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PRACTICAL ASPECTS OF THE NEW OECD TRANSFER PRICING GUIDANCE ON INTRA-GROUP FINANCIAL TRANSACTIONS

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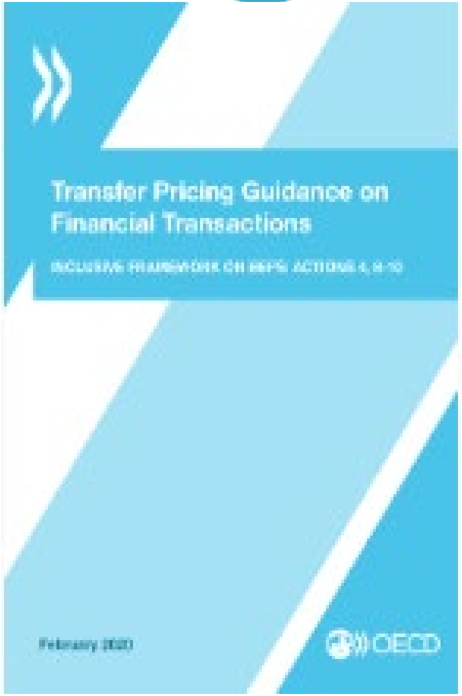
Introduction

- February 2020: New Chapter X of the OECD Guidelines as part of the BEPS outcomes (**FT Report**)

- **Three** key concepts:
  1) Accurate delineation of transactions;
  2) Control over risk; and
  3) Financial capacity.

- TPG tend to “apply” **retroactively** to existing transactions, creating significant exposure to transfer pricing disputes and double taxation



FT Report Overview

FT Report

- **Treasury functions:**
  (1) Intra-group loans; (2) Cash pooling; and
  (3) Hedging.
- **Financial guarantees**
- **Captive insurance**
- **Risk-free and risk-adjusted rates of return**

Purpose of the FT Report

Loans	➢ Cash rich companies with lack of substance ➢ Unusual contractual terms leading to high interest rates
Cash pools	➢ High returns to cash pool leaders but little activity ➢ Participants leaving balances in the pool long term
Treasury centres	➢ Interest income in treasury centres with limited substance
Captives	➢ Typically used to shift profits to low or no tax jurisdictions, but not truly insurers
Guarantees	➢ High guarantee fees and enhancement of debt quantum

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Interaction with other anti-avoidance rules

- FT Report states that "*this guidance is not intended to prevent countries from implementing approaches to address the balance of debt and equity funding of an entity and interest deductibility under domestic legislation*" (see FT Report paragraph 10.9.)

- Consequently, other approaches may be applicable such as:
  - Earning stripping rules (OECD via BEPS Action 4 or ATAD Article 4);
  - Thin capitalisation rules;
  - Domestic – General Anti-Avoidance Rule (GAAR); and
  - Tax Treaty – Beneficial owner & Principal Purpose Test.

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Tax authorities can either *not recognise* or *re-characterise* an intra-group loan.

- In case the transaction is found to be **commercially irrational** then the foreign tax authorities may **disregard** the transaction and therefore **disallow the interest expense**. (10.08)

