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

This commentary follows the feature published on 2 October and considers some further aspects of the new FTG, Section C including treasury function, credit ratings and group membership.

Intra-group loans

General considerations

Both the lender's and the borrower's perspectives should be taken into account. Taxpayers will need to substantiate the considerations made before determining the quantum of the intra-group loan and interest rate applied; this includes the decision-making process before putting in place an intra-group loan which is likely to be scrutinised for evidence of consideration of, inter alia:

- The business reason for and business strategy behind the decision for obtaining the loan;
- The availability of financial resources in the relevant industry and for the borrower;
- The amount and type of financing required in the mne's business and that of the borrower;
- The capital intensity level in the mne's business and the industry;
- The typical level of short-term cash balance in the mne's business and industry due to commercial needs;
- The options realistically available to both the borrower and creditor with respect to the intended funding;
- Whether there were alternative and more attractive opportunities to meet the stated commercial objectives;
- Cost of capital management or optimisation strategies within the mne group;
- Whether a thorough assessment has been made of the borrower's creditworthiness; and
- What the source of repayment of the loan will be and whether the borrower's cash flow forecast was considered.

The choice for the type of loan (e.g. long-term, short-term, revolving) to be put in place will most likely be compared to the following aspects:

- The purpose of the loan;
- The mne group's external financing policy and common practices;
- How the mne group prioritises funding needs among different projects;
- The strategic significance of the borrower within the mne group;
- Whether the mne group typically targets a specific credit rating or debt-equity ratio; and
- How the funding strategy adopted with respect to this loan compares to that observed in the industry in question.

As regards the actual contract underlying the funding instrument, it is expected that there is evidence that the following questions have been considered:

- Who carries the risk of the funding provided?
- What is the currency of the loan?
- What covenants are captured in the loan instrument, if any?
- What collateral is made available to secure the loan?
- Is there a risk that the credit rating of the borrower will change due to economic circumstances?
- Are any guarantees made available and by which entity?
- Are interest and loan repayment terms clearly included and what are the consequences of interest payments or loan repayments not being made in a timely manner?
- What is the seniority of the loan?
- What are the renegotiation terms?

In addition, tax authorities are likely to review whether the actual conduct of the borrower and creditor is consistent with the contractual terms underlying the loan.

Credit ratings

It is useful to recap a couple of well-known points:

- A credit rating is an opinion about the general creditworthiness of a MNE or MNE group. Where a MNE has a credit rating, that rating may be useful for purposes of an arm's length analysis.
- A debt issuance rating considers specific features of a financial instrument, such as guarantees, securities and level of seniority. The credit rating of a MNE may differ from the credit rating of a particular debt issuance. If there is comparability between the third-party debt issuance and the controlled transaction, the issue rating would be more appropriate to price the controlled financial transaction.

Effect of group membership

Implicit support is the incidental benefit which a MNE is assumed to receive solely by virtue of group affiliation. The effect of implicit group support on the credit rating of an entity and any effect on that entity's ability to borrow or the interest rate paid on those borrowings does not require any payment or comparability adjustment. These considerations were dealt with at some length in the GE Capital Case. Furthermore, the FTG also appear to reflect elements of the Australian Chevron Case and this will be discussed further in our fourth article.

Determining the arm's length rate

The arm's length interest rate can be benchmarked against publicly available data for other borrowers with the same credit rating for loans with sufficiently similar terms and conditions or, perhaps, internal comparable uncontrolled prices ("CUPs"). In addition, the return on realistic alternative transactions (e.g. uncontrolled loans) can be considered. Also, potential comparable loans within the borrower's or its MNE group's financing with an independent lender as counterparty may be available but require appropriate adjustments.

Loan characteristics that are likely to have an impact on lender risk and thus on interest rates are:

Increased risk/increased interest rate:

- Long maturity date;
- Absence of security;
- Subordination;
- Loan for a risky project.

Reduced risk/lower interest rate:

- Strong collateral;
- High quality guarantee;
- Restrictions on borrower.

Treasury function

Very briefly, key functions of a Corporate Treasury are listed as:

- Optimise liquidity across the MNE group;
- Optimise the cost of capital;
- Raise debt (e.g. through bond issuances) and equity; and
- Manage the relationship with external banks and independent credit agencies.

The FTG takes the position that the Treasury function is often a support function to the main value-creating functions of an MNE group and a commensurate return is required.

As indicated in the previous feature and demonstrated above, the FTG go much further than any previous OECD guidance with respect to the requirements of considering the arm's length nature of intra-group financing arrangements and may leave MNE's with some work to do.

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