



Transfer Pricing Guidance on Financial Transactions

INCLUSIVE FRAMEWORK ON BEPS: ACTIONS 4, 8-10

February 2020



OECD/G20 Base Erosion and Profit Shifting Project

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Inclusive Framework on BEPS: Actions 4, 8-10



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Executive summary

The 2015 BEPS Action Plan reports on Action 4 (*Limiting base erosion involving interest deductions and other financial payments*) and Actions 8-10 (*Aligning Transfer Pricing Outcomes with Value Creation*) mandated follow-up work on the transfer pricing aspects of financial transactions. In particular, Action 4 of the BEPS Action Plan called for the development of:

“...transfer pricing guidance ... regarding the pricing of related party financial transactions, including financial and performance guarantees, derivatives (including internal derivatives used in intra-bank dealings), and captive and other insurance arrangements.”

Under these mandates, the Committee on Fiscal Affairs produced a non-consensus discussion draft on financial transactions in July 2018. The discussion draft aimed to clarify the application of the principles included in the 2017 edition of the *OECD Transfer Pricing Guidelines (the “Guidelines”)*, in particular, the accurate delineation analysis under Chapter I, to financial transactions. It also provided guidance with specific issues relating to the pricing of loans, cash pooling, financial guarantees, and captive insurance.

The guidance contained in this report takes account of comments received in response to the public discussion draft. This guidance is significant because it is the first time the *Guidelines* will be updated to include guidance on the transfer pricing aspects of financial transactions, which should contribute to consistency in the application of transfer pricing and help avoid transfer pricing disputes and double taxation. Sections A to E of this report will be included in the *Guidelines* as Chapter X. The guidance in Section F of this report will be added to Section D.1.2.1 in Chapter I of the *Guidelines*, immediately following paragraph 1.106.

This report describes the transfer pricing aspects of financial transactions, including a number of examples to illustrate the principles discussed. Section B provides guidance on the application of the principles contained in Section D.1 of Chapter I of the *Guidelines* to financial transactions. In particular, Section B.1 of this report elaborates on how the accurate delineation analysis under Chapter I applies to the capital structure of an MNE within an MNE group. It also clarifies that the guidance included in that section does not prevent countries from implementing approaches to address capital structure and interest deductibility under their domestic legislation. Section B.2 outlines the economically relevant characteristics that inform the analysis of the terms and conditions of financial transactions.

Sections C, D and E of this report address specific issues related to the pricing of financial transactions (e.g. treasury functions, intra-group loans, cash pooling, hedging, guarantees and captive insurance). This analysis elaborates on both the accurate delineation and the pricing of the controlled financial transactions. Finally, Section F provides guidance on how to determine a risk-free rate of return and a risk-adjusted rate of return.

Sections A to E of this report are added to the OECD Transfer Pricing Guidelines as Chapter X. Numbering and cross-references included in other parts of the OECD Transfer Pricing Guidelines will be amended as needed.

Table of contents

Executive summary	3
A. Introduction	6
B. Interaction with the guidance in Section D.1 of Chapter I	7
B.1. Determination of whether a purported loan should be regarded as a loan	7
B.2. Identifying the commercial or financial relations	8
C. Treasury function	13
C.1. Intra-group loans	14
C.2. Cash pooling	23
C.3. Hedging	28
D. Financial guarantees	29
D.1. Accurate delineation of financial guarantees	29
D.2. Determining the arm's length price of guarantees	31
D.3. Examples	33
E. Captive insurance	35
E.1. Definition and rationale for a captive insurance and reinsurance	35
E.2. Accurate delineation of captive insurance and reinsurance	36
E.3. Determining the arm's length price of captive insurance and reinsurance	39
F. Risk-free and risk-adjusted rates of return	42
F.1. Determining a risk-free rate of return	42
F.2. Determining a risk-adjusted rate of return	43

A. Introduction

10.1. The purpose of this Chapter is to provide guidance for determining whether the conditions of certain financial transactions between associated enterprises are consistent with the arm's length principle.

10.2. Section B describes the application of the principles of Section D.1 of Chapter I to financial transactions. Section C provides guidance on determining the arm's length conditions for treasury activities including intra-group loans, cash pooling and hedging. Section D examines financial guarantees, and Section E outlines the analysis of captive insurance companies.

10.3. The conditions of financial transactions between independent enterprises will be the result of various commercial considerations. In contrast, an MNE group has the discretion to decide upon those conditions within the MNE group. Thus, in an intra-group situation, other considerations such as tax consequences may also be present.

B. Interaction with the guidance in Section D.1 of Chapter I

B.1. Determination of whether a purported loan should be regarded as a loan¹

10.4. It may be the case that the balance of debt and equity funding of a borrowing entity that is part of an MNE group differs from that which would exist if it were an independent entity operating under the same or similar circumstances. This situation may affect the amount of interest payable by the borrowing entity and so may affect the profits accruing in a given jurisdiction.

10.5. Commentary to Article 9 of the OECD Model Tax Convention notes at paragraph 3(b) that Article 9 is relevant “not only in determining whether the rate of interest provided for in a loan contract is an arm’s length rate, but also whether a prima facie loan can be regarded as a loan or should be regarded as some other kind of payment, in particular a contribution to equity capital.”²

10.6. In the context of the preceding paragraphs, this subsection elaborates on how the concepts of Chapter I, in particular the accurate delineation of the actual transaction under Section D.1, may relate to the balance of debt and equity funding of an entity within an MNE group.

10.7. Where it is considered that the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner in comparable circumstances, the guidance at Section D.2 of Chapter I may also be relevant.

10.8. Although this guidance reflects an approach of accurate delineation of the actual transaction in accordance with Chapter I to determine the amount of debt to be priced, it is acknowledged that other approaches may be taken to address the issue of the balance of debt and equity funding of an entity under domestic legislation before pricing the interest on the debt so determined. These approaches may include a multi-factor analysis of the characteristics of the instrument and the issuer.

10.9. Accordingly, this guidance is not intended to prevent countries from implementing approaches to address the balance of debt and equity funding of an entity and interest deductibility under domestic legislation, nor does it seek to mandate accurate delineation under Chapter I as the only approach for determining whether purported debt should be respected as debt.

¹ The guidance contained in this subsection is consistent with the Commentary on Article 9 of the 2017 OECD Model Tax Convention and also with the Commentary as it would read with proposed changes that have been agreed by Working Party No. 1. The guidance might be revised in the event that those proposals are materially changed at any stage.

² As discussed in the Committee on Fiscal Affairs’ Report on “Thin Capitalisation” adopted by the Council of the OECD on 26 November 1986 and reproduced in Volume II of the full version of the OECD MTC at page R (4)-1.

10.10. Although countries may have different views on the application of Article 9 to determine the balance of debt and equity funding of an entity within an MNE group, the purpose of this section is to provide guidance for countries that use the accurate delineation under Chapter I to determine whether a purported loan should be regarded as a loan for tax purposes (or should be regarded as some other kind of payment, in particular a contribution to equity capital).

10.11. Particular labels or descriptions assigned to financial transactions do not constrain the transfer pricing analysis. Each situation must be examined on its own merits, and subject to the prefatory language in the previous paragraph, accurate delineation of the actual transaction under Chapter I will precede any pricing attempt.

10.12. In accurately delineating an advance of funds, the following economically relevant characteristics may be useful indicators, depending on the facts and circumstances: the presence or absence of a fixed repayment date; the obligation to pay interest; the right to enforce payment of principal and interest; the status of the funder in comparison to regular corporate creditors; the existence of financial covenants and security; the source of interest payments; the ability of the recipient of the funds to obtain loans from unrelated lending institutions; the extent to which the advance is used to acquire capital assets; and the failure of the purported debtor to repay on the due date or to seek a postponement.

10.13. For example, consider a situation in which Company B, a member of an MNE group, needs additional funding for its business activities. In this scenario, Company B receives an advance of funds from related Company C, which is denominated as a loan with a term of 10 years. Assume that, in light of all good-faith financial projections of Company B for the next 10 years, it is clear that Company B would be unable to service a loan of such an amount. Based on facts and circumstances, it can be concluded that an unrelated party would not be willing to provide such a loan to Company B due to its inability to repay the advance. Accordingly, the accurately delineated amount of Company C's loan to Company B for transfer pricing purposes would be a function of the maximum amount that an unrelated lender would have been willing to advance to Company B, and the maximum amount that an unrelated borrower in comparable circumstances would have been willing to borrow from Company C, including the possibilities of not lending or borrowing any amount (see comments upon "The lender's and borrower's perspectives" in Section C.1.1.1 of this chapter). Consequently, the remainder of Company C's advance to Company B would not be delineated as a loan for the purposes of determining the amount of interest which Company B would have paid at arm's length.

B.2. Identifying the commercial or financial relations

10.14. In determining the arm's length conditions of financial transactions, the same principles apply as described in Chapters I-III of these Guidelines for any other controlled transaction.

10.15. As with any controlled transaction, the accurate delineation of financial transactions requires an analysis of the factors affecting the performance of businesses in the industry sector in which the MNE group operates. Because differences exist among industry sectors, factors such as the particular point of an economic, business or product cycle, the effect of government regulations, or the availability of financial resources in a given industry are relevant features that have to be considered to accurately delineate the controlled transaction. This examination will take account of the fact that MNE groups operating in different sectors may require, for example, different amounts and types of financing due to different capital intensity levels between industries, or may require different levels of short-term cash balances due to different commercial needs between industries. Where the relevant MNEs are regulated, such as financial services

entities subject to regulations consistent with recognised industry standards (e.g. Basel requirements), due regard should be had to the constraints those regulations impose upon them.³

10.16. As described in Chapter I, the process of accurate delineation of the actual transaction also requires an understanding of how the particular MNE group responds to those identified factors. In this regard, the MNE group's policies may inform the accurate delineation of the actual transaction through the consideration of, for instance, how the MNE group prioritises the funding needs among different projects; the strategic significance of a particular MNE within the MNE group; whether the MNE group is targeting a specific credit rating or debt-equity ratio; or whether the MNE group is adopting a different funding strategy than the one observed in its industry sector (see Section B.3.5).

10.17. In accordance with the guidance established in Chapter I, the accurate delineation of the actual transaction should begin with a thorough identification of the economically relevant characteristics of the transaction – consisting of the commercial or financial relations between the parties and the conditions and economically relevant circumstances attaching to those relations –, including: an examination of the contractual terms of the transaction, the functions performed, assets used, and risks assumed, the characteristics of the financial instruments, the economic circumstances of the parties and of the market, and the business strategies pursued by the parties.

10.18. In common with the analysis of any other transaction between associated enterprises, in applying the arm's length principle to a financial transaction it is necessary to consider the conditions that independent parties would have agreed to in comparable circumstances.

10.19. Independent enterprises, when considering whether to enter into a particular financial transaction, will consider all other options realistically available to them, and will only enter into the transaction if they see no alternative that offers a clearly more attractive opportunity to meet their commercial objectives (see paragraph 1.38 of Chapter I). In considering the options realistically available, the perspective of each of the parties to the transaction must be considered. For instance, in the case of an entity that advances funds, other investment opportunities may be contemplated, taking account of the specific business objectives of the lender and the context in which the transaction takes place. From the borrower's perspective, the options realistically available will include broader considerations than the entity's ability to service its debt, for example, the funds it actually needs to meet its operational requirements. In some instances, although an entity may have the capacity to borrow and service an additional amount of debt, it may choose not to do so to avoid placing negative pressure on its credit rating and increasing its cost of capital, and jeopardising its access to capital markets and its market reputation (see comments upon "The lender's and borrower's perspectives" in Section C.1.1.1 of this chapter).

10.20. In an ideal scenario, a comparability analysis would enable the identification of financial transactions between independent parties which match the tested transaction in all respects. With the many variables involved, it is more likely that potential comparables will differ from the tested transaction. Where differences exist between the tested transaction and any proposed comparable, it will be necessary to consider whether such differences will have a material impact on the price. If so, it may be possible, where appropriate, to make comparability adjustments to improve the reliability of a comparable. This is more likely to be achievable where the adjustment is based on a quantitative factor and there is good quality data easily available (e.g. on currency differences) than, for instance, in trying to compare loans to borrowers with qualitative differences or where data is not so readily available (e.g. borrowers with different business strategies).

³ See footnote in Section D.1.2.1 of Chapter I of these Guidelines.

B.3. The economically relevant characteristics of actual financial transactions

10.21. To inform an analysis of the terms and conditions of a financial transaction as part of the accurate delineation of the actual transaction or seeking to price the accurately delineated actual transaction, the following economically relevant characteristics should be considered.

B.3.1. Contractual terms

10.22. The terms and conditions of a financial transaction between independent enterprises are usually explicitly stated in a written agreement. However, between associated enterprises the contractual arrangements may not always provide information in sufficient detail or may be inconsistent with the actual conduct of the parties or other facts and circumstances. It is therefore necessary to look to other documents, the actual conduct of the parties – notwithstanding that such consideration may ultimately result in the conclusion that the contractual form and actual conduct are in alignment – and the economic principles that generally govern relationships between independent enterprises in comparable circumstances in order to accurately delineate the actual transaction in accordance with Section D.1.1 of Chapter I.

B.3.2. Functional analysis

10.23. In accurately delineating the actual financial transaction, a functional analysis is necessary. This analysis seeks to identify the functions performed, the assets used and the risks assumed by the parties to that controlled transaction.

