New OECD guidance on transfer pricing guidelines for financial transaction (FTG)

This commentary follows the features published on 2 & 9 October and considers what the FTG has to say regarding financial guarantees, cash pooling and hedging.

Financial Guarantees

The accurate delineation of financial guarantees requires consideration of the economic benefit arising to the borrower beyond the one that derives from passive group association. Potential benefits are to enhance the terms of the borrowing (e.g. by reducing the cost of the debt-funding) or increasing the borrower's debt capacity.

The decision-making process

The decision-making process before putting in place an intra-group guarantee will be scrutinised for evidence of consideration of the following questions:

- What is the overall economic benefit for the borrower as result of the guarantee?
- Can it be identified upfront what terms of the borrowing are (positively) affected by the guarantee?
- Does paying for the guarantee really put the debtor in a better position than not having a guarantee, when comparing the cost of borrowing with and without the guarantee?
- Would an unrelated party have paid for a guarantee?
- Would the guaranteed party have obtained benefit from being part of the MNE anyway?

The financial guarantee

The form of the financial guarantee is also considered to have relevance:

- An explicit guarantee exposes the guarantor to additional risk and creates a legal commitment to pay.
- A letter of comfort or lesser form of credit support involves no explicit assumption of risk.
- Without any explicit guarantee, expectations that other MNE group members will provide support will generally be deemed derived from passive association, and will constitute implicit support.
- Are there any cross guarantees put in place?

As regards the assertion that there is a guarantee in place, the following aspects will be scrutinised:

- Is there a formal written guarantee or only implied support attributable solely to membership of the MNE group?
- Is the guarantee made in the form of a legally binding commitment?
- Is the obligation assumed by the guarantor specified and is it specified when the guarantor's obligation to perform commences?
- Does the guarantee provide actual benefit, considering the financing agreement as a whole?
- What is the financial capacity of the guarantor?
- What credit rating is applied for the guarantor and for the borrower?
- What asset pool can the guarantor draw from?
- Is there a high level of correlation between the guarantor's and the borrower's exposure to market conditions?

The price of the guarantee

There is a Canadian tax case, the GE Capital case, which considers in detail how to price financial guarantees and anyone with interest in this topic is encouraged to read it. In contrast, the FTG has a section on questions to disallow a guarantee fee and sets out where the focus would be as follows:

- If a lender assumes that the MNE group will provide support to an associated enterprise in respect of its borrowings by virtue of that borrower being a member of the MNE group, yet without any legally enforceable contractual obligation, that assumption is based on passive association of the borrower and there is no real service provided by any MNE group member to the borrower for which a fee would be due.
- If a debtor has no debt capacity at all and would not have been able to borrow in the market on a stand-alone basis absent the financial guarantee, the guarantor may be performing a function in its own self-interest by not justifying a guarantee fee.
- If a financial guarantee is put in place per the request of the creditor to avoid that the parent company diverts the funds (for moral hazard reasons), similarly the guarantee may not merit a guarantee fee.
- If the parent company provides a guarantee under circumstances as a result of which it essentially should be considered the borrower (which subsequently makes an equity contribution to the deemed borrower), no guarantee fee would apply.
- How was the guarantee fee determined and has this been documented?

Perhaps interestingly, HMRC's guidance on guarantee fees was updated a day before the issue of the new FTG. Its approach is that at arm's length, a company would not take on the extra cost of a guarantee unless that guarantee makes the overall cost of finance cheaper than it would be on a stand-alone basis. If the cost of the guarantee itself is greater than the saving it brings, it will be disallowed to the extent that it causes the total finance costs relating to the guaranteed debt to exceed the stand-alone arm's length price. HMRC's approach appears to be consistent with the FTG.

Cash pooling

There are two basic approaches to cash pooling arrangements;

- **Physical pooling:** Bank account balances of all pool members are transferred daily to a single central bank account owned by cash pool leader. Any deficit is brought to balance by a transfer from the master account.
- **Notional pooling:** No physical transfer of balances between participating members' accounts. The bank notionally aggregates the various balances of participating members' accounts and pays or charges interest on the net balance.

There is generally a group synergy benefit which needs to be priced and an appropriate reward is also often required to the cash pool leader. There is a Norwegian case which covers this topic involving ConocoPhillips.

Hedging

Interestingly, whilst cash pooling receives forty paragraphs, the more difficult topic of hedging receives just five. The only definitive comment is that a centralised function arranging hedging can be seen as providing a service to the operating entity and needs to be priced.

Whilst it is recognised that more difficult transfer pricing issues may arise if the contract instrument is entered into by the treasury entity or another group entity, with the result that the positions are not matched within the same entity, no specific transfer pricing guidance is given.

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