

Base Erosion and Profit Shifting (BEPS)

Public Discussion Draft

BEPS ACTIONS 8 - 10

Financial transactions

3 July- 7 September 2018



DISCUSSION DRAFT ON FINANCIAL TRANSACTIONS

Under the mandate of the Report on Actions 8-10 of the BEPS Action Plan (“*Aligning Transfer Pricing Outcomes with Value Creation*”), Working Party No. 6 (“WP6”) has produced a non-consensus discussion draft on financial transactions.

The first part of the discussion draft provides guidance on the application of the principles contained in Section D.1 of Chapter I of the Transfer Pricing Guidelines to financial transactions. In particular, Section B.1 of the discussion draft elaborates on how the accurate delineation analysis under Chapter I applies to the capital structure of an MNE within an MNE group. The discussion draft clarifies that the guidance included in this section does not prevent countries from implementing approaches to address capital structure and interest deductibility under their domestic legislation. Section B.2 outlines the economically relevant characteristics that inform the analysis of the terms and conditions of financial transactions.

The second part of the discussion draft, contained in sections C, D and E, addresses specific issues related to the pricing of financial transactions such as treasury function, intra-group loans, cash pooling, hedging, guarantees and captive insurance.

The discussion draft also includes a number of questions to commentators on which inputs from stakeholders will be particularly relevant to WP6 to further its work and prepare another discussion draft after considering the input received.

Interested parties are invited to send their comments on this discussion draft, and to respond to the specific questions included in the boxes, **by 7 September 2018** by e-mail to TransferPricing@oecd.org in Word format (in order to facilitate their distribution to government officials). Comments in excess of ten pages should attach an executive summary limited to two pages. Comments should be addressed to the Tax Treaties, Transfer Pricing and Financial Transactions Division, OECD/CTPA.

Please note that all comments received on this discussion draft will be made publicly available. Comments submitted in the name of a collective “grouping” or “coalition”, or by any person submitting comments on behalf of another person or group of persons, should identify all enterprises or individuals who are members of that collective group, or the person(s) on whose behalf the commentator(s) are acting.

The proposals included in this discussion draft do not, at this stage, represent the consensus views of the CFA or its subsidiary bodies but are intended to provide stakeholders with substantive proposals for analysis and comment.

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DISCUSSION DRAFT ON FINANCIAL TRANSACTIONS

A. Introduction

1. The purpose of the following sections is to provide guidance for determining whether the conditions of certain financial transactions between associated enterprises are consistent with the arm's length principle.
2. Section B describes the application of the principles of Section D.1 of Chapter I to financial transactions. Section C provides guidance on determining the arm's length conditions for treasury activities, including intra-group loans, cash pooling and hedging. Section D examines financial guarantees, and section E outlines the analysis of captive insurance companies.

B. Interaction with the guidance in Section D.1 of Chapter I

B.1. Identifying the commercial or financial relations

3. In the absence of other influences such as legal or regulatory constraints, the balance of debt and equity funding between independent enterprises will be the result of various commercial considerations. In contrast, an MNE group has the discretion to decide upon the amount of debt and equity that will be used to fund any MNE within the group. Thus, in an intra-group situation, other considerations such as tax consequences may also be present.
4. Therefore, it may be the case that the capital structure of a borrowing entity that is part of an MNE group differs from that which would exist if it were an independent entity operating under the same or similar circumstances. This situation may affect the amount of interest payable by the borrowing entity and so may affect the profits accruing in a given jurisdiction.
5. Commentary to Article 9 of the OECD MTC notes¹ at paragraph 3(b) that Article 9 is relevant *“not only in determining whether the rate of interest provided for in a loan contract is an arm's length rate, but also whether a prima facie loan can be regarded as a loan or should be regarded as some other kind of payment, in particular a contribution to equity capital.”*
6. In the context of the preceding paragraphs, Section B.1 of this guidance elaborates on how the concepts of Chapter I, in particular the accurate delineation of the actual

¹ As discussed in the Committee on Fiscal Affairs' Report on "Thin Capitalisation" adopted by the Council of the OECD on 26 November 1986 and reproduced in Volume II of the full version of the OECD Model Tax Convention at page R (4)-1.

transaction under Section D.1 of that Chapter, may relate to the capital structure of an entity within an MNE group.

7. Where it is considered that the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner in comparable circumstances, the guidance at Section D.2 of Chapter I may also be relevant.

Box B.1. Question to commentators

Commentators' views are invited on the guidance included in paragraphs 8 to 10 of this discussion draft in the context of Article 25 of the OECD Model Tax Convention ("MTC"), paragraphs 1 and 2 of Article 9 of the OECD MTC as well as the BEPS Action 4 Report.

8. Although this guidance reflects an approach of accurate delineation of the actual transaction in accordance with Chapter I of these Guidelines to determine the amount of debt to be priced, it is acknowledged that other approaches may be taken to address the issue of the capital structure 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.

9. Accordingly, this guidance is not intended to prevent countries from implementing approaches to address capital structure 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.

10. Although countries may have different views on the application of Article 9 to determine the capital structure of an entity within an MNE group, the purpose of this section is to provide guidance for those 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).

11. In determining the arm's length conditions of financial transactions, the same principles apply as described in Chapters I-III of the OECD Transfer Pricing Guidelines ('TPG') for any other controlled transaction.

12. Particular labels or descriptions assigned to financial transactions do not constrain the transfer pricing analysis. Each situation must be examined on its own merits, and subject to the prefatory language in paragraph 10, accurate delineation of the actual transaction under Chapter I will precede any pricing attempt.

13. As with any controlled transaction, the accurate delineation of financial transactions requires an analysis of the factors affecting the performance of businesses in the industry sector in which the MNE group operates. Because differences exist among industry sectors, factors such as the particular point of an industry in its life cycle, the effect of government regulations, or the availability of financial resources in a given industry are relevant features that have to be considered to accurately delineate the controlled transaction. This examination will take account of the fact that MNE groups operating in different sectors may require, for example, different amounts and types of financing due to

different capital intensity levels between industries, or may require different level of short-term cash balance due to different commercial needs between industries.

14. As described in Chapter I, the process of accurate delineation of the actual transaction also requires an understanding of how the particular MNE group responds to those identified factors. In this regard, the MNE group's policies may inform the accurate delineation of the actual transaction through the consideration of, for instance, how the group prioritises the funding needs among different projects; the strategic significance of a particular MNE within the MNE group; whether the MNE group is targeting a specific credit rating or debt:equity ratio; or whether the MNE group is adopting a different funding strategy than the one observed in its industry sector. (See Section B.2.5 on business strategies)

15. In accordance with the guidance established in Chapter I, the accurate delineation of the actual transaction should begin with a thorough identification of the economically relevant characteristics of the transaction – consisting of the commercial or financial relations between the parties and the conditions and economically relevant circumstances attaching to those relations –, including: an examination of the contractual terms of the transaction, the functions performed, assets used, and risks assumed, the characteristics of the financial products or services, the economic circumstances of the parties and of the market, and the business strategies pursued by the parties.

16. For instance, in accurately delineating an advance of funds, the following economically relevant characteristics may be useful indicators, depending on the facts and circumstances: the presence or absence of a fixed repayment date; the obligation to pay interests; 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.

Box B.2. Question to commentators

Commentators' views are invited on the example contained in paragraph 17 of this discussion draft; in particular on the relevance of the maximum amounts that a lender would have been willing to lend and that a borrower would have been willing to borrow, or whether the entire amount needs to be accurately delineated as equity in the event that either of the other amounts are less than the total funding required for the particular investment.

17. For example, consider a situation in which Company B, a member of an MNE group, needs additional funding for its business activities. In this scenario, Company B receives an advance of funds from related Company C which is denominated as a loan with a term of 10 years. Assume that, in light of all good-faith financial projections of Company B for the next 10 years, it is clear that Company B would be unable to service a loan of such an amount. Based on these facts and circumstances, it can be concluded that an unrelated party would not be willing to provide such a loan to Company B. Accordingly, the accurately delineated amount of Company C's loan to Company B for transfer pricing purposes would be a function of the maximum amount that an unrelated lender would have

been prepared to advance to Company B; and the maximum amount that an unrelated borrower in comparable circumstances would have been willing to borrow from Company C. (See Section C.1.1 The lender's and borrower's perspectives). Consequently, the remainder of Company C's advance to Company B would not be recognised as a loan for the purposes of determining the amount of interest which Company B would have paid at arm's length.

18. 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.

19. 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. For instance, in the case of an entity that advances funds, other investment opportunities may be contemplated. From the borrower's perspective, the options realistically available will include broader considerations than the entity's ability to service its debt, for example, the funds it actually needs to meet its operational requirements; in some instances, although a company may have the capacity to borrow and service an additional amount of debt, it may choose not to do so to avoid placing negative pressure on their credit rating and increasing its cost of capital, and jeopardising its access to capital markets and its market reputation. (See Section C.1.1 The lender's and borrower's perspectives).

20. In an ideal scenario, a comparability analysis would enable the identification of financial transactions between independent parties which match the tested transaction in all respects. With the many variables involved, it is more likely that potential comparables will differ from the tested transaction. Where differences exist between the tested transaction and any proposed comparable, it will be necessary to consider whether such differences will have a material impact on the price. If so, it may be possible, where appropriate, to make comparability adjustments to improve the reliability of a comparable. This is more likely to be achievable where the adjustment is based on a quantitative factor and there is good quality data easily available (for example, on currency differences) than, for instance, in trying to compare loans to borrowers with qualitative differences or where data is not so readily available (for example, borrowers with different business strategies).

21. To inform an analysis of the terms and conditions of a financial transaction as part of the accurate delineation of the actual transaction or seeking to price the accurately delineated actual transaction, the following economically relevant characteristics should be considered.

Box B.3. Question to commentators

Commentators' views are invited on the breadth of factors specific to financial transactions that need to be considered as part of the accurate delineation of the actual transaction.

Commentators' views are also invited on the situations in which a lender would be allocated risks with respect to an advance of funds within an MNE group.

B.2. The economically relevant characteristics of actual financial transactions

B.2.1. Contractual terms

22. The terms and conditions of a financial transaction between independent enterprises are usually explicitly stated in a written agreement. However, between associated enterprises 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 in order to accurately delineate the actual transaction in accordance with Section D.1.1 of Chapter I.

B.2.2. Functional analysis

23. In accurately delineating the actual financial transaction, a functional analysis is necessary. This analysis seeks to identify the functions performed, the assets used and the risks assumed by the parties to that controlled transaction.

24. For instance, in the particular case of a related-party loan, the key functions performed by a lender would typically include an analysis and evaluation of the risks inherent in the loan, the capability to commit capital of the business to the investment, determining the terms of the loan and organising and documenting the loan. This may also include any ongoing monitoring and review of the loan. Such a functional analysis is likely to include consideration of similar information to that which a commercial lender or ratings agency would consider in determining the creditworthiness of the borrower. A related-party lender will not necessarily perform all of the same functions at the same intensity as an independent lender. However, in considering whether a loan has been advanced on conditions which would have been made between independent enterprises, the same commercial considerations and economic circumstances are relevant (see Sections C.1.1 The lender's and borrower's perspectives and C.1.2 Use of credit ratings).

