OECD has released in February final TP guidance on financial transactions

Treasurers were waiting for the OECD guidance to better understand how to practically apply the measures listed by BEPS Actions 4, 8 to 10 issued couple of years ago. Beside the provisions and principles, having examples and clarifications is useful to delineate how to achieve it and how to document properly financial transactions.

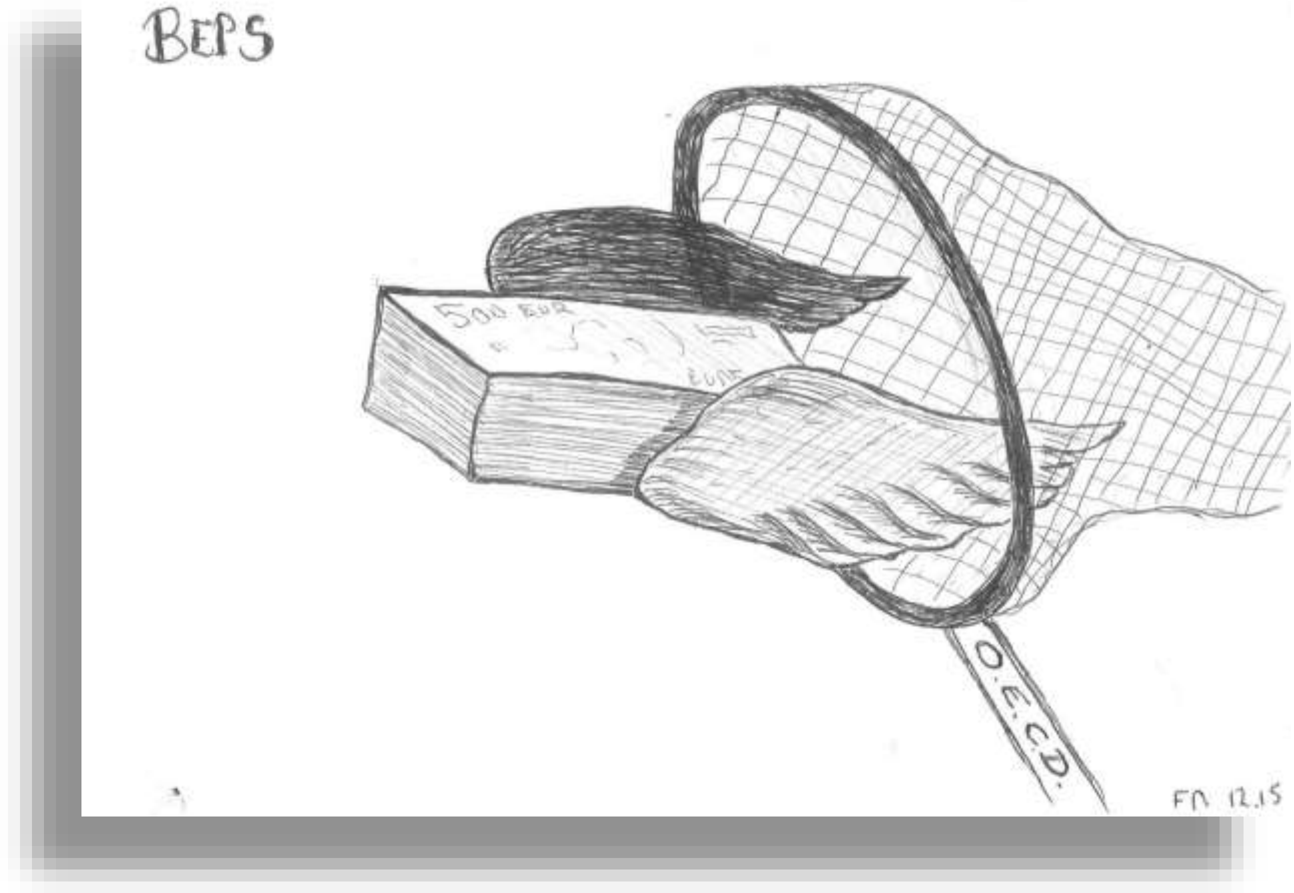
How to apply the fair price to financial transactions?

This 44-page guidance from OECD on transfer pricing (TP) on financial operations was highly awaited by all corporate treasurers all over the world. On February 2020, the Organization for Economic Co-operation and Development (i.e. OECD) released its final report with transfer pricing details on the financial and treasury intercompany transactions. It was a logical follow-up after the publications of the 15 actions of BEPS (the guidance is focusing on action 4 and 8 to 10). It aims at clarifying the way to apply the new or reviewed principles on a consistent basis. The idea is to reduce and prevent disputes and double taxation situations. This report is important as it covers the appropriate delineation of all financial transactions, with respect of MNC’s capital structures. It addresses the specific issue related to pricing of transactions such as treasury, intra-group loans, cash-pooling, hedging, guarantees and captives of reinsurance. The guidance also defines the way to determine the risk-free rates of return and risk-adjusted rates of return where an associated company or affiliate is entitled to such a return under the guidance. Eventually the report also includes examples to illustrate the principles.

