Transfer Pricing of Financial Transactions

Matheson

As discussed in our recent article, Ireland's transfer pricing rules were amended and the scope of their application was significantly expanded with effect for 2020 onwards. The amendments have had a particular impact on financial transactions, bringing many more financial transactions within the ambit of transfer pricing rules, including documentation requirements. This change has also coincided with the publication by the OECD of their guidance on the transfer pricing of financial transactions (the Guidance), resulting in enhanced focus on the pricing and documentation of these transactions more generally.

The Guidance is significant because it is the first time that the OECD has provided specific commentary on the application of the arm's length principle to financial transactions. Businesses with significant treasury operations will find the latest commentary particularly relevant. Although the Guidance has not yet been formally incorporated into Ireland's transfer pricing legislation[1], the Irish Revenue Commissioners have recently advised that they would consider it "best practice"[2] for taxpayers and practitioners to have regard to it when reviewing their intra-group financial transactions.

In this article, we provide a high level overview of key aspects of the Guidance and its application to particular types of financial transactions.

1 Ireland's existing transfer pricing legislation requires that the arm's length principle be interpreted (by reference) in accordance with the OECD's 2017 Guidelines for Multinational Enterprises and Tax Administrations, as supplemented by their additional guidance on Hard-to-Value Intangibles (2018) and on the Transactional Profit Split Method (2018).

2 Revenue TDM Part 35A-01-01 (February 2021) at paragraph 4.4.2.

Re-characterisation of transactions

The Guidance discusses the circumstances in which financial transactions can be re-characterised as something other than their legal form for transfer pricing purposes.

For instance, where the accurate delineation of a loan transaction shows that independent parties behaving in a commercially rational manner would not have entered into the loan, the OECD advise that it is open to tax authorities to consider re-characterising the arrangement as something else (such as a contribution to equity capital), with a corresponding effect on the tax treatment of the transaction. Where financial projections show that a borrower would be unable to pay back an intra-group loan, the OECD suggest that the loan could only be respected as a loan up to the maximum amount that an independent lender would be willing to advance to that borrower (with the remainder subject to re-characterisation).

In the context of group financial guarantees, the Guidance suggests that, where a guarantee serves to both lower the interest rate available and increase the borrowing capacity of a borrower, the arrangement may be partially re-characterised as a loan from the external lender to the guarantor and as an equity contribution from the guarantor to the borrower.

Loans

The Guidance provides useful direction on how to price intra-group loans and benchmark them against comparable loans between independent parties. The OECD acknowledge that the absence of certain standard contractual terms in loan documentation (eg, the granting of asset security and covenants) does not necessarily mean that the loan cannot be compared against loans between third parties which have such terms. For instance, in the context of a loan between parent and subsidiary, the absence of asset security or charges does not reflect the economic reality that the parent company will likely have recourse to the borrower's assets in the event of non-payment anyway. This part of the guidance serves as a reminder that it is necessary to look beyond the contractual/legal terms of a transaction (to ensure alignment with the economic reality) when undertaking the comparability analysis at the heart of the arm's length principle.

The Guidance suggests that multinational enterprise (MNE) groups can use their external credit rating as a basis for pricing their internal loans in certain circumstances, provided they appropriately document the selection of such ratings and that a particular borrower's credit-worthiness indicators do not differ significantly from the group as a whole.

The OECD endorses a practical and common sense approach by acknowledging that MNE groups may choose to benchmark the interest rates set on their intra-group loans against the interest rates they are themselves charged by external lenders. However, the use of such data will only be considered 'valid' where the economically relevant conditions between the internal (tested) transaction and the external transaction are 'sufficiently similar'.

Given the range and depth of information that is publically available for the pricing of loans by independent lenders, the OECD note that it may be easier to apply the Comparable Uncontrolled Price (CUP) method to loan transactions compared to other types of transactions. It is noted that in practice there is more likely to a 'range of rates' available for comparison from the market against the tested transaction.

