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REDEFINING THE ARM'S LENGTH
PRINCIPLE FOR FINANCIAL
TRANSACTIONS WITH RESPECT TO
CHANGES IN THE REGULATORY
FRAMEWORK

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I. Abbreviations

APA	Advance Pricing Agreement
ATO	Australian Taxation Office
AUD	Australian Dollar
BEPS	Base Erosion and Profit Shifting
Bps	Basis points
CAHPL	Chevron Australia Holdings Pty Ltd
CAPM	Capital Asset Pricing Model
CbC	Country-by-Country
CDS	Credit Default Swap
CFC	Controlled Foreign Corporation
CML	Capital Market Line
CUP	Comparable Uncontrolled Pricing
DD	Discussion Draft (on transfer pricing of financial transactions)
EAD	Exposure At Default
EBIT	Earnings Before Interest and Tax
EBITDA	Earnings Before Interest, Tax, Depreciation and Amortization
ECB	European Central Bank
EDGAR	Electronic Data Gathering, Analysis and Retrieval
EL	Expected Loss
EU	European Union
FX	Foreign Exchange
GAAR	General Anti-Avoidance Regulation
GECUS	General Electric Capital United States
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards
IRB	Internal Ratings Based
ICT	Income Tax Code
LGD	Loss Given Default
LIBID	London Interbank Bid Rate
LIBOR	London Interbank Offered Rate
M	Maturity
MNE	Multinational Enterprise
MTC	Model Tax Convention
OAS	Option Adjusted Spread
OECD	Organization for Economic Co-operation and Development
PD	Probability of Default
RMBS	Residential Mortgage-Backed Security
SEC	Securities and Exchange Commission
SPV	Special Purpose Vehicle
TEI	Tax Executive Institute
TPG	Transfer Pricing Guidelines
UL	Unexpected Loss
USD	United States Dollar
VaR	Value-at-Risk
WP	Working Party

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1. Introduction

As many examples of aggressive tax planning by Multinational Enterprises (MNEs) were published, it created the suspicion that some taxpayers were not paying their fair share of taxes. Politicians and decision makers, with sometimes different national incentives, were to take action. The G20 and the OECD started the Base Erosion and Profit Shifting (BEPS) inclusive framework. The BEPS framework became a catalysator for tax administrations to strengthen their grip on MNEs. The initiative is centred around 15 actions. Each action point aims to reduce harmful tax planning strategies by international collaboration within its domain.

Actions 8 – 10 focus on transfer pricing as a means to limit BEPS. Action 8 concerns transfer pricing of intangibles. Action 9 aims at preventing BEPS through the transfer of risk within the organization. Action 10 aims at preventing BEPS through transfers that would normally not occur between unrelated parties. These actions suggest transfer pricing guidance to ensure market conform remuneration for intragroup transactions.¹

The general Transfer Pricing Guidelines (TPG), issued by the OECD in 2017, give practical advice to taxpayers and tax administrations that deal with the challenges in the context of actions 8, 9 and 10 on a daily basis.² These guidelines became the standard for many tax administrations and MNEs around the globe. However, the general transfer pricing guidelines have lacunas. Particular areas such as digital economy, hard-to-value intangibles, financial transactions, etc. have specific features and challenges. These topics are discussed in separate consensus documents negotiated between the OECD member states.

This thesis focuses on the discussion draft (DD) on transfer pricing of financial transactions.³ The document was issued on the 3rd of July 2018 in the context of actions 9 and 10. It has been negotiated by Working Party (WP) 6 of the OECD that manages the ongoing negotiations on this topic. However, it is not a consensus document. A final consensus is expected to be reached at the WP meeting in April 2019.

¹ OECD (2018), OECD/G20 Inclusive Framework on BEPS: Progress Report July 2017-June 2018, OECD publishing, Paris, page 5.

² OECD (2017), OECD Transfer Pricing Guidelines for Multinational Enterprises and tax administrations, OECD publishing, Paris.

³ OECD (2018), Discussion Draft on Financial Transactions, OECD publishing, Paris.

2. Research scope and objectives

Cooperation between countries is needed due to the international nature of transfer pricing challenges. However, countries might have different national incentives in the process of negotiating consensus transfer pricing guidelines. The aim of this thesis is to analyse the discussion draft in its judicial context by applying a methodology that incorporates both legal and economic concepts. The thesis will provide answers to three fundamental questions:

1. Are these draft guidelines in line with existing national legislation and international soft law?
2. Are these draft guidelines in line with international case law?
3. How can the compliance burden for taxpayers be minimized?

The scope of this research is limited to three financial instruments: intercompany loans, (physical and notional) cash pooling and financial guarantees. Hedging activities and captive insurance are left out of scope. A selection of transfer pricing landmark cases has been made based on their relevance to this topic. Four countries have been identified to draft how countries formalize transfer pricing in their national tax statutes.

Firstly, this thesis will focus on the transfer pricing foundations as outlined by OECD soft law. Secondly, different financial transactions and their transfer pricing treatment according to the discussion draft are discussed. Subsequently, the different national regulations and case law are discussed in separate chapters. This thesis concludes with a practical methodology to apply a CUP analysis for financial transactions in line with the discussion draft and based on the EU capital requirements directive.⁴

⁴ *Infra Supra* page 44, nr. 177.

3. Arm's length pricing defined by the OECD

In 2017, the OECD published its most recent version of the transfer pricing guidelines for multinational enterprises and tax administrations.⁵ Such guidelines present the general principles underlying the arm's length price for intercompany transactions. This chapter will provide insights on the five fundamental transfer pricing methods proposed by the OECD. The selection of the appropriate method depends on the circumstances of each transaction.⁶ There is no absolute ranking of these methods, according to the OECD.

It is not needed to make an in-depth analysis of the preferred transfer pricing method for each controlled transaction. The applied policy, covering multiple controlled transactions, should substantiate the selection process.⁷ It is also not required to apply multiple methods when pricing a single transaction.⁸

The nature of the controlled transaction, determined by a functional analysis, will make certain methods more suitable than others. In determining the appropriate transfer pricing method, one should also take into account the availability of reliable information. This information is also needed to define reliable comparability adjustments.⁹

The proposed transfer pricing methods can be grouped into two categories: the traditional transaction methods and the transactional profit methods. The first category consists of the CUP, cost plus and resale price method. These traditional transaction methods are considered most direct as the difference in pricing between the tested transaction and the comparables can be linked to commercial and financial relations. In other words, the commercial and financial factors of an uncontrolled transaction imply the price. The second category, the transactional profit methods, are applied when the link between the commercial and financial relations and the price cannot be readily determined. This can be due to integrated activities, unique and valuable contributions or the unavailability of market information.¹⁰

For this reason, the OECD recommends the use of a traditional transaction method over a transactional profit method when both are applicable. Moreover, when multiple traditional

⁵ Supra page 5, nr. 2.

⁶ Soo, M.J., Glaize, A. (2018), OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2017 Edition) and Transfer Pricing Features of Selected Countries 2018, IBFD, page 97.

⁷ Supra page 5, nr. 2, paragraph 2.8.

⁸ Supra page 5, nr. 2, paragraph 2.12.

⁹ Supra page 5, nr. 2, paragraph 2.2.

¹⁰ Supra page 5, nr. 2, paragraph 2.4.

transaction methods could be applied, the CUP method is preferred.¹¹ This finding is crucial for the next chapters of this thesis. For this reason, the proposed approach to determine the arm's length price for intercompany financial transactions will focus on the CUP method (infra chapter 7).

3.1 Transfer pricing methods

This section discusses the five transfer pricing methods that are put forward by the OECD in the 2017 TPG for MNEs and tax administrations.

3.1.1 CUP method

The comparable uncontrolled pricing (CUP) method uses the market price of uncontrolled transactions. For every difference between the controlled and the uncontrolled transaction a comparability adjustment should be made.¹²

An MNE could use available market data to price an internal commodity contract, for example. The commodity under review is frequently traded on international exchanges with standardized contracts. The results of the functional analysis indicate that the internal contract matches the standardized contracts. In this example there is a high degree of comparability between the uncontrolled and the controlled transaction. In order to apply the CUP method correctly, the MNE should not overlook the purchase date when determining the arm's length price. When there is no market data available for the same date as the controlled transaction, the MNE should make a comparability adjustment.¹³

3.1.2 Resale price method

The starting point for the resale price method is the price at which the product is sold to an independent enterprise after the internal transaction. A gross margin for the selling entity is then deducted from the resale price in order to obtain the value of the controlled transaction.¹⁴ This margin accounts for the cost of sales, risks assumed, functions performed, etc.¹⁵ This method is in fact the reverse starting point compared with the cost plus method (infra section 3.1.3).

It should be clear to the reader that a precise and correct determination of the gross margin is crucial. Hereby the MNE could apply the gross margin of the same entity on similar products (internal comparable) or the gross margin of similar independent entities (external comparable)

¹¹ Supra page 5, nr. 2, paragraph 2.3.

¹² Supra page 5, nr. 2, paragraph 2.14.

¹³ Supra page 5, nr. 2, paragraph 2.24.

¹⁴ Supra page 5, nr. 2, paragraph 2.27.

¹⁵ Supra page 5, nr. 2, paragraph 2.30.

as the starting point.¹⁶ When no reasonably accurate comparability adjustments could be made using the CUP method, the resale price method might be more suitable. The resale price method also wins importance when the reseller adds relatively less added value to the product and sells the product within a short time after the internal transaction.¹⁷

3.1.3 Cost plus method

The cost plus method commences with the price of the input for the controlled transaction. A suitable cost plus mark-up should then be determined and added to the cost. This mark-up is defined by the functions performed, accounting practices (taking into account direct, indirect, historical costs and operating expenses)¹⁸ and risks assumed by the internal entity on the sell side of the controlled transaction.¹⁹

Similar to the resale price method this can be achieved through internal as well as external comparables.²⁰ When comparing external enterprises that offer similar products, the MNE should not take into account the price differences due to (in)efficiencies compared to the other enterprise.²¹ When no reasonably accurate comparability adjustments could be made using the CUP method, the cost plus method might be more suitable. The cost plus method will also be more suitable in those situations where the cost price as well as the margin are easily determinable.

3.1.4 Transactional net margin method

This method inspects the net profit that the internal entity realizes from the controlled transaction relative to an appropriate base, such as sales, costs or assets. In order to determine this net profit, the net profit indicator of the internal entity should be similar to an independent but comparable company.²²

The starting point of this method is thus not an actual comparable uncontrolled transaction. Therefore, this method is less affected by fluctuations in the price compared to the CUP method. On the other hand, the selection of the appropriate net profit indicator is a vulnerable process. The impact of the underlying base on the margin should be explanatory, also throughout time.²³

¹⁶ Supra page 5, nr. 2, paragraph 2.28.

¹⁷ Supra page 5, nr. 2, paragraphs 2.35 – 2.36.

¹⁸ Supra page 5, nr. 2, paragraphs 2.53 – 2.55.

¹⁹ Supra page 5, nr. 2, paragraph 2.45.

²⁰ Supra page 5, nr. 2, paragraph 2.46.

²¹ Supra page 5, nr. 2, paragraph 2.51.

²² Supra page 5, nr. 2, paragraph 2.64.

²³ Supra page 5, nr. 2, paragraph 2.70.

This method is most reliable when the internal entity does not add unique value to the product, i.e. limited risk distributor or agency function.²⁴

3.1.5 Transactional profit split method

The transactional profit split method determines the appropriate arm's length price based on the allocation of profits within independent enterprises.²⁵ This method is particularly useful for highly integrated operations with unique added value.²⁶ This is often the case for intangible assets.

As already pointed out, the allocation of profits should be conducted with special caution. On top of the known difficulties, such as adjusting for accounting differences, it can be challenging to identify costs with each step of the highly integrated process.²⁷

3.2 Comparability analysis

The selection of the right transfer pricing method is crucial. Unfortunately, there is no one-method-fits-all approach for MNEs. The functional analysis of the intercompany transaction and the availability of information will cause one method to produce more reliable outcomes compared to other transfer pricing methods. The CUP method, however, remains the preferred method when it produces equally reliable results compared to one or multiple other methods.²⁸

Once the appropriate transfer pricing method has been chosen, the search for internal or external comparables is the first step of the comparability analysis. Comparables should have similar economic characteristics as the controlled transaction. To identify comparables, a taxpayer is not required to perform an exhaustive search.²⁹ A taxpayer should allocate resources and effort relative to the materiality of the transaction.³⁰ The emphasis of the comparability analysis should be on a consistent methodology that identifies comparables in an analytical matter.³¹

Very often the controlled transaction will have different characteristics than comparable uncontrolled transactions. If possible, taxpayers are required to make comparability adjustments in the price to reflect material differences. These objective adjustments should be

²⁴ Supra page 5, nr. 2, paragraph 2.65.

²⁵ Supra page 5, nr. 2, paragraph 2.114.

²⁶ Supra page 5, nr. 2, paragraph 2.115.

²⁷ Supra page 5, nr. 2, paragraph 2.120.

²⁸ Supra page 5, nr. 2, paragraph 2.3.

²⁹ Supra page 5, nr. 2, paragraph 3.2.

³⁰ Supra page 5, nr. 2, paragraph 3.82.

³¹ Supra page 5, nr. 2, paragraph 2.2.

attributable to a specific different characteristic.³² For example, a consistent adjustment for the timing difference between the controlled and the tested transaction should be made.

