentions the guidance is consistent with the existing Commentary and with the Commentary as it would read with the proposed changes. The guidance might be revised on the event that terms and conditions of written agreements should be modified. Furthermore, the commercial or financial relations between the parties and the conditions and economically relevant circumstances attaching to those relations should be identified. Similar to the analysis of any controlled transaction, this includes an examination of the contractual terms of the transaction, the functions performed, assets used, and risks assumed, the characteristics of the financial instruments, the economic circumstances of the parties and of the market, and the business strategies pursued by the parties.

One of the questions raised by commentators to the previous discussion draft was whether the guidance in Chapter X is intended to apply to the financial services industry (e.g., banks, broker-dealers, and insurance companies), or whether it is instead intended to apply solely to financial transactions of non-financial groups. The final guidance suggests that the chapter applies to the financial services industry, but states that “where the relevant MNEs are regulated, such as financial services entities subject to regulations consistent with recognized industry standards (e.g., Basel requirements), due regard should be had to the constraints those regulations impose upon them,” and further references similar guidance provided in Chapter I of the Guidelines. Specific emphasis is placed on the importance of assessing the options realistically available to parties when entering into financial transactions, as well as the importance to consider the options from both the lender and the borrower perspectives, i.e., a two-sided perspective.

The economically relevant characteristics of actual financial transactions
Specific guidance in the context of financial transactions is provided for each of the economically relevant characteristics.

Regarding contractual arrangements, the Report stipulates that terms and conditions of written agreements should be considered in conjunction with other documents, the actual conduct of the parties, and economic principles that generally govern relationships between independent enterprises in comparable circumstances.

The Report states that in accurately delineating the actual financial transaction, a functional analysis is necessary. With respect to the functional analysis, an overview is provided of the typical key functions performed by lenders and borrowers with respect to intra-group loans. It is recognized that an associated lender may not perform all these functions at the same intensity as an independent lender. However, the guidance stipulates that when the lender is not exercising
control over the risks associated to an advance of funds or does not have the financial capacity to assume the risks, such risks should be allocated to the enterprise exercising control and having the financial capacity to assume the risk. In this case, based on the accurate delineation analysis, the enterprise exercising control will bear the consequences of such risks and the lender will only be entitled to no more than a risk-free return. This incorporates guidance already found in Chapter I and Chapter VI relating to funding and control over risk.

The most important characteristics of loan transactions for transfer pricing purposes include, among others, the amount of the loan, its maturity, the schedule of repayment, the nature or purpose of the loan (trade credit, merger/acquisition, mortgage, etc.), level of seniority and subordination, geographical location of the borrower, currency, collateral provided, presence and quality of any guarantee, and whether the interest rate is fixed or floating.

The most relevant economic circumstances for delineating financial transactions include macroeconomic trends such as central bank lending rates or interbank reference rates, financial market events (e.g., credit crisis), currency differences, regulatory controls and restrictions.

Examples of relevant business strategies listed are expansion (mergers or acquisitions) versus steady operations, the MNE group's global financing policies, pre-existing loans and shareholder interests.

Treasury function

The next section of the Report describes the transfer pricing aspects of the treasury function within an MNE group and acknowledges that the management of group finances is an important and potentially complex activity. The organization of the treasury function, including the level of centralization, depends on the structure of the MNE group and the complexity of its operations. The Report provides an overview of typical key functions performed by treasury.

According to the new guidance, usually the treasury function constitutes a support service to the main value-creating business operations. In other situations, the treasury function may be more complex and should be compensated accordingly. It is also recognized that the activities of the treasury are closely linked to and influenced by the vision, strategy, and policies established by group management. As such, the higher strategic decisions will usually be associated with policy setting at the group level, rather than driven by the treasury function itself.

Intra-group loans

Two-sided perspective

When analyzing the commercial and financial relations as well as the economically relevant characteristics of intra-group financial transactions, the perspective of both the lender and the borrower should be considered. In this respect, the risks associated with the provision and acceptance of the loan should be taken into account. Although an associated enterprise may not go through the same process of information gathering as an independent lender, as certain information is more readily available within the group, the same commercial considerations are relevant. These considerations include for example creditworthiness, credit risk and economic circumstances.

