[2018] 96 taxmann.com 363 (Article)

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# Discussion Draft on Financial Transactions – An Analysis


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## Introduction

**1.** The Organisation for Economic Cooperation and Development (OECD) on July 3, 2018 released the long-awaited discussion draft on financial transactions (Draft) under Base Erosion Profit Shifting (BEPS) Action Plan 8-10[1] of 2015, which mandated follow-up work in this area.

The Draft is a guidance on the application of principles incorporated in 2017 edition of the OECD TP Guidelines (Guidelines) to financial transactions. In particular, it discusses on delineation of financial transactions based on guidance in Chapter 1 of the Guidelines and examines specific issues relating to pricing various financial transactions like intra-group loans, cash pooling, hedging, guarantees and captive insurance. The Draft is not a consensus document and, accordingly, the OECD has invited key stakeholders to send their comments/ responses/ recommendations to specific questions and/ or area of doubt/ disagreement by September 7, 2018

## Delineation and pricing of Financial Transactions

**2.** As per the Draft, the delineation of financial transactions should precede the determination of arm's length pricing. In this regard, as in the previous BEPS reports, the Draft calls for assessing the transactions beyond the contractual terms, with due consideration to be given to the full set of circumstances surrounding the transactions (such that it extends to industry factors, business strategies of MNEs, etc.) and the options are realistically available to both the transacting parties.

The Draft also clarifies that guidance does not prevent countries from implementing approaches to address capital structure and interest deductibility under their domestic legislation. Considering this, it would be imperative to understand India's position on the issue of capital structure a.k.a. thin captialisation (thin cap).

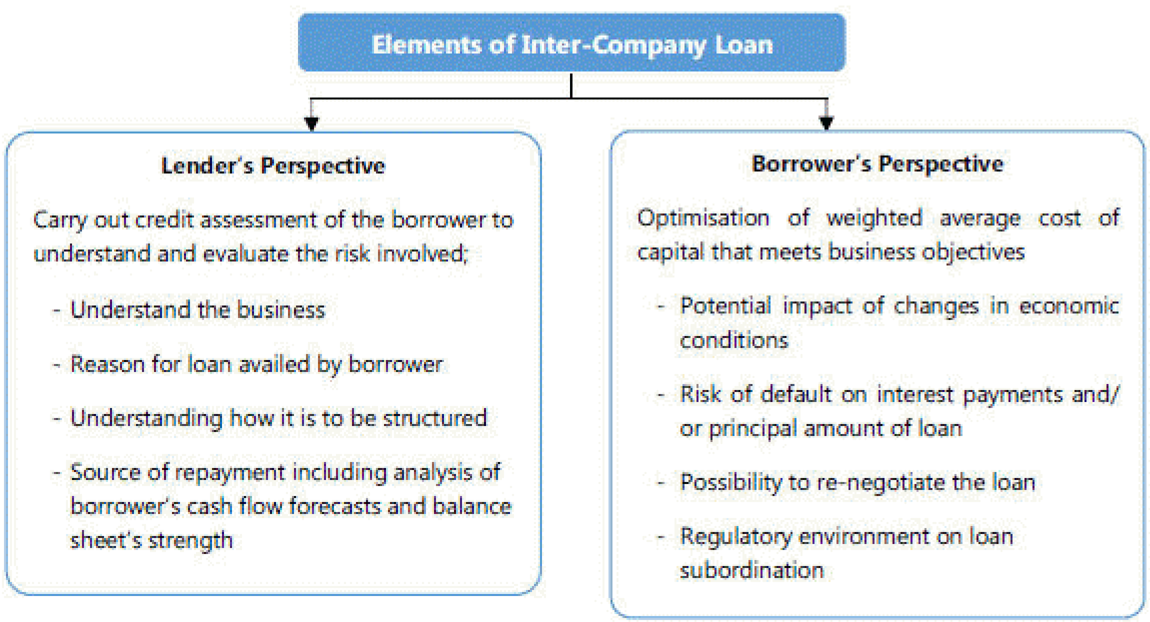
India does not have express thin cap rules under its domestic tax laws. However, effective April 1, 2017, general anti-avoidance rules (GAAR) empowered the Revenue Officer to re-characterise equity into debt or *vice versa* as a consequence of commercially unviable arrangement. Further, it was also legislated vide Section 94B of the Income tax Act, 1961 (the Act) in line with BEPS Action Plan 4 to restrict interest deductions in the hands of the Indian companies or permanent establishments of foreign companies in India, on borrowings obtained from their non-resident associated enterprises (AEs), or even from third parties, which are backed up by - (a) either implicit or explicit guarantees; or (b) deposit of matching funds, provided by such AEs, to 30% of earnings before interest, taxes, depreciation and amortisation of the payer[2]. Therefore, thin capitalisation gets a back door entry into the Indian regulations. Considering this, it would be helpful if the Legislators can clearly formulate their stances on thin capitalisation and come up with formal regulations on it.

