Executive summary

On 3 July 2018, the Organisation for Economic Co-operation and Development (OECD) released the first public discussion draft on the transfer pricing aspects of financial transactions (the Discussion Draft). The Discussion Draft, which has been published as follow up work in relation to Base Erosion and Profit Shifting (BEPS) Actions 8-10, aims to clarify the application of the principles included in the 2017 edition of OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD TPG), covering the accurate delineation of financial transactions and addressing specific issues related to the pricing of financial transactions such as treasury function, intra-group loans, credit ratings, cash pooling, hedging, guarantees, and captive insurance.

The Discussion Draft does not yet represent a consensus position of the OECD.

Focusing on the accurate delineation of related-party financial transactions pursuant to Chapter I of the OECD TPG, the Discussion Draft provides further guidance on the following specific areas:

- Detailed perception of the economically relevant characteristics (comparability factors) mentioned in Chapter I of the OECD TPG from the financial transactions viewpoint, and how such characteristics may impact commercial rationality and specific terms and conditions of a financial arrangement.
Specific issues related to the transfer pricing of financial transactions such as treasury function, including intra-group loans, cash pooling, hedging, guarantees and captive insurance

The Discussion Draft contains a number of examples illustrating these principles.

Interested parties are invited by the OECD to send their comments on the Discussion Draft and to respond to the specific questions by 7 September 2018.

Detailed discussion

Background
Prior to the publishing the Discussion Draft, the OECD has not provided specific guidance on transfer pricing aspects of financial transactions. As a 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. More concretely, the 2015 report on Aligning Transfer Pricing Outcomes with Value Creation pursuant to BEPS Actions 8-10 and the 2015 report on Limiting Base Erosion Involving Interest Deductions and Other Financial Payments pursuant to BEPS Action 4 mandated follow-up work on the transfer pricing aspects of financial transactions. Under this mandate, the Discussion Draft represents the first OECD document on this topic, aiming to clarify the principles included in the OECD TPG, as well as specific issues frequently arising in the area of transfer pricing of financial transactions. It is noted that the Discussion Draft is a non-consensus document.

Structure of the Discussion Draft
The Discussion Draft is divided into four main sections, including:

- Interaction with the guidance provided in section D.1 of the OECD TPG
- Treasury function, including related transactions such as intra-group loans, cash pooling and hedging
- Guarantees
- Captive insurance

Some of the sections contain practical examples on the respective topics that help to illustrate specific aspects covered in the Discussion Draft. Each section also contains several boxes with questions of the OECD working party to the commentators, where specific input of the public is sought on the more complex elements of the particular topic.

Accurate delineation of financial transactions
The first part of the Discussion Draft sets out the principles that should be followed with respect to accurate delineation of a financial transaction.

Capital structure
It is stated that in general, the accurate delineation of the actual financial transaction pursuant to Section D.1. (Identifying the commercial or financial relations) of the OECD TPG may relate to the capital structure of an entity. 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 Discussion Draft indicates that it is appropriate to take into account specific industry sectors, business strategies of the multinational enterprise (MNE) group, and the MNE group's policies when delineating the underlying capital structure of an entity as part of a transfer pricing analysis.

It is acknowledged that countries may adopt approaches other than transfer pricing approaches, to address the capital structure and interest deductibility under domestic legislation.

The Discussion Draft also outlines examples of economically relevant characteristics that may be used as indicators for accurate delineation of an advance of funds and addressing the capital structure, including the presence or absence of a fixed repayment date, the obligation to pay interest, the right to enforce payment of principal and interest, the status of the funder in comparison to regular corporate creditors, the existence of financial covenants and security, the source of interest payments, the ability of the recipient of the funds to obtain loans from unrelated lending institutions, the extent to which the advance is used to acquire capital assets, and the failure of the purported debtor to repay on the due date or to seek a postponement. The Discussion Draft also emphasizes 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.
Economically relevant characteristics of financial transactions

The Discussion Draft states that the accurate delineation of financial transactions should follow the general OECD TPG guidance with respect to the economically relevant characteristics (comparability factors), i.e., contractual terms, functions performed, assets used, risks assumed, characteristics of financial products or services, economic circumstances of the parties and the markets, and the business strategies pursued by the parties.

