New OECD Guidance on Financial Transactions

March 19, 2020

What You Need to Know to Assess Impact on Your Company

Duff & Phelps

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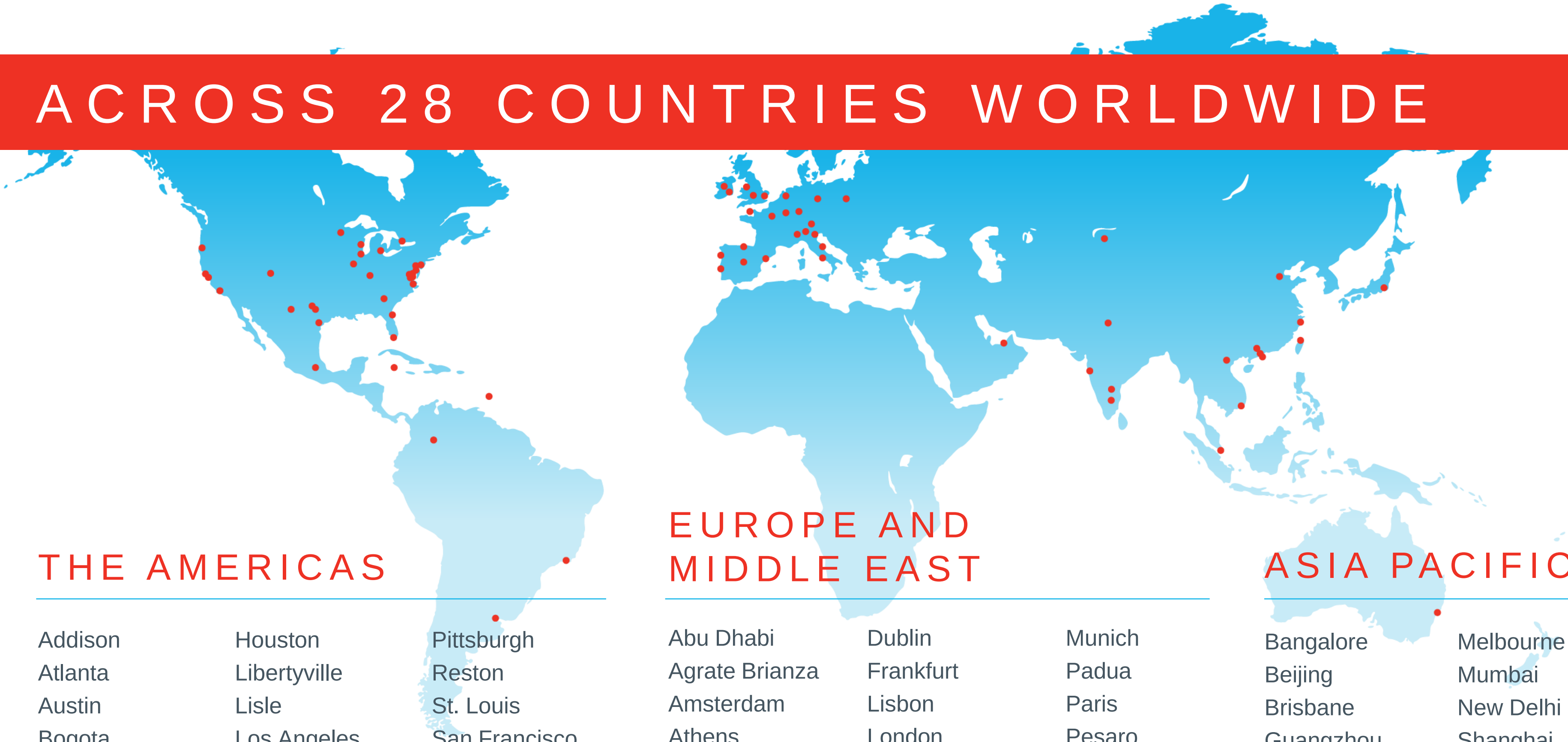

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Presenters

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The OECD’s Work to Fill Guidance Vacuum on Intercompany Financing