The comparability analysis may lead to a single arm's length range. The use of multiple comparables could however also lead to a price range. Moreover, when pricing complex transactions, a transfer pricing model might not be able to explain the price entirely. It is also possible that the market would price similar transactions slightly different. In these cases, and under the condition that a large number of comparables are available, the use of a price range is allowed.³³ Measures of central tendency, such as the (weighted) average, the mean or interquartile range, can then indicate the correct arm's length price.³⁴

3.3 Special considerations

3.3.1 Specific challenges for intra-group services

The seventh chapter of the OECD guidelines concerns special considerations for intra-group services. Intercompany financial transactions are the result of the intercompany finance service that is often performed by a treasury entity. When pricing intercompany financial transactions it is thus necessary to incorporate the special consideration in relation to intra-group services.

In the determination of the arm's length price of the service it is necessary to consider the perspective of both sides of the transaction. The recipient of the service should not be willing to pay more for the service compared to an independent provider. The internal provider, on the other hand, should not make a loss by providing this intra-group service.³⁵ It should be pointed out that this does not mean that with each transaction the internal provider should make a profit.³⁶

Two issues arise when pricing intra-group services. First, it might be challenging to determine whether a service has actually been provided. The OECD suggests to apply the benefit test. It comes down to determining whether the recipient would be willing to pay for the service provided by an external enterprise, under comparable circumstances.³⁷ It is crucial to only consider the benefit for the recipient. If the parent company (or another subsidiary) is willing

³² Supra page 5, nr. 2, paragraph 3.51.

³³ Supra page 5, nr. 2, paragraph 3.55.

³⁴ Supra page 5, nr. 2, paragraph 3.62.

³⁵ Supra page 5, nr. 2, paragraph 7.27.

³⁶ Supra page 5, nr. 2, paragraph 7.35.

³⁷ Supra page 5, nr. 2, paragraphs 7.5 – 7.6.

to provide services to subsidiaries that would not be willing to pay for to an external provider, these services cannot be considered intra-group services.

Intra-group services should be paid for and can be distinguished from stewardship activities. Stewardship activities should not be compensated for as they solely arise from ownership interests. These services to subsidiaries are performed but only in the interest of the parent company and not for the benefit of the receiving subsidiary.³⁸

The second issue is that determining the price for an intra-group service can be particularly difficult. The compensation for these services can be made explicit in an agreement. This would be considered the direct-charge method.³⁹ For other types of services, the costs cannot be easily assigned to the beneficiaries of the service. In this case an indirect-charge method is appropriate. A possible allocation key could be based on the usage of the service.⁴⁰

The most used transfer pricing methods for intra-group services are the CUP and any cost-based (i.e. cost-based transactional net margin method or cost plus method) pricing methods.⁴¹ If the provider of the service is merely an intermediary, the cost-based method will in general be most suitable.

3.3.2 Documentation

Whereas, actions 8 to 10 of the BEPS project focus on transfer pricing guidance, action 13 focusses on the documentation requirements for transfer pricing.⁴² Due to a wide range of different national requirements, documentation of transfer pricing activities is a cumbersome task for MNEs. Making a global transfer pricing policy compliant with all involved local requirements thus places a high burden of compliance cost on taxpayers.⁴³

The OECD tried to improve transfer pricing documentation by introducing a separate chapter with specific guidance in the general transfer pricing guidelines. The objectives of these requirements are threefold:

- Documentation should enable taxpayers to show a transparent and compliant arm's length methodology.

³⁸ Supra page 5, nr. 2, paragraphs 7.9 – 7.10.

³⁹ Supra page 5, nr. 2, paragraph 7.21.

⁴⁰ Supra page 5, nr. 2, paragraphs 7.24 – 7.25.

⁴¹ Supra page 5, nr. 2, paragraph 7.31.

⁴² Supra page 5, nr. 1, page 5.

⁴³ Supra page 5, nr. 2, paragraph 5.3.

- Documentation should assist tax administrations with evaluation of the effective transfer pricing risk identification in order to select cases, i.e. transactions, to be audited.
- Documentation should present all necessary information for tax authorities when conducting an audit on the specified cases.⁴⁴

The OECD adopted standardized documentation requirements in order to meet these objectives. Transfer pricing documentation should consist out of three main documents⁴⁵:

- A master file which describes the overall business and transfer pricing policies.⁴⁶ This document should be made available to each country where they MNE is active.⁴⁷ It should not document specific intercompany agreements but could make cross-references to those documents. The main components of a master file are: a legal organization chart, a description of the MNEs business activities, an overview of the MNEs policy on intangibles and intercompany finance as well as the MNEs consolidated financials.⁴⁸
- A local file that presents more detailed information on local transfer pricing assessments.⁴⁹ Information included will give a description of the local legal entity and its controlled transactions. A detailed transfer pricing report is required for each material controlled transaction. This report should, at least, include the functional and comparability analysis (including the comparables) as well as the intercompany agreement itself.⁵⁰
- The Country-by-Country (CbC) report is the only document for which MNEs need to follow a predefined template. The report aggregates tax information from all countries where the MNE is active. It should at least provide a clear overview of where profits, sales, employees and assets are located and where income taxes are paid.⁵¹

⁴⁴ Supra page 5, nr. 2, paragraph 5.5.

⁴⁵ Supra page 5, nr. 2, paragraph 5.16.

⁴⁶ Supra page 5, nr. 2, paragraph 5.18.

⁴⁷ Supra page 5, nr. 2, paragraph 5.20.

⁴⁸ Supra page 5, nr. 2, Annex I to Chapter V.

⁴⁹ Supra page 5, nr. 2, paragraph 5.22.

⁵⁰ Supra page 5, nr. 2, paragraph Annex II to Chapter V.

⁵¹ www.oecd.org/tax/beps/country-by-country-reporting.htm.

4. Introduction to financial transactions and their transfer pricing treatment defined by the OECD

The 2017 TPG from the OECD point out that traditional treasury services should be seen as intra-group services. Due to the high complexity of some intra-group financial services and products the OECD published the discussion draft on financial transactions. These draft guidelines offer additional guidance for determining the arm's length price, i.e. interest rate, for such transactions. The paper also invited the commentators to share their insights. This has resulted into numerous inputs from the working field, such as tax advisory firms and MNEs. The final guidelines for financial transactions are expected by the end of 2019.

This chapter first introduces each instrument's basic characteristics. Secondly, the view of the OECD for each type of instrument is outlined. Finally, the shortcomings of this discussion draft are presented in the last section of this chapter.

4.1 Introduction to financial instruments

4.1.1 Intercompany loans

Intercompany loans are a frequently used instrument for MNEs to provide subsidiaries with short-term and long-term funding. The circumstances under which the transfer of funds occurs is captured in an intercompany loan agreement. A wide variety in terms and conditions intercompany loan agreements exist compared to other, more structured, financial instruments. Therefore, a profound functional analysis is critical.

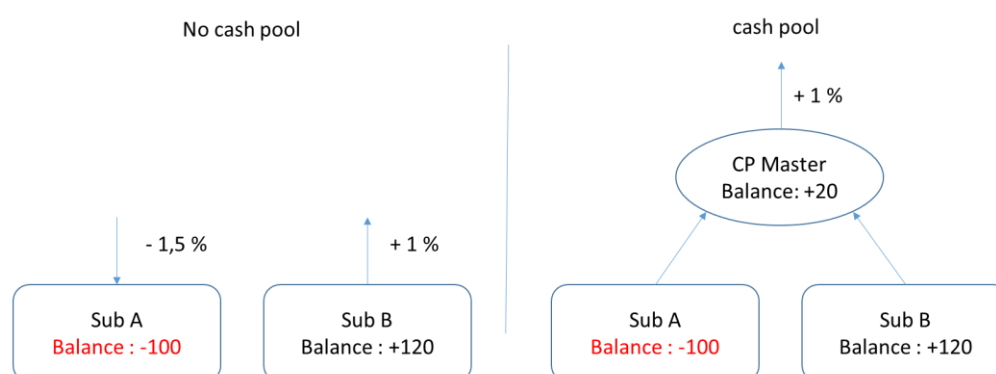
For example, a five-year subordinated bullet loan will have a higher arm's length rate than a linearly repaid one-year senior secured loan for the same amount between the same contracting parties. The functional analysis will identify that the first loan is inherently riskier than the second one, although the credit risk worthiness and economic factors such as country, risk and business risk of both contracting parties are exactly the same. The credit risk is caused by a higher risk profile of the loan itself. The longer maturity, higher level of subordination and longer exposure due to the repayment schedule contributed to this.⁵² The next chapter (infra section 4.2.1 intercompany loans) will further elaborate on the functional analysis and the transfer pricing guidance for intercompany loans.

⁵² Chand, V. (2016), Transfer Pricing Aspects of Intra – Group Loans in Light of the Base Erosion and Profit Shifting Action Plan, INTERTAX, volume 44, issue 12, section 1 – 2.4.

4.1.2 Cash pooling

In order to accommodate operational cash management practices, many MNEs rely on cash pooling structures. A cash pool is a structure involving related bank accounts whose balances have been aggregated for the purposes of optimizing interest and improving liquidity management. It enables an MNE to minimize financing costs.⁵³

The benefit of such cash concentration can be explained by the following example. It is given that there are two subsidiaries part of the same group. Subsidiary A has a negative balance of 100 on its bank account. Subsidiary B has a positive balance of 120 on its bank account. Given is also that subsidiary A pays 1.5% interest on the borrowed funds. Subsidiary B receives 1% of interest on the deposited funds. The aggregated interest will result of an expense of 0,3. In the second scenario, these two accounts would participate in a cash pool with one another. The balances of both participants are concentrated (notionally or due to physical sweeps) towards a master account. The master thus has a positive balance of 20. Given that it can deposit the funds at the same rate as Subsidiary B in the first scenario, this will result in an aggregate interest income of 0,2. The corporate group is, on a consolidated basis, benefiting from having a cash pool when the costs of this cash pool are less than 0,5. This is called the cash pool synergy.



1. The situation without a cash pool results in an aggregate interest expense of 0,3.
2. The situation with a cash pool results in an aggregate interest income of 0,2.

Some banks would give better interest conditions if more cash is deposited with them. The MNE of the above example could therefore be able to negotiate better interest conditions with the cash management bank compared to interest conditions that subsidiaries might get on stand-alone current accounts. In such cases the cash pool synergy is the sum of the economies of scale

⁵³ Blum, M (2012), Tax Issues of Intragroup Open Accounts and Cash Management Systems, The Tax Magazine, issue 12, page 31.

i.e. the benefit of negotiating better interest rates, and the cash pool benefit, i.e. the benefit from interest offsetting.

Different types of cash pools exist: physical v. notional pools, domestic v. cross-border pools, single currency v. multicurrency pools, etc. These cash pooling structures are offered by most international corporate banks. Some of them are specialized in cash management products, such as Bank Mendes Gans, which is a part of the ING Group.⁵⁴

From a transfer pricing point of view, it is important to understand the difference between a physical and a notional cash pool.⁵⁵ Both structures will create intercompany positions which might not be taxed in the same manner. A physical pool consists of real, physical bank accounts that an MNE holds with a bank. The balances of the participant accounts are set to a target at the end of each business day with physical, automated transactions. This is called target balancing. A frequently used variant is zero balancing where the target balance is zero.⁵⁶

In the previous example, a zero balancing physical pool would result in a funding from the master account towards the account of subsidiary A of 100. At the end of the day the 120 in cash on the account of subsidiary B will be swept towards the master account at the same time and used for the funding of the cash position of A.

A notional cash pool consolidates bank accounts without physical movements. Debit balances virtually offset credit balances for interest optimization. Interest is then calculated on the overall pool position.⁵⁷ This type of cash pool is not allowed by numerous countries in the world as some governments see it as co-mingling of funds between different countries.⁵⁸ One entity with a high positive balance could via a notional pool indirectly give financial aid to structurally loss-making subsidiaries without the physical movement of funds. This results in substantial credit risk.

Some MNEs use both types of cash pools. In those situations, a multinational often has one physical cash pool per country. The entity that holds the master account in the physical pool also holds a participant account in the notional overlay pool. Each day the total balance of the

⁵⁴ www.mendesgans.com/our-services/cash-pool/benefits.aspx.

⁵⁵ Infra page 23, nr. 94.

⁵⁶ Hillman, S. (2011) 'Notional vs. physical cash pooling revisited', International Treasurer, February/March 2011 edition.

⁵⁷ Supra page 16, nr. 56.

⁵⁸ Notional pooling operated out of the US is not allowed. US entities are, however, allowed to participate in notional pooling operated by a non-US bank (branch) according to DBS bank (www.treasuryprism.dbs.com/treasury-concepts/notional-pooling).

physical cash can be brought back to the target balance by physically moving funds from/to the notional pool to/from the master account of each physical pool.⁵⁹

Taxation of cash pools is particularly difficult. The arm's length interest rate for the intercompany positions between the participant and the master should be determined by two components. The first component of the rate should be the applicable rate at which the participant could deposit or borrow, in similar circumstances, on the external market. The second component is the result of the allocation of the cash pool synergy over the master and the participants. The functional analysis of a cash pool leader will be different between a physical and notional pool. Therefore, the allocation key will be different as well. This results in different arm's length rates for each type of transaction.⁶⁰

4.1.3 Financial guarantees

The International Accounting Standards Board (IASB) defines financial guarantees as: “a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument” in the International Financial Reporting Standard (IFRS) 9 on financial instruments.⁶¹

Financial guarantees are often used by multinationals to mitigate credit risk throughout the organization. The instrument is part of the trade finance strategy of MNEs. Hereby, the MNE will aim at efficiently facilitating transactions with its clients and suppliers. These third parties will often request a financial guarantee that backs the trade. If the subsidiary would default on its obligation, then the parent company, which contracted the financial guarantee, will have a legal obligation to compensate the third party adequately. From this point of view, a financial guarantee is similar to a bank guarantee whereby the bank will assume the credit risk. The financial guarantee in intercompany situations should be distinguished from a letter of comfort. This document is also issued by the holding entity towards a subsidiary but does not establish a legally-binding commitment.⁶²

⁵⁹ Klosterman, M. (2017) 'Global Cash Management: the Challenges of Multicurrency Operations', TMI, issue 252.