10.24. For instance, in the particular case of an intra-group loan, the key functions performed by a lender to decide whether and under which terms to advance funds would typically include an analysis and evaluation of the risks inherent in the loan, the capability to commit capital of the business to the investment, determining the terms of the loan and organising and documenting the loan. This may also include any ongoing monitoring and periodic review of the loan. Such a functional analysis is likely to include consideration of similar information to that which a commercial lender or ratings agency would consider in determining the creditworthiness of the borrower. An associated lender will not necessarily perform all of the same functions at the same intensity as an independent lender. However, in considering whether a loan has been advanced on conditions which would have been made between independent enterprises, the same commercial considerations and economic circumstances are relevant (see comments on “The lender’s and borrower’s perspectives” and “Use of credit ratings” in Sections C.1.1.1 and C.1.1.2 of this chapter).

10.25. When, under accurate delineation, the lender is not exercising control over the risks associated to an advance of funds, or does not have the financial capacity to assume the risks, such risks should be allocated to the enterprise exercising control and having the financial capacity to assume the risk (see paragraph 1.98 of Chapter I). For instance, consider a situation where Company A advances funds to Company B. Consider further that the accurate delineation of the actual transaction indicates that Company A does not exercise control functions related to the advance of funds but that Company P, the parent company of the MNE group, is exercising control over those risks, and has the financial capacity to assume such risks. Under Chapter I analysis, Company P will bear the consequences of the playing out of such risks and Company A will be entitled to no more than a risk-free return (see Section D.1.2.1 in Chapter I).

10.26. From the perspective of the borrower, the relevant functions would usually refer to ensuring the availability of funds to repay the principal and the interest on the loan in due time; providing collateral, if needed; and monitoring and fulfilling any other obligation derived from the loan contract (see comments upon “The lender’s and borrower’s perspectives” in Section C.1.1.1 of this chapter).

10.27. In some instances, the functions of the lender and the borrower may be undertaken by the same entity in different transactions. That could be the case, for example, of centralised treasury activities within an MNE group where the treasury entity raises and provides funds to other members of the MNE group. In those circumstances, the functional analysis should consider the applicability of the guidance in Section C of this chapter, and, in particular, paragraphs 10.44 and 10.45.

B.3.3. Characteristics of financial instruments

10.28. There is a wide variety of financial instruments in the open market that present very different features and attributes, which may affect the pricing of those products or services. Consequently, when pricing controlled transactions, it is important to document the transactions' features and attributes.

10.29. For instance in the case of a loan, those characteristics may include but are not limited to: the amount of the loan; its maturity; the schedule of repayment; the nature or purpose of the loan (trade credit, merger/acquisition, mortgage, etc.); level of seniority and subordination, geographical location of the borrower; currency; collateral provided; presence and quality of any guarantee; and whether the interest rate is fixed or floating.

B.3.4. Economic circumstances

10.30. To achieve comparability requires that the markets in which the independent and associated enterprises operate do not have differences that have a material effect on price or that appropriate adjustments can be made.

10.31. The prices of financial instruments may vary substantially on the basis of underlying economic circumstances, for example, across different currencies, geographic locations, local regulations, the business sector of the borrower and the timing of the transaction.

10.32. Macroeconomic trends such as central bank lending rates or interbank reference rates, and financial market events like a credit crisis, can affect prices. In this regard, the precise timing of the issue of a financial instrument in the primary market or the selection of comparable data in the secondary market can therefore be very significant in terms of comparability. For instance, it is not likely that multiple year data on loan issuances will provide useful comparables. The opposite is more likely to be true, i.e. that the closer in timing a comparable loan issuance is to the issuance of the tested transaction, the less the likelihood of different economic factors prevailing, notwithstanding that particular events can cause rapid changes in lending markets.

10.33. Currency differences are another potentially important factor. Economic factors such as growth rate, inflation rate, and the volatility of exchange rates, mean that otherwise similar financial instruments issued in different currencies may have different prices. Moreover, prices for financial instruments in the same currency may vary across financial markets or countries due to regulations such as interest rate controls, exchange rate controls, foreign exchange restrictions and other legal and practical restrictions on financial market access.

B.3.5. Business strategies

10.34. Business strategies must also be examined in accurately delineating the actual financial transaction and in determining comparability for transfer pricing purposes since different business strategies can have a significant effect on the terms and conditions which would be agreed between independent enterprises.

10.35. For example, independent lenders may be prepared to lend on terms and conditions to an enterprise undertaking a merger or acquisition which might otherwise not be acceptable to the lender for the same business if it were in a steady state. In this kind of scenario, the lender may take a view over the

term of the loan and consider the borrower's business plans and forecasts, effectively acknowledging that there will be temporary changes in the financial metrics of the business for a period as it undergoes changes. Section D.1.5 of Chapter I gives other examples of business strategies that must be examined in accurately delineating the actual transaction and determining comparability.

10.36. The analysis of the business strategies will also include consideration of the MNE group's global financing policy, and the identification of existing relationships between the associated enterprises such as pre-existing loans and shareholder interests (see Annex I to Chapter V of these Guidelines about the information to be included in the master file).

10.37. For example, consider that Company A, a member of AB Group, advances funds with a term of 10 years to an associated enterprise, Company B, which will use the funding for short-term working capital purposes. This advance is the only loan in Company B's balance sheet. AB Group's policy and practices demonstrate that the MNE group uses a one-year revolving loan to manage short-term working capital. In this scenario, under the prevailing facts and circumstances, the accurate delineation of the actual transaction may conclude that an unrelated borrower under the same conditions of Company B would not enter into a 10-year loan agreement to manage its short-term working capital needs and the transaction would be accurately delineated as a one-year revolving loan rather than a 10-year loan. The consequences of this delineation would be that assuming the working capital requirements continue to exist, the pricing approach would be to price a series of refreshed one-year revolver loans.

10.38. In any case, the reliability of results is generally improved to the extent comparable borrowers pursue similar business strategies to the tested borrower involved in an intra-group transaction.

C. Treasury function

10.39. For MNE groups, the management of group finances is an important and potentially complex activity where the approach adopted by individual businesses will depend on the structure of the business itself, its business strategy, place in the business cycle, industry sector, currencies of operation, etc.

10.40. The organisation of the treasury will depend on the structure of a given MNE group and the complexity of its operations. Different treasury structures involve different degrees of centralisation. In the most decentralised form, each MNE within the MNE group has full autonomy over its financial transactions. Decentralised treasury structures may be present, for instance, in MNE groups with multiple operating divisions that operate in discrete industries or with regional hub structures, or in MNE groups required to comply with specific local regulations. At the opposite end of the scale, a centralised treasury has full control over the financial transactions of the MNE group, with entities within the MNE group responsible for operational but not financial matters.

10.41. A key function of a corporate treasury may be, for example, to optimise liquidity across the MNE group to ensure that the business has sufficient cash available and that it is in the right place when it is needed and in the right currency. In general, efficient management of MNE group liquidity is driven by considerations above the level of individual entities, and acts to help mitigate risk across a number of entities.

10.42. Whilst the treasury's cash and liquidity management function is concerned with day-to-day operations, corporate financial management is concerned with development of strategies and planning for investment decisions in the longer term. Financial risk management requires identification and analysis of, and responses to, the financial risks to which the business is exposed. By identifying and taking action to address financial risk, treasury can help to optimise the cost of capital to the advantage of the users of the MNE group's treasury services.

10.43. Other examples of activities which the treasury may have responsibility for include raising debt (through bond issuances, bank loans or otherwise) and raising equity, and managing the relationship with the MNE group's external bankers and with independent credit rating agencies.

10.44. When evaluating the transfer pricing issues related to treasury activities, as with any case, it is important to accurately delineate the actual transactions and determine exactly what functions an entity is carrying on rather than to rely to any extent upon a general description such as "treasury activities".

10.45. Generally, the treasury function is part of the process of making the financing of the commercial business of the MNE group as efficient as possible. As such, the treasury function will usually be a support service to the main value-creating operation as in the case, for example, of the services provided by a cash pool leader (see Section C.2.3). Depending on the facts and circumstances of each case, such activities may be services in which case the pricing guidance on intra-group services at Chapter VII applies.

10.46. Similarly, the treasury may act as the contact point to centralise the external borrowing of the MNE group. External funds would then be made available within the MNE group through intra-group lending provided by the treasury. On prevailing facts and circumstances, guidance in paragraph 1.168 of Chapter I would apply to these situations and the treasury would be expected to receive an arm's length fee for its coordination activities.

10.47. In other situations, the treasury may be found to perform more complex functions and, therefore, it should be compensated accordingly.

10.48. Another key concern regarding treasury activities is the identification and allocation of the economically significant risks in accordance with Chapter I.

10.49. The activities of the treasury function take into account issues at a group level and follow the vision, strategy and policies set out by MNE group management. Accordingly, the approach of the treasury to risk will depend on the MNE group's policy where certain objectives may be specified, such as targeted levels of investment return (e.g. the yield must exceed the cost of capital), reduced cash flow volatility, or targeted balance sheet ratios (e.g. assets to liabilities). Therefore, it is important to note that usually the higher strategic decisions will generally be the result of policy set at group level rather than determined by the treasury itself.

10.50. The following sections outline the transfer pricing considerations which arise from some relevant treasury activities that are often performed within MNE groups, i.e. the provision of intra-group loans, cash pooling, and hedging activities.

Caveat

The following sections deal with specific issues related to determining whether the rate of interest provided for in a loan contract is an arm's length rate. The analysis included in these sections is based on the assumption that the transactions are respected as loans pursuant to an accurate delineation under Chapter I or domestic legislation, as the case may be.

C.1. Intra-group loans

C.1.1. General considerations

C.1.1.1. The lender's and borrower's perspectives

10.51. In considering the commercial and financial relations between the associated borrower and lender, and in an analysis of the economically relevant characteristics of the transaction, both the lender's and borrower's perspectives should be taken into account, acknowledging that these perspectives may not align in every case.

10.52. As in any other transfer pricing scenarios, the guidance in Section D.1 of Chapter I applies to determine whether the lender and the borrower assume risks related to intra-group loans. In particular, it is important to consider the risks that the funding arrangements carry for the party providing the funds, and the risks related to the acceptance and use of the funds from the perspective of the recipient. These risks will relate to repayment of the amount transferred, compensation expected for the use of that amount over time, and compensation for other associated risk factors.

10.53. The lender's perspective in the decision of whether to make a loan, how much to lend, and on what terms, will involve evaluation of various factors relating to the borrower, wider economic factors affecting both the borrower and the lender, and other options realistically available to the lender for the use of the funds.

10.54. An independent lender will carry out a thorough credit assessment of the potential borrower to enable the lender to identify and evaluate the risks involved and to consider methods of monitoring and

managing these risks. That credit assessment will include understanding the business itself as well as the purpose of the loan, how it is to be structured and the source of its repayment which may include analysis of the borrower's cash flow forecasts and the strength of the borrower's balance sheet.

10.55. When an enterprise is making a loan to an associated enterprise, it will not necessarily follow all of the same processes as an independent lender. For example, it may not need to go through the same process of information gathering about the borrower's business, as the required information may already be readily available within the MNE group. However, in considering whether the loan has been made on conditions which would have been made between independent enterprises, the same commercial considerations such as creditworthiness, credit risk and economic circumstances are relevant.

10.56. In the case of a loan from the parent entity of an MNE group to a subsidiary, the parent already has control and ownership of the subsidiary, which would make the granting of security less relevant to its risk analysis as a lender. Therefore, in evaluating the pricing of a loan between associated enterprises it is important to consider that the absence of contractual rights over the assets of the borrowing entity does not necessarily reflect the economic reality of the risk inherent in the loan. If the assets of the business are not already pledged as security elsewhere, it will be appropriate to consider under Chapter I analysis whether those assets are available to act as collateral for the otherwise unsecured loan and the consequential impact upon the pricing of the loan.

10.57. Credit risk for the lender is the potential that the borrower will fail to meet its payment obligations in accordance with the terms of the loan. In deciding whether a prospective loan is a good commercial opportunity, a lender will also consider the potential impact of changes which could happen in economic conditions affecting the credit risk it bears, not only in relation to the conditions of the borrower but in relation to potential changes in economic conditions, such as a rise in interest rates, or the exposure of the borrower to movements in exchange rates.

10.58. Borrowers seek to optimise their weighted average cost of capital and to have the right funding available to meet both short-term needs and long-term objectives. When considering the options realistically available to it, an independent business seeking funding operating in its own commercial interests will seek the most cost effective solution, with regard to the business strategy it has adopted. For example in respect of collateral, in some circumstances, assuming that the business has suitable collateral to offer, this would usually be secured funding, ahead of unsecured funding, recognising that a business's collateral assets and its funding requirements may differ over time, e.g. because collateral is finite, the decision to pledge collateral on a particular borrowing precludes the borrower from pledging that same collateral on a subsequent borrowing. Therefore, an MNE pledging collateral would take into account its options realistically available regarding its overall financing (e.g. possible subsequent loan transactions).

10.59. Borrowers will also consider the potential impact of changes in economic conditions such as interest rates and exchange rates, as well as the risk of not being able to make timely payments of interest and principal on the loan if the borrower's business encounters unexpected difficulties, and the risk of not being able to raise more capital (either debt or equity) if necessary.

10.60. Macroeconomic circumstances may lead to changes in the financing costs in the market. In such a context, a transfer pricing analysis with regard to the possibilities of the borrower or the lender to renegotiate the terms of the loan to benefit from better conditions will be informed by the options realistically available to both the borrower and the lender.

