



**Transfer Pricing Intermediate Level
Regional Workshop
Nairobi, Kenya
5-6 December 2019**

FINANCIAL TRANSACTIONS



<http://www.un.org/esa/ffd/>

FINANCIAL TRANSACTIONS

MELINDA BROWN (OECD)

SANYA GBONJUBOLA (FIRS, NIGERIA)

3 OECD DEVELOPMENTS

- The [2015 report on BEPS Actions 8-10](#) mandated follow-up work on the transfer pricing aspects of financial transactions.
- **July 2018 Discussion Draft** (not purporting to be a consensus OECD or Inclusive Framework position).
- Aims to clarify the application of the principles included in the 2017 edition of the [OECD Transfer Pricing Guidelines](#), in particular, the “accurate delineation” analysis under Chapter I, to financial transactions.

4 OECD DEVELOPMENTS

- OECD discussion draft also addressed specific issues related to the pricing of financial transactions such as treasury functions, intra-group loans, cash pooling, hedging, guarantees and captive insurance.
- **Public consultation** – comments received published in September 2018.

5 OECD DEVELOPMENTS

- Next steps?
- Changes to guidelines agreed in OECD WP 6.
- WP 6's compromise on the issue of whether an arm's length capital structure for companies should be recognized and, if so, **whether domestic law provisions**, such as deduction limits or rules deeming an instrument a prima facie loan, **should take precedence** when determining debt v. equity.

6 CAPITAL STRUCTURE, TREATIES AND ACCURATE DELINEATION

- When should a purported loan be regarded as a loan?
 - Current commentary to Art 9 of UN MTC (para 6) notes the interplay between tax treaties and domestic thin capitalization rules. It quotes from the commentary to the OECD MTC (para 3b) that the Article is relevant, “*not only in determining whether the rate of interest...is arm’s length..., but also whether a prima facie loan can be regarded as a loan, or should be regarded as...a contribution to equity...*”
- Using accurate delineation of the transaction, or
- Other approaches, e.g. domestic law provisions on characterisation of financial instruments.

7 OECD DEVELOPMENTS

- The compromise recognizes that **Article 9 is relevant but will confirm that domestic law has priority**, except to the extent the domestic provision discriminates,
- OECD WP I on treaties is working on **treaties language clarifying the commentary to Article 9** concerning whether Article 9 is overridden by domestic law, doctrine, or judicial decisions, and the BEPS action 4 EBITA fixed ratio.

8 UNITED NATIONS WORK

• The United Nations Tax Committee Work

- Will be a new chapter for the 2020/2021 version of the **United Nations Practical Manual on Transfer Pricing for Developing Countries**.
- Will pay attention to developments in the **OECD** but, as usual, will express itself independently with a focus on developing countries issues and priorities.
- ... with **examples** that especially speak to their experiences.
- **Current text** (to be edited and examples added) is Attachment A of:
https://www.un.org/esa/ffd/wp-content/uploads/2019/09/I9STM_CRPI5_Transfer-Pricing.pdf:

9 THE BASICS

- Recognises **importance of financial transactions to MNE value chains.**
- Notes:
 - the importance of corporate financing decisions for an MNE;
 - Financial transactions subject to the arm's length principle like e.g. intra-group services;
 - ... so **requires accurate delineation of the actual transaction**, including its purpose, in the context of the MNE's business;
- ...

10 THE BASICS

....

- that those decisions can lead to **base erosion as interest may be deductible;**
- what financing departments in an MNE may look like; and
- common types of intra group financial transactions and their transfer pricing aspects.

|| THE BASICS

- Financial transactions that are discussed in the most detail are:
 - **intra group loans; and**
 - **intra group financial guarantees**
- Does not cover financial transactions within a **regulated financial institution.**
- Chapter **will not be exhaustive**: it serves as introduction to the topic.

12 WHY SO IMPORTANT NOW?

- Several factors combine :
 - The significance (in terms of amounts involved and frequency) of these transactions for MNE Groups;
 - The fact that money is mobile and fungible, which makes it relatively simple for an MNE to shift debt to group companies and claim an interest deduction;
 - The difficulty that tax administrations face in determining the true character and characteristics of certain financial instruments; and
 - The concern that excessive interest deductions provide opportunity for tax base erosion.
- Has led to tax measures that must be developed and administered by you.

13 DEBT OR EQUITY CHOICES

- The choice to finance transactions and operations through **debt or equity** is discussed:
 - tax aspects (especially deductibility of interest);
 - but also there may be non-tax reasons, e.g. assuring cash flow, funding mergers, ensuring cost effective credit facilities.
- Treasurers are generally seeking **financial risk management** attuned to the level of risk the MNE wishes to assume.

