Transfer Pricing and Financial Transactions

By Mimi Song

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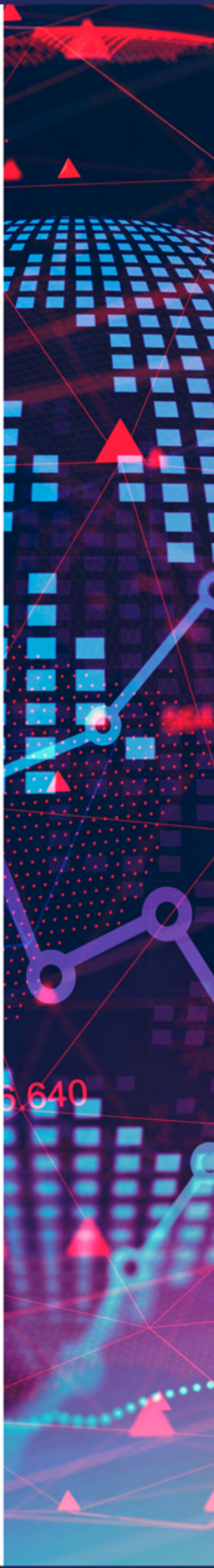

Financial transactions are common intragroup (or intercompany) transactions and, like transactions involving tangibles, intangibles, and services, they're subject to transfer pricing rules and principles.

There are many types of financial transactions—intragroup loans, capital structures, treasury functions, guarantees, captive insurance and reinsurance, among others—and in the U.S., and most other countries, all must be priced according to the arm's length principle.

Historically, with the exception of financial institutions, multinational companies haven't paid much attention to financial transactions in terms of transfer pricing.

So, in an attempt to motivate corporate taxpayers to apply the same transfer pricing treatment to financial transactions that they apply to other transactions, the OECD released a public discussion draft on transfer pricing financial transactions back in 2018. However, that draft left many questions unanswered.

Last year, the OECD released *Transfer Pricing Guidance on Financial Transactions: Inclusive Framework on BEPS: Actions 4, 8-10*, which will become Chapter X of the OECD's transfer pricing guidelines.

The OECD guidelines are not law unless they are adopted into country regulations, but the guidance offers a holistic view of financial transactions through a transfer pricing lens.

Accurate Delineation of the Transaction

The OECD guidelines puts a strong emphasis on the "accurate delineation" of the transaction, which is meant to give taxpayers a framework for assessing the arm's length nature of intercompany financial transactions.

The OECD recommends taxpayers break down each financial transaction in terms of the functions, assets, and risks of each related party involved in the transaction.

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The accurate delineation is an extra compliance burden for the taxpayer, but it's advisable for taxpayers to practice due diligence in a world of heightened tax scrutiny.

To accurately delineate a transaction, taxpayers will have to breakdown each intercompany financial arrangement, first to identify the business purpose of the transaction, the commercial rationality, and the terms and conditions of the transaction. Once that's determined, taxpayers can see if they do, in fact, have an arm's length arrangement.

The OECD emphasizes that taxpayers should establish the economic substance of the transaction, as opposed to relying on its legal form. Taxpayers must show that debt (or another financial transaction) is bona fide.

The report lists the following characteristics as economically relevant for delineating transactions:

- 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 creditor
- 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
- The risk that the debtor does not repay on the due date or seeks a postponement

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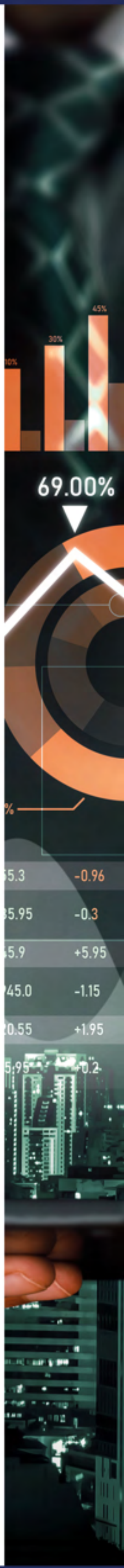
OECD Guidance for Intercompany Loans

When analyzing intercompany loan pricing, practitioners have traditionally focused on the borrower's ability to repay, based on the agreement's terms. The OECD emphasizes looking at both sides of the transaction.

Key functions include the lender having the capacity to perform essential risk monitoring and control activities and make corresponding decisions. A passive lender may be restricted to no more than a risk-free rate of return.

It's necessary to use commercial credit rating tools, like Moody's RiskCalc™, and supplementary qualitative analysis of the lender and borrower. When analyzing credit ratings, it's also important to consider any implicit support to the borrower from its membership in a multinational group.

