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The OECD Releases a 2022 Update to Its Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations

On January 20, 2022, the OECD published an updated version of its Transfer Pricing Guidelines (TPG) for Multinational Enterprises and Tax Administrations (the "2022 TPG"). The 2010 TPG was updated in 2017 at the conclusion of the G20/OECD and Inclusive Framework (IF) Base Erosion and Profit Shifting (BEPS) project (2013–2016). In addition to a new Chapter X providing guidance on financial transactions, the 2022 TPG revises Chapter I to provide much anticipated clarification on the returns entitled to certain entities: (i) **risk-free return:** for companies lacking financial control over an investment and not exercising control over other economically significant risks, and (ii) **risk-adjusted return**: for companies exercising financial control over an investment, having financial capacity to bear financial risks, but not controlling other economically significant risks. Also, the 2022 TPG now provides guidance on how to calculate these returns. In addition, the 2022 TPG contains the 2018 final revisions to Chapter II of the 2010 TPG concerning transactional profit splits. Conforming changes to other paragraphs of the TPG were made, as appropriate.

Changes to Chapter I

1. Interpretation of a Risk-Free Rate of Return

The 2017 TPG Chapter I provided that an entity funding an investment but not controlling its associated financial risks or other economically significant risks is only entitled to a risk-free rate of return (paragraph 1.103). This guidance sought to limit the return a multinational enterprise (MNE) can provide to a "cash-box" type entity located in a low-tax jurisdiction for contributing to the funding of the intellectual property of the MNE. No interpretation of what a "risk-free rate of return" was provided. The

2022 TPG adds new paragraphs 1.107–1.116 that clarify that a risk-free rate of return is meant to measure a return free of risk of loss (default risk). The new guidance suggests that a risk-free rate of return should be measured by reference to a yield curve. The OECD suggested measures, which include sovereign debt issued in the functional currency of the taxpayer and of comparable duration, interbank rates, interest rate swaps and repurchase agreements ("repos") of highly rated sovereign debt securities. Facts and circumstances of the transaction, data availability and liquidity of the underlying instruments may impact the most reliable data to be used in constructing the yield curve. This guidance carries over, at least partially, to the guidance provided to calculate a "risk-adjusted rate of return," to the extent that it is calculated as a risk-free rate plus a risk premium.

2. Interpretation of a Risk-Adjusted Rate of Return

The 2017 TPG Chapter VI provided that an entity funding an investment and controlling its associated financial risks but not any other economically significant risks is only entitled to a risk-adjusted rate of return (paragraphs 6.62–6.64). This guidance sought to limit the return an MNE can provide a "financial investor-type" entity with little operational substance but contributing to the funding of the intellectual property of the MNE. No interpretation of what a "risk-adjusted" rate of return was provided. The 2022 TPG adds new paragraphs 1.107 and 1.117-1.126 that clarify that a risk-adjusted rate of return is meant to measure a return exposed to the risk of loss (default risk). Uncontrolled comparable transactions or the yield on realistically available comparable alternative investments could provide a measure of a risk-adjusted return. The alternative is to measure a risk-adjusted return by adding a risk premium to the risk-free rate within the meaning of new paragraphs 1.107–1.116 . That risk premium could be measured as the difference between the yield of sovereign debt and traded commercial paper (bond) or by a measure of an uncontrolled risk premium for an investment of comparable risk.

Key Takeaway for U.S. Multinationals

The 2022 TPG and the clarification provided by the OECD on "risk-free" and "risk-adjusted" rates of return confirm that the IF is not willing to provide any level of default risk premium to low-substance entities deemed to not exercise sufficient control over their financial investments. In the current interest rate macroeconomic environment, that return for a 10-year investment is between 1% and 2% in many large economies. The guidance on risk-free rate of return will be most often relevant in the process of determining an appropriate risk-adjusted return; very few U.S. MNEs are still operating through entities that do not, at least, exercise financial control over their financial investments. However, many still do operate through entities that exercise sufficient control over their financial risks but little control over operational economic risks. They are now clearly only entitled to a risk-adjusted return within the meaning of paragraphs 1.117–1.126. Unless the IF or local tax administrations provide taxpayers with the yield curves they are supposed to use to determine a risk-free rate of return (or the starting point for a risk-adjusted return), MNEs will have to develop their own methodology. Since yield curves differ in (i) the currency used, (ii) the underlying securities used at different tenors of the curve, (iii) the maturity of these underlying securities at various tenors, and (iv) the liquidity of the underlying instruments, taxpayers have a significant number of methodological choices. Kroll and its transfer pricing professionals can help in the development of these methodologies, and more broadly, in understanding the impact of the 2022 TPG on your master file and local files. They can also assist in how these files support the arm's-length nature of the allocation of returns within your MNE.

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New Chapter X in 2022 TPG

On February 11, 2020, the OECD released its final TPG on Financial Transactions developed as a mandated follow-up to Actions 4 and 8–10 of the BEPS Action Plan. It is now incorporated in the 2022 TPG as a new Chapter X, without substantive changes. In summary, Section B of the 2022 TPG provides guidance on the application of the principles contained in Section D.1 of Chapter I of the TPG to financial transactions. Specifically, Section B.1 elaborates on how the accurate delineation analysis under Chapter I applies. It also clarifies that the guidance does not prevent countries from implementing other approaches to address capital structure and interest deductibility under their own domestic legislation (paragraph 10.3). Section B.2 outlines the economically relevant characteristics that inform the analysis of the terms and conditions of financial transactions. Sections C, D and E of the 2022 TPG address specific issues related to treasury functions (including loans, cash pooling and hedging), financial guarantees and captive insurance, respectively.

For a concise overview of key takeaways from the guidance please read our "OECD Guidelines for Financial Transactions – Important Highlights from the Finalized Guidance."

Key Takeaway for U.S. Multinationals

The guidance in Chapter X of the 2022 TPG does not explicitly impose new documentation requirements concerning financial transactions. However, with the clarity it now provides, taxpayers are advised to carefully review their transfer pricing policies and associated documentation and address any daylight that may exist. In aggregate, Chapter X highlights that a taxpayer must consider not only the arm's-length compensation of a financial transaction but also whether the overall arrangement is consistent with the arm's-length principle. Specifically, to avoid recharacterization of debt as equity, or as another debt instrument, for federal income tax purposes, taxpayers may be advised to include information concerning the characteristics of the debt and the decision to enter into the debt as presently structured. This analysis should be performed considering realistically available alternatives to both the lender and the borrower and address their respective abilities to meet their debt obligations. Kroll has assisted numerous taxpayers in preparing transfer pricing documentation for intercompany financial transactions. Our independent, world-renowned debt structuring and capital markets services and deep expertise in valuation and transfer pricing provide us with a unique ability to assist taxpayers in this space.

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