25. From the perspective of the borrower, the relevant functions would usually refer to ensuring the availability of funds to repay the principal and the interest on the loan in due time; providing collateral, if needed; and monitoring and fulfilling any other obligation derived from the loan contract. (See Section C.1.1 The lender's and borrower's perspectives)

26. In some instances, the functions of the lender and the borrower may be undertaken by the same entity in different transactions. That could be the case, for example, of

centralised treasury activities within an MNE group where the treasury company raises and provides funds to other members of the MNE group. In those circumstances, the functional analysis should consider the applicability of the guidance in Section C Treasury function, and, in particular, paragraphs 42 and 43.

B.2.3. Characteristics of financial products or services

27. There is a wide variety of financial products and services in the open market that present very different features and attributes, which may affect the pricing of those products or services. Consequently, when pricing related party products and services, it is important to document the transactions' features and attributes.

28. For instance in the case of a loan, those characteristics may include but are not limited to: the amount of the loan; its maturity; the schedule of repayment; the nature or purpose of the loan (trade credit, merger/ acquisition, mortgage, etc.); level of seniority and subordination, geographical location of the borrower; currency; collateral provided; presence and quality of any guarantee; and whether the interest rate is fixed or floating.

B.2.4. Economic circumstances

29. To achieve comparability requires that the markets in which the independent and associated enterprises operate do not have differences that have a material effect on price or that appropriate adjustments can be made.

30. The prices of financial instruments may vary substantially on the basis of underlying economic circumstances, for example, across different currencies, geographic locations, local regulations, the business sector of the borrower and the timing of the transaction.

31. Macroeconomic trends such as central bank lending rates or interbank reference rates, and financial market events like a credit crisis, can affect prices. In this regard, the precise timing of the issue of a financial instrument in the primary market or the selection of comparable data in the secondary market can therefore be very significant in terms of comparability. For instance, it is not likely that multiple year data on loan issuances will provide useful comparables. The opposite is more likely to be true, i.e., that the closer in timing a comparable loan issuance is to the issuance of the tested transaction, the less the likelihood of different economic factors prevailing, notwithstanding that particular events can cause rapid changes in lending markets.

32. Currency differences are another potentially important factor. Economic factors such as growth rate, inflation rate, and the volatility of exchange rates, mean that otherwise similar financial instruments issued in different currencies may have different prices. Moreover, prices for financial instruments in the same currency may vary across financial markets or countries due to regulations such as interest rate controls, exchange rate controls, foreign exchange restrictions and other legal and practical restrictions on financial market access.

B.2.5. Business strategies

33. Business strategies must also be examined in accurately delineating the actual financial transaction and in determining comparability for transfer pricing purposes since different business strategies can have a significant effect on the terms and conditions which would be agreed between independent enterprises.

34. For example, independent lenders may be prepared to lend on terms and conditions to an enterprise undertaking a merger or acquisition which might otherwise not be acceptable to the lender for the same business if it were in a steady state. In this kind of scenario, the lender may take a view over the term of the loan and consider the borrower's business plans and forecasts, effectively acknowledging that there will be temporary changes in the financial metrics of the business for a period as it undergoes changes. Section D.1.5 of Chapter I gives other examples of business strategies that must be examined in accurately delineating the actual transaction and determining comparability.

35. The analysis of the business strategies will also include consideration of the MNE group's global financing policy, and the identification of existing relationships between the related parties such as pre-existing loans and shareholder interests. (See Annex I to Chapter V of the TPG about the information to be included in the master file).

36. In any case, the reliability of results is generally improved to the extent comparable borrowers pursue similar business strategies to the tested borrower involved in an intercompany transaction.

Box B.4. Question to commentators

Commentators' views are invited on the guidance contained in this Box and its interaction with other sections of the discussion draft, in particular Section C.1.7 Pricing approaches to determining an arm's length interest rate.

Risk free rate of return

1. Where, in accordance with the guidance in Chapter I of these Guidelines, the accurate delineation of the actual transaction shows that a funder lacks the capability, or does not perform the decision-making functions, to control the risk associated with investing in a financial asset, it will be entitled to no more than a risk-free return as an appropriate measure of the profits it is entitled to retain.
2. A risk-free rate of return is the hypothetical return which would be expected on an investment with no risk of loss. Ultimately there is no investment with zero risk, and the reliability of available proxies for approximating a risk-free rate of return will depend on prevailing facts and circumstances.
3. An approach which is widely used in practice is to treat the interest rate on certain government issued securities as a reference rate for a risk-free return, as these securities are generally considered by market practitioners not to carry significant default risk. The intention of this guidance is to outline an approach for reference purposes without suggesting that a particular government security should always be used to determine a risk-free rate.
4. To eliminate currency risk, the reference security for determining the risk-free rate would need to be a security issued in the same currency as the investor's cash flows, i.e. the functional currency of the investor rather than its country of domicile. When there are multiple countries issuing bonds in the same currency, the reference point for the risk-free rate of return should be the government security with the lowest rate of return as any difference in rate must be due to differences in risk between the issuers. (See paragraph 32)
5. Another relevant aspect in determining the risk-free rate of return will be the temporal proximity of the reference security to the tested transaction. The security should ideally be issued at the time as the controlled transaction was entered into to eliminate the effect of differences which may be present between securities issued at different times. (See paragraph 31)
6. Another key consideration would be the maturity of the financial instrument. The duration of the reference security should match the duration of the investment since the duration of an investment will usually affect its price. The duration of the controlled investment should be determined as part of the process of accurate delineation of the actual transaction. For example, a financial instrument which is short-term under the written contractual terms between the parties but which is consistently replaced with a new instrument may, depending upon the exact facts and circumstances, be accurately delineated as a long-term investment.
7. Due to difficulties in practice, practical solutions might be considered for estimating the risk-free rate of return. For instance, assume a situation where Company A, a member of an MNE group, is not entitled to any more than a risk-free return under

the guidance in Chapter I in relation to an advance of funds with a term of 1 year to an associated party, Company B. In approximating that return, the starting point would be to identify a security issued at the time of the provision of the funding in the same currency as Company A's functional currency. Assume that the tax administration of Country X, where Company A is resident, identifies three securities issued in Company A's functional currency by the governments of Country X, Country Y and Country Z with a term of 1 year. The credit ratings of the issuing governments are A for Country X, B for Country Y and AA for Country Z. In specifying a minimum credit rating for the issuing government to consider the issued security as a risk-free investment comparable to the controlled financial transaction, the tax administration of Country X may select the security issued by Country Z as a reference for the risk free rate of return since it represents the lowest rate of return available at the time of the provision of the funding on all outstanding government bonds in the relevant currency with a term of 1 year.

8. To approximate risk-free rate of returns, government issued securities are not the only reference, and other alternatives may be considered on prevailing facts and circumstances of each case.

Box B.5. Question to commentators

Commentators are invited to describe financial transactions that may be considered as realistic alternatives to government issued securities to approximate risk-free rate of returns.

9. The risk-free rate of return may be relevant, for example, as a component in calculating a risk-adjusted rate of return on an investment or as the return allocable to an investor who has provided funding but has not assumed any of the risks related to the funding.

10. Paragraph 1.85 gives an example of circumstances where an investor would not be entitled to any more than a risk-free return as an appropriate measure of the profits it is entitled to retain, where it lacks the capability to control the risk associated with investing in a financial asset. In such circumstances, the risk will be allocated to the enterprise which has control and the financial capacity to assume the risk associated with the financial asset. That enterprise will be entitled for transfer pricing purposes to the return commensurate with the risk allocated to it. Reference is also made in paragraph 1.103 to the possibility of an assessment being needed of the commercial rationality of the transaction in paragraph 1.85 based on the guidance in Section D.2, taking into account the full facts and circumstances of the transaction.

Box B.6. Question to commentators

Commentators' views are invited on the practical implementation of the guidance included in paragraph 11 of this Box B.4, and its interaction with Article 25 OECD MTC in a situation where more than two jurisdictions are involved. This could arise, for instance, where a funded party is entitled to deduct interest

expense up to an arm's length amount, but the funder is entitled to no more than a risk-free rate of return under the guidance of Chapter I (see, e.g., paragraph 1.85), and the residual interest would be allocable to a different related party exercising control over the risk.

11. Where a funder lacks the capability to control the risk associated with investing in a financial asset and so is entitled to no more than a risk-free rate of return, subject to other constraints, the funded party would still be entitled to a deduction up to an arm's length amount in respect of the funding. The difference between those amounts would be allocable to the party exercising control over the investment risk in accordance with the guidance in Chapter I.

Risk-adjusted rate of return

12. As stated in paragraph 6.61, “*where a party providing funding exercises control over the financial risk associated with the provision of funding, without the assumption of, including the control over, any other specific risk, it could generally only expect a risk-adjusted rate of return on its funding.*” (See also Section D.1.2 and paragraphs 1.85 and 1.103 in particular).

13. Therefore, in determining the risk-adjusted rate, it is important to identify and differentiate the financial risk which is assumed by the funder in carrying on its financing activity, and the operational risk that is assumed by the funded party and is connected to the use of the funds, e.g., for developing an intangible asset. Guidance on the relationship between risk assumption in relation to the provision of funding and the operational activities for which the funds are used is given in paragraphs 6.60-6.64.

14. For instance, consider a situation where Company F advances a loan to an associated party, Company D, which undertakes the development of an intangible. Under Chapter I guidance, it is determined that Company F controls and consequently is allocated the financial risk associated with funding the development of the intangible, including the potential risk of Company D failing to develop the intangible and therefore being unable to repay the loan. However, Company F does not assume the risk of developing the intangible, which is entirely assumed by Company D under the accurate delineation of the actual transaction. Accordingly, in the event that the *ex post* results derived from the exploitation of the developed intangible were higher (or lower) than the results calculated on an *ex ante* basis, Company F would not be entitled to that difference but to a risk-adjusted rate of return as described in this section.

15. In general, the expected risk-adjusted rate of return on a funding transaction can be considered to have two components, i.e., the risk-free rate and a premium reflecting the risks assumed by the funder.

16. When the funder is assuming the financial risk under the guidance in Chapter I and is therefore exposed to the potential playing out of that risk, it will encounter the upside and downside consequences of that risk outcome. Therefore, the assumption of that risk will warrant an expected remuneration higher than a risk-free rate of return.

17. A risk-adjusted rate of return can be determined under different approaches, for example, based on the return of a realistic alternative investment with comparable economic characteristics or the cost of funds.

18. It may be possible to find a reasonable indicator of a risk-adjusted rate of return from comparable uncontrolled transactions or by considering realistically available alternative investments reflecting the same risk profile. Depending on the facts and circumstances, realistic alternatives to an intra-group loan could be bond issuances or loans which are uncontrolled transactions.

19. Another approach to determining the risk-adjusted rate of return would be to add a risk premium to the risk-free return, based on the information available in the market on financial instruments issued under similar conditions and circumstances.

20. For instance, consider the same fact pattern as described in paragraph 7 but, in this particular scenario, assume that Company A is found to be entitled to a risk-adjusted rate of return under Chapter I. To determine that return, the tax administration of Country A considers adding a risk premium to the risk-free rate of return, i.e., the security issued by the government in Country C with a term of 1 year. To estimate the risk-adjusted return, Country A's tax administration considers that corporate bonds issued by independent parties resident in Country A operating in the same industry as Company B yield a return comparable to the one that an independent party would have expected had it invested its funds in Company B under comparable circumstances.