10.61. The economic conditions of loans should also be viewed in the context of regulations that may affect the position of the parties. For example, insolvency law in the jurisdiction of the borrower may provide that liabilities towards associated enterprises are subordinated to liabilities towards unrelated parties.

C.1.1.2. Use of credit ratings

10.62. The creditworthiness of the borrower is one of the main factors that independent investors take into account in determining an interest rate to charge. Credit ratings can serve as a useful measure of creditworthiness and therefore help to identify potential comparables or to apply economic models in the context of related party transactions. Furthermore, in the case of intra-group loans and other financial instruments that are the subject of controlled transactions, the effect of group membership may be an economically relevant factor that affects the pricing of these instruments. Accordingly, this subsection elaborates on the use of credit ratings and the effect of group membership in the context of pricing intra-group loans. Where appropriate, reference to this subsection will be made in other parts of this guidance.

10.63. Credit ratings can be determined for the overall creditworthiness of an MNE or MNE group⁴ or for a specific issuance of debt. As detailed in the following paragraphs, determining credit ratings requires consideration of quantitative – e.g. financial information – and qualitative factors – e.g. industry and country in which the MNE or MNE group operates.

C.1.1.2.1 The credit rating of an MNE or MNE group

10.64. The credit rating of an MNE or MNE group (usually referred to as the “issuer credit rating”) is an opinion about its general creditworthiness. Such an opinion is usually premised on the MNE or MNE group’s capacity and willingness to meet its financial obligations in accordance with the terms of those obligations. The credit rating of an MNE or MNE group is effectively a form of relative ranking of the creditworthiness in comparison to other borrowers. In general, a lower credit rating will indicate a greater risk of default and be expected to result in a higher rate of return for lenders.

10.65. Information is readily available in many lending markets on the different rates of interest charged for differently rated enterprises and such information may usefully contribute to performing comparability analyses. Financing transactions that the borrowing MNE or another MNE within the group has with external lenders may also be reliable comparables for interest rates charged by associated enterprises (see paragraphs 10.94 and 10.95). Financing transactions undertaken by the borrowing MNE or another entity in the MNE group, for example the MNE group parent, will be reliable comparables only where the differences between the controlled and uncontrolled transactions do not materially affect the interest rate or reasonably accurate adjustments can be made.

10.66. As a credit rating depends on a combination of quantitative and qualitative factors, there is still likely to be some variance in creditworthiness between borrowers with the same credit rating. In addition, when making comparisons between borrowers using the kind of financial metrics typically seen as important to lenders, such as debt-earnings or debt-equity ratios, it is important to note that the same financial metrics will not necessarily result in the same credit rating if there are other differences between the rated parties. For example, it may require stronger financial metrics to obtain a given rating in some industries than to obtain the same rating for a borrower in other industries. More intrinsically risky industries and those with less stable revenue streams tend to require better financial ratios in order to obtain the same rating.

10.67. There may be special circumstances, such as in the case of start-up entities, or those that have recently been part of a merger, that may have an impact on the credit rating of a group entity. These special situations should be taken into consideration.

⁴ For the purpose of this guidance, the credit rating of an MNE group is intended to refer to the credit rating of the ultimate parent entity of the MNE group calculated on consolidated financial statements.

10.68. It is important that the MNE group appropriately documents the reasons and selection of the credit rating used for a particular MNE when pricing intra-group loans and other controlled financial transactions.

C.1.1.2.2. The credit rating of a specific debt issuance

10.69. The credit rating of a particular debt issuance (“issue rating”) is an opinion about the creditworthiness of the issuer with respect to a specific financial instrument. The issue rating considers specific features of the financial instrument, for instance, guarantees, securities and level of seniority.

10.70. The credit rating of an MNE or MNE group may differ from an issue rating due to the fact that the credit risk of a financial instrument is linked to its specific features and not only to the risk profile of the borrowing MNE. On prevailing facts and circumstances, and provided there is comparability between the third party debt issuance and the controlled transaction, when both an issuer and issue ratings are available, the issue rating of the particular debt issuance would be more appropriate to use to price the controlled financial transaction.

C.1.1.2.3. Credit rating determinations

10.71. Particular considerations should be borne in mind when determining a credit rating for a specific MNE within an MNE group for the purpose of assessing controlled transactions. Where an MNE has a publicly available credit rating published by an independent credit rating agency, that rating may be informative for an arm’s length analysis of the MNE’s controlled financing transactions. However, in most cases, publicly available credit ratings are only available for the MNE group. An approach often used for a specific MNE is to apply quantitative and qualitative analyses of the individual characteristics of the MNE using publicly available financial tools or independent credit rating agencies’ methodologies to seek to replicate the process used to determine the credit rating of the MNE group. This approach also involves taking into account improvements in creditworthiness that the specific MNE would be assumed to receive as a result of being part of the MNE group.

C.1.1.2.4. The use of publicly available financial tools or methodologies to approximate credit ratings

10.72. Publicly available financial tools are designed to calculate credit ratings. Broadly, these tools depend on approaches such as calculating the probability of default and of the likely loss should default occur to arrive at an implied rating for the borrowing. This can then be compared to a market database in a search for comparables to arrive at a price or price range for the borrowing. In considering whether the application of these tools results in a reliable assessment of the credit rating of controlled transactions, potential issues that need to be borne in mind include that the results are not based on a direct comparison with transactions between independent parties but are subject to the accuracy of the input parameters, a tendency to rely more on quantitative inputs at the expense of qualitative factors, and a lack of clarity in the processes (i.e. the workings of the underlying algorithms and processes may not be transparent).

10.73. The credit rating methodology used in publicly available financial tools may differ significantly in certain respects from the credit rating methodologies applied by independent credit rating agencies to determine official credit ratings and the impact of any such differences should be carefully considered. For instance, publicly available tools generally use only a limited sample of quantitative data to determine a credit rating. Official credit ratings published by independent credit rating agencies are derived as a result of far more rigorous analysis that includes quantitative analysis of historic and forecast entity performance as well as detailed qualitative analysis of, for instance, management’s ability to manage the entity, industry specific features and the entity’s market share in its industry.

10.74. For these reasons, the reliability of credit rating results derived from the use of publicly available financial tools may be improved to the extent the analysis can reproducibly demonstrate consistency of ratings using such tools with those provided by independent credit rating agencies.

10.75. In conducting a credit rating analysis, it is important to note that the financial metrics may be influenced by current and past controlled transactions (such as sales, or interest expenses). If it appears that such controlled transactions are not in accordance with the arm's length principle, the credit rating derived in light of such intra-group transactions may not be reliable. (See also guidance in section B). These considerations apply both to controlled transactions that may affect the current earnings of the MNE and to previous funding and other intra-group transactions that may have had an impact on the measures of income and capital of the MNE that are the subject of quantitative analysis.

C.1.1.3. Effect of group membership

10.76. The effect of group membership is relevant for informing the conditions under which an MNE would have borrowed from an independent lender at arm's length in two ways in particular. Firstly, the external funding policies and practices of group management will assist in informing the form and terms and conditions of the debt the MNE would have entered into with an independent lender, including the pricing (i.e. interest rate paid), and all economically relevant characteristics such as the type of loan, its term, currency, security, covenants, business strategies, and so forth. Secondly, the MNE may receive support from the group to meet its financial obligations in the event of the borrower getting into financial difficulty. Paragraph 1.158 of Chapter I of these Guidelines is relevant to analyse the effect of group membership on the terms and conditions of a borrowing when the borrowing MNE obtains an incidental benefit arising solely by virtue of group affiliation, i.e. passive association.

10.77. In the context of intra-group loans, this incidental benefit that the MNE is assumed to receive solely by virtue of group affiliation, is referred to as implicit support. The effect of potential group support on the credit rating of an entity and any effect on that entity's ability to borrow or the interest rate paid on those borrowings would not require any payment or comparability adjustment. See Example 1 at paragraphs 1.164 - 1.166 of Chapter I and Section D.3.

10.78. Implicit support from the group may affect the credit rating of the borrower or the rating of any debt which it issues. The relative status of an entity within the group may help determine what impact that potential group support has on the credit rating of a debt issuer. Entities of an MNE group will be more or less likely to receive group support according to the relative importance of the entity to the MNE group as a whole and the linkages between the entity and the rest of the MNE group, either in its current form or in terms of future strategy. An MNE group member with stronger links, that is integral to the group's identity or important to its future strategy, typically operating in the group's core business, would ordinarily be more likely to be supported by other MNE group members and consequently have a credit rating more closely linked to that of the MNE group. Conversely, it may be reasonable to assume that an entity would be likely to receive support from the rest of the MNE group in more limited circumstances where it does not show those same indicators or the linkages are weaker. In the case of an entity where there is evidence that no support would be provided by the MNE group, it may be appropriate on the prevailing facts and circumstances to consider the entity on the basis of its own stand-alone credit rating only.

10.79. Another key consideration would be the likely consequences for other parts of the MNE group of supporting or not supporting the borrower. The criteria used to determine the status of an entity in this regard may include such considerations as legal obligations (e.g. regulatory requirements), strategic importance, operational integration and significance, shared name, potential reputational impacts, negative effects on the overall MNE group, general statement of policy or intent, and any history of support and common behaviour of the MNE group with respect to third parties. The relative relevance of those factors may vary from one industry to another.

10.80. The impact of an assessment of implicit support is a matter of judgement. The kind of information on which the MNE group would base a decision of whether or not to provide support to a borrower in particular circumstances may not be available to a tax administration, as is frequently the case in transfer pricing examinations, and the existence of information asymmetry may affect the ability of tax administrations to establish the likelihood of support (see section B.2 in Chapter IV). Furthermore, changing facts and circumstances affecting the willingness or ability of the MNE group to provide support may mean that there is no decision by the MNE group itself until the eventuality for such support arises. This contrasts, for example, where the MNE receives a formal guarantee from another group member. The past behaviour of an MNE group as regards providing support may be a useful indicator of likely future behaviour but an appropriate analysis should be undertaken to identify whether different conditions apply.

C.1.1.4. Use of MNE group credit rating

10.81. It is also important to note that although there are established approaches to estimate a credit rating for a particular group member or debt issuance, the considerations detailed above mean that a pricing approach based on the separate entity credit ratings that are derived from publicly available financial tools (see paragraph 10.72), the implicit support analysis, the difficulties of accounting for controlled transactions reliably and the presence of information asymmetry may pose challenges that, if not resolved, may result in outcomes that are not reliable.

10.82. Where this is the case, the credit rating of the MNE group may also be used for the purpose of pricing the accurately delineated loan where the facts so indicate, particularly in situations such as where the MNE is important to the group as described in paragraphs 10.78 and 10.79 and where the MNE's indicators of creditworthiness do not differ significantly from those of the group. An MNE group credit rating is unaffected by controlled transactions and reflects the actual basis on which the group seeks external funding from independent lenders. In situations where an MNE group does not have an external credit rating, consideration may be given to conducting the credit rating analysis at the MNE group level for assessing the controlled transaction. In all cases, the MNE group credit rating, like any other credit rating, will be appropriate only if it is determined to be the most reliable indicator of the MNE credit rating in light of all the facts and circumstances.

C.1.1.5. Covenants

10.83. The purpose of covenants in a loan agreement is generally to provide a degree of protection to the lender and so limit its risk. That protection may be in the form of incurrence covenants or maintenance covenants.

10.84. Incurrence covenants require or prohibit certain actions by the borrower without the consent of the lender. Incurrence covenants may, for example, prohibit the borrower from taking on additional debt, creating any charge on the assets of the entity or disposing of particular assets of the entity, thus giving some degree of certainty over the balance sheet of the borrower.

10.85. Maintenance covenants refer typically to financial indicators which have to be met at regular, predetermined intervals during the life of a covenanted loan. Maintenance covenants can act as an early warning system so that in the event of financial underperformance by the borrower, the borrower and/or lender can move to take remedial action at an early stage. This can help to protect unrelated lenders against information asymmetry.

10.86. There may be less information asymmetry between entities (that is, better visibility) in the intra-group context than in situations involving unrelated parties. Intra-group lenders may choose not to have covenants on loans to associated enterprises, partly because they are less likely to suffer information asymmetry and because it is less likely that one part of an MNE group would seek to take the same kind of action as an independent lender in the event of a covenant breach, nor would it usually seek to impose

the same kind of restrictions. Where there is an absence of covenants in any written agreement between the parties, it will be appropriate to consider under Chapter I guidance whether there is, in practice, the equivalent of a maintenance covenant between the parties and the consequential impact upon the pricing of the loan.

C.1.1.6. Guarantees

10.87. A guarantee from another party may be used to support the borrower's credit. A lender placing reliance on a guarantee or guarantees would need to evaluate the guarantor(s) in a similar way to that in which it evaluates the original borrower. For the lender to take a guarantee into account in setting or adjusting the terms and conditions of a loan, it would need to be reasonably satisfied that the guarantor(s) would be able to meet any shortfall resulting from the borrower being unable to meet its obligations in full in the event of a default. Guarantees are discussed in more detail in Section D.

C.1.2. Determining the arm's length interest rate of intra-group loans

10.88. The following paragraphs present different approaches to pricing intra-group loans. As in any other transfer pricing situation, the selection of the most appropriate method should be consistent with the actual transaction as accurately delineated, in particular, through a functional analysis (see Chapter II).

C.1.2.1. Comparable uncontrolled price method (CUP method)

10.89. Once the actual transaction has been accurately delineated, arm's length interest rates can be sought based on consideration of the credit rating of the borrower or the rating of the specific issuance taking into account all of the terms and conditions of the loan and comparability factors.