⁶⁰ Infra page 23, nr. 94.

⁶¹ IASB (2014), IFRS 9 – financial instruments, IFRS Foundation, page 54.

⁶² Kowitz, R., William, M., Rengifo, E. (2016), Trade finance as a financial asset: risks and mitigants for non-bank investors, Journal of Risk Management in Financial Institutions, vol. 9, page 62 – 66.

4.2 Discussion draft guidelines per financial instrument

A treasury division within an MNE is typically in charge of the financial risk management, cash and liquidity management as well as corporate and intercompany finance. In order to exercise its main responsibilities, it will execute multiple types of financial transactions such as intercompany loans.

The arm's length pricing process, often carried out in cooperation with the tax department, should start with the delineation of the financial and economical characteristics of each individual transaction.⁶³ The functional analysis as described in the 2017 TPG should thus also be applied when determining the arm's length price for intra-group financial transactions. The analysis identifies the risks assumed, functions performed and assets transferred.⁶⁴ Risk-free entities with no decision making power or control of risks will not be rewarded with a portion of the profit. In this regard, the draft guidelines follow the general transfer pricing guidelines.

It is important to look at general criteria of the agreement, such as:

- the start and end date (and the maturity);
- the amount and currency of the transaction;
- the level of seniority (defined by the hierarchy of claims to collateral);
- the repayment schedule;
- the type of interest rate: fixed or floating.

Additionally, the existence of specific covenants in the terms and conditions of the agreement should be factored in as well.

Next to the contract, specific information of the contracting parties should be considered. It is thus recommended to include information on the creditworthiness of the borrowing entity. This can be obtained from commercial rating agencies.⁶⁵

The capital structure of the borrowing entity should be taken into account as well. It not only impacts the interest rate at which it could borrow funds on the external market but also the maximum borrowing capacity.⁶⁶ This analysis should not only give the arm's length rate at

⁶³ Supra page 5, nr.3, paragraph 11.

⁶⁴ Supra page 5, nr.3, paragraph 23.

⁶⁵ Supra page 5, nr.3, paragraph 24.

⁶⁶ Supra page 5, nr.3, paragraphs 15 -17 and 27 – 35.

which the borrower can obtain funds but also if the borrower would be able to borrow from an external party.

Finally, economic circumstances will have an impact on the pricing as well. The draft guidelines indicate that, amongst others, economic circumstances entail the country regulation, industry sector and business strategies.

Discrepancies on the above-mentioned criteria will form the start of the comparability analysis. It should be clear that the comparability adjustments will be done on both quantitative as well as qualitative criteria.⁶⁷ A practical approach towards making comparability adjustments for financial instruments is proposed a separate chapter of this thesis (infra chapter 7). The chapter ends with an example.

4.2.1 Intercompany loans

The section of the draft guidelines on intercompany loans gives minor attention to the analysis of the contract.⁶⁸ It hereby follows the general guidance that is set out in the above section (supra 4.2).⁶⁹ The major part of guidance from the OECD focusses on the determination of the creditworthiness of the borrower.

The OECD recommends using credit ratings as a measure of creditworthiness of the borrower.⁷⁰ According to the OECD and common practice, the credit rating assessment should take into account financial as well as qualitative information.⁷¹ It has been pointed out that the impact of the controlled transaction should be considered in the financial credit rating assessment.⁷² A substantial intercompany loan could alter the capitalization degree significantly. It thus has an impact on *how* to price an intercompany loan. This should not be confused with a similar analysis that should be conducted (BEPS action 9). The debt capacity analysis addresses the question *if* the borrower is able to absorb the amount of additional debt (BEPS action 10).

The credit rating assessment should be conducted for each borrower individually. However, this can be particularly difficult for Special Purpose Vehicles (SPVs) or restructured entities. Additionally, it is interesting to point out that the rating of the subsidiary should be capped by the rating of the parent company. This is even the case when the stand-alone rating of the

⁶⁷ Supra page 5, nr.3, paragraph 20.

⁶⁸ Supra page 5, nr.3, paragraphs 47 – 93.

⁶⁹ Supra page 5, nr.3, paragraph 82 – 83.

⁷⁰ Supra page 5, nr.3, paragraph 58.

⁷¹ Supra page 5, nr.3, paragraph 63.

⁷² Supra page 5, nr.3, paragraph 65.

subsidiary is higher than the parent's rating.⁷³ It is the author's opinion that subsidiaries that have ring-fenced financial statements, due to being recently acquired for example, or structurally subordinated entities, due to regulated entities for example, could form exceptions to this general rule.

The draft discussion paper pays special attention to one qualitative factor: the effect of group support. Group support is the level of support from the parent towards the borrower, which is a subsidiary of that parent. This is in line with the milestones in the jurisprudence of group support, such as the Chevron⁷⁴ or the GE Capital⁷⁵ case. These cases are discussed in a separate chapter of this thesis (infra sections 6.1 and 6.2).

The draft guidelines distinguish implicit from explicit support. Explicit group support is triggered by a formal, written and legally binding guarantee. In this case, the rating of the borrower can be made equal to the parent rating. This guarantee should not be confused with a letter of comfort. The latter is written but legally not binding. The arm's length rate will thus not represent any adjustment for the stand-alone creditworthiness of the borrower. This is compliant with the transfer pricing guidelines as the price of this explicit guarantee will be cross-charged to the borrower in a separate invoice. It thus follows a direct-charge method.⁷⁶

In case that the stand-alone rating of the borrower is different from the parent rating, implicit group support will shift the stand-alone rating one or multiple notches towards the parent rating. The magnitude depends on how strong the relation of passive assertion is.⁷⁷ Very little guidance is given on how to determine the level of implicit group support. Paragraph 72 of the draft guidelines only points out that subsidiaries with no strategic importance are likely to be considered on their stand-alone rating. A large share of the commentators pointed out this lacuna. Therefore, more guidance on determining the level of implicit group support can be expected to be included in the final release of the guidelines. Until then, the only source of judiciary guidance can be found in case law. This is addressed in a separate chapter (infra section 6.1 and 6.2).

After the functional analysis of the intercompany loan under review, including the rating analysis, the credit risk profile of the loan is known. The proposed arm's length interest rate

⁷³ Supra page 5, nr.3, paragraph 73.

⁷⁴ Infra page 36, nr. 139.

⁷⁵ Infra page 39, nr. 162.

⁷⁶ Supra page 5, nr.3, paragraph 142.

⁷⁷ Supra page 5, nr.3, paragraphs 67 -72.

should match this credit risk profile. It should also be borne in mind that residual costs, for administrative work, should be included in the arm's length rate as well. The draft guidelines propose to use the CUP method. It is crucial to understand that it is common practice to use publicly available corporate bond data⁷⁸ as comparable uncontrolled transactions for controlled intercompany loans. The selection of bond data (primary, secondary or both) has also been acknowledged by the OECD.⁷⁹

Financial institutions in Europe are obliged to report qualifying loans to the European Central Bank (ECB). The ECB stores this granular, loan-by-loan data in its Analytical Credit Database (AnaCredit). For each reported loan the ECB demands approximately 100 parameters which can be grouped into categories: instrument data, financial data, counterparty data, counterparty risk data, etc. This data is used by the ECB to develop an enhanced understanding of the aggregate credit risk exposure in the Eurozone. Unfortunately, this information is not made public and therefore there is no public database available with intercompany or corporate external loan information in the European Union.⁸⁰

In the US, the Securities and Exchange Commission (SEC) obliges companies to report on their loan agreements via their SEC filings. The 8-K form should contain the original loan agreement. This Electronic Data Gathering, Analysis, and Retrieval (EDGAR) database is publicly available on the website of the SEC.⁸¹ Unfortunately this data is unstructured and designed to retrieve a particular loan agreement for a particular enterprise. It is extremely cumbersome to for an MNE to go through all recent 8-K SEC filings to extract the relevant information from unstructured loan documents. However, corporations such as CUFTAnalytics⁸² and RoyaltyRange⁸³ are specialized in extracting this information.

This causes that the use of corporate bond data as proxy for the intercompany loans is generally accepted. Some transfer pricing specialists will therefore add a liquidity premium in the arm's length rate to correct for the difference in liquidity between bonds and loans, as bonds are generally more liquid instruments.⁸⁴

⁷⁸ Accessible via market data providers such as Bloomberg.

⁷⁹ Supra page 5, nr.3, paragraph 86.

⁸⁰ www.ecb.europa.eu/explainers/tell-me-more/html/anacredit.en.html.

⁸¹ www.sec.gov/edgar/searchedgar/webusers.htm.

⁸² www.cuftanalytics.com/ServicesSolutions/ComparableLoanData.aspx.

⁸³ www.royaltyrange.com/loan-interest-rates.

⁸⁴ Hands, G., Hollas J. (2010), Intercompany financial transactions: selecting comparable data, Tax and accounting Centre, page 6.

Any discrepancy between the intercompany loan and the selected bond should be subject to appropriate comparability adjustments. The spread of the selected comparable bonds can then be benchmarked against the controlled intercompany loan. By doing so a similar interest rate can be obtained as if the borrower would borrow funds from an external financial institution.⁸⁵ A practical approach to the use of an external CUP is addressed in chapter seven. The draft guidelines also point out that internal comparables may be used.⁸⁶

If the financing entity is only exercising an agency function, a cost plus method seems most appropriate.⁸⁷ This is for example the case when a financing entity is accommodating a pass-through loan. The financing entity attracts funds from the external market at a specific interest rate, i.e. the price of the transaction. When the financing entity extends this funding, by entering into a back-to-back intercompany loan with a subsidiary, it only has an agency function. This loan will have the same characteristics as the external loan. It seems most appropriate to price this controlled transaction with the cost plus method. The cost base is the interest rate at which the financing entity lends funds from the market. A margin can be added for the administrative functions performed, often referred to as handling fee. The arm's length interest rate of the controlled loan will be the sum of the external interest rate and the margin.

To conclude this section, it is remarkable that the OECD does not recognize another commonly used technique as valid. MNEs often request bank quotes for intercompany loans and add these to the transfer pricing documentation. Herewith, an MNE tries to substantiate the market conformity of its proposed arm's length interest rate towards tax authorities. The OECD now finds that these bank quotes cannot be used as a proxy for intercompany loans as they do not represent actual market transactions.⁸⁸

4.2.2 Cash pooling

The OECD recognizes that the arm's length pricing of cash pool transactions is different from the commonly used overnight deposit or overdraft. The cash pool transactions should not be viewed in isolation.⁸⁹ This is in line with the step transaction doctrine. Ultimately the allocation of the cash pooling synergy should be calculated. The cash pool synergy consists out of economies of scale as well as the cash pool benefit. The economies of scale arise when a cash

⁸⁵ Supra page 5, nr.3, paragraphs 83- 84.

⁸⁶ Supra page 5, nr.3, paragraph 88.

⁸⁷ Supra page 5, nr.3, paragraphs 89 -91.

⁸⁸ Supra page 5, nr.3, paragraph 92 -93.

⁸⁹ Supra page 5, nr.3, paragraph 101.

pool leader is able to negotiate better interest rates due to a higher amount being deposited in comparison with a stand-alone subsidiary. The cash pool benefit is the result of the interest offsetting of credit and debit balances (supra section 4.1.2).

The cash pooling agreement is the crucial starting point for a functional analysis of the cash pool. It will provide information in order to calculate the total cash pool synergy but will also give more information on the risks assumed and functions performed by the participants and the cash pool master.

Cash pool participants should pay arm's length interests on their debit and credit positions within the cash pool. It is not clear whether the debit interest rate should be the same for debit as well as credit positions. The Danish court ruled in the Bombardier case in favor for equal debit and credit interest rates. The Norwegian court ruled in the ConocoPhillips case in favor of different debit and credit rates (infra section 6.3).⁹⁰ The draft guidelines from the OECD do not offer a solution for this inconsistency in case law.

The draft discussion paper, however, does propose three allocation methods to divide the cash pool synergy over the participants. If this allocation is priced in into the interest rates of the pool, then it forms a deduction on the overdraft rate or a surplus on the deposit rate.

Firstly, the interest rate for all participants can be enhanced irrespectively of whether they are a net borrower or lender in the pool. The size of the average balance would be key to determine the allocation. Secondly, the cash pool synergy can be divided evenly over all participants in a situation whereby all cash pool members have a similar credit rating. Thirdly, the cash pool synergy can be allocated over the net depositors of the pool only.⁹¹

The OECD discussion draft recognizes the approach to reward the cash pool leader based on the risks assumed and functions performed.⁹² For a cash pool leader with merely an agency function the remuneration should thus be limited.⁹³

There are three different types of cash pool leaders, according to Chand.⁹⁴

⁹⁰ Vistisen, E. (2014), Bombardier case: first published cash pool decision, International Transfer Pricing Journal, IBFD, Volume 21, n°3.

⁹¹ Supra page 5, nr.3, paragraphs, 125-129.

⁹² Supra page 5, nr.3, paragraph 109 and 122.

⁹³ Supra page 5, nr.3, paragraph 111.

⁹⁴ Chand, V. (2016), Transfer pricing aspects of cash pooling arrangements in light of the BEPS action plan, International transfer pricing journal, IBFD, January/February 2016, section 2.5.