Regarding contractual arrangements, the Discussion Draft 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.

With respect to functional analysis, the Discussion Draft provides an overview of the typical key functions performed by lenders and borrowers with respect to intra-group loans. The functions of the lender typically include an analysis and evaluation of the risks inherent in the loan, the capability to commit capital of the business to the investment, determining the terms of the loan, and organizing and documenting the loan. It may also include any ongoing monitoring and review of the loan. The functions of the borrower typically include ensuring the availability of funds to repay the principal and the interest on the loan in due time, providing collateral, if needed, and monitoring and fulfilling any other obligation derived from the loan contract.

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.

Before addressing the treasury function and specific intra-group transactions, the Discussion Draft also includes the proposal of guidance regarding risk free rate of return and risk-adjusted rate of return, on which the commentator’s views are sought by the OECD. This specific section is not a formal part of the Discussion Draft yet, and depending on input to be received by the OECD from interested parties, it may be subject to less or more significant changes.

Treasury function

This section of the Discussion Draft starts with an acknowledgment that the management of group finances is an important and potentially complex activity. The organization of the treasury function may differ across individual businesses. Various ways in which treasury activities are structured involve different degrees of centralization, ranging from decentralized to fully centralized structures.

Key functions of a corporate treasury may include, but are not limited, to cash and liquidity management, financial risk management, strategic functions and long-term investments planning, optimizing cost of capital, raising funds through debt or equity, and managing relationships with external parties such as banks and rating agencies. When evaluating treasury activities and delineating financial transactions, actual facts and circumstances, including functions performed by the corporate treasury, should be considered.

According to the Discussion Draft, in general the treasury function constitutes a support service to the main value-creating business operations. 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, and 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

The Discussion Draft emphasizes the importance of the two-sided perspective in considering the commercial and financial relations as well as in analyzing the economically relevant characteristics of the financial transactions between the associated borrowers and lenders.

While acknowledging that there might be differences in the processes pertaining to the provision of loans between associated enterprises when compared to loans provided between independent enterprises such as different extent
of information asymmetry, the Discussion Draft recognizes there are certain commercial considerations that are equally relevant for both intra-group and third-party loans, such as creditworthiness, credit risk and other economic circumstances.

Credit ratings
The Discussion Draft recognizes that one of the most important factors relating to the borrower from the lender’s perspective is thorough credit rating assessment.

It is stated that credit rating methodologies applied by independent rating agencies to determine official credit ratings are based on far more rigorous analysis. Specifically, such methodologies use both qualitative and quantitative factors, while credit rating methodologies used in commercial tools, which calculate the probability of default and loss likelihood, may result in potential issues due to over-dependency on accuracy of the input parameters, tendency to prefer quantitative factors at the expense of the qualitative factors, and lack of clarity in the models used. Nevertheless, the Discussion Draft recognizes that commercial credit rating tools might also usefully contribute to benchmarking studies for interest rates within intra-group loans.

In addition, the Discussion Draft emphasizes the importance of adjustments within the credit rating process in cases where the reliability of the credit rating analysis might be jeopardized by the presence of related-party transactions which may not be priced at arm’s length and the importance to consider industry specifics when evaluating the relevant financial metrics used in credit rating analyses.

Specifically, with respect to the start-up companies, special purpose vehicles and freshly restructured entities, the Discussion Draft mentions that in the case of such borrowers, lenders normally conduct a due diligence process aimed at examining the cash-flow and earnings projections, preferably for the entire period of the funding. In any event, the OECD Discussion Draft recognizes that a related-party lender will not necessarily perform all of the same functions at the same intensity as an independent lender.

