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The Fundamental Approach for Allocation of Risks and Returns for Financing Entities

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Introduction

One of the most controversial topics of transfer pricing, in today's multinational world, is the pricing of intercompany financial transactions. The 2017 OECD transfer pricing guidelines (TPG) lack clear rules specifically tailored to financial transactions, which can lead to a higher risk of divergent treatment of these transaction between tax administrations and taxpayers and ultimately to an increase in tax disputes. This high susceptibility to disputes can be seen in a large number of cases that have occurred recently such as the Australian Chevron case. For this reason the OECD is currently working on new guidance specifically focussed on financial transactions and has recently released a non-consensus draft (See OECD discussion draft on financial transactions). The aim of this short blog is to display the fundamental approach in the valuation of financial transactions of all kinds. The existing guidance of the TPG is used for this purpose and references are made to the recent draft.

Types of financing entities

A large proportion of multinational enterprises (MNEs) in one form or another have companies that provide financial services to the group. Financing entities in MNEs have the advantage that all financial transactions can be handled through one company, thus pooling know-how and exploiting synergy effects. These kinds of entities can be structured differently and perform diverse functions in accordance with the request of the MNE. Broadly speaking, the remuneration of companies depends on the entities' profiles. The functions performed can range from liquidity and cash management to financing, financial asset management and financial risk management (See OECD discussion draft on financial transactions paras 38-43). These functions can include the planning, monitoring, managing, administrating, negotiating of conditions and controlling of these areas. Typical activities conducted by a financial entity are the granting of loans and other credit facilities, the provision of intercompany guarantees, organising notional or physical cash pooling arrangements and the performing of other treasury activities like factoring or risk management.

Financial entities can broadly be classified into two categories, according to their functional profile. They can be qualified as cost centres or profit centres. A cost centre acts as a service provider, executing routine services like administrative or calculating tasks and managing financial transactions on behalf of other group members without taking capital related risks. A profit centre operates like an in-house bank, providing financial services in its own name, with the aim of yielding a profit and assuming major capital related risks. The range of services provided can vary from one to all kinds.

Correlation between risk and returns for financing entities

The main question that arises in the treatment of intercompany financial transactions is what level of financial return should be paid to the treasury entity for the provision of its services/activities. In accordance with the TPG, the remuneration should be at arm’s length and be based on the value generated by the financial entity. This value depends on the functions performed, risks assumed and assets deployed.

The TPG establish a strong link between income allocation and the assumption of risks. Therefore, the risks assumed have a strong influence on the amount of consideration that an entity is entitled to. Financial transactions (such as intercompany loans) are exposed to various financial risks for example credit risk, interest rate risk, possibly exchange rate risk, etc.

The determination of whether and which risks were assumed by the financial entity is a part of the functional and risk analysis, and, is based on the new guidance of the TPG, on the analysis of risks considering the commercial and financial relations introduced by the BEPS project (TPG para 1.56 onwards). The TPG introduce a six-step analysis to determine the risks assumed by an entity. In short, the guidance provides that a risk is only assumed by a company if that company has control over the risk and has the financial capacity to bear the potential economic consequences if the risk was to materialize. More importantly, it is not sufficient to assume the risk only from a contractual perspective. Depending on the result of the functional and risk analysis, the activity of the financial entity can be assigned to the categories of risk-free and risk-adjusted compensation.

Risk-free returns: If the financial entity does not bear any financial risks according to the risk analysis, which means that the enterprise does not make risk-related decisions independently and on its own responsibility or does not have a sufficient amount of capital to bear the consequences of the risk realization, then arguably it may be awarded a risk-free remuneration (or less) and mainly recoup the costs incurred (See OECD discussion draft on financial transactions Box B.4. para. 1).

For example, assume a treasury entity T (resident in country T) grants a loan to an affiliated company S (resident in country S). Company T has no employees and all decisions related to the loans are taken by another company of the MNE, company R (resident in country R). Specifically, T does not perform any tasks related to loan creation and loan management (see section 2.3 of an article published by Chand on Loans in Intertax for a list of such activities). Neither does company T make any risk management decisions. The question that arises is which company can be entitled to the interest from this loan?

A functional analysis of company T will conclude that it does not carry out any significant functions with regard to the granting/managing of the loan and does not exercise any control over the risks associated with the transaction (see example in para 1.85 TPG read with para 1.103 TPG). As company T has no control over the financing risk associated with the transaction; the company can only be allocated an arm's length risk-free return. Such a risk-free return can be determined using a comparison with government securities as such securities offer a safe and nearly risk-free investment (See OECD discussion draft on financial transactions Box B.4 paras. 2-7).

In fact, one major target of the OECD within the BEPS project was to address the so-called "cash boxes". In the OECD's view, value is created in an entity through the assumption of significant functions and risks and the provision of assets. A company with substantial financial resources that enters into a financial transaction on the basis of this capital, but does not perform any other related tasks, such as making decisions about transaction partners and reviewing them and managing the funds or transaction terms, does not add value to the transaction since it does not assume any significant functions or bear any risks. The financial resources of the company alone cannot be sufficient to allocate the profits generated by the granting of the loan to this company. This is because financial resources are highly mobile and therefore offer a high potential for base erosion and profit shifting.

Risk-adjusted returns: On the other hand, if the financial entity bears all or some financial risks according to the risk analysis, which means that the company employs people who make risk management decisions on their own responsibility and has a sufficient amount of capital to bear the financial consequences of the risk, it may be awarded a risk-adjusted remuneration. In this case, the financial entity acts more like an entrepreneurial financing entity (See OECD discussion draft on financial transactions Box B.4 paras. 12, 15-16).

Based on the previous example, the treasury entity T (resident in country T) grants a loan to a related company S (resident in country S). This time company T has its own employees. These employees are responsible for loan creation as well as loan management activities. In addition, T has financial resources that can bear the effects of the risk.

A functional analysis will conclude that company T performs the significant functions of the transaction and takes control of the risk and has the financial capacity to bear the risk and therefore can be entitled to a risk-adjusted return. (See the example in para 6.61 TPG). Such risk-adjusted returns may be determined by resorting to the CUP method (internal or external CUPs) or with the use of other methods such as build-up approach (See OECD discussion draft on financial transactions Box B.4 paras. 17-21; section 2.2.3 of an article published by Chand on Loans in Intertax).

Concluding remarks

The rules to be developed by the OECD vis-à-vis financial transactions should reflect this basic concept of allocation of returns in line with value creation. In addition, there is an urgent need to provide guidance on individual financial transactions, to ensure consistent and correct application of the rules by tax administrations and taxpayers. The recent discussion draft is surely a huge step in the right direction.

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