- A cash pool leader of a physical cash pool which operates as an in-house bank entity with equity at stake and also manages other financial risks and corporate finance needs.
- A cash pool leader of a physical cash pool which merely operates as a service provider. (cfr. Bombardier case, infra section 6.3)
- A cash pool leader of a notional cash pool which merely operates as a service provider.

Chand recognizes that the difference between the credit and debit interest rate is the appropriate remuneration for the first category of cash pool leaders. This remuneration makes abstraction of possible cross-guarantee fees that might be due by the cash pool participants (see below). The second and third category should be remunerated for their functions performed in the form of a service fee. The determination of the size of this fee is arbitrary. The Danish court ruled that the service fee for a cash pool leader, in casu a subsidiary of Bombardier in Zurich, of 25 bps on the interest rate was appropriate.⁹⁵ The case will be further discussed in a separate chapter of this thesis (infra section 6.3).

The arm's length pricing of cash pools also faces taxpayers with a different challenge. A cash pool is normally used as a means to coordinate short term liquidity management. It enables to create intercompany positions between participants in order to achieve this. If a subsidiary is showing a negative intercompany balance over the long-term, it indirectly receives financial support from the other cash pool participants. In this case, one could consider this an intercompany loan.⁹⁶ These typically have a higher interest rate. It can be difficult to establish the boundary between different instruments. Further guidance from OECD is expected from the final version of this draft discussion paper.

In order to finalize this section on cash pooling and to build a bridge towards the next section on financial guarantees, the OECD raises the question to which extent cash pool cross-guarantees between participants should be priced.⁹⁷ The OECD concludes that there is no guarantee fee due when this would not lead to benefits beyond the level of implicit group support.⁹⁸ This is in line with case law, more specifically the General Electric Capital Canada case (infra section 6.2).

⁹⁵ Supra page 23, nr. 90, section 3.

⁹⁶ Supra page 5, nr.3, paragraph 106.

⁹⁷ Supra page 5, nr.3, paragraph 130.

⁹⁸ Supra page 5, nr.3, paragraph 131.

4.2.3 Financial guarantees

The draft guidelines for financial transactions give valuable insights in the pricing of intercompany guarantee fees. This fee should be determined as the difference in cost of borrowing with and without a guarantee.⁹⁹ If the guarantee fee would be above this value, the subsidiary would have no incentive to enter into the intercompany guarantee. The difference in the cost of borrowing arises from a different level of creditworthiness of the subsidiary with or without a guarantee in place.¹⁰⁰

The draft guidelines also make the distinction between an explicit guarantee and a letter of comfort. As an explicit guarantee is legally binding, it is fair to conclude that funding can be obtained at the credit rating of the group or supporting entity. The guarantee fee will thus not be priced higher than the difference in cost of borrowing of the group and the subsidiary. The draft guidelines recognize that a letter of comfort is an instrument that provides less credit support. The guarantee fee of a letter of comfort should, holding all other factors constant, be smaller compared to a guarantee fee of an explicit guarantee.¹⁰¹

In the determination of the correct arm's length remuneration it is crucial to consider the level of implicit group support. Implicit group support might have an upward effect on the credit rating of the subsidiary. Subsequently, it will lower the arm's length guarantee fee.¹⁰²

The draft guidelines discuss five different methods for determining the arm's length rate. The CUP method can lead to reliable results using internal and external comparables. External comparables will in practice be very unlikely to be found.¹⁰³

The second method, the yield approach, will result in less practical difficulties. It follows the concept of value for each guarantee as described above. It is simply the calculation of the spread between financing with and without a guarantee but including implicit group support. It will be especially convenient to calculate this spread if the group or support entity has an independent credit rating.¹⁰⁴ The GE Capital Canada case (infra section 6.2) gives a practical example of the use of the yield approach.

⁹⁹ Supra page 5, nr.3, paragraph 141.

¹⁰⁰ Assef, S., Patrun, E. (2012), Pricing Intercompany loans and guarantees, Corporate Business Taxation Monthly, July 2012, page 36.

¹⁰¹ Supra page 5, nr.3, paragraph 142.

¹⁰² Supra page 5, nr.3, paragraph 143.

¹⁰³ Supra page 5, nr.3, paragraphs 147 – 148.

¹⁰⁴ Supra page 5, nr.3, paragraphs 149 – 151.

As a third and fourth method, MNEs could use the cost approach. The cost of a guarantee will be the value of the expected loss.¹⁰⁵ The third method uses the magnitude of the expected loss as the starting point. The relevance of the expected loss concept under Basel II regulation for transfer pricing of financial instruments is discussed in a separate chapter (infra chapter 7). Other approaches in determining credit risk such as option pricing models (Black Scholes & Merton models) or credit default swap (CDS) pricing are left out of scope of this thesis. The fourth method, the valuation of expected loss approach, uses the probability of default as the starting point. After adjustments, the expected return can be priced using the Capital Asset Pricing Model (CAPM).¹⁰⁶ The risk premium can then be calculated as the triangular area above the capital market line (CML) for a specific transaction.

Lastly, the capital support method uses the return on capital as the main concept. The MNE should determine how much capital it should inject in the balance sheet of the borrowing subsidiary in order to obtain the same credit rating as the guarantor. The price of the guarantee is defined as the expected return of this amount of capital.¹⁰⁷ It should be noted that this approach is highly prone to model risk. The credit rating of a subsidiary typically takes into account financial ratios that are not affected by the amount of equity, such as the debt/EBITDA ratio.

4.3 Criticism on the draft guidelines for financial transactions

The draft guidelines for financial transactions have generated a rich debate. They touch upon different aspects of MNEs intercompany finance activities, giving an indication on how to perform financial arm's length calculations for the most common instruments: term loans, cash pooling, hedging activities, guarantees and captive insurance.

Critics appreciate the wide scope of this paper but underline the lack of detail.¹⁰⁸ The paper gives only a high level of aspects relevant in the arm's length calculations. Many practical implications of these recommendations remain a grey area for taxpayers and practitioners, for example:

¹⁰⁵ Supra page 5, nr.3, paragraph 153.

¹⁰⁶ Supra page 5, nr.3, paragraph 154.

¹⁰⁷ Supra page 5, nr.3, paragraph 155.

¹⁰⁸ De Robertis, G. (2019), Recent developments on TP and Intragroup Financing, Tax Institute for Austrian and International Tax Law, Global Transfer Pricing Conference February 2019.

- The discussion draft seems to be in favour of a credit rating analysis per entity.¹⁰⁹ It remains to be clarified how MNEs should perform a credit rating analysis. The first approach could be an in-depth credit rating analysis which is very detailed, but also very cumbersome. This type of credit rating is highly technical and requires specific data sets. It would overcomplicate arm's length calculations for MNEs with hundreds of entities worldwide. Alternatively, a more high-level credit scoring based on financial statements and complemented with limited qualitative overrides may be a simplified solution.
- One of the qualitative criteria to be considered is implicit group support. The discussion draft is, by formulating this requirement, in line with international case law (infra section 6.1 and 6.2). Unfortunately, the discussion draft does not suggest a framework or criteria. It remains undetermined which aspects of implicit group support should be included in an analysis. The number of notches as adjustment for implicit group support is not clear either.
- The chapter on cash pool suggests three different approaches, as described above, to allocate the cash pool synergy. It remains unclear if one method will be preferred over the other. This is relevant for MNEs as they must choose one approach per cash pool. This would apply to all participants in the pool. This is now particularly difficult as international case law illustrates the different approaches of national judges and tax administrations. This is discussed in a separate chapter (infra section 6.3).¹¹⁰

¹⁰⁹ Supra page 5, nr.3, paragraphs 58 – 66.

¹¹⁰ These points of criticism have, amongst other, been pointed out by the comments from Tax Executive Institute (TEI), on their public consultation document. This concern was also mentioned by the TEI in Tax Executive Institute (2018), TEI submits comments to the OECD Regarding the Transfer Pricing Aspects of Financial Transactions, Tax Executive, Vol. 70, issue 6, page 67 – 84.

5. Arm's length pricing for financial transactions defined by national legislation

5.1 Belgium

Belgium follows the OECD guidance. Belgium built this reputation, among other reasons, by being one of the first countries to implement the BEPS action point 13 documentation requirements. The initial transfer pricing guidance was given by means of a circular letter after the creation of the transfer pricing unit on the 1st of July 2016.¹¹¹ This was also confirmed in an answer to a parliamentary question. The Belgian Minister of finance conformed that the Belgian Tax Authorities will adhere to BEPS action points 8 -10.¹¹²

The most relevant articles in the Belgian Income Tax Code (ITC) for transfer pricing are:

- Art. 25 on granting abnormal or gratuitous advantages.
- Art. 55 specifically indicates that interest payments on financial instruments only remain deductible expenses when they meet market conditions.
- Art. 79 and 207 on the tax consequences of granting abnormal or gratuitous advantages.
- Art. 185, §2 which defines the arm's length principle. Belgian tax treaties are typically even more strict than the OECD Model Tax Convention (MTC) by adding that no deduction or exemption will be allowed for arm's length transactions in case of fraud.
- Art. 225 – 228 (Royal Decree/ITC) which defines that fraud charges can be filed until seven years after the tax return under review. Penalties can range between 10% and 200%, which is a high cap relative to neighbouring countries.
- Art. 344 which is a general anti-avoidance rule (GAAR).
- Art. 445, §3 which outlines administrative sanctions for non-compliance with disclosure requirements.¹¹³
- Art. 11 of the Belgian Companies Code defines the national definition of associated enterprises.

Transfer pricing documentation is a special topic to consider for MNEs active in Belgium. This country has introduced extensive documentation requirements which are effective since 2016.¹¹⁴ The latest administrative guidance was given on the 8th of February 2019 by means of

¹¹¹ Circular Letter Ci.RH.421/580.456 (AAFisc Nr. 40/2006), 14.11.2006.

¹¹² Parliamentary question nr. 623 Deseyn, 04.11.2015.

¹¹³ Supra page 7, nr. 6, page 645 – 646.

¹¹⁴ Art. 63 of the Program Law of 1 July 2016 amended art. Art. 445, §3 BITC, published on 04.07.2016.

a circular letter and concerned the application of penalties for failing to comply with these requirements.¹¹⁵ Belgium has copied the three-tiered approach of the OECD requiring a local file, master file and CbC report (only for Belgian ultimate parent entities). The specific content of these reports is discussed in a separate section (supra section 3.3).

The Belgian tax administration published a draft circular letter on transfer pricing on the 9th of November 2018.¹¹⁶ This document was open for public consultation and comments. Chapter 10 of this document focusses on financial transactions. The key takeaways in relation to the OECD draft guidelines, according to the author, are:

- The Belgian tax administration aligns with the OECDs view on credit ratings. It has to be conducted for each subsidiary individually. Hereby it should take implicit group support into account. There should not be any compensation for implicit group support from the subsidiary towards the parent. The rating of the parent will be used for each subsidiary with an explicit guarantee in place. A rating cap for subsidiaries applies and equals the rating of the parent.¹¹⁷
- The OECD and the Belgian tax administration confirm that the CUP method is the preferred method for pricing intercompany loans. A cost plus calculation is only more preferred when pricing pass-through loans whereby the intermediary entity assumes very little risks and performs very little functions. A handling fee will be mark-up in this scenario.¹¹⁸
- The yield approach is the preferred method of the Belgian tax administration to calculate the arm's length price of a guarantee.¹¹⁹ This is one of the five methods that the OECD recommends.
- The Belgian tax administration follows the OECD recommended transfer pricing approach towards cash pools. It also proposes to allocate the cash pool synergy towards the participants. The allocation depends on the type of cash pool, i.e. physical or notional.
 - Interestingly, the draft circular letter explicitly states that not all cash pool participants require an individual credit rating when cross-guarantees are in

¹¹⁵ Circular letter 2019/C/14, 08.02.2019.

¹¹⁶ Which can be consulted at their website www.financien.belgium.be/nl/Actueel/multinationale-ondernemingen-geef-uw-mening-over-het-ontwerp-van-circulaire-verrekenprijzen.

¹¹⁷ Supra page 29, nr. 116, paragraphs 254 – 256.

¹¹⁸ Supra page 29, nr. 116, paragraphs 259 and 262.

¹¹⁹ Supra page 29, nr. 116, paragraph 264.

place. The same credit rating for all participants will then apply. It is thus an exception to the general rule of using credit ratings whereby each subsidiary requires an individual rating.

- The Belgian tax administration gives even more precise guidance towards the classification of short-term and long-term pool positions. When a participant has a constant debit or credit pool position for more than six months it should be priced as a short-term loan. It hereby clearly defines the maturity threshold.¹²⁰

5.2 Luxembourg

Alike Belgium, Luxembourg does not have specific transfer pricing legislation. Transfer pricing is integrated in the Luxembourg ITC via:

- Art. 56 which defines the arm's length price.
- Art. 56bis which formalizes the OECD TPG definitions and guidelines.
- Art. 171 of the General Tax Code which provides documentation requirements for Luxembourg taxpayers. A local file and master file are not yet required in Luxembourg. CbC reporting is however required due to the implementation of EU Directive 2016/881¹²¹ on mandatory automatic exchange of information in the field of taxation.¹²²

Transfer pricing regulation in Luxembourg is especially interesting in two different areas: transfer pricing aspects of intra-group financing activities and advanced pricing agreements (APAs).

