OECD: Transfer pricing guidance on financial transactions

Background

On 11 February 2020, the Organisation for Economic Cooperation and Development (“OECD”) released its final report providing transfer pricing guidance on financial transactions (click here), which will be incorporated as Chapter X of the OECD Transfer Pricing Guidelines.

The OECD report—Transfer Pricing Guidance on Financial Transactions: Inclusive Framework on BEPS: Actions 4, 8-10 (“the Report”)—marks the first time that the OECD Transfer Pricing Guidelines has provided specific guidance on the transfer pricing aspects of financial transactions.

The aim of the Report is to help ensure consistency in the application of transfer pricing rules and avoid future transfer pricing disputes as well as double taxation issues. It is expected to have a large impact on local transfer pricing legislation and bilateral discussions going forward.

A comparison of the Discussion Draft published in the summer of 2018 and the final version of the Report shows that the document content is largely unchanged though a number of examples have been added to illustrate the principles discussed.

Overall, the Report outlines the economically relevant characteristics that form the analysis of the terms and conditions of financial transactions, and addresses specific issues related to the pricing of financial transactions (including treasury functions, intra-group loans, cash pooling, hedging, guarantees and captive insurance). These are discussed in detail below.

Overview of the Report

1. Accurate Delineation Analysis

   The Report first elaborates on how the accurate delineation analysis applies to the capital structure of a multinational enterprise (“MNE”) within an MNE group.

   a. Loan versus Equity

   The first section of the Report deals, at a general level, with the application of the Chapter 1 “transaction delineation analysis” to determine whether a “purported loan” should be treated as a loan.

   In particular, it sets out reference criteria to determine if a loan should be considered as a loan or as equity. It is noted that, for a full analysis, consideration needs to be given to the industry in question (e.g., different industries have different
capital intensity and different accepted leverage levels), and factors specific to the MNE group in question (e.g., the stage that the borrowing entity is at in its business or product cycle; the MNE group’s policy on prioritizing financing of certain projects). The analysis would also need to look at the options realistically available from both the lender and borrower perspectives.

The new OECD guidance on debt-equity characterization in the Report is not intended to be mandatory, as countries/jurisdictions may choose to continue to use any multifactor analysis that they already have in place in their domestic law (e.g., approaches to address capital structure and interest deductibility).

b. Lending Risk Control

Even if a related party debt is not recharacterized as equity, if the lender does not control the risks and/or have the financial capacity to absorb loan losses, then the risks/returns should be allocated away to other MNE group companies. This leaves the lender with solely a risk-free return. The types of activity that the lender is expected to conduct to exercise control are listed, which include evaluating lending risks (using similar information to a bank or rating agency), determining loan terms and arranging the loan, as well as monitoring loan servicing.

There is also the possibility that considerations of commercial reality lead to a recharacterization of the loan (set out in the contract) as a different type of loan arrangement, with different pricing. For example, a 10-year loan is given by a parent to a subsidiary to finance working capital requirements. When borrowing externally for working capital, the MNE would normally get a one-year loan. The 10-year loan is then recharacterized as 1-year revolving loans, which are repeatedly rolled over. This is more in line with the commercial reality of the group’s external financing policy. The factors to be considered in conducting the comparability analysis for pricing the loan are also spelled out in detail within the Report.

2. Treasury Function

a. Intra-Group Lending

The Report calls for an assessment of whether the treasury centre activities are considered ‘low’ or ‘high’ functions. At the lower end of the spectrum is simple cash and liquidity management (i.e., ensuring operating companies have enough cash when they need it), including cash pooling. The higher end may include corporate financial management (i.e., planning to finance investments over the long term, optimizing group cost of capital, strategic responses to group financial risks, etc.). The conducting of higher value adding activities for the group (with real control) will justify a higher profit allocation to the treasury centre versus a more basic coordination fee for lower value activities.