Risk-free and Risk-adjusted Rates: The OECD guidelines also emphasize that if the lender isn't performing the essential risk monitoring and control activities and make corresponding decisions, it will only be entitled to a risk-free return. So, it's essential to look at a multinational enterprise's behavior when assessing the specific terms applied to an intercompany loan. It's also important to consider the guidance on determining a risk-adjusted rate.



Transfer Pricing Approaches

To determine arm's length interest rates on financial transactions, taxpayers should consider the following:

Comparable Uncontrolled Price (CUP): External comparables can be used to measure loans, bonds, convertible debentures, and commercial papers, among other financial arrangements. Comparability adjustments may be needed to eliminate material differences.

Cost of Funds: Another way to price intragroup loans, the cost of funds method usually applies to intermediaries. It considers costs incurred by the lender to extend the loan: bank charges, legal expenses, and so on. A premium is added to the costs to determine the arm's length price of the loan.

Yield Approach: Quantifies the benefit that guaranteed party receives from the guarantee in terms of lower interest rates. The yield approach calculates the spread between the interest rate the borrower receives with and without the guarantee and determines a maximum fee that the borrower should pay for an arm's length guarantee.

The Cost Approach: This method is used to quantify the cost a guarantor would have to pay in the event of a default by the borrower and sets a minimum fee that a guarantor would accept.

Other Methods: When the CUP and cost of funds approaches don't apply, it may be necessary to employ another—and there are several to consider. Credit default swaps are potentially useful to calculate risk premiums. Economic modeling can also be useful in determining arm's length pricing.

Common Intragroup Financial Transactions

Treasury Function: Typically, a treasury's policy-making and overall strategy stem from a group strategy. A treasury's functions will usually be support services to the group's main value creation. The treasury entity is expected to receive an arm's length fee for its coordination activities. The guidance on intragroup services in Chapter VII of the OECD guidelines may apply.

Cash Pooling: A cash-pooling arrangement refers to the pooling of debit and credit of cash-pool members to arrive at a net balance. The overall balance will determine the interest to be paid or received. Multinational groups rely on this type of intercompany financial transaction to have ready access to a permanent source of financing and also reduced exposure to banks.

The cash-pool leader's remuneration depends on its characterization. A higher spread-based return is provided if the cash-pool leader takes higher risks–such as hedging, liquidity, management, etc. But typically, a cash-pool leader performs no more than a coordination or agency function and, therefore, receives limited remuneration.

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Hedging: Centralized in a treasury entity, hedging is a means of transferring risk within the group by mitigating exposure to certain risks, such as foreign exchange or commodity price movements. A hedging contract provided by one group member to other members may be seen as a service, which should then be treated as a service transaction and remunerated at arm's length.

Financial Guarantees: A financial guarantee is a legally binding commitment to assume a specified obligation of a debtor should the debtor default on that obligation.

A financial guarantee is assessed based on the following factors:

- **Economic Benefit:** A financial guarantee can affect the terms of the borrowing, either by enhancing the terms of the borrowing or by providing access to a larger amount of borrowing. A guarantee fee should only be paid to the guarantor if the guarantee helps achieve better terms.
- **Effects of Group Membership:** The benefit arising from being part of a group is not seen as a service for which payment of a fee would be necessary.
- **Financial Capacity of the Guarantor:** The financial capacity of a guarantor requires an evaluation of the guarantor's credit rating and the borrower, as well as the business correlations between them.

Captive Insurance

The function of captive insurance entities is to insure the risks of entities belonging to the same multinational group. To accurately delineate captive insurance, it's important to determine whether the insurance is genuine, a risk exists, and if the risk is allocated to the captive insurance.

As captive insurance ensures the risk and reinsures it in the open market, it should receive an appropriate reward for the basic services it provides.

What Should Businesses do?

The OECD guidelines are, of course, just guidelines. It's always important for taxpayers to follow country-specific regulations. However, the OECD has outlined some practices that are likely to be acceptable in many countries.

Conduct a thorough review of your intragroup financial transactions. Assess whether functions and control of risk are in the same place as financial returns. Consider (and document) relevant economic characteristics on both sides of the transaction.

Evaluate the compensation of treasury operations relative to functions and risks. As part of the evaluation, explore restructuring opportunities.

Revisit the economic substance and pricing behind your captive insurance arrangements. It's important to anticipate potential challenges.

The Takeaway

No doubt, new guidelines are sure to open the door to more controversy as there's always more room for interpretation. However, for taxpayers and tax administrations, these guidelines provide a clear framework for financial transactions.

Are there more rules to follow for taxpayers? Absolutely—once-overlooked financial transactions now need to be documented, substantiated, and supported as much as say, transactions involving tangible goods.

The good news is now you have facts and conditions to consider. While new guidelines may add additional burdens in terms of due diligence, they also provide more predictability, which in the world of transfer pricing is often hard to find.

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