

Application of the Arm's Length Principle to Physical Cash Pooling Arrangements in Light of the OECD Discussion Draft on Financial Transactions

Alexander Haller* & Vikram Chand**

The authors would like to express their gratitude to Antonfortunato Corneli (EY), Stefaan De Baets (PwC), Rachit Agarwal (DLA Piper) and Amanda Pletz (NERA) for reviewing the draft versions of the article. The views and opinions expressed in this article are those of the authors.

Although cash pooling arrangements are one of the most important tools to facilitate efficient liquidity management within multinational enterprises (MNEs or group companies), the application of the arm's length principle to these arrangements has not been sufficiently explored as yet. Against this background, this article critically discusses the transfer pricing aspects of physical cash pooling arrangements, especially in the light of the OECD's recent Discussion Draft on Financial Transactions. Specifically, the article discusses the application of the arm's length principle to cash pooling borrowings and deposits, guarantees issued in the context of the pooling arrangement, remuneration of the cash pool leader (CPL) as well as allocation of the cash pool benefit, in particular, the netting benefit and the volume discount. The authors also provide comments on the impact of the negative interest rate environment on cash pooling arrangements.

I INTRODUCTION

Even if cash pooling arrangements are considered to be one of the most significant tools to facilitate liquidity management within MNEs,¹ the application of the arm's length principle to cash pooling transactions is nevertheless subject to intense discussions with the tax administration.² One main reason is that cash pooling transactions are usually not found between independent enterprises.³ Thus, it is difficult to establish arm's length transfer prices for cash pooling transactions between group companies. Accordingly, the question arises regarding how to approach such arrangements for transfer pricing purposes. This question can generally be answered from

two different angles, namely from a transactional angle or on the basis of a *clear reflection of income approach*⁴ (or combinations thereof),⁵ taking into consideration the particular characteristics of cash pooling arrangements. This article critically discusses the application of the arm's length principle to physical cash pooling transactions based on the former approach.

After an introduction to the background and characteristics of physical cash pooling arrangements and the challenges in applying the arm's length principle to them (section 2), the article discusses the application of the arm's length principle to various transactions found in the arrangement, such as short-term funding transactions

Notes

* Certified Tax Advisor/Senior Manager, WTS, Munich, Germany. Email: alexander.haller@wts.de.

** Executive Director – Executive Program in Transfer Pricing & Masters of Advanced Studies in International Taxation, University of Lausanne, Switzerland. The author finalized the article during his postdoctoral research stay at the Max Planck Institute for Tax Law and Public Finance (Munich). Email: vikram.chand@unil.ch.

¹ PwC, *Clarifying the Rules: Sustainable Transfer Pricing in the Financial Services Sector* 137 (PwC Apr. 2012).

² K. Lukosz, A. Ursu & M. Druga, *Transfer Pricing of Intra-Group Cash-Pooling Arrangements Through the Lens of Business and Economic Reality*, 25(3) Int'l Transfer Pricing J. 208 (2018); V. Chand, *Transfer Pricing Aspects of Cash Pooling Arrangements in Light of the BEPS Action Plan*, 23(1) Int'l Transfer Pricing J. 38–47 (2016).

³ OECD, Discussion Draft, *BEPS Actions 8-10: Financial Transactions*, OECD/G20 Base Erosion and Profit Shifting Project, para. 100 (OECD Publishing 3 July 2018); H. M. Andresen, N. Pearson-Wood & H.-M. Jørgensen, *ConocoPhillips Case: Implications in Norway and Beyond*, 17(6) Int'l Transfer Pricing J. 464 (2010); E. Vistisen, *Bombardier Case: First Published Cash Pool Decision*, 21(3) Int'l Transfer Pricing J. 189 (2014).

⁴ From a holistic perspective, cash pooling arrangements could be regarded as pooling of balances as part of a short-term liquidity management arrangement. OECD, *supra* n. 3, para. 101. They could therefore be more than the consolidation of (single) account balances of group companies. The arm's length analysis could correspondingly focus on the cash pooling arrangement as a whole, rather than on the single transactions it combines. By contrast, from a transactional perspective, cash pooling could also be seen as a combination of single transactions between group companies. By applying a transactional approach, the arm's length analysis could therefore focus on pricing the single transactions between the group companies to ensure an arm's length allocation of income and expenses between the associated enterprises.

⁵ A difference exists between a transactional approach and clear reflection of income approaches vis-à-vis transfer pricing. A transactional approach is based on the assumption that if transactional pricing is at arm's length, the overall allocation of income and expenses between the relevant group companies will be appropriate. By contrast, clear reflection of income approaches refer to any type of aggregate assessment of contributions of the respective group companies. Such approaches could range from different types of profit split analyses, to formalized contribution analysis, to formulaary apportionment in various forms. R. S. Collier & J. L. Andrus, *Transfer Pricing and the Arm's Length Principle After BEPS* 102–05 (Oxford U. Press 2017).

(section 3), cash pool guarantees (section 4), the remuneration of the CPL (section 5) and the allocation of cash pool benefits (section 6). It also examines the general implications of the low or even negative interest rate environment on physical cash pooling arrangements (section 7). Notably, this article focuses on a detailed technical analysis of various issues at stake in the physical pooling arrangement. The authors' views on each issue are included in each section of the article.

2 PHYSICAL CASH POOLING

2.1 Introduction

It is a well-established fact that the cost of external funding for MNEs had increased substantially due to the financial crisis. In order to reduce such costs, MNEs had to rethink their cash management strategies. One such strategy was to implement cash pools.⁶ By establishing a cash pool, MNEs can manage the liquidity requirements of the group on a consolidated basis (virtually or physically) by concentrating the cash of the group companies (cash pool members) in one place, i.e. in the master account of the CPL (typically a finance or treasury company (TCo) of the group). The general effect of cash pooling is that the MNE pays or receives interest only on the net (consolidated) cash amount of the master account. Apart from the fact that cash pooling can significantly reduce external funding costs, cash pooling can also create several other benefits such as enhanced credit terms and reduced transaction costs.⁷

More specifically, in a physical cash pool (different to a notional cash pool),⁸ the surplus cash of the cash pool members is transferred (usually daily or weekly) to the master account owned by the CPL. Surplus liabilities are thus correspondingly eliminated by transferring funds from the master account. Each bank account is brought to target balance (usually zero). Due to the physical cash transfer, the ownership of cash changes with the effect of establishing (intercompany) financial arrangements between the CPL and the cash pool members.⁹ The following simplified example illustrates the functioning of physical cash pooling arrangement:

A parent company (PCo) has three subsidiaries, namely SCo 1, SCo 2 and SCo 3. Each subsidiary has an external bank account. SCo1 and SCo 2 show a positive balance of EUR 200 and EUR 150, respectively, whereas SCo3 has a

negative balance of 100. The interest rates offered by the external banks are 10% (SCo1 and SCo2) and 15% (SCo3). PCo decides to establish a TCo. TCo concludes a physical cash pool arrangement with Bank Y that sets up the cash pool. The interest rates applied by Bank Y on the master account are more favourable than the interest rates offered to the single group companies due to economies of scale, i.e. 12% (positive balance) and 14% (negative balance).

The total cash pool benefit is calculated as follows:

	Stand-alone transaction (without pooling)				Cash pooling	Total cash pool benefit
	SCo1	SCo2	SCo3	Total		
Balance	200	150	-100	250	250	
Interest rate (%)	10%	10%	15%		12%	
Interest	20	15	-15	20	30	10

This example shows that, through the establishment of a physical cash pool, the group can significantly enhance its interest income and reduce the cost of funding cash shortfalls. With pooling, the (consolidated) interest income can be increased to EUR 30. Thus, the *total benefit* from establishment of the cash pool (the cash pool benefit) is EUR 10 (30–20). Furthermore, the establishment of the cash pool could potentially create benefits that would not be available to the single cash-pooling participant without the cash pool, such as a 'volume discount' (i.e. better credit terms due to economies of scale).

Additionally, in a physical cash pool, the CPL may perform a broad set of functions. Prior scholarly literature on this topic distinguishes between two extreme ends of such a spectrum of functions.¹⁰ On the one hand, a CPL could be a (low-risk) financial service provider. In this situation, the CPL usually conducts activities related to the daily execution of the cash pool, such as the assurance of the daily cash transfers, the calculation of the interest expense and the issuance of reports on the cash positions of the cash pool members.¹¹ On the other hand, the CPL could function as an 'internal bank'. In this situation, the CPL assumes higher strategic

Notes

⁶ PwC, *supra* n. 1, at 137.

⁷ A. Russo & O. Moerer, *Introduction*, in *Transfer Pricing and Intra-Group Financing* 44 (A. Bakker & M. M. Levey eds, IBFD 2012); *ibid.*

⁸ In a notional arrangement, each cash pool member generally maintains its credit or debt position on its own bank accounts. The accounts are not physically balanced by the master account. By contrast, the bank creates a notional or shadow position (virtual master account) and charges or pays interest on the consolidated amount. S. Hillman, *Notional vs. Physical Cash Pooling Revisited*, *Int'l Treasurer* (Feb. 2011).

⁹ A. J. Bakker, *Transfer Pricing and Intra-group Financing: Low Hanging Fruit?*, 15(2) *Derivatives & Fin. Instruments* 30 (2013).

¹⁰ R. Petruzzi, *Transfer Pricing Aspects of Intra-Group Financing* 145, 146 (Wolters Kluwer 2016); Russo & Moerer, *supra* n. 7, at 45; Chand, *supra* n. 2, at 39.

¹¹ Russo & Moerer, *supra* n. 7, at 45.