- BEPS Actions 4 and 8-10 mandated follow-up work on the transfer pricing aspects of financial transactions
- Discussion Draft on financial transactions issued as a non-consensus document in July 2018
- 75+ businesses/organizations/firms provided 900+ pages of commentary
- Final Guidance published in February 2020
- The first time specific guidance on financial transactions will be included in the OECD Guidelines (Chapter I and Chapter X)

Content Overview of the Final Guidance

Contents of the Final Guidance		
Section B Chapter X	Accurate Delineation	Interaction with the guidance provided in Section D.1 of Chapter I of the OECD Transfer Pricing Guidelines
Sections C – E Chapter X	Specific issues related to the pricing of financial transactions	• Treasury functions • Intra-group loans • Cash pooling • Hedging • Guarantees • Captive insurance
Section F Chapter I	Risk-free rate of return and risk-adjusted rate of return	

Functional Analyses for Financial Transactions

Functional Analysis

Functional Analysis as a Necessary Step in Accurately Delineating a Financial Transaction

- Any intra-group loan pricing approach should be based on a functional analysis.

- The functional analysis of a cash pooling arrangement should determine the nature of its advantages or disadvantages, the amount of the benefit or detriment it provides, and how that benefit or detriment should be divided among members of the MNE group.

- A functional analysis is necessary to determine if a guarantee, in fact, is a guarantee. If not, other pricing approaches should be considered, in particular those applicable to intragroup services.

The Final Guidance makes emphasis on the Lender, Borrower and Treasury roles.

Functional Analysis

Key Functions

Lenders	Borrowers	Treasury
• Evaluating the risks and the capability to commit capital • Determining the terms • Organizing and documenting • Ongoing monitoring and periodic review	• Ensuring the availability of funds to repay • Providing collateral, if needed • Monitoring and fulfilling other obligations	• Pricing of financial transactions • Identification and allocation of significant risks • Usually, a support service • Do not rely on general description *"treasury activities"*

If the lender does not control the risks or does not have the financial capacity to assume it, such risks should be allocated to the enterprise exercising control and having the financial capacity to assume the risk.

<u>A lender may only be entitled to no more than a risk-free return.</u>

Functional Analysis

Example 2 from the Final Guidance

Company T performs as the MNE group treasury

- T provides treasury services to the other entities within the MNE group, including strategy and management of group liquidity.
- T issues bonds and borrows from third party banks and arranges intra-group loans.
- T operates the MNEs cash pooling arrangement.
- T sets the intra-group interest rates and is at risk for differences between those rates, and the rates agreed with the independent lenders.
- T also bears credit risk, liquidity risk, and currency risk for intra-group finance and decides on how or whether to hedge such risks.
- T controls the financial risks contractually allocated to it and has the financial capacity to bear those risks.

In this example, T's compensation may include earning part or all of the spread between the borrowing and lending positions it adopts. Other group members transacting with T would do so only if this left them no worse off than their next best option.

OECD Guidance Now Covers Accurate Delineation of Financial Transactions

Accurate Delineation of Financial Transactions

- **Section B provides guidance on accurate delineation of financial transactions.**

- **Debt vs. equity characterization is discussed at length:**

  "Although countries may have different views on the application of Article 9 to determine the balance of debt and equity funding of an entity within an MNE group, the purpose of this section is to provide guidance for countries that use the accurate delineation under Chapter I to determine whether a purported loan should be regarded as a loan for tax purposes (or should be regarded as some other kind of payment, in particular a contribution to equity capital)."
  - (OECD Guidance, Para. 10.10)

- **Also within scope is recharacterizing a financing transaction as another type of financing transaction:**
  - How would a transaction have been structured at arm's-length?
  - Does behavior in practice match contractual terms?