14 FINANCING DEPARTMENTS

- Different types of financing departments exist:
 - Centralized (scale benefits)/ decentralized (closeness to regions/ lines);
 - **Cost centres** (service providers – not assuming capital risks, seeking efficiency and stability. Can be decentralized);
 - **Value-adding centres** ((cost-saving – more risk tolerant than cost centres, consolidating and adding expertise – more likely to be centralized); and
 - **Profit centres** (creating market positions as well as managing operational exposures, assuming capital risks. Tend to be centralized).

15 FINANCING DEPARTMENTS

- Type of department/entity that renders the specific financial transactions may be relevant and provide an *initial* indication of the most appropriate method to be used to assess the arm's length nature of the intercompany transactions.
 - E.g. **cost centres** typically remunerated by applying the CUP method, the cost-plus method, or the TNMM based on cost.
 - E.g. **profit centres** are typically remunerated based on a pricing the various transactions allocating the credit risk of the transactions to the treasury department. Consequently, the 'spread' between costs of funding and return on cash invested will be mainly allocated to that treasury department.

16 DEBT AND BASE EROSION

- Draft chapter notes the **potential base erosion impact of debt** (including mention of General Anti Avoidance rules (GAARs) and Specific Anti Avoidance rules (SAARs))
- On this issue , mostly cross references to the ***UN Practical Portfolio on Protecting the Tax Base of Developing Countries against Base-eroding Payments: Interest and Other Financing Expenses***: https://www.un.org/esa/ffd/wp-content/uploads/2017/03/PP_Interest.pdf
- A link is also made with the ***BEPS Action 4 Report*** and the recommendations under Action 4 (such as the fixed ratio recommendation): <https://www.oecd.org/tax/limiting-base-erosion-involving-interest-deductions-and-other-financial-payments-action-4-2015-final-report-9789264241176-en.htm>

17 SPECIFIC FINANCIAL TRANSACTIONS: LOANS

- Intra-group loans are discussed in some detail:
 - Types of loans;
 - Types of risks related to loans;
 - The steps to accurately delineate an intra company loan, its commercial rationale, the creditworthiness of the borrower, and the choice of transfer pricing method
- Not addressed: replacement of LIBOR/Euribor (the measure of the average rate at which banks are willing to borrow wholesale unsecured funds) and alternatives.
 - Manipulation was possible because under LIBOR banks were asked to estimate the rate at which they *could* borrow from other banks, not rates at which they *actually* borrowed.
 - Search is for benchmarks based on observable, arms-length transactions rather than estimates. One example is the Treasury/ Fed Secured Overnight Financing Rate (SOFR).

18 GUARANTEES

- Intra-Group Guarantees are also discussed in some detail:
 - **types** of guarantees (with emphasis on the difference between implicit and explicit guarantees and their impact).
 - the steps to **accurately delineate** an intra company guarantee (does it have commercial value?),
 - its **commercial rationale**; and
 - the **choice of transfer pricing method/approaches** to calculate a guarantee fee.

19 TYPES OF INSTRUMENTS

- Additional (common) financial instruments are described, but not subjected to a TP analysis (accurate delineation and arm's length pricing):
 - **Cash pooling** - to reduce the cost of the credit facility (or not have to take out a loan for other needs) and to make more optimal use of the average balances sitting idle at the respective departments).
 - **Captive insurance** – creating a licensed insurance company to provide coverage for participating MNE group entities. By creating an insurance company, the parent company can stabilize premiums, reduce their costs, insure difficult-to-insure risks, have direct access to reinsurance markets, and increase cash flow.

20 CREDIT RATINGS

- Credit rating (of borrowers and of financial instruments themselves) and implicit support are discussed
 - **credit ratings** are important and useful, but may not always be perfect.;
 - for example, in the 2009 financial crisis, some entities with high credit ratings nevertheless ended up going bankrupt.
 - and in some countries the government may have **official prescribed interest rates** in place - no use is made of international commercial credit rating approaches.

21 COUNTERING BASE EROSION

- To reduce the base erosion effect of debt financing and the relevance of the tax factor in choosing between equity and debt financing, some countries have made the tax policy choice to introduce in their domestic tax laws **measures aimed at either reducing the advantage of debt financing or increasing the advantages of equity financing.**
- These measures can be broadly grouped into:
 - **General Anti-Avoidance Rules (GAARs);**
 - **Specific Anti-Avoidance Rules (SAARs); or**
 - **Application of arm's length pricing:**
 - Article 9 of treaties is relevant not only in determining whether the rate of interest provided for in a loan contract is an arm's length rate but also whether a prima facie loan can be regarded as a loan or should be regarded as some other kind of payment, in particular a contribution to capital.