10.90. The widespread existence of markets for borrowing and lending money and the frequency of such transactions between independent borrowers and lenders, coupled with the widespread availability of information and analysis of loan markets may make it easier to apply the CUP method to financial transactions than may be the case for other types of transactions. Information available often includes details on the characteristics of the loan and the credit rating of the borrower or the rating of the specific issuance. Characteristics which will usually increase the risk for the lender, such as long maturity dates, absence of security, subordination, or application of the loan to a risky project, will tend to increase the interest rate. Characteristics which limit the lender's risk, such as strong collateral, a high quality guarantee, or restrictions on future behaviour of the borrower, will tend to result in a lower interest rate.

10.91. The arm's length interest rate for a tested loan can be benchmarked against publicly available data for other borrowers with the same credit rating for loans with sufficiently similar terms and conditions and other comparability factors. With the extent of competition often present within lending markets, it might be expected that, given the characteristics of the loan (amount, maturity, currency, etc.) and the credit rating of the borrower or the rating of the specific issuance (see Section C.1.1.2.), there would be a single rate at which the borrower could obtain funds and a single rate at which a lender could invest funds to obtain an appropriate reward. In practice, however, there is unlikely to be a single "market rate" but a range of rates although competition between lenders and the availability of pricing information will tend to narrow the range.

10.92. In the search for comparability data, a comparable is not necessarily restricted to a stand-alone entity. In examining commercial loans, where the potentially comparable borrower is a member of an MNE group and has borrowed from an independent lender, provided all other economically relevant conditions are sufficiently similar, a loan to a member of a different MNE group or between members of different MNE groups could be a valid comparable.

10.93. Arm's length interest rates can also be based on the return of realistic alternative transactions with comparable economic characteristics. Depending on the facts and circumstances, realistic alternatives to intra-group loans could be, for instance, bond issuances, loans which are uncontrolled transactions, deposits, convertible debentures, commercial papers, etc. In the evaluation of those alternatives as potential comparables it is important to bear in mind that, based on facts and circumstances, comparability adjustments may be required to eliminate the material effects of differences between the controlled intra-group loan and the selected alternative in terms of, for instance, liquidity, maturity, existence of collateral or currency.

10.94. When considering issues of comparability, the possibility of internal CUPs should not be overlooked.

10.95. Whereas it is unlikely that an MNE group's average interest rate paid on its external debt meets the comparability requirements to be considered as an internal CUP, it may be possible to identify potential comparable loans within the borrower's or its MNE group's financing with an independent lender as the counterparty. As with external CUPs, it may be necessary to make appropriate adjustments to improve comparability. See Example 1 at 1.164 - 1.166.

C.1.2.2. Loan fees and charges

10.96. In considering arm's length pricing of loans, the issue of fees and charges in relation to the loan may arise. Independent commercial lenders will sometimes charge fees as part of the terms and conditions of the loan, for example arrangement fees or commitment fees in relation to an undrawn facility. If such charges are seen in a loan between associated enterprises, they should be evaluated in the same way as any other intra-group transaction. In doing so, it must be borne in mind that independent lenders' charges will in part reflect costs incurred in the process of raising capital and in satisfying regulatory requirements, which associated enterprises might not incur.

C.1.2.3. Cost of funds

10.97. In the absence of comparable uncontrolled transactions, the cost of funds approach could be used as an alternative to price intra-group loans in some circumstances. The cost of funds will reflect the borrowing costs incurred by the lender in raising the funds to lend. To this would be added the expenses of arranging the loan and the relevant costs incurred in servicing the loan, a risk premium to reflect the various economic factors inherent in the proposed loan, plus a profit margin, which will generally include the lender's incremental cost of the equity required to support the loan.

10.98. One consideration to be kept in mind with the cost of funds approach is that it should be applied by considering the lender's cost of funds relative to other lenders operating in the market. The cost of funds can vary between different prospective lenders, so the lender cannot simply charge based on its cost of funds, particularly if there is a potential competitor who can obtain funds more cheaply. A lender in a competitive market may seek to price at the lowest possible rate in order to win business. In the commercial environment, this will mean that lenders drive operating costs as low as possible and seek to minimise the cost of obtaining funds to lend.

10.99. The application of the cost of funds approach requires consideration of the options realistically available to the borrower. On prevailing facts and circumstances, a borrowing MNE would not enter into a transaction priced under the cost of funds approach if it could obtain the funding under better conditions by entering into an alternative transaction.

10.100. In some intra-group transactions, the cost of funds approach may be used to price loans where capital is borrowed from an unrelated party which passes from the original borrower through one or more associated intermediary enterprises, as a series of loans, until it reaches the ultimate borrower. In such cases, where only agency or intermediary functions are being performed, as noted at paragraph 7.34, "it

may not be appropriate to determine the arm's length pricing as a mark-up on the costs of the services but rather on the costs of the agency function itself."

C.1.2.4. Credit default swaps

10.101. Credit default swaps reflect the credit risk linked to an underlying financial asset. In the absence of information regarding the underlying asset that could be used as a comparable transaction, taxpayers and tax administrations may use the spreads of credit default swaps to calculate the risk premium associated to intra-group loans.

10.102. As financial instruments traded in the market, credit default swaps may be subject to a high degree of volatility. This volatility may affect the reliability of credit default swaps as proxies to measure the credit risk associated to a particular investment in isolation, since the credit default spreads may reflect not only the risk of default but also other non-related factors such as the liquidity of the credit default swaps contracts or the volume of contracts negotiated. Those circumstances could lead to situations where, for instance, the same instrument may have different credit default swaps spreads.

10.103. Accordingly, the use of credit default swaps to approximate the risk premium associated to intra-group loans will require careful consideration of the above-mentioned circumstances to arrive at an arm's length interest rate.

C.1.2.5. Economic modelling

10.104. Certain industries rely on economic models to price intra-group loans by constructing an interest rate as a proxy to an arm's length interest rate.

10.105. In their most common variation, economic models calculate an interest rate through a combination of a risk-free interest rate and a number of premiums associated with different aspects of the loan – e.g. default risk, liquidity risk, expected inflation or maturity. In some instances, economic models would also include elements to compensate the lender's operational expenses.

10.106. The reliability of economic models' outcomes depends upon the parameters factored into the specific model and the underlying assumptions adopted. In evaluating the reliability of economic models as an approach to pricing intra-group loans it is important to note that economic models' outcomes do not represent actual transactions between independent parties and that, therefore, comparability adjustments would be likely required. However, in situations where reliable comparable uncontrolled transactions cannot be identified, economic models may represent tools that can be usefully applied in identifying an arm's length price for intra-group loans, subject to the same constraints regarding market conditions discussed in paragraph 10.98.

C.1.2.6. Bank opinions

10.107. In some circumstances taxpayers may seek to evidence the arm's length rate of interest on an intra-group loan by producing written opinions from independent banks, sometimes referred to as a "bankability" opinion, stating what interest rate the bank would apply were it to make a comparable loan to that particular enterprise.

10.108. Such an approach would represent a departure from an arm's length approach based on comparability since it is not based on comparison of actual transactions. Furthermore, it is also important to bear in mind the fact that such letters do not constitute an actual offer to lend. Before proceeding to make a loan, a commercial lender will undertake the relevant due diligence and approval processes that would precede a formal loan offer. Such letters would not therefore generally be regarded as providing evidence of arm's length terms and conditions.

C.2. Cash pooling

C.2.1. Cash pooling structures

10.109. The use of a cash pool is popular among multinational enterprises as a way of achieving more efficient cash management by bringing together, either physically or notionally, the balances on a number of separate bank accounts. Depending on the particular arrangements in place, a cash pool can help to achieve more effective liquidity management, whereby reliance on external borrowing can be reduced or, where there is a cash surplus, an enhanced return may be earned on any aggregated cash balance. Financing costs may also be reduced by eliminating the bank spread embedded in the interest which would be payable or receivable on a number of separate debit or credit account balances and by reducing banking transaction costs.

10.110. In the context of this section, cash pooling is the pooling of cash balances as part of a short-term liquidity management arrangement. Cash pool arrangements are complex contracts which may involve controlled and uncontrolled transactions. For instance, one common structure is that the participating members of the MNE group conclude a contract with an unrelated bank that renders cash pooling services, and each participating member opens a bank account with that bank.

10.111. Although there are two basic types of cash pooling arrangements – physical and notional – other variations and combinations may be arranged to meet specific business needs. For example, a number of physical pools might be held, one for each currency in which the business operates, along with a notional pool which then combines those individual currency pools.

C.2.1.1. Physical pooling

10.112. In a typical physical pooling arrangement, the bank account balances of all the pool members are transferred daily to a single central bank account owned by the cash pool leader. Any account in deficit is brought to a target balance (usually zero) by a transfer from the master account to the relevant sub account. Depending on whether there is a surplus or a deficit after the members' accounts have been adjusted to the target balance, the cash pool leader may borrow from the bank to meet the net funding requirement of the pool or deposit any surplus as appropriate.

C.2.1.2. Notional pooling

10.113. In a notional cash pool, some of the benefits of combining credit and debit balances of several accounts are achieved without any physical transfer of balances between the participating members' accounts although the bank will usually require cross-guarantees from pool participants to enable the right to set off between accounts if necessary. The bank notionally aggregates the various balances of the individual accounts of participating members and pays or charges interest according to the net balance, either to a designated master account or to all participating accounts under a formula determined in the cash pooling agreement.

10.114. With no physical transfers of funds, the transactional costs of operating a notional pool are likely to be less than transactional costs of operating a physical pool. Functions carried out by the bank would be accounted for in the charges or interest rate of the bank. With minimal functions carried out by the pool leader (because functions are primarily performed by the bank), there will be little, if any, value added by the pool leader to be reflected in the intra-group pricing. An appropriate allocation of the benefit created as a result of the elimination of the bank spread and/or the optimisation of a single debit or credit position would need to consider the contribution or burden of each pool participant.

C.2.2. Accurate delineation of cash pooling transactions

10.115. The accurate delineation of the cash pooling transactions will depend on the particular facts and circumstances of each case. As cash pooling is not undertaken regularly, if at all, by independent enterprises, the application of transfer pricing principles requires careful consideration. As paragraph 1.11 notes “Where independent enterprises seldom undertake transactions of the type entered into by associated enterprises, the arm’s length principle can be difficult to apply because there is little or no direct evidence of what conditions would have been established by independent enterprises.”

10.116. The accurate delineation of cash pooling arrangements would need to take into account not only the facts and circumstances of the balances transferred but the wider context of the conditions of the pooling arrangement as a whole. For example, a cash pool is likely to differ from a straightforward overnight deposit with a bank or similar financial institution in that a cash pool member with a credit position is not depositing money as a transaction in isolation with a view to a simple depositor return.

10.117. The cash pool member is likely to be participating in providing liquidity as part of a broader group strategy, an arrangement in which the member can have a credit or debit position, which may include among its aims a range of benefits that can only be achieved as part of a collective strategy involving the pool members, done for the benefit of all of the pool participants, and the membership of which is limited to entities within the MNE group. Pool participants deposit cash to the pool (or withdraw cash from the pool), and not to (or from) a particular cash pool member.

10.118. No member of the pooling arrangement would expect to participate in the transaction if it made them any worse off than their next best option. The analysis of an MNE’s decision to participate in a cash pool arrangement should be done with reference to its options realistically available, taking into account that an MNE can obtain benefits as a member of the cash pool other than an improved interest rate (see paragraph 10.146).

10.119. In delineating the cash pool transactions, it may be that the savings and efficiencies achieved are determined to arise as a result of group synergies created through deliberate concerted action (as discussed in Section D.8 of Chapter I).

10.120. As indicated in paragraph 1.159, the determination of the results that arise from deliberate concerted group actions must be established through a thorough functional analysis. Accordingly, in the context of cash pooling arrangements, it is necessary to determine (i) the nature of the advantage or disadvantage, (ii) the amount of the benefit or detriment provided, and (iii) how that benefit or detriment should be divided among members of the MNE group.

10.121. An advantage of a cash pooling arrangement may be the reduction of interest paid or the increase of interest received, which results from netting credit and debit balances. The amount of that group synergy benefit, calculated by reference to the results that the cash pool members would have obtained had they dealt solely with independent enterprises, would generally be shared by the cash pool members, provided that an appropriate reward is allocated to the cash pool leader for the functions it provides in accordance with C.2.3.

10.122. Another key consideration in analysing intra-group funding arrangements which might be described as cash pooling are situations where members of an MNE group maintain debit and credit positions which, rather than functioning as part of a short-term liquidity arrangement, become more long term. It would usually be appropriate to consider whether, on accurate delineation, it would be correct to treat them as something other than a short-term cash pool balance, such as a longer term deposit or a term loan.

10.123. One of the practical difficulties in such situations will be deciding how long a balance should be treated as part of the cash pool before it could potentially be treated as something else, for example a term loan. As cash pooling is intended to be a short-term, liquidity-driven arrangement, it may be appropriate to

consider whether the same pattern is present year after year and to examine what policies the MNE group's financial management has in place, given that yield on cash balances is a key financial management issue.

10.124. A potential difficulty for tax administrations in analysing cash pooling arrangements is that the various entities in a cash pool may be resident across a number of jurisdictions, potentially making it difficult to access sufficient information to verify the position as set out by the taxpayer. It would be of assistance to tax authorities if MNE groups would provide information on the structuring of the pool and the returns to the cash pool leader and the members in the cash pool as part of their transfer pricing documentation. (See Annex I to Chapter V of these Guidelines about the information to be included in the master file).