Debt Characterization Framework

The following passages within Section B are helpful to understanding the general framework Section B seeks to apply:

- *"In common with the analysis of any other transaction between associated enterprises, in applying the arm's length principle to a financial transaction it is necessary to consider the conditions that independent parties would have agreed to in comparable circumstances."* (Para 10.18)

- *"Independent enterprises, when considering whether to enter into a particular financial transaction, will consider all other options realistically available to them, and will only enter into the transaction if they see no alternative that offers a clearly more attractive opportunity to meet their commercial objectives…In considering the options realistically available, the perspective of each of the parties to the transaction must be considered."* (Para 10.19)

- *"Particular labels or descriptions assigned to financial transactions do not constrain the transfer pricing analysis." (Para 10.11)*

- *"…the contractual arrangements may not always provide information in sufficient detail or may be inconsistent with the actual conduct of the parties or other facts and circumstances. It is therefore necessary to look to other documents, the actual conduct of the parties – notwithstanding that such consideration may ultimately result in the conclusion that the contractual form and actual conduct are in alignment – and the economic principles that generally govern relationships between independent enterprises in comparable circumstances…"* (Para 10.22)

Debt Characterization Considerations

CONSIDERATION	HOW TO ADDRESS
Loan Characteristics	▪ Debt-like characteristics (interest, maturity date, enforceability). ▪ Robust and legally binding loan agreement. ▪ Documentation makes reference to these characteristics. ▪ Documentation explains why loan was structured the way it is (e.g., financing strategy, business needs).
Ability to Bear Debt	▪ Credit rating analysis. ▪ Leverage and coverage ratio analysis (compared to comparable borrowers). ▪ Repayment analysis.
Reasonable Alternatives	▪ Documentation (e.g., functional analysis) describes lender/borrower objectives, steps taken to evaluate goals and related considerations, and why subject loan is the best option for both borrower and lender.
Ongoing Behavior	▪ Loan agreement needs to actually be followed – interest payments made, covenants (if any) followed etc.

Applications Across Tax Jurisdictions

The OECD leaves room for individual countries to set their own policies on the deductibility of interest:

"Although this guidance reflects an approach of accurate delineation of the actual transaction in accordance with Chapter I to determine the amount of debt to be priced, it is acknowledged that other approaches may be taken to address the issue of the balance of debt and equity funding of an entity under domestic legislation before pricing the interest on the debt so determined. These approaches may include a multi-factor analysis of the characteristics of the instrument and the issuer.

Accordingly, 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 I as the only approach for determining whether purported debt should be respected as debt. "

(OECD Guidance, Para. 10.8 – 10.9)

Comparison to U.S. Common Law

- Within the U.S., debt characterization is not codified as part of transfer pricing rules but is subject to guidelines introduced in Common Law.
- U.S. court opinions introduce lists of factors to be used for debt/equity questions.

List of factors given in Estate of Mixon v. United States, 464 F.2d 394 (5th Cir. 1972):

The names given to the certificates evidencing the indebtedness; **the presence or absence of a fixed maturity date**; **the source of payments**; **the right to enforce payment of principal and interest**; participation in management flowing as a result; **the status of the contribution in relation to regular corporate creditors**; the intent of the parties; "thin" or adequate capitalization; identity of interest between creditor and stockholder; **source of interest payments; the ability of the corporation to obtain loans from outside lending institutions; the extent to which the advance was used to acquire capital assets**; and **the failure of the debtor to repay on the due date or to seek a postponement**.

List of factors given in Final Guidance, Para 10.12:

The presence or absence of a fixed repayment date; the obligation to pay interest; **the right to enforce payment of principal and interest; the status of the funder in comparison to regular corporate creditors**; the existence of financial covenants and security; **the source of interest payments; the ability of the recipient of the funds to obtain loans from unrelated lending institutions; the extent to which the advance is used to acquire capital assets; and the failure of the purported debtor to repay on the due date or to seek a postponement**.

- Significant overlap in both factors and intent may mean low risk of tax authority dispute.

Pricing and Consideration for Implicit Support

Pricing of Intra-group Loans and Guarantees

Use of credit ratings	• Credit rating tools (black box) vs. rating model • Quantitative and qualitative factors
Effect of group membership	• Presence of the group should not be ignored • Impact of passive association depends on the strategic importance of the entity
Covenants	• May be assumed, although they may not be explicitly mentioned in the loan agreement
Arm's length interest rate	• CUPs • Cost of funds • Bank Opinions • CDS • Economic Modelling
Guarantees	• Evaluating similar to an original borrower • Needs to be able to bear the risk (financial capacity) • Consider implicit support

Implicit Support

Impacts on Loans

The Final Guidance states that implicit support from the multinational group **"may affect" the credit rating of a borrower**, but that the extent of the impact will depend on factors such as the **importance of the entity to the multinational group** and the strength of the link between the borrowing entity and the overall multinational.