(valuable) functions.¹² The CPL could indeed be in the position to decide on major issues such as liquidity planning in the group and complete internalization of the cash accounts of the cash pooling members.¹³ It may also negotiate with the banks and, correspondingly, take all relevant decisions with regard to external (short-term) funding, portfolio strategies (e.g. hedging or investment of surplus cash) and the internal allocation of (short-term) cash on the basis of the specific needs of the group companies.¹⁴

2.2 Challenges in Applying the Arm's Length Principle to Physical Cash Pooling Arrangements

The authoritative statement of the arm's length principle is found in Article 9(1) of the OECD Model Tax Convention (OECD Model). This provision, when applied to physical cash pooling transactions, implies that – from a transfer pricing perspective – physical cash pooling transactions among associated enterprises must be at arm's length.¹⁵ Thus, in order to determine arm's length consideration for these transactions, comparable transactions between independent enterprises in similar circumstances must be identified. However, cash pooling transactions are usually not found between independent enterprises.¹⁶ The limited availability of third-party evidence does not necessarily mean that cash pool transactions are not at arm's length at all or cannot be priced at arm's length.¹⁷ In particular, if the commercial rationale of the operation of a cash pool can be demonstrated (e.g. reduction

of transaction costs), cash pooling transactions should not be disregarded for transfer pricing purposes.¹⁸ Even though tax authorities generally acknowledge that the reasons for the establishment of cash pooling arrangements can be commercially justified,¹⁹ they nevertheless carry out detailed tax audits to determine the transfer pricing aspects of cash pools.²⁰ Thus, the application of the arm's length principle to physical cash pooling transactions requires careful consideration.²¹

Additionally, the interpretation and application of the arm's length principle has significantly been enhanced by the OECD/G20 BEPS project.²² BEPS Actions 8–10 seek to align transfer pricing outcomes with value creation.²³ In this regard, the concept of 'actual conduct' plays an important role.²⁴ Specifically, the OECD has clarified that if the actual conduct of an entity differs from contractual arrangements, the actual conduct will prevail.²⁵ In a nutshell, this economic approach to transfer pricing seeks to appropriately understand the role and function of the group company and its contribution to overall value creation in the group.²⁶ The appropriate 'people functions' can now be considered as the prominent factor for allocation of risks and returns to an entity, rather than the contractual arrangements.²⁷ These changes in the interpretation and application of the arm's length principle may provide the tax administration in each case with the ability – perhaps even a mandate – to look behind contractual arrangements and to examine the actual conduct of the parties.²⁸ Given this, it is necessary to ascertain whether the physical cash pooling arrangements are aligned with the actual conduct of the parties. If the contractual arrangements differ from the actual conduct

Notes

¹² J. Hollas & G. Hands, *Transfer Pricing and Intra Group Cash Pooling*, 19(20) Tax Mgmt. Transfer Pricing Rep. 4 (Feb. 2011).

¹³ OECD, *supra* n. 3, paras 119 et seq.; *ibid.*; Chand, *supra* n. 2, at 42.

¹⁴ Petruzzi, *supra* n. 10, at 146 & 147; Russo & Moerer, *supra* n. 7, at 45; Chand, *supra* n. 2, at 39; Hollas & Hands, *supra* n. 12, at 4.

¹⁵ For a detailed analysis of the arm's length principle, see J. Wittendorff, *Transfer Pricing and the Arm's Length Principle in International Tax Law*, Series on International Taxation (Kluwer Tax Law International 2010). For a critical discussion on the arm's length principle, see L. Schoueri, *Arm's Length: Beyond the Guidelines of the OECD*, 69(12) Bull. Int'l Tax'n 690–716 (2015).

¹⁶ OECD, *supra* n. 3, para. 100; Andresen, Pearson-Wood & Jørgensen, *supra* n. 3, at 464; Vistisen, *supra* n. 3, at 189.

¹⁷ OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* para. 1.11 (OECD Publishing 10 July 2017).

¹⁸ *Ibid.*, para. 1.123.

¹⁹ UK: Her Majesty Revenue and Customs (HMRC), *Cash Pooling: Introduction to Cash Pooling*, INTM 503110.

²⁰ Łukosz, Ursu & Druga, *supra* n. 2, at 208; Chand, *supra* n. 2, at 38–47.

²¹ OECD, *supra* n. 17, para. 1.11; OECD, *supra* n. 3, para. 100. See also CH: Federal Supreme Court, 16 Oct. 2014, BGE 104 III 533.

²² Collier & Andrus, *supra* n. 5, para. 6.13.

²³ OECD, *Aligning Transfer Pricing Outcomes with Value Creation – Actions 8-10 Final Reports*, OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing 5 Oct. 2015).

²⁴ OECD, *supra* n. 17, para. 1.51.

²⁵ *Ibid.*, paras 1.45 & 1.119–1.128.

²⁶ *Ibid.*, para. 1.6.

²⁷ M. Heggmaier, *The New Interpretation of the Arm's Length Principle: A Post-BEPS Evaluation*, 24(4) Int'l Transfer Pricing J. 2 et seq. (2017). The new economic interpretation of the arm's length principle in Art. 9(1) OECD Model Tax Convention (2017) seems to be inspired by the former work of the OECD on the attribution of profits to permanent establishments in Art. 7 (2) OECD Model Tax Convention (2017) (Authorized OECD Approach). See W. Schön, *International Taxation of Risk*, 68(6/7) Bull. Int'l Tax'n 290 (2014); J. Wittendorff, *BEPS Actions 8-10: Birth of a New Arm's Length Principle*, 81(4) Tax Notes Int'l 331–32 (2016).

²⁸ Collier & Andrus, *supra* n. 5, para. 6.13.

(economic substance of the transaction), transfer price adjustments could be imposed.²⁹

Against this background, the OECD recently released its long-expected discussion draft on the transfer pricing aspects of financial transactions including cash pooling transactions (OECD Discussion Draft on Financial Transactions, or simply Discussion Draft) aimed at providing guidance in this very controversial area.³⁰ The major statements in the guidance related to cash pooling transactions can be summarized as follows:

- *characterization*: The OECD defines cash pooling as the pooling of balances as part of a short-term liquidity management arrangement.³¹ It emphasizes that the application of the arm's length principle would need to consider not only the facts and circumstances of the cash transfers, but the wider context of the cash pooling arrangement³²;
- *remuneration of the CPL*: The CPL must be remunerated based on the functions it performs.³³ If the role of the CPL goes beyond that of a service provider, it may be entitled to earn more than a routine return for the services it provides.³⁴ An arm's length remuneration may even be composed of an arm's length interest spread between the borrowing and lending positions³⁵;
- *cash pool benefit*: The cash pool benefit (generally composed of, for example, the netting benefit and the volume discount)³⁶ must be established through a functional analysis and should generally be shared among the cash pool members, provided that an appropriate reward is attributed to the CPL for the function it performs.³⁷ The OECD also illustrates three possible (non-exclusive) approaches for the allocation of the cash pool benefit³⁸; and
- *cash pool guarantees*: The issuance of guarantees between cash pool members for each other (cross-guarantees) may be nothing more than *an acknowledgement that it would be detrimental to the interest of the group not to support the performance of the CPL and so, by*

*extension, the borrower.*³⁹ Thus, a guarantee fee would, in such cases, typically not be payable.

Although the Discussion Draft was aimed at clarifying the application of the arm's length principle to cash pooling transactions, some critical areas of cash pooling are not sufficiently discussed and explained in the Discussion Draft (e.g. determination and allocation of the cash pool benefit and the impact of the negative interest rate environment). Also, the Discussion Draft itself does not represent the consensus view of the OECD on the application of the arm's length principle to financial transactions. It is (only) *intended to provide stakeholders with substantive proposals for analysis and comment.*⁴⁰ Thus, common principles for determining the transfer pricing of financial transactions (including cash pooling transactions) are not yet available.

3 CASH POOL BORROWINGS AND CASH POOL DEPOSITS

3.1 Classification of the Funds

3.1.1 Classification for Domestic Law (Civil Law) Purposes

Physical cash pooling entails actual cash movements between the CPL and the cash pool members. The cash pool members could either have cash deposits or cash pool borrowings with the master account of the CPL. These cash deposits and cash borrowings generally replace the balances that the cash pool members would have with external banks in the absence of the cash pooling arrangement. Thus, the cash transfers create intercompany financial arrangements that must be classified and priced at arm's length.

In the authors' opinion, first, it is necessary to ascertain if the financial arrangements arising from the cash

Notes

²⁹ It is clear that Art. 9 (1) OECD Model Tax Convention (2017) authorizes a state to make price adjustments. However, it is arguable whether the provisions authorize structural adjustments. In the authors' opinion, Art. 9 authorizes structural adjustments that are commercially irrational. This being said, such adjustments must be authorized by domestic law of a state. For a detailed discussion of this issue and the scope of Art. 9(1) vis-à-vis structural adjustments, see A. Bullen, *Arm's Length Transaction Structures: Recognizing and Restructuring Controlled Transactions in Transfer Pricing*, IBFD Doctoral Series vol. 20 (IBFD 2011); J. Wittendorff, *The Transactional Ghost of Article 9(1) of the OECD Model*, 63(3) Bull. Int'l Tax'n 108 (2009); A. Navarro, *Transactional Adjustments in Transfer Pricing*, IBFD Doctoral Series vol. 40, 79–111 (IBFD 2018); A. Navarro, *The Arm's Length Standard and Tax Justice: Reflections on the Present and Future of Transfer Pricing*, 10(3) World Tax J. 374–77 (2018).

³⁰ OECD, *supra* n. 3, paras 94–131.

³¹ *Ibid.*, para. 95.

³² *Ibid.*, para. 101.

³³ *Ibid.*, para. 109.

³⁴ *Ibid.*, para. 112.

³⁵ *Ibid.*, para. 122.

³⁶ *Ibid.*, para. 125.

³⁷ *Ibid.*, paras 104, 105.

³⁸ *Ibid.*, paras 124–29.

³⁹ *Ibid.*, paras 130–31.