Guarantees

The Guidance deals with the pricing of financial guarantees provided by one member of an MNE group (the guarantor) to another (the borrower), with such guarantees most commonly provided for the benefit of an external lender.

It is clarified that only legally enforceable guarantees should be regarded as an assumption of risk (and therefore capable of requiring remuneration). Letters of comfort or representation are not to be considered equivalent to guarantees. The Guidance acknowledges that even legally enforceable guarantees may not provide any additional benefit for a borrower and, in such circumstances, should not need to be remunerated. This can arise, for example, where banking covenants applicable to a member of the group require them to cover any shortfall in payments by another borrower in the group – in such cases, the provision of a separate guarantee to that borrower would be unlikely to provide them with any additional benefit.

The Guidance provides useful and practical clarification on the effects of group membership on pricing financial guarantees. It is acknowledged that 'legal, financial or operational' ties may mean that, even in the absence of a guarantee, an MNE group would be unlikely to allow a group borrower default on its borrowings with an external lender (eg, it might risk the group's credit rating). The result of such ties may mean that the group entities are 'financially interdependent' and guarantees provided between them would not confer any specific benefit on any individual borrower. The Guidance clarifies that 'implicit support' provided by passive group membership is not required to be remunerated and in such circumstances no guarantee fees should need to be paid.

Similarly, where cross-guarantees are provided by multiple guarantors in a group, it may be difficult to trace any specific benefit flowing from one single guarantor to a borrower. In these circumstances, it may be considered that the credit standing of a borrower is not enhanced by any guarantor and therefore no remuneration for the guarantee should be payable.

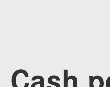
In circumstances where a guarantee is found to provide a benefit to a borrower, the Guidance outlines a number of different approaches to pricing guarantee fees in accordance with the arm's length principle:

(i) The first approach is the CUP method which examine what an independent guarantor would charge for an equivalent guarantee. The Guidance acknowledges that it would be difficult to find comparable arrangements in the market due to the rarity of independent guarantors and, in any event, an independent guarantor would be likely to incur additional costs (such as regulatory requirements) that may not be applicable to an MNE group guarantor.

(ii) The second approach is the 'yield' method which calculates the value of a benefit accruing to a borrower by virtue of the provision of the guarantee. This is done by looking at the difference between the interest rate that the borrower would have been charged without the benefit of the guarantee and the interest rate they were charge with the guarantee in place. The difference between the two is the maximum fee that the recipient of the guarantee would be willing to pay for it in an independent scenario. A useful worked example of this method is given by the OECD at paragraph D.3 of the Guidance.

(iii) The remaining suggested approaches examine the cost to the guarantor of providing the guarantee by: (a) reference to the cost of equivalent financial products such as credit default swaps; (b) valuing an expected loss by reference to the probability of default; or (c) calculating the amount of 'additional notional capital' that would be necessary to provide to the borrower in order to align its credit rating with the guarantor's credit rating and then estimating the expected return from providing that capital.

Cash pooling



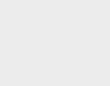
Of particular interest to MNE groups with large treasury functions may be the guidance provided in respect of cash pooling activities. The OECD acknowledge that businesses rarely engage in cash pooling operations with independent parties, resulting in a lack of directly comparable market data to help inform the transfer pricing of such arrangements. As a result, the Guidance suggests some specific approaches to pricing cash pooling activities.

As with all transactions subject to transfer pricing review, the Guidance re-iterates that cash pooling transactions should be accurately delineated to determine the functions and risks assumed by each party before an attempt is made to price such transactions. The Guidance emphasises that a cash pool leader's risk exposure (ie, their liquidity or credit risk) will not always be the same and it is necessary to determine which MNE group member is, in reality, exercising the control function and assuming any risk in the arrangement.