10.125. Before any attempt is made to determine the remuneration of the cash pool leader and participants, it is central to the transfer pricing analysis to identify and examine under Chapter I guidance the economically significant risks associated to the cash pooling arrangement. These could include liquidity risk and credit risk. These risks should be analysed taking into account the short-term nature of the credit and debit positions within the cash pooling arrangement (see paragraph 10.123).

10.126. Liquidity risk in a cash pool arrangement arises from the mismatch between the maturity of the credit and debit balances of the cash pool members. Assuming the liquidity risk associated to a cash pool requires the exercise of control functions beyond the mere offsetting of the credit and debit positions of the cash pool members. Therefore, an analysis of the decision-making process related to the amounts of the debit and credit positions within the cash pool arrangement will be required to allocate the liquidity risk under Chapter I.

10.127. Credit risk refers to the risk of loss resulting from the inability of cash pool members with debit positions to repay their cash withdrawals. From the cash pool leader's perspective, there needs to be a probability for it to incur losses derived from the default of cash pool members with debit positions to bear the credit risk. Therefore, an examination under Chapter I guidance will be required to determine, under the specific facts and circumstances, which entity within the MNE group is exercising control functions and has the financial capacity to assume the credit risk associated with the cash pool arrangement.

C.2.3. Determining the arm's length price of cash pooling transactions

10.128. As with many types of financial transactions, different intent and understanding can be ascribed to the labels or descriptions attached to particular transactions. Each case must be considered on its own facts and circumstances and in each case accurate delineation of the actual transactions in accordance with the principles of Chapter I will be needed before any attempt to decide on an approach to pricing a transaction.

C.2.3.1. Rewarding the cash pool leader function

10.129. The appropriate reward of the cash pool leader will depend on the facts and circumstances, the functions performed, the assets used and the risks assumed in facilitating a cash pooling arrangement.

10.130. In general, a cash pool leader performs no more than a co-ordination or agency function with the master account being a centralised point for a series of book entries to meet the pre-determined target balances for the pool members. Given such a low level of functionality, the cash pool leader's remuneration as a service provider will generally be similarly limited.

10.131. Where accurate delineation of the actual transactions determines that a cash pool leader is carrying on activities other than coordination or agency functions, the pricing of such transactions would follow the approaches included in other parts of this guidance, as appropriate.

10.132. The following examples illustrate the principles described above.

Example 1

10.133. X is the parent entity of an MNE group which has subsidiaries H, J, K, and L which participate in a physical cash pooling arrangement with fellow subsidiary M acting as cash pool leader. All participants have the same functional currency and that is the only currency in the pool.

10.134. M sets up an intra-group cash pooling arrangement with an unrelated bank. Legal arrangements are put in place for all participants which allow transfers to or from M's cash concentration account to meet a specified target balance for each pool participant.

10.135. Under the cash management services agreement the bank makes any transfers necessary to meet the target balance for each pool participant with any net surplus deposited by M or any net overdrawn position being met by the bank lending to M. The facility that M may draw on is guaranteed by X. The third-party bank pays interest to, or receives interest from M based on the overall, pooled, position. In this instance, M receives surplus funds from MNE group members H and J and provides funds to MNE group members K and L which have a funding need. Interest on the balances of the pool participants is charged or paid in accordance with the pooling agreements.

10.136. As a result of the arrangements in place, M pays less interest to the bank or receives more interest than would have been the case absent the pooling arrangements.

10.137. A functional analysis shows that M is not subject to credit risk, which remains with the cash pool members, but merely performs a co-ordination function. Furthermore M is not performing the functions or assuming the risks that a bank would. Therefore M would not earn the kind of reward that a bank would earn such as retaining the interest spread between deposits and loans. Accordingly, M would earn a reward commensurate with the service functions it provides to the pool.

Example 2

10.138. Company T, a member of MNE Group Y, performs as the MNE group treasury entity and undertakes a range of different financial transactions both intra-group and externally. Company T's main purpose is to provide treasury services to the other entities within the MNE group including strategy and management of group liquidity. T is responsible for raising finance across the MNE group by issuing bonds or borrowing from third party banks and arranges intra-group loans to meet the funding needs of other group members as necessary.

10.139. As part of the group liquidity arrangements, T operates an MNE group cash pooling arrangement and is responsible for deciding how to invest surplus funds or fund any shortfall. T sets the intra-group interest rates and is at risk for any differences between the rates it sets with other group members and the rates at which it transacts with the independent lenders. T also bears credit risk, liquidity risk and currency risk for intra-group finance and decides on how or whether to hedge such risks.

10.140. The analysis under the guidance in Section D.1 of Chapter I indicates that the actual transactions should be accurately delineated as intra-group loans in the context of the treasury activities undertaken by Company T since Company T is performing functions and assuming risks that go beyond the coordination role of a cash pool leader. In particular, the functional analysis shows that Company T controls the financial risks contractually allocated to it and has the financial capacity to bear those risks.

10.141. Accordingly, T should be compensated for the functions it performs and the risks it assumes in accordance with the guidance in Section C.1. This may include earning part or all of the spread between the borrowing and lending positions which it adopts.

10.142. It should be borne in mind that the other group members which transact with T would still only do so if this left them no worse off than their next best option.

C.2.3.2. Rewarding the cash pool members

10.143. The remuneration of the cash pool members will be calculated through the determination of the arm's length interest rates applicable to the debit and credit positions within the pool. This determination will allocate the synergy benefits arising from the cash pool arrangement amongst the pool members and it will generally be done once the remuneration of the cash pool leader has been calculated.

10.144. Eventually, the remuneration of the cash pool members will depend upon the specific facts and circumstances and the functions, assets and risks of each of the pool members. Therefore, this guidance does not intend to provide a prescriptive approach for allocating the cash pooling benefits to the participating cash pool members in any given situation but rather lays down the principles that should guide that allocation.

10.145. Determining the arm's length interest rates for the cash pool intra-group transactions may be a difficult exercise due to the lack of comparable arrangements between unrelated parties. In this context, banking arrangements involving the cash pool leader, taking into account functional differences between the bank and the cash pool leader, and the options realistically available to the cash pool members may inform the identification of comparable interest rates in the transfer pricing analysis.

10.146. It is expected that all cash pool participants will be better off than in the absence of the cash pool arrangement. Under prevailing facts and circumstances that could imply, for instance, that all cash pool participants would benefit from enhanced interest rates applicable to debit and credit position within the cash pooling arrangement compared to the rates that they would expect to obtain from borrowing or depositing cash outside of the pool. However, it is important to note that cash pool members might be willing to participate in cash pool arrangements to access benefits from the membership of the cash pool other than an enhanced interest rate like, for instance, access to a permanent source of financing; reduced exposure to external banks; or access to liquidity that may not be available otherwise.

C.2.3.3. Cash pooling guarantees

10.147. As part of the cash pooling arrangement, cross-guarantees and rights of set-off between participants in the cash pool may be required. This raises the question of whether guarantee fees should be payable. It will always be appropriate to consider the particular facts and circumstances in any situation but there are certain factors which are likely to be common to many cash pools: there will be numerous members of the pool, there may be both entities with debit positions and entities with credit positions in the pool, each pool member may have a different stand-alone credit rating, and the pooling agreement with the bank is likely to require full cross-guarantees and rights of set-off between all pool participants.

10.148. These cross-guarantees and set-off rights are a feature of an arrangement which would not occur between independent parties. Each guarantor is providing a guarantee for all members of the pool but will not have control over membership of the pool, has no control over the quantum of the debt which it is guaranteeing, and may not be able to access information on the parties for whom it is providing a guarantee. With other parties providing guarantees on the same loans, it may not be possible for the guarantor to evaluate its real risk in the event of a default. Thus, the practical result of the cross-guaranteeing arrangement is such that the formal guarantee may represent nothing more than an acknowledgement that it would be detrimental to the interests of the MNE group not to support the performance of the cash pool leader and so, by extension, the borrower. In such circumstances the guaranteed borrower may not be benefitting beyond the level of credit enhancement attributable to the implicit support of other group members. If the prevailing facts and circumstances support such a conclusion, no guarantee fee would be due, and any support, in case of a default from another group member, should be regarded as a capital contribution.

C.3. Hedging

10.149. Intra-group financial transactions may include instruments by which risk is transferred within the MNE group. For example, hedging arrangements 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. An independent entity may decide to assume such risks or hedge against them according to its own policies. However, in an MNE group, such risks might be treated differently depending on the MNE group's approach to risk management and hedging.

10.150. Often an MNE group will centralise treasury functions and implement risk mitigation strategies relating to interest rate and currency risks in order to improve efficiency and effectiveness with the result that individual entities may not contractually enter into hedging arrangements although their risk is hedged from the perspective of the MNE as a whole.

10.151. Possible mechanisms by which an MNE group may centralise the hedging of risk include:

- delegation of responsibility for hedging to an MNE group treasury entity, with the hedging contracts arranged for and in the name of the relevant operating companies;
- delegation of responsibility for hedging to an MNE group treasury entity, with the hedging contracts made by and in the name of another MNE group entity;
- identification of the existence of natural hedges within the MNE group, in which case no formal hedging contracts are made.

10.152. Where the centralised treasury function arranges a hedging contract that the operating entity enters into, that centralised function can be seen as providing a service to the operating entity, for which it should receive compensation on arm's length terms.

10.153. More difficult transfer pricing issues may arise, however, if the contract instrument is entered into by the treasury entity or another MNE group entity, with the result that the positions are not matched within the same entity, although the MNE group position is protected. Where off-setting hedging contract instruments exist within the MNE group but not within the same entity, or where contract instruments do not exist within the MNE group but the MNE group position is protected (as may be the case with a natural hedge, for example), it would be inappropriate to match the hedges within the same entity or recognise hedging transactions where written contracts do not exist without a comprehensive analysis of the accurate delineation of the actual transactions under Section D.1 of Chapter I (for example, the existence of a deliberate concerted action to engage in a hedge of a specific risk) and the commercial rationality of the transactions under Section D.2 of Chapter I.

D. Financial guarantees

10.154. This section considers financial guarantees on certain intra-group transactions. To consider any transfer pricing consequences of a financial guarantee, it is first necessary to understand the nature and extent of the obligations guaranteed and the consequences for all parties, accurately delineating the actual transaction in accordance with Section D.1 of Chapter I.

10.155. In general, a financial guarantee provides for the guarantor to meet specified financial obligations in the event of a failure to do so by the guaranteed party. There are various terms in use for different types of credit support from one member of an MNE group to another. At one end of the spectrum is the formal written guarantee and at the other is the implied support attributable solely to membership in the MNE group. In the context of this section, a guarantee is 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. The situation likely to be encountered most frequently in a transfer pricing context is that in which an associated enterprise (guarantor) provides a guarantee on a loan taken out by another associated enterprise from an unrelated lender.

D.1. Accurate delineation of financial guarantees

D.1.1. Economic benefit derived from a financial guarantee

10.156. The accurate delineation of financial guarantees requires initial consideration of the economic benefit arising to the borrower beyond the one that derives from passive association, as explained in the Section C.1.1.3.

10.157. From the borrower perspective, a financial guarantee may affect the terms of the borrowing – for instance, the existence of a guarantee may allow the guaranteed party to obtain a more favourable interest rate since the lender has access to a wider pool of assets –, or the amount of the borrowing – for instance, enabling the borrower to access a larger amount of funds.

D.1.1.1. Enhancement of the terms of the borrowing

10.158. From the perspective of a lender, the consequence of one or more explicit guarantees is that the guarantor(s) are legally committed; the lender's risk would be expected to be reduced by having access to the assets of the guarantor(s) in the event of the borrower's default. Effectively, this may mean that the guarantee allows the borrower to borrow on the terms that would be applicable if it had the credit rating of the guarantor rather than the terms it could obtain based on its own, non-guaranteed, rating. The principles and methodologies of pricing a guarantee in these circumstances are similar to those explained for loan pricing in Section C.1.2.

10.159. Where the effect of an intra-group guarantee as accurately delineated is to reduce the cost of debt-funding for the borrower, it might be prepared to pay for that guarantee, provided it was in no worse a position overall. In considering the borrower's overall financial position as a result of the guarantee, its cost of borrowing with the guarantee (including the cost of the guarantee and any associated costs of arranging the guarantee) would be measured against its non-guaranteed cost of borrowing, taking into

account any implicit support. Borrowing with a guarantee might also affect terms and conditions of the loan other than price; each case will depend on its own facts and circumstances.

10.160. Alternatively, Chapter I analysis may indicate that the purported financial guarantee is not providing any benefit to the borrower but merely recognising the benefit that the guaranteed party would have obtained in any case by being part of the MNE group. In such situations, based on facts and circumstances, an unrelated enterprise in comparable circumstances would be unwilling to pay for the provision of a financial guarantee, and the guarantor would be found as providing no more than an administrative service to the borrower (see paragraph 10.164 and guidance in Chapter VII).

D.1.1.2. Access to a larger amount of borrowing

10.161. Where the effect of a guarantee is to permit a borrower to borrow a greater amount of debt than it could in the absence of the guarantee, the guarantee is not simply supporting the credit rating of the borrower but could be acting both to increase the borrowing capacity and to reduce the interest rate on any existing borrowing capacity of the borrower. In such a situation there may be two issues – whether a portion of the loan from the lender to the borrower is accurately delineated as a loan from the lender to the guarantor (followed by an equity contribution from the guarantor to the borrower), and whether the guarantee fee paid with respect to the portion of the loan that is respected as a loan from the lender to the borrower is arm's length. The conclusion of an analysis of such transactions may be, taking into account the full facts and circumstances, that the evaluation of the guarantee fee should be limited to a fee on the portion that has been accurately delineated as a loan, and the remainder of the loan granted should be regarded as effectively a loan to the guarantor followed by an equity contribution by the guarantor to the borrower.

