TP Spotlight

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Financial transactions: transfer pricing control and analysis

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Consulting on transfer pricing issues

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Dear Readers,

We are delighted to be able to bring to your attention this general overview of recent changes in Kazakhstan's Transfer Pricing legislation; changes that could influence the activities of your business in Kazakhstan.

Financial transactions: a separate transaction type for transfer pricing purposes

Historically, transactions related to goods and services have been the subject to transfer pricing control in intra-group transactions. As new relationships develop between companies, other types of transactions, such as financial transactions (in particular, loans and guarantees), become subject to transfer pricing control.

The purpose of transfer pricing control of such transactions is determined primarily by the ability of parties to influence the decisions of particular taxpayers and their tax base in comparison with the actions of independent parties in the similar situation. However, the national legislation of each country may have specific rules regarding the necessity to analyze the arm's length range in financial transactions and approaches to this analysis.

The transfer pricing analysis may be required for transactions where no separate agreements are concluded. A guarantee transaction may serve as an example: a company of the X Group vouched to an independent bank for a loan to another company of the X Group. As a rule, a guarantee agreement can only be concluded between the guarantor and the bank, whereas a guarantee agreement between the guarantor and the borrower, as well as payment for the guarantee, may not exist at all. At the same time, if there is a