ELVINGER HOSS
LUXEMBOURG LAW

New transfer pricing guidance on financial transactions

Posted 28.02.2020

On 11 February 2020, the OECD released the final version of the transfer pricing guidance on financial transactions – a long-awaited report after the draft published on 3 July 2018 ("**Report**").

The Report is significant because it is the first time the OECD issues specific guidance on the transfer pricing aspects of financial transactions, which should help harmonise interpretations of the arm's length principle and avoid transfer pricing disputes and double taxation. The guidance will be included in the 2017 version of the OECD Transfer Pricing Guidelines as a new Chapter X and an addition to the current Chapter I.

Key takeaways

- **What should be treated as debt for tax purposes:** the Report indicates that the arm's length principle is relevant in determining not only whether the interest rate provided for in a loan contract is at arm's length, but also whether a prima facie loan can be regarded as a loan or should be regarded as a contribution to equity capital. In this respect, the Report lists the economically relevant characteristics – such as the presence or absence of a fixed repayment date, the obligation to pay interest, the right to enforce payment of principal and interest, the ability of the recipient of the funds to obtain loans from unrelated lending institutions and to repay on the due date – that could serve as indicators to determine whether a purported loan should be regarded as debt or equity. The Report also clarifies that this guidance does not prevent countries from implementing approaches to address the balance of debt and equity funding and interest deductibility under their domestic legislation.
- **Intra-group loans:** the Report introduces a two-sided approach, emphasising the importance to analyse the arm's length nature of a financial transaction from both the lender's and the borrower's perspectives. On the lender's side, the decision of whether to make a loan, how

much to lend, and on what terms, should involve a credit assessment of the potential borrower to evaluate the risks involved. On the borrower's side, the options realistically available should be considered by taking into account that an independent borrower always seeks the most cost-effective solution with regard to the business strategy it has adopted.

- **Lending companies without functional substance:** companies without the capability or actual performance of the decision-making functions to control and manage the risk associated with the granting of a loan would not be entitled to the respective interest income but only to a risk-free return. The remainder would be allocable to the party exercising control over the risk.

- **Use of credit ratings:** the Report provides guidance on how to determine the group companies' stand-alone rating and how to take into account the benefit of group membership ("implicit support"). For this issue, the OECD places greater emphasis on ensuring that both quantitative factors – e.g. financial information – and qualitative factors – e.g. industry and country in which the entity or the group operates – are taken into account in credit rating analysis.

- **Arm's length interest rate:** different approaches to pricing intra-group loans are presented in the Report. Not surprisingly, the CUP method remains the preferred method. In the absence of comparable uncontrolled transactions, the Report proposes alternative approaches, such as the cost of funds where the pricing is based on the lender's cost of raising funds, and the economic models with comparability adjustments. The use of the credit default swaps is however discouraged and the reliability of bank opinions is denied.

- **Financial guarantees:** the Report reiterates that financial guarantees should only be remunerated where they provide measurable benefits, such as a more favourable interest rate, beyond the one that derives from implicit support. Where a financial guarantee also permits a company to borrow a greater amount of debt, this additional borrowing may be, taking into account the facts and circumstances, re-characterised as an equity contribution by the guarantor to the borrower, and the guarantee fee limited on the portion that has been accurately delineated as a loan. The Report also describes five transfer pricing approaches to price guarantee fees (i.e. CUP, cost approach, yield approach, valuation of expected loss approach and capital support method).

- **Cash pooling:** the Report indicates that, in general, a cash pool leader performs no more than coordination or agency functions and that, given such a low level of functionality, the cash pool leader's remuneration as a service provider is similarly limited. However, where a cash pool leader is carrying on activities other than coordination or agency functions, its arm's length remuneration should be determined based on its control over the risks and financial capacity to bear the economically significant risks linked to the cash pool (e.g. credit risk, liquidity risk, interest rate risk, currency risk).

Implications for Luxembourg

Although the OECD Transfer Pricing Guidelines are not legally binding, it is very likely that the Luxembourg tax authorities will follow this new OECD guidance to assess the intra-group financial transactions of Luxembourg companies.

The new guidance may in particular lead to the reclassification of an intra-group loan into equity for transfer pricing purposes, with the tax consequences thereof (no interest deduction and potential dividend withholding tax). Based on the new guidance, the Luxembourg tax authorities might also require more detailed transfer pricing documentation of financial transactions including, for instance, the consideration of both quantitative and qualitative factors such as the effect of group membership, and the analysis of the options realistically available from the lender's and borrower's perspectives (two-sided approach).

We strongly recommend to Luxembourg taxpayers engaged in intra-group financial transactions to check the compliance of their transactions and related transfer pricing documentation with the new guidance.

For further information, please contact:
Isabelle Gervais (Counsel, Transfer Pricing Expert).

Yves Prussen, Dirk Richter, Elisabeth Adam (Partners)

ELVINGER HOSS PRUSSEN

Société anonyme, Registered with the Luxembourg Bar, RCS Luxembourg B 209469, VAT LU28861577