⁴⁰ *Ibid.*, preface.

movements qualify as loans or something else under domestic law.⁴¹ For example from a German perspective, a loan arrangement (under Section 488 of the German Civil Code) is generally defined as the temporary lending of capital from the lender to a borrower. The borrower has the right to use the capital, but generally bears a repayment and compensation obligation (Section 488(1), sentence 1 of the German Civil Code). The purpose of physical cash pooling is to facilitate efficient cash allocation within the group. From the perspective of the single cash pool member, the cash movements within a physical cash pool may therefore comprise the temporary lending of capital from the CPL to the cash pool members and vice versa. Thus, they may be characterized as loan arrangements.⁴² Also, the German Federal Court⁴³ classified the financial arrangements as loan arrangements for domestic law purposes. Thus, a cash pool borrowing generally creates a loan liability of the cash pool member and, correspondingly, a loan receivable of the CPL. A cash pool deposit leads, on the other hand, to a loan liability of the CPL and a loan receivable of the cash pool member for the same amount.⁴⁴

3.1.2 Classification for Transfer Pricing Purposes

Even if the cash transfers between the members of a physical cash pool qualify as (short-term) loans,⁴⁵ under Article 9(1) of the OECD Model (2017) it is necessary to ask whether these loans are at arm's length.⁴⁶ Group companies (as a result of their group relationship) might not act as third parties would in comparable circumstances. The actual conduct of the parties (and the options realistically available to them) may therefore be determinative rather than the contractual arrangements.⁴⁷ Thus,

the classification of the financial arrangements for transfer pricing purposes must consider the factual circumstances of the cash transfers. A classification based on the contractual arrangements alone will likely not be sufficient for transfer pricing purposes.⁴⁸

For instance in the Discussion Draft, the OECD assumes a situation where a group company is obliged by the group's policy to participate in the physical cash pool and to transfer or borrow funds from the cash pool, also if it had not participated given the particular conditions it faces.⁴⁹ The actual low – or even negative – interest rate environment could potentially have such an impact on physical cash pooling transactions.⁵⁰

Nevertheless, given that it can be demonstrated that the operation of a physical cash pool (as a whole) has a commercial rationale from the group's perspective (such as interest rate savings), the individual loan arrangements should not be disregarded for transfer pricing purposes.⁵¹ The particular conditions of the cash pool member (e.g. cash pool interest rates) could rather be tested against the next-best options that are realistically available to it (e.g. interest rates as offered or applied by external banks).⁵² This could result in transfer pricing adjustments, however not in non-recognition of the cash pool loans.⁵³

On the other hand, one might ask if, in such a situation, the actual participation of the cash pool member in the cash pool creates a benefit for the cash pool or the group as a whole. Given this, and assuming that there is a clearly identifiable benefit, one could even argue that the cash pool member renders a service to the cash pool or the group as a whole by its participation in the cash pool. Thus, a service fee could potentially be payable.⁵⁴ However, the particular conditions of the cash pool member should always be analysed and be based on a two-sided

Notes

⁴¹ The classification of arrangements under domestic laws is also necessary to determine the legal rights and obligations of the parties as required in the performance of a functional analysis. OECD, *supra* n. 17, para. 1.51.

⁴² K. P. Berger, §488, in *MünchKommBürgerliches Gesetzbuch* para. 32 (Beck 2016).

⁴³ DE: BGH, 16 Jan. 2006, II RZ 75/04, GmbHR 2006, at 477.

⁴⁴ Berger, *supra* n. 42, § 488, para. 32.

⁴⁵ Petruzzi, *supra* n. 10, at 223; Russo & Moerer, *supra* n. 7, at 43. PwC, *supra* n. 1, at 141; Bakker, *supra* n. 9, at 30; Hollas & Hands, *supra* n. 12, at 3.

⁴⁶ V. Chand, *Transfer Pricing Aspects of Intra-Group Loans in Light of the Base Erosion and Profit Shifting Action Plan*, 44(12) Intertax 885 et seq. (2016).

⁴⁷ Collier & Andrus, *supra* n. 5, para. 6.13.

⁴⁸ OECD, *supra* n. 17, paras 1.42 et seq.

⁴⁹ *Ibid.*, para. 102.

⁵⁰ See s. 6. *infra* (on the negative interest rate environment).

⁵¹ The OECD stipulates that transaction may be disregarded, where the arrangements made in relation to the transactions, viewed in their totality, differ from those which would have been adopted by independent enterprises. OECD, *supra* n. 17, para. 1.122.

⁵² The OECD seem to regard interest rates that the cash pool members would have received from, or owed to, the bank absent the pooling arrangement as an option realistically available to the cash pool members. OECD, *supra* n. 3, para. 125. For a detailed discussion of this concept, see S. Parekh, *The Concept of 'Options Realistically Available' Under the OECD Transfer Pricing Guidelines*, 22(5) Int'l Transfer Pricing J. (Sept. 2015); Bullen, *supra* n. 29, at 540–63.

⁵³ A tax administration should disregard the actual transaction only in exceptional cases. OECD, *supra* n. 17, para. 1.121; OECD, *Comments Received on Public Discussion Draft – BEPS Actions 8-10: Financial Transactions: Part III* (OECD 14 Sept. 2018), Comments by WTS Global, at 361, 384.

⁵⁴ The OECD believes that a service fee could potentially be payable to a loss bearing group company in a situation where a group company consistently realizes losses because it produces, obliged by the group's policy, loss-making products while other members produce profit-making products. OECD, *supra* n. 17, para. 1.130. One could argue that the same logic could apply to cash pooling arrangements where a group company is obliged to participate in the cash pool also if it had not participated given the bad conditions it faces.

approach, meaning that the position of the counterparty to the transaction should be considered. It would arguably not be at arm's length if one decides to grant benefits to a particular cash pool member without an economically viable justification from the perspective of the counterparty.⁵⁵ Thus, the decision to enhance the conditions for one cash pool member should be based on a consistent mechanism that also takes the position of the counterparty into account.⁵⁶

Furthermore, considering that the risk of double taxation is actually significant in such a situation, tax authorities should formulate appropriate conclusions only after a thorough analysis of all relevant facts. A multi-year analysis may, for instance, demonstrate that the cash pool created sufficient benefits for the particular cash pool member in the past and that the actual 'bad' conditions are only the result of short-term market fluctuations.⁵⁷ On the other hand, an independent enterprise could be willing to accept 'bad' conditions in the cash pool as a part of its business strategy or due to particular economic circumstances. For example it could be that the enterprise requires access to cash that is readily available in a particular situation (e.g. to cover unexpected short-term debts) or in a business environment (e.g. highly volatile financial markets) where it is difficult to plan and to fulfil the short-term liquidity needs.⁵⁸ Thus, the application of transfer pricing adjustments or the assumption of an additional service provision may not be an adequate measure in this situation.

Additionally, also if cash pooling is performed on the assumption that cash deposits and borrowings are of a short-term nature,⁵⁹ there could be situations where cash pool balances become 'long term' (more than six or twelve months)⁶⁰ as, amongst group companies, there may not be performed the same level of monitoring (as an independent enterprises would perform) or there may be no criteria being applied to determine when a balance becomes long term or

structural.⁶¹ However, the application of short-term interest rates on such positions might not correspond to the behaviour of independent enterprises in comparable circumstances. More specifically, independent parties would usually agree to a higher interest rate.⁶² Thus, structural positions within a physical cash pool could potentially be characterized as long-term loans.⁶³

Nevertheless, from the perspective of the single group company, several reasons may exist to maintain the structural balance in the cash pool. For instance an independent enterprise may decide to keep structural positions in a cash pool for general market reasons (e.g. global or local financial crisis) or specific business reasons (e.g. expected defaults of customers or planned investment activities), or there may actually not be another more attractive option that is realistically available to the enterprise.⁶⁴ If the group company can explain the underlying economic reasons for the liquidity buffer and can further provide appropriate documentation, the tax administrations should not reclassify the (short-term) cash pool loans. Thus, the broader circumstances of the structural balance should also be examined (and documented) to arrive at an appropriate conclusion.

3.2 Arm's Length Pricing

3.2.1 Banking Approach: Application of Bank Interest Rates

Given the general classification of the financial arrangements as short-term loans, a question arises with respect to how arm's length interest rates can be calculated. Usually the (internal or external) comparable uncontrolled price method (CUP method) is applied to determine (arm's length) interest rates for (short-term) cash pool loans. Within this framework, there are two main pricing approaches, namely (i) the banking approach (application of bank interest rates)⁶⁵ and (ii) the build-up approach

Notes

⁵⁵ Also, the conditions of the counterparty must be tested against the next best options.

⁵⁶ OECD, *supra* n. 3, paras 47 et seq.

⁵⁷ OECD, *supra* n. 53, Comments by WU Transfer Pricing Center, at 407.

⁵⁸ Access to liquidity involves costs. Łukosz, Ursu & Druga, *supra* n. 2, at 208. Therefore, having access to cash i.e. readily available could be regarded as 'asset' that should be considered in the evaluation process.

⁵⁹ OECD, *supra* n. 3, paras 106 & 107.

⁶⁰ In the view of the UK tax authorities, a period exceeding twelve months could be regarded as an indication of a 'structural position'. HMRC, *supra* n. 19. The Belgian authorities, on the other hand, consider a period of six months as indicative for a structural position. KPMG, *Belgium: Draft Circular Letter on Transfer Pricing*, Insights (Nov. 2018).

⁶¹ PwC, *supra* n. 1, at 140.

⁶² The credit risk of the borrower is the deciding pricing factor to be considered in debt-financing decisions. The credit risks generally increase with the increase in the maturity of the loan.

⁶³ OECD, *supra* n. 3, para. 107.

⁶⁴ For an extensive discussion on this matter, see Łukosz, Ursu & Druga, *supra* n. 2, at 209–15; The British tax authorities illustrates certain factors to be considered when analysing structural positions within a cash pool. HMRC, *supra* n. 19.

⁶⁵ This approach is often illustrated and discussed in the German transfer pricing literature. See e.g. X. Ditz & V. Tchervenjachki, *Fremdübliche Verzinsung im Rahmen eines grenzüberschreitenden Cash Pools*, 11 Internationales Steuerrecht (IStR) 399 (2014).

(adding a risk premium to a (short-term) risk-free base rate).⁶⁶

In absence of the cash pooling arrangement, the single cash pool members could maintain cash deposits and cash borrowings with an external bank. By establishing the cash pool, these arrangements with external banks are replaced by arrangements with the CPL. Thus, for transfer pricing purposes, it could be an option to apply the same interest rates as applied by the external banks on current accounts of the single group companies.