Credit ratings

The Report acknowledges that the credit worthiness of the borrower is one of the main factors considered by independent lenders. In this respect, credit ratings are a useful measure of credit worthiness. As a credit rating depends on a combination of quantitative and qualitative factors, there is still likely some variance in creditworthiness between borrowers with the same credit rating. Special situations should also be considered, such as in the case of start-up entities or those that have been recently part of a merger. Furthermore, the guidance stipulates that when the issue rating of a particular debt issuance is available, the use of this rating over a more generic issuer rating would be more appropriate. It is important to document the reasons and selection of the credit rating used when pricing financial transactions.

With respect to the use of publicly available financial tools or methodologies to approximate credit ratings, it is stated that potential issues should be considered. The results of these tools are not based on direct comparables but are subject to the accuracy of the input parameters, which tend to prefer quantitative factors at the expense of the qualitative factors. Moreover, there is a general lack of clarity in the models and underlying algorithms used. Nevertheless, the Report recognizes that commercial credit rating tools may be useful contributions to benchmarking studies for interest rates within intra-group loans.

Effect of group membership

According to the Report, the effect of group membership is relevant in two ways when analyzing financial transactions. First, the external funding policies and practices of group
management will assist in determining whether the form and terms and conditions of the debt are similar to those that the MNE would have entered into with an independent lender. Second, the MNE may receive support from the group to meet its financial obligations in the event of the borrower getting into financial difficulty.

The Report stipulates that implicit group support should be considered in the determination of the credit rating of the borrower or any debt issued by the borrower. The level of implicit group support is dependent on factors such as the relative importance of the entity to the group as a whole, linkages between the entity and the rest of the group, and the consequences of (non-)support of the entity. The guidance describes that important MNE group members with stronger links will have a credit rating that is more closely linked to that of the MNE group. On the other hand, for group members with limited to no implicit group support it may be appropriate to consider the entity on the basis of its own stand-alone credit rating only. The Report also recognizes that the use of the group rating may be appropriate to price an intra-group loan in certain situations, in particular where the implicit group support for the associated enterprise is strong.

Covenants
With respect to covenants, it is mentioned that these are less likely to be included in an intra-group loan situation as lenders are less likely to suffer from information asymmetry and to take the same kind of action in the case of a covenant breach. When a covenant is absent, it should be assessed whether based on the accurate delineation of the transaction, a covenant is effectively in place between the parties and the consequential impact upon the pricing of the loan.

Determining the arm's-length interest rate of intra-group loans
The Report states that due to the widespread availability of information and analysis of loan markets, it is typically easier to apply the Comparable Uncontrolled Price (CUP) method to financial transactions than in the case of other types of transactions. Consequently, the arm's-length interest rate for a tested loan can be easily benchmarked (using the external form of the CUP method) against publicly available data for other borrowers with the same credit rating for loans or realistic alternative transactions (such as bonds) with sufficiently similar terms and conditions and other comparability factors. Potential internal CUPs should also not be overlooked.

The Report mentions the possibility to use an interest rate setting approach based on the cost of funds incurred by the lender in raising the funds to lend, increased by expenses incurred by the lender with respect to arranging the loan and relevant costs of servicing the loan, and a risk premium reflecting various economic factors inherent in the proposed loan and a profit margin. The guidance stipulates that if such an approach is used, it should be based on lender's costs of funds relative to other market lenders' costs of funds as lenders in a competitive market may seek to price at the lowest possible rate in order to win business. When applying the cost of funds approach, specific thought should be given to the borrower's options realistically available, i.e., its ability to obtain funds under better conditions via alternative transactions.

The Report also describes the situation in which the costs of funds approach is used when external capital is passed via one or more intra-group intermediary companies to the ultimate borrower. In such cases, depending on the functionality and substance of the intermediary companies, they may be remunerated merely for the on-lending function itself, or may be entitled to earn a risk premium and a profit margin.

In relation to the use of credit default swaps as a method to calculate risk premiums associated to intra-group loans, careful consideration is required for factors other than default risk which may be reflected in the credit default spreads. Furthermore, the Report recognizes that economic modeling tools may be useful in situations where reliable comparable uncontrolled transactions cannot be identified but notes that the outcomes of such models do not represent actual transactions and therefore comparability adjustments would likely be required.

The Report denies the comparability of external bank opinions to intra-group loans as these informal letters do not constitute an actual offer to lend and therefore cannot be considered comparable to actual transactions.