21. Under an approach based on the cost of funds, the controlled transaction would be priced by adding a profit margin to the costs incurred by the lender to raise the funds advanced to the borrower. That mark-up should be proportionate to the risk assumed by the lender and calculated according to the guidance provided in paragraphs 89 to 91.

C. Treasury function

37. For MNE groups, the management of group finances is an important and potentially complex activity where the approach adopted by individual businesses will depend on the structure of the business itself, its business strategy, place in the business cycle, industry sector, currencies of operation, etc.

Box C.1. Question to commentators

Commentators are invited to describe situations where, under a decentralised treasury structure, each MNE within the MNE group has full autonomy over its financial transactions, as described in paragraph 38 of this discussion draft.

38. The organisation of the treasury will depend on the structure of a given MNE group and the complexity of its operations. Different treasury structures involve different degrees of centralisation. In the most decentralised form, each MNE within the MNE group has full autonomy over its financial transactions. At the opposite end of the scale, a centralised treasury has full control over the financial transactions of the group, with individual group members responsible for operational but not financial matters.

39. A key function of a corporate treasury may be, for example, to optimise liquidity across the group to ensure that the business has sufficient cash available and that it is in the right place when it is needed and in the right currency. In general, efficient management of

group liquidity is driven by considerations above the level of individual entities, and acts to help mitigate risk across a number of entities.

40. Whilst the treasury's cash and liquidity management function is concerned with day-to-day operations, corporate financial management is concerned with development of strategies and planning for investment decisions in the longer term. Financial risk management requires identification and analysis of, and responses to, the financial risks to which the business is exposed. By identifying and taking action to address financial risk, treasury can help to optimise the cost of capital to the advantage of the users of group treasury services.

41. Other examples of activities which the treasury may have responsibility for include raising debt (through bond issuances, bank loans or otherwise) and raising equity, and managing the relationship with the group's external bankers and with rating agencies.

42. When evaluating the transfer pricing issues related to treasury activities, as with any case, it is important to accurately delineate the actual transactions and determine exactly what functions a company is carrying on rather than to rely to any extent upon a general description such as "treasury activities".

43. Generally, the treasury function is part of the process of making the financing of the commercial business of the group as efficient as possible. As such, the treasury function will usually be a support service to the main value-creating operation as in the case, for example, of the services provided by a cash pool leader (see Section C.2.3 Pricing of cash pooling transactions). Depending on the facts and circumstances of each case, such activities may be services in which case the pricing guidance on intra-group services at Chapter VII applies.

44. Another key concern regarding treasury activities is the identification and allocation of the economically significant risks in accordance with Chapter I.

45. The activities of the treasury take into account issues at a group level and follow the vision, strategy and policies set out by group management. Accordingly, the approach of the treasury to risk will depend on the group policy where certain objectives may be specified, such as targeted levels of investment return (e.g., the yield must exceed the cost of capital), reduced cash flow volatility, or targeted balance sheet ratios (e.g., assets to liabilities). Therefore, it is important to note that usually the higher strategic decisions will generally be the result of policy set at group level rather than determined by the treasury itself.

46. The following sections outline the transfer pricing considerations which arise from some relevant treasury activities that are often performed within MNE groups, i.e., the provision of intra-group loans, cash pooling, and hedging activities.

Caveat

The following sections deal with specific issues related to determining whether the rate of interest provided for in a loan contract is an arm's length rate. The analysis included in these sections is based on the assumption that the transactions are respected as loans pursuant to an accurate delineation under Chapter I or domestic legislation, as the case may be.

C.1. Intra-group loans

C.1.1. The lender's and borrower's perspectives

47. In considering the commercial and financial relations between the associated borrower and lender, and in an analysis of the economically relevant characteristics of the transaction, both the lender's and borrower's perspectives should be taken into account, acknowledging that these perspectives may not align in every case.

48. As in any other transfer pricing scenarios, the guidance in Section D.1 of Chapter I applies to determine whether the lender and the borrower assume risks related to intra-group loans. In particular, it is important to consider the risks that the funding arrangements carry for the party providing the money, and the risks related to the acceptance and use of the money from the perspective of the recipient. These risks will relate to repayment of the value transferred, compensation expected for the use of that value over time, and compensation for other associated risk factors.

49. The lender's perspective in the decision of whether to make a loan, how much to lend, and on what terms, will involve evaluation of various factors relating to the borrower, wider economic factors affecting both the borrower and the lender, and other options realistically available to the lender for the use of the funds.

50. An independent lender will carry out a thorough credit assessment of the potential borrower to enable the lender to identify and evaluate the risks involved and to consider methods of monitoring and managing these risks. That credit assessment will include understanding the business itself as well as the purpose of the loan, how it is to be structured and the source of its repayment which may include analysis of the borrower's cash flow forecasts and the strength of the borrower's balance sheet.

51. When an enterprise is making a loan to an associated enterprise, it will not necessarily follow all of the same processes as an independent lender. For example, it may not need to go through the same process of information gathering about the borrower's business, as the required information may already be readily available within the group. However, in considering whether the loan has been made on conditions which would have been made between independent enterprises, the same commercial considerations such as creditworthiness, credit risk, and economic circumstances are relevant.

52. In the case of a loan from the parent entity of an MNE group to a subsidiary, the parent already has control of and ownership of the assets of the subsidiary, which would make the granting of security less relevant to its risk analysis as a lender. Therefore, in evaluating the pricing of a loan between related parties it is important to consider that the absence of contractual right over the assets of the borrowing company does not necessarily reflect the economic reality of the risk inherent in the loan. If the assets of the business are

not already pledged as security elsewhere, it will be appropriate to consider under Chapter I analysis whether those assets are available to act as collateral for the otherwise unsecured loan and the consequential impact upon the pricing of the loan.

53. Credit risk for the lender is the potential that the borrower will fail to meet its payment obligations in accordance with the terms of the loan. In deciding whether a prospective loan is a good commercial opportunity, a lender will also consider the potential impact of changes which could happen in economic conditions affecting the credit risk it bears, not only in relation to the conditions of the borrower but in relation to potential changes in economic conditions, such as a rise in interest rates, or the exposure of the borrower to movements in exchange rates.

54. Borrowers seek to optimise their weighted average cost of capital and to have the right funding available to meet both short-term needs and long-term objectives. When considering the options realistically available to it, an independent business seeking funding operating in its own commercial interests will seek the most cost effective solution, with regard to the business strategy it has adopted. For example in respect of collateral, in some circumstances, assuming that the business has suitable collateral to offer, this would usually be secured funding, ahead of unsecured funding, recognising that a business's collateral assets and its funding requirements may differ over time, e.g., because collateral is finite, the decision to pledge collateral on a particular borrowing precludes the borrower from pledging that same collateral on a subsequent borrowing.

55. Borrowers will also consider the potential impact of changes in economic conditions such as interest rates and exchange rates, as well as the risk of not being able to make timely payments of interest and principal on the loan if the borrower's business encounters unexpected difficulties, and the risk of not being able to raise more capital (either debt or equity) if necessary.

56. Borrowers will also consider the possibility to renegotiate loans to obtain better conditions taking into account the facts and circumstances of each case. This could be particularly relevant, for example, when macroeconomic circumstances lead to a reduction of the financing costs in the market.

57. The economic conditions of loans should also be viewed in the context of regulations that may affect the position of the parties. For example, insolvency law in the jurisdiction of the borrower may provide that liabilities towards related parties are subordinated to liabilities towards unrelated parties.

C.1.2. Use of credit ratings

58. In seeking to compare the conditions of transactions between associated enterprises with the conditions which would apply to those between independent enterprises, credit ratings can serve as a useful measure of creditworthiness and so help to identify potential comparables. Credit ratings can be assigned to the overall creditworthiness of a company or in relation to a specific issuance of debt.

59. A credit rating of a company is effectively a form of relative ranking of the creditworthiness of one company in comparison to another. Although, as a credit rating will depend on a combination of quantitative and qualitative factors, there is still likely to be some variance in creditworthiness between companies with the same credit rating.

60. In general, a lower credit rating will indicate a greater risk of default and be expected to be compensated by a higher rate of return. However, the same financial metrics

will not necessarily be reflected in the same level of credit rating if there are other differences between the rated parties.

61. Information is readily available in many lending markets on the different rates of interest charged for differently rated enterprises and such information may usefully contribute to benchmarking studies for interest rates charged by associated enterprises.

62. The estimation of the credit rating may be particularly challenging for start-up companies, special purpose vehicles, or those which have recently been part of a merger or demerger. In circumstances such as these, an independent lender would usually conduct a due diligence process that includes examining cash-flow and earnings projections for the business, preferably for the entire period covered by the funding.

63. In addition to ratings prepared for an entity, commercial tools are also available which are designed to rate a specific debt borrowing, particularly where no issuer credit rating is available. Similarly, in-house models may have been developed by lenders such as those in the banking or aircraft leasing sectors. Broadly, these models depend on approaches such as calculating the probability of default and of the likely loss should default occur to arrive at an implied rating for the borrowing. This can then be compared to a market database in a search for comparables to arrive at a price or price range for the borrowing. Potential issues which need to be borne in mind with this kind of modelling include that the results are not based on a direct comparison with transactions between independent parties but are subject to the accuracy of the parameters input, a tendency to rely more on quantitative inputs at the expense of qualitative factors, and a lack of clarity in the processes (i.e., the workings of the underlying algorithms and processes may not be clear). Where a reasonably reliable rating for a debt borrowing can be arrived at using such a model, this again may usefully contribute to benchmarking studies for interest rates charged by associated enterprises.

64. The credit rating methodology used in commercial tools differs significantly from the credit rating methodologies applied by independent credit rating agencies to determine official credit ratings. For instance, such tools generally use only a limited sample of quantitative data to determine a credit rating. Official credit ratings published by independent credit rating agencies are derived as a result of far more rigorous analysis which includes quantitative analysis of historic and forecast company performance as well as detailed qualitative analysis of, for instances, management's ability to manage the company, industry specific features and the company's market share in its industry.

65. In conducting a credit rating analysis, it is important to note that the financial metrics may be influenced by controlled transactions. For example, if the entity has related party transactions (such as sales, or interest expenses) which may not be priced in accordance with the arm's length principle, any credit rating derived using these values is likely to be unreliable without proper comparability adjustments.

66. When considering making comparisons between borrowers using the kind of financial metrics typically seen as important to lenders, such as debt-earnings or debt:equity ratio, it is important to note that for the same credit rating there are frequently differences between the typical financial ratios in different sectors. For example, to obtain a given rating in extractives, healthcare or technology may require stronger financial metrics than to obtain the same rating for a borrower in space and defence, energy or media. More intrinsically risky industries and those with less stable revenue streams tend to need to achieve better financial ratios in order to obtain the same rating.

C.1.3. Effect of group membership

Box C.2. Question to commentators

Commentators are invited to consider whether the following approaches would be useful for the purpose of tax certainty and tax compliance:

- a rebuttable presumption that an independently derived credit rating at the group level may be taken as the credit rating for each group member, for the purposes of pricing the interest rate, subject to the right of the taxpayer or the tax administration to establish a different credit rating for a particular member;
- a rebuttable presumption that tax administrations may consider to use the credit rating of the MNE group as the starting point, from which appropriate adjustments are made, to determine the credit rating of the borrower, for the purposes of pricing the interest rate, subject to the right of the taxpayer or the tax administration to establish a different credit rating for a particular member.