The Report delves into many complex issues, including the issue raised in the Chevron court case (i.e., Chevron versus Australian Taxation Office). The guidance discusses the circumstances in which the MNE group’s credit rating will be the more relevant guide for determining the borrowing costs of a group entity in a related party loan than a particular group entity’s standalone credit rating (i.e., the importance of ‘passive association’ of a group entity with the MNE as a whole). If the MNE entity is highly likely to be supported (i.e., implicit support) then the entity would not be expected to pay other group entities for loan guarantees. Consequently, contracts for any guarantee payments would need to be disregarded.

Further guidance is provided in the Report on the use of financial tools to determine credit ratings for an MNE or specific entity, and on interpreting the significance of particular financial metrics for creditworthiness in industries with different features. Guidance is also provided on the choice of transfer pricing method for pricing a loan, on the use of information on credit default swaps to determine the risk premium on a loan, and on the use of economic modelling.
b. Cash Pooling

The Report explains how to use the Chapter 1 guidance to determine whether the treasury centre, as cash pool leader, controls the economically significant risks of the cash pool. It also explains how the synergy benefits of the cash pool are to be allocated amongst pool members, and how to deal with cash pool cross-guarantees.

c. Hedging

The Report explores how to deal with a number of complex scenarios, involving foreign exchange, commodity price movements and interest rate hedging. It looks at cases where the hedging contracts (while arranged by the treasury centre) are entered into by the group operating company where the hedged risk exists. It also looks at cases where the treasury centre finds ‘natural hedges’ at group level (e.g., the risks at the level of one operating entity cancel out those at the level of another group entity). It further examines where the treasury centre enters into hedging contracts that counteract risks when viewed at the group level (already taking into account the natural hedges).

3. Financial Guarantees

A number of complex issues around guarantee are dealt with in the Report. For example, where the ‘implicit support’ of an MNE group for a particular group entity is high (e.g., it is strategically crucial), then contracts for intra-group guarantees may need to be disregarded, as they have no economic justification (e.g., these would not be commercially rational for the borrower to enter into in view of its “options realistically available”).

Another scenario looked at is where a bank lends money to a financially weak MNE group entity, which is guaranteed by a financially strong group entity. In this case, as no bank would have found it commercially logical to lend to the weak entity, the transaction may be recharacterized as a loan from the bank to the financially sound entity, and an equity injection from the financially sound entity to the weak entity (resulting in part or all of the guarantee fee being disregarded). Extensive guidance on different transfer pricing methods for pricing guarantees are set out.

4. Captive Insurance and Reinsurance

In applying the Chapter 1 guidance, the Report highlights that the captive insurance MNE entity needs to be shown to control the risks, and to conduct a commercially rational business, in a way that it can be seen to undertake a ‘genuine’ insurance business. Relevant factors are set out, including that there is genuine risk diversification, that the entity has the requisite skills, and that the insured risk could be insurable outside the MNE. If the captive insurance entity business makes no commercial sense, and if it does not fully control the relevant risks, the economic benefits of MNE group risk aggregation and management may be simply allocated out to group entities.

5. Risk-Free and Risk-Adjusted Rates of Return

The Report also provides guidance where a funder lacks the capability to control the risks associated with investing in a financial asset, then it will only be entitled to a risk-free return. The balance of the financial return may then be allocated to the party exercising control over the investment risk.

It then outlines the importance of choosing an appropriate reference rate that matches the characteristics of the tested transaction such as currency, term and issue date.

This Report also discusses the risk-adjusted rate of return, which the draft guidance notes would be relevant where the party providing funding exercises control over the financial risk but not over any other specific risks. In this case, the funder should only receive a financial return, rather than a return from the wider operations of the business being funded.
Potential Impact on the Hong Kong Transfer Pricing Environment

The Report explains how the analysis for the ‘accurate delineation of the actual transactions’ and control over risks applies for financial transaction arrangements. Analysis on the accurate delineation of transactions and control over risks was a key addition to the OECD Transfer Pricing Guidelines, made in the 2017 update following the 2015 BEPS Actions 8-10 Report.