D.1.2. Effect of group membership

10.162. This section elaborates on the effect of group membership on determining the arm's length price of financial guarantees, building upon the principles laid out in Section C.1.1.

10.163. By providing an explicit guarantee the guarantor is exposed to additional risk as it is legally committed to pay if the borrower defaults. Anything less than a legally binding commitment, such as a "letter of comfort" or other lesser form of credit support, involves no explicit assumption of risk. Each case will be dependent on its own facts and circumstances but generally, in the absence of an explicit guarantee, any expectation by any of the parties that other members of the MNE group will provide support to an associated enterprise in respect of its borrowings will be derived from the borrower's status as a member of the MNE group. For this purpose, whether a commitment from one MNE group member to another MNE group member to provide funding to meet its loan obligations, constitutes a letter of comfort or a guarantee depends on all the facts and circumstances, including whether the commitment provides the creditor relevant legal rights to enforce the commitment. The benefit of any such support attributable to the borrower's MNE group member status would arise from passive association and not from the provision of a service for which a fee would be payable. See paragraph 7.13 on passive association.

10.164. A borrower would not generally be prepared to pay for a guarantee if it did not expect to obtain an appropriate benefit in return. Even an explicit guarantee will not necessarily confer a benefit on the borrower; for example, banking covenants applicable to a parent or other MNE group member's debt facilities can include the default of another MNE group member as an event that may cause the termination of a facility or other adverse consequences. Other legal, financial or operational ties may mean that it would not be possible to abandon the borrower if it encounters financial difficulty without the MNE group suffering a credit rating downgrade. Any of these circumstances may produce the practical result that MNE group members are financially interdependent quite apart from any formal guarantee arrangement, so that the economic risk of the guarantor may not change materially on it giving an explicit guarantee. In other words, the formal guarantee may represent nothing more than an acknowledgement that it would be detrimental

to the interests of the MNE group not to support the performance of the borrower. In such circumstances the guaranteed borrower is not benefitting beyond the level of credit enhancement attributable to the implicit support of other MNE group members and no guarantee fee would be due.

10.165. A similar issue arises in respect of cross-guarantees, where two or more entities in an MNE group guarantee each other's obligations. From the lender's perspective, it has access to the assets of every cross-guaranteeing entity in the event of a default by a guaranteed borrower. This potentially gives the lender greater comfort than a single guarantee as it can choose where within the cross-guaranteeing MNE group it seeks, if necessary, to make its recoveries. The effect of a cross-guarantee from a borrower's perspective is that it now has multiple guarantees on its borrowings and may stand as guarantor for multiple borrowings itself. This can give rise to questions on how to evaluate each guarantee. Not only is this complex from the perspective of potentially large numbers of guarantees to be evaluated but also because each party providing a guarantee may in turn be guaranteed by the party for whom it is now acting as guarantor. Evaluating the effect of a cross-guarantee arrangement is difficult and as the number of parties involved increases, may be practically impossible. It may not be possible to determine the effect of the guarantee between any two parties where the same risk is subject to multiple guarantees. An analysis of the facts may lead to the conclusion that such an arrangement does not enhance the credit standing of an MNE group member beyond the level of passive association, in which case any support in the event of default from another MNE group member should then be regarded as a capital contribution.

D.1.3. Financial capacity of the guarantor

10.166. The examination of financial guarantees under accurate delineation needs also to consider the financial capacity of the guarantor to fulfill its obligations in case of default of the borrower. This requires an evaluation of the credit rating of the guarantor and the borrower, and of the business correlations between them.

10.167. A lender would benefit from the stronger credit rating of the guarantor (compared to the borrower's credit rating) and/or the guarantor's asset pool (in addition to the borrower's asset pool), and the borrower accordingly may expect a benefit in the form of a lower interest rate. Thus, based on facts and circumstances, a guarantee may provide a benefit to the borrower that has the same or higher credit rating as the guarantor, if the guarantee effectively allows the lender to access wider recourse and, therefore, reduces the interest rate despite the guarantor not having a higher credit rating. In determining the credit rating of the guarantor and the borrower, the effect of implicit support must be considered as explained in Section C.1.1.

10.168. Likewise, the financial capacity of the guarantor to meet its obligations requires an analysis of the correlation between the guarantor's and borrower's businesses. In situations where the guarantor and the borrower operate under similar market conditions, an adverse market event that affects the performance of the borrower and increases its risk of default might also affect the guarantor and its capacity to fulfill its obligations.

D.2. Determining the arm's length price of guarantees

10.169. This section describes a number of pricing approaches for those circumstances where a guarantee is found to be appropriate. However, when the accurate delineation of the actual transaction indicates that the purported guarantee is not a guarantee, other pricing approaches should be considered, in particular the guidance in Chapter VII. As in any other transfer pricing situation, the selection of the most appropriate method should be consistent with the actual transaction as accurately delineated, in particular, through a functional analysis. (See Chapter II).

D.2.1. CUP method

10.170. The CUP method could be used where there are external or internal comparables; independent guarantors providing guarantees in respect of comparable loans to other borrowers or where the same borrower has other comparable loans which are independently guaranteed.

10.171. In considering whether controlled and uncontrolled transactions are comparable, regard should be had to all the factors which may affect the guarantee fee including: the risk profile of the borrower, terms and conditions of the guarantee, term and conditions of the underlying loan (amount, currency, maturity, seniority etc.), credit rating differential between guarantor and guaranteed party, market conditions, etc. When available, uncontrolled guarantees are the most reliable comparable to determine arm's length guarantee fees.

10.172. The difficulty with using the CUP method is that publicly available information about a sufficiently similar credit enhancing guarantee is unlikely to be found between unrelated parties given that unrelated party guarantees of bank loans are uncommon.

10.173. An independent entity providing a financial guarantee would expect to receive a fee to compensate it for the risk it is taking in accepting the contingent liability and to reflect any value it is providing to the borrower in respect of the guarantee. However, it must be borne in mind that an independent guarantor's charges will in part reflect costs incurred in the process of raising capital and in satisfying regulatory requirements. Those are costs which associated enterprises might not incur.

D.2.2. Yield approach

10.174. This approach quantifies the benefit that the guaranteed party receives from the guarantee in terms of lower interest rates. The method calculates the spread between the interest rate that would have been payable by the borrower without the guarantee and the interest rate payable with the guarantee. The first step is to determine the interest rate that would have been payable by the borrower on its own merits, taking into account the impact of implicit support as a result of its group membership. See Section C.1.2.

10.175. The next step would be to determine, by a similar process (unless directly observable in the case of a loan from a third party), the interest rate payable with the benefit of the explicit guarantee. The interest spread can be used in quantifying the benefit gained by the borrower as a result of the guarantee. In determining the extent of the benefit provided by the guarantee, it is important to distinguish the impact of an explicit guarantee from the effects of any implicit support as a result of group membership. See Example 2 at paragraph 1.167. The benefit to be priced is not the difference between the cost to the unguaranteed borrower on a stand-alone basis and the cost with the explicit guarantee but the difference between the cost to the borrower after taking into account the benefit of any implicit support and the cost with the benefit of the explicit guarantee.

10.176. The benefit of implicit support will be the difference between the borrowing terms attainable by the borrowing entity based on its credit rating as a member of the MNE group and those attainable on the basis of the stand-alone credit rating it would have had if it were an entirely unaffiliated enterprise. If the borrower has its own independent credit rating from an unrelated credit rating agency, this will usually reflect its membership of the MNE group and so ordinarily no adjustment would be needed to this credit rating to reflect implicit support.

10.177. The result of this analysis sets a maximum fee for the guarantee (the maximum amount that the recipient of the guarantee will be willing to pay), namely, the difference between the interest rate with the guarantee and the interest rate without the guarantee but with the benefit of implicit support (and taking into account any costs). The borrower would have no incentive to enter into the guarantee arrangement if, in total, it pays the same to the bank in interest and to the guarantor in fees as it would have paid to the bank in interest without the guarantee. Therefore this maximum fee does not of itself necessarily reflect

the outcome of a bargain made at arm's length but represents the maximum that the borrower would be prepared to pay.

D.2.3. Cost approach

10.178. This method aims to quantify the additional risk borne by the guarantor by estimating the value of the expected loss that the guarantor incurs by providing the guarantee (loss given default). Alternatively the expected cost could be determined by reference to the capital required to support the risks assumed by the guarantor.

10.179. There are a number of possible models for estimating the expected loss and capital requirement. Popular pricing models for this approach work on the premise that financial guarantees are equivalent to another financial instrument and pricing the alternative, for example, treating the guarantee as a put option and using option pricing models, credit default swap pricing models, etc. For instance, publicly available data of credit default swaps spreads may be used to approximate the default risk associated to the borrowing and, therefore, the guarantee fee. When using this type of data, the identification of the default event (e.g. bankruptcy) is central to the comparability analysis between the controlled transaction and the potentially comparable credit default swap (See Section C.1.2, on the reliability of credit default swap data).

10.180. Pricing under each model will be sensitive to the assumptions made in the modelling process. Whatever valuation model is used, the evaluation of cost method sets a minimum fee for the guarantee (the minimum amount that the provider of the guarantee will be willing to accept) and does not of itself necessarily reflect the outcome of a bargain made at arm's length. The arm's length amount should be derived from a consideration of the perspectives (taking into account options realistically available) of the borrower and guarantor.

D.2.4. Valuation of expected loss approach

10.181. The valuation of expected loss method would estimate the value of a guarantee on the basis of calculating the probability of default and making adjustments to account for the expected recovery rate in the event of default. This would then be applied to the nominal amount guaranteed to arrive at a cost of providing the guarantee. The guarantee could then be priced based on an expected return on this amount of capital based on commercial pricing models such as the Capital Asset Pricing Model (CAPM).

D.2.5. Capital support method

10.182. The capital support method may be suitable where the difference between the guarantor's and borrower's risk profiles could be addressed by introducing more capital to the borrower's balance sheet. It would be first necessary to determine the credit rating for the borrower without the guarantee (but with implicit support) and then to identify the amount of additional notional capital required to bring the borrower up to the credit rating of the guarantor. The guarantee could then be priced based on an expected return on this amount of capital to the extent that the expected return so used appropriately reflects only the results or consequences of the provision of the guarantee rather than the overall activities of the guarantor-enterprise.

D.3. Examples

10.183. The following examples build on the principles discussed in Section D.8 of Chapter I, in particular in paragraph 1.167.

D.3.1. Example 1

10.184. Company M, the parent entity of an MNE group, maintains an AAA credit rating based on the strength of the MNE group's consolidated balance sheet. Company D, a member of the same MNE group, has a credit rating of only BBB on a stand-alone basis, and needs to borrow EUR 10 million from an independent lender.

10.185. Assume that the accurate delineation of the actual transaction shows that the effect of passive association raises Company D's credit standing from BBB to A, and that the provision of the explicit guarantee additionally enhances the credit standing of Company D to AAA. Assume further that independent lenders charge an interest rate of 8% to entities with a credit rating of A, and of 6% to entities with a credit rating of AAA. Assume further that Company M charges Company D a fee of 3% for the provision of the guarantee so the guarantee fee more than completely offsets the benefit of Company D's enhanced credit standing derived from the provision of such guarantee.

10.186. In that situation, the analysis under Chapter I may indicate that an independent enterprise borrowing under the same conditions as Company D would not be expected to pay a guarantee fee of 3% to Company M for the provision of the explicit guarantee since Company D is better off in the absence of the guarantee.

D.3.2. Example 2

10.187. Consider the same fact pattern as described in Example 1, but in this case assume that under the guidance in Section D.2, comparable uncontrolled transactions can be identified showing that the arm's length price of a comparable guarantee would be in the range of 1% to 1.5%.

10.188. The accurate delineation of the actual transaction indicates that the enhancement of Company D's credit standing from A to AAA is attributable to a deliberate concerted group action, i.e. the guarantee provided by Company M. Company D would be expected to be willing to pay an arm's length guarantee fee to Company M for the provision of the explicit guarantee since Company D is better off than in the absence of the guarantee.

E. Captive insurance

E.1. Definition and rationale for a captive insurance and reinsurance

10.189. There are many ways that MNE groups may manage risks within the group. For example, they may choose to set aside funds in reserves, pre-fund potential future losses, self-insure, acquire insurance from third parties or simply elect to retain the specific risk. In some other cases an MNE group may choose to consolidate certain risks through a so-called “captive” insurance.

10.190. In this guidance, the term captive insurance is intended to refer to an insurance undertaking or entity substantially all of whose insurance business is to provide insurance policies for risks of entities of the MNE group to which it belongs.

10.191. In contrast, in this guidance the term reinsurance refers to a reinsurance undertaking or entity the purpose of which is to provide reinsurance policies for risks of unrelated parties that are in the first instance insured by entities of the MNE group to which it belongs.⁵ (The situation in which risks of entities within an MNE group are insured in the first instance by an unrelated party but then reinsured by an entity within the MNE group is discussed in Section E.2.4).

10.192. Captive insurances may be subject to regulation in the same way as other insurance and reinsurance companies⁶. The precise requirements of insurance regulation will vary from one jurisdiction to the next but typically include certain actuarial, accounting and capital requirements. While insurance regulation is intended to protect policyholders, local regulators may impose a lighter regulatory regime where the captive insurance provides insurance exclusively to members of the MNE group.