Commentators' views are invited on the use of an MNE group credit rating for the purpose of tax certainty and tax compliance to determine the credit rating of a borrowing MNE.

Commentators are also invited to provide a definition of an MNE group credit rating, how an MNE group credit rating could be determined in the absence of a publicly-available rating, and how reliable such a group credit rating would be when not provided by a credit rating agency.

67. In pricing an intra-group loan, the borrower is viewed as an independent enterprise. This does not mean that the presence of the rest of the group is necessarily ignored. Therefore, the potential impact of passive association on creditworthiness and other terms is taken into account. In particular, the external funding policies and practices of group management will assist in informing the conditions under which the subsidiary would have borrowed from an independent lender, including all economically relevant characteristics such as the type of loan, its term, currency, security, covenants, and so forth.

Box C.3. Question to commentators

Commentators are invited to provide a definition of the stand-alone credit rating of an MNE.

Commentators' views are invited on the effect of implicit support as discussed in paragraphs 68 to 74 of the discussion draft, and how that effect can be measured.

68. As discussed in more detail in the remainder of this section, an independent lender would usually take into account the possibility of implicit support from elsewhere in the MNE group when considering the terms and conditions of any loan to an MNE. Implicit support is the benefit that may arise from passive association when, for example, an MNE attains a better credit rating and correspondingly reduced interest rate from an independent lender due to its membership of the MNE group of which it is a part and where there is no contractual obligation of any group member to provide support.

69. The presence of implicit group support may affect the credit rating of the borrower (if it has a rating independent of any group rating) or the rating of any debt which it issues. In determining the likelihood of support from other group members in the event of the borrower getting into financial difficulty, the relative status of an entity within the group may help determine what impact if any that potential group support has on the credit rating of a debt issuer. Typically group members are considered to be more, or less, likely to receive group support according to the relative importance of the entity to the group as a whole and the linkages between it and the rest of the group, either in its current form or in terms of future strategy. Another key consideration would be the likely consequences for other parts of the MNE group of supporting or not supporting the borrower. The criteria used to determine the status of an entity in this regard may include such considerations as legal obligations (including any guarantee commitments or regulatory requirements), strategic importance, operational integration and significance, shared name, potential reputational impacts, general statement of policy or intent, and any history of support.

Box C.4. Question to commentators

Commentators' views are invited on the relevance of the analysis included in paragraph 70 of this discussion draft.

70. In assessing the extent to which it may be reasonable to assume that the group would be likely to support a particular entity, a group member with stronger links, that is integral to the group's identity or important to its future strategy, typically operating in the group's core business, would ordinarily be more likely to be supported by other group members than a less integral member. The impact of an assessment of implicit support is a matter of judgement but depending on the particular facts and circumstances it may be appropriate to treat those entities most likely to receive group support as having a credit rating more closely linked to the group rating.

71. Conversely, it may be reasonable to assume that a group entity would be likely to receive support from the rest of the group in more limited circumstances where it does not show those same indicators or the linkages are weaker. It may be appropriate in such cases to first consider the stand-alone credit rating of the entity modifying the rating upward according to the same criteria.

72. In the case of an entity which is of no strategic importance to the group and has only weak linkage it might be appropriate on the prevailing facts and circumstances to consider the entity on the basis of its own stand-alone rating only.

73. Particular circumstances may apply which depart from this general approach. For example, if the stand-alone credit rating of an entity is higher than that of the group, it may be appropriate to consider capping the issuer rating for the entity at the group level in circumstances where the parent would likely be able to impose requirements that would undermine the existing rating.

74. The kind of information on which the group would base a decision of whether or not to provide support to a borrower in particular circumstances is usually not available to a tax administration. Furthermore, changing facts and circumstances affecting the willingness or ability of the group to provide support may mean that there is no decision by the group itself until the eventuality for such support arises. This contrasts, for example, with a formal guarantee where a binding commitment is made when the guarantee is

written. An evidenced or publicly stated policy in respect of the group's general approach or its commitment to a particular group member would provide a strong indication of the likelihood of support albeit that such commitment may fall short of a legally binding guarantee. Similarly, the past behaviour of a group as regards providing support can be a useful indicator of likely future behaviour. The effect of potential group support on the credit rating of a company and so, by extension, any effect on its ability to borrow or on the interest rate on its borrowings would not require any payment or comparability adjustment. See example 1 at Paragraphs 1.164 -1.166.

C.1.4. Covenants

75. The purpose of covenants in a loan agreement is generally to provide a degree of protection to the lender and so limit its risk. That protection may be in the form of incurrence covenants or maintenance covenants.

76. Incurrence covenants require or prohibit certain actions by the borrower without the consent of the lender. Incurrence covenants may, for example, prohibit the borrower from taking on additional debt, creating any charge on the assets of the company or disposing of particular assets of the company, thus giving some degree of certainty over the balance sheet of the borrower.

77. Maintenance covenants refer typically to financial indicators which have to be met at regular, predetermined intervals during the life of covenanted loan. Maintenance covenants can act as an early warning system so that in the event of financial underperformance by the borrower, the borrower and/or lender can move to take remedial action at an early stage. This can help to protect unrelated lenders against information asymmetry.

78. There may be less information asymmetry (that is, better visibility) in the intra-group context than in situations involving unrelated parties. Intra-group lenders may choose not to have covenants on loans to associated enterprises, partly because they are less likely to suffer information asymmetry and because it is less likely that one part of a group would seek to take the same kind of action as an independent lender in the event of a covenant breach, nor would it usually seek to impose the same kind of restrictions. Where there is an absence of covenants in any written agreement between the parties, it will be appropriate to consider under Chapter I guidance whether there is, in practice, the equivalent of a maintenance covenant between the parties and the consequential impact upon the pricing of the loan.

C.1.5. Guarantees

79. A guarantee from another party may be used to support the borrower's credit. A lender placing reliance on a guarantee or guarantees would need to evaluate the guarantor(s) in a similar way to that in which it evaluates the original borrower. For the lender to take a guarantee into account in setting or adjusting the terms and conditions of a loan, it would need to be reasonably satisfied that the guarantor(s) would be able to meet any shortfall resulting from the borrower being unable to meet its obligations in full in the event of a default. Guarantees are discussed in more detail in Section D.

C.1.6. Loan fees and charges

80. In considering arm's length pricing of loans, the issue of fees and charges in relation to the loan may arise. Independent commercial lenders will sometimes charge fees as part

of the terms and conditions of the loan, for example arrangement fees or commitment fees in relation to an undrawn facility. If such charges are seen in a loan between associated enterprises, they should be evaluated in the same way as any other intra-group transaction. In doing so, it must be borne in mind that independent lenders' charges will in part reflect costs incurred in the process of raising capital and in satisfying regulatory requirements, which associated enterprises might not incur.

C.1.7. Pricing approaches to determining an arm's length interest rate

Box C.5. Question to commentators

Commentators' views are invited on:

- the role of credit default swaps (CDS) in pricing intra-group loans;
- the role of economic models in pricing intra-group loans (for instance, interest determination methods used by credit institutions).

81. The following paragraphs present different approaches to pricing intra-group loans. As in any other transfer pricing situation, the selection of the most appropriate method should be consistent with the actual transaction as accurately delineated, in particular, through a functional analysis. (See Chapter II).

Comparable uncontrolled price

82. Once the actual transaction has been accurately delineated, arm's length interest rates can be sought based on consideration of the credit rating of the borrower taking into account all of the terms and conditions of the loan and comparability factors.

83. The widespread existence of markets for borrowing and lending money and the frequency of such transactions between independent borrowers and lenders, coupled with the widespread availability of information and analysis of loan markets may make it easier to apply the CUP method to financial transactions than may be the case for other types of transactions. Information available often includes details on the characteristics of the loan and the credit rating of the borrower. Characteristics which will usually increase the risk for the lender, such as long maturity dates, absence of security, subordination, or application of the loan to a risky project, will tend to increase the interest rate. Characteristics which limit the lender's risk, such as strong collateral, a high quality guarantee, or restrictions on future behaviour of the borrower, will tend to result in a lower interest rate.

84. The arm's length interest rate for a tested loan can be benchmarked against publicly available data for other borrowers with the same credit rating for loans with sufficiently similar terms and conditions and other comparability factors. With the extent of competition often present within lending markets, it might be expected that, given the characteristics of the loan (amount, maturity, currency, etc.) and the credit rating of the borrower (see C.1.2. Use of credit ratings), there would be a single rate at which the borrower could obtain funds and a single rate at which a lender could invest funds to obtain an appropriate reward. In practice, however, there is unlikely to be a single "market rate" but a range of rates although competition between lenders and the availability of pricing information will tend to narrow the range.

85. In the search for comparability data, a comparable is not necessarily restricted to a stand-alone company. In examining commercial loans, where the potentially comparable borrower is a member of a multinational group and has borrowed from an independent lender, provided all other economically relevant conditions are sufficiently similar, a loan to a member of a different group or between members of different groups could be a valid comparable.

86. Arm's length interest rates can be also based on the return of realistic alternative transactions with comparable economic characteristics. Depending on the facts and circumstances, realistic alternatives to intra-group loans could be, for instance, bond issuances.

Box C.6. Question to commentators

Commentators are invited to identify financial transactions that may be considered as realistic alternatives to intra-group loans.

Internal CUPs

87. When considering issues of comparability, the possibility of internal CUPs should not be overlooked.

88. Whereas it is unlikely that an MNE group's average interest rate paid on its external debt meets the comparability requirements to be considered as an internal CUP, it may be possible to identify potential comparable loans within the borrower's or its MNE group's financing with an independent lender as the counterparty. As with external CUPs, it may be necessary to make appropriate adjustments to improve comparability. See Example 1 at 1.165-1.166.

Box C.7. Question to commentators

Commentators are invited to describe situations in which an MNE group's average interest rate paid on its external debt can be considered as an internal CUP.

Cost of funds

89. In this approach the loan would be priced based on the cost of funds incurred by the lender in raising the funds to lend. To this would be added the expenses of arranging the loan and the relevant costs incurred in servicing the loan, a risk premium to reflect the various economic factors inherent in the proposed loan, plus a profit margin.

90. One consideration to be kept in mind with the cost of funds approach is that it should be applied by considering the lender's cost of funds relative to other lenders' operating in the market. The cost of funds can vary between different prospective lenders, so the lender cannot simply charge based on its cost of funds, particularly if there is a potential competitor who can obtain funds more cheaply. A lender in a competitive market may seek to price at the lowest possible rate in order to win business. In the commercial

environment, this will mean that lenders drive operating costs as low as possible and seek to minimise the cost of obtaining funds to lend.

91. In some intra-group transactions, the cost of funds approach may be used to price loans where capital is borrowed from an unrelated party which passes from the original borrower through one or more associated intermediary companies, as a series of loans, until it reaches the ultimate borrower. In such cases, where only agency or intermediary functions are being performed, as noted by paragraph 7.34, “*it may not be appropriate to determine the arm’s length pricing as a mark-up on the costs of the services but rather on the costs of the agency function itself.*”

Bank opinions

92. In some circumstances taxpayers may seek to evidence the arm’s length rate of interest on an intra-group loan by producing written opinions from independent banks, sometimes referred to as a “bankability” opinion, stating what interest rate the bank would apply were it to make a comparable loan to that particular enterprise.