Subsequently, the Draft provides that delineated transaction needs to be priced on basis of the factors specified in Chapter I-III of the Guidelines as are relevant to financial transactions. In particular, the Draft states that entities with limited or no control over the financial risks in intra-group financial transactions should be entitled to no more than a risk-free rate of return. Though this Section is in draft form and will be finalized on basis of the inputs from stakeholders.

**Discussion on issues relating to pricing of specific Financial Transactions**

**3.** This section of the Draft acknowledges that treasury function is an integral function of any organisation and can vary in complexity, depending on whether a business has a centralised treasury structure or decentralized structure. The Draft goes on to explain that treasury function can be performed in the capacity of a support service provider (involving limited cash and liquidity management functions) or a more risk-based function (involving development of strategies, planning for investments, financial risk management, etc.). Having said that, it does clarify that usually treasury function constitutes a support service to the main value adding operations of a business. Therefore, there exists a need to accurately delineate the actual transaction and ascertain its arm's length pricing. Accordingly, the Draft covers TP consideration for following relevant financial transactions/ activities within treasury function:

- *Intra-Group Loans* - The key takeaway relating to intra-group loans is to consider a dual perspective while undertaking an analysis of the arm's length interest rate. This entails consideration of the following:




Further, the Draft goes on to elaborate on the following key factors:

**Credit Rating**

- From a lender's perspective, the Draft accentuates credit ratings methodology is one of the most important tool to evaluate options to ward-off high-risk borrowers
- Therefore, AEs must conduct due diligence process and credit rating analysis, which should adjust for differences including the presence of inter-co transactions

**Effect of Group Membership**

- Draft has sought stakeholders comment on possible approaches[Refer Note] to determine credit rating of a borrowing MNE
- Draft evaluates that being a member of an MNE group, the presence of the implicit group support is incidental to the borrowing MNE whether or not this is intended. Therefore, it invites commentators to provide a definition of the standalone credit rating of an MNE and how to measure the impact of implicit support

**Covenants, Guarantees, Loan Fees/ Charges**

- These are briefly discussed in the Draft and entail that factors such as covenants in loan agreements, guarantees provided and any additional loan fees charged under intra-group loan agreements must be evaluated when setting the transfer price

Note: A rebuttable presumption to use the credit rating at the group level as the credit rating for each group member or to use the credit rating at the group level as a starting point, from which appropriate adjustments are made.