By applying bank interest rates on the single loan arrangements between the CPL and the cash pool members, the CPL would generally earn the same interest income as an external bank, namely an interest spread between lower interest rates on cash deposits and higher interest rates on cash borrowings. However, these interest rates might not necessarily be considered at arm's length.⁶⁷ Under the arm's length principle, the CPL must be remunerated on the basis of the functions actually performed (including assets used and risks assumed).⁶⁸ The CPL could be nothing more than a (low-risk) financial service provider.⁶⁹ Such a CPL would arguably not be entitled to earn this interest spread.⁷⁰ This being said, even if the CPL assumes more functions such that it qualifies as an internal bank, the functional analysis may nevertheless show that the CPL is not necessarily comparable with a bank. For example banks generally operate a more complex business model, have different cost structures, implement highly sophisticated risk diversification strategies and are governed by special regulations.⁷¹

Moreover, from the perspective of the single cash pool depositor, a cash pool deposit with the CPL may not be subject to the same level of credit risk as a cash deposit with an external bank. The credit risk of a bank (i.e. the risk that the external bank is in default with their payments) is typically lower than the credit risk of the CPL or of the cash pool

borrowers. An independent enterprise would therefore not necessarily agree to the application to lower deposit rates as applied by an external bank.⁷²

The Danish Administrative Tax Court in the *Bombardier* case as well as the Norwegian Court of Appeal in the *ConocoPhillips* case did not accept the application of bank interest rates on physical cash pooling arrangements in light of the particular facts and circumstances of the cases.⁷³ Especially in a situation where the CPL assumes only limited functions, has a poor amount of capital at risk and bears limited risks, the application of bank interest rates might be challenged by the tax authorities. Bank interest rates should therefore generally not be applied.⁷⁴ However, they can nevertheless be useful to evaluate the options realistically available to the cash pool members.⁷⁵

3.2.2 Build-Up Approach: Adding a Risk Premium to a (Short-Term) Risk-Free Base Rate

Arm's length interest rates could potentially also be determined by the application of a build-up approach, i.e. by adding a risk premium to a (short-term) risk-free base rate.⁷⁶ The first factor, i.e. (short-term) risk-free base rate, can easily be determined on the basis of public information (e.g. LIBID, LIBOR).⁷⁷ The second factor, i.e. risk premium for the specific credit risk of borrower, can instead be derived from data on default yield spreads related to the credit risk of the borrower.⁷⁸

An advantage of this approach is that it generally considers the particular circumstances of the loan arrangements, such as characteristics of the borrower (e.g. sector or market in which the borrower is engaged) and the maturity of the specific loan.⁷⁹ Thus, the specific facts and circumstances of the loans arising from the cash movements in a physical cash pool can be considered by applying this approach. However, one of the most debated

Notes

⁶⁶ Petruzzi, *supra* n. 10, at 223; PwC, *supra* n. 1, at 141.

⁶⁷ Bakker, *supra* n. 9, at 32.

⁶⁸ OECD, *supra* n. 3, para. 109.

⁶⁹ *Ibid.*, para. 111.

⁷⁰ Bakker, *supra* n. 9, at 32.

⁷¹ These are typical reasonings by the German tax authorities when rejecting the application of bank interest rates. Schreiber & D. Bubeck, *Fremdvergleich beim internationalen Cash Pool – Preisvergleich oder cost plus*, 18 Der Betrieb 983 (2014). Also, the OECD does not seem to agree with the application of bank interest rates, stating that 'a cash pool is likely to differ from a straightforward overnight deposit with a bank'. OECD, *supra* n. 3, para. 101.

⁷² PwC, *supra* n. 1, at 140; Bakker, *supra* n. 9, at 30; Hollas & Hands, *supra* n. 12, at 4.

⁷³ DK: LSR, 21 Oct. 2013, Case 12-0189459; NO: LR (Court of Appeal), 11 Jan. 2010, ConocoPhillips Skandinavia AS & Norske ConocoPhillips AS v. Oljeskattekontoret [ConocoPhillips Scandinavia AS & Norwegian ConocoPhillips AS v. Oil Tax Office], LB-2009-081881, Urv 2010. See Vistisen, *supra* n. 3, at 191; Andresen, Pearson-Wood & Jørgensen, *supra* n. 3, at 462–63.

⁷⁴ Bakker, *supra* n. 9, at 32; OECD, *supra* n. 53, Comments by WTS Global, at 385; A. Rafiq et al., *Cash Pooling in Today's World: A Transfer Pricing Perspective*, 18(18) Tax Mgmt. Transfer Pricing Rep. s. 3.2 (2010).

⁷⁵ OECD, *supra* n. 3, para. 125.

⁷⁶ Petruzzi, *supra* n. 10, at 223; PwC, *supra* n. 1, at 141.

⁷⁷ Russo & Moerer, *supra* n. 7, at 45; Chand, *supra* n. 2, at 41.

⁷⁸ Chand, *supra* n. 46, at 889–90; M. Pankiv, *Contemporary Application of the Arm's Length Principle in Transfer Pricing*, WU series vol. 6, Ch. 4, 79 (IBFER 2017).

⁷⁹ Petruzzi, *supra* n. 10, at 212.

issues with regard to this approach is the credit assessment and, especially, the type of the credit rating that can be used to derive proper risk premiums. Three approaches could be considered.

- *application of the credit rating of the group*: The underlying assumption of this approach is that the individual creditworthiness of a group company is always equal to the creditworthiness of the group as a whole. Differently stated, a group would always prevent a default of a single group company as long as the group as a whole is not in default.⁸⁰ For example in the *Bombardier* case, the Danish Tax Court upheld the position of the tax authorities to apply the group rating for the interest calculation on a cash pool deposit.⁸¹ Also, a lower German tax court recently reasoned in the context of intra-group loans that the credit rating of the single group company can only be that of the group⁸²;
- *determination and application of a stand-alone credit rating without consideration of implicit support*: This approach assumes that each group company has its individual credit rating and that group affiliation does not affect this rating. For instance one of the takeaways from the Australian Federal Court decision in the *Chevron Australia* case⁸³ was that group affiliation should be considered, but it has very little impact on the pricing of third parties⁸⁴; and
- *determination and application of a stand-alone credit rating adjusted for implicit support*: This approach is based on the assumption that each group company has its individual credit rating. However, the group affiliation can positively or negatively affect the individual credit worthiness of the group company. Thus, the individual credit rating should be adjusted for implicit support arising from the group affiliation. For example this approach was applied by the Tax Court of Canada in the *GE Capital* case.⁸⁵ Furthermore, the example on the effect

of group affiliation on guarantees illustrated in the revised OECD Transfer Pricing Guidelines⁸⁶ (OECD Guidelines) indicates that the OECD also supports this view.

With regard to physical cash pooling, it is imaginable that also independent parties establishing a pooling system would consider the creditworthiness as a significant pricing criterion.⁸⁷ Independent parties, as the methods and tools used by international credit rating firms show, start from the analysis of the creditworthiness of the single (group) company. However, group affiliation is considered in the rating.⁸⁸ Thus, also independent parties would generally base their lending decision on the creditworthiness of the borrower (adjusted for implicit support). Consequently, from an arm's length perspective, the starting point should be the stand-alone credit rating of the single group company (adjusted for implicit support). Credit rating analysis should therefore be performed for all cash pool members, including the CPL.⁸⁹

However, the loans arising from the cash movements between the CPL and the cash pool members are embedded in a wider context of the physical cash pooling arrangements. As explained above, cash pooling could create benefits (such as a volume discount) that are not available to the cash pooling participants on a stand-alone basis.⁹⁰ For example the arm's length interest rate for a single cash pool deposit may be 4%, while the external bank applies an interest rate of 6% on the cash deposit in the master account due to economies of scale.⁹¹ A transactional pricing of the cash pool loans (on the basis of the stand-alone credit profiles of the cash pool members, including the CPL) may not necessarily ensure an arm's length allocation of the additional benefits (such as the volume discount – if any) arising from economies of scale.⁹² As a result, the stand-alone pricing of the

Notes

⁸⁰ PwC, *supra* n. 1, at 135.

⁸¹ Vistisen, *supra* n. 3, at 190 et seq.

⁸² DE: FG Münster, 7 Dec. 2016, 13 K 4037/13, K,F, para. 91.

⁸³ AU: FCA, 23 Oct. 2015, *Chevron Australia Holdings Pty Ltd v. Commissioner of Taxation* (No 4), [2015] FCA 1092.

⁸⁴ M. Butler, J. Pengelly & R. Neilson, *Federal Court Hands Down Transfer Pricing Decision in Chevron Australia Case*, 23(1) Int'l Transfer Pricing J. 31 (2016); J. Hollas & G. Hands, *Intercompany Financial Transactions: Factor to Consider in Analysing the Impact of Implicit Parental Support*, 22(20) Tax Mgmt. Transfer Pricing Rep. 3 (2011).

⁸⁵ CA: TC, 4 Dec. 2009, *General Electric Capital Canada, Inc. v. The Queen*, 2009 TCC 563, *aff'd* 2010 FCA 344 (1 Nov. 2010).

⁸⁶ OECD, *supra* n. 17, para. 1.164.

⁸⁷ Russo & Moerer, *supra* n. 7, at 45; Petruzzi, *supra* n. 10, at 145; PwC, *supra* n. 1, at 140 & 141; Chand, *supra* n. 2, at 41. Also, the OECD Discussion Draft on Financial Transactions emphasizes that the credit risk could be a significant criterion for the allocation of the cash pool benefit. OECD, *supra* n. 3, paras 127–29. There can also be other significant risks linked to the cash pool. In the context of the actual low or even negative interest rate environment, other risks (such as liquidity risks) could be significant, as well.

⁸⁸ S&P distinguishes between core, highly strategic, strategically important, moderately strategic and non-strategic entities of the group. S&P, *Group Rating Methodology and Assumptions* (9 Nov. 2011), <http://img.en25.com/Web/StandardandPoors/GroupRatingMethodology%20110911.pdf> (accessed 6 Sept. 2018).

⁸⁹ PwC, *supra* n. 1, at 141; Petruzzi, *supra* n. 10, at 145; by contrast, the Belgian tax authorities assume that all companies in a cash pool have the same credit rating. KPMG, *supra* n. 60. The credit rating can generally be determined on the basis of different methods, e.g. financial ratios analysis, credit scoring tools, notch up/down parent rating, etc.