22 APPLYING AN ARM'S LENGTH APPROACH

- Applying the arm's length principle to financial transactions is described, by largely following the **OECD Financial Transactions Discussion Draft approach**:
 - requiring **accurate delineation of the transaction** (including the need for a 2-sided analysis);
 - Addressing **economically significant characteristics** of financial transactions.
- The issue whether a charge is appropriate for an intra-group financial transaction is discussed (**benefit test/commercial rationale and proper characterization of the transaction**).

23 **ECONOMICALLY SIGNIFICANT CHARACTERISTICS**

- As noted in the UN Practical Portfolio on Protecting the Tax Base of Developing Countries against Base-eroding Payments: Interest and other Financing Expenses, measures to counter excessive interest deductions have pros and cons that must be carefully considered before implementing them.
- Draft provides an overview of economically significant characteristics of a financial transaction that may be considered when assessing intercompany financial transactions for transfer pricing / benchmarking purposes.

24 ECONOMICALLY SIGNIFICANT CHARACTERISTICS

- **Contractual terms** such as;
 - **the price** for obtaining the financing, which generally is the interest to be paid for obtaining financing.;
 - **the repayment obligations** and (what happens upon) failure to repay (default) by the borrower are a material aspect of an intercompany loan;
 - the **term** (time-period) for which financing is provided;
 - whether the amount of financing extended is secured by **collateral**, a guarantee or unsecured. This will impact the chances of repayment of the funding extended by the lender;
 - the **loan currency**;
 - the **status** (subordination or preferred status) of the lender with respect to other creditors. Subordinated?; and
 - **convertibility** of the funding (for example the right to convert the funding from debt into equity) and who may convert.

25 ECONOMICALLY SIGNIFICANT CHARACTERISTICS

- **Functional analysis:** (to determine what functions are performed by the respective parties (borrower and lender) in relation to the financial transaction).
- **Facts and circumstances that may assist** might include:
 - whether the debtor can obtain **credit/funding from other sources** (possibly including consideration of the debt capacity of the borrower);
 - the **(credit and other) risk of the lender** in providing funding to this borrower;
 - **who monitors** ongoing compliance with the terms of the funding agreement;

26 ECONOMICALLY SIGNIFICANT CHARACTERISTICS

- for the borrower it could also include consideration of **functions relating to ensuring availability of funds to repay a loan when due, i.e. considering the source of funds for repayment of the financing obtained;**
- the **(intended/actual) use of the funds/financing** provided to the borrower;
- it may also include considering the **purpose of the financial transaction in the context of the parties' businesses**, what **assets may be used and what risks are assumed** in relation to the financial transaction and how those risks are controlled.
- The above analysis should consider how those functions relate to the wider generation of value by the MNE Group to which the parties belong, the circumstances surrounding the transaction, and industry practices.

27 ECONOMICALLY SIGNIFICANT CHARACTERISTICS

- Characteristics of financial products or services.
 - To accurately delineate the actual transaction, it is important that the **characteristics of the specific financial transactions (or financial services) under review are clearly defined** and supported by the conduct of the parties and other facts.

28 ECONOMICALLY SIGNIFICANT CHARACTERISTICS

- Economic circumstances:

Conditions (including the pricing) of financial transactions can greatly vary depending on the economic circumstances that apply when those financial transactions are entered into or take place. Aspects that may be considered include:

- the **currency** of the financial transaction;
- the **economies / jurisdictions** of the parties to the financial transaction or the economies/ jurisdictions relevant to the terms of the financial transaction;

...

29 ECONOMICALLY SIGNIFICANT CHARACTERISTICS

- Economic circumstances: ...
 - the **specific business sector or industry** in which the parties operate that enter into the financial transaction;
 - the **timing** of the transaction – which can affect pricing; and
 - **macro-economic trends** will may impact interbank lending rates and as such, may impact the (interest) cost of financial transactions. It is therefore important to ascertain what the relevant economic circumstances are.

30 ECONOMICALLY SIGNIFICANT CHARACTERISTICS

- **Business strategies:** an MNE group's global financing policy may have impact on how the intercompany financing transaction under review is structured:
 - while accurately delineating the actual transaction, it will be helpful to have a clear understanding of the **company's financing strategy**; and
 - the **intent of the parties with respect to the funding provided**, participation in management and voting power by the party extending the financing all may be relevant considerations.