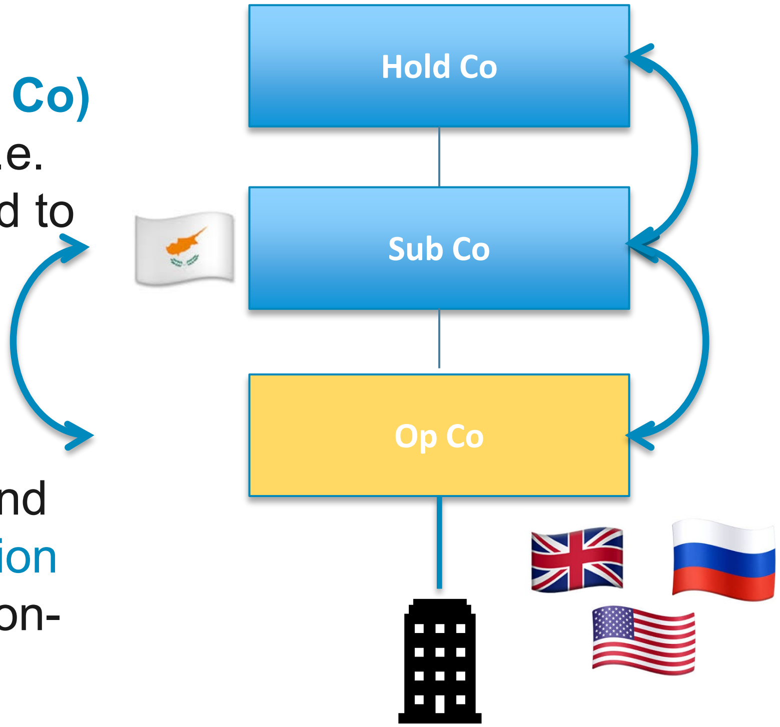
- The same result would be achieved in case the foreign tax authorities decide to **re-characterise** the transaction/payments thereunder, normally from **interest to dividends**.

- The generally **lower tax treaty rate** for interest income (i.e. Article 11 of the OECD Model) **would not apply**, and therefore the source country will have an unlimited taxing right to apply its domestic withholding tax rate imposed on interest paid to non-residents.

Back-to-back arrangements: Two Lines of Defense

Source country (Op Co) can tax the income (i.e. interest expense) paid to non-residents in two ways:

1) Impose a WHT; and
2) Denying a deduction for payments to non-residents



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Practical Steps

- To avoid such unwanted implications, an intra-group loan needs to be analysed from both perspectives (i.e. lender and borrower, 10.51.) and effectively, answer the following **two questions**:

  - ***Could*** the borrowing entity as an independent enterprise obtain access to similar level of debt from third-party lender such as a bank?
  - ***Would*** the borrowing entity be willing to obtain such a loan under such terms and conditions from a third-party lender?

Intra-group loans: Building Blocks

Accurate Delineation of the transaction

- Interaction with Chapter I of TPG
- Article 9 OECD Model

Credit Rating

- Creditworthiness of the borrower.
- Consider implicit support (Group rate? or Standalone rating).

Arms length Loan Terms and Conditions

- Analysis from both perspectives (i.e. lender and borrower)

Interest rates

- CUP Method is preferred
- Alternatives methods also available (e.g. COF or CDS)
- Bankability opinions not acceptable

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Arm's Length Terms and Conditions

- Key terms and conditions of the loans to be examined (10.12.)

Characteristics of the Loan	
Amount	Covenants
Interest rate	Currency
Start date	Guarantees
Maturity date	Interest payment frequency
Type of loan	Payment Options (on demand)
Purpose	Security/Collateral
Conversion	Seniority/Payment rank

Analysis from both perspectives (i.e. lender and borrower

Lender

- Options realistically available
- Decision to enter into a loan
- Lending terms and How much to lend
- Collateral
- Risk monitoring
- Risk assessment (credit risk / economic circumstances)

Borrower

- Options realistically available
- Economic conditions and circumstances
- Capital structure and Optimize WACC
- Right funding mix
- Collateral
- Rating impact

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Alternatives methods also available

- Loan fees and charges (10.96.)
- Credit default swaps (10.101.)
- Cost of funds (10.97.)
- Economic modelling (10.105.)
- Bank opinions (10.107.)

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Two types of Financing entities

Types of Financing entities

<u>(1) Handling fee</u>

Treasury departments/entities operate as a **<u>service</u>** centres

- Does not assume (hence does **not control**) risks of capital

<u>(2) Financing entity</u>

Treasury departments/entities operate as a **<u>profit</u>** centres

- Assume and control risks
- Financial capacity

Comparable to a real in-house financial institution

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THANK YOU!

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Christos specialises in private clients and corporate tax issues (including transfer pricing) with an international dimension, such as private equity structuring, cross-border investments, structured finance, IP structuring and international trade. Christos is a contributor to international tax publications such as IBFD, Tax Notes International, Bloomberg BNA, International Tax Review and IFA as a national reporter

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