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Transfer pricing for financial transactions: what just changed?

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The OECD's new guidance marks a change in approach, as experts at Simmons & Simmons explain.

New transfer pricing rules on financial transactions were released, on 11 February 2020, by the OECD (see bit.ly/3csIMpz). Traditionally, the OECD's transfer pricing guidelines (TPG) have been consensus-based guidance. This has been a significant part of their strength, and many countries have incorporated the guidelines by reference in domestic law. The new guidance, though, shows more opportunity for divergent opinions and approaches, which may foreshadow more need for (bilateral or multilateral) dispute resolution.

Finalisation of financial transactions guidance

Two key issues held up the finalisation of the financial transactions guidance: MNE capital structure analysis; and MNE group credit rating.

MNE capital structure analysis

The first issue was whether tax authorities can challenge 'the balance of debt and equity funding' of an MNE group entity (meaning the capital structure) based on the arm's length principle. This was addressed in the new OECD TPG:

'This guidance is not intended to prevent countries from implementing approaches to address the balance of debt and equity funding of an entity and interest deductibility under domestic legislation, nor does it seek to mandate accurate delineation under Chapter 1 as the only approach for determining whether purported debt should be respected as debt.' (OECD TPG (2020) chapter B.1 para 10.9)'

This text allows for divergence between countries, however, and the risk of double taxation in case of (transfer pricing) adjustments.

Countries can take different approaches to determine a maximum amount of debt that gives rise to deductible interest payments. A benefit of using the arm's length principle is that its application is generally covered by the article on associated enterprises of treaties for the avoidance of double taxation. These treaties tend to provide for a mutual agreement process that can help resolve related disputes and double taxation. Domestic thin capitalisation rules, general anti-avoidance rules (GAARs) and special anti-avoidance rules (SAARs) do not have that benefit. However, allowing the arm's length principle to recharacterise intercompany debt may, in some countries, be possible without explicit new legislation, leading to possible retroactive application and recharacterisation.

If countries can apply the arm's length principle to recharacterise debt, intercompany debt could arguably be at risk of recharacterisation if:

- the debt 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; or
- relevant characteristics (or a combination thereof) of a debt instrument are absent, such as: a fixed repayment date; an obligation to pay interest; the right to enforce payment of the principal and interest; and financial covenants and security.

Other characteristics (or a combination thereof) that can be considered are:

- the status of the funder in comparison to regular corporate creditors;
- 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 next question is: how would the arm's length principle determine the character of a loan? This could be by applying the process that third party lenders use to determine the maximum amount they would lend to the taxpayer, including consideration of:

- a debt-capacity analysis of the borrower;
- forecasted cash flows of the debtor, subject to a stress test if need be;
- the type of loan (e.g. long-term, short-term, subordinated, mezzanine, revolving, etc.);
- the purpose of the loan (e.g. short-term working capital purposes);
- the perception that the MNE group affiliate can not pay the interest and repay the loan;
- the quality of the collateral that is made available to secure the loan, i.e. whether assets are pledged as security and those assets are also actually available as collateral;
- the risk that the credit rating of the borrower changes due to economic circumstances (rising interest rates, volatile exchange rate exposure);
- whether any guarantees are made available and by whom;

- the quality of the management of the borrower and of the MNE group of which the borrower is a member;
- the overall health of the economy; and
- the liquidity position of the lender.

It could also be determined by applying a 'separate enterprise approach' when postulating the borrowing capacity of MNE group affiliates, while:

- applying the MNE group credit rating, if appropriate;
- applying the borrower's credit rating, if that can reliably be established;
- considering the impact of implicit support, if any; and
- considering the issue credit rating in addition to the issuer's credit rating.

MNE group credit rating

The second issue delaying publication of the new guidance was the proposal to use the MNE group credit rating for pricing intra-group loans. Consensus was found in stating that in those cases where the individual/stand-alone credit rating taking into account the effect of group membership is 'not reliable', the MNE group credit rating may be used to price intercompany loans. There is no definition of what constitutes an 'unreliable' outcome, so those countries that implement a group credit rating with a high reliability threshold can force taxpayers into using an MNE group credit rating when assessing intra-group loans (OECD TPG (2020) chapter C.1.1.4 paras 10.81–10.82).