3 | METHODS

- The most commonly used transfer pricing methods for financial transactions are:
 - for **intra-group loans**, the **CUP method** (when comparable transactions exist between one party to the intra-group loan transaction and an independent party (“internal comparable”) or between two independent parties, neither of which is a party to the intra-group loan transaction (“external comparable”)) ;
 - if a **separate valuation of the treasury function is needed**, a **cost plus or TNMM approach** may be used considering the service nature of the treasury department; and
 - in certain circumstances **where the financing entity adds no value**, **remuneration at cost may apply**.

32 METHODS

- If a financing department/entity, **provides financing to group members and refinances these with deposits from other group members or external sources** and has, therefore, a mismatch in timing and/or currencies as well as exposure in creditworthiness, **the cost-plus method might not be the appropriate transfer pricing method.**
- the **transactional profit split method** might be relevant, but its use in practice for this kind of transactions is **quite limited** (e.g. for **global trading or for certain cash pooling transactions**).

33 METHODS

- Chapter also addresses:
 - ***special measures*** (such as using the MNE credit rating as the basis for reviewing the arm's length nature of the intra-group financial transaction)
 - and ***safe harbours*** – usually as to interest rates (which may have particular relevance in the case of developing countries).

34 COMFORT LETTERS & FINANCIAL GUARANTEES

- **Comfort letters** and the like do not transfer risk and are not generally considered to require arm's length payment.
- **Guarantees:**
 - Types of guarantees include:
 - Explicit guarantees legally binding and of three types:
 - **downstream** – parent issues guarantee for the benefit of a sub (decentralized or location of sub is better for financing);
 - **upstream** – group company issues a guarantee for the benefit of the parent (e.g. when parent performs central treasury functions);
 - **cross guarantees** – group companies issue guarantees for the benefit of each other – so can be treated as a single obligated entity (common for cash pooling).

35 INTRA-GROUP FINANCIAL GUARANTEES

- Need to consider economically relevant characteristics:
 - **contractual terms** (including terms and conditions of the guaranteed instrument), as supported by the conduct of the parties;
 - the **risk profile** of the borrower also accounting for the possible impact of implicit support, by considering **the functions performed, and assets used by the guaranteed entity** (including any available external credit rating of the borrower and of the guaranteed instrument as well as the probability of default of the borrower);

36 INTRA-GROUP FINANCIAL GUARANTEES

- Need to consider economically relevant characteristics:
 - the risk profile and financial capacity of the guarantor;
 - the characteristics of the financial guarantee (including benefits provided by the financial guarantee, if any);
 - the economic circumstances of both the guarantor and the guaranteed entity and of the market in which they operate; and
 - the business strategies pursued by the guarantor and guaranteed entity.

37 INTRA-GROUP FINANCIAL GUARANTEES

- All the terms and conditions must be considered in determining the accurately delineated transaction, following from terms and conditions and conduct.
- Is there a **commercial purpose?** Analyse what **obligation is transferred to the guarantor** by looking at:
 - **form of guarantee;**
 - **its purpose;**
 - **Willingness and ability of guarantor to support** the guaranteed entity; and
 - **request by lender for the guarantee.**

38 INTRA-GROUP FINANCIAL GUARANTEES

- Intra-group financial guarantee will have **commercial value if:**
 - **obligations transferred** to guarantor under circumstances described in guarantee;
 - **independent party would be willing** to pay for the guarantee; and
 - guaranteed entity receives a **better price for the loan** because of the guarantee.

39 INTRA-GROUP FINANCIAL GUARANTEES

- Intra-group financial guarantee costs **might not be deductible if and to the extent that:**
 - guaranteed entity is perceived as having a **better credit rating because of an implicit guarantee;**
 - there is **no credit status allowing access to capital markets without the guarantee** –guarantor is in effect the borrower; and
 - financial guarantee requested **only to avoid the parent company diverting the funds.**

40 INTRA-GROUP FINANCIAL GUARANTEES

- Selection of methods
 - **Most common compensation is a guarantee fee.**
 - Such fees take into account :
 - **probability of default;**
 - **amount of guarantee; and**
 - **guarantor's cost of capital.**

4 | INTRA-GROUP FINANCIAL GUARANTEES

- **CUP** may apply if comparables are available, internally or externally.
- Other approaches:
 - “**yield**” approach – benefit received by guarantor (maximum potential interest rate savings for guaranteed entity); and
 - “**cost**” approach – capital required to support the risks assumed by guarantor?

Questions and Comments?