Cash pooling
The Report states that the accurate delineation of cash pooling arrangements needs to take into account not only the facts and circumstances of the relevant balances, but also the context of the arrangements as a whole. One key consideration in the context of cash pools includes the allocation of synergy benefits. In this respect, the guidance stipulates that these benefits would generally be shared by the cash pool members, provided that an appropriate
reward is allocated to the cash pool leader. Another key consideration is whether it is appropriate for the transaction to be treated as a short-term cash pool balance, or whether the facts and circumstances support an alternative view such as being a long-term deposit or term loan.

Rewarding the cash pool leader
The appropriate reward of the cash pool leader will depend on the facts and circumstances, the functions performed, the assets used, and the risks assumed in facilitating a cash pooling arrangement. Where a cash pool leader performs no more than a coordination or agency function to meet a pre-determined target balance, its remuneration as a service provider should be in accordance with these routine functions. The Report states that in a notional pool setup many functions are primarily performed by the bank and little, if any, value is added by the cash pool leader. Activities other than coordination or agency functions may infer that a higher remuneration is appropriate, which can include earning part or all of the spread between the borrowing and lending positions which it adopts.

Rewarding the cash pool members
The remuneration of the cash pool members will be calculated through the determination of the arm’s-length interest rates applicable to the debit and credit positions within the pool. The allocation of synergy benefits to the cash pool members will generally be done once the remuneration of the cash pool leader has been calculated. All cash pool participants are expected to be better off than in the absence of the cash pool. Benefits for cash pool participants can take the form of enhanced interest rates to debit and credit positions, but also qualitative benefits such as access to a permanent source of financing, reduced exposure to banks, or access to liquidity that may not be available otherwise.

Cross-guarantees
Cash pool arrangements may require cross-guarantees and rights of set-off between participants in the cash pool. Although the particular facts and circumstances of any situation should always be considered, the practical result of the cross-guarantees may factually represent nothing more than an acknowledgement that it would be detrimental to the interests of the group not to support the performance of the cash pool leader and so, by extension, the borrower. In such circumstances the benefits associated with the guarantee may not exceed the benefits related to the implicit support of the MNE group. If the prevailing facts and circumstances support such a conclusion, no guarantee fee would be due. On the other hand, the Report concludes that any support, in the case of a default from another group member, should be regarded as a capital contribution.

Hedging
The Report acknowledges that hedges are frequently used in the ordinary course of business as a means of mitigating exposure to risks such as foreign exchange or commodity price movements. Whereas an independent entity may decide to accept or hedge such risks, within an MNE group these risks may be treated differently because of the group's approach to risk management and hedging.

The guidance states that treasury functions relating to hedging will often be centralized to improve efficiency and effectiveness. This may result in the situation where risks are not hedged on an entity level but an MNE’s risk is hedged from a group perspective. The central arrangement of a hedging contract by treasury, that an operating entity enters into, can be seen as the provision of a service, for which treasury should get an arm’s-length compensation. More difficult transfer pricing issues may arise, however, if the contract instrument is entered into by the treasury company or another group company, with the result that the positions are not matched within the same company, although the group position is protected.

Financial guarantees
Section D of the Report provides guidance on financial guarantees that are legally binding, that is, explicit guarantees. The accurate delineation of financial guarantees requires initial consideration of the economic benefit arising to the borrower beyond the one that it derives from passive association, that is, through implicit guarantees. Two types of economic benefits should be distinguished in this respect, the first being a guarantee that enhances the borrower’s conditions, for example through an improved credit rating and reduced borrowing costs. The pricing for such guarantees would follow the same principles and methodologies as described for loan pricing.

Secondly, there are guarantees that allow the borrower to increase its borrowing capacity in addition to enhancing its credit rating. In such case, it should be determined whether a portion of the loan from the lender to the borrower is accurately delineated or should be regarded effectively as
The cost approach, on the other hand, aims to quantify the cost expected by the guarantor in the case of a default by the borrower. The expected cost can be determined as the value of the expected loss or, alternatively, by reference to the capital required to support the additional risk assumed by the guarantor. Usually a number of various models are used for quantifying the expected cost. The result of the cost approach represents the minimum fee the guarantor would be willing to accept, which again is subject to bargaining between the borrower and the guarantor.

Captive insurance and reinsurance

Section E covers captive insurance, being 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. It also provides considerations in relation to reinsurance captives, referred to as “fronting.” Although the focus of Section E is captive insurance, intra-group reinsurance within an MNE group is also discussed and is distinguished from captive insurance.