Luxembourg has issued a circular letter particularly on the transfer pricing aspects of intra-group financing activities.¹²³ MNEs with financing entities in Luxembourg, which is very common among MNEs, are subject to stricter regulation. The circular letter sets out to actively manage risks arising from financing entities. This implies that debt as well as equity at risk should be covered with equity as well. The subsidiary should have a buffer to support all financial consequences of the risks it assumes.¹²⁴ This is an additional requirement. In most countries, only debt should be covered with equity. The last chapter of this thesis will suggest a practical CUP method which can be used to calculate the arm's length credit risk premium

¹²⁰ Supra page 29, nr. 116, paragraphs 266 – 270 and 273.

¹²¹ EU Directive, 2016/881/EU, 22.05.2016, amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation.

¹²² Supra page 7, nr. 6, page 857 and 862.

¹²³ Circular letter L.I.R. n°56/1 – 56bis/1, 27.12.2016.

¹²⁴ Marinier, C. (2018), Equity-at-Risk and Transfer Pricing: Annualised Expected Loss versus Cumulative Expected Loss, Moody's Analytics Viewpoints October 2018, page 3.

for debt instruments. In Luxembourg, however, an arm's length return on equity should be calculated as well. A practical approach could use the concept of risk-adjusted return on capital which is outlined by the Basel II and III regulation.¹²⁵ Such practical analysis is left out of scope of this thesis as the last chapter uses Basel regulation for the arm's length pricing of debt instruments.

The second point of attention is the use of advance tax rulings and APAs in Luxembourg. The country's advanced ruling practice has a reputation of making APAs with MNEs which play a vital part in aggressive tax planning structures. The APA between Luxembourg and Amazon is just one example. Amazon collected nearly all its European sales in its Luxembourg operational entity between 2006 and 2014. It was able to shift these profits to a Luxembourg holding company. This holding entity was owned by the US parent entity and therefore the profits were only taxable when repatriated to the US. The critical step in this scheme was the APA between Luxembourg and Amazon. This allowed Amazon to shift profit from the operating company to the holding company by only paying a fraction of taxes on this profit.¹²⁶ Since the circular letter effective 1st of January 2017, the APA process has been formalized.¹²⁷ Contracted APAs which do not comply with the new process lose their binding effect.¹²⁸

5.3 The Netherlands

Art. 8b of the Dutch ITC legally defines the arm's length principle. However, most transfer pricing guidance in the Netherlands is given by means decrees. A decree with significant impact was issued in May 2018.¹²⁹ The decree promotes the use of the TPG in the Netherlands. On two aspects the decree goes beyond the TPG: intra-group services and intra-group finance activities.¹³⁰

In specific situations such as low-value adding services, a Dutch taxpayer can charge a price based on full costing rather than an arm's length price for intra-group services. This will lead to an application of a cost plus method as the preferred transfer pricing method for such intra-group services. Similar to Luxembourg, the group financing of MNEs will often be done out of

¹²⁵Thomas, G. (2006), The role and significance of funds transfer pricing in RAROC models, *Journal of Performance Management.*, November 2006, Vol. 19, Issue 3, p25-40.

¹²⁶ www.europa.eu/rapid/press-release_IP-17-3701_en.htm.

¹²⁷Supra page 30, nr. 123.

¹²⁸ Supra page 7, nr. 6, page 865.

¹²⁹ Decree Stcrt-2018-26874 (IFZ 2013/184M), 14.11.2013.

¹³⁰ Supra page 7, nr. 6, page 893.

the Netherlands. This decree provides more information on arm's length interest rates and the use of credit ratings.¹³¹

More similarities between the Netherlands and Luxembourg exist. The APA practice in Netherlands, which is based in Rotterdam, can create legally binding tax agreements with MNEs. The Dutch APA practice is controversial as well for example. The European Commission concluded in 2010 that a 2006 ruling between Ikea and the Netherlands broke the EU rules on state aid. Currently, the European Commission is investigating a second ruling, from 2011, with Ikea. A Dutch subsidiary bought the intellectual property of Ikea from a Luxembourg subsidiary. It required significant funding for this acquisition which it borrowed, via an intercompany loan, from its parent in Lichtenstein. The key aspect under review is the price of that the Dutch subsidiary paid for the intellectual property. It is suspected that this price was artificially high. This was one of the elements of the 2011 ruling. The Dutch subsidiary had to borrow this amount and the interest arising from the loan was deductible. This eroded the taxable base of the Dutch subsidiary.¹³²

5.4 Switzerland

Switzerland is a federal state, whereby transfer pricing legislation can still be found in the federal ITC:

- Art. 58 of the Federal Income Tax Act disallows taxpayers to deduct expenses incurred with unjustified business reasons.
- Art. 65 of the Federal Income Tax Act provides a basis for reclassifying interest payments that are not at arm's length as deemed equity. Switzerland requires taxpayers to disclose all loans (intercompany as well as external loans) and the interest conditions. This enables the Swiss tax authorities to enforce thin capitalization rules which were already introduced in 1997.
- Art. 24(1) of the Federal law on Harmonization introduces the arm's length concept in Swiss tax statutes.¹³³

Swiss tax authorities have introduced safe harbour rules for intercompany financial transactions, which is a significant difference with the national regulation of the other countries under review. Safe harbour statutes allow deviations from a general rule. On a yearly basis, the

¹³¹ Supra page 31, nr. 129, paragraphs 7.43 – 7.65.

¹³² www.europa.eu/rapid/press-release_IP-17-5343_en.htm.

¹³³ Supra page 7, nr. 6, page 1001.

Swiss tax authorities publish a circular letter on safe harbour interest rates on intercompany loans (denominated in CHF or other currencies) for Swiss taxpayers. It allows taxpayers to use the stipulated interest rates even when a different interest rate would result from an arm's length analysis. The interest rate depends on the nationality of the lender and borrower (Swiss or non-Swiss), the currency and the level of security. The most recent circular letter dates from the 31st of January 2019.¹³⁴ It is, however, important to note that taxpayers still need to be compliant with thin capitalization rules. Even if a taxpayer would set the stipulated interest on an intercompany loan according to the safe harbour regulation, it should still be within the thin cap limits. Otherwise the safe harbour interest payments will still be classified as deemed equity.

As of 2018, Swiss MNEs are required to create CbC-reports. Local and master files are not required.

5.5 Regulatory considerations for a compliant intercompany financing framework: the arm's length principle under pressure?

Transfer pricing regulation among countries can be very different as illustrated in the previous sections. Safe harbour statutes allow deviations from a general rule for specific situations. As such national safe harbour regulation limits the use of the arm's length principle. Switzerland, for example, has safe harbour regulation on interest rates.

National thin cap and earnings stripping legislation also poses regulatory limits to the arm's length principle.¹³⁵ Countries generally encourage companies to have sufficient capital. This will allow for more stability in the national economy. If an economic downturn would occur, companies with a lower debt-to-equity ratio will withstand market pressures longer. Companies, on the other hand, will have incentives to hold more debt than equity. More debt will allow more funds to invest. From a tax perspective, debt is more interesting than capital. Companies can deduct interest on their debt as an expense, lowering the taxable profit. There are no real economic interest payments for a full-equity financed entity which can be deducted.

This regulation formulates the maximum level of interest that can be deductible. The deductibility is linked with the level of capital (thin cap regulation) or EBITDA (earnings strippings regulation). Even if the intercompany financial transactions are contracted at arm's length, the interest expense would not be deductible. All interest payments in excess of the threshold are reclassified and these payments shall thus not be tax deductible. The impact of

¹³⁴ www.internationallawoffice.com/Newsletters/Corporate-Tax/Switzerland/Walder-Wyss/Intra-group-debt-financing-updated-safe-haven-rates-and-thin-capitalisation-rules.

¹³⁵ Implemented in EU member states as a result of the ATAD directive.

such measures is very different among industries. Each industry is characterized by specific financial ratios, e.g. due to the importance of intellectual property, the high dependence on tangible assets, high or low profit margins, etc. This is a clear downside of this type of regulation.

Such regulation triggers a fundamental question: should there be an arm's length capital structure?¹³⁶ If national legislation on the debt capacity of MNEs and interest deductibility limits were absent, an MNE would be able to determine its own level of capitalization. A lower level of capitalization would have major consequences for the arm's length price of financial transactions.

First, the company would be able to absorb more debt. Subsequently, the creditworthiness of the taxpayer will decrease as the financial ratios will be weaker. As a consequence, the arm's length interest rate will soar. This would lead to more interest expenses which can be deducted and undermines the application of the arm's length principle for the reduction of base erosion and profit shifting.

For example, two similar companies would aim to reduce the profit of a subsidiary A in a highly taxed environment and increase the profit of a subsidiary B in a low taxed environment by means of an intercompany loan from subsidiary B to subsidiary A. Then the interest rate on this loan should be according to the arm's length principle. The portion of interest above the arm's length interest rate would be reclassified and taxable with subsidiary A.

If there was no regulation enforcing the capital structure of subsidiary A, this subsidiary would have an incentive to lower its level of capitalization so that the arm's length rate would be higher. This would lead to more interest deductibility and profit shifting but would remain within the correct use of the arm's length principle.

Countries have introduced a wide variety of different measures related to the capital structure of companies. Due to a lack of integration and harmonization, these measures create an unequal level playing field for MNEs. An MNE in one country might be able to set a higher arm's length interest rate compared to an MNE in another country, while both countries apply the TPG. The

¹³⁶ This question was raised by the chairs at the WU Transfer Pricing Conference 2019, see Petruzzi, R., Storck A. (2019), Recent developments on TP and Intragroup Financing, Tax Institute for Austrian and International Tax Law, Global Transfer Pricing Conference February 2019, slide 2.

discussion draft on financial transactions briefly addresses this challenge. It mentions that the amount of the loan should not be larger than an independent lender would have provided.¹³⁷

¹³⁷ Supra page 5, nr. 3, paragraph 17.

6. Arm's length pricing for financial transactions defined by case law

6.1 Intercompany loans with a special focus on implicit group support: Chevron

Australia Holdings Pty Ltd v. Australia

One of the recent landmark cases in the domain of transfer pricing of intercompany finance is Chevron Australia Holdings Pty Ltd (CAHPL) v. Commissioner of Taxation before the federal court of Australia. The case discusses the impact of implicit group support, often also referred to as parental support, in the determination of arm's length interest rates for intercompany loans. According to different pieces of literature, the decision of the case impacts the intercompany finance choices of other MNEs.¹³⁸ The effect is not only limited to the arm's length pricing of intercompany loans but also to other financial instruments such as cash pooling and financial guarantees.

The case concerns an appeal from CAHPL against a tax claim from the Australian Taxation Office (ATO). The ATO suspected that Chevron, by artificially inflating the interest rate, tried to avoid corporate taxation. The ATO thus questioned whether the interest rate on an intercompany loan from Chevron Texaco Funding Corporation (CFC) to CAHPL was set at arm's length. CFC is a US resident which is wholly (100%) owned by CAHPL. The loan under review was contracted on June 6th 2003 for a nominal amount of 2,5 billion USD equivalent. The loan was denominated in AUD and for a term of 5 years.¹³⁹ Interest was paid monthly. CAHPL claimed to use the proceeds of this loan for general corporate purposes such as the financing of exploration activities.¹⁴⁰ The principal was due on the maturity date. The loan was an unsecured loan, which was explained by the inability to grant security by CAHPL.¹⁴¹ Finally, there was no guarantee provided by Chevron to CAHPL for this loan.

CAHPL paid 9% interest over the loan. It should be noted that at that point in time the one-month AUD LIBOR was 4.86%. The interest paid was thus AUD LIBOR + 4.14%.¹⁴² The Chevron group was able to borrow USD in the US at a rate of 1.2%.¹⁴³

One of the critical points in the determination of this arm's length interest rate is the impact of implicit group support. As indicated above, there was no explicit guarantee provided by

¹³⁸ Wells, P. and Houlder, V. (2017), Financials Times, London, 21 April 2017.

¹³⁹ Chevron Australia Holdings Pty Ltd v Commissioner of Taxation (No 4) (2017) FCA 1092, summary.

¹⁴⁰ Flanagan, K. (2017), Cleaning up after Chevron, Columbia Journal of Transnational Law, vol. 56, Issue 1 (2017), page 151.

¹⁴¹ Chevron Australia Holdings Pty Ltd v Commissioner of Taxation (2017) FCAFC 62, paragraph 37.

¹⁴² Supra page 36, nr. 139, paragraph 125.

¹⁴³ Supra page 36, nr. 138.

Chevron to CAHPL. Therefore, the group credit rating cannot be used to calculate the interest rate that CAHPL would have received from the financial market for a similar loan. The appellant argued that the ATO should use the CAHPL stand-alone credit rating for their calculations.¹⁴⁴ The ATO, on the other hand, argued that implicit group support should be an essential part of the credit rating analysis of CAHPL. The judge agreed with the ATO's point of view.¹⁴⁵ This case thus established the common practice that one should look at the factual information of each intercompany loan when determining the arm's length price.¹⁴⁶

The implicit group support entails all relevant economic arguments arising from a group situation. Even when there is no legally binding guarantee in place the group will have economic incentives that a subsidiary, i.e. CAHPL, will not default on its debt payments.¹⁴⁷ If a subsidiary were to default, the group might have reputational costs for example. Implicit group support might increase the stand-alone rating of a subsidiary with one or multiple notches upward towards the group rating. Multiple aspects of implicit group support should be considered, for example: can the subsidiary be regarded as strategic towards the group?¹⁴⁸

Additionally, the primary judge also concluded that if the loan would have been contracted between two independent parties, the borrower would have been given (more) security in order to reduce the interest rate burden.¹⁴⁹

The judge took the larger intercompany finance structure into account. The Australian CAHPL had founded a wholly owned subsidiary, CFC, in the US in order to attract US commercial paper. This entity is thus not a direct subsidiary of Chevron Corporation (CC).¹⁵⁰ Due to a parental guarantee from Chevron Corporation, CFC was able to attract commercial paper at a one month USD LIBOR +1,2% rate. It is clear that due to this guarantee, the commercial paper was the cheapest way to attract funds from the financial markets.¹⁵¹ These funds were transferred to CAHPL, which did not receive a parental guarantee for the loan, at a higher rate. Bank quotes from Deutsche Bank and Goldman Sachs were used to defend the AUD LIBOR

¹⁴⁴Supra page 36, nr. 141, paragraph 56.