93. Such an approach would represent a departure from an arm’s length approach based on comparability since it is not based on comparison of actual transactions. Furthermore, it is also important to bear in mind the fact that such letters do not constitute an actual offer to lend. Before proceeding to make a loan, a commercial lender will undertake the relevant due diligence and approval processes that would precede a formal loan offer. Such letters would not therefore generally be regarded as providing evidence of arm’s length terms and conditions.

C.2. Cash pooling

Box C.8. Question to commentators

With respect to the operation of a physical cash pool, commentators’ views are invited on the situations in which a cash pool leader would be allocated risks with respect to lending within the MNE group rather than as providing services to cash pool participants coordinating loans within the group without assuming risks with respect to those loans.

Commentators’ views are also invited regarding the three possible approaches that are described in the draft for allocating the cash pooling benefits to the participating cash pool members, along with examples of their practical application. In particular,

- are there circumstances in which one or another of the approaches would be most suitable?;
- does the allocation of group synergy benefits suffice to arrive at an arm’s length remuneration for the cash pool members?;
- whether, in commentators’ experience, the allocation of group synergy benefits is the approach used in practice to determine the remuneration of the cash pool members?

Commentators are also invited to describe approaches other than the ones included in the discussion draft that may be relevant to remunerate the cash pool members.

C.2.1. Cash pooling structures

94. The use of a cash pool is popular among multinational enterprises as a way of achieving more efficient cash management by bringing together, either physically or notionally, the balances on a number of separate bank accounts. Depending on the particular arrangements in place, a cash pool can help to achieve more effective liquidity management, reliance on external borrowing can be reduced or, where there is a cash surplus, an enhanced return may be earned on any aggregated cash balance. Financing costs may also be reduced by eliminating the bank spread embedded in the interest which would be payable or receivable on a number of separate debit or credit account balances and by reducing banking transaction costs.

95. In the context of this section, cash pooling is the pooling of cash balances as part of a short-term liquidity management arrangement. Cash pool arrangements are complex contracts which may involve controlled and uncontrolled transactions. For instance, one common structure is that the participating members of the MNE group conclude a contract with an unrelated bank that renders cash pooling services, and each participating member opens a bank account with that bank.

96. Although there are two basic types of cash pooling arrangements – physical and notional – other variations and combinations may be arranged to meet specific business needs. For example, a number of physical pools might be held, one for each currency in which the business operates, along with a notional pool which then combines those individual currency pools.

Physical pooling

97. In a typical physical pooling arrangement, the bank account balances of all the pool members are transferred daily to a single central bank account owned by the cash pool leader. Any account in deficit is brought to a target balance (usually zero) by a transfer from the master account to the relevant sub account. Depending on whether there is a surplus or a deficit after the members' accounts have been adjusted to the target balance, the cash pool leader may borrow from the bank to meet the net funding requirement of the pool or deposit any surplus as appropriate.

Notional pooling

98. In a notional cash pool, some of the benefits of combining credit and debit balances of several accounts are achieved without any physical transfer of balances between the participating members' accounts although the bank will usually require cross-guarantees from pool participants to enable the right to set off between accounts if necessary. The bank notionally aggregates the various balances of the individual accounts of participating members and pays or charges interest according to the net balance, either to a designated master account or to all participating accounts under a formula determined in the cash pooling agreement.

99. With no physical transfers of funds, the transactional costs of operating a notional pool are likely to be less than transactional costs of operating a physical pool. Functions carried out by the bank would be accounted for in the charges or interest rate of the bank. With minimal functions carried out by the pool leader (because functions are primarily performed by the bank), there will be little if any value added by the pool leader to be reflected in the intra-group pricing. An appropriate allocation of the benefit created as a

result of the elimination of the bank spread and/or the optimisation of a single debit or credit position would need to consider the contribution or burden of each pool participant.

C.2.2. Accurate delineation of cash pooling transactions

100. The accurate delineation of the cash pooling transactions will depend on the particular facts and circumstances of each case. As cash pooling is not undertaken regularly, if at all, by independent enterprises, the application of transfer pricing principles requires careful consideration. As paragraph 1.11 notes, “*Where independent enterprises seldom undertake transactions of the type entered into by associated enterprises, the arm’s length principle can be difficult to apply because there is little or no direct evidence of what conditions would have been established by independent enterprises.*”

101. The accurate delineation of cash pooling arrangements would need to take into account not only the facts and circumstances of the balances transferred but the wider context of the conditions of the pooling arrangement as a whole. For example, a cash pool is likely to differ from a straightforward overnight deposit with a bank or similar financial institution in that a cash pool depositor is not depositing money as a transaction in isolation with a view to a simple depositor return.

Box C.9. Question to commentators

In the context of the last sentence of paragraph 102, commentators’ views are invited on a situation where an MNE, which would have not participated in a cash pool arrangement given the particular conditions facing it, is obliged to participate in it by the MNE group’s policy.

102. The cash pool member is likely to be participating in providing liquidity as part of a broader group strategy, an arrangement in which the member can participate as depositor or borrower, which may include among its aims a range of benefits that can only be achieved as part of a collective strategy involving the pool members, done for the benefit of all of the pool participants, and the membership of which is limited to entities within the group. Pool participants deposit cash to the pool (or withdraw cash from the pool), and not to (or from) a particular cash pool member. No member of the pooling arrangement would expect to participate in the transaction if it made them any worse off than their next best option.

103. In delineating the cash pool transactions, it may be that the savings and efficiencies achieved are determined to arise as a result of group synergies created through deliberate concerted action (as discussed in Section D.8 of Chapter I).

104. As indicated in paragraph 1.159, the determination of the results that arise from deliberate concerted group action must be established through a thorough functional analysis. Accordingly, in the context of cash pooling arrangements, it is necessary to determine (i) the nature of the advantage or disadvantage, (ii) the amount of the benefit or detriment provided, and (iii) how that benefit or detriment should be divided among members of the MNE group.

105. An advantage of a cash pooling arrangement may be the reduction of interest paid or the increase of interest received, which results from netting credit and debit balances. The amount of that group synergy benefit, calculated by reference to the results that the

cash pool members would have obtained had they dealt solely with independent enterprises, would generally be shared by the cash pool members, provided that an appropriate reward is allocated to the cash pool leader for the functions it provides in accordance with C.2.3. Pricing of cash pooling transactions.

106. Another key consideration in analysing intra-group funding arrangements which might be described as cash pooling are situations where group members maintain surpluses or borrowing positions which, rather than functioning as part of a short-term liquidity arrangement, become more long term. It would usually be appropriate to consider whether, on accurate delineation, it would be correct to treat them as something other than a short-term cash pool balance, such as a longer term deposit or a term loan.

107. One of the practical difficulties in such situations will be deciding how long a balance should be treated as part of the cash pool before it could potentially be treated as something else, for example a term loan. As cash pooling is intended to be a short-term, liquidity-driven arrangement, it may be appropriate to consider whether the same pattern is present year on year and to examine what policies the MNE's financial management has in place, given that yield on cash balances is a key financial management issue.

108. A potential difficulty for tax administrations in analysing cash pooling arrangements is that the various entities in a cash pool may be resident across a number of jurisdictions, potentially making it difficult to access sufficient information to verify the position as set out by the taxpayer. It would be of assistance to tax authorities if MNE groups would provide information on the structuring of the pool and the returns to the cash pool leader and the members in the cash pool as part of their transfer pricing documentation. (See Annex I to Chapter V of the TPG about the information to be included in the master file).

C.2.3. Pricing of cash pooling transactions

Rewarding the cash pool leader

109. The appropriate reward of the cash pool leader will depend on the facts and circumstances, the functions performed, the assets used and the risks assumed in facilitating a cash pooling arrangement.

110. As with many types of financial transactions, different intent and understanding can be ascribed to the labels or descriptions attached to particular transactions. Each case must be considered on its own facts and circumstances and in each case accurate delineation of the actual transactions in accordance with the principles of Chapter I will be needed before any attempt to decide on an approach to pricing a transaction.

111. In general, a cash pool leader performs no more than a co-ordination or agency function with the master account being a centralised point for a series of book entries to meet the pre-determined target balances for the pool members. Given such a low level of functionality, the cash pool leader's remuneration as a service provider will generally be similarly limited.

112. Where accurate delineation of the actual transactions determines that a cash pool leader is carrying on activities other than coordination or agency functions, the pricing of such transactions would follow the approaches included in other parts of this guidance, as appropriate.

113. The following examples illustrate the principles described above.

Example 1

114. X is the parent company of an MNE group which has subsidiaries H, J, K, and L which participate in a physical cash pooling arrangement with fellow subsidiary M acting as cash pool leader. All participants have the same functional currency and that is the only currency in the pool.

115. M sets up an intra-group cash pooling arrangement with an unrelated bank. Legal arrangements are put in place for all participants which allow transfers to or from M's cash concentration account to meet a specified target balance for each pool participant.

116. Under the cash management services agreement the bank makes any transfers necessary to meet the target balance for each pool participant with any net surplus deposited by M or any net overdrawn position being met by the bank lending to M. The facility that M may draw on is guaranteed by X. The third-party bank pays interest to, or receives interest from M based on the overall, pooled, position. In this instance, M receives surplus funds from group members H and J and provides funds to group members K and L which have a funding need. Interest on the balances of the pool participants is charged or paid in accordance with the pooling agreements.

117. As a result of the arrangements in place, M pays less interest to the bank or receives more interest than would have been the case absent the pooling arrangements.

118. A functional analysis shows that M is not subject to credit risk, which remains with the cash pool members, but merely performs a co-ordination function. Furthermore M is not performing the functions or assuming the risks that a bank would. Therefore M would not earn the kind of reward that a bank would earn such as retaining the interest spread between deposits and loans. Accordingly, M would earn a reward commensurate with the service functions it provides to the pool.

Example 2

119. Company T, a member of MNE Group Y, performs as the group treasury company undertaking a range of different financial transactions both intra-group and externally. Company T's main purpose is to provide treasury services to the group including strategy and management of group liquidity. T is responsible for raising finance across the group by issuing bonds or borrowing from third party banks and arranges intra-group loans to meet the funding needs of other group members as necessary.

120. As part of the group liquidity arrangements, T operates a group cash pooling arrangement and is responsible for deciding how to invest surplus funds or fund any shortfall. T sets the intra-group interest rates and is at risk for any differences between the rates it sets with other group members and the rates at which it transacts 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.

121. The analysis under the guidance in Section D.1 of Chapter I indicates that the actual transactions should be accurately delineated as intra-group loans in the context of the treasury activities undertaken by Company T since Company T is performing functions and assuming risks that go beyond the coordination role of a cash pool leader. In particular, the functional analysis shows that Company T controls the financial risks contractually allocated to it and has the financial capacity to bear those risks.

122. Accordingly, T should be compensated for the functions it performs and the risks it assumes in accordance with the guidance in Section C.1 The lender's and borrower's

perspectives of this guidance. This may include earning part or all of the spread between the borrowing and lending positions which it adopts.

123. It should be borne in mind that the other group members which transact with T would still only do so if this left them no worse off than their next best option.

Rewarding the cash pool members

124. The method for allocating the synergy benefit among the pool participants will depend on the specific facts and circumstances of each pool.