- The OECD **opted against a rebuttable presumption** of implicit support (such as those proposed in the Draft Guidance) and takes a less prescriptive stance in the Final Guidance.
- The Final Guidance will **increase documentation needs around implicit support**, particularly with the *factors* mentioned above.
- Taxpayers should make a **case-by-case determination** of the role of implicit support based on relevant facts and circumstances.

Highlights from Guidance on Guarantee Fees

The Final Guidance states that the accurate delineation of financial guarantees requires initial consideration to the **consequences, nature and extent of the obligations guaranteed for all parties.** In particular, the Final Guidance highlights the following:

Economic Benefit

- Enhancement of the terms of the borrowing
- Access to a larger amount of borrowing

Effect of Group Membership

- Facts and Circumstances
- Level of benefit attributable to the guarantee

Financial Capacity

- Substance of the guarantor's asset pool
- Stress testing the guarantor's capacity

Method of Pricing

- CUP Method
- Yield Approach
- Cost Approach
- Valuation of Expected Loss
- Capital Support Method

Risk Control Frameworks
(Including Applications to Cash Pools)

Risk Control Framework

Functional Analyses Observation on Risk Control Function	Consequence
• If a lender / guarantor: – Does not exercise the control functions related to the advance of funds – Does not have the financial capacity to assume such risks	• Lender / guarantor is only entitled to: – Risk-free return

- Ignores that this is observable in third party arrangements
- Consequences could be dramatic for many existing arrangements
- Increased documentation requirements on risk control functions
- Has also significant implications for cash pools

Highlights from the Final Guidance on Cash Pooling

The focus of the Final Guidance revolves around the **accurate delineation of cash pool transactions.**

Functional Analyses	• Functions, assets and risk • Nature and treatment of synergies • Cash pool transaction vs. loan transaction
Rewarding the cash pool leader	• In general a "co-ordination function" • Other activities based on accurate delineation od the actual transaction
Rewarding the cash pool members	• Does not provide a prescriptive approach • All members should be better off
Guarantees	• Cross-guarantees may be required • Members stand alone credit ratings may differ • Formal guarantee may represent implicit support

Key Takeaways

- Increased scrutiny on intercompany financing is causing many taxpayers to rethink their policies for managing risks.
- The Final Guidance from the OECD gives taxpayers a framework with which to assess their positions and amend their approaches. Consider:
  - Loan inventory and risk assessment models
  - Standardized loan agreements and checklists
  - Tiered documentation strategies
  - Augmenting documentation for material transactions
  - Changes to current best practices
- The OECD Guidelines are just that – guidelines.
- It is still too soon to know how OECD Countries (and others) will interpret this, but it is not too soon be proactive in assessing and mitigating exposures.

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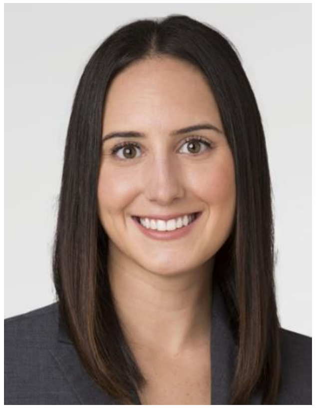

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As a leader in Duff & Phelps' New York Transfer Pricing Practice, Stefanie provides global transfer pricing advice to organizations that range from Fortune 500 companies to start-up businesses. Specifically, she has over eight years of experience assisting these clients with all aspects of transfer pricing from planning, documentation, and implementation to controversy and advanced pricing agreements.