¹⁴⁵ Supra page 36, nr. 139, paragraph 604 and 606.

¹⁴⁶ Supra page 36, nr. 140, page 157.

¹⁴⁷ Supra page 36, nr. 139, paragraph 212.

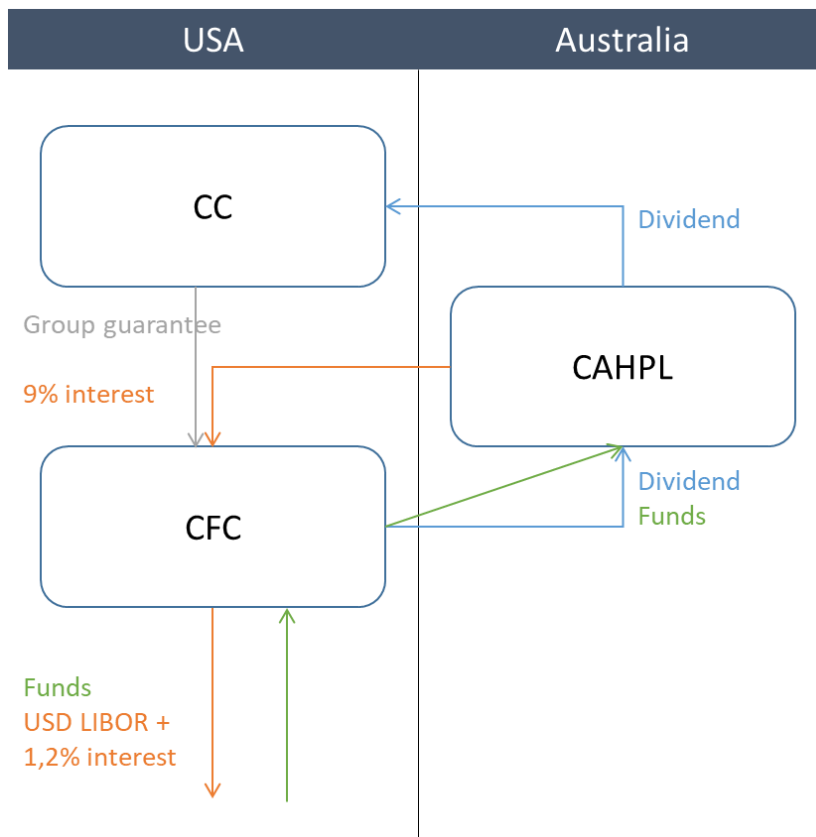
¹⁴⁸ Supra page 36, nr. 139, paragraph 252.

¹⁴⁹ Supra page 36, nr. 139, paragraph 87.

¹⁵⁰ Supra page 36, nr. 139, paragraph 107.

¹⁵¹ Supra page 36, nr. 139, paragraph 108.

+4.14% interest rate.¹⁵² The FX risk was not hedged by Chevron's treasury, which suggested the interest rate.¹⁵³ The below figure summarizes the scheme.



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The interest payments under this credit agreement were tax deductible for CAHPL. Therefore, the taxable base eroded. CFC did not have to pay Australian withholding tax on these interest payments due to an ATO tax ruling. CFC made substantial profits due to the interest spread of about 7%. This profit totaled up to AUD 1,1 billion.¹⁵⁵ The dividends from CFC to its shareholder, CAHPL, were not taxed in Australia as they were subject to the participation exemption. This is clearly a situation of double non-taxation.¹⁵⁶

¹⁵² Supra page 36, nr. 139, paragraph 110.

¹⁵³ Supra page 36, nr. 139, paragraph 111.

¹⁵⁴ www.bdo.in/en-gb/news/2017/global-transfer-pricing-battleground-australian-f.

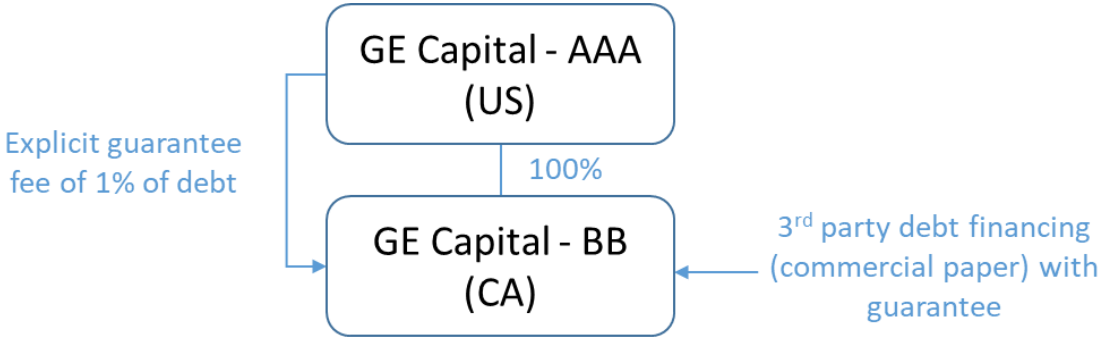
¹⁵⁵ Supra page 36, nr. 140, page 152.

¹⁵⁶ Supra page 36, nr. 139, paragraph 126.

The court ruled in favour of the ATO by finding the 9% as excessively high.¹⁵⁷ Hereby the absence of security and financial covenants was crucial.¹⁵⁸ Chevron owed USD 256 mio to the ATO, which mainly consisted out of taxes, interest and penalties.¹⁵⁹

6.2 Financial guarantees with a special focus on implicit group support: General Electric Capital Canada Inc. v. Canada

The second landmark case in transfer pricing of financial transactions is the General Electric Capital Canada Inc. (GE Capital Canada) v. Canada. From 1996 to 2000 the appellant, deducted a guarantee fee from its taxable base. The fees totalled USD 135,4 mio over this period. It concerned a guarantee given from GE Capital US (GECUS) to GE Capital Canada. Due to this guarantee GE Capital Canada was able to attract funds, mainly commercial paper, at a cheaper rate in the market.¹⁶⁰



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However, this fiscal situation was reassessed by the tax authorities denying this deduction. Moreover, the guarantee was deemed to be a dividend and withholding tax was added. The main point of consideration was the arm’s length price of the guarantee, which the tax authorities considered to be zero. It was the view of the tax authorities that GECUS would have supported GE Capital Canada regardless of the guarantee. Therefore, the guarantee would not create any value. GE claimed that the arm’s length price for the guarantee fee would be 1%.¹⁶²

The main argument from the tax authorities was that the financial market would recognize that GECUS had a strong incentive to support GE Capital Canada as it was considered to be a core subsidiary of the group. Apart from the fact that GE Capital Canada accounted for 20% of the

¹⁵⁷ Supra page 36, nr. 139, paragraph 614.
¹⁵⁸ Supra page 36, nr. 139, paragraph 87.
¹⁵⁹ Supra page 36, nr. 138
¹⁶⁰ General Electric Capital Canada Inc. v. The Queen (2010), FCA 344, paragraph 9.
¹⁶¹ Makode, M. and Tijdhof, L. (2018), How to achieve BEPS & Transfer Pricing Compliance, AFP annual conference, Chicago.
¹⁶² General Electric Capital Canada Inc. v. The Queen (2009), TCC 563, paragraph 1.

assets of the consolidated group¹⁶³, five different criteria that rating agencies often use were put forward:

- *“the specialness, significance and value attaching to the AAA rating;*
- *the branding aspect of having the same name: investors are more likely to run from a parent that has the same name as a subsidiary that fails;*
- *the high degree of financial and managerial integration;*
- *the longevity of the subsidiary: the appellant has been in Canada close to 40 years; and*
- *the size of the subsidiary (the appellant) in relation to the Canadian capital market.”*¹⁶⁴

It was however the position of GE that implicit group support would not exist in an arm’s length relationship.¹⁶⁵ The judge however concluded that implicit group support was a relevant factor based on subsection 69(2) and subsection 247(2) of the Canadian Income Tax Act defines the arm’s length principle for cross-border situations.¹⁶⁶

Subsequently the judge found the yield approach as the most reliable manner to measure the value of the explicit guarantee, i.e. to determine the arm’s length rate.¹⁶⁷ The value would equal the difference in interest cost between lending funds at the subsidiary rating (without an explicit guarantee) and at the group rating (with an explicit guarantee). The value of the guarantee would, however, decrease by taking implicit group support into account. The stand-alone subsidiary rating will increase one or multiple notches, resulting in a final subsidiary rating (incl. implicit group support).¹⁶⁸

The judge concluded that the rating difference between BB+/BBB- with AAA, at that time, would have resulted in an interest differential of 1,83%. The 1% that GECUS invoiced to GE Capital Canada for the guarantee is below this net economic benefit. GE Capital Canada thus had an incentive to enter into this transaction. The financial guarantee was thus at arm’s length. The judge consequently rejected that these guarantee fees should be taxed as deemed dividends.¹⁶⁹

¹⁶³ Supra page 39, nr. 162, paragraph 121.

¹⁶⁴ Supra page 39, nr. 162, paragraph 111.

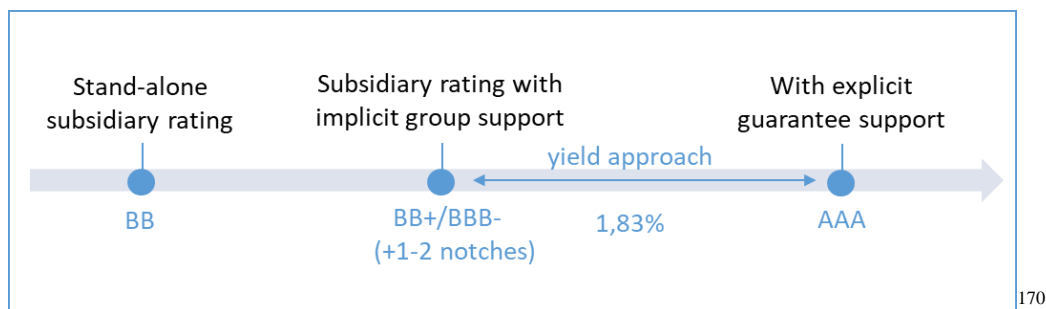
¹⁶⁵ Supra page 39, nr. 162, paragraph 180.

¹⁶⁶ Supra page 39, nr. 160, paragraph 199.

¹⁶⁷ Supra page 39, nr. 160, paragraph 305.

¹⁶⁸ Supra page 39, nr. 160, paragraph 259.

¹⁶⁹ Supra page 39, nr. 160, paragraph 305.



6.3 Cash pooling: ConocoPhillips v. Norway and Bombardier v. Denmark

Two cases prevail when analyzing the transfer pricing aspects of cash pools. Both cases address how cash pool participants should be remunerated for participating in a cash pool. The main problem is that cash pooling structures are unique to MNEs. Therefore, there are no external comparables to be found. This makes the arm's length pricing, including the division of the cash pool synergy, especially difficult. The cases are similar in the sense that they both concern a cross-country physical cash pool. However, the decisions from both judges are significantly different.

The first case is *ConocoPhillips v. the Oil Taxation Authorities (Norway)*. Two Norwegian subsidiaries (COPSAS and NCOPAS) were participating in a cross-country physical cash pool with a master account at Bank of America, together with 150 other subsidiaries. Both cash pool participants were net depositors with the pool.¹⁷¹ The cash pool agreement stated that positive balances were to earn an interest of London Interbank Bid Rate (LIBID) minus 25 bps. Negative balances can borrow at LIBOR rate plus 25 bps. This would, generally, result in a spread of 62.5 bps.

The taxpayers, COPSAS and NCOPAS, argued that, due to the lack of direct comparables, one should take deposit rates for current accounts held at an independent bank as proxy. Additionally, the taxpayers believed that the cash pool synergy should not be split among the cash pool participants. The cash pool synergy would be to reside within the cash pool master.

The Oil Taxation Authorities disagreed with this last point. They were in favor of splitting the cash pool synergy among the cash pool participants relative to their respective contributions. A higher balance would, in their view, result in more bargaining power towards a bank when

¹⁷⁰ Supra page 39, nr. 161.

¹⁷¹ Supra page 23, nr. 94.

leaving other factors, such as creditworthiness, unchanged. Therefore, higher balances would result in higher arm's length rates.

The judge ruled in favour of the tax authorities. The cash pool synergy should, in this case, be divided relative to the respective contributions.¹⁷² This can be linked back to one of the three allocation methods that the OECD recommended for the division of the cash pool synergy among cash pool participants (supra section 4.2.2).¹⁷³ The taxable income for both COPSAS and NCOPAS was raised.

The second case is *Bombardier v. Denmark*. This dispute dates back to 2013. The Danish subsidiary of the Bombardier group was a cash pool participant in a physical cash pool with a Swiss master account. The cash pool was operated by the Bombardier treasury entity out of Switzerland. This treasury entity did not have a rating, but the Bombardier group had a public rating of BB. The cash pool agreement used daily overnight bank offered rate as a basis in determining the cash pool interest rates. Positive balances received a resp. IBOR -50 bps and negative balances could lend from the cash pool at the resp. IBOR + 115 bps. Next to operating the cash pool, the Swiss treasury entity was also responsible for granting intercompany loans for longer term funding for which it applied a spread of 110 bps to 300 bps. All transactions were structured as unsecured.