125. This could be achieved by considering the amount of interest the participant would have received from, or owed to, the bank absent the pooling arrangement and making an adjustment in respect of the pooling effect. The pooling benefit itself may have different components, e.g. an enhancement of the MNE group's liquidity management; the saving made from offsetting debit and credit positions ("netting benefit"); the "volume discount" on the overall balance, etc. Accordingly, it may be appropriate to vary the proportion of the benefit attributed to each pool member by a different method in each case.

126. Three approaches can be envisaged for allocating the cash pooling benefits to the participating cash pool members. These approaches are not necessarily mutually exclusive.

Enhancing the interest rate for all participants

127. Where there are both debit and credit balances in the pool, it may be appropriate to benefit both borrowers and lenders with a more favourable interest rate, for example by relating this to the size of the balance that they contribute to the pool, regardless of whether that is a credit or debit balance.

Applying the same interest rate for all participants

128. Another way to allocate the interest rate benefit, in a situation where all cash pool members have the same or a similar credit profile, may be by using the same interest rate for all pool participants regardless of whether they are depositors to or borrowers from the pool.

Allocating the cash pooling benefits to the depositors

129. In those situations where there is a genuine credit risk to the depositors, the interest rate benefit of pooling may be rateably allocated among the net depositors to the pool on the basis that the depositors have their capital at risk across all net borrowers from the pool members and so should be entitled to any benefit arising from the use of that capital.

Cash pooling guarantees

Box C.10. Question to commentators

Commentators' views are invited on whether cross-guarantees are required in the context of cash pooling arrangements (physical or notional), and how they are implemented in practice, along with examples.

Commentators' views are also invited on whether cross-guarantees are, in effect and substance (even if not in written contractual form), present in cash pooling arrangements.

130. As part of the cash pooling arrangement, cross-guarantees and rights of set-off between participants in the cash pool may be required. This raises the question of whether guarantee fees should be payable. It will always be appropriate to consider the particular facts and circumstances in any situation but there are certain factors which are likely to be common to many cash pools: there will be numerous members of the pool, there may be both borrowers and depositors in the pool, each pool member may have a different stand-alone credit rating, and the pooling agreement with the bank is likely to require full cross-guarantees and rights of set-off between all pool participants.

131. These cross-guarantees and set-off rights are a feature of an arrangement which would not occur between independent parties. Each guarantor is providing a guarantee for all members of the pool but will not have control over membership of the pool, has no control over the quantum of the debt which it is guaranteeing, and may not be able to access information on the parties for whom it is providing a guarantee. With other parties providing guarantees on the same loans, it may not be possible for the guarantor to evaluate its real risk in the event of a default. Thus, the practical result of the cross-guaranteeing arrangement is such that the formal guarantee may represent nothing more than an acknowledgement that it would be detrimental to the interests of the group not to support the performance of the cash pool leader and so, by extension, the borrower. In such circumstances the guaranteed borrower may not be benefitting beyond the level of credit enhancement attributable to the implicit support of other group members. If the prevailing facts and circumstances support such a conclusion, no guarantee fee would be due, and any support, in case of a default from another group member, should be regarded as a capital contribution.

C.3. Hedging

132. Intra-group financial transactions may include instruments by which risk is transferred within the MNE group. For example, hedging arrangements are frequently used, in the ordinary course of business, as a means of mitigating exposure to risks such as foreign exchange or commodity price movements. An independent entity may decide to assume such risks or hedge against them according to its own policies. However, in an MNE group, such risks might be treated differently depending on the group's approach to risk management and hedging.

133. Often an MNE group will centralise treasury functions and implement risk mitigation strategies relating to interest rate and currency risks in order to improve efficiency and effectiveness with the result that individual entities may not contractually

enter into hedging arrangements although their risk is hedged from the perspective of the MNE as a whole.

134. Possible mechanisms by which an MNE group may centralise the hedging of risk include:

- delegation of responsibility for hedging to a group treasury company, with the hedging contracts arranged for and in the name of the relevant operating companies;
- delegation of responsibility for hedging to a group treasury company, with the hedging contracts made by and in the name of another group company;
- identification of the existence of natural hedges within the group, in which case no formal hedging contracts are made.

135. Where the centralised treasury function arranges a hedging contract that the operating company enters into, that centralised function can be seen as providing a service to the operating company, for which it should receive compensation on arm's length terms.

136. More difficult transfer pricing issues may arise, however, if the contract instrument is entered into by the treasury company or another group company, with the result that the positions are not matched within the same company, although the group position is protected. Where off-setting hedging contract instruments exist within the group but not within the same entity, or where contract instruments do not exist within the group but the group position is protected (as may be the case with a natural hedge, for example), it would be inappropriate to match the hedges within the same entity or recognise hedging transactions where written contracts do not exist without a comprehensive analysis of the accurate delineation of the actual transactions under Section D.1 of Chapter I and the commercial rationality of the transactions under Section D.2 of Chapter I.

Box C.11. Question to commentators

In a situation where there are off-setting positions within an MNE group, commentators' views are invited on how accurate delineation of the actual transaction under Chapter I affects the profits and losses booked in separate entities within the MNE group as a result of exposure to risks.

Regarding scenarios where a member of an MNE group has a risk exposure which it wishes to hedge but there is an off-setting position elsewhere in the group and group policy prevents the MNE from hedging its exposure, commentators' views are invited on whether that risk should be treated as being assumed by the unhedged MNE or by the entity which sets the group policy. If the latter, what would be the resulting treatment under the Transfer Pricing Guidelines?

D. Guarantees

Box D.1. Question to commentators

Commentators' views are invited on

- how a related party financial guarantee should be accurately delineated in accordance with the guidance in Chapter I of the TPG (considering also, for example, situations where it could be considered as a provision of a financial service, the sale of a financial asset or as a simple treasury service associated with a loan);
- the circumstances in which a guarantee is likely to be insisted upon by an independent lender granting a loan to a member of an MNE group;
- where guarantees are insisted upon by an independent lender who grants a loan to a member of an MNE group, how and why guarantees affect credit rating and loan pricing; and
- examples of the most frequent cases where borrowers obtain guarantees from independent guarantors when borrowing from independent lenders together with examples of the process or mechanism by which a price is arrived at.

137. This section considers financial guarantees on certain intra-group transactions. To consider any transfer pricing consequences of a financial guarantee, it is first necessary to understand the nature and extent of the obligations guaranteed and the consequences for all parties, accurately delineating the actual transaction in accordance with Section D.1 of Chapter I.

138. In general, a financial guarantee provides for the guarantor to meet specified financial obligations in the event of a failure to do so by the guaranteed party. There are various terms in use for different types of credit support and from one member of an MNE group to another in particular, at one end of the spectrum is the formal written guarantee and at the other is the implied support attributable solely to membership in the MNE group. In the context of this section, a guarantee is a legally binding commitment on the part of the guarantor to assume a specified obligation of the guaranteed debtor if the debtor defaults on that obligation. The situation likely to be encountered most frequently in a transfer pricing context is that in which a related party guarantor provides a guarantee on a loan taken out by an associated enterprise from an unrelated lender.

D.1. Financial guarantees

139. From the perspective of a lender, the consequence of one or more explicit guarantees is that the guarantor(s) are legally committed; the lender's risk would be expected to be reduced by having access to the assets of the guarantor(s) in the event of the borrower's default. Effectively, this may mean that the guarantee allows the borrower to borrow on the terms that would be applicable if it had the credit rating of the guarantor rather than the terms it could obtain based on its own, non-guaranteed, rating. The principles and methodologies of pricing a guarantee in these circumstances are similar to those explained for loan pricing in Section C.1.7.

140. Where the effect of a guarantee is to permit a borrower to borrow a greater amount of debt than it could in the absence of the guarantee, the guarantee is not simply supporting the credit rating of the borrower but could be acting both to increase the borrowing capacity and to reduce the interest rate on any existing borrowing capacity of the borrower. In such a situation there may be two issues – whether a portion of the loan from the lender to the borrower is accurately delineated as a loan from the lender to the guarantor (followed by an equity contribution from the guarantor to the borrower), and whether the guarantee fee paid with respect to the portion of the loan that is respected as a loan from the lender to the borrower is arm’s length. The conclusion of an analysis of such transactions may be, taking into account the full facts and circumstances, that the evaluation of the guarantee fee should be limited to a fee on the portion of the alternative structure appropriately characterised as debt, and the remainder of the loan granted should be regarded as effectively a loan to the guarantor followed by an equity contribution by the guarantor to the borrower.

141. Where the effect of a related party guarantee as accurately delineated is to reduce the cost of debt-funding for the borrower, it might be prepared to pay for that guarantee, provided it was in no worse a position overall. In considering the borrower's overall financial position as a result of the guarantee, its cost of borrowing with the guarantee would be measured against its non-guaranteed cost of borrowing, as adjusted for any implicit support, and the cost of the guarantee (including any associated costs of arranging the guarantee). Borrowing with a guarantee might also affect terms and conditions of the loan other than price, each case will depend on its own facts and circumstances. An independent company providing a financial guarantee would expect to receive a fee to compensate it for the risk it is taking in accepting the contingent liability and to reflect any value it is providing to the borrower in respect of the guarantee. However, it must be borne in mind that an independent guarantor's charges will in part reflect costs incurred in the process of raising capital and in satisfying regulatory requirements. Those are costs which associated enterprises might not incur.

D.1.1. Explicit guarantees, implicit guarantees and cross-guarantees

142. By providing an explicit guarantee the guarantor is exposed to additional risk as it is legally committed to pay if the borrower defaults. Anything less than a legally binding commitment, such as a “letter of comfort” or other lesser form of credit support, involves no explicit assumption of risk. Each case will be dependent on its own facts and circumstances but generally, in the absence of an explicit guarantee, any expectation by any of the parties that other members of the MNE group will provide support to a related party in respect of its borrowings will be derived from the borrower's status as a member of the group. The benefit of any such support attributable to the borrower's group member status would arise from passive association and not from the provision of a service for which a fee would be payable. See paragraph 7.13 on passive association and Section C.1.3 Effect of group membership.

143. A borrower would not generally be prepared to pay for a guarantee if it did not expect to obtain an appropriate benefit in return. Even an explicit guarantee will not necessarily confer a benefit on the borrower; for example, banking covenants applicable to a parent or other group member’s debt facilities can include the default of another group member as an event that may cause the termination of a facility or other adverse consequences. Other legal, financial or operational ties may mean that it would not be possible to abandon the borrower if it encounters financial difficulty without the group suffering a credit rating downgrade. Any of these circumstances may produce the practical result that group members are financially interdependent quite apart from any formal

guarantee arrangement, so that the economic risk of the guarantor may not change materially on it giving an explicit guarantee. In other words, the formal guarantee may represent nothing more than an acknowledgement that it would be detrimental to the interests of the group not to support the performance of the borrower. In such circumstances the guaranteed borrower is not benefitting beyond the level of credit enhancement attributable to the implicit support of other group members and no guarantee fee would be due.

