



# Final OECD transfer pricing guidelines on financial transactions (Part II: Treasury Functions)

## Mazars tax newsletter – Feb 2022

### Background

The Organization for Economic Co-operation and Development (OECD) has released in February 2020 the final Transfer Pricing Guidance on Financial Transactions (“Guidance”). The Guidance provides an insight on the arm’s length treatment of various financial transactions among related parties. The Guidance has been published as a follow up guidance in relation to Base Erosion and Profit Shifting (“BEPS”) Action 4 and Actions 8-10. Sections A-E of the Guidance will be added as a new Chapter X of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (“OECD TPG”), whereas the guidance on the determination of risk-free and risk-adjusted rates of return ( Section F) will be included in Chapter I of the OECD TPG. This is the first

## time that multinational enterprise (MNE) groups are provided with guidelines on how to structure and price intra-group financial transactions.

### Structure of the guidance

The Guidance is divided into five main sections. These are:

- Accurate delineation of the transactions;
- Treasury function, including related transactions such as intra-group loans, cash pooling and hedging;
- Guarantees;
- Captive insurance; and
- Risk-free and risk-adjusted rates of return

### Detailed analysis

In this newsletter, we will focus on treasury functions – cash pooling and hedging, guarantees, captive insurance and risk-free and risk adjusted rates of return. The discussion about “accurate delineation of the transactions” and “intra-group loans” are covered in our newsletter issued in Part I: Intra-Group Loan.

#### 1. Treasury functions

The organization of the treasury will depend on the structure of a given MNE group and the complexity of its operation. It is very common for MNE group to have the treasury function within the group. The treasury function can be structured in centralized and decentralized and form.

The decentralized treasury function refers to instances where each entity handles its own financial transactions and receives limited support from the treasury entity even though there is one within the group. The

treasury entity may only be utilizing its the excess fund to earn its own investment return. On the other hand, for a centralized structure, the treasury entity has full responsibility for funding and other related functions.

Some key functions of a centralized treasury entity include centralizing external borrowing of the MNE group, optimizing liquidity, mitigating risk, raising debts and optimizing cost of capital. Typically, a treasury function constitutes a support service to the main value-creating business operations. Therefore, the centralizing treasury entity is expected to receive an arm’s length fee for its coordination activities. The two frequently encountered treasury functions are cash pooling and hedging. These are described in the following.

#### 1a. Cash pooling

Cash pooling is arranged within an MNE group to ensure efficient cash management and achieve cost efficiency.

A cash pooling arrangement refers to the pooling of debit and credit balances of the separate bank accounts of cash pool members to arrive at a net balance, generally with the cash pool leader. Interests will be paid or received based on the overall balance. The types of cash pooling include physical and notional pooling. Nevertheless, the Guidance states that the accurate delineation of cash pooling arrangements needs to take into account not only the existence of the relevant balances, but also the context of

the arrangement as a whole. For example, there could be synergy benefits because of the cash pooling. These benefits would generally be shared by the cash pool members and the cash pool leader. In addition, one needs to consider whether the cash pooling should be treated as a short-term cash pool balance, or whether the facts and circumstances support an alternative view such as being a long-term deposit or term loan to the MNE group.

To determine an arm's length remuneration to each of the cash pool member and the cash pool leader, it is important to identify:

- Nature of the advantage or disadvantage of a cash pooling arrangement, e.g., provision of a lower bank borrowing rate;
- Amount of the benefit or detriment provided, e.g., the quantum of bank interest reduced;
- How should the benefit or detriment be divided among members of the MNE group; and
- Control and capacity related to the risks, such as the liquidity risk and credit risk.

A cash pool leader is remunerated depending on the type of cash pooling arrangement and the activities performed by it. Typically, a cash pool leader performs no more than a co-ordination or agency function and therefore receives limited remuneration. On the other hand, activities other than co-ordination or agency functions may infer that a higher remuneration is appropriate. For example, if the leader assumes the responsibility for the investment strategy, selection of financial products and maturities and performing certain positioning with the bank to earn part or all of the spread between the borrowing and lending positions, the leader

should earn a higher remuneration for its functions.

The reward for the cash pool members is generally calculated through the determination of the arm's length interest rates applicable to the debit and credit positions within the pool after the remuneration of the cash pool leader is determined. In addition, if there is a synergy benefit, this synergy benefit would be allocated and added to the arm's length interest rate so determined.

### 1b. Hedging

Hedges are frequently used in the ordinary course of business as a means of mitigating exposure to risks such as foreign exchange or commodity price movements.

The Guidance states that hedging could often be centralized to improve efficiency and effectiveness. From that perspective, risks are often hedged from a group perspective, instead of on an entity level. The central arrangement of a hedge contract by the treasury entity can be regarded as the provision of a service, for which the treasury entity should only get an arm's length compensation for the services. More difficult transfer pricing issues may arise, however, if the contract instrument is entered into by the treasury entity or another group entity, with the result that the positions are not matched within the same entity although the MNE group position is protected.

For example, in a financial institution such as a banking group, hedging contract with a customer may be entered into by a bank in a jurisdiction, with a corresponding sub-contract with another bank in another jurisdiction. If the bank that enters into the sub-contract will be covered by the head-office through equity, that bank should

receive a compensation for the service provided in addition to the gain or loss on the hedging transaction with the customer. On the other hand, if the gain or loss on the hedging transaction will be on the participating bank's own control, there would not be compensation on these services.