During the tested period, the liquidity management of the Danish subsidiary was not performed efficiently. The Danish subsidiary had a surplus of cash which it deposited in short-term loans. It put too much funds in these instruments and had to borrow from the cash pool when in need of cash. This created a situation whereby the subsidiary borrowed funds from the Swiss entity that has deposits as collateral. As these deposits were larger than the borrowing, the risk of the borrowings was zero.

The tax authorities used this analysis therefore to equalize the interest to be paid and the interest to be received. As the interest rate was assumed to be equal, the interest was calculated over the net deposit amount.

The Danish administrative tax court recognized that there was no credit risk to the loans. There was thus no clear spread needed between borrowing and lending rates. The court however found

¹⁷² Escribese, D. (2003), Portuguese cash pooling, international euro cash pooling, the treasurer, February 2003, page 656.

¹⁷³ Supra page 5, nr. 3, paragraph 129.

the +115bps margin to be at arm's length. This decision could be a hint towards using the simplest pricing method for cash pooling: an equal interest rate for debit and credit balances.¹⁷⁴ In this particular case, it was difficult for Bombardier to justify all pricing choices as there was no proper transfer pricing documentation. This shifted the burden of proof towards Bombardier.

¹⁷⁴Supra page 23, nr. 90.

7. A practical approach to pricing intercompany financial instruments: the CUP method using Basel regulation

7.1 A theoretical approach to modelling credit risk

Transfer pricing practitioners often stress the need for simplification and the need for a consistent approach in applying the transfer pricing methods. This chapter suggests the incorporation of certain concepts under banking regulation to meet these requests.¹⁷⁵ The Basel Committee on Banking Supervision has issued many guidelines for financial institutions. The overall goal of these guidelines is to increase the stability of the financial industry as banks have a commercial incentive to minimize the amount of capital that they hold as it restricts them in investing.

With regards to the measurement of credit risk, the Basel Committee has introduced the internal ratings-based (IRB) approach. The IRB methodology uses primary risk inputs to calculate the regulatory capital that a bank should hold to absorb the risk of a particular type of funding, e.g. a loan. This can enable taxpayers to calculate an arm's length credit risk premium which can be added on top of a risk-free benchmark rate.¹⁷⁶

This chapter will focus on the Foundation-IRB approach under Basel II. This is the most basic approach and makes abstraction of the more complex, econometric challenges resulting from the Basel guidelines. Adjustments done under Basel III and the advanced-IRB approach are therefore out of scope of this chapter. The F-IRB was put into European legislation via the Capital Requirements Directives and applied since January 1st, 2014. This specific IRB approach is enforced via Chapter III of EU Directive 575/2013.¹⁷⁷

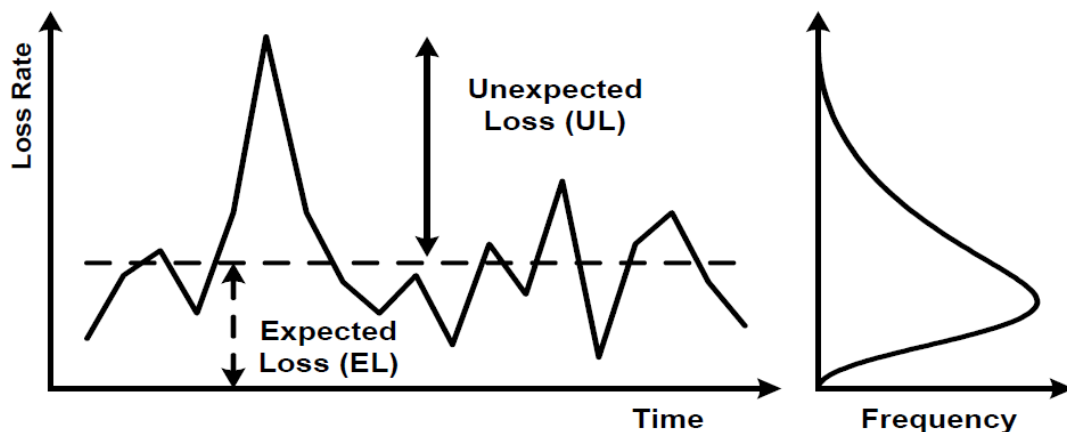
The basic concept underlying the IRB approach is the distinction between expected loss (EL) and unexpected loss (UL). The EL is the expected level of losses that a financial institution will incur from providing credit. These losses are characterized by a high frequency and relative low magnitude. UL, also often referred to as peak losses, are exceptional losses. From this characteristic follows that they occur less often but have a higher impact for the financial

¹⁷⁵ As suggested in Hands, G., Hollas J. (2009), Comparability Adjustments: Finding an Arm's-Length Interest Rate, Tax Management Transfer Pricing Report, Vol. 18, No. 9, page 3-4.

¹⁷⁶ The assumption is made that an arm's length interest rate consists out of a risk-free interest rate and a credit risk premium (dependent on the risk profile of the tested transaction). A possible sovereign or liquidity risk premium is left out of scope of this analysis.

¹⁷⁷ EU Directive 575/2013 of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012.

institution. The expected loss and unexpected loss are represented in the figure below.



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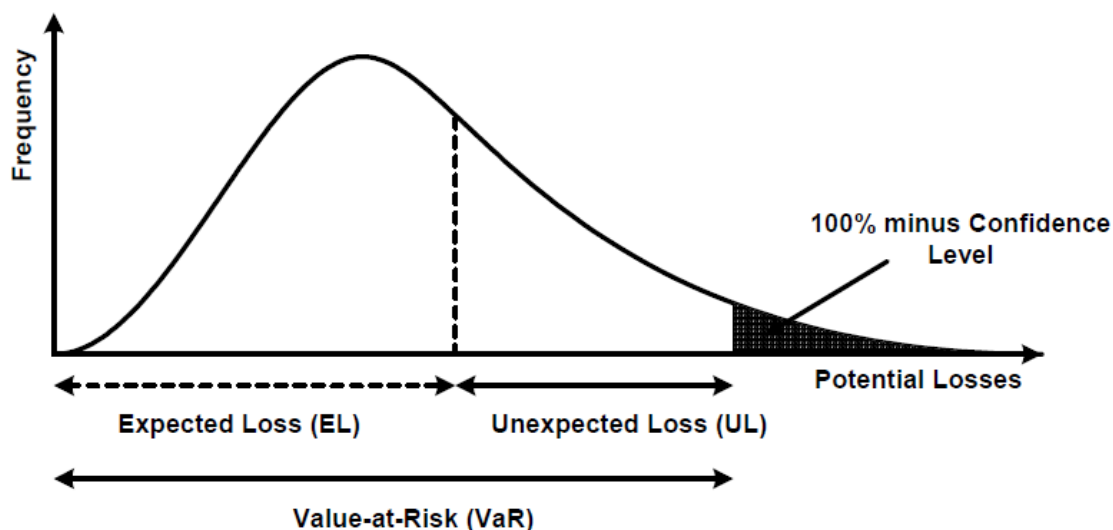
Regulatory capital should function as a buffer for expected levels of losses as well as peak losses, the compensation for providing debt should cover UL as well as EL. The IRB approach uses the concept of Value-at-Risk (VaR) given a regulatory confidence interval. VaR is a frequently used measure of risk that states a certain loss and the probability that it occurs.¹⁷⁹ Therefore, the likelihood that losses will exceed the sum of UL and EL equals 100% - the confidence level. In other words, this means that the likelihood that the resp. financial institution will remain solvent throughout the next year will equal the confidence interval.¹⁸⁰ The EU directive sets the confidence level at 99,9%.¹⁸¹

¹⁷⁸ Basel Committee on Banking Supervision (2005), An explanatory Note on Basel II IRB Risk Weight Functions, Bank for International Settlements, page 2.

¹⁷⁹ Kaplan Inc. (2018), FRM I: Foundations of Risk management (2018), Kaplan Schweser, page 3.

¹⁸⁰ Supra page 45, nr. 179, page 3.

¹⁸¹ Supra page 44, nr. 177, art. 153 (1).



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Four key risk inputs used in the IRB methodology are the probability of default (PD), loss given default (LGD), exposure at default (EAD) and the maturity (M). The first variable, PD, will be the result of the creditworthiness of the borrower. The creditworthiness is captured by a credit rating analysis. This is in line with the draft discussion paper from the OECD as discussed in a separate chapter (supra chapter 4). The final credit rating will be mapped to a one-year probability of default.¹⁸³ The PD figures can be obtained from commercial rating agencies such as Moody's (RiskCalc), S&P, Fitch, etc.

The LGD is the portion of the facility that the lender would lose in case of a default. It can also be expressed as one minus the recovery rate. It is measured by the type of security, provided in the form of collateral, of the transaction. The Basel Committee gives guidance on the values of the LGD per type of securitization. It advises to use an LGD level of 45% for unsecured debt instruments and 75% for subordinated debt instruments.¹⁸⁴ This is in line with the priority of legal claims to the underlying collateral of the debt instrument. The EAD is the amount outstanding and is determined by the repayment schedule of the facility. Guidance on the EAD value is given by the Basel Committee as well.¹⁸⁵

Using the IRB formula, each taxpayer will be able to assign a credit risk profile to each tested transaction using these four comparables. Additionally, it can calculate the same credit risk

¹⁸² Supra page 45, nr. 178, page 3.

¹⁸³ Supra page 44, nr. 177, art. 180(1) a).

¹⁸⁴ Basel Committee on Banking Supervision (2004), International convergence of capital measurement of capital standards: a revised framework, Bank for International Settlements, paragraphs 287 – 288.

¹⁸⁵ Supra page 45, nr. 178, paragraph 4.7.

profile for each comparable. In case that there is no exact comparable to the tested transaction, the taxpayer will make comparability adjustments in line with the same methodology by substituting the different parameters. By filtering on the credit risk profile and the absolute value of all comparability adjustments, the taxpayer will be able to identify the most comparable uncontrolled transactions. It will always be clear how the market will price these differences by using a yield measure such as the option adjusted spread (OAS), yield-to-maturity, etc. The Basel IRB methodology can thus facilitate an external CUP method, which is the preferred TP method, in order to price all intercompany facilities in a consistent manner.

7.2 The tested transaction and observed comparable uncontrolled transactions

The external CUP method using the IRB approach requires taxpayers to have access to secondary corporate bond data. As mentioned, corporate loan information is not made public. Therefore, bonds are considered the best alternative comparable debt instrument (supra section 4.2.1). Secondary corporate bond data is preferred over primary bond data as the market is more liquid and may eliminate primary market inefficiencies.¹⁸⁶ For MNEs, corporate bond data will be the most comparable category of bonds. From a functional perspective, which takes the risks assumed by the lender into account, it does not seem appropriate to include bonds issued by financial institutions, residential mortgage-backed securities (RMBS), etc.

The relevant characters of the data need to be extracted for each bond. The extracted issue rating, maturity, security and repayment schedule for each bond can be valued in term of resp. PD, M, LGD and EAD. These serve as input for calculating the credit risk profile of each bond using the IRB formula.¹⁸⁷ The mechanics of the formula are left out of scope for this paper. The same calculation should be made for the tested transaction. The credit risk profile, which serves as a proxy of credit risk, of the tested transaction can then be benchmarked to the credit risk profile of the comparables uncontrolled transactions, i.e. corporate bonds. Each debt transaction can then be mapped on a risk to return basis. The calculated credit risk profile can be the measure of risk on the horizontal axis. The OAS can be the measure of return mapped on the vertical axis.

For example, an unsecured bullet loan will be given to a subsidiary with a BBB rating for a term of 10 years. The taxpayer observes five comparables in the secondary corporate bond

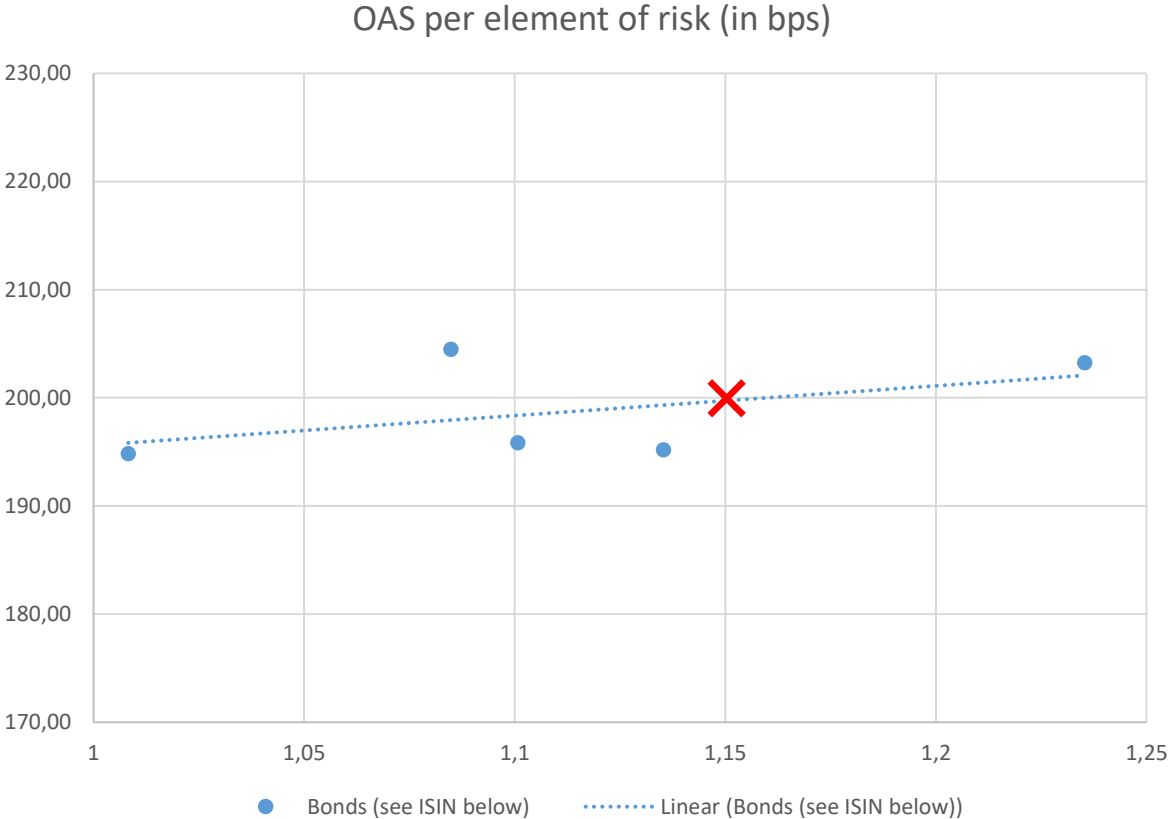
¹⁸⁶ Supra page 21, nr. 84.

