New OECD guidance on transfer pricing guidelines for Financial Transactions (FTG)

This is the fourth feature following those published on 2, 9 and 16 October. Those features sought to share a high-level summary of the key technical areas outlined in the new guidance. In this feature we share our thoughts and observations on certain key elements of the FTG.

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The new guidance clarifies the process of accurate delineation for financial transactions. The process set out is both far more detailed and far broader than previously so current transfer pricing methodologies supporting the pricing of intra-group financial transactions may very well not stand up to challenges under the new guidance. However, despite this increased level of sophistication and certainty, the comment at paragraph 10.9 of the FTG explicitly allows for divergence between countries on implementing approaches to address the balance of debt and equity funding of an entity and interest deductibility under domestic legislation thus increasing the risk of double taxation; whilst possibly inevitable, it is disappointing. Whether this turns out to be a significant issue and what effect it may have on the negotiation and settlement of MAP cases remains to be seen. In any event, it will be vital to have a clear audit trail in order to defend approaches taken in preparation for any challenge by taxing jurisdictions.

The FTG also reflects the need for both the lender's and the borrower's perspectives to be taken into account. Taxpayers will need to substantiate the considerations made before determining the quantum of the intra-group loan and interest rate applied; this includes the decision-making process before putting in place an intra-group loan. Additionally, the choice for the type of loan (e.g. long-term, short-term, revolving) needs to be considered carefully and fully documented. As regards the actual contract underlying the funding instrument, it is expected that there is evidence to support the arm's length nature of the arrangements. Finally, tax authorities are likely to review whether the actual conduct of the borrower and creditor is consistent with the contractual terms underlying the loan.

The new guidance appears to reflect the issues covered in several court cases challenging financial transactions, e.g. the Chevron Australia Holdings case. Of particular interest was the different approach taken by the court in relation to the characteristics of the 'hypothetical independent parties' that need to be taken into account when determining arm's length consideration. The evidence revealed that the borrower was part of a group that had a policy to borrow externally at the lowest cost and the parent would generally provide a third party guarantee for a subsidiary borrowing externally. The court concluded that there is no reason to ignore those essential facts in order to assess the hypothetical consideration to be given. It also concluded that the 'independence' hypothesis does not necessarily require the detachment of the taxpayer, as one of the independent parties, from the group which it is part of, or the elimination of all the commercial and financial attributes of the taxpayer.

The implications of this approach are potentially significant for taxpayers as it would enable features of the taxpayer, in the context of the group of which it forms a part, to be taken into account. Whether all jurisdictions would agree with such an approach and how that would pan out in MAP discussions is, of course, moot. Indeed, the UK's transfer pricing legislation specifically excludes both implicit and explicit financial guarantees from being taken into account for the purposes of considering their capitalisations - s152(5) TIOPA 2010.

By contrast, HMRC's approach with regard to the pricing of guarantee fees themselves appears to be consistent with the FTG. HMRC's guidance on guarantee fees was updated a day before the issue of the new FTG. Its approach is that at arm's length, a company would not take on the extra cost of a guarantee unless that guarantee makes the overall cost of finance cheaper than it would be on a stand-alone basis. If the cost of the guarantee itself is greater than the saving it brings, it will be disallowed to the extent that it causes the total finance costs relating to the guaranteed debt to exceed the stand-alone arm's length price. Clearly, a full audit trail of the consideration given to such pricing will be more important than ever.

In summary, the key issues that need to be considered are:

- The possibility of jurisdictions taking different views and thus leading to potential double taxation and/or problems with MAP.
- The emphasis new guidance gives to the attention with which intra-group transactions ought to be delineated before they can be compared with third party transactions.
- The emphasis on the need for both the lender's and the borrower's perspectives to be considered.
- Elements of the Australian Chevron Case seemingly reflected in the guidance.
- The accurate delineation of financial guarantees requires consideration of the economic benefit arising to the borrower beyond the one that derives from passive group association.

All these issues are important in themselves but also overlap with one another to a lesser or greater extent, and they also suggest that audit trails and evidence of pricing and delineation of financial transactions have become more important than ever.

This series of features is co-authored by Ruth Steedman, Chris Liu and Martin Brooks from FTI Consulting LLP.

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