OECD Public Discussion Draft on Financial Transaction: A Critical Review

The article discusses the intricacies of the recent Draft Transfer Pricing guidance on financial transactions issued by The Organization for Economic Cooperation and Development. OECD brings out a new perspective of looking at Financial Transactions from a Transfer Pricing point of view. The article highlights the shortcomings in these new approaches as well as areas where guidance is missing and where further insight would be valuable for tax administrators as well as businesses. Read on to know more…

CA. Manesh Kumar Gupta

CA. Aayushi Verma

The authors are members of the Institute. They can be reached at camaneshgupta@gmail.com and eboard@icai.in

The Organisation for Economic Cooperation and Development (OECD) recently came out with Draft Transfer Pricing (TP) guidance on Financial Transactions. This provides much needed guidance on a very complicated and litigated matter. The Draft proposes a two pronged approach at arriving at correct Pricing of Financial Transactions. First, it recommends examining whether the terms and conduct of financing arrangement itself is at arms' length i.e., correct delineation of the transaction in line with the revised TP guidelines issued by OECD in 2017. It emphasis on accurate classification of financial transaction as debt, equity or hybrid instrument. Only once the nature of transaction is accurately established, then the pricing question needs to be addressed.

The OECD in its Transfer Pricing Guidelines issued in 2017 stoutly defended the Arm's length principle amidst a call for shift to the global formulary apportionment method, given the difficulty and complication in its application in certain significant cases. This blind backing comes even in cases where associated enterprises

enter into transactions that even independent enterprises would not undertake. The OECD's justification of using the arm's length principle in such cases is simply that – '*the mere fact a transaction may not be found between independent parties does not of itself mean that it is not arm's length.*' Considering this glaring gap, there is a need to consider the practical utility of applying some sort of logical apportionment method based on value creation arising out of the economic arrangement especially where multiple entities are involved across numerous jurisdictions. For instance, a typical cash pooling arrangement among members of a multi-national group is rarely found between independent enterprises. Therefore, even if the commercial rationale of such arrangement is demonstrated, justifying the arm's length nature on a hypothetical construct (what would have been adopted by an independent enterprise) would not suffice. In such scenarios, formulary apportionment methods or some variations of profit split method can come in to fill the gaps. However, OECD in the entire document has nowhere discussed the application of the aforementioned methods to specific financial transactions.

> The pertinent question then arises is whether it is appropriate to base our analysis under the arm's length principles on such hypothetical propositions.

The arm's length principle is founded on the basis of Article 9 of the OECD Model Tax Convention which seeks to adjust profits accruing from controlled transactions on the basis of conditions existing in commercial or financial relations between independent enterprises. Such conditions on the basis of which profits ought to be adjusted should approximate to situation prevailing in real world dealings. OECD in the discussion draft has advocated the use of many methods which are extremely theoretical and analytical and have rarely been found to have practical utility for pricing purposes especially in the Indian context. Usage of indirect methods such as option pricing, credit default swap pricing and Expected loss approach is yet to be witnessed in Indian rulings.[1] The pertinent question then arises is whether it is appropriate to base our analysis under the arm's length principles on such hypothetical propositions.

Apart from drawing a parallel between contractual terms of the contract and actual conduct of the parties as suggested in BEPS action plan 8, this paper discusses a stimulating process for delineation of financial transaction requiring a thorough analysis of the lender and borrower engaged in the intra-group funding. The following points should be considered for a two-way analysis:

- The borrowing capacity of the borrower.
- Other alternative options available in market.
- The investment options available for lender.
- The funds actually needed for operational requirement.

The fundamental question that has not been adequately addressed in the draft guideline is whether the existing guidance on delineation of transaction adequate to address issues arising in Intra-group financing arrangements. This problem arises at two levels - one, to actually assess the behaviour between the parties could be difficult, and two, related party agreements do not have the same degree of depth and specificity as that in a non-related party agreement. Is this lack of depth merely a reflection of the fact that the parties are related or should they be considered material enough to be factored in while pricing the transaction? This will require a clear understanding of the principles on which terms or clauses can be distinguished between those that are missing solely because parties are related and those which are material and have to be accounted for when arriving at the correct pricing.