<u>Key items addressed by OECD in its report</u>

- Intra-group lenders without functional substance is important. A group treasury center should evaluate the profit from intra-group lending in countries where they don't have the people functions to manage risks. The lender is entitled to the risk-free rate and the remainder if it exercises control over the investment risk. The control and management of risks is the key factor.

- Delineation of guaranteed loans is also essential to determine whether the loan would be only granted because of the guarantee by another group company and would have not raised the funds on its own. It could be viewed as a capital contribution from the guarantor.
- The delineation of the transaction should be documented by the terms and conditions. All terms and conditions must be at arm’s length and not only the interest rate and margins.
- Cash-pooling are managed by a cash pool leader which performs coordination and agency function. As a service provider, the leader’s remuneration should be limited. The remuneration of cash pool leader should substantiate the allocation of income based on performance of control functions over credit, liquidity and risks. The documentation is also recommender.
- The credit rating or “implicit support” is crucial (known as the “halo effect”) the benefit of group membership should be considered. A treasury center must analyze the rating of each subsidiary and ability or willingness of the group GT to support troubled affiliate companies.



Necessity of guidelines for practitioners

This guidance has been initiated in 2013 as part of the BEPS actions to focus on frequent transfer pricing issues related to financial transactions. All treasurers were expecting such guidance to better understand what they should do or not and how to properly document it. This report includes four main parts: (1) treasury function, including related transactions such as intra-group loans, cash-pooling and hedging, (2) guarantees (3) Captive insurance (4) risk-free and risk-adjusted rates of return. The report tends to delineate if the transaction is an equity or a funding transaction and the appropriate capital structure and balance between equity and debt funding. It is always required to prove that the transactions differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner in comparable circumstances. It is intended to determine whether the debt should be considered as such. The new guidelines recognize that a borrowing entity's balance of debt-to-equity funding impacts the amount of interest paid by the borrower and may affect profits. It is a basic financial principle; nevertheless, not always applied for intercompany transactions. Associated enterprises should be funded at arm's length not only to determine whether the rate of interest provided for a loan is an arm's length, but also whether prima facie loan can be regarded as a loan or should be analyzed as some other kind of payment, like a contribution to equity capital. Debts could be requalified into equity. They emphasize the comparability factor based on five economic relevant characteristics (i.e. contractual terms, functional analysis, characteristics of the instruments used, business strategies and economic circumstances). Both perspectives must be considered: lender and borrower. OECD recommends relying on credit ratings, which are based on qualitative and quantitative data. It is a case-by-case analysis and passive association and support must be weighted too. For guarantees, there are two methods to be applied: the cost (quantifies additional risk borne by the guarantor by estimating loss for providing the guarantee) and the yield approaches (calculation of spreads between interest rate that would be payable by the borrower without the guarantee and interest payable with the guarantee). Treasury functions must be distinguished based on role: (1) simple coordination (day-to-day operations, centralization of external borrowing, etc…) and (2) more complex functions (corporate finance management, identification of risks, responses and analysis on risks, etc…). The remuneration of treasury fees must be in line with treasury services effectively performed. The risk-free rate of return must be applied to a funder who lacks the ability to control the associated risks with investment in financial assets. If you do not perform the decision-making function, you should only apply the risk-free rate. But a higher return is possible and proportional to the assessment of the risk of a transaction. We should note that the report denies the comparability to external bank opinions to intra-group loans as these informal letters do not constitute an actual offer to lend and cannot be considered “comparable” to actual transactions. The same principle for cash-pooling where the allocation of synergy benefits must be clear. The reward to the cash-pool leader is possible according to functions performed, assets used, and risks assumed in facilitating the cash-pooling arrangement. An agency or coordination role should be less remunerated as well as notional pooling’s run by the banks. What is often missing is the remuneration of participants and benefits of being in the pooling. Treasurers assess their benefits and not those of participants. They should be shared between participants. The transaction must be considered as short-term, however, sometimes, facts can support an alternative view such as long-term deposit/loan if it stays forever.

Significant step forward

This document was awaited by treasurers as it gives examples to determine the nature of funding. Although this guidance is not binding for tax authorities (considered as soft law), some tax inland revenues follow this guidance. The report has been approved by 137 members of OECD Inclusive Framework. It acknowledges there are potentially different views on various topics (e.g. capital structure or interest deductibility limitation). Treasurers must now ensure that TP policies are aligned with new guidance and that they have supporting documentation in place to support these policies. It is far from being a simple exercise as many peers believe. When the control will come (and it will come), better to have documentation in place if not it will be too late to get everything back.

François Masquelier ***Simply*****TREASURY** - March 2020