The impact of accurate delineation

TPG chapter B explains the process of accurate delineation for financial transactions. We expect that the new guidance will have significant impact on the practice of pricing financial transactions as traditionally applied.

The OECD TPG provide that a comparability analysis is at the heart of the application of the arm's length principle. This assumes that a comparison takes place between the conditions in a controlled transaction and the conditions that would have been made had the parties been independent and undertaking a comparable transaction under comparable circumstances.

There are two aspects to this assumption. The first is the process of identification of commercial or financial relations between associated enterprises and the conditions and economically relevant circumstances attaching to those relations. The second is comparing the conditions and economically relevant circumstances of the controlled transaction with those of comparable transactions between independent enterprises. The new guidance emphasises the attention with which intra-group transactions ought to be delineated before they can be compared with third party transactions.

Traditionally, if an analysis would be requested to determine an arm's length interest rate, in many 'high level/plain vanilla' cases (only) the following information would have been collected and reviewed:

- What is the amount of the loan?
- What is the effective date of the loan?
- What is the maturity of the loan?
- What is the stand-alone credit rating of the borrower?
- What is the seniority of the loan instrument? Is it subordinated or not?
- What is the currency of the loan?
- What type of interest rate is applied (fixed or variable)?
- Is there any security for the loan (a guarantee or collateral)?

With the availability of credit rating tools and databases, such information would have been considered more or less adequate for many taxpayers to determine a 'third party' interest rate. The new guidance on accurate delineation indicates that several additional aspects will need to be considered, with documentation to show that they were considered, at the time the loan was put in place.

The financial transaction must be accurately delineated based on an analysis of the contractual terms, functional analysis (including risks assumed and assets used), characteristics of financial instruments, economic circumstances and business strategies. Furthermore, it will need to be revisited during the term of the loan and be applied dynamically, just as unrelated parties would have done.

The following is an overview of aspects which, based on the new guidance, are likely to play a role in intra-group loans and intra-group financial guarantees.

Intra-group loans

For intra-group loans, taxpayers will need to substantiate that several considerations were made before determining the amount of the intra-group loan, the credit rating applied and the interest rate applied to the intra-group loan. This includes the decision-making process before putting in place an intra-group loan, which will likely be scrutinised for evidence of consideration of:

- the business reason for and business strategy behind the decision for obtaining the loan;
- the particular point of an economic, business or product cycle relevant to your business and that of the borrower;
- the effect of government regulations on your business and that of the borrower;
- the availability of financial resources in your industry and for the borrower;
- the amount and type of financing required in your business and that of the borrower;

- the capital intensity level in your business and industry;
- the typical level of short-term cash balance in your business and industry due to commercial needs;
- the options realistically available to both the borrower and creditor with respect to the intended funding;
- whether there are alternative and more attractive opportunities to meet the stated commercial objectives;
- the cost of capital management or optimisation strategies within the MNE group;
- whether a thorough assessment has been made of the borrower's creditworthiness; and
- what the source of repayment of the loan will be and whether the borrower's cash flow forecast was considered.

The choice for the type of loan (long-term, short-term, subordinated, mezzanine, revolving, etc.) to be put in place will most likely be compared to the following aspects:

- the purpose of the loan (e.g. short-term working capital purposes);
- the MNE group's external financing policy and common practices;
- how the MNE group prioritises funding needs among different projects;
- the strategic significance of the borrower within the MNE group;
- whether the MNE group typically targets a specific credit rating or debt-equity ratio; and
- how the funding strategy adopted with respect to this loan compares to that observed in the industry in question.

