

# OECD on transfer pricing of financial transactions (3/38/18)

One of the last missing pieces of the OECD's BEPS project involves developing transfer pricing guidance on financial transactions. While the OECD had pushed back the publication several times, on 3 July 2018 they released a non-consensus discussion draft that sets out various approaches that may be appropriate for the topics covered, without giving explicit guidance. The public were invited to comment on the draft by 7 September 2018, while the report is to be finalised by April 2019. This article provides a brief summary of the draft.

## Accurate delineation of the transaction

The draft begins by noting that any financing transaction between related parties should be accurately delineated before transfer prices can be applied to it. This means that before using an interest rate, the taxpayer should consider and demonstrate the arm's length nature of the following items:

- *The terms of the transaction.* Would an arm's length loan, for example, have similar duration, be unsecured, use a fixed interest rate, and be denominated in that currency?
- *The volume of the loan.* Could and would the borrower have funded their business in the same way if they were not borrowing from a group company? For instance, would they have used more equity and less debt?
- *The economic context of the transaction.* For example, did the lender have investment opportunities that would have yielded a higher return? At arm's length, would the lender have pursued those, instead of lending to the borrower? Or would the lender have demanded a higher interest rate from the borrower?

The draft also provides guidance on how the five comparability factors noted in the OECD Guidelines tie in with financial transactions. For instance, when considering the business strategies, terms and conditions linked to a merger or acquisition, funding may be different from those of the same business in a steady state.

These OECD observations are very important. Many Latvian multinational enterprise groups, or Latvian entities that are part of such a group, do not have a process in place for assessing the arm's length nature of their terms of business and considering the delineation of transactions. Thus, many groups will need to take action to update their pricing policies and processes.

## Treasury functions

The draft looks at the activities performed by treasury functions on an intragroup basis and the different ways that treasury functions might be organised, i.e. a full-autonomy decentralised treasury versus a group-led centralised treasury. The draft then notes that the treasury strategy may be at least partly determined at group level since the treasury policymaking and strategy might build on group strategy. This might be relevant when delineating the treasury activities and testing where the financial risk management activities are actually performed.

Perhaps most interestingly, the OECD commentary notes that treasury activities should in most instances

be characterised as support services. This might be read as implying that treasury activities should be remunerated on a cost-plus basis or in some other way that results in a relatively low profit margin.

## Guarantees

The draft defines a financial guarantee as a legally binding commitment by the guarantor to assume a specified obligation of the guaranteed debtor if the latter were to default on that obligation. The draft also indicates that anything less than a legally binding commitment would not require the payment of a guarantee fee.

The draft outlines five alternative approaches to pricing guarantees:

- *The comparable uncontrolled price method.* The draft notes that a third-party comparable is unlikely to be found given the comparability requirement of all the relevant factors affecting the guarantee fee.
- *The yield approach.* The draft suggests any interest savings from a guarantee (after excluding the impact of implicit support) as a potential cap, focusing on the benefit provided to the guaranteed party.
- *The cost approach.* The draft suggests that the guarantor's expected costs (i.e. expected loss and capital requirements) may suggest a potential floor, focusing on the risks borne by the guarantor.
- *The valuation of expected loss approach.* This uses data about expected default rates and recovery rates available on the market to assess the potential cost of providing the guarantee, to which an appropriate return is then to be applied, e.g. using the capital asset pricing model.
- *The capital support method.* The draft also discusses evaluating a guarantee by reference to the expected return on the notional capital enhancement it provides.

(to be continued)