As the latest edition of the OECD Transfer Pricing Guidelines (i.e., 2017 edition) is referenced in the Hong Kong Transfer Pricing Ordinance, the Hong Kong Transfer Pricing Ordinance effectively adopts the guidance from the Report. The question of how the Hong Kong Inland Revenue Department (“HKIRD”) will apply the new OECD guidance on financial transactions in practice (particularly against domestic tax legislation) is yet to be seen.

Potentially, we could see some more practical guidance by way of a Departmental Interpretation Practice Note (“DIPN”) issued by HKIRD on financial transactions transfer pricing in the future. Furthermore, we could observe how the HKIRD will apply some measures of the Report in its administration of financial transactions transfer pricing, such as in the context of bilateral discussions and negotiations with overseas competent authorities.

Discussed below are key issues which Hong Kong taxpayers face in relation to financial transactions.

1. Approach to Financial Transactions Transfer Pricing and Accurate Delineation Analysis

Hong Kong taxpayers generally follow OECD approaches when pricing intercompany financing transactions (e.g., performing credit rating analysis, determining the arm’s length interest rate for a tested loan by benchmarking against publicly available data for borrowers with similar terms and conditions and making appropriate adjustments to comparable data identified). In particular cases, Hong Kong taxpayers may also consider qualitative factors in supporting the arm’s length nature of such arrangements.

It is worthwhile to note that as the Hong Kong Transfer Pricing Ordinance refers to the latest OECD Transfer Pricing Guidelines, it follows that it has adopted the accurate delineation analysis on the capital structure of an MNE within an MNE group.

The Report explains the accurate delineation analysis of the actual transactions and control over risks for financial transactions. Under this approach, the arm’s length mix of debt and equity shall be determined based on the economically relevant characteristics of a transaction.

The Report does not mandate that accurate delineation analysis as the only approach. It allows for the possibility that countries continue to use domestic legislation and approaches to address the balance of debt and equity funding of an entity and interest deductibility.

With this in mind, it appears that the Report’s intention is geared towards very large, bespoke financial transactions as detailed / extended analyses are recommended. Thus, it may not be practical to expect the detailed / extended analyses prescribed for determining the appropriate capital structure (i.e., debt versus equity) to be applied to very small, basic day-to-day and short-term loans. Although there are no specific materiality criteria specified in the Report, the question of capital structure may rightfully be more relevant to very sizeable loans in which borrowing capacity is a relevant factor.

Further, one controversial point mentioned in the Report is the application of risk-free returns in certain cases in which the lender does not exert control over the risks associated with investing in a financial asset. The balance of the financial return may then be allocated to the party exercising control over the investment risk. The application of risk-free returns may be viewed as a deviation from the traditional arm’s
length pricing principle, and the adjustment of the balance somewhat mirrors the OECD’s move to promote a formulary apportionment approach.

Overall, this may end up bringing added complexity to Hong Kong taxpayers – they may then need to rely on the local transfer pricing legislation to help lessen the compliance burden where possible.

2. Recharacterization of Related Party Debt

At this moment, there is no established market practice or legislation from both the Hong Kong profits tax and transfer pricing perspectives regarding the recharacterization of a related party debt.

There have been public statements made by the HKIRD whereby they would examine, amongst other factors, the legal rights and obligations created by hybrid instruments to determine their nature.

The general practice in Hong Kong is that form prevails, and it is not typical for the form to change for tax treatment purposes. As such, there may be some actual tension between the recharacterization of a transaction for transfer pricing and the more traditional approach for Hong Kong profits tax purposes in which form prevails over substance.

