On 11 February 2020, the OECD published its final Transfer Pricing Guidance on Financial Transactions, as an amendment to the OECD Transfer Pricing Guidelines.

The most important point being made is that the OECD requires a comprehensive analysis of the commercial and financial relations among the parties involved in the transaction. Furthermore, such an analysis should consider the options realistically available to both the borrower and the lender. In light of the recent guidance provided, it is recommended that taxpayers review and update their existing documentation of financial transactions to ensure it complies with the new guidelines. In absence of such documentation, tax administrations may deny or adjust deductions associated with financial transactions or, in some cases, even requalify the entire transaction.

In the approach proposed in the Guidance, the OECD emphasizes the need for an analytical framework to effectively document financial transactions, especially with regard to the accurate delineation of the transactions. This means that for all financial transactions, a detailed analysis of the commercial and financial relations between parties is necessary—in particular the functions performed, risks assumed, and assets owned. Another important point raised by the OECD is that it considers the actual conduct of the parties to the transaction as the relevant fact, as opposed to the terms of written agreements.

Some of the main items discussed in the documents are presented below:

- **Accurate Delineation of Financial Transactions**
  The taxpayer needs to analyse and document the characteristics of a controlled transaction (e.g., qualification of a transaction as debt rather than equity). This assessment needs to be based on the terms and conditions of the case (i.e., whether there is an obligation to pay interest, a fixed repayment date or the ability of the borrower to actually repay a loan).
The OECD further stresses the need for the identification of the commercial or financial relations and of the economic circumstances (e.g., the strategy of the companies). This requires assessing options realistically available to both parties to the transaction. Another important aspect of the OECD guidance is the consideration of the economic circumstances. This should be done in line with the OECD comparability criteria outlined in chapter 1 of the Guidelines.

- **Treasury Functions**
  The OECD acknowledges that intra-group financing is a complex and important activity making the financing of an MNE as efficient as possible, but the OECD generally qualifies treasury as a support service. However, in cases in which treasury performs more complex functions, the OECD allows for a higher remuneration, depending on the level of risk-taking and strategic decisions being made at the treasury level.

- **Intra-group Loans**
  The new guidance stresses that when assessing intra-group loans, both the perspective of the lender and the borrower need to be considered. In particular this refers to risks taken by both parties. From the perspective of the lender, this requires a credit assessment of the borrower, an assessment of the level of debt to be issued, and the corresponding terms. The OECD also states that granting a security (by the borrower) may be less relevant to the arm’s length remuneration, since the lender already has control and ownership over the subsidiary. From a borrower’s perspective, a borrower will seek the most cost-effective solution, given its business strategy.

- **Credit Ratings**
  With regard to the use of credit ratings, the main point raised by the OECD is that available financial tools may not be sufficient, due to their purely quantitative nature. The OECD acknowledges that public ratings typically have both quantitative and qualitative elements. If synthetic credit ratings tools are used in controlled transactions, the taxpayers would have to demonstrate that their ratings tools and methods are consistent with those used by independent rating agencies.

- **Implicit Support**
  When discussing the effect of group memberships, the OECD Guidance stipulates that the borrowing entity generally should not pay for the implicit support received. However, in a shift from its prior position, the OECD does not assume that a subsidiary is always supported by its group, but that the level of support depends on the nature of the subsidiary. If and to what level an entity receives implicit support depends on aspects such as its strategic importance, its operational integration and significance, reputational impacts (e.g., shared name), and whether the group has a history of supporting subsidiaries, among other factors.

- **Determination of the Arm’s Length Interest Rate**
  The OECD discusses several approaches to determine the arm’s length interest rate and expresses a slight preference for the CUP (comparable uncontrolled price) method, given the availability of data.

The OECD further states that *bank opinions* are not regarded as providing evidence for arm’s length terms, since they do not constitute an actual offer to lend and are thus not representative of conditions of actual transactions.
• **Cash Pooling**
The OECD stipulates that in some cases when no physical transfer of funds occurs, the cash pool leader may generally be considered to perform only minimal functions (if any) and thus is only entitled to a limited remuneration. In cases of physical cash pooling, situations may exist in which the cash pool leader has more functionality, which can lead to a higher remuneration. In order to receive more than a service fee, the cash pool leader needs to have the substance necessary to negotiate with external banks and set the interest rates, and the financial capacity to bear the risks, should they materialise. The OECD, however, does not stipulate how to allocate the cash pooling benefits.

• **Financial Guarantees**
The OECD Guidance discusses several pricing methods for guarantees, such as the CUP, the yield approach, the expected loss approach, and others. The borrower would not pay for a guarantee if it does not expect to obtain a benefit in return. Given the consideration of implicit support, the guarantee might be no more than a formal acknowledgement of the situation already in place due to implicit support. A borrower would not be willing to pay for a guarantee fee in such situations. The OECD acknowledges that it is important to consider the correlation between the guarantor and the borrower business when evaluating the benefit achieved through a guarantee.

• **Captives**
The OECD discusses several methods for related-party insurance premiums and highlights that the critical item is the question on whether a risk exists and, if so, if a transfer of risk to the captive insurer has occurred. The OECD also acknowledges the relevance of Part IV of the report on the Attribution of Profits to Permanent Establishments.

To conclude, the OECD requires a comprehensive analysis of the commercial and financial relations among the parties involved in the transaction and such an analysis should consider the options realistically available to both the borrower and the lender. Therefore, it is recommended that taxpayers review and update their existing documentation of financial transactions to ensure it complies with the new guidelines. In absence of such documentation, tax administrations may deny or adjust deductions associated with financial transactions or, in some cases, even requalify the entire transaction.

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NERA experts can perform detailed reviews of your intercompany financing arrangements to determine if your documentation is compliant with the regulatory guidance. The standard of our independent advice has strengthened our reputation with tax authorities, and we have substantial experience in assisting clients with financing arrangements in the context of both tax controversy proceedings and documenting controlled transactions to manage tax risk.
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