Effect of group membership
The Discussion Draft affirms that regardless of the fact that borrowers are viewed as independent enterprises, the presence of the rest of the group should not be necessarily ignored as the funding policies of the group management are important in informing the conditions under which the group subsidiary would have borrowed from independent lenders including all economically relevant characteristics such as the type of loan, its term, currency, security and covenants.

Based on the views presented in the Discussion Draft, implicit group support is a required step in determination of the credit rating of the borrower or any debt issued by the borrower. The Discussion Draft mentions important factors to be considered when evaluating the level of implicit group support of the borrower, such as the relative importance of the entity to the group as a whole, linkages between the entity and the rest of the group, consequences of (non-) support of the entity. The specific criteria used to determine the status of the entity normally include legal obligations, strategic importance, operational integration and significance, shared name, potential reputational impacts, general statement of policy or intent and any history of support. Consequently, the Discussion Draft concludes that the entities with stronger implicit group support might be rated notches above their stand-alone credit rating, while entities with weaker or no implicit group support might be rated closer to or at their stand-alone credit rating. The Discussion Draft also invites views on potential application of more practical approaches towards determination of credit ratings for transfer pricing purposes.

Covenants, guarantees and loan fees
The Discussion Draft mentions that other elements impacting intra-group loans such as covenants in the loan agreements, existence of guarantees and loan fees and charges might be important when setting the transfer prices within such loans.

The Discussion Draft also recognizes that given the fact that there is typically less information asymmetry in loan agreements between related parties when compared to third-party loan agreements, intra-group lenders might opt not to include maintenance and insurance covenants in the respective intra-group loan agreements. In case there is a guarantee provided in order to support the borrower’s credit profile, the lenders need to evaluate the guarantor in the same way as the original borrower. In order to adjust the terms and conditions of the loan agreement taking into consideration the credit rating uplift, it should be reasonably satisfied that the guarantor would be able to meet any shortfall resulting from borrower’s potential inability to meet its debt obligations under the loan agreement. It is
clear from the Discussion Draft that accurate delineation of intra-group loans may result in terms and conditions different from those stipulated in the actual legal agreement, by for example, imposing collaterals and covenants before proceeding to interest rate pricing.

Finally, the Discussion Draft mentions that if there are additional loan fees charged under intra-group loan agreements, these charges should be evaluated as any other intra-group transactions.

**Pricing approaches to determining arm’s-length interest rates**

The Discussion Draft stipulates 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 external form of 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. The Discussion Draft also emphasizes that potential internal comparable uncontrolled prices should not be overlooked.

The Discussion Draft also 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 Discussion Draft emphasizes 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.

The Discussion Draft also mentions situations in which the costs of funds approach is used when external capital is passed via a chain of intra-group intermediary companies to the ultimate borrower. In such cases, the intermediary companies may be remunerated merely for the intermediary function itself, in line with paragraph 7.34 of OECD TPG.

Finally, the Discussion Draft denies the comparability of external bank opinions to the 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 Discussion Draft suggests 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, i.e., recognizing that the benefits of the pooling arrangements are only achieved by a deliberate concerted group action. A further key consideration in respect of the accurate delineation of a cash pooling transaction 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.

The Discussion Draft reinforces that the determination of the allocation of the benefits of the cash pool must be established through a thorough functional analysis. The Discussion Draft describes three possible approaches on how to allocate the benefit of a cash pooling arrangement to the cash pool participants, and invites comments on these.

**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. As such a limited co-ordination or agency function will result in the appropriate cash pool leader’s remuneration being similarly limited, while activities other than coordination or agency functions, infer that a higher remuneration is appropriate, and this may include earning part or all of the spread between the borrowing and lending positions which it adopts.

However, the Discussion Draft is silent on the approach to identifying the proportion of the cash pooling benefits to be allocated to the cash pool leader (other than by reference to the need to consider that cash pool participants should be left no worse off than their next best option).