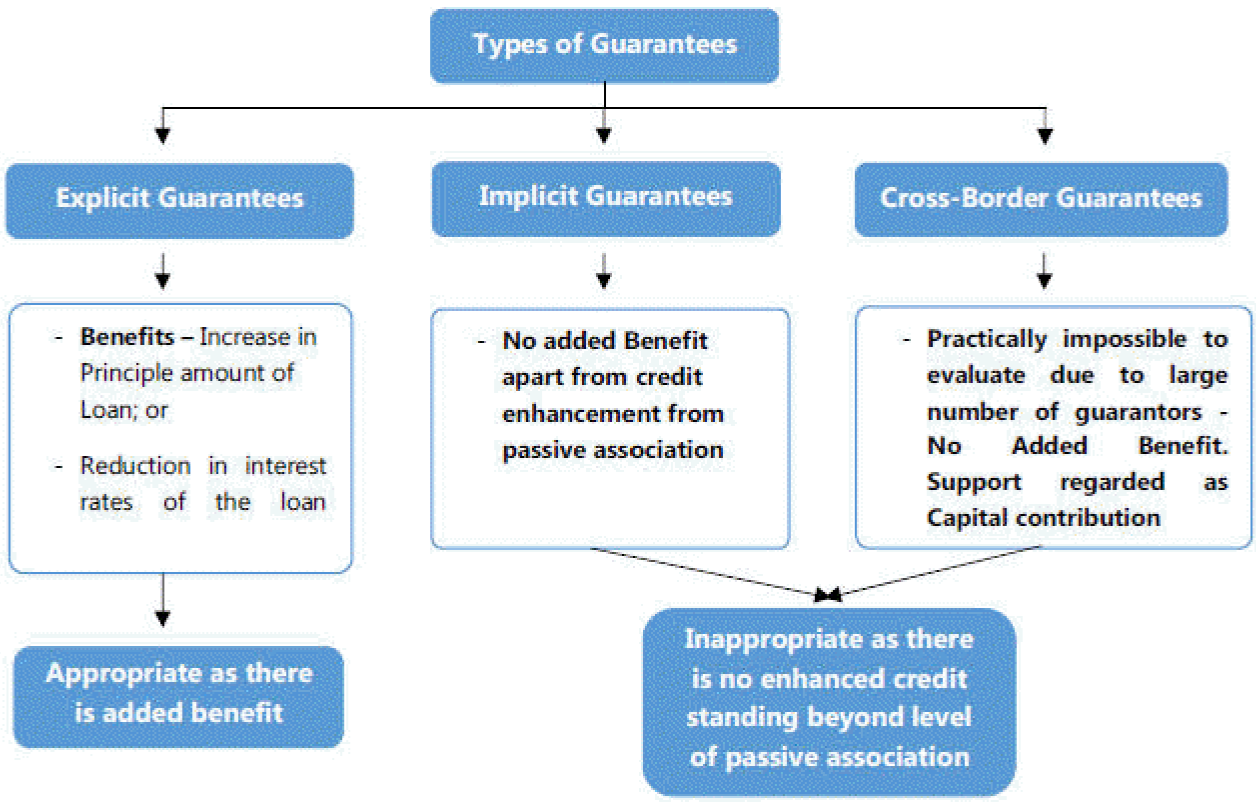
Before we discuss on pricing of these transactions as covered in the Draft, it would be imperative to note that there is sufficient jurisprudence in India that stresses upon the fact that features such as, the manner of financing, contractual terms, type of instrument, etc., are important considerations to define the return expected out of the intra-Group loan transaction, in line with the Draft. Further, issues such as application of credit ratings of the parent for the interest-ALP have also been touched upon in the Indian courts. In Income Tax Appellate Tribunal (ITAT) ruling in the case of *VVF Ltd.* v. *Dy. CIT* ITA No. 673/Mum/06, the ITAT held that credit ratings of the parent could be applied to the subsidiary. However, the Indian courts do not entirely align with the views emerging in this Draft. A case in point is the ruling by the ITAT in the case of *Soma Textiles & Industries Ltd.* v. *Addl. CIT* [2017] 81 taxmann.com 67 (Ahd. - Trib.), wherein the Revenue Officer had proposed adjustment in connection with the arm's length interest rate of inter-company loan, as it did not factor in guarantee fees that would have been paid by the Asseesee, had it obtained a loan from a third party due to its lower credit rating was deleted by the ITAT.

Having discussed on the above, at a broad level, Indian administration has acknowledged in the revised UN TP Manual (2017) that TP approach for inter-company loans revolves around examination of the agreement pertaining to terms and conditions of the loan and determination of credit ratings of lender and borrower. Hence, the OECD comments will be important for the Indian MNEs, as they re-emphasize on the manner in which interest rate pricing strategy is expected to be evaluated in future.