⁹⁰ OECD, *supra* n. 3, para. 94.

⁹¹ Russo & Moerer, *supra* n. 7, at 46.

⁹² PwC, *supra* n. 1, at 142. Nevertheless, the allocation of the cash pool benefits should be combined with the arm's length standalone interest rate. OECD, *Comments Received on Public Discussion Draft – BEPS Actions 8-10: Financial Transactions: Part 1* (OECD 14 Sept. 2018), Comments by BE-VVA, at 91, 92.

individual cash pooling loans on the basis of a build-up approach can be considered only as a first step to ensure an arm's length allocation of the cash pool benefit within a physical cash pool.

4 CASH POOL GUARANTEES⁹³

4.1 General Principles Articulated by International Tax Courts⁹⁴ and the OECD (so far)

A (financial) guarantee can generally be defined as a 'legally binding commitment on the part of the guarantor to assume a specified obligation of the guaranteed debtor (beneficiary) if the debtor defaults on that obligation'.⁹⁵ In a physical cash pool, the PCo of the group or other group companies (as guarantors) may be required by the external bank (as creditor) to issue a guarantee on behalf of the CPL (as beneficiary of the guarantee).⁹⁶ The issuance of the guarantee may entail certain benefits for the CPL (and the other cash pool members) such as enhanced credit terms.⁹⁷ The provision of a guarantee could therefore (potentially) be classified as an intra-group service by the intercompany guarantor to the cash pool. Thus, under the arm's length principle, the question needs to be asked as to whether a service has actually been rendered and what the arm's length remuneration of that service provision is.⁹⁸

In 2000, the German Federal Tax Court issued a verdict on a guarantee-related issue.⁹⁹ A PCo of a group residing in Germany issued a guarantee on behalf of a subsidiary, a finance company of the group, in the Netherlands. The subsidiary needed the (explicit) guarantee of its PCo in order to borrow a certain amount of debt from external parties. It was a fact that, without the guarantee, the subsidiary would not have received any financing from external parties, as the subsidiary did not have sufficient equity to

assume its functions as a financing company of the group. The Federal Tax Court reasoned that, in this case, the guarantee by the PCo on behalf of its subsidiary cannot be regarded as a service, as the subsidiary would otherwise not maintain sufficient capital to perform its functions. Stated differently, the necessity to provide the guarantee was borne by the shareholder relationship. The guarantee can therefore be characterized as a substitute of equity.¹⁰⁰

On the other hand, in the Canadian *GE Capital* case,¹⁰¹ a US PCo issued an (explicit) guarantee on behalf of its subsidiary residing in Canada that required external financing. As a result, the Canadian subsidiary paid a guarantee fee to its PCo. The Canadian tax authorities did not consider the payment to be deductible. The Canadian Tax Court, however, reasoned that, considering the circumstances of the case, a guarantee fee is payable because the Canadian subsidiary benefits from a reduction of funding costs as an effect of the issuance of the explicit guarantee to the external creditor. Thus, in the opinion of the Tax Court, the guarantee fee had to be adjusted by the impact of implicit support, as the effect of group affiliation does not justify a separate payment.¹⁰²

The OECD Discussion Draft on Financial Transactions also indicates that a guarantee could have two effects:

- it allows the borrower to borrow a greater amount of debt. In such a situation, the (additional) amount of debt borrowed by a borrower could be regarded as a loan from the lender to the guarantor and as an equity contribution from the guarantor to the borrower. As a result, a guarantee fee may not be payable from the beneficiary to the guarantor¹⁰³; or
- it could be a mere reduction of funding costs for the borrower. In such a case, a guarantee fee from the borrower to guarantor could be payable if the interest rate of the borrower is enhanced over and above the level of implicit support.¹⁰⁴

Notes

⁹³ The authors focus on the provision of explicit guarantees within the multinational group, as such instruments create legally enforceable obligations for the guarantor.

⁹⁴ The court decisions do not specifically concern physical cash pooling structures. Nevertheless, in the views of the authors, the general principles as illustrated by the Courts may also be relevant for guarantees issued in favour of the CPL.

⁹⁵ OECD, *supra* n. 3, para. 138.

⁹⁶ Russo & Moerer, *supra* n. 7, at 45; Chand, *supra* n. 2, at 40.

⁹⁷ PwC, *supra* n. 1, at 141.

⁹⁸ OECD, *supra* n. 17, para. 7.5.

⁹⁹ DE: BFH, 29 Nov. 2000, I R 85/95, Federal Tax Gazette (BStBl.) issue II, 2002, at 720; also the European Court of Justice has recently decided on an intercompany guarantee case. The question to be decided by the Court was whether s. 1 of the German Foreign Tax Act (in the version in force in 2003), a domestic adjustment clause, is considered compatible with EU law. DE: ECJ, 31 May 2018, Case C-382/16, *Hornbach-Baumarkt AG v. Finanzamt Landau*, ECLI:EU:C:2018:366. See also R. Petruzzini, *Transfer Pricing Rules Under the ECJ's Scrutiny: Green Light for Non-Arm's Length Transactions*, 25(5) Int'l Transfer Pricing J. (2018).

¹⁰⁰ On the basis of this decision, one could argue that the legal and actual control of the parent company of the group over its affiliate would even mitigate any additional risk for the parent company. M. Puls, *Finanzierungsunterstützung im Konzern aus Verrechnungspreissicht*, 6 IStR 209, 211 (2012). This also seems to be the opinion of the German tax authorities. Schreiber & Bubeck, *supra* n. 71, at 985.

¹⁰¹ CA: TC, 4 Dec. 2009, *General Electric Capital Canada, Inc. v. The Queen*, 2009 TCC 563, *aff'd* 2010 FCA 344 (1 Nov. 2010).

¹⁰² V. Averyanova & J. Sampat, *Transfer Pricing of Intra-Group Financial Guarantees in Light of the BEPS Action Plan*, 22(6) Int'l Transfer Pricing J. 363, 364 (2015). For a critical analysis of this issue, see Navarro, *The Arm's Length Standard and Tax Justice*, *supra* n. 29, at 366–68.

¹⁰³ OECD, *supra* n. 3, para. 140.

¹⁰⁴ *Ibid.*, para. 141.

Taking into consideration the decisions of both various national courts and the OECD, it could generally be important to look at the position of the beneficiary of the guarantee. The provision of a guarantee fee could be characterized as a service provision if the beneficiary (only) benefits from a reduction of funding costs (over and above the level of implicit support). However, the answer could be different if the beneficiary would, in absence of the guarantee, not receive the same amount of debt from external parties. In such a case, the issuance of the guarantee could be characterized as a substitute for equity (i.e. a shareholder activity).

4.2 Application to Cash Pool Guarantees

In the authors' opinion, these principles can generally also be applied to analyse guarantees issued in favour of the CPL in a physical cash pool. Thus, if the issuance of the guarantee only reduces the external funding costs of the CPL (over and above the level of implicit support), a guarantee fee could be payable. On the other hand, if – in absence of the explicit guarantee from the parent entity (shareholder) – the CPL cannot borrow the same amount of debt, the payment of a guarantee fee might not be justified.

However, in a physical cash pool, it could also be the case that all cash pool members are required to issue an explicit guarantee on behalf of the CPL, such that all cash pool members are jointly and severally liable (a so-called 'cross-guarantee').¹⁰⁵ The OECD Discussion Draft addresses the implications of cross-guarantees on cash pooling transactions.¹⁰⁶ The occurrence of cross-guarantees implies that each guarantor provides a guarantee for all cash pool members, but does not have control over the cash pool nor has access to information about the borrowers. An independent party would normally not enter into such an arrangement. The OECD concludes that the guarantee could be nothing more than an acknowledgement that it would be detrimental to the interests of the group not to support the cash pool.¹⁰⁷ Thus, in general, a (separate) guarantee fee

might not be payable. Also, the benefit created by the issuance of a cross-guarantee by the cash pool members on behalf of the CPL can often be negligible,¹⁰⁸ especially if the CPL has sufficient equity at risk. Nevertheless, in some limited circumstances, it may be reasonable to further analyse the effect of the issuance of the cross-guarantee on the position of the cash pool members as cross-guarantors.¹⁰⁹

If it can be substantiated on the basis of the facts and circumstances of each case, that the issuance of a guarantee by a guarantor creates a service from the guarantor to the CPL, it is necessary to determine what the arm's length service fee (i.e. guarantee fee) is. According to the OECD, there are generally different methods available (e.g. the CUP method, the yield approach, the cost approach) that could determine arm's length guarantee fees.¹¹⁰ The yield approach is the most commonly used method in practice and, apparently, the preferred one of the OECD.¹¹¹ In general terms, the yield approach determines the arm's length guarantee fee as the difference between the interest rate that the borrower could obtain on a stand-alone basis (adjusted for implicit support), and the interest rate that the borrower could obtain with inclusion of the guarantee. The yield approach, thus, provides a range of possible guarantee fees. The actual guarantee fee must be fixed within this range.¹¹² The following simplified example illustrates the determination of an arm's length guarantee fee on the basis of the yield approach:

Assumed that the stand-alone interest rate which the borrower would obtain (without inclusion of implicit support) is 8% (credit rating: Bba). With inclusion of implicit support, the borrowing rate can be reduced to 5% (enhanced credit rating of the company because of group affiliation i.e. A). With the issuance of the guarantee by the guarantor, the interest rate as offered by the creditor is again reduced to 4% (improved credit rating due to the explicit guarantee, i.e. triple-A credit rating). Thus, the arm's length guarantee fee should be within the range of 0 to 1%, as the effect of the implicit support (here, 3%) does not justify a separate payment (no legally binding commitment of the group).¹¹³ The benefit (here,

Notes

¹⁰⁵ For more details about transfer pricing implications of the issuance of cross-guarantees in notional cash pools, see F. Sousa & B. Santiago, *Portuguese Arbitration Tax Court Rules on Notional Cash Pooling Arrangements*, 70(10) Tax Notes Int'l 999–1003 (2013).