144. Similarly, independent lenders may require guarantees of loans as part of a comprehensive approach to security even though there may be no significant difference between the credit standing of the borrower and an individual guarantor. A similar issue arises in respect of cross-guarantees, where two or more entities in an MNE group guarantee each other's obligations. From the lender's perspective, it has access to the assets of every cross-guaranteeing entity in the event of a default by a guaranteed borrower. This potentially gives the lender greater comfort than a single guarantee as it can choose where within the cross-guaranteeing group it seeks, if necessary, to make its recoveries. The effect of a cross-guarantee from a borrower's perspective is that it now has multiple guarantees on its borrowings and may stand as guarantor for multiple borrowings itself. This can give rise to questions on how to evaluate each guarantee. Not only is this complex from the perspective of potentially large numbers of guarantees to be evaluated but also because each party providing a guarantee may in turn be guaranteed by the party for whom it is now acting as guarantor. Evaluating the effect of a cross-guarantee arrangement is difficult and as the number of parties involved increases, may be practically impossible. It may not be possible to determine the effect of the guarantee between any two parties where the same risk is subject to multiple guarantees. An analysis of the facts may lead to the conclusion that such an arrangement does not enhance the credit standing of a group member beyond the level of passive association, in which case any support in the event of default from another group member should then be regarded as a capital contribution.

D.1.2. Determining the arm's length price of guarantees

145. This section describes a number of pricing approaches for those circumstances where a guarantee is found to be appropriate. However, when the accurate delineation of the actual transaction indicates that the purported guarantee is not a guarantee, other pricing approaches should be considered, in particular the guidance in Chapter VII. As in any other transfer pricing situation, the selection of the most appropriate method should be consistent with the actual transaction as accurately delineated, in particular, through a functional analysis. (See Chapter II)

CUP method

146. The comparable uncontrolled price (CUP) method could be used where there are external or internal comparables; independent guarantors providing guarantees in respect of comparable loans to other borrowers or where the same borrower has other comparable loans which are independently guaranteed.

147. In considering whether controlled and uncontrolled transactions are comparable, regard should be had to all the factors which may affect the guarantee fee including: the risk profile of the borrower, terms and conditions of the guarantee, term and conditions of the underlying loan (amount, currency, maturity, seniority etc.), credit rating differential between guarantor and guaranteed party, market conditions, etc. When available,

comparable guarantees are the most reliable method to determine arm's length guarantee fees.

148. The difficulty with using the CUP method is that a sufficiently similar credit enhancing guarantee is unlikely to be found between unrelated parties given that unrelated party guarantees of bank loans are uncommon.

Yield approach.

149. This approach quantifies the benefit that the guaranteed party receives from the guarantee in terms of lower interest rates. The method calculates the spread between the interest rate that would have been payable by the borrower without the guarantee and the interest rate payable with the guarantee. The first step is to determine the interest rate that would have been payable by the borrower on its own merits, taking into account the impact of implicit support as a result of its group membership. See Section C.1.7 Pricing approaches to determining an arm's length interest rate.

150. The next step would be to determine, by a similar process, the interest rate payable if the borrower had the credit rating of the guarantor. The interest spread can be used in quantifying the benefit gained by the borrower as a result of the guarantee. In determining the extent of the benefit provided by the guarantee, it is important to distinguish the impact of an explicit guarantee from the effects of any implicit support as a result of group membership. See example 1 at 1.167. The benefit to be priced is not the difference between the cost to the unguaranteed borrower on a standalone basis and the cost with the explicit guarantee but the difference between cost to the borrower after taking into account the benefit of any implicit support and the cost with the benefit of the explicit guarantee.

151. The benefit of implicit support will be the difference between the borrowing terms attainable by the borrowing entity based on its credit rating as a member of the group and that attainable on the basis of the credit rating it would have on a stand-alone basis as if it were an entirely unaffiliated enterprise. If the borrower has its own independent credit rating from a commercial credit rater, this will usually reflect its membership of the group and so ordinarily no adjustment would be needed to this credit rating to reflect implicit support.

152. The result of this analysis sets a maximum fee for the guarantee (the maximum amount that the recipient of the guarantee will be willing to pay), namely, the difference between the interest rate with the guarantee and the interest rate without the guarantee but with the benefit of implicit support (and taking into account any costs). The borrower would have no incentive to enter into the guarantee arrangement if, in total, it pays the same to the bank in interest and to the guarantor in fees as it would have paid to the bank in interest without the guarantee. Therefore it does not of itself necessarily reflect the outcome of a bargain made at arm's length but represents the maximum that the borrower would be prepared to pay.

Cost approach

153. This method aims to quantify the additional risk borne by the guarantor by estimating the value of the expected loss that the guarantor incurs by providing the guarantee (loss given default). Alternatively the expected cost could be determined by reference to the capital required to support the risks assumed by the guarantor. There are a number of possible models for estimating the expected loss and capital requirement. Popular pricing models for this approach work on the premise that financial guarantees are

equivalent to another financial instrument and pricing the alternative, for example, treating the guarantee as a put option and using option pricing models, credit default swap pricing models, etc. Pricing under each model will be sensitive to the assumptions made in the modelling process. Whatever valuation model is used, the evaluation of cost method sets a minimum fee for the guarantee (the minimum amount that the provider of the guarantee will be willing to accept) and does not of itself necessarily reflect the outcome of a bargain made at arm's length. The arm's length amount should be derived from a consideration of the perspectives (taking into account options realistically available) of the borrower and guarantor.

Valuation of expected loss approach

154. The valuation of expected loss method would estimate the value of a guarantee on the basis of calculating the probability of default and making adjustments to account for the expected recovery rate in the event of default. This would then be applied to the nominal amount guaranteed to arrive at a cost of providing the guarantee. The guarantee could then be priced based on an expected return on this amount of capital based on commercial pricing models such as the Capital Asset Pricing Model (CAPM).

Capital support method

155. The capital support method may be suitable where the difference between the guarantor and borrower's risk profiles could be addressed by introducing more capital to the borrower's balance sheet. It would be first necessary to determine the credit rating for the borrower without the guarantee (but with implicit support) and then to identify the amount of additional notional capital required to bring the borrower up to the credit rating of the guarantor. The guarantee could then be priced based on an expected return on this amount of capital to the extent that the expected return so used appropriately reflects only the results or consequences of the provision of the guarantee rather than the overall activities of the guarantor-enterprise.

D.1.3. Examples

156. The following examples build on the principles discussed in Section D.8 of Chapter I, in particular in paragraph 1.167.

Example 1

157. Company M, the parent company of an MNE group, maintains an AAA credit rating based on the strength of the group's consolidated balance sheet. Company D, a member of the same MNE group, has a credit rating of only BBB on a stand-alone basis, and needs to borrow EUR 10 million from an independent lender.

158. Assume that the accurate delineation of the actual transaction shows that the effect of passive association raises Company D's credit standing from BBB to A, and that the provision of the explicit guarantee additionally enhances the credit standing of Company D to AAA. Assume further that independent lenders charge an interest rate of 8% to entities with a credit rating of A, and of 6% to entities with a credit rating of AAA. Assume further that Company M charges Company D a fee of 3% for the provision of the guarantee so the guarantee fee completely offsets the benefit of Company D's enhanced credit standing derived from the provision of such guarantee.

159. In that situation, the analysis under Chapter I may indicate that an independent enterprise borrowing under the same conditions as Company D would not be expected to pay a guarantee fee of 3% to Company M for the provision of the explicit guarantee since Company D is better off in the absence of the guarantee.

Example 2

160. Consider the same fact pattern as described in Example 1, but in this case assume that under the guidance in Section D.1.2 Determining the arm's length price of guarantees, comparable uncontrolled transactions can be identified showing that the arm's length price of a comparable guarantee would be in the range of 1% to 1.5%.

161. The accurate delineation of the actual transaction indicates that the enhancement of Company D's credit standing from A to AAA is attributable to a deliberate concerted group action, i.e., the guarantee provided by Company M. Company D would be expected to pay an arm's length guarantee fee to Company M for the provision of the explicit guarantee since Company D is better off than in the absence of the guarantee.

E. Captive insurance

Box E.1. Question to commentators

Commentators' views are invited on the following:

- when an MNE group member issues insurance policies to other MNE group members, what indicators would be appropriate in seeking to arrive at a threshold for recognising that the policy issuer is actually assuming the risks that it is contractually assuming;
- when an MNE group member issues insurance policies to other MNE group members, what specific risks would need to be assumed by the policy issuer for it to earn an insurance return, and what control functions would be required for these risks to be considered to have been assumed; and
- whether an MNE group member that issues insurance policies to other MNE group members can satisfy the control over risk requirements of Chapter I, in particular in the context of paragraph 1.65, in situations where it outsources its underwriting function. Comments are also invited on whether an example would be helpful to illustrate the effect of outsourcing the underwriting function on the income allocated to the MNE group member that issues insurance policies;
- when an MNE group member that issues insurance policies does not satisfy the control of risk requirements of Chapter I, what would be the effect of this on the allocation of insurance claims, premiums paid and return on premiums invested by that MNE group member.

162. There are many ways that MNE groups may manage risks within the group. For example, they may choose to set aside funds in reserves, pre-fund potential future losses, self-insure, acquire insurance from third parties or simply elect to retain the specific risk.

163. In some cases the group may choose to consolidate certain risks through a so-called "captive" insurance company, a group member that provides insurance-type services

exclusively or mainly to members of the MNE group. This section provides guidance on applying the arm's length principle to such intra-group transactions.

E.1. Overview of insurance

164. As stated in Part IV of the 2010 Report on the Attribution of Profits to Permanent Establishments, *“As a general matter, the insurance business is the business of accepting obligations or liabilities in respect of uncertain losses arising from the realisation of events outside the control of the insured. Insurance businesses are able to do this by pooling the potential losses of many risk-averse persons via the payment of an amount by the insured to the insurer, called a premium. In consideration of the payment of the premium, when the insured incurs a loss or a specified event occurs, he, she or a beneficiary is indemnified for the amount of the value of his or her loss or receives an agreed payment or service.”*

165. This description covers the general scheme of insurance but is not intended to exclude from this guidance risks which the insured has some ability to influence, such as product liability risk.

166. A frequent concern when considering the transfer pricing of captive insurance transactions is whether the transaction concerned is genuinely one of insurance, i.e., whether a risk exists and, if so, whether it is allocated to the captive in light of the facts and circumstances. Prescriptive definitions of insurance are beyond the scope of this guidance and the accurate delineation of the actual transaction for transfer pricing purposes must follow the principles set out in Chapter I. The following are indicators, all or substantially all of which would typically be expected in an independent insurer:

- there is diversification and pooling of risk in the captive insurer;
- the economic capital position of the group has improved as a result of diversification and there is therefore a real economic impact for the group as a whole (i.e. the captive insurer either: (i) does not only insure group risks but diversifies those group risks by inclusion within its portfolio of a significant proportion of non-group risks, or (ii) it reinsures a significant proportion of the risks it insures outside of the MNE group);
- both the insurer and any reinsurer are regulated entities with broadly similar regulatory regimes and regulators that require evidence of risk transfer and appropriate capital levels;
- the insured risk would otherwise be insurable outside the group;
- the captive has the requisite skills, including investment skills, and experience at its disposal, including employees with senior underwriting expertise;
- the captive has a real possibility of suffering losses.

167. A captive may be subject to regulation in the same way as other insurance and reinsurance companies. The precise requirements of insurance regulation will vary from one jurisdiction to the next but typically include certain actuarial, accounting and capital requirements. Insurance regulation is intended to protect policyholders. Where the captive insurer provides insurance exclusively to members of the MNE group, local regulators may impose a lighter regulatory regime.