As regards the actual contract underlying the funding instrument, it is expected that there is evidence that the following questions have been considered:

- Which party carries the risk of the funding provided?
- What is the currency of the loan?
- What covenants are captured in the loan instrument, if any? These include limits for the borrower to take on additional debt, or the financial indicators that the borrower must meet at regular intervals to maintain good standing.
- What collateral is made available to secure the loan? Are assets pledged as security and are those assets also actually available and earmarked as collateral?
- Is there a risk that the credit rating of the borrower will change due to economic circumstances (rising interest rates, volatile exchange rate exposure)?
- Are any guarantees made available and by whom?
- Are interest and loan repayment terms clearly included and what are the consequences of interest payments or loan repayments not being made timely?
- What is the seniority of the loan (e.g. subordinated)?
- What are the renegotiation terms (when is renegotiation appropriate and when not)?

In addition, tax authorities are instructed to review whether the actual conduct of the borrower and creditor is consistent with the contractual terms underlying the loan.

The credit rating of the borrower used to price the loan is already a top audit topic. If anything, the reasons and selection of the credit rating used for a particular MNE when pricing intra-group loans must be documented appropriately to withstand scrutiny and be prepared for audits, including:

- Does the MNE group and/or the borrower have a publicly available credit rating?
- How was the relevant credit rating determined? What it by using publicly available tools, independent credit rating agency assistance or internally developed tools? Is the MNE group's credit rating used or is it a different one, and if so, why?
- Will the borrower get MNE group support in case it gets into financial difficulty, and is this implicit support or based on a financial guarantee?
- What is the status of the borrowing entity within the MNE group, considering its strategic importance and its operational integration and significance?
- Does the borrowing entity share its name with the MNE group, has there been any history of support by group members within the MNE group?

The tax authorities will review the interest rate applied and ask the following questions:

- How was the interest rate determined and has this been documented?
- Who monitors the creditor risk, considering the purpose of the loan and the borrower's business and the economic circumstances under which the loan is granted?
- Has the borrowing entity also obtained a loan from third parties, e.g. banks? If so, has this been considered in determining the interest rate for the intra-group loan?

The new guidance reflects the issues covered in several court cases globally challenging such transactions. For example, the *Chevron Australia Holdings* case ([2017] FCAFC 62) concerns the pricing of an internal credit facility agreement amounting to the AUD equivalent of $2.5bn at AUD LIBOR plus 4.14% (about 9%) based on standalone credit rating of an Australian Chevron entity with no guarantee and covenant-lite was held to be not at arm's length. The MNE group raised the funds made available to the Australian Chevron entity at rates of interest around 1.2% through an issuance of USD commercial paper with a credit guarantee provided by Chevron Corporation. This case shows the importance of analysing the arm's length nature of the intra-group loan terms and conditions based on the external funding policies and practices of the MNE group.

Intra-group guarantees

For intra-group financial guarantees, taxpayers will need to substantiate that several considerations were made before putting in place a fee for the financial guarantee; and that there is a clear benefit.

This was litigated in *GE Capital Canada* [2010] FCA 344. In that case, Revenue Canada held that that the arm's length fee to be paid by GECC for a financial guarantee from its parent company, GE Capital US, in connection with GECC's borrowing in the capital market was zero. Revenue Canada argued that GECC's credit rating was the same as that of GE Capital US due to implicit support resulting from GECC being part of the MNE group. Essentially, GECC could have borrowed the same amount of money at the same interest rate without an explicit guarantee. GECC argued that implicit support does not occur between independent enterprises and should therefore not be considered in determining the credit rating of GECC. The court was of the view that implicit support should be considered, but it disagreed with Revenue Canada on the extent of its impact. The court ruled that the 1% fee paid by GECC did not exceed an arm's length amount. Whether the GE Capital US guarantee de facto provided GECC with economic benefit was the core of the dispute, and while GECC prevailed, the issue of implicit support and de facto benefit from financial guarantees have now been explicitly made part of the transfer pricing analysis.

A summary of the focus points is set out below.