As per the Draft, the comparable uncontrolled price (CUP) method has been identified as the preferred method for determining the arms' length interest rate for such loans owing to availability of publicly available information in the loan market. As per the India Chapter in the UN Manual on TP regulations, identification of comparable third party loan agreements with suitable adjustments needs to be adopted to benchmark these transactions.

In addition to the above approach, the Draft is flexible to evaluate other methods to ascertain the arm's length nature of these transactions, such as return of realistic alternative transactions like bond issues and cost of funds incurred by lender in raising funds to lend. However, applicability of informal letters or rather 'bank opinions' obtained from external banks still remains fluid as regards the Draft and 'Other Method' as the Indian TP regulations.

- *Cash Pooling* - The Draft stipulates that cash pooling arrangements need to define clear synergies and the savings must be spread across all MNE's participants. It discusses on three mechanisms for sharing of cash pool synergies, all of which do not impact the Indian MNEs as cash pooling arrangements from non-resident companies are currently not permitted under Indian Law.
- *Hedging* - The Draft contemplates that a centralised hedging function usually structured at the Group level improves efficiency and effectiveness as individual entities risks are hedged at a Group level, even though it may not be possible to contractually hedge individual entities separately. Therefore, OECD seeks specific comments from the participants on dealing with such cases. It also indicates that such a centralised hedging function would be characterised as a provision of service for which an arms' length remuneration should be payable.
- *Guarantees* - The Draft defines a guarantee as "a legally binding commitment on the part of the guarantor to assume a specified obligation of the guaranteed debtor if the debtor defaults on that obligation."The Draft further details the different types of guarantees, namely, explicit, implicit and cross-border guarantees and their key features as shown below:

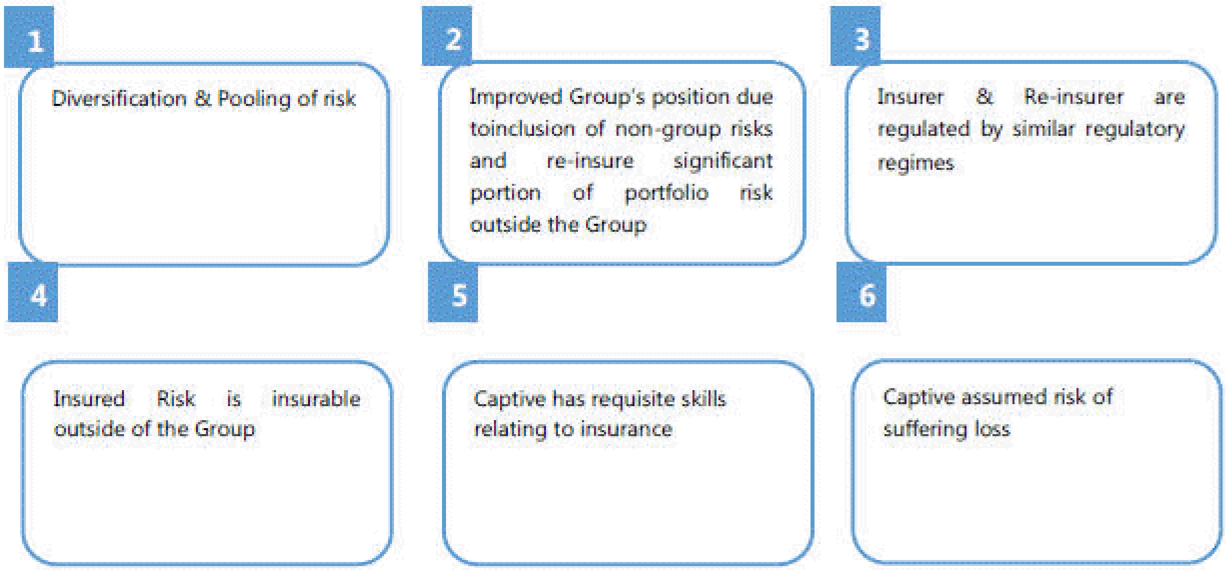



The Draft also discusses on the possibility where there is an implicit element in an explicit guarantee as a result of financial interdependency of the MNE group resulting in no added benefit beyond the level of credit enhancement. In such a case, the Draft includes discussion that no guarantee fee should be due. But the Draft does not give any solution on how to measure the impact of implicit element on the explicit guarantee such that no guarantee is due.