168. Captives may be self-managed from within the MNE group, or managed by an unrelated service provider (often a division of a large insurance broker). Typically this would include ensuring compliance with local law, issuing policy documents, collecting

premiums, paying claims, preparing reports and providing local directors. If the captive is managed from within the MNE group it is necessary to determine which entity manages it (if such management is not exercised by employees of the captive) and to appropriately reward that management.

169. The principles of accurate delineation of the actual transactions and allocation of risk detailed in Chapter I of these Guidelines apply to captive insurance scenarios in the same manner that they apply to any other intra-group transactions. In particular, it should be borne in mind that:

- the carrying on of risk mitigation functions falls within the wider concept of risk management but not within that of control of risk (see paragraphs 1.61 and 1.65);
- there is a difference between the specific risk being insured (the party taking the decision to insure – i.e., mitigate – or not, controls this. That party will usually be the insured but may be another entity within the group) and the risk taken on by the insurer in providing insurance to the insured party.

170. Although the quantum of the risk reward for each might be dependent upon exactly the same events in both cases, that quantum could be significantly different (for example, if the insured risk materialises and a claim is made, the insured party could potentially receive significant upside relative to the premium paid whereas the insurer's income will be limited to the insurance premiums and investment income it has received regardless of the quantum of risk reward received by the insured party).

171. The insurer is carrying out a risk mitigation function in respect of the insured party's risk but not actually assuming that risk. It is assuming the risk of insuring (i.e. mitigating) the insured party's risk. That risk will be controlled by either the insurer or (more likely in a captive insurer scenario) another entity within the group that makes the decision that the risk should be assumed by the insurer. (See paragraph 185). The insurer (or other entity) can make decisions as to how to respond to this risk – in accordance with Para 1.61 (ii) – by, for example, further diversifying its portfolio of insured risks or by re-insuring.

E.2. Rationale for a captive

172. Potential commercial reasons for an MNE group to use a captive insurer include the following: to stabilize premiums paid by MNEs within the MNE group; to benefit from tax and regulatory arbitrage; gaining access to reinsurance markets; or because the group considers that retaining the risk within the group is more cost effective.

173. Another possible reason for the use of a captive insurer by an MNE group in addition to those listed is the difficulty or impossibility of getting insurance coverage for certain risks. Where such risks are insured by a captive insurer this may raise questions as to whether an arm's length price can be determined and the commercial rationality of such an arrangement.

E.3. Existence of insurance

174. In order to consider the transfer pricing implications of a transaction with an MNE captive insurer, it is first necessary to identify the commercial or financial relations between the associated enterprises and the conditions and economically relevant circumstances attaching to those relations in order that the actual transaction is accurately delineated. The

initial question will therefore be whether the transaction under consideration is one of insurance, as defined above.

175. Insurance requires the assumption of risk by the insurer. In the event of a claim, the insured does not suffer the financial impact of a potential economic loss to the extent that risk has been assumed by the insurer, because the loss is offset by the insurance payment. The assumption of risk by the insurer can only take place if the insurer has a realistic prospect of being able to satisfy claims in the event of the risk materialising.

176. Insurance also requires risk distribution. Risk distribution is the pooling of a portfolio of risks by which the insurer reduces the impact of individual claims. Large commercial insurers rely on having sufficiently large numbers of policies with similar probabilities of loss to allow statistical laws of averages to apply and permit accuracy of modelling of the likelihood of claims. The insurer also maintains a portfolio of risks for which it has a capital reserve based on regulatory needs and rating agency requirements. A captive insurer within an MNE may lack the scale to achieve significant risk diversification and may lack sufficient reserves to meet additional risks represented by the relatively less diversified portfolio of the MNE group. In that case, the accurate delineation of the actual transaction may indicate that the captive is operating a business other than an insurance one. (See also paragraph 166.)

E.4. Reinsurance captives – Fronting

177. A reinsurance captive is a particular type of captive insurer which does not issue policies directly but operates as a reinsurer under an arrangement known as “fronting”. Captive insurers may not be able to deal with all risks in the same way as traditional insurance companies. For instance, certain insurance risks must be placed with regulated insurers as a legal requirement. This may lead to the use of a fronting arrangement in which the first contract of insurance is between the insured member of an MNE group and an unrelated insurer (the fronter); the fronter then reinsures with the captive most or all of the risk of the first contract. The fronter may remain responsible for claims handling and other administrative functions or these functions may be handled by a member of the same MNE group as the captive. The fronter retains a commission to cover its costs and to compensate for any portion of the insured risk which it retains. The majority of the fronter’s premium passes to the captive as part of the reinsurance contract.

178. Fronting arrangements represent particularly complex controlled transactions to price as they involve the participation of a third party that is indifferent to the levels of the price of the insurance and re-insurance transactions. The key issues which are likely to arise in fronting cases are whether the transactions involved amount to genuine insurance or reinsurance and, if there is genuine insurance, whether the premiums payable (ultimately to the MNE reinsurance captive) are on arm’s length terms.

E.5. Determining the arm’s length price of captives

179. The following paragraphs outline different approaches to pricing intra-group transactions involving captive insurance. As in any other transfer pricing situation, the most appropriate method should be selected under the guidance of Chapter II.

E.5.1. Pricing of premiums

180. Comparable uncontrolled prices may be available from comparable arrangements between unrelated parties. These may be internal comparables if the captive has suitably similar business with unrelated customers, or there may be external comparables. In practice, detailed analysis may be needed to determine the need for and quantification of comparability adjustments. In particular, account should be taken of potential differences between the controlled and uncontrolled transactions that may affect the reliability of the comparables, such as volume differences.

Box E.2. Question to commentators

Commentators' views are invited on the relevance and the practical application of the approach described in paragraph 181 of this discussion draft.

181. Alternatively, actuarial analysis may be an appropriate method to independently determine the premium likely to be required at arm's length for insurance of a particular risk. In setting prices for an insurance premium, an insurer will seek to cover its expected losses on claims, its costs associated with writing and administering policies and dealing with claims, plus a profit to provide a return on capital, taking into account any investment income it expects to receive on the excess of premiums received less claims and expenses paid.

E.5.2. Combined ratio and return on capital

182. A comparable uncontrolled price can be arrived at by considering the arm's length profitability of the captive by reference to a two staged approach which takes into account both profitability of claims and return on capital. (i) The first step would be to identify the captive's combined ratio. This can be determined by expressing claims and expenses payable as a tested party's claims and expenses paid to arrive at an arm's length measure of annual premiums and thus underwriting profit (premiums receivable less claims and expenses). (ii) The second step is to assess the investment return achieved by the captive against an arm's length return. This step requires two further considerations (a) the amount of capital held by the captive and (b) to the extent to which the captive invests in connected party investments (e.g. intra-group bonds, loans, etc.), the rate of investment return achieved by the captive on those investments. The sum of underwriting profit from step one and investment income from step two gives total operating profit.

183. It is important to recognise that the capital adequacy requirements of a captive insurer are likely to be significantly lower than an insurer writing policies for unrelated parties. This factor should be considered and, if necessary, adjusted for in order to determine the appropriate level of capital to use when calculating the investment return. Differences in capital adequacy between captive insurers and arm's length insurers typically arise because of regulatory and commercial factors. Insurance regulators frequently set lower regulatory capital requirements for captives. A primary commercial driver for arm's length insurers is capital efficiency. In order to attract investors and customers arm's length insurers will target a strong credit rating by holding a level of operating capital which is in excess of the regulatory minimum. At the same time, arm's length insurers will attempt to maximise their return on capital results. They will try to hold the optimum amount of capital to meet these opposing drivers. Captive insurers have no

commercial imperative to seek a credit rating nor to optimise their return on capital in order to attract investors. Reasonable adjustments may need to be made to ensure that the comparable investment return is restricted to the capital that the captive needs under relevant regulatory requirements (plus a reasonable operating buffer to minimise the possibility of inadvertently breaching the regulatory requirement) to accept the insurance risk rather than the level of capital that might be needed by an independent insurer. Adjustments may be needed to account for differing capital adequacy requirements between different regulators and different categories of insurance business.

E.5.3. Group synergy

184. Where a captive is used so that the group can access the re-insurance market to divest itself of risk through insuring risk outside the group, whilst making cost savings over using a third party intermediary, by pooling risks within the MNE group, the captive arrangement harnesses the benefits of collective negotiation on any reinsured risks and more efficient allocation of capital in respect of any risks retained. These benefits arise as a result of the concerted actions of the MNE policyholders and the captive. The insured participants jointly contribute with the expectation that each of them will benefit through reduced premiums. This is similar to the type of group-wide arrangements that might exist for other group functions such as purchasing of goods or services. Where the captive insures the risk and reinsures it in the open market, it should receive an appropriate reward for the basic services it provides. The remaining group synergy benefit should be allocated among the insured participants by means of discounted premiums.

185. For example, a manufacturing MNE group has 50 subsidiaries in different locations around the world, all in locations with substantial risk of earthquake, each insures against earthquake damage at its manufacturing plant, with each plant in a different location, assessed on its individual level of risk. The group sets up a captive which accepts the risk from all of the subsidiaries and reinsures it with independent reinsurers. By bringing together a portfolio of insurance risks across different geographical zones, the group already represents a diversified risk to the market. The synergy benefit arises from the collective purchasing arrangement, not from value added by the captive. It should be allocated amongst the insured according to the level of premium they contributed.

E.6. Agency sales

186. Where an insurance contract is not sold directly from insurer to insured, recompense will usually be due to the party who arranges the original sale. In certain circumstances a higher rate of profit might be earned on the third party sale than would otherwise be expected from comparison with similar transactions. Where the sales agent and insurer or reinsurer are associated, any comparability analysis as part of the process of determining the arm's length level of reward for the parties would need to consider the circumstances that give rise to the high level of profit. Competition would usually work to limit the amount of profit which can be earned on a transaction both on the part of the sales agent and on that of the insurer or reinsurer. The availability of alternative providers may also influence the ability of each party to negotiate a higher level of profit as part of the overall transaction.

Box E.3. Question to commentators

Commentators' views are invited on the example described in paragraphs 187 and 188 of this discussion draft.

187. For example Company A is a high street retailer of high value new technology consumer goods. At the point of sale, A offers insurance policies to third party customers which provide accidental damage and theft cover for a 3-year period. The policies are insured by B, an insurer which is part of the same MNE group as A. A receives a commission with substantially all of the profit on the insurance contract going to B. A full factual and functional analysis shows that the insurance contracts are very profitable and that there is an active market for insurance and reinsurance of the type of risks covered by the policies. Benchmarking studies show that the commission paid to A is in line with independent agents selling similar cover as a standalone product. The profit B earns is above the level of insurers providing similar cover.

188. In considering how the conditions of the transaction between A and B differ from those which would be made between independent enterprises, it is important to consider how the high level of profitability of the insurance policies is achieved and the contributions of each of the parties to that value creation. The product sold to the third party is an insurance policy substantially the same as that which any other insurer in the general market could provide. The sales agent has the advantage of offering the insurance policy to its customer alongside the sale of the goods to be insured. It is the advantage of intervening at the point of this sale which provides the opportunity to earn a high level of profit. A could sell policies underwritten by another insurer and retain most of the profit for itself. B could not find another agent that has the advantage of point of sale contact with the customer. The ability to achieve the very high level of profit on the sale of the insurance policies arises from the advantage of customer contact at the point of sale. The arm's length remuneration for B would be in line with the benchmarked return for insurers insuring similar risks and the balance of the profit should be allocated to A.