Transfer pricing and financial transactions

On February 11th, 2020 the OECD released the technical guidance on the transfer pricing aspects of financial transactions (FTs), which are now included as a new chapter X in the 2022 OECD transfer pricing guidelines, thus formalizing the relevant transfer pricing elements to consider in ensuring that FTs are priced at arm's length.
Most of them are far from being new, as in 2010 the OECD released the well-known "Report On The Attribution Of Profits To Permanent Establishments" which empathized the importance of what would have become the "accurate delineation of the financial transaction", which should begin with the identification of the economically relevant characteristics of the transaction, such as the examination of the contractual terms, the functions performed, the characteristics of the financial instrument, the economic circumstances and the business strategy pursued by the parties.

The OECD guidance identifies different types of FTs, of which the most relevant and common ones are detailed here below.

INTRAGROUP LOANS

In analyzing the economically relevant characteristics of the loan, both the lender's and borrower's perspectives should be taken into account: the parties should consider all the options available before entering into the given FT, such as if they were contracting with unrelated parties in comparable circumstances.
Accordingly, the lender should always assess the borrower creditworthiness': in fact, this is one of the main factors that independent investors normally take into account in determining an arm's length interest rate they would like to retrieve from the financial investment.

On the other side of the FT, the borrower shall always evaluate whether entering into the intragroup transaction be the most convenient option for him.
Actually, a proper file on the options available at both sides at the moment the intragroup FT was undertaken shall always be kept. Furthermore, MNEs deciding to structure intercompany loans (short, medium or long term) should primarily focus on determining the arm's length of the capital structure, and afterwards in determining the arm's length price of the interest rate.

In accurately delineating an intercompany loan, it's important to consider the borrowing capacity of the borrower: in case the principal exceeds such capacity, for tax purposes the excess loan received should be treated as other kind of payment, such as contribution to equity.

FINANCIAL GUARANTEES

The OECD has clarified that anything less than a legally binding commitment such as a "letter of comfort" involves no explicit assumption of risk. For this reason, in delineating a guarantee, it's important to determine its nature (explicit or implicit). Another point of attention should be the economic benefit deriving from the financial guarantees to the borrower. It's important to keep in mind that an unrelated party would be willing to pay for an actual service it received only if it got some benefit in return. The same principle applies to financial guarantees: if they result in an economic benefit to the borrower, then charging a fee for that would be correct; however, in cases where the guarantee results in an increased debt capacity of the borrower, the transaction should be re-characterized as a loan plus an equity contribution. In this last case, the fee should be applied only to what has been delineated as debt.

CASH POOLING

When a cash pool structure is set up, it's important to assess the functional and risk profile of the cash pool leader, and accordingly, whether the cash pooling leader will act as an agent or an in-house bank: in the first case it will be entitled to a service fee, in the latter to an interest margin (spread). As for cash pool participants, the allocation of synergy benefits arising out from the cash pooling system will be done once the remuneration for the cash pool leader has been determined.
It is nonetheless important to pay attention to the risks linked to a wrong setting of the cash pool management system: in fact, longer positions in participants' deposits or debts might lead to a re-characterization of the FT, triggering higher (or lower) interest rates, depending on the case, leading to potential tax assessments.

In light of the importance that FTs have already gained, in particular where a cross-border transaction takes place, please do not hesitate to reach out to your local transfer pricing specialist for further assistance on the matter.

The Andersen
Transfer Pricing Team

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