3. Interest Free Loans

A common question among Hong Kong taxpayers is the acceptability of interest free loans. Based on the Hong Kong transfer pricing rules, emphasis has been placed on whether there is a decrease of the group’s overall tax burden (i.e., any tax advantage). With the Hong Kong transfer pricing rules in place, it may no longer be tenable to have interest free loans, specifically cross-border ones, as they could be considered as not being concluded on an arm’s length basis. An interest element would be expected for any similar loan transaction with a third party bank and therefore, there may be a need to impute an interest rate on interest-free loans.

The HKIRD has confirmed that the arm’s length principle should be applied before considering the source of profits as they believe that this two-step approach is more consistent with the BEPS principle. However, Hong Kong taxpayers would still need to take note of profits tax rules when setting up their financial transaction arrangements (e.g., provision of credit test / operations test, deductibility of interest expenses, etc.). Overall, Hong Kong taxpayers should look to resolve any inconsistencies in their overall group transfer pricing policy for financial transactions (e.g., certain loans are interest bearing, while others are not) in order to help mitigate transfer pricing risk both in Hong Kong and the counterparty jurisdiction(s) which may not be familiar with Hong Kong’s somewhat unique rules.

The Report illustrates that a debt can carry the characteristics of equity. A case-by-case analysis is merited to evaluate the arm’s length nature of interest-free debt arrangements, i.e. whether it shall be accurately delineated as quasi-equity or debt.

4. Cash Pooling

The Report directs that the appropriate reward of the cash pool leader should be determined based on its functions and risks undertaken. This could range from a coordination or agency function to a more comprehensive in-house bank function and risk profile (e.g., assumption of credit risk, liquidity risk and currency risk for intra-group financing arrangements). In the case that the cash pool leader only performs coordination functions, it should only receive a reward commensurate with its service function, as opposed to retaining the interest spread between deposits and loans. Any synergy benefits arising from the cash pool arrangement after the remuneration of the cash pool leaders should be allocated among the cash pool members.

Although this is in line with how certain Hong Kong taxpayers are setting up their cash pooling arrangement, whether all Hong Kong taxpayers would need to align with the new guidance again depends on the HKIRD’s administration in this area. If applied,
comprehensive transfer pricing documentation will also be needed to provide details on the cash pooling structure and the returns attributed to the cash pool leader and members.

5. Grandfathered Transactions and Exempted Domestic Transactions

DIPN 59 states that a transaction entered into or effected before the commencement date of the Hong Kong Transfer Pricing Ordinance (i.e., 13 July 2018) will not be subject to the arm’s length principle. Furthermore, specified domestic transactions would also be exempted from the application of the arm’s length principle.

With this in mind, for any related party financial transactions which fulfill the grandfathering provisions and/or domestic transactions exemption criteria, the Report may be of less relevance.
KPMG observations

In recent times, we have noted that the HKIRD has been taking a more assertive stance on intra-group financing transactions. We expect this to intensify going forward against the backdrop of the evolving global transfer pricing environment. The new guidance will provide the HKIRD with an additional tool in performing tax audits. If and when the HKIRD does issue a new DIPN on intercompany financing transactions and/or when there are more audits focused on such transactions, Hong Kong taxpayers will have more precedents to follow.

We expect the HKIRD will eventually turn their focus to intercompany financing transactions and likewise further their understanding on such transactions. Hong Kong taxpayer will need to stand ready to defend their related party financing arrangements when audit activity does pick up. Taxpayers should also pay attention to how the Report’s comments will interact with the new tax incentives suggested by the HKIRD in relation to captive insurance and corporate treasury centres.

Taxpayers are recommended to proactively review their existing and planned financial transactions and consider mitigating actions to address the gap. Consideration should also be given to documentation preparation. Though the Report does not specify any documentation requirements, it does call for careful documentation to support many aspects of the financial arrangements. This includes analysis on the commercial rationality of loans, functional analysis for cash pooling and treasury functions and return allocation, direct/indirect benefits for pricing the guarantee, etc. Where required, taxpayers should seek professional support to carefully formulate the pricing policy and documentation strategy.

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