The Guidance notes that a cash pool leader often provides nothing more than a co-ordination service and this would entitle them to "similarly limited" remuneration. However, the Guidance also gives the example of a substantive treasury operation which bears risks such as credit, liquidity and currency risks in relation to a cash pooling arrangement, raises funds externally (for on-lending to other group members) and is responsible for investing surplus funds or meeting any shortfall. In such circumstances, the Guidance suggest that the treasury company may need to be additionally remunerated in accordance with the guidance on pricing intra-group loans.

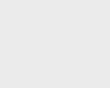
Where members of a cash pooling arrangement provide cross-guarantees and rights of set-off, the Guidance explores whether remuneration for these services should be provided. Consistent with their position on financial guarantees generally (discussed above), the OECD note that guarantee fees may not be payable where it is difficult to trace any particular benefit being provided by one cross-guarantor to another: "the guaranteed borrower may not be benefitting beyond the level of credit enhancement attributable to the implicit support of other group members". In the event of a default, the OECD suggest that any financial support given should be regarded as a capital contribution.

Hedging arrangements



The Guidance acknowledges that MNE groups often choose to shield the group from external risks (eg, foreign currency or commodity price movements) by arranging for one 'central' company (such as its treasury company) to enter into hedging transactions that benefit the group as a whole. In these situations, although other entities in the group may not be privy to such hedging transactions they can still benefit from the protection provided. The OECD state that remuneration should only be payable by the entities which benefit from such arrangements following an accurate delineation of the actual transactions, in accordance with the principles set out in Chapter I of their main transfer pricing guidelines (as supplemented by the Guidance). The implication is that any benefits arising to group members by virtue of a hedging transaction arranged by a single member should not require remuneration where there is no 'deliberate concerted action' which benefits a particular member.

Captive insurance



MNE groups may choose to pool certain risks through a member of the group, referred to as a captive insurance company. MNE groups may wish to have a captive insurer for a variety of reasons, including to access reinsurance markets, to smooth volatility in operating results (by avoiding unexpected insurance events) or because it is not possible to obtain external insurance coverage for a particular risk.

The Guidance provides detailed and practical commentary on how to determine whether risk has truly been assumed by a captive insurer and whether a transaction can be respected as "genuinely one of insurance", with corresponding implications for the pricing of the transaction.

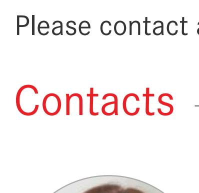
Regarding the pricing of captive insurance, the Guidance explores the most suitable options available. For instance, the OECD note that the CUP method may be suitable where external or internal comparables are available, although it cautions that comparability adjustments may be required. The possibility of using an independent actuarial analysis to calculate an arm's length price for a particular risk is included as a valid methodology but, similar to the CUP method, the likelihood of comparability adjustments are flagged as a risk.

Other pricing methods explored by the Guidance include an examination of the arm's length profitability of the captive insurer which is achieved by (i) reviewing its profitability from claims, as benchmarked against independent insurers; and (ii) calculating the investment return earned by it from capital held in investments, as benchmarked against the equivalent return earned by independent insurers. The OECD note that independent insurers will often hold more capital than captive insurers, for both regulatory and commercial reasons, and this will require comparability adjustments when examining limb (ii) of this pricing method.

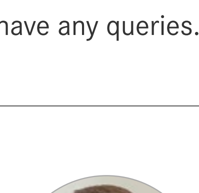
Given the expansion of Ireland's transfer pricing rules, a wide range of financial transactions referred to in the Guidance will need to be reviewed to ensure that they comply with arm's length requirements, including that appropriate documentation is in place to support the pricing adopted.

Please contact a member of Matheson's transfer pricing team if you have any queries.

Contacts



Catherine O'Meara
Partner
T +353 1 232 2106
E catherine.o'meara@matheson.com



Raphael Clancy
Senior Associate
T +353 1 232 2564
E raphael.clancy@matheson.com