**Rewarding the cash pool members**

The Discussion Draft highlights the following three approaches for allocating the cash pooling benefits to the participating cash pool members, albeit inviting views on alternatives:

- Enhancing the interest rate for all participants
- Applying the same interest rate for all participants (where all cash pool members have the same or a similar credit profile)
• Allocating the cash pooling benefits to depositing cash pool participants (where there is a genuine credit risk to the depositors)

Cross-guarantees
The Discussion Draft recognizes that cash pooling arrangements may require cross-guarantees and rights of set-off between participants in the cash pool. The question of whether guarantee fees should be payable is seen as dependent on the particular facts and circumstances in any situation. It might be that such guarantees 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 guaranteed borrower may not be benefitting beyond the level of credit enhancement attributable to the implicit support of other group members. If the prevailing facts and circumstances support such a conclusion, no guarantee fee would be due, and any support, in the case of a default from another group member, should be regarded as a capital contribution.

Hedging
The Discussion Draft recognizes that in many instances intra-group financial transactions entail hedging arrangements, which are used in the ordinary course of business to mitigate risk exposures (for example to foreign exchange or commodity price movements). An independent entity may decide to either assume such risks (by keeping open positions) or hedge the risk exposure. On the other hand, in an MNE group this may be influenced (at an individual group member level) by the overall group’s approach to risk management and hedging.

The Discussion Draft indicates that MNE groups often centralize treasury functions, including risk management and hedging in order to improve efficiency and effectiveness, but this may result in situations where individual entities do not contractually hedge their risks, although at the (consolidated) group level the risks are hedged. The OECD seeks specific feedback on how to deal with such cases.

The centralized hedging function would usually be characterized as the provision of a service to operating companies, for which an arm’s-length remuneration should be due. 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.

Guarantees
The Discussion Draft focuses on legally binding financial guarantees on certain intercompany transactions, where most commonly, a related-party guarantor grants a guarantee on debt raised by a group entity from an independent lender.

A differentiation is made between guarantees that are provided to enhance the borrower’s credit rating and, therefore, to enhance its borrowing conditions, including reducing its borrowing cost. Pricing for such guarantees would follow principles described for loan pricing in the Discussion Draft.

On the other hand, there are also guarantees that allow the borrower to increase its borrowing capacity in addition to enhancing its credit rating. In such a case, an accurate delineation of the loan from the lender to the guarantor followed by an equity contribution from the guarantor to the borrower. The guarantee fee on the portion of the loan viewed as debt provided by the lender to the borrower could be based on the difference in borrowing conditions with and without the guarantee, adjusted for implicit support or other cost of the guarantee.

Types of guarantees
The Discussion Draft confirms what has been stated in the OECD TPG regarding credit enhancement attributable to group membership. Any benefit arising from passive association would not be seen as provision of service for which payment of a fee would be necessary.

It is assumed that a borrower would usually be willing to pay a fee for an expected benefit. However, it is recognized that even an explicit guarantee by a related party may not provide the borrower any additional benefit beyond an acknowledgement that the group as a whole may suffer negative consequences by not supporting the borrower in honoring its debt. The expected benefit for the borrower in this case would not exceed the benefit attributable to implicit support, so that no guarantee fee would be expected to be paid.
Cross-guarantees are highlighted as particularly complex constructs to evaluate. The benefit of a cross-guarantee to a lender is that it secures access to the assets of all cross-guaranteeing group companies. As the number of entities in a cross-guarantee arrangement increases, the evaluation of the benefit to each participant may be practically impossible. The conclusion may be that no credit enhancement beyond implicit support is expected for the cross-guarantors. The support provided in the case of default by a related participant to such an arrangement should be seen as a capital contribution.

Arm's-length price of a guarantee
The Discussion Draft suggests that the CUP method is the most reliable for determining the arm's-length guarantee fee, recognizing that the application of the CUP method may be difficult because of the lack of comparable credit enhancing transactions among third parties. Identifying CUPs will involve consideration of factors which may affect the guarantee fee, such as the risk profile, terms and condition of the guarantee as well as of the underlying loan, etc.