Stefanie is also a thought leader on Duff & Phelps' Financial Services Transfer Pricing team, spending a significant amount of time focused on transfer pricing strategy for financial services clients as well as establishing best practices for assessing intercompany debt and other intercompany financing arrangements for clients across a wide spectrum of industries. Stefanie also has significant experience providing transfer pricing valuation services associated with cost sharing arrangements and intangible transfers to clients primarily in the pharmaceutical and medical device space.

Early in her career, Stefanie co-lead two high-profile litigation engagements on behalf of taxpayers under audit by the IRS. Stefanie began her career in transfer pricing at NERA Economic Consulting, and prior to joining Duff & Phelps, was an Associate Director for Ceteris.

Stefanie received a B.S. degree (summa cum laude) in International Affairs with a concentration in Finance and a M.A. degree in International Economic Relations from American University. Stefanie has co-authored a number of articles for publications, such as Bloomberg BNA and Thomson Reuter's Practical International Tax Strategies, and is an award winning speaker that has also presented on transfer pricing topics at international conferences.

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Fabian Alfonso is a managing director in the Transfer Pricing practice, based in the Miami office. He leverages more than 17 years of experience in implementing, documenting and defending cross-border transactions for multinational companies.

Prior to joining Duff & Phelps, Fabian served as a partner at BaseFirma, a member of Duff & Phelps' Transfer Pricing Alliance. Fabian has been involved in numerous transfer pricing projects for companies operating in various industries, including private banking, transportation and logistics, insurance, energy, personal goods and telecommunications. He specializes in managing multi-country transfer pricing projects for multinationals throughout the Americas.

Fabian is a frequent speaker at international transfer pricing seminars and a contributor to international tax publications, such as *International Tax Review-UK* and the Bureau of National Affairs of Washington. In addition, he was recognized as Americas Transfer Pricing Adviser of the Year at *Finance Monthly*'s Global Awards in 2017.Fabian has a degree in business administration with an emphasis in finance from Universidad de los Andes in Bogota and a graduate degree in international tax law from Universidad Externado de Colombia. He is fluent in Spanish and English.

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Kerim Keser is a managing director in the Munich Office and leads Duff & Phelps' German, Swiss and Austrian Transfer Pricing activities, leveraging 15 years of transfer pricing experience in consulting firms and at the Australian Taxation Office (ATO).

Kerim has extensive experience advising or auditing companies of all industries, including automotive, consumer products, pharmaceuticals, technology and financial services. Kerim has a results-driven approach, developing transfer pricing solutions for companies considering their size, complexity and industry's best practices. He is always aiming at practical solutions that are easy to implement.

Before joining Duff & Phelps, Kerim worked as an executive director for Ernst & Young in Munich, where he advised companies on transfer pricing issues associated with setting up new business units, decentralizing key functions, entering new markets and post-merger integration. He has successfully supported multinationals during difficult audits and competent authority procedures, delivered global documentation projects and served as an expert witness for an intellectual property dispute. His clients ranged from startups to large DAX companies. In addition, he has considerable experience developing and leading country-by-country reporting initiatives in Germany and is a key source for consultation on BEPS related topics.

During his time at the ATO, Kerim was a lead economist in Australia's most important transfer pricing cases, a member of the ATO's National Transfer Pricing Review Panel and a member of the National Tax Liaison Sub-group for Transfer Pricing. He also built a team specializing in financial transactions and the financial services industry.

Kerim holds a PhD and MA in Economics (Dipl. Volkswirt) from the University of Potsdam, and an MA in Economics from the University of Wisconsin-Milwaukee.

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Zachary focuses on transfer pricing in the financial services space. He has significant experience in serving hedge fund, PE and real estate (including REIT) clients. Additionally, he specializes in assisting clients with compliance and documentation around the use of intercompany debt, including debt characterization analyses and arm's-length interest rate benchmarking studies. Within Duff & Phelps' Financial Services Transfer Pricing team, Zachary is a thought leader on intercompany debt best practices and development and maintenance of proprietary Excel and Visual Basic for Applications (VBA)-based models for transfer pricing and intercompany debt purposes.

Zachary received a BBA with concentrations in finance and analytic consulting from Emory University's Goizueta Business School. He is also a Chartered Financial Analyst (CFA) charterholder from the CFA Institute.