¹⁰⁶ OECD, *supra* n. 3, paras 130, 131. In practise, such guarantees are frequently issued in the context of notional arrangements (as opposed to physical arrangements).

¹⁰⁷ *Ibid.*, para. 131.

¹⁰⁸ OECD, *supra* n. 53, Comments by PwC, at 134.

¹⁰⁹ For example assuming a situation where the CPL only qualifies as (low risk) financial service provider (with a low amount of equity at risk) and if, in such a case, the credit rate enhancement from the guarantee goes beyond the level attributable to implicit support, it could be necessary to further analyse the effect on the position of the cash pool members. OECD, *Comments Received on Public Discussion Draft – BEPS Actions 8-10: Financial Transactions: Part II* (OECD 14 Sept. 2018), Comments by KPMG, at 224. However, in such a situation, it may be difficult to determine the degree of real risk assumed by the cash pool members (as cross guarantors) due to the usually large number of participants and the permanent fluctuations in balances. OECD, *supra* n. 109, Comments by EY, at 85.

¹¹⁰ OECD, *supra* n. 3, paras 145–55.

¹¹¹ Petruzzi, *supra* n. 10, at 138. The Belgian tax authorities prefer the application of this approach. See KPMG, *supra* n. 60.

¹¹² OECD, *supra* n. 3, para. 149–52.

¹¹³ OECD, *supra* n. 17, para. 1.167.

1%) must be shared between the parties on the basis of their contribution to the creation of the value.¹¹⁴

5 REMUNERATION OF THE CPL

5.1 Identification and Attribution of Significant Risks to the CPL

The OECD Guidelines¹¹⁵ are based on the general assumption that the remuneration of an independent party (usually) correlates with the (economically significant) functions it performs (including the assets it uses and risks it assumes).¹¹⁶ The functions performed (including assets used and risks assumed) by a group company and the options realistically available to the parties¹¹⁷ can be established by an appropriate functional analysis.¹¹⁸ This general approach can also be applied to the CPL in a physical cash pool.¹¹⁹ Given this – and considering that (especially) risks and their actual assumption may play a key role in the determination of an appropriate remuneration for the CPL, one can ask what the significant risks related to a physical cash pooling arrangement could be and under what conditions they can be attributed to the CPL under the new risk and return framework as contained in the OECD Guidelines.¹²⁰

With respect to the question as to what the significant risks linked to a physical cash pool arrangement could be, one should consider that the most important

(bilateral) transactions within a physical cash pool are the intercompany loans arising from the cash movements between the CPL and the cash pool members. These intercompany loans are subject to risks. Specifically, the credit risk of the borrower¹²¹ may play a significant role in the determination of arm's length interest rates for the loans within a physical cash pool.¹²² Thus, credit risks can generally be regarded as significant risks linked to a physical cash pooling arrangement.¹²³ The capacity to take over the credit risks (of the cash pool borrowers) by the CPL may therefore also be an important criterion for the establishment of an arm's length remuneration for the CPL.¹²⁴

However, the contractual allocation of credit risks within a physical cash pool may not be the deciding factor for the actual attribution of the credit risk to the CPL.¹²⁵ Under the new risk and return framework as contained in the OECD Guidelines, the CPL must rather have the capacity to actually assume those risks. More specifically, it must have the financial capacity (equity at risk) to assume those risks and, additionally, it should perform control over the risk assumed.¹²⁶

The 'control over risk' factor is generally linked to the activities performed by the people employed by the CPL.¹²⁷ For instance the CPL could monitor the liquidity of the cash pool members; could conduct credit ratings on the basis of certain covenants or by the use of credit rating tools; and could decide on securities or the replacement of cash pool borrowings by loans. These activities could

Notes

¹¹⁴ For a more detailed analysis, see Averyanova & Sampat, *supra* n. 102, at 363.

¹¹⁵ OECD, *supra* n. 17, paras 1.36, 1.37.

¹¹⁶ *Ibid.*, para. 1.51.

¹¹⁷ *Ibid.*, para. 1.38.

¹¹⁸ *Ibid.*, paras 1.51 et seq.

¹¹⁹ OECD, *supra* n. 3, para. 109 ('The appropriate reward of the cash pool leader will depend on (...) the functions performed, the assets used and the risks assumed in facilitating a cash pool arrangements').

¹²⁰ It seems that tax administrations in Europe have different views on the question of whether a CPL can perform more than routine functions. For instance in the view of some representatives of the German tax authorities, a CPL does generally not perform any significant functions. Therefore, it can typically be qualified as (low-risk) financial service provider i.e. entitled to not more than a routine return. Schreiber & Bubeck, *supra* n. 71, at 980 et seq. The same position is also taken by the Austrian tax authorities. AT: BMF, 28 Oct. 2010, *Verrechnungspreisrichtlinien* 2010, para. 110. A different view on the topic is illustrated in the Transfer Pricing Guidance of the UK tax authorities. The guidelines can be interpreted in the way that, a CPL should be remunerated on the basis of the functions it performs (including assets used and risks assumed). The remuneration of the CPL may, correspondingly, also consist of an interest spread between lower interest deposit rates and higher interest borrowing rates (HMRC, *supra* n. 19). In the views of the authors, the CPL should consistently be remunerated on the basis of the functions it performs (including assets used and risk assumed).

¹²¹ Credit risk can be defined as the risk of loss arising from a failure to perform on contractual obligation by the borrower or from credit deterioration. For a more detailed analysis, see Petrucci, *supra* n. 10, at 119 et seq.

¹²² Russo & Moerer, *supra* n. 7, at 45; Petrucci, *supra* n. 10, at 145; PwC, *supra* n. 1, at 140, 141; Chand, *supra* n. 2, at 41. Also, the OECD Discussion Draft emphasizes that the credit risk could be a significant criterion for the allocation of the cash pool benefit. OECD, *supra* n. 3, paras 127–29. There could also be other significant risks linked to the cash pool. In the context of the actual low or even negative interest rate environment, other risks (such as liquidity risks) might have a higher importance. EY, *supra* n. 109, at 84.

¹²³ Step 1 in the risk analysis comprises the identification of economically significant risks with specificity. OECD, *supra* n. 17, paras 1.71 et seq.

¹²⁴ Hollas & Hands, *supra* n. 12, at 3–4. For a critical discussion of risk premiums within multinational enterprises, see Schön, *supra* n. 27, at 291; KPMG, *supra* n. 109, at 224.

¹²⁵ OECD, *supra* n. 17, para. 1.86 et seq.

¹²⁶ *Ibid.*, para. 1.60 et seq. For a critical discussion of this concept, see Schön, *supra* n. 27, at 288 & 289; Wittendorff, *supra* n. 27, at 335–40; It is also argued that the concept of control over risk is not necessarily in line with the arm's length standard. Collier & Andrus, *supra* n. 5, at 228–32. See also J. G. Ballentine, *Ownership, Control and the Arm's Length Standard*, 82 Tax Notes Int'l 1177–79 (2016).

¹²⁷ OECD, *supra* n. 17, paras 1.65–1.70.

arguably be linked to the (internal) credit risks within a physical cash pool. Thus, a CPL that conducts these activities may be considered to perform control over the internal credit risks.¹²⁸

Given that the CPL has sufficient financial capacity (equity at risk) and additionally performs (functional) control over the credit risks, the credit risks should, correspondingly, be attributed to it.¹²⁹ The higher risk assumption by the CPL should also be reflected in its remuneration, as independent parties would usually expect a higher compensation for a higher risk assumption.¹³⁰ Thus, with regard to physical cash pooling arrangements, a higher risk assumption could be reflected by higher interest rates on cash pool borrowings and lower interest rates on cash pool deposits.¹³¹ In the authors' opinion, the same methodology can generally also be applied to analyse and attribute other significant risks, such as liquidity risks.¹³²

5.2 Application to the CPL

A CPL with a 'low' level of functionality and limited financial capacity, including a low amount of equity at risk, would arguably not be capable of assuming significant (credit) risks. Indeed, in such a situation, the credit risks and, in particular, the downside consequences of the materialization of those risks (i.e. default of a cash pool borrowing) might not be limited or reduced by the CPL. By contrast, the cash pool depositors would be primarily affected by such a default. Thus, the cash pool depositors could therefore be entitled to earn a (higher) interest income from the loans as determined on the basis of the credit risks of the cash pool borrowers.¹³³ On the other hand, in such circumstances, a CPL would arguably not be entitled

to more than a routine return.¹³⁴ Two separate elements could be taken into consideration,¹³⁵ namely (i) remuneration for services rendered to the cash pool members (often based on a cost-plus approach)¹³⁶ and (ii) remuneration for the CPLs equity at risk (insofar as equity is, in fact, at risk). The remuneration of the CPL can be established by an adjustment of the interest rates for cash pool borrowings and cash pool deposits. Thus, the CPL could increase the deposit rates or equalize the deposit rates and the borrowing rates, such that it ends up with a profit level that is in line with that of a (low-risk) financial service provider by the end of the business year.

In contrast, a CPL with a 'high' level of functionality may also assume more strategic (valuable) functions comparable to those of an external bank.¹³⁷ If the CPL has sufficient equity at risk to assume credit risks and, additionally, performs the control over those risks, the (credit) risks can economically be attributed to it under the new risk-and-return framework.¹³⁸ Indeed, in such a case, the (credit) risks and, in particular, the downside consequences of a materialization of those risks (i.e. actual default of a cash pool borrowing) would be taken over by the CPL. Differently stated, the cash pool depositors would not actually bear a high level of credit risk with regard to their cash deposits (even if the actual risk of a default of a cash pool borrowing is high), as the equity at risk of the CPL actually safeguards the status of the cash deposits.¹³⁹ Given this, a CPL that qualifies as an internal bank could be entitled to earn more than a routine return. Thus, an arm's length pricing of the individual intercompany loans arising from the cash movements (in the context of the expected higher creditworthiness of the CPL) could already establish an arm's length remuneration for the CPL consisting

Notes

¹²⁸ An issue could be that the concept of control does not prevent MNEs to shift profit to low-tax jurisdictions. Collier & Andrus, *supra* n. 5, at 228–32.