The Report is concerned with establishing a threshold for determining whether the captive has assumed and is capable of controlling the insurance risk contractually transferred to it. The paragraphs in the OECD TPG that concern the analysis of risk apply equally to an associated enterprise’s insurance and reinsurance business. Specifically, if certain underwriting functions are outsourced, special consideration is required to ensure the control functions can be allocated to the captive insurance. Furthermore, the Report elaborates on the importance of risk diversification within the insurance business and describes various ways in which diversification can be realized. The guidance discusses a number of indicators, all or substantially all of which would be met if the captive insurance was found to undertake a genuine insurance business, including of diversification of risk. Lack of sufficient reserves may also indicate that the captive insurance is operating a business other than an insurance one.

In relation to the pricing of captives, the guidance acknowledges that practical difficulties may arise in the application of the CUP method, for example due to functional and business or capital volume differences between the captive insurance and a commercial insurer. An alternative would be to price the premiums through the use of actuarial analyses, noting that the outcomes of such analyses do not represent actual transactions between independent parties and that, therefore, comparability adjustments would be likely required.
The Report deals with two specific scenarios, group synergy and agency sales. Where the captive is used as a vehicle for group companies to act together to offer a portfolio of insurance risks to the reinsurance market the guidance concludes that the benefit of lower premiums should be allocated among the insured companies.

**Risk-free and risk-adjusted rates of return**

The last section of the Report contains guidance that will be added to Chapter I of the OECD TPG and describes how to determine a risk-free rate of return and a risk-adjusted rate of return in situations where, based on the accurate delineation, an associated enterprise is entitled to any of those returns.

According to the Report, where an entity is only entitled to a risk-free rate of return, the funder’s cost of funding should be taken into account in determining such return. Subject to other constraints, the borrower in this situation would still be entitled to the deduction of an arm’s-length interest rate, with the difference between the interest rates being allocable to the party performing the relevant risk control functions. One approach to determine the risk-free rate may be through reference to certain government issued securities with the same functional currency and tenor. Other alternatives may include interbank rates, interest rate swap rates or repurchase agreements of highly rated government issued securities.

The risk-adjusted rate of anticipated return will generally have two components, the risk-free rate and a premium reflecting the risks assumed by the funder. In determining the risk-adjusted rate, it is important to differentiate between risks assumed by the funder in relation to its financing activity and the operational risks that the funded party may assume in connection to the use of the funds. Potential methods to determine the risk-adjusted rate of return include comparable uncontrolled transactions such as bond issuances or loans, adding a risk premium based on information available on comparable financial instruments, or the cost of funds approach.

Unfortunately, the final guidance does not address an important unresolved issue from the BEPS Actions 8-10 work, namely the ex post (actual) return to a funder who controls investment risk. Such funding relates not only to loans, but also to capital put at risk in the form of risky investments (e.g., funding and assuming risks associated with the acquisition of a large capital asset). The final guidance retains an example of a lender not being entitled to upside or downside return if the funded asset has higher or lower results than the anticipated returns but does not address what happens when the investment is not in the form of a loan but, for example, a direct investment of an asset for which the funder has financial control but not operational control.

**Implications**

The new guidance on financial transactions represents a significant step in the development of the OECD TPG, as it is the first time that guidance on such transactions will be included. The Report has been approved by the 137 members of the Inclusive Framework, and therefore its importance stretches beyond the OECD member countries. The Report acknowledges that different views on various important topics may be possible. In particular with regard to the issue of balancing debt versus equity funding, the guidance acknowledges that different approaches to capital structures and interest deductibility may be taken under domestic legislation. MNE groups with intra-group financial transactions should assess whether their transfer pricing policies are aligned with the new guidance and ensure they have the supporting documentation in place to support these policies.
Endnotes


2. Specifically, the final guidance references a footnote in Chapter I of the Guidelines, which states that “the guidance in this chapter, and in this section on risk in particular, is not specific to any particular industry sector. While the basic concept that a party bearing risks must have the ability to effectively deal with those risks applies to insurance, banking and other financial services business, these regulated sectors are required to follow rules prescribing arrangements for risks, and how risks are recognized, measured, and disclosed. The regulatory approach to risk allocation for regulated entities should be taken into account and reference made as appropriate to the transfer pricing guidance specific to financial services businesses in the Report on the Attribution of Profits to Permanent Establishments (OECD, 2010).”

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