Following are the brief thoughts on the major issues encountered in financial industry transactions:

Guarantees

When it comes to Intra-group guarantee arrangements, the Draft document covers only financial guarantees and does not delve on the subject of performance guarantees, an area which is again very complicated and where enough guidance is missing. When it comes to financial guarantees, the Draft captures few scenarios why

[1] *Sanjay Kumar and Neha Gupta, Corporate Guarantee: A lingering controversy, Taxsutra*

parties require remuneration for providing guarantee. It does not address a situation where guarantee is required not because of the borrower being under-capitalised but because there is risk-constrain at the level of the lender. The Draft also does not discuss all the situations where arms' length payment for guarantees would not be required. For instance, financial guarantee may have been required by the creditors in order to preclude any behavioral issue (i.e.; moral hazard) such as the parent company diverting the borrowed funds from original purpose of the loan to other purposes. Here, the guarantee cannot be regarded as a service for the benefit of the guaranteed party.[1] The article outlines methods such as yield approach, cost approach, valuation of expected loss and capital support for valuation of guarantee.

> The insurance industry is considerably regulated and hence conformity with applicable rules (FDI, FEMA/ exchange control, capital adequacy norms) will also come into play.

Cash Pooling

The OECD has taken a simplified view of cash pooling arrangements. Generally, cash pooling arrangements are part of a broader treasury management function and include a gamut of activities like netting, foreign exchange management and hedging, etc. The group functional characterisation as well as the synergies that accrue as a result of this set-up is different from what has been suggested by OECD. Further, a lot more guidance is needed to list down situations where it is appropriate to characterise a short term cash pool balance as a long term deposit or term loan.

OECD adopts a very narrow view of the functions that a Cash Pool leader performs. It suggests that the same are *"no more than a coordination or agency function"* and *"given such a low level of functionality, the cash pool leader's remuneration as a service provider will generally be similarly limited"*. This pricing model is however applicable mainly to Notional cash pooling arrangements.

In a physical cash pooling arrangement, a cash pool leader may also act as an entrepreneurial entity in an in-house bank structure wherein its FAR is similar to that of an external bank. Here the cash pool leader essentially acts as counterparty to the transactions and bears risks. The functions performed by the cash pool leader involves planning the financial needs of the multinational group, developing the cash pooling concept, and implements the cash pooling concept by negotiating the cash pooling, arrangement and interest rates, drafting intercompany loan agreements, coordinating the cash pool and managing internal offsets of debit and credit positions. In terms of risks, in addition to bearing the credit risk, the cash pool leader also bears the interest rate risk and foreign exchange risk.[2]

Captive Insurance

The article gives a good overview of in-house risk management function through a captive insurance entity, the functions performed by captive insurance entity and different types of captive insurance entity. It also details the methods for valuation of premiums for performing insurance activities such as combined ratio and return on capital and agency sales. The insurance industry is considerably regulated and hence conformity with applicable rules (FDI, FEMA/ exchange control, capital adequacy norms) will also come into play. These considerations should also apply in determining TP for captive insurance. There is a need for further guidance on the interplay between regulatory norms and arm's length pricing for captive Insurers.

The discussion draft although does not sufficiently describe all the scenarios possible in a transaction, it does gives us a direction to proceed further and develop solutions for each case in a manner that is in alignment with the purpose of BEPS action plans. ■

[2] *Anuschka Bakker and Mark M. Levey, Transfer Pricing and Intra-Group Financing, IBFD*
[3] *Vikram Chand, Transfer Pricing Aspect of Cash Pooling Arrangement in Light of the BEPS Action Plan, International Transfer Pricing Journal IBFD*