¹²⁹ OECD, *supra* n. 17, para. 1.87 ('Where a party contractually assuming a risk applies that contractual assumption of risk in its conduct, and also both exercises control over the risk and has the financial capacity to assume the risk, then there is no further analysis required (...) to determine the risk assumption').

¹³⁰ OECD, *supra* n. 17, para. 1.56; OECD, *supra* n. 92, Comments by BE-VVA, at 93.

¹³¹ Russo & Moerer, *supra* n. 7, at 45.

¹³² EY, *supra* n. 109, at 84 ('The analysis should consider all risks assumed by the cash pool leader, including foreign exchange risk and liquidity risk, and not focus solely on credit risk which is currently the implied guidance in the discussion draft').

¹³³ OECD, *supra* n. 3, para. 1.29 ('In those situations where there is a genuine credit risk to the depositors, the interest rate benefit of pooling may be rateably allocated among the net depositors on the basis that the depositors have their capital at risk across all net borrowers from the pool members and so should be entitled to any benefits arising from the use of that capital').

¹³⁴ OECD, *supra* n. 23, at 10 ('cash boxes').

¹³⁵ Russo & Moerer, *supra* n. 7, at 45–46.

¹³⁶ A cost-plus 5% remuneration could be justified in those cases where the CPL can be characterized as (low-value) adding financial service provider. On the matter of low-value added services, see Wittendorff, *supra* n. 27, at 355.

¹³⁷ Hollas & Hands, *supra* n. 12, at 4.

¹³⁸ OECD, *supra* n. 17, para. 1.87.

¹³⁹ PwC, *supra* n. 1, at 141. Moreover, the performance of risk controlling activities by the CPL (such as monitoring the creditworthiness of the borrowers, the decision on securities etc) may limit or reduce the risk of a default of a cash pool borrowing.

of lower interest rates on cash deposits and higher interest rates on cash pool borrowings.¹⁴⁰

6 CASH POOL BENEFIT

6.1 Netting Benefit

Physical cash pooling arrangements could potentially create benefits in the form of cost savings and other efficiencies that would not be available to the group in the absence of a cash pooling arrangement.¹⁴¹ This benefit is referred to as cash pool benefit or synergy benefit and is likely the result of a deliberate, concerted action among the cash pool members and the CPL.¹⁴²

In the view of the OECD, the cash pool benefit can have different components.¹⁴³ According to existing literature on this topic,¹⁴⁴ the major components are (1) the savings from offsetting debit and credit positions (netting benefit) and (2) a 'volume discount' on the overall balance.¹⁴⁵ With regard to the characterization, quantification and allocation of the benefit, it could therefore generally be reasonable to distinguish between these two components, as both components could be based on different determinants.¹⁴⁶

The following simplified example illustrates the determination of the netting benefit.

A PCo has three subsidiaries, namely SCo 1, SCo 2 and SCo 3. Each subsidiary has an external bank account. SCo1 and SCo 2 show a positive balance of EUR 200 and EUR 150, respectively, whereas SCo3 has a negative balance of 100. The interest rates offered by external banks are 10% on deposits (SCo1 and SCo2) and 15% on borrowings (SCo3). PCo decides to establish a TCo. TCo concludes a physical cash pool arrangement with Bank Y that sets up the cash pool. However, the external bank does not apply enhanced interest rates on the master account of the CPL. Thus, the interest rates still remain 10% on deposits and 15% on borrowings.

The total cash pool benefit can be calculated as follows:

	Stand-alone transaction (without pooling)				Cash Pooling	Total cash pool benefit
	SCo1	SCo2	SCo3	Total		
Balance	200	150	-100	250	250	
Interest rate (%)	10%	10%	15%		10%	
Interest	20	15	-15	20	25	5

As it can be seen from this example, by the establishment of a physical cash pool, the group can significantly enhance its interest income (also in the absence of any volume effect). In a scenario without pooling, the group would earn a (consolidated) interest income of EUR 20. As a result of the pooling, the (consolidated) interest income is increased to EUR 25. Thus, the *total benefit* from establishment of the cash pool is EUR 5 (25–20). In this case, the cash pool benefit is *entirely generated by the netting of the accounts within the cash pool (netting benefit)*.

As the example shows, in a situation without a cash pool, the bank would additionally earn the netting benefit (of five, see above), i.e. the interest spread between the lower interest rates on the external cash deposits and the higher interest rates on the external cash borrowings. Thus, the 'netting benefit' increases or decreases with the amount of the difference between the interest rates on cash borrowings and cash deposits.¹⁴⁷ In the authors' opinion, the amount of the interest spread could potentially be linked to the (credit) risk profiles of the borrowers: The better the (credit) risk profiles of the borrowers, the lower the interest spread (difference in interest rates between borrowing and lending positions) and the lower the netting benefit.

Notes

¹⁴⁰ PwC, *supra* n. 1, at 141; Rafiq et al., *supra* n. 74, s. 3.3.

¹⁴¹ OECD, *supra* n. 3, para. 94.

¹⁴² For a critical discussion on group synergies, see Navarro, *The Arm's Length Standard and Tax Justice*, *supra* n. 29, 368–74; Wittendorff, *supra* n. 27, at 342–44.

¹⁴³ OECD, *supra* n. 3, para. 125. The OECD defines the netting benefit as the saving made from offsetting debit and credit positions.

¹⁴⁴ Russo & Moerer, *supra* n. 7, at 46; Petruzzini, *supra* n. 10, at 146; Deloitte Economist Debt Pricing Group, *Transfer Pricing Implications of Cash Pooling Structures*, 20 Tax Mgmt. Transfer Pricing Rep. 17 (2012).

¹⁴⁵ OECD, *supra* n. 3, para. 125.

¹⁴⁶ PwC, *supra* n. 1, at 142; OECD, *supra* n. 92, Comments by BE-VVA, at 92–94; EY, *supra* n. 109, at 84.

¹⁴⁷ For example, if the interest rate on cash borrowings increases to 18%, the netting benefit would increase to eight. By contrast, if the interest rate on cash borrowings decreases to 12%, netting benefit would decrease to two.

On the other hand, by the establishment of the physical cash pool, the external bank deposits and borrowings are replaced by intercompany loans between the CPL and the cash pool members. The (credit) risks¹⁴⁸ of the cash pool borrowers (which could potentially explain the difference in the interest rates between the lending and borrowing positions in absence of the cash pooling arrangement (*see above*)), are taken over by the cash pool depositors and the CPL in a physical cash pool. Consequently, the netting benefit should be earned by the risk-bearing entities in the cash pool.¹⁴⁹ A CPL which qualifies as an internal bank, and which is, correspondingly, capable of assuming significant (credit) risks, could also be entitled to earn (at least a portion of) the netting benefit. By contrast, a CPL that qualifies as merely a (low-risk) financial service provider and, thus, could not assume any (credit) risks, should not be entitled to this benefit. In such a case, the netting benefit should be attributed to the parties that bear the (credit) risks of the borrowers, i.e. the cash pool depositors. Given this – and considering the explanations in the previous sections – an arm’s length pricing of the cash pool loans (taking into account the functions performed by the CPL) may, in the authors’ opinion, already ensure an arm’s length allocation of this benefit.¹⁵⁰

6.2 Volume Discount

The establishment of the cash pool may enable the group to achieve more favourable interest rates in comparison to the rates that the single cash pool members could obtain in the absence of the physical cash pool.¹⁵¹ Thus, the cash pool members (including the CPL) may benefit from interactions or synergies amongst group members. However, in practice, the relevant criteria for the application of enhanced interest rates (if any) by the external bank on the master account of the CPL may be multi-fold.¹⁵² Even if one of the possible drivers is the higher consolidated cash volume in the master account,¹⁵³ there may be other criteria with the same or even a higher

contribution to the creation of the value such as the number of cash pool participants, the creditworthiness of the cash pool participants, the number of transactions, the expertise and equity at risk of the CPL etc. Thus, the relevant criteria (that led to the creation of the value) must be established by considering the facts and circumstances of each case.¹⁵⁴ The following simplified example illustrates the determination of the volume discount:

Unlike the scenario described in the previous chapter, *the external bank applies enhanced interest rates* to the master account of the CPL. Thus, the deposit rate is increased (from 10%) to 12%. The total cash pool benefit can be calculated as follows:

	Stand-alone transaction (without pooling)				Cash Pooling	Total cash pool benefit
	SCo1	SCo2	SCo3	Total		
Balance	200	150	–100	250	250	
Interest rate (%)	10%	10%	15%		12%	
Interest	20	15	–15	20	30	10

The total cash pool benefit amounts to EUR 10 (30–20). This includes the *netting benefit* of EUR 5 (*see example above*) and the *volume discount* of EUR 5 (2% x250).

If a clearly identifiable (and quantifiable) benefit exists in the physical cash pool after the arm’s length pricing of the cash pool loans (taking into account the functions performed by the CPL), that benefit should be shared among the cash pool members.¹⁵⁵ As discussed above, the cash pool depositors might not be the only parties entitled to earn this benefit.¹⁵⁶ The mechanism to allocate this benefit should rather reflect the factors that lead to the creation of the benefit.¹⁵⁷

Notes

¹⁴⁸ The analysis should consider all significant risks (such as liquidity risks and foreign exchange risk), and, thus should not focus solely on credit risk. EY, *supra* n. 109, at 84.

¹⁴⁹ EY, *supra* n. 109, at 83 (“The so called “netting benefit” reflects the risk-related return (liquidity and credit risk premium), not a group synergy. As such, netting benefits should be allocated to parties assuming such risks”).

¹⁵⁰ PwC, *supra* n. 1, at 142 (“As a consequence of application of a method to determine the arm’s length credit and debit interest rates, the cash pool benefit may not necessarily reside with the CPL. Instead, the cash pool benefit may need to end up with those participants (and potentially the CPL) that (economically) incur the debtor’s risk with respect to the cash pool”). Rafiq et al., *supra* n. 74, s. 3.4.

¹⁵¹ Russo & Moerer, *supra* n. 7, at 46.

¹⁵² PwC, *supra* n. 1, at 142.

¹⁵³ OECD, *supra* n. 92, Comments by BE-VVA, at 92–94.