The yield approach quantifies the benefit to the guaranteed party by determining the spread between the interest cost to the borrower without the guarantee and the interest cost with the guarantee. When calculating the interest rate at which the borrower could raise funds without a guarantee, it is important to take into account the impact of implicit support on the interest rate as opposed to considering the interest rate it would be expected to pay on a stand-alone basis. The spread resulting from the application of the yield approach is the maximum fee a borrower would be willing to pay for the guarantee, which is then subject to bargaining between the borrower and the guarantor.

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, e.g., option pricing models, credit default swap pricing models, etc. 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
The section on captive insurers starts with an overview of the features of insurance and offers six indicators that typically would be expected in an independent insurer. There is also a brief discussion of the commercial, tax and regulatory rationale for MNEs to use captives and an explanation of reinsurance through so-called fronting arrangements. The Discussion Draft mentions that fronting transactions that involve third parties are considered controlled transactions. Unsurprisingly, given that the essence of an insurance business is the assumption of risk, the Discussion Draft 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 Discussion Draft confirms that the paragraphs in the OECD TPG that concern the analysis of risk apply to insurance businesses in the same way as they apply to other businesses.

The captive must have the financial capacity to assume the risk and it should able to satisfy claims in the event of the risk materializing. Furthermore, the Discussion Draft recognizes the importance of risk diversification as a tool for managing risks assumed and questions whether a captive without a diversified portfolio of risks is carrying out the business of insurance. In the absence of these features the accurate delineation of the transaction may indicate that the captive is not carrying out the business of insurance. The Discussion Draft does not provide further detail on the circumstances when a captive may be deemed not to be carrying out insurance business but asks for commentators' views.

The suggestions in the Discussion Draft for pricing intra-group insurance transactions are, pricing premiums using actuarial analysis, or comparing the captives return on capital and combined ratios with independent insurers. It recognizes that captives may not have the same capital discipline as independent insurers and that adjustments may be due where the captive holds more capital than an independent insurer would be expected to hold in similar circumstances.

Finally the Discussion Draft 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 Discussion Draft concludes that the benefit of lower premiums should be allocated among the insured companies.
The Discussion Draft recognizes the existence of an agent’s point of sale advantage where an agent in the group sells insurance on behalf of a captive together with its own products and confirms that because of the point of sale advantage the agent may be entitled to a higher commission than independent agents selling similar insurance products.¹

**Request for public comments**
The OECD invites the public to send comments to the Discussion Draft by 7 September 2018 that will be made publicly available and are expected to be discussed by the respective OECD working party during November 2018. Based on the recent public statement of the OECD’s Head of the Transfer Pricing Unit, the OECD plans to evaluate and implement the relevant comments, so that a public consensus discussion draft can be issued by the beginning of 2019. The ultimate plan of the OECD is to reach a final agreement at the respective working party level by April 2019.

**Implications**
The Discussion Draft contains the first official OECD detailed comments and proposals on transfer pricing aspects of financial transactions. Although the Discussion Draft is a non-consensus document, it provides insight into the direction of thinking of the OECD. Most global businesses are involved in financial transactions, and therefore the guidance will be relevant for them. Global businesses should monitor the developments in this respect and also consider providing comments as requested by the OECD.

**Endnote**
1.  DSG Retail v HMRC (2009) UKFFT 31 (TC).
For additional information with respect to this Alert, please contact the following:

**Ernst & Young Belastingadviseurs LLP, Amsterdam & Rotterdam**
- Ronald van den Brekel  ronald.van.den.brekel@nl.ey.com
- Krzysztof Łukosz  krzysztof.lukosz@nl.ey.com

**Ernst & Young LLP (United Kingdom), London**
- Martin Rybak  mrybak@uk.ey.com
- Martin Powell  mpowell@uk.ey.com
- Ariana Kosyan  akosyan@uk.ey.com
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