10.193. There are multiple reasons for an MNE group to use a captive insurance such as: to stabilise premiums paid by entities within the MNE group; to benefit from tax and regulatory arbitrage; gaining access to reinsurance markets; mitigating the volatility of market capacity; or because the MNE group considers that retaining the risk within the group is more cost effective.

10.194. Another possible reason for the use of a captive insurance by an MNE group in addition to those listed is the difficulty or impossibility of getting insurance coverage for certain risks. Where such risks are insured by a captive insurance this may raise questions as to whether an arm’s length price can be determined and the commercial rationality of such an arrangement (see Section D.2 of Chapter I).

⁵ For this section, insurance and reinsurance undertakings are defined by reference to insurance and reinsurance business as described in Part IV of the *Report on the Attribution of Profits to Permanent Establishments*. This description, which covers the general scheme of insurance, is not intended to exclude from this guidance risks which the insured has some ability to influence, such as product liability risk.

⁶ See paragraph 10.3.

E.2. Accurate delineation of captive insurance and reinsurance

10.195. The principles of accurate delineation of the actual transactions and allocation of risk detailed in Chapter I of these Guidelines apply to captive insurance and reinsurance in the same manner that they apply to any other intra-group transactions. However, this section addresses mainly captive insurance (as well as captive reinsurance - fronting). In particular, it should be borne in mind that:

- the carrying on of risk mitigation functions falls within the wider concept of risk management but not within that of control of risk (see paragraphs 1.61 and 1.65);
- there is a difference between the specific risk being insured (the party taking the decision to insure – i.e. mitigate – or not, controls this risk; that party will usually be the insured but may be another entity within the MNE group) and the risk taken on by the insurer in providing insurance to the insured party.

10.196. Although the quantum of the risk reward for the insured party and the insurer might be dependent upon exactly the same events in both cases, that quantum could be significantly different (for example, if the insured risk materialises and a claim is made, the insured party could potentially receive significant upside relative to the premium paid whereas the insurer's income will be limited to the insurance premiums and investment income it has received regardless of the quantum of risk reward received by the insured party).

10.197. The insurer is carrying out a risk mitigation function in respect of the insured party's risk but not actually assuming that risk. It is assuming the risk of insuring (i.e. mitigating) the insured party's risk. That risk will be controlled by either the insurer or (more likely in a captive insurance scenario) another entity within the MNE group that makes the decision that the risk should be assumed by the insurer. (See paragraph 10.223). The insurer (or other entity) can make decisions as to how to respond to this risk – in accordance with paragraph 1.61 (ii) – by, for example, further diversifying its portfolio of insured risks or by reinsuring.

10.198. Captive insurances may be self-managed from within the MNE group, or managed by an unrelated service provider (often a division of a large insurance broker). Typically this management would include ensuring compliance with local law, issuing policy documents, collecting premiums, paying claims, preparing reports and providing local directors. If the captive insurance is managed from within the MNE group it is necessary to determine which entity manages it (if such management is not exercised by employees of the captive insurance) and to appropriately reward that management.

10.199. A frequent concern when considering the transfer pricing of captive insurance transactions is whether the transaction concerned is genuinely one of insurance, i.e. whether a risk exists and, if so, whether it is allocated to the captive insurance in light of the facts and circumstances. The following are indicators, all or substantially all of which would be found if the captive insurance was found to undertake a genuine insurance business:

- there is diversification and pooling of risk in the captive insurance;
- the economic capital position of the entities within the MNE group has improved as a result of diversification and there is therefore a real economic impact for the MNE group as a whole;
- both the captive insurance and any reinsurer are regulated entities with broadly similar regulatory regimes and regulators that require evidence of risk assumption and appropriate capital levels;
- the insured risk would otherwise be insurable outside the MNE group;
- the captive insurance has the requisite skills, including investment skills, and experience at its disposal (see paragraph 10.213);
- the captive insurance has a real possibility of suffering losses.

10.200. In order to consider the transfer pricing implications of a transaction with a captive insurance, it is first necessary to identify the commercial or financial relations between the associated enterprises and the conditions and economically relevant circumstances attaching to those relations in order that the actual transaction is accurately delineated. The initial question will therefore be whether the transaction under consideration is one of insurance, as defined above. This analysis requires consideration of whether the risk has been assumed by the insurer and whether risk diversification has been achieved.

E.2.1. Assumption of risk and risk diversification

10.201. Insurance requires the assumption of insurance risk by the insurer. In the event of a claim, the insured does not suffer the financial impact of a potential economic loss to the extent that insurance risk has been assumed by the insurer, because the loss is offset by the insurance payment.

10.202. From the captive insurance's perspective, the fact that the captive insurance is exposed to the downside outcome of the insured risk and to the possibility of significant loss could be an indicator that the insurance risk has been assumed by the captive insurance. In addition, the assumption of the insurance risk can only take place if the captive insurance has a realistic prospect of being able to satisfy claims in the event of the risk materialising, i.e. the captive insurance needs to have access to funding to bear the consequences of the playing out of the insured risk. Determining whether the captive insurance has the financial capacity to assume the risk requires consideration of the capital readily available to the captive and its options realistically available. In particular, when the captive insurance invests the premiums into the insured entities within the MNE group, the relation between the captive insurance's capacity to satisfy the claims and the financial positions of those other MNEs would be central to Chapter I analysis.

10.203. Insurance also requires risk diversification. Risk diversification is the pooling of a portfolio of risks by which the insurer achieves an efficient use of capital. Large commercial insurers rely on having sufficiently large numbers of policies with similar probabilities of loss to allow statistical laws of averages to apply and permit accuracy of modelling of the likelihood of claims. The insurer also maintains a portfolio of risks for which it has a capital reserve based on regulatory needs and rating agency requirements.

10.204. Risk diversification is at the core of insurance business. Combining non-correlated risk and varied geographical exposures lead to an efficient use of capital, allowing the insurer to have a lower level of capital than that the insured parties would have been required to maintain to face the consequences of risk materialisation.

10.205. A captive insurance may achieve risk diversification by insuring not only internal risks of its MNE group, but also including within its portfolio a significant proportion of external, non-group risks (while still staying within the definition of captive insurance in paragraph 10.190).

10.206. Alternatively, risk diversification may be achieved by covering internal risks when the breadth and depth of the MNE group allows the captive insurance to cover non-correlated or less than fully correlated risks and varied geographical exposures. Situations where a captive insurance only covers internal risks require a thorough analysis under Chapter I guidance to determine whether risk diversification actually occurred, i.e. whether a sufficient quantum and variety of risks are covered by the captive insurance. In this context, determining whether risk diversification occurred is a question of threshold and the conclusion of the analysis would be dependent upon the specific facts and circumstances.

10.207. Notably, internal risk diversification might generate lower capital efficiencies than those achieved through external risk diversification. Therefore, the remuneration of a captive insurance that exclusively covers internal risks might be lower than when risk diversification is achieved by insuring external, non-group risks, or by reinsuring a significant proportion of the MNE group's risks outside of the group. In addition, when the accurate delineation of the actual transaction indicates that the capital efficiencies achieved through the pooling of internal risks in the captive insurance arise from the result of group synergies created through deliberate concerted group actions, the benefits of such synergies should

generally be shared by the MNEs that contributed to the creation of those synergies (see Section D.8 of Chapter I and paragraphs 10.222 and 10.223).

10.208. In situations where the captive insurance lacks the scale to achieve significant risk diversification or lacks sufficient reserves to meet additional risks represented by the relatively less diversified portfolio of the MNE group, the accurate delineation of the actual transaction may indicate that the captive insurance is operating a business other than an insurance one (see guidance in Chapter VII).

E.2.2. The assumption of the economically significant risks

10.209. In the process of accurately delineating the actual transaction involving a captive insurance, the economically relevant risks associated with issuing insurance policies, i.e. underwriting, must be identified with specificity. Part IV of the *Report on the Attribution of Profits to Permanent Establishments*⁷ provides a description of those risks that include, inter alia, insurance risk, commercial risk or investment risk. These descriptions remain valid for the purpose of this guidance.

10.210. The accurate delineation of the actual transaction in scenarios involving captive insurance requires identifying whether the captive insurance is performing control functions regarding the economically significant risks associated to the underwriting function - in particular the insurance risk - to determine whether those risks should be allocated to the captive.

10.211. Part IV of the *Report on the Attribution of Profits to Permanent Establishments* describes the activities that form part of the underwriting function such as setting the underwriting policies, classifying and selecting the insured risk, setting the premiums (pricing), the analysis of risk retention and the acceptance of the insured risk. These activities would imply, inter alia, deciding to underwrite a risk or not and under what terms and conditions, or whether reinsurance protection should be purchased or not. On prevailing facts and circumstances, those activities may be considered as control functions as described in paragraph 1.65 of Chapter I and, if exercised by a captive insurance that possesses the financial capacity to assume the risk, would lead to the allocation of risk to the captive insurance under Chapter I analysis. Notably, the mere setting of parameters or the policy environment for the risk would not qualify as control functions for this purpose (see paragraph 1.66 of Chapter I, and paragraph 94 of Part IV of the *Report on the Attribution of Profits to Permanent Establishments*).

10.212. When the captive insurance does not have access to the appropriate skills, expertise and resources and, therefore, the captive insurance is not found to exercise control functions related to the risks associated to the underwriting, an analysis under Chapter I, based on facts and circumstances, may conclude that the risk has not been assumed by the captive insurance or that another MNE is exercising these control functions. In this latter case, the return derived from the investment of the premiums would be allocated to the member(s) of the MNE group that are assuming the risk associated with the underwriting in accordance with the guidance in Chapter I.

E.2.3. Outsourcing the underwriting function

10.213. In many cases, outsourcing certain aspects of the underwriting function would be inconsistent with the minimum regulatory standards required to operate an insurance business. However, in those situations where the captive insurance is permitted to outsource some of the activities that constitute the underwriting function (for instance, a captive insurance may be allowed to outsource the acceptance of insurance risk to an associated enterprise that acts as a broker and receives an arm's length remuneration), special consideration of the retention by the captive insurance of the control functions would be required in order to conclude whether the risk is allocated to the captive insurance. A captive insurance

⁷ Report on the Attribution of Profits to Permanent Establishments, approved by the Committee on Fiscal Affairs on 22 June 2010 and by the Council for publication on 22 July 2010.

that outsources all aspects of the underwriting process without performing control functions would not assume the insurance risk under Chapter I analysis.

E.2.4. Reinsurance captives – Fronting

10.214. A reinsurance captive is a particular type of captive insurance which does not issue policies directly but operates as a reinsurance under an arrangement known as “fronting”. Captive insurance may not be able to underwrite insurance policies in the same way as traditional insurance companies. For instance, certain insurance risks must be placed with regulated insurers as a legal requirement. This may lead to the use of a fronting arrangement in which the first contract of insurance is between the insured member of an MNE group and an unrelated insurer (the fronter); the fronter then reinsures with the captive insurance most or all of the risk of the first contract. The fronter may remain responsible for claims handling and other administrative functions or these functions may be handled by a member of the same MNE group as the captive. The fronter retains a commission to cover its costs and to compensate for any portion of the insured risk which it retains. The majority of the fronter’s premium passes to the captive insurance as part of the reinsurance contract.

10.215. In accurately delineating fronting arrangements, the same principles stated for captive insurance apply. It is important to note, however, that fronting arrangements represent particularly complex controlled transactions to price as they involve the participation of a third party that is indifferent to the levels of the price of the insurance and reinsurance transactions. The key issues which are likely to arise in fronting cases are whether the transactions involved amount to genuine insurance or reinsurance and, if there is genuine insurance, whether the premiums payable (ultimately to the reinsurance captive) are on arm’s length terms.

E.3. Determining the arm’s length price of captive insurance and reinsurance

10.216. The following paragraphs outline different approaches to pricing intra-group transactions involving captive insurance and reinsurance. Each case must be considered on its own facts and circumstances and in each case accurate delineation of the actual transactions in accordance with the principles of Chapter I will be needed before any attempt to decide on an approach to pricing a transaction. As in any other transfer pricing situation, the most appropriate method should be selected under the guidance of Chapter II.

E.3.1. Pricing of premiums

10.217. Comparable uncontrolled prices may be available from comparable arrangements between unrelated parties. These may be internal comparables if the captive insurance has suitably similar business with unrelated customers, or there may be external comparables.

10.218. The application of the CUP method to a transaction involving a captive insurance may encounter practical difficulties to determine the need for and quantification of comparability adjustments. In particular, account should be taken of potential differences between the controlled and uncontrolled transactions that may affect the reliability of the comparables. Those differences may refer, for instance, to situations where the functional analysis indicates that a captive insurance performs less functions than a commercial insurer (e.g. a captive insurance that only insures internal risks within the MNE group may not need to perform distribution and sales functions). Similarly, differences between the captive insurance and the potential comparables in business volume or in the level of capital between the captive insurance and unrelated parties may require comparability adjustments (see paragraph 10.221).

10.219. Alternatively, actuarial analysis may be an appropriate method to independently determine the premium likely to be required at arm’s length for insurance of a particular risk. In setting prices for an

insurance premium, an insurer will seek to cover its expected losses on claims, its costs associated with writing and administering policies and dealing with claims, plus a profit to provide a return on capital, taking into account any investment income it expects to receive on the excess of premiums received less claims and expenses paid. The practical application of actuarial analysis may be a complex exercise. In evaluating the reliability of actuarial analysis to determine the arm's length price of premiums it is important to note that actuarial analyses do not represent actual transactions between independent parties and that, therefore, comparability adjustments would be likely required.

