OECD releases Discussion Draft on Transfer Pricing Aspects of Financial Transactions

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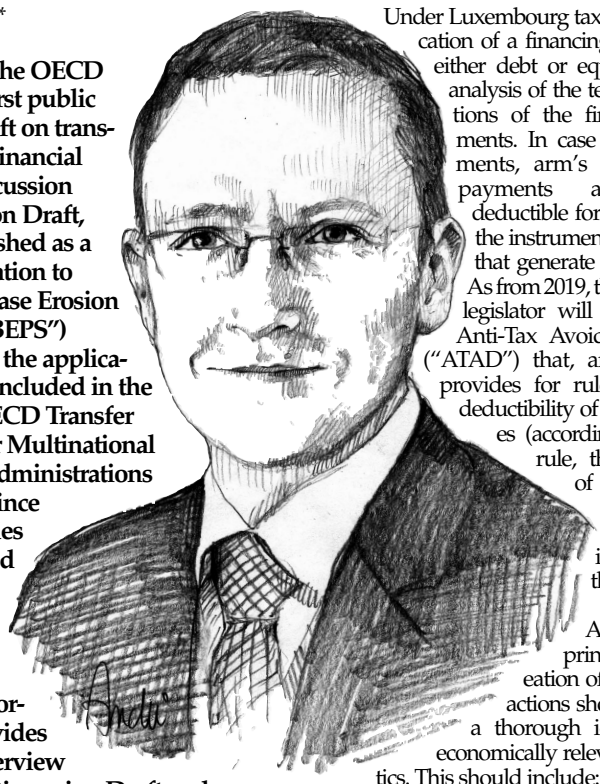

On 3 July 2018, the OECD released the first public discussion draft on transfer pricing aspects of financial transactions (the "Discussion Draft"). The Discussion Draft, which has been published as a follow up work in relation to Actions 8 – 10 of the Base Erosion and Profit Shifting ("BEPS") Project, aims to clarify the application of the principles included in the 2017 version of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the "OECD TPG"). Since Luxembourg companies are frequently involved in financial transactions, the additional guidance provided in the Discussion Draft will be of utmost importance. This article provides a clear and concise overview of the content of the Discussion Draft and analyses the potential impact on Luxembourg companies.

1. Introduction

The 2017 version of the OECD TPG does not include any specific guidance on transfer pricing aspects of financial transactions. As part of the BEPS Project, the OECD initiated work on the most frequent transfer pricing issues in the area of financial transactions. Given that this work stream could not be completed by October 2015, when the final reports on the 15 BEPS Actions have been issued, follow-up work on the transfer pricing aspects of financial transactions has been mandated at that time.

Under this mandate, the Discussion Draft represents the first OECD document on this topic, aiming to clarify the principles included in the OECD TPG as well as specific issues frequently arising in the area of transfer pricing of financial transactions. More precisely, the Discussion Draft covers the accurate delineation of financial transactions and addresses specific issues related to the pricing of financial transactions such as treasury functions, intra-group loans, credit ratings, cash pooling, hedging, guarantees and captive insurance. However, the Discussion Draft does not, at this stage, reflect a consensus position of the governments involved. Instead, it is designed to provide substantive proposals for further review and comments.

The Discussion Draft is divided into four main sections, including:
- Interaction with the guidance provided in section D.1 of the OECD TPG;
- Treasury function (including intra-group transactions such as intra-group loans, cash pooling and hedging);
- Guarantees;
- Captive insurance.

A few recurring themes surface throughout the Discussion Draft, for example, the need to accurately delineate the transaction, the impact of implicit support, the importance of commercial considerations and commercial rationality and the non-recognition of transactions. Moreover, the Discussion Draft contains a number of boxes with questions of the OECD working party to the commentators where specific input of the public is sought on the more complex elements of the different topics. Interested parties were invited by the OECD to submit their comments on the Discussion Draft and to respond to the specific questions by 7 September 2018.

2. Interaction with the general guidance in Section D.1 of Chapter I

The Discussion Draft provides guidance on the application of post-BEPS transfer pricing principles to financial transaction. This includes how to accurately delineate the capital structure (i.e. the mix and types of debt and equity) used to fund an entity within a multinational group. Hence, according to the draft guidance it needs to be tested from a transfer pricing perspective whether the legal form of the funding (in the form of debt) is acceptable from a transfer pricing perspective. The guidance provided in the Discussion Draft may, under certain conditions, result in a reclassification of debt into equity for tax and transfer pricing purposes.

However, it is explicitly stated that the Discussion Draft is not intended to prevent countries from implementing alternative approaches to address the capital structure of companies and related interest deductibility under domestic legislation. Accordingly, Luxembourg should not be obliged to rely on this transfer pricing guidance when it comes to the classification of financing instruments for tax purposes.

