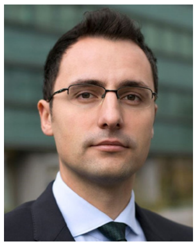
5. Practical Overview of the New Guidance on Financial Transactions from a US, Swiss and OECD Perspective

Salim Damji and Georgy Galumov, Deloitte, Zurich



Introduction

On February 11, 2020, the Organisation for Economic Cooperation and Development ("**OECD**") issued the final version of the Transfer Pricing Guidance on Financial Transactions (the "FT Guidance").

Although tax and transfer pricing professionals had started to digest the implications of the Guidance and to implement relevant changes relating to financial arrangements, the momentum was very quickly interrupted by the onset of the COVID-19 virus and the resulting economic impact for many sectors within the global economy. In this article the authors highlight some of the important practicalities arising from the FT guidance.

Currently both Swiss and US multinational enterprises ("**MNEs**") may need to take action to manage their liquidity and mitigate the impact of the current situation. In this context, the treasury activities and financial arrangements covered by the FT Guidance are of the uttermost importance for the effective execution of such mitigation and cash management strategies. However, in the current situation, MNEs should take into account the principles outlined in the latest FT Guidance in order to comply with the latest OECD requirements and thus provide support needed to minimise the costs of future audits.

Overview on the FT Guidance

The FT Guidance, part of the Actions 8-10 of the Base Erosion and Profit Shifting ("BEPS") project, reflects the comments received in response to the non-consensus public discussion draft released July 3, 2018 and it will update Chapter I of the OECD transfer pricing guidelines ("TPG") as well as a new Chapter X, dedicated to financial transactions. The final FT Guidance provides a framework for determining arm's length compensation in relation to financial transactions.

Accurate Delineation of the Transaction

The FT Guidance focuses on the accurate delineation of the actual transaction to assess the capital structure used to fund an entity within a MNE. The FT Guidance indicates that an approach of accurate delineation, which may include a multifactor analysis, is necessary before pricing a loan to determine whether the purported loan is treated correctly, or should be re-characterized as equity for tax purposes. The FT Guidance lists some factors as useful indicators in accurately delineating a loan, e.g. presence or absence of a fixed repayment date; obligation to pay interest; right to enforce payment of principal and interest; etc.

In applying the arm's length principle to a financial transaction, the FT Guidance advocates for consideration of the conditions that independent parties would have agreed to in comparable circumstances. Further, it is necessary to consider the options realistically available to each of the parties to the transaction.

Treasury Functions: Intragroup Loans, Cash Pooling, and Hedging

The FT Guidance states that the organization of the treasury functions will depend on the structure of the MNE group and the complexity of its operations. It sets out transfer pricing considerations that arise from treasury activities such as intragroup loans, cash pooling, and hedging activities.

Intragroup Loans

In determining the arm's length interest rate on intragroup loans, the FT Guidance recommends that some of the main aspects to be analysed are: the lender's and borrower's perspectives; the credit rating; the effects of group membership; incurrence and maintenance covenants; use of MNE group credit rating; guarantees; and qualitative aspects of the borrower's business. The FT Guidance also outlines transfer pricing approaches that can be undertaken to determine arm's length interest rates.

Cash pooling

The FT Guidance indicates that accurate delineation of cash pooling arrangements would need to take into account the facts and circumstances of the balances transferred, but also the wider context of the conditions of the pooling arrangement as a whole. The FT Guidance mentions two broad pricing models for cash pooling transactions: rewarding the cash pool leader and rewarding the cash pool members. The appropriate basis on which to reward the cash pool leader depends on the specific facts and circumstances of the arrangement. The FT Guidance illustrates the allocation of the benefits of cash pooling to the participating members through the determination of the arm's length interest rates applicable to the debit and credit positions within the pool.

Hedging

When a centralized treasury function arranges a hedging contract that an operating company enters into, the FT Guidance indicates that the centralized function can be seen as providing a service to the operating company and should be rewarded accordingly. When hedging positions are not matched within the same company, although the group position is protected, more difficult transfer pricing issues may arise.

Risk-Free and Risk-Adjusted Rates of Return

The FT Guidance states that when the accurate delineation analysis 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. In such situations the approach to determine the return should be based, among others, on the interest rate on certain government-issued securities as a reference rate for a risk-free return.

Practical Implications from US and Swiss Perspectives

Switzerland and the US, as OECD member States, are broadly following the transfer pricing principles set out within the TPG. The recommendations prescribed by the FT Guidance could thus be used by the US and Swiss tax authorities in the context of assessing the arm's length nature of financial transactions. Although local rules and practices in relation to financial transactions may vary, the OECD FT Guidance will be particularly prominent for discussions in the context of the mutual agreement procedure ("**MAP**"). Further to the approval on July 2019 of the amending protocol[1)], the double taxation agreement ("**DTA**") between US and Switzerland includes a mandatory arbitration clause to protect the tax payer against potential double taxation. As such, since MAP and arbitration may be the ultimate instances in such transfer pricing disputes, and these are governed by OECD principles, we expect that that tax authorities both in the US and Switzerland will pay very close attention to the main concepts outlined within the new FT Guidance.