The decision-making process

The decision-making process before putting in place an intra-group guarantee will be scrutinised for evidence of consideration of the following questions:

- What is the overall economic benefit for the borrower as result of the guarantee?
- Can it be identified upfront what terms of the borrowing are (positively) affected by the guarantee (including the amount to be borrowed, the interest rate to be applied or other factors)?
- Does paying for the guarantee really put the debtor in a better position than not having a guarantee, when comparing the cost of borrowing with and without the guarantee?
- Would an unrelated party have paid for a guarantee?
- Would the guaranteed party have obtained benefit from being part of the MNE anyway?

The financial guarantee

The form of the financial guarantee (explicit, implicit or as letter of comfort) is also considered to have relevance:

- An explicit guarantee exposes the guarantor to additional risk and creates a legal commitment to pay.
- A letter of comfort or lesser form of credit support involves no explicit assumption of risk.
- Without any explicit guarantee, expectations that other MNE group members will provide support will generally be deemed derived from passive association, i.e. being a member of the MNE, and will constitute implicit support (and not justify an intercompany guarantee fee).
- Are there any cross guarantees put in place?

As regards the assertion that there is a guarantee in place, the following aspects will be scrutinised:

- Is there a formal written guarantee or only implied support attributable solely to membership of the MNE group?
- Is the guarantee made in the form of a legally binding commitment?
- Is the obligation assumed by the guarantor specified and is it specified when the guarantor's obligation to perform commences?
- Does the guarantee provide actual benefit, considering the financing agreement as a whole? If the default of another MNE group member is listed as an event that may cause termination of a facility or adverse consequences, the MNE group may be so financially interdependent that it is required to step in to protect its credit rating anyway. In that case, a formal guarantee may have little added value.
- What is the financial capacity of the guarantor?
- What credit rating is applied for the guarantor and for the borrower?
- What asset pool can the guarantor draw from?
- Is there a high level of correlation between the guarantor's and the borrower's exposure to market conditions?

The price of the guarantee

The price of the guarantee fee is a hot audit topic. Audit questions to disallow a guarantee fee will particularly focus on the following issues:

- If a lender assumes that the MNE group will provide support to an associated enterprise in respect of its borrowings by virtue of that borrower being a member of the MNE group, yet without any legally enforceable contractual obligation, that assumption is based on passive association of the borrower and there is no real service provided by any MNE group member to the borrower for which a fee would be due.
- If a debtor has no debt capacity at all and would not have been able to borrow in the market on a stand-alone basis absent the financial guarantee, the guarantor may be performing a function in its own self-interest by not justifying a guarantee fee.
- If a financial guarantee is put in place per the request of the creditor to avoid that the parent company diverts the funds (for moral hazard reasons), similarly the guarantee may not merit a guarantee fee.
- If the parent company provides a guarantee under circumstances as a result of which it essentially should be considered the borrower (which subsequently makes an equity contribution to the deemed borrower), no guarantee fee would apply.
- How was the guarantee fee determined and has this been documented?

The new transfer pricing guidance on financial transactions also covers treasury functions, hedging, cash pooling and captive insurance. Those have not been discussed in this article, but they require the same detail of information pursuant to the accurate delineation as intra-group loans and financial guarantees.

Final thoughts

What changed is that the accurate delineation process required for financial transactions has been clarified and is far more intricate and detailed than many taxpayers have considered so far. This may leave many taxpayers exposed in case of transfer pricing audits. To reduce exposure to transfer pricing adjustments, we recommend MNEs to conduct a review of their intra-group financial transaction portfolio and the application (and documentation) of the now explicit accurate delineation aspects.

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The OECD has issued new guidance on transfer pricing for financial transactions. The guidance clarifies the process of accurate delineation for financial transactions, which is expected to have a significant impact on the practice of pricing financial transactions. This process is both far more detailed and far broader than previously, as a result of which current transfer pricing studies supporting the pricing of intra-group financial transactions may very well not withstand tax audit scrutiny. A number of aspects must be considered when pricing intra-group loans and intra-group financial guarantees, as well as the circumstances in which intra-group debt may be recharacterised as equity through application of the arm’s length principle.

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