¹⁵⁴ Russo & Moerer, *supra* n. 7, at 46.

¹⁵⁵ The actual low or even negative interest rate environment may marginalize the benefit arising from economies of scale (for more details, *see s. 6*). Thus, there could not be any additional significant benefit that would be shared.

¹⁵⁶ PwC, *supra* n. 1, at 142.

¹⁵⁷ OECD, *supra* n. 17, paras 1.162 (“If important group synergies exist and can be attributed to deliberate concerted group actions, the benefits of such synergies should generally be shared by members of the group in proportion to their contribution of the creation of the synergy”).

If a thorough functional analysis shows that the consolidated cash volume is the main driver of this benefit in a particular case, this benefit may be shared between the cash pool depositors.¹⁵⁸ The amount of the cash deposits could then serve as the basis for deriving a reasonable allocation key. The allocation of the benefit can also be reflected by an enhancement of the deposit rates of the depositors.¹⁵⁹ Furthermore, depending on the factors that created the benefit, the CPL could also be entitled to earn a portion of the benefit. As a principle, a CPL that qualifies as an internal bank would likely be entitled to earn a portion of the benefit, as its contribution to the creation of any additional value could be significant. By contrast, in a situation where the CPL assumes only limited functions (comparable to those of a low-risk financial service provider), its contribution to the creation of any additional value could be negligible. Thus, the benefit might not be attributed to it.

The OECD Discussion Draft on Financial Transactions clearly highlights that members of a cash pool would transact with each other only if this left them no worse off than their next best option.¹⁶⁰ This could potentially be tested against the interest rates offered or applied by external banks on cash deposits or borrowings (possible next best option of the cash pool members).¹⁶¹ These interest rates could therefore be considered as a sort of boundary for the setting of interest rates and the attribution of the cash pool benefit to the single cash pool members.¹⁶² In this sense, situations where the same interest rates can

be applied for all participants should rarely occur in reality.¹⁶³

7 PHYSICAL CASH POOLING ARRANGEMENTS IN A NEGATIVE INTEREST RATE ENVIRONMENT

In the years since the financial crisis, some central banks – including the European Central Bank – have established negative interest rate policies.¹⁶⁴ The aim was to encourage business investment and consumer spending.¹⁶⁵ Also, if this objective has partly been achieved,¹⁶⁶ it has created an environment where banks and savers suffer from low or even negative interest rates.¹⁶⁷ Banks may even block cash transfers to the accounts over a target limit.¹⁶⁸ In this environment, cash concentration in a single account may be adversely affected. The negative interest rate could even be higher due to cash concentration compared to a situation where each group company individually deposits its cash with its external bank. Cash concentration in a negative interest rate environment may therefore create negative synergy effects.

In the past, negative interest rates were considered as a purely theoretic issue.¹⁶⁹ When theory becomes reality, some economists even fear that the low or negative interest rate environment could cause serious damage to the business model operated by banks so that banks would cease to exist in the long term.¹⁷⁰ Given the current environment, it could be foreseeable that under such circumstance, over the long run the benefits associated

Notes

¹⁵⁸ In the *Bombardier* case, the Court reasoned that, on the basis of the facts available, the main contribution to the cash pool was cash and, correspondingly, the cash pool depositors are the parties entitled to earn a higher portion of the cash pool benefit. Andresen, Pearson-Wood & Jørgensen, *supra* n. 3, at 463. Also, the OECD regards the allocation of the benefit to the depositors as one possible approach. OECD, *supra* n. 3, para. 129. In the authors' opinion, this approach could potentially be applied if the cash pool depositors (and not the CPL) actually bear significant risks related to the cash pooling arrangement and if the source of any volume effect can be explained through the amount of the cash deposits. On this basis, it could be argued that cash pool depositors are the parties with a higher bargaining power and should be entitled to earn a higher portion of the cash pool benefit.

¹⁵⁹ KPMG, *supra* n. 109, at 224 ('A residual profit split approach could make sense, wherein routine functions are first rewarded, and the residual is allocated through a combination of premiums on deposit rates and discounts on borrowing rates').

¹⁶⁰ OECD, *supra* n. 3, para. 123.

¹⁶¹ *Ibid.*, para. 125.

¹⁶² One of the proposed OECD approaches comprises the enhancement of the interest rates for all participants. *Ibid.*, para. 127. In the authors' opinion, the interest rates applied in the cash pool should be at least as favourable as the interest rates offered or applied by external banks. Thus, the approach to (slightly) enhance the interest rates for all participants may rather be considered as a principle (than as an independent approach).

¹⁶³ The OECD regards the equalization of the interest rates as one possible approach. OECD, *supra* n. 3, para. 128. Assuming that the CPL qualifies as only (low-risk) financial service provider (such that it does not assume any significant risks) and that all cash pool members have the same or a similar credit profile (up to the level of the group rating) and contribute in the same manner to the creation of any volume discount, the application of the same interest rate for all participants (up to the level of the interest rates applied on the master account) could potentially be an option.

¹⁶⁴ For example, Denmark, Japan and Switzerland.

¹⁶⁵ B. Cœuré, *Assessing the Implications of Negative Interest Rates* (28 July 2016), <https://www.ecb.europa.eu/press/key/date/2016/html/sp160728.en.html> (accessed 28 Aug. 2018).

¹⁶⁶ Deloitte, *CFO Survey* (Deloitte 2017), https://www2.deloitte.com/content/dam/Deloitte/de/Documents/finance-transformation/CFO_Frühjahr_2017.pdf (accessed 28 Aug. 2018).

¹⁶⁷ IMF, *Negative Interest Rate Policies – Initial Experiences and Assessments*, IMF Policy Paper 7-8 (Aug. 2018).

¹⁶⁸ Deloitte, *Treasury & Risk Survey* (Deloitte 2016), https://www2.deloitte.com/content/dam/Deloitte/de/Documents/financial-services/FSI_Treasury%20&%20Risk%20Management%20Survey%202016.pdf (accessed 28 Aug. 2018).

¹⁶⁹ D. M. Arseneau, *How Would US Banks Fare in a Negative Interest Rate Environment?* Finance and Economics Discussion Series 2017-030 (2017), <https://www.federalreserve.gov/econres/feds/files/2017030pap.pdf> (accessed 28 Aug. 2018).

¹⁷⁰ N. Irwin, *Negative 0.5% Interest Rate: Why People Are Paying to Save*, New York Times (13 Feb. 2016).

with the cash pool may no longer be commercially viable from the perspective of the single cash pool member. However, it is imaginable that if independent parties had established a cash pool they would not immediately change their behaviour for potential short-term market fluctuations and would also consider what the future expectations would be. Thus, short-term negative synergy effects could potentially be accepted by the cash pool members if they were independent enterprises.

However, it could also be in the interests of the PCo of the group to operate a cash pooling system also in the context of a longer period of negative interest rates. A cash pool creates transparency and makes it easier to manage the liquidity requirements and the cash flows along the finance function of the group. However, enhanced liquidity management at the group level might not lead to quantifiable advantages for the single cash pool members. Thus, there could be a risk that tax authorities will attempt to reclassify the cash pool arrangement into a service provision to the PCo of the group.¹⁷¹ High cash deposits in the master account should therefore be mitigated.

If it is identified that there is a potential effect resulting from negative group synergies, the question then concerns how this should be shared between the parties in the short or mid-term. The residual cash pool disadvantage could potentially be shared based on the same principles as a cash pool benefit. The mechanism used should reflect the contribution of the parties to the creation of the disadvantage. In cases where the CPL qualifies as an internal bank, it may also bear a portion of the disadvantage since it may economically bear certain financial as well as market risks.

8 CONCLUSION

Even if third-party evidence with regard to physical cash pooling arrangements is sparingly available, the application of a transactional arm's length approach could potentially nevertheless provide arm's length results:

- *intercompany deposits and borrowings*: The financial arrangements arising from the cash movements between the CPL and the cash pool members can generally be classified as loans for transfer pricing purposes. The application of bank interest rates on the cash pool balances may not be considered at arm's length. However, the intercompany loans may be priced by using a build-up approach (i.e. by applying a risk premium to a short-term, risk-free base rate). Nevertheless, the application of this pricing method

does not necessarily facilitate an arm's length allocation of the cash pool benefit (such as the volume discount);

- *cash pool guarantees*: Guarantees issued in the context of pooling arrangements lead to a service provision by the guarantor (e.g. PCo of the group) to the CPL only if (i) the guarantee is not a substitute for equity (shareholder activity) and (ii) the CPL benefits from the guarantee over and above the level of implicit support. The issuance of cross-guarantees generally does not justify a separate payment;
- *remuneration of the CPL*: The CPL should be remunerated according to the function it actually performs. The financial and functional capability of the CPL to assume (credit) risks may be the deciding factor for the attribution of the credit risk. Thus, a CPL that can be characterized as a (limited-risk) financial service provider may not be entitled to earn more than a routine return. By contrast, a CPL that qualifies as an internal bank may earn more than a routine return. The arm's length remuneration for such a CPL may consist of interest spread between lower interest rates on cash pool deposits and higher interest rates on cash pool borrowings; and
- *cash pool benefit*: The major components of the cash pool benefit are the netting benefit and the volume discount. The netting benefit arises from the consolidation of the borrowings and deposits within the cash pool. The arm's length pricing of the intercompany loans may already lead to an arm's length allocation of this benefit. Other factors might have to be taken into consideration to ensure an arm's length allocation of the volume discount (i.e. the benefit arising from group synergies reflected in the enhanced interest rates applied on the master account).

Finally, the *low or even negative interest rate* environment could significantly impact the transfer pricing of physical cash pooling arrangements. The operation of a physical cash pool in a negative interest rate environment could create negative group synergies. Thus, the participation in the physical cash pool may no longer be commercially viable from the perspective of the single cash pool member. However, an independent enterprise would not necessarily leave the cash pool for potential short-term market fluctuations. The cash pool disadvantage arising from negative group synergies should be shared between the cash pool members on the basis of their contribution to the creation of the disadvantage.

Notes

¹⁷¹ OECD, *supra* n. 17, paras 1.129–1.131.