Thin Capitalization Rules vs Arm's Length Determination
The FT Guidance emphasizes the importance of an adequate delineation of the capital structure (the mix and types of debt and equity) of the taxpayer, as this can effectively impact the deductibility of interest. There is a significant difference between the US provision[2)] for the limitation of interest deductibility, which foresees that the net business interest expense can be deducted only up to 30% of the "adjusted taxable income"[3)], and the Swiss provision that provides for safe haven rules requiring a maximum debt to capital ratio for each asset class (e.g. receivables may be 85% debt financed, investments and IP 70%, etc.).

Although the FT Guidance does not deter governments from applying mechanical thin capitalisation rules, any arm's length disputes are still likely to be covered by OECD principles (e.g. under MAP). It should also be noted that a disallowance of interest under the FT Guidance can be triggered in addition and alongside other local thin capitalisation and interest deductibility rules. It is thus advisable that, when implementing new financial transactions, MNEs take into account not only the local transfer pricing regulations but also the FT Guidance, to strengthen the characterisation of the transactions as debt and support the commercial and financial substance of such transactions.

Safe Haven Interest Rates vs Arm's Length Determination
Switzerland and the US allow taxpayers to make use of safe haven interest rates when pricing intra-group loan transactions. Whereas it is clear that the use of Safe Haven rates does not take into account many of the factors which are usually considered when estimating an arm's length interest rate, the FT Guidance highlights, among other factors, the importance of the analysis of the borrower and lender perspectives. Although there may be times where Safe Haven rates overlap (from borrowing and lending perspectives), it should be noted that due to the way they are implemented by the two jurisdictions, discrepancies may arise, and such Safe Haven approaches will add no weight to discussions under MAPs.

It is advisable that, when implementing new financial transactions, MNEs should take into account the new FT Guidance to ensure that the functional and risk profile of the parties involved is taken into account and to reduce the risk of potential discord between the Swiss and US tax authorities.

Covid-19 and the Immediate Impact on Financial Transactions
The economic downturn linked to the COVID-19 crisis has resulted in significant volatility within the financial capital markets. In accordance with the FT Guidance, this significantly impacts the pricing considerations associated with financial transactions. For example, according to the FT Guidance, the importance of contemporary pricing and consideration of business circumstances is vital. According to the Refinitiv Eikon database, yields on BB rated EUR denominated bonds, with a maturity of 5 years, increased from around 2% to 6% as a result of the COVID-19 crisis. This illustrates that contemporary pricing and appropriate reflection of market considerations is vital. The crisis is also illustrating the importance of cash management and risk management activities for MNEs, and so the value and remuneration of treasury activities needs to be carefully considered in line with the new FT Guidance.

Key takeaways
The latest FT Guidance represents a useful tool for taxpayers and will allow MNEs to review and improve transfer pricing policies in the context of financial transactions, as well as to upgrade transfer pricing documentation, and reinforce benchmarking analyses – all with the aim of avoiding lengthy transfer pricing audits in the future.

In light of the provisions of the Swiss/US DTA, in cases of disagreement between the US and Swiss tax authorities, the Guidance will be relevant for reaching agreement and avoiding double taxation. Therefore, both Swiss and US multinationals should take into account the latest FT Guidance.

For these purposes, provided below is a list of points to consider when entering into intercompany financing arrangements[4)]:

Checklist:
✓ **Accurate delineation: consideration of the arm's length nature of the various terms of debt financing (quantum of debt, term to maturity, currency, security, collateral, interest type, optionality, etc.)**
✓ **Options realistically available: consideration of the options realistically available to both the borrower and lender as potential economic alternatives to a given financial transaction**
✓ **Substance of the lender: consideration of the substance of the lending entity (adequate functional profile of the lender) and potential application of the risk free/risk adjusted rate of return methodology**
✓ **Credit ratings: determination of standalone credit ratings that take into account the impact of passive association/implicit support from the Group**
✓ **Debt pricing: consideration of best sources of data for identifying potential comparables and determining arm's length pricing**
✓ **Cash pooling: consideration of the functional profile of the cash pool leader, and analysing the allocation of benefit between cash pool leader and participants**
✓ **Guarantees: consideration of both guarantor risk and guaranteed entity benefit associated with guarantee arrangements – pricing implications**
✓ **Hedging: consideration of discrepancies between where hedges are booked and where underlying risks are incurred**
✓ **Other considerations: Local interest deductibility requirements, including thin cap and any anti-avoidance rules**

1) On 17 July 2019, the US Senate approved the amending protocol. The Swiss Federal Assembly approved it on 18 June 2010.
2) Regulated under the US Tax CODE §163(J)
3) Similar to EBITDA but starting in 2022 adjusted taxable income will be similar to EBIT.
4) We note that this indicative check list is provided for illustrative purposes only. We have summarized some of the aspects that we consider relevant, however, the list is not exhaustive.

About the authors:

Salim Damji is Partner, Transfer Pricing at Deloitte AG in Zurich.

Georgy Galumov is Director at Deloitte AG in Zurich.