Under Luxembourg tax law, the qualification of a financing instrument as either debt or equity follows an analysis of the terms and conditions of the financing instruments. In case of debt instruments, arm's length interest payments are generally deductible for tax purposes if the instrument finances assets that generate taxable income. As from 2019, the Luxembourg legislator will implement the Anti-Tax Avoidance Directive ("ATAD") that, amongst others, provides for rules limiting the deductibility of interest expenses (according to the main rule, the deductibility of exceeding borrowing costs should be limited to 30% of the EBITDA).

As a matter of principle, the delineation of financial transactions should begin with a thorough identification of economically relevant characteristics. This should include:
- An analysis of the contractual terms;
- A functional analysis identifying the functions performed, the assets used and the risks assumed by the parties;
- The characteristics of the financial products or services;
- The wider economic circumstances of the parties and the market; and
- The business strategies of the parties and the wider group.

All in all, the new guidance would add much complexity in each and every transfer pricing analysis relating to financial transactions, requiring a much more detailed functional analysis.

3. Treasury function, intra-group loans, cash pooling and hedging

The Discussion Draft recognizes that treasury functions differ from one multinational group to another, depending on the degree of centralization, autonomy, functionality and the risk profile of the treasury function. Differences further exist in the strategies relating to corporate financial management, including how costs of capital are optimized and how investment returns are managed or maximized. Activities undertaken by the treasury team may, depending on the facts and circumstances, be services that require remuneration from other group companies. The Discussion Draft provides guidance on three particular treasury activities often performed within multinational groups, including (a) intra-group loans, (b) cash pooling and (c) hedging.

Key issues include:
a) The determination of arm's length interest rates on intra-group loans through:
- The consideration of both the lender's and borrower's perspectives, advocating a two-sided perspective rather than a one-sided approach;
- The use of credit ratings to measure creditworthiness and identify potential comparables, including various methodologies for performing credit rating analyses and factors to be taken into account;
- The effects of group membership and any associated implicit support;
- The evaluation of covenants, loan fees and charges;
- The transfer pricing approaches which may be used to determine arm's length interest rates, including internal and external Comparable Uncontrolled Prices (CUPs) and tracing the cost of funds incurred by the original lender in raising the funds to on-lend to related parties;
- The reliance on written opinions from independent banks.

b) Cash pooling enables a group to benefit from more efficient cash management by bringing together the balances on separate bank accounts, be it notionally or physically. Considerations in the Discussion Draft include:
- The appropriate basis upon which to reward the cash pool leader in various circumstances. Here, examples are provided where a cash pool leader (i) merely performs a co-ordination role and, therefore, receives limited remuneration as a service provider or (i) performs additional functions, controls and bears the financial risks contractually allocated to it and has the financial capacity to bear those risks (in case they materialize) which should be remunerated by a more significant reward.
- The Discussion Draft points to three approaches for allocating benefits of cash pooling to the participating members, including:
(i) Enhancing the interest rate for all participants (depositors and borrowers);
(ii) Applying the same interest rates for all participants (in situations where all members have the same or similar credit profile) regardless of whether they are depositors or borrowers;
(iii) Allocating cash pooling benefits to depositors, and not borrowers, within the group (in situations where there is genuine credit risk to the depositors). Notably, these approaches are not necessarily mutually exclusive.
- Cross-guarantees and rights of set-off may be required between participants in the cash pool.

c) Where a treasury function arranges a hedging contract that an operating company enters into, the treasury function can be seen as providing a service to the operating company and should be remunerated at arm's length. There might also be more complex situations where the contract instrument and the risks hedged arise in different entities within the group.

4. Guarantees

The Discussion Draft further provides guidance on how to accurately delineate and price financial guarantees in intra-group financial transactions. Typically, this would involve situations in which a guarantor provides a guarantee on a loan received by another group company. Here, the Discussion Draft distinguishes between explicit guarantees (with the guarantor being legally obliged to pay if the borrower defaults) and implicit guarantees (derived from the borrower's status as a member of the same group without legally binding obligations). The benefit of implicit support generally arises from passive association and not from the provision of a service (as in case of an explicit guarantee) for which a fee would be due at arm's length.

The Discussion Draft further suggests that when the guarantee has the effect to permit the borrower to increase its borrowing capacity, it should be analysed whether a portion of the loan from the external lender is to be considered as a loan from the external lender to the guarantor (e.g. the parent company) followed by an equity contribution from the guarantor to the borrower (i.e. the subsidiary). The effect of this fiction would be that interest expenses charged on the portion of the loan which has been received in view of the guarantee should not be deductible for tax purposes. It is needless to say that if this approach were to be adopted, it could have a material impact on the arm's length guarantee fees and interest expenses incurred by the borrower.

When a guarantee results in a lower interest rate payable to the external lender, five different approaches to pricing the guarantee fee are described:
(i) CUP approach;
(ii) Yield approach;
(iii) Cost approach;
(iv) Valuation of expected loss approach;
(v) Capital support method.

5. Captive insurance

The Discussion Draft further includes guidance on the application of the arm's length principle to captive insurance arrangements. For a number of commercial reasons such as diversification of risk or volatility reduction in inherent material risks, multinational groups may choose to pool certain risks through a group member, a "captive" insurance company. A "captive" insurance company provides insurance services exclusively or mainly to other members of the group. For regulatory reasons, risks are typically ceded by the operating company through a fronting company (usually an insurance broker or agent), which in turn reinsures the risks to the group captive. In this regard, the Discussion Draft considers the complexity of pricing the premium paid to the group captive insurance company given the participation of third parties that are indifferent to the levels of the price for insurance and reinsurance transactions.

The Discussion Draft highlights the frequent concern that a transaction involving a "captive" insurance company is genuinely one of insurance which requires a transfer of risks. Here, the Discussion Draft provides draft guidance regarding the accurate delineation of such transactions and the pricing of premiums.

6. Critical considerations and impact analysis

While it is welcome that the OECD develops specific guidance on TP aspects of financial transactions which is important for any multinational group and cross-border investment, the Discussion Draft also contains a number of guiding principles that may be seen critically.

Some of these principles are already included in the general guidance relating to the application of the arm's length principle and, thus, a mere transposition to the specific guidance for financial transactions. Here, the guidance around the accurate delineation of the transaction may be mentioned, which seems to suggest a suspicion that the contractual form may deviate from the real transaction and the actual conduct of the parties. However, in case of financial transactions, the terms and conditions defined in an agreement should generally be determining the actual transaction and related conduct of the parties involved.

This goes hand in hand with a lowered standard for disregarding a transaction as structured by related parties. The new guidance introduces, in addition, guidance regarding the (re)classification of debt instruments into equity (guidance regarding the capital structure of a company). This introduces a lot of legal uncertainty and entails the risk of double taxation and long-lasting disputes between taxpayers and tax administrations.

When the accurate delineation of the actual transactions shows that a lender lacks the capability to perform (or does not perform) the decision-making functions to control the risk associated with investing in a financial asset, it will be entitled to no more than a risk-free return. Where a lender exercises control over the financial risk associated with the provision of funding, without the assumption of (including the control over) any other specific risk, it could, according to the new guidance, generally only expect a risk-adjusted rate of return on its funding. Hence, for a company to be able to enjoy the interest income for tax purposes, it should perform all relevant functions in relation to the management of the financial assets, assume and manage related risks and have the financial capacity to bear the risk in case it materializes.

The purpose of this guidance is to tackle so-called "cash boxes" without substance, a notion that refers to highly capitalized companies that are commonly resident in low-tax jurisdictions. Under the new guidance, such entities should not be able any longer to enjoy all the income derived from financial assets unless they perform all functions around their financing activity. However, as a matter of principle, the arm's length principle provided under Article 9 of the OECD Model is not an anti-avoidance rule but a bilateral concept that is aimed at the appropriate allocation of profits between source and residence state. By its very nature, it cannot be used to tackle perceived abusive tax practices.

It seems that under the post-BEPS transfer pricing principles, it should not only be tested whether the terms and conditions of intra-group transactions adhere to the arm's length standard. Instead, it is put into question whether a transaction should have been structured as it is or should be reinterpreted for tax purposes. It is at least questionable whether these new principles still advocate results that may be expected between third parties. Analysing the impact of the draft guidance on Luxembourg companies, one may distinguish between Luxembourg companies that are members of multinational groups and those that are involved in Alternative Investments (Private Equity, Real Estate, Infrastructure, etc.).

In an Alternative Investment context, the impact of the new guidance should generally be limited or, at least, manageable. This is because Alternative Investments do not involve many of the more complex financial transactions such as cash pooling, hedging or captive insurance. However, the increased level of complexity that will be induced in each and every transfer pricing analysis will also concern Alternative Investments. In contrast, multinational groups may be more affected by the draft guidance given that Luxembourg companies that are members of those groups may be involved in more complex financial transactions that are dealt with in the Discussion Draft.

7. Conclusion

The Discussion Draft contains the first detailed draft guidance on transfer pricing aspects of financial transactions. Although the Discussion Draft is a non-consensus document, it provides insights into the direction the OECD is heading.

Public comments on the Discussion Draft had to be submitted by 7 September 2018 and will be made publicly available. The public comments are expected to be discussed by the respective OECD working party during November 2018. Based on a public statement of the OECD's Head of the Transfer Pricing Unit, the OECD intends to evaluate and implement the relevant comments by the end of the year with a view to issue a public consensus discussion draft beginning of 2019. The ultimate plan of the OECD is to reach a final agreement at the respective working party level by April 2019.

The new guidance will likely require a much more detailed functional analysis to accurately delineate financial transactions. This may, using the example of intra-group loans, include a detailed analysis of the decision-making processes of the entities involved, along with the functions performed by both the lender and the borrower in evaluating and mitigating the risks inherent to the loan arrangement. Ultimately, Luxembourg companies should carefully analyse the potential impact of the Discussion Draft on existing and new financial transactions with a view to manage potential tax risks. As a tendency, multinational enterprises should consider to add, where appropriate, more treasury functions to their Luxembourg investment platform in order to broaden the functional profile.

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