Until the amendment to Finance Act 2012, Guarantee fees was not included as an international transaction in the Act. Post the amendment, payment of guarantee fee was included in the definition of international transaction in *Explanation* 1(c) to Section 92(B) of the Act. Consistent with the Draft, Safe Harbour Rules, 2013 also prescribed rules for charging guarantee fee but only in case of explicit guarantee. In the UN TP guidelines, Indian tax administrators have acknowledged that factoring in the implicit element of guarantee remains to be an issue faced by the tax administration. This principle has also been dealt with in the case of *Dy. CIT* v. *EIH Ltd.* [2018] 89 taxmann.com 417, the Kolkata ITAT confirmed that explicit guarantee provided for the benefit of the guarantor in the capacity of a shareholder's benefit would not constitute a guarantee fee charge. But, as there are rulings wherein these contrary views have been taken, clarity of the Legislators stance in the form of guidelines would be very useful and can help avert protracted litigation.

Further, the Draft suggests that CUP method is the most reliable for determining the arm's-length guarantee fee. This is also acknowledged to be the preferred method for the Indian administrations as stated in the UN TP Manual. The Draft further outlines four other approaches, such as the yield approach, cost approach, valuation of expected loss approach and capital support method.

- *Captive Insurance* - As per the Draft, the first step is to determine that the transaction is genuinely one of insurance. For the same, it lays out following indicators that are typically expected of an independent insurer.




Under Captive Insurance, the Draft focusses on 'fronting arrangements', which have been mentioned as particularly complex controlled transactions to price. Fronting arrangements involve an insurance arrangement between a third party (Fronter) and an Associated Enterprise post which most or all of the risk of first contract is then re-insured with the captive. The Fronter is paid a commission to cover its costs and the premium is passed on to the captive as part of re-insurance contract.

The Draft also provides suggestions on pricing the intra-group insurance transactions while recognizing that there may be differences in capital discipline of independent insurers and captives and appropriate adjustments may be required.

Finally, the Draft delves into two specific scenarios, Group synergy and Agency sales. Where the captive is used as a vehicle for Group entities to act together to offer a portfolio of insurance risks to the reinsurance market the Draft concludes that the benefit of lower premiums should be allocated among the insured companies. In case of Agency sales, where an agent in the Group sells insurance on behalf of a captive together with its own products, the Draft confirms that because of the point of sale advantage, the agent may be entitled to a higher commission than independent agents selling similar insurance products.

**Conclusion**

**4.** Financial transactions and issues surrounding them can be very complicated, especially in a complex matrix management/ organizational structure of a MNE groups. In light of this, the Draft is a welcome relief for both, the tax administrations and the taxpayers, since it analyses different situations and provides valuable guidance on the implication. Once finalized it would be the most comprehensive guide on this subject, as it lays out OECD's perspective on dealing with the complexities and challenges linked to such transactions. Although a number of critical areas remain open as of now but this Draft serves as a to winds of change expected to blow in the future. Groups should now closely monitor developments as well as carefully understand diversity of application and interpretation by tax authorities in this area.

Thus, considering the above, Indian MNEs should timely act upon the window of opportunity[3] to revisit/ reassess/ revise their existing financial arrangements/ structures and processes/ systems/ policies in this area.

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1. Aligning Transfer Pricing (TP) Outcomes with Value Creation
2. Exceptions for companies engaged in banking and insurance businesses
3. Especially as it is expected that OECD will reach a consensus agreement by April 2019.