

Japan Tax Bulletin

OECD Transfer Pricing Guidance on Financial Transactions

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On 11 February 2020, as part of tax base erosion and profit shifting project, the OECD released final Transfer Pricing Guidance on financial transactions. The Guidance mainly addressed regarding the intra-group loans, cash pooling arrangements, financial guarantees, and captive insurance. This article aims to summarize the key chapters of the Guidance and the possible impact the Guidance may have on transfer pricing arrangements for financial transactions within a multinational enterprise group.

1. *Accurate Delineation*

The accurate delineation of the financial transactions is one of the key changes in the Guidance, which emphasized the importance of determining whether a purported loan should be regarded as a loan for tax purposes or should be regarded as some other kind of payment, in particular a contribution to equity capital.

According to the Guidance, in order to price the accurately delineated actual transaction, the following economically relevant characteristics should be considered.

- Contractual terms
- Functional analysis
- Characteristics of financial instruments
- Economic circumstances
- Business strategies.

With regards to characteristics of financial instruments, the features may include but not limited to: the amount of the loan; its maturity; the schedule of repayment; the nature or purpose of the loan; 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 Guidance suggested to document the transaction's features and attributes.

Regarding economic circumstances, to achieve comparability requires that the markets in which the independent and associated enterprises operate do not have differences that have a material effect on price. In this regard, macroeconomic trends factors and currency differences are considered to be important factors. Macroeconomic trends factors include central bank lending rates or interbank reference rates, and financial market events like a crisis. Currency differences factors include growth rate, inflation rate, and the volatility of exchange rates.

2. *Intra-group Loans*

When considering the commercial and financial relations between the associated borrower and lender, and in an analysis of the economically relevant characteristics of the transaction, the guidance noted both the lender's and borrower's perspectives should be taken into account.

The lender's perspective in the decision of whether to make a loan, how much to lend, and on what terms, will involve evaluation of various factors relating to the borrower, wider economic factors affecting both the borrower and the lender, and other options realistically available to the lender for the use of the funds. In contrast, from the borrower's perspective, when considering whether to enter into a particular financial transaction, will consider all other options realistically available to them, and will only enter into the transaction if they see no alternative that offers a clearly more attractive opportunity to meet their commercial objectives

The creditworthiness of the borrower is one of the main factors that independent investors take into account in determining an interest rate to charge. An approach often used is to apply quantitative and qualitative analyses of the individual characteristics of the multinational enterprise group using publicly available financial tools or independent credit rating agencies' methodologies to seek to replicate the process used to determine the credit rating of the multinational enterprise group.

The CUP method is considered to be the most common method to determine the arm's length interest rate of intra-group loans. Because the widespread existence of markets for borrowing and lending money and the frequency of such transactions between independent borrowers and lenders, coupled with the widespread availability of information and analysis of loan markets may make it easier to apply the CUP method to financial transactions than may be the case for other types of transactions. Alternatively, credit default swap and economical modelling are considered to price intra-group interest rate.

3. *Cash Pooling Arrangements*

The use of a cash pooling is arranged within a multinational group to ensure efficient cash management and achieve financing cost efficiency.

A cash pooling arrangement refers to the pooling of debit and credit balances of the separate bank accounts of cash pool members to arrive at a net balance. Interests will be paid or received based on the overall balance. There are two type of cash pooling arrangements include physical and notional pooling.

To determine an arm's length remuneration for a cash pooling arrangement, it is necessary to identify:

- Nature of the advantage or disadvantage of a cash pooling arrangement;
- Amount of the benefit or detriment provided; and
- How that benefit or detriment should be divided among members of the multinational group.

A cash pool leader performs no more than a co-ordination or agency function with the master account being a centralized point for a series of book entries to meet the pre-determined target balances for the pool members. Given such a low level of functionality, the cash pool leader's remuneration as a service provider will generally be similarly limited.

The remuneration of the cash pool members will be calculated through the determination of the arm's length interest rates applicable to the debit and credit positions within the pool. This determination will allocate the synergy benefits arising from the cash pool arrangement amongst the pool members and it will generally be done once the remuneration of the cash pool leader has been calculated.

However, to determine the arm's length interest rates for the cash pool intra-group transactions may be a difficult exercise due to the lack of comparable arrangements between unrelated parties.

4. *Financial Guarantees*

A financial guarantee provides for the guarantor to meet specified financial obligations in the event of a failure to do so by the guaranteed party. From the borrower perspective, a financial guarantee may affect the terms of the borrowing. From the perspective of a lender, the consequence of one or more explicit guarantees is that the guarantors are legally committed; the lender's risk would be expected to be reduced by having access to the assets of the guarantors in the event of the borrower's default.

To determine the arm's length price of guarantees, the Guidance illustrated 5 methods as below.

1) *CUP method*

The CUP method could be used where there are external or internal comparable; independent guarantors providing guarantees in respect of comparable loans to other borrowers or where the same borrower has other comparable loans which are independently guaranteed. The difficulty with using the CUP

method is that publicly available information about a sufficiently similar credit enhancing guarantee is unlikely to be found between unrelated parties given that unrelated party guarantees of bank loans are uncommon.

2) *Yield approach*

This approach quantifies the benefit that the guaranteed party receives from the guarantee in terms of lower interest rates. The method calculates the spread between the interest rate that would have been payable by the borrower without the guarantee and the interest rate payable with the guarantee.

3) *Cost approach*

This method aims to quantify the additional risk borne by the guarantor by estimating the value of the expected loss that the guarantor incurs by providing the guarantee. Alternatively the expected cost could be determined by reference to the capital required to support the risks assumed by the guarantor.

4) *Valuation of expected loss approach*

The valuation of expected loss method would estimate the value of a guarantee on the basis of calculating the probability of default and making adjustments to account for the expected recovery rate in the event of default. This would then be applied to the nominal amount guaranteed to arrive at a cost of providing the guarantee. The guarantee could then be priced based on an expected return on this amount of capital based on commercial pricing models such as the Capital Asset Pricing Model (CAPM).

5) *Capital support method*

The capital support method may be suitable where the difference between the guarantor's and borrower's risk profiles could be addressed by introducing more capital to the borrower's balance sheet. It would be first necessary to determine the credit rating for the borrower without the guarantee (but with implicit support) and then to identify the amount of additional notional capital required to bring the borrower up to the credit rating of the guarantor. The guarantee could then be priced based on an expected return on this amount of capital to the extent that the expected return so used appropriately reflects only the results or consequences of the provision of the guarantee rather than the overall activities of the guarantor-enterprise.

5. *Captive Insurance Companies*

Captive insurance entities are defined as entities whose primary function is to insure risks of entities belonging to the same multinational group. In order to accurately delineate a captive insurance, it is important to determine whether the insurance is genuine, whether a risk exists and whether the risk is allocated to the captive insurance.

Some indicators of genuine insurance are as follows:

- There is diversification and pooling of risk in the captive insurance;
- The economic capital position of the entities within the MNE group has improved as a result of diversification and there is therefore a real economic impact for the MNE group as a whole;

- Both the captive insurance and any reinsurer are regulated entities with broadly similar regulatory regimes and regulators that require evidence of risk assumption and appropriate capital levels;
- The insured risk would otherwise be insurable outside the MNE group;
- The captive insurance has the requisite skills, including investment skills, and experience at its disposal; and
- The captive insurance has a real possibility of suffering losses.

Also, the Guidance discussed two methods as appropriate for pricing intra-group transactions that involve captive insurance and reinsurance premiums: CUPs and actuarial analysis.