¹⁸⁷ Supra page 44, nr. 177, art. 154 (1) :

$$RW = \left(LGD * N \left(\frac{1}{\sqrt{1-R}} * G(PD) + \sqrt{\frac{R}{1-R}} * G(0.999) \right) - LGD * PD \right) * 12,5 * 1,06$$

market.¹⁸⁸ The dots on the graph represent the observed bonds. The Y-axis shows the return, in terms of OAS. The X-axis shows the level of risk, in terms of the IRB credit risk profile. In order to calculate the arm’s length credit risk premium, the taxpayer will determine the credit risk profile and the credit risk premium of each bond. A best fit curve is drawn as well.

The credit risk premium of the tested transaction is determined as the point on the curve with the corresponding risk profile. This specific loan has a credit risk profile of 1,15 which corresponds with a credit risk premium, OAS, of 200,82 bps on the regression line.¹⁸⁹ Increasing the numbers of comparables would enable the taxpayer to calculate statistical ranges, such as an interquartile range or confidence interval.¹⁹⁰



In order to calculate an arm’s length interest rate on an intercompany loan, a taxpayer might need to calculate the arm’s length credit risk premium which should be added to a risk-free interest rate such as the resp. interest rate swap.

¹⁸⁸ Limited comparables in order to give a simplified example.
¹⁸⁹ Only a linear regression line is considered for this simplified example.
¹⁹⁰ Which would be in line with: supra page 5, nr. 2, paragraph 3.57.

7.3 Comparability adjustments

Finding external comparable bonds with the identical characteristics as the tested transactions will often not be possible. It is however possible to substitute different characteristics in the IBR formula. This will result in a change in credit risk profile and a resp. change in the credit risk premium. The comparable bonds from the example have similar structures and repayment schedules as the tested loan. However, the remaining term as well as the rating are different. The below comparability analysis will show the change in credit risk premium per different characteristic. The result of this comparability analysis will be that all comparables, after adjustments, will have the same risk profile.

As the pricing of bonds is not entirely captured in the PD, LGD, EAD and M there will be a small portion of the return unexplained by this model. This is represented in the below table by the idiosyncratic return. One of the factors not captured by the model is the impact of new information. When a company publishes quarterly financial results, it will influence the expectations of investors in their bonds. However, this is not immediately taken into account in the rating and therefore is not captured in the Basel IBR approach.

Tested transaction & comparables									
	Issuer	Type	Rating	M (weeks)	Curr. ¹⁹¹	Structure	Repaym.	OAS	
	Test	Loan	BBB	522	EUR	Unsec.	Bullet	200.82	
ISIN	Issuer	Type	Rating	M(weeks)	Curr.	Structure	Repaym.	Idiosyncr.	OAS
XS1463101680	Vodafone	Bond	BBB+	649	EUR	Unsec.	Bullet		204.47
	<i>comparability adjustment</i>	-	34	-32	-	-	-	-5	-4
XS1721051495	EDP	Bond	BBB-	457	EUR	Unsec.	Bullet		203.23
	<i>comparability adjustment</i>	-	-31	17	-	-	-	12	-2
XS1146286205	Verizon	Bond	BBB+	667	EUR	Unsec.	Bullet		195.84
	<i>comparability adjustment</i>	-	34	-37	-	-	-	8	5
XS1721422068	Vodafone	Bond	BBB+	561	EUR	Unsec.	Bullet		194.91
	<i>comparability adjustment</i>	-	34	-10	-	-	-	-19	6
XS1846632104	EDP	Bond	BBB-	362	EUR	Unsec.	Bullet		195.18
	<i>comparability adjustment</i>	-	-31	41	-	-	-	-5	6¹⁹²

¹⁹¹ Differences in currencies (in terms of FX and market characteristics) are left out of scope of this example.

¹⁹² Calculations performed are estimations based on market data.

7.4 Practical advantages and research relevance

Different approaches in applying the CUP analysis for financial transactions exist. The main benefit of this IRB-based approach is that it can be applied consistent throughout different types of intercompany financial transactions. It facilitates the pricing of intercompany loans as explained in this chapter. It can also be used to price guarantees following the yield approach. Hereby the difference between the cost of funding between the situation with and without a guarantee should be calculated. It thus requires the calculation of two arm's length prices for loans following the same steps. The arm's length price of the guarantee should then be between those two arm's prices. This methodology also facilitates the pricing of cash pooling as it calculates an arm's length cost of funding. Adding the allocated cash pool benefit on top of this arm's length price should be the final step.

This methodology also provides a framework for a consistent selection of comparable uncontrolled transactions and the calculation of comparability adjustments. Without a framework, a transfer pricing professional might slice and dice the entire dataset of market transactions by filtering down on specific features of the tested transactions, e.g. industry, rating, maturity, etc. Such selection of comparable bonds is subjective and open for inconsistencies. Is a bond with a one notch rating difference more or less comparables than a bond with a one-year shorter maturity but with the same rating? This methodology factors in all key risk indicators and enables a ranking on comparability. It also enables to calculate consistent comparability adjustments by substituting different characteristics in the IRB formula.

Having a consistent methodology is especially relevant for taxpayers.¹⁹³ Having many financial transactions throughout the globe places a significant compliance burden on MNEs. Moreover, transfer pricing calculations for financial transactions require specific knowledge. Therefore, the MNE should have access to skilled people (either in-house or via a consultancy firm). By applying one methodology consistently MNEs are able to perform the transfer pricing calculations more efficiently and reduce the compliance costs.

¹⁹³ Supra page 5, nr. 2, paragraph 2.19.

8. Conclusion

The aim of this thesis is to draft the regulatory framework for the arm's length pricing of financial transactions. Due to the recent draft guidelines, many changes for taxpayers are expected. Taxpayers and tax administrations will have to update their transfer pricing policies and redesign their processes. In order to estimate the impact, three main questions were key in this research:

1. Are these draft guidelines in line with existing national legislation and international soft law?
2. Are these guidelines in line with international case law?
3. How can the compliance burden for taxpayers be minimized?

Firstly, the regulatory framework is reshaped by two types of legislative measures. On the one hand, countries tend to harmonize national transfer pricing rules by implementing the OECD TPG. On the other hand, other national regulation undermines the arm's length principle. Unharmonized safe harbor regulations have a direct effect on arm's length prices. Thin cap and earnings stripping regulation pose, indirectly, limits to the use of arm's length prices. This second category of measures creates an unequal level playing field for MNEs across different countries.

Secondly, the draft guidelines are in line with international case law. However, where international case law is inconsistent, i.e. the allocation of the cash pool synergy, the guidelines allow for multiple methods to be applicable. Consequently, a point of criticism towards the draft guidelines is that it does not give enough detail. In-depth guidance is missing in different areas such as the determination of a credit rating, the allocation of the cash pool synergy, etc. Taxpayers could be using different compliant transfer pricing approaches which would still lead to significantly different results.

Thirdly, this thesis suggests a uniform CUP approach towards transfer pricing of financial transactions leveraging Basel regulation. The practical advantage for taxpayers is that it can be applied throughout various types of intercompany finance transactions. By introducing a single measure for credit risk, it allows to benchmark the tested transaction with market comparables in a consistent manner. It also enables taxpayers to make reliable comparability adjustments.

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10. Appendix I: summary

To enforce that all taxpayers pay their fair share of taxes, the G20 and the OECD started the Base Erosion and Profit Shifting (BEPS) inclusive framework. This thesis focuses on the OECD discussion draft on transfer pricing of financial transactions. The document was issued on the 3rd of July 2018 in the context of actions 9 and 10 of the BEPS framework. It is not a consensus document. A final consensus is expected to be reached at the OECD Working Party 6 meeting in April 2019.

The objective of this thesis is to analyse the discussion draft in its judicial context by applying a methodology that incorporates both legal and economic concepts. The scope of this research is limited to three financial instruments: intercompany loans, (physical and notional) cash pooling and financial guarantees. The thesis aims at providing answers to three fundamental questions:

1. Are these draft guidelines in line with existing national legislation and international soft law?
2. Are these draft guidelines in line with international case law?
3. How can the compliance burden for taxpayers be minimized?

The answers to these questions should serve treasury and tax departments within MNEs as they are typically in charge of financial risk management, liquidity management as well as intercompany finance. These centralized corporate functions are executing financial transactions globally. The wide variety of national tax statutes and different approaches of tax administrations place a compliance burden on MNEs.

Firstly, the draft guidelines should be considered as a follow-up document to the general transfer pricing guidelines issued by the OECD in 2017. The discussion draft uses the same concepts to make an in-depth analysis for financial transactions. In order to gain insight in the discussion draft a profound understanding of the transfer pricing guidelines is required.

Determining the arm's length price for financial transactions has the same starting point as outlined in the general transfer pricing guidelines. The nature of the controlled transaction, determined by a functional analysis, will serve as primary input for the transfer pricing assessment. The analysis identifies the risks assumed, functions performed and assets transferred. Risk-free entities with no decision-making power or control of risks will not be rewarded with a portion of the profit. In this regard, the draft guidelines follow the general

transfer pricing guidelines. The transfer pricing guidelines also point out that when multiple transfer pricing methods are applicable, the CUP method is preferred (supra chapter 3).

Additionally, when pricing intercompany financial transactions it is necessary to incorporate special considerations in relation to intra-group services. The most used transfer pricing method for intra-group services is the CUP method. For this reason, the thesis will propose a methodology focussing on the CUP method to determine the arm's length price for intercompany financial transactions. If the provider of the service is merely an intermediary, the cost plus method will be more suitable (supra chapter 4).

Although international soft law aims at coordination, there is a lack of integration and harmonization in national tax statutes. Due to thin capitalization rules, earnings stripping regulation and safe harbour measures an MNE in one country might be able to set a higher arm's length interest rate compared to an MNE in another country, while both countries apply the OECD transfer pricing guidelines. This creates an unequal level playing field for MNEs.

Such regulation triggers a fundamental question: should there be an arm's length capital structure? If national legislation on the debt capacity of MNEs and interest deductibility limits were absent, an MNE would be able to determine its own level of capitalization. A lower level of capitalization would have major consequences for the arm's length price of financial transactions. The discussion draft on financial transactions briefly addresses this challenge. It mentions that the amount of the loan should not be larger than an independent lender would have provided. Specific harmonization of national tax statutes is left out of scope of the discussion draft (supra chapter 5).

Secondly, the draft guidelines are in line with international case law. However, the guidelines allow for multiple methods where international case law is inconsistent. This is the case for more complex financial instruments, such as cash pooling. Consequently, a point of criticism towards the draft guidelines is that it does not give enough detail. In-depth guidance is missing in different areas such as the determination of a credit rating, the allocation of the cash pool synergy, etc. Taxpayers could be using different compliant transfer pricing approaches which would still lead to significantly different prices (supra chapter 6).

Thirdly, this thesis suggests a methodology that should facilitate treasury and tax departments to cope with the compliance burden. The Basel IRB methodology uses primary risk inputs to calculate the regulatory capital that a bank should hold to absorb the risk of a particular type of

funding, e.g. a loan. It enables taxpayers to capture the credit risk profile of a financial transaction in a single measure. This credit risk profile can be calculated for the tested transaction as well as all comparable uncontrolled transactions.

The selection of the comparables can be done by selecting the comparable uncontrolled transactions with the most comparable credit risk profile. The arm's length credit spread can be obtained by using a statistical measure of central tendency on the credit spread of the observed comparables. Comparability adjustments can be made by substituting the different characteristics into the IRB formula.

Different approaches towards the CUP analysis for financial transactions exist. The main benefit of this IRB-based approach is that it can be applied consistent throughout different types of intercompany financial transactions. This methodology also provides a framework for a consistent selection of comparable uncontrolled transactions and a uniform calculation of comparability adjustments. Having a consistent methodology is especially relevant for taxpayers. By applying one methodology consistently MNEs are able to perform the transfer pricing assessments more efficiently and reduce the compliance burden (supra chapter 7).

Critics acknowledge the wide scope of the discussion draft but underline the lack of detail. The discussion draft gives high level guidance on most aspects relevant in the arm's length pricing of financial transactions. However, many practical implications of these recommendations remain a grey area. Therefore, the OECD consensus paper is expected to have a major impact for taxpayers, tax authorities and transfer pricing practitioners.