E.3.2. Combined ratio and return on capital

10.220. The remuneration of the captive insurance can be arrived at by considering the arm's length profitability of the captive insurance by reference to a two staged approach which takes into account both profitability of claims and return on capital. The first step would be to identify the captive insurance's combined ratio. This can be determined by expressing claims and expenses payable as a percentage of premiums receivable. The benchmarked combined ratio achieved by unrelated insurance companies indemnifying similar insurance risks can be identified. The benchmarked combined ratio can then be applied to the tested party's claims and expenses paid to arrive at an arm's length measure of annual premiums and thus underwriting profit (premiums receivable less claims and expenses). The second step is to assess the investment return achieved by the captive insurance against an arm's length return. This step requires two further considerations: (a) the amount of capital held by the captive insurance, and (b) to the extent to which the captive insurance invests in controlled investments (e.g. intra-group bonds, loans, etc.), the rate of investment return achieved by the captive insurance on those investments. The sum of underwriting profit from step one and investment income from step two gives total operating profit (see Section B.5 of Chapter III on multiple year data).

10.221. It is important to recognise that the capital adequacy requirements of a captive insurance are likely to be significantly lower than an insurer writing policies for unrelated parties. This factor should be considered and, if necessary, adjusted for in order to determine the appropriate level of capital to use when calculating the investment return. Differences in capital adequacy between captive insurance and arm's length insurers typically arise because of regulatory and commercial factors. Insurance regulators frequently set lower regulatory capital requirements for captive insurances. A primary commercial driver for arm's length insurers is capital efficiency. In order to attract investors and customers, arm's length insurers will target a strong credit rating by holding a level of operating capital which is in excess of the regulatory minimum. At the same time, arm's length insurers will attempt to maximise their return on capital results. They will try to hold the optimum amount of capital to meet these opposing drivers. Captive insurances have no commercial imperative to seek a credit rating nor to optimise their return on capital in order to attract investors. Reasonable adjustments may need to be made to ensure that the comparable investment return is restricted to the capital that the captive insurance needs under relevant regulatory requirements (plus a reasonable operating buffer to minimise the possibility of inadvertently breaching the regulatory requirement) to accept the insurance risk rather than the level of capital that might be needed by an independent insurer. Adjustments may be needed to account for differing capital adequacy requirements between different regulators and different categories of insurance business.

E.3.3. Group synergy

10.222. Where a captive insurance is used so that the MNE group can access the reinsurance market to divest itself of risk through insuring risk outside the MNE group, whilst making cost savings over using a third party intermediary, by pooling risks within the MNE group, the captive arrangement harnesses the benefits of collective negotiation on any reinsured risks and more efficient allocation of capital in respect of any risks retained. These benefits arise as a result of the concerted actions of the MNE policyholders and the captive insurance. The insured participants jointly contribute with the expectation that each of them

will benefit through reduced premiums. This is similar to the type of group-wide arrangements that might exist for other group functions such as purchasing of goods or services. Where the captive insurance insures the risk and reinsures it in the open market, it should receive an appropriate reward for the basic services it provides. The remaining group synergy benefit should be allocated among the insured participants by means of discounted premiums.

10.223. For example, a manufacturing MNE group has 50 subsidiaries in different locations around the world, all in locations with substantial risk of earthquake, each insures against earthquake damage at its manufacturing plant, with each plant in a different location, assessed on its individual level of risk. The MNE group sets up a captive insurance which accepts the risk from all of the subsidiaries and reinsures it with independent reinsurers. By bringing together a portfolio of insurance risks across different geographical zones, the MNE group already represents a diversified risk to the market. The synergy benefit arises from the collective purchasing arrangement, not from value added by the captive insurance. It should be allocated amongst the insured according to the level of premium they contributed.

E.3.4. Agency sales

10.224. Where an insurance contract is not sold directly from insurer to insured, recompense will usually be due to the party who arranges the original sale. In certain circumstances a higher rate of profit might be earned on the third party sale than would otherwise be expected from comparison with similar transactions. Where the sales agent and insurer or reinsurer are associated, any comparability analysis as part of the process of determining the arm's length level of reward for the parties would need to consider the circumstances that give rise to the high level of profit. Competition would usually work to limit the amount of profit which can be earned on a transaction both on the part of the sales agent and on that of the insurer or reinsurer. The availability of alternative providers may also influence the ability of each party to negotiate a higher level of profit as part of the overall transaction.

10.225. For example Company A is a high street retailer of high value new technology consumer goods. At the point of sale, A offers insurance policies to third party customers which provide accidental damage and theft cover for a 3-year period. The policies are insured by Company B, an insurer which is part of the same MNE group as A. A receives a commission with substantially all of the profit on the insurance contract going to B. A full factual and functional analysis shows that the insurance contracts are very profitable and that there is an active market for insurance and reinsurance of the type of risks covered by the policies. Benchmarking studies show that the commission paid to A is in line with independent agents selling similar cover as a standalone product. The profit B earns is above the level of insurers providing similar cover.

10.226. In considering how the conditions of the transaction between A and B differ from those which would be made between independent enterprises, it is important to consider how the high level of profitability of the insurance policies is achieved and the contributions of each of the parties to that value creation. The product sold to the third party is an insurance policy substantially the same as that which any other insurer in the general market could provide. The sales agent has the advantage of offering the insurance policy to its customer alongside the sale of the goods to be insured. It is the advantage of intervening at the point of this sale which provides the opportunity to earn a high level of profit. A could sell policies underwritten by another insurer and retain most of the profit for itself. B could not find another agent that has the advantage of point of sale contact with the customer. The ability to achieve the very high level of profit on the sale of the insurance policies arises from the advantage of customer contact at the point of sale. The arm's length remuneration for B would be in line with the benchmarked return for insurers insuring similar risks and the balance of the profit should be allocated to A.

The following paragraphs are added to Section D.1.2.1 in Chapter I of the OECD Transfer Pricing Guidelines, immediately following paragraph 1.106. Numbering and cross-references included in other parts of the OECD Transfer Pricing Guidelines will be amended as needed.

F. Risk-free and risk-adjusted rates of return

1.107. This section of Chapter I provides guidance on how to determine a risk-free rate of return and a risk-adjusted rate of return in those situations where an associated enterprise is entitled to any of those returns under the guidance in this chapter and Chapter VI of these Guidelines.

F.1. Determining a risk-free rate of return

1.108. Where, in accordance with the guidance in this Chapter, the accurate delineation of the actual transaction shows that a funder lacks the capability, or does not perform the decision-making functions, to control the risk associated with investing in a financial asset, it will be entitled to no more than a risk-free return as an appropriate measure of the profits it is entitled to retain (see paragraph 1.103 and its footnote). In this context, the funder's costs related to the borrowing associated to the funding should be taken into account in determining the risk-free rate of return, and subject to other constraints, the funded party would still be entitled to a deduction up to an arm's length amount in respect of the funding. The difference between those amounts would be allocable to the party exercising control over the investment risk in accordance with the guidance in this chapter.

1.109. A risk-free rate of return is the hypothetical return which would be expected on an investment with no risk of loss. Ultimately, there is no investment with zero risk, and the reliability of available proxies for approximating a risk-free rate of return will depend on prevailing facts and circumstances.

1.110. An approach which is widely used in practice is to treat the interest rate on certain government issued securities as a reference rate for a risk-free return, as these securities are generally considered by market practitioners not to carry significant default risk. The intention of the guidance in this section is to outline an approach for reference purposes without suggesting that a particular government security should always be used to determine a risk-free rate.

1.111. To eliminate currency risk, the reference security for determining the risk-free rate would need to be a security issued in the same currency as the investor's cash flows, i.e. the functional currency of the investor rather than its country of domicile. When there are multiple countries issuing bonds in the same currency, the reference point for the risk-free rate of return should be the government security with the lowest rate of return as any difference in rate must be due to differences in risk between the issuers (see paragraph 10.33).

1.112. Another relevant aspect in determining the risk-free rate of return will be the temporal proximity of the reference security to the tested transaction. The security should ideally be issued at the time, or have

a similar remaining maturity, as the controlled transaction was entered into to eliminate the effect of differences which may be present between securities issued at different times (see paragraph 10.32).

1.113. Another key consideration would be the maturity of the financial instrument. The duration of the reference security should match the duration of the investment since the duration of an investment will usually affect its price. The duration of the controlled investment should be determined as part of the process of accurate delineation of the actual transaction. For example, a financial instrument which is short-term under the written contractual terms between the parties but which is consistently replaced with a new instrument may, depending upon the exact facts and circumstances, be accurately delineated as a long-term investment.

1.114. Due to difficulties in practice, practical solutions might be considered for estimating the risk-free rate of return. For instance, assume a situation where Company A, a member of an MNE group, is not entitled to any more than a risk-free return under the guidance in this chapter in relation to an advance of funds with a term of one year to an associated enterprise, Company B. In approximating that return, the starting point would be to identify a security issued at the time of the provision of the funding in the same currency as Company A's functional currency. Assume that the tax administration of Country X, where Company A is resident, identifies three securities issued in Company A's functional currency by the governments of Country X, Country Y and Country Z with a term of one year. The credit ratings of the issuing governments are A for Country X, B for Country Y and AA for Country Z. In specifying a minimum credit rating for the issuing government to consider the issued security as a risk-free investment comparable to the controlled financial transaction, the tax administration of Country X may select the security issued by Country Z as a reference for the risk-free rate of return since it represents the lowest rate of return available at the time of the provision of the funding on all outstanding government bonds in the relevant currency with a term of one year.

1.115. To approximate risk-free rate of returns, highly rated government issued securities are not the only reference, and other alternatives may be considered on prevailing facts and circumstances of each case, for instance interbank rates, interest rate swap rates or repurchase agreements of highly rated government issued securities.

1.116. The risk-free rate of return may be relevant, for example, as a component in calculating a risk-adjusted rate of return on an investment or as the return allocable to an investor who has provided funding but has not assumed any of the risks related to the funding.

F.2. Determining a risk-adjusted rate of return

1.117. As stated in paragraph 6.61, "where a party providing funding exercises control over the financial risk associated with the provision of funding, without the assumption of, including the control over, any other specific risk, it could generally only expect a risk-adjusted rate of return on its funding." (See paragraphs 1.85 and 1.103).

1.118. Therefore, in determining the risk-adjusted rate, it is important to identify and differentiate the financial risk which is assumed by the funder in carrying on its financing activity, and the operational risk that is assumed by the funded party and is connected to the use of the funds, e.g. for developing an intangible asset. Guidance on the relationship between risk assumption in relation to the provision of funding and the operational activities for which the funds are used is given in paragraphs 6.60 - 6.64.

1.119. For instance, consider a situation where Company F advances a loan to an associated enterprise, Company D, which undertakes the development of an intangible. Consider further that under the guidance in this chapter it is determined that Company F controls and consequently is allocated the financial risk associated with funding the development of the intangible, including the potential risk of Company D failing to develop the intangible and therefore being unable to repay the loan. However, Company F does not

assume the risk of developing the intangible, which is entirely assumed by Company D under the accurate delineation of the actual transaction. Accordingly, in the event that the *ex post* results derived from the exploitation of the developed intangible were higher (or lower) than the results calculated on an *ex ante* basis, Company F would not be entitled to that difference but to a risk-adjusted rate of return as described in this section.

1.120. In general, the expected risk-adjusted rate of return on a funding transaction can be considered to have two components, i.e. the risk-free rate and a premium reflecting the risks assumed by the funder.

1.121. When the funder is assuming the financial risk under the guidance in this chapter and is therefore exposed to the potential playing out of that risk, it will encounter the upside and downside consequences of that risk outcome. Therefore, the assumption of that risk will warrant an expected remuneration higher than a risk-free rate of return.

1.122. A risk-adjusted rate of return can be determined under different approaches, for example, based on the return of a realistic alternative investment with comparable economic characteristics or the cost of funds (see Section C.1.2).

1.123. It may be possible to find a reasonable indicator of a risk-adjusted rate of return from comparable uncontrolled transactions or by considering realistically available alternative investments reflecting the same risk profile. Depending on the facts and circumstances, realistic alternatives to an intra-group loan could be bond issuances or loans which are uncontrolled transactions (see paragraph 10.93).

1.124. Another approach to determining the risk-adjusted rate of return would be to add a risk premium to the risk-free return, based on the information available in the market on financial instruments issued under similar conditions and circumstances.

1.125. For instance, consider the same fact pattern as described in paragraph 1.114 but, in this particular scenario, assume that Company A is found to be entitled to a risk-adjusted rate of return under this chapter. To determine that return, the tax administration of Country X considers adding a risk premium to the risk-free rate of return, i.e. the security issued by the government in Country Z with a term of one year. To estimate the risk-adjusted return, Country X's tax administration considers that corporate bonds issued by independent parties resident in Country X operating in the same industry as Company B yield a return comparable to the one that an independent party would have expected had it invested its funds in Company B under comparable circumstances.

1.126. Under an approach based on the cost of funds, the controlled transaction would be priced by adding a profit margin to the costs incurred by the lender to raise the funds advanced to the borrower. That mark-up should be proportionate to the risk assumed by the lender and calculated according to the guidance provided in paragraphs 10.97 - 10.100.

Transfer Pricing Guidance on Financial Transactions

INCLUSIVE FRAMEWORK ON BEPS: ACTION 4, 8-10