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

Introduction

New transfer pricing rules on financial transactions were released on 11 February 2020 by the OECD. Traditionally, the OECD's Transfer Pricing Guidelines have been consensus-based guidance – something that is obviously good for business. The new guidance, though, appears to give opportunity for divergent opinions and approaches, which may lead to potential double taxation and thus more need for invoking the mutual agreement procedure (MAP) in double taxation treaties.

The guidance clarifies the process of accurate delineation for financial transactions. This is likely to have a significant impact on the practice of pricing financial transactions. The process set out is both far more detailed and far broader than previously.

Sections A-E of the new Guidance are added as new Chapter X to the OECD Transfer Pricing Guidelines. Section F is added in Chapter 1 Section D.1.2.1 following paragraph 1.106.

The material covered is wide ranging and so to do it justice, this is the first of a four-article series by FTI Consulting's transfer pricing team. In the first three articles we aim to share a high-level summary of the key technical areas outlined in the new guidance. In the fourth article we will share our thoughts and observations. This article will focus on section B whilst bringing in aspects of C and D as necessary.

B.1 When should a purported loan be regarded as a loan?

Where the borrowing entity is part of a Multinational Entity ("MNE") group, the balance of debt and equity funding may differ from the balance of an independent entity operating under the same or similar circumstances. In this context, the question arises as to whether a loan made by a lending entity which is part of the same MNE group can be regarded as loan or should be regarded as a contribution of equity capital.

A straightforward example given in the FTG demonstrates the point:

- Company B needs funding for business requirements. Company C provides a substantial loan with a term of 10 years. Both are within the same corporate group.
- Financial projections indicate that Company B would be unable to service a loan of such amount.
- An unrelated party (e.g. a bank) would not be willing to provide such loan to Company B due to Company B's inability to service and ultimately repay the loan.

Would this arrangement likely be acceptable for transfer pricing purposes?

This arrangement is unlikely to be acceptable. The acceptable amount of the loan for transfer pricing purposes would consider both the lender's and the borrower's perspectives. Factors include:

- The maximum amount that an unrelated lender would have been willing to advance to Company B.
- The maximum amount that an unrelated borrower would have been willing to borrow from Company C.
- The remainder of Company C's advance would not be considered to be a loan for the purposes of determining the amount of interest which Company B would have paid at arm's length.

There is perhaps a potentially unhelpful comment in this chapter at paragraph 10.9 of the FTG. This states:

> *"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, nor does it seek to mandate accurate delineation under Chapter 1 as the only approach for determining whether purported debt should be respected as debt."*
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> (Chapter B.1 para 10.9)

This wording seems to allow for divergence between countries and thus the risk of double taxation in case of transfer pricing adjustments. Comment from HMRC is awaited as to how this might affect the number and negotiation of MAP cases.

B.2 and B. 3 Commercial / financial relations and economically relevant characteristics

The FTG explains the process of accurate delineation for financial transactions. This new guidance may have significant impact on the practice of pricing financial transactions as traditionally applied.

The FTG provides that a comparability analysis is at the heart of the application of the arm's length principle. This assumes that a comparison takes place between the conditions in a controlled transaction and the conditions that would have been present had the parties been independent and undertaking a comparable transaction under comparable circumstances.

There are two aspects to this assumption:

- First is the process of identification of commercial or financial relations between associated enterprises and the conditions and economically relevant circumstances attaching to those relations ; and,
- Second is comparing the conditions and economically relevant circumstances of the controlled transaction with those of comparable transactions between independent enterprises.

The new guidance emphasises the attention with which intra-group transactions ought to be delineated before they can be compared with third party transactions.

In an analysis to determine an arm's length interest rate, in addition to considering usual criteria (e.g. the stand-alone credit rating of the borrower, the seniority of the loan instrument, subordination and security) the new guidance on accurate delineation indicates that several additional aspects will need to be considered, with documentation to show that they were considered, at the time the loan was put in place.

The financial transaction must be accurately delineated based on an analysis of the contractual terms, functions, risks and assets analysis, characteristics of financial instruments, economic circumstances and business strategies.

Furthermore, just as unrelated parties would have covenants or other financial measures in their contracts, perhaps it is now time for such terms to be considered in the context of intragroup agreements.

Conclusion

What will have been seen from this and the three articles to follow is that the accurate delineation process required for financial transactions has been clarified and is far more intricate and detailed than may have been considered so far. This may leave many taxpayers exposed to what has gone before and so reviews of existing methodologies and documentation could be in order.

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