Tax update

19 July 2018

# The OECD releases the Base Erosion and Profit Shifting (BEPS) public discussion draft on BEPS actions 8-10: Financial Transactions

On 3 July 2018, the OECD launched a consultation on the transfer pricing of financial transactions by publishing the first draft of a new chapter of the OECD Transfer Pricing Guidelines for Tax Administrations and Multinational Enterprises. The consultation comments are invited until the end of the consultation period on 7 September 2018.

This new chapter on financial transactions can help to fill a large gap in the Transfer Pricing Guidelines, which has resulted in high profile disputes in this area having to be settled by courts around the world on the basis of expert evidence on how independent parties approach such transactions. The issues covered by the new chapter are especially relevant to Luxembourg, given its attractiveness to financial institutions and as a location for non-financial companies to place their group treasury centres.

The draft proposes some controversial approaches and whatever form the final guidance takes, it is clear that all businesses with related party financial transactions will need to review how they price them, that the agreements are properly worded, that both parties are able to perform their roles in the transaction and that they actually do so in practice.

The first part of the discussion draft provides guidance on the situations in which loans can be recharacterised as debt, while the second part provides guidance on the pricing of financial transactions such as treasury services, loans, cash pooling, hedging, financial guarantees and captive insurance.

### *Identifying what should be treated as debt for tax purposes*

The draft guidance suggests that debt should be treated as equity (i.e., with no interest tax deduction) if the borrower cannot service the full amount of the debt. It is even suggested that the whole of a loan could be treated as equity even if only a small part of the loan could not be serviced. In addition, the agreement for the funding should have the features of a loan, and it should be operated as a loan (thus, failure to demand an instalment of interest when due could lead to the whole loan being treated as equity).

It should also be asked whether the provider of the funds could have used them more profitably in another investment opportunity and whether the borrower has a business need for the funds.

The guidance also suggests that whether funding should be respected as a loan or not should be influenced by the extent to which the provider of the funds performs the usual functions of a lender, and the extent to which the beneficiary of funding performs borrower functions (but with recognition of the fact that the functions of a lender and a borrower may be undertaken by a central treasury company).

### *Identifying the arm's length interest rate*

It is noted that appropriate interest rates can be identified from similar recent loans to similar borrowers. The guidance also refers to the possibility of building up an interest rate by adding a risk-appropriate "profit margin" to the lender's cost of funds. The guidance notes that interest rates charged between independent parties are usually in addition to loan arrangement or commitment fees, and that this should be taken into account when deciding on related party interest rates when no such fees additional fees are being charged.

When financing is through "back-to-back" loans, it is noted that only agency or intermediary services functions may be being performed and hence a mark-on on the cost of the "agency" function might then be a more appropriate transfer pricing method than an additional interest rate margin.

The guidance suggests (very controversially) that the granting of security over its assets is not necessary for a subsidiary which is borrowing from its parent because the parent already has control and ownership of those assets. It follows that if those assets are not already pledged as security to another lender, any parental loan could be priced as if it were secured (i.e., at a lower interest rate meriting a smaller tax deduction).

In a similar vein, the controversial suggestion is made that it can be assumed that there is a key financial ratio maintenance agreement by every borrower to its related-party lender by reason of the visibility of the borrower's financial information to the lender, even though such an agreement does not exist. (It is not stated, but this would also have the effect of reducing the interest rate).

Another controversial suggestion is that when a borrower's assets are not pledged to a third party, its best option would usually be to seek a secured loan from a related party (which would be at a lower interest rate - the implication would be that a tax deduction would only be allowed for the lower interest rate on almost every related party loan). The exception would be where a borrower needed to keep its collateral available in case it might need a further loan.

A further controversial proposal is that the credit rating of any subsidiary can be assumed to be the same as that of the parent company of the group as a whole.

Another controversial suggestion is that the average interest rate paid by a group on its external debt could be used as the rate for all loans within the group.

### *Centralised treasury services*

The guidance suggests that treasury services are usually “a support service” for which the general guidance on intra-group services can be applied (i.e., often a cost plus reward). However, it is noted that group treasury may sometimes make key decisions with regard to risk management and investments.

### *Cash pooling*

Two hypothetical examples in the guidance illustrate how the reward for a cash pool leader should be determined. In the first example, the leader sets up the arrangement with a bank and has the net balance with the bank. These are not thought to be “bank-like” functions and as such, it is not thought to be appropriate for the leader to earn an interest spread like a bank.

In the second example, the cash pool leader is also the group treasury company and as such it also sets the financial management strategy, manages group liquidity, raises funds for the group and makes related party term loans. It bears credit risk, liquidity risk and currency risk and manages those risks. As a result, it is concluded that it should earn part or all of the spread between the borrowing and lending positions which it adopts.

It is noted that ideally the method of sharing the benefits of pooling between the participants would reflect how much each had contributed to the total interest saving, which could vary according to the source or sources of that interest rate saving (for example, smaller net balances with the bank and/or better interest rates). Three possible methods for sharing these benefits are suggested, which are: to offer a better interest rate to participants with larger balances in the pool, whether they are credit or debit balances: where the participants have similar credit profiles, to use the same interest rate for all participants regardless of whether they are depositors or borrowers: or, where there is a genuine credit risk to the depositors, to only share the benefits of pooling among the depositors.

Where there are cross-guarantees, as between cash pool members, it is suggested that because each party does not know the amount which it will have to guarantee for each of the other participants, no fees should be charged, and even more controversially, that any financial support arising because of the default of another participant should be treated as a capital contribution (i.e. with no tax deduction).

### *Financial guarantees*

It is suggested that only legally binding commitments to pay merit a guarantee fee, and not, for example, letters of comfort. Guarantees are said to have a value even if they are by parties with the same credit rating as the borrower, because they increase the likelihood that a debt can be repaid.

With regard to the pricing of guarantees, four alternative methods are discussed. The first of these is the “yield approach”, which is the difference in interest rates with and without the guarantee: this is the maximum fee which would be paid.

The second method is the “cost approach”, which seeks to cover the guarantor’s loss in the event of default “or” the capital required to support the risks. The third method is the “valuation of expected loss”, while the fourth is the “capital support method”, which is the expected return on the amount of capital which the borrower would have to add to its balance sheet to give it the same credit rating as the guarantor.

It is noted that the arm’s length guarantee fee will be somewhere between the outcome of the yield approach and the cost approach.

### *Captive insurance*

The remainder of the discussion draft is concerned with captive insurance, including some tests to determine whether a captive insurance service really is being provided.

The draft suggests that an actuarial approach may be needed in order to calculate arm’s length premiums, which should be sufficient to cover the expected loss, the administrative costs, and a return on capital (taking into account the investment income earned on the premiums).

### *Next steps*

We can expect the next iteration of this discussion document to provide more detail on the pricing methods taking into account the comments received in the consultation exercise, probably in early 2019.

### *How can we help?*

The partners and your usual contacts at Arendt remain at your disposal to further discuss with you the consultation launched by the OECD on the transfer pricing of financial transactions.

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