## 2. Financial guarantees

A financial guarantee is defined as a legally binding commitment on the part of the guarantor to assume a specified obligation of the guaranteed debtor if the debtor defaults on that obligation. A financial guarantee is assessed based on the following factors:

### 2a. Economic benefit

There should be an economic benefit arising to the borrower beyond the one that it derives from passive association. A financial guarantee can affect the terms of the borrowing either by (i) enhancing the terms of the loan, e.g., reduced borrowing costs, and (ii) increasing the borrowing capacity.

A guarantee fee should only be paid to the guarantor if the guarantee helps in achieving better terms to the borrower. It should be distinguished from a situation whereby a portion of the loan should be delineated and regarded as effectively as a loan to the guarantor followed by an equity contribution by the guarantor to the borrower. In that case, there should be no charging of guarantee fee.

### 2b. Effect of group membership

The Guidance reiterates that any benefit arising from being part of a group (passive association) would not be regarded as the

provision of a service for which payment of a guarantee fee would be necessary.

### 2c. Financial capacity of the guarantor

The Guidance also reiterates that the financial capacity of a guarantor requires an evaluation of the credit rating of the guarantor and the borrower and the business correlations between them.

### 2d. Determining an arm's length guarantee fee

The Guidance states that when available, the application of the CUP method through uncontrolled guarantees is the most reliable comparable approach to determine arm's length guarantee fees. However, the Guidance also acknowledges that there may be a difficulty because of a lack of sufficiently comparable transactions.

The other two approaches recommended include the Yield Approach and the Cost Approach.

The Yield Approach is the maximum fee a borrower would be willing to pay for the guarantee and is subject to bargaining between the borrower and the guarantor. In that respect, the borrower would determine the spread between the interest cost without the guarantee and the interest cost with the guarantee.

The Cost Approach, on the other hand, aims to quantify the cost expected by the guarantor in the case of a default by the borrower. The expected cost can be determined as the value of the expected loss, or, alternatively, by reference to the capital required to support the additional risk assumed by the guarantor. The guarantee fee would be the minimum fee which the guarantor would be willing to



accept, subject to bargaining between the two parties.

### 3. Captive insurance

Captive insurance entities are defined as entities whose primary function is to insure the risks of entities belonging to the same MNE Group. As in intra-group loans, the first step is to accurately delineate a captive insurance. To accurately delineate a captive insurance, the Guidance states that it is important to determine whether the insurance is genuine, whether a risk exists and whether the risk is allocated to the captive insurance.

Some indicators of a genuine insurance are as follows:

- Diversification and pooling of risk in the captive insurance;
- Economic capital position of the entities within the MNE group has improved as a result of the diversification;
- Regulated entities with broadly similar regulatory regimes;
- Has the requisite skills, including investment skills, and experience at its disposal; and
- Has a real possibility of suffering losses.

Where the captive insurance insures the risk and/or reinsures it in the open market, it should receive an appropriate reward for the basic services it provides. Any synergies created by a captive program may need to be shared among the MNE group entities.

In relation to the pricing of premiums, the Guidance acknowledges that practical difficulties may arise in the application of the CUP method, even though it states that

it is the preferred approach. For example, the functions and business or capital volume may be different between the captive insurance and a commercial insurer.

An alternative would be to price the premiums by the use of actuarial analysis.

### 4. Risk free and risk adjusted rates of return

The last section of the Guidance contains guidance that has been added to Chapter I of the OECD TPG and describes how to determine a risk-free rate of return and a risk-adjusted rate of return in situations where, based on the accurate delineation, an associated entity is entitled to any of these returns.

A risk-free rate of return is applied when the funder lacks the capability, or does not perform the decision-making functions, to control the risk associated with investing in a financial asset. The funder's cost of funding should be taken into account in determining such return. In order to determine the risk-free rate of return, reference can be made to certain government issued securities with the same functional currency and tenor.

The risk adjusted rate of return comprises two components namely the (i) risk-free rate and (ii) a premium reflecting the risks assumed by the funder. The methods that are applied would be the CUP methods, comparing with bond issuances or loans, adding a risk premium based on information available on comparable financial instruments, or the cost of funds approach. In analyzing the risk adjusted rate of return, it is important to differentiate between risks assumed by the funder in relation to its financing activity and the operational risks that the funded party may assume in connection to the use of the funds.

## **Mazars' thoughts**

The Guidance represents a significant step in the development of the OECD TPG, as it is the first time that guidance on financial transactions will be included.

There are the following key messages from the OECD:

MNE groups with Malaysia, Hong Kong and Mainland China entities would no doubt be affected by these new transfer pricing guidelines which would be incorporated into the new version of the OECD TPG. These guidelines would also provide the basis for resolution of any potential bilateral dispute in respect of intra-group financial transactions. This is particularly important in light of the ongoing COVID-19 pandemic, in which there would be inevitable internal financial re- structuring involving intra-group loans, requirement of additional financing from banks which may require guarantees. We are pleased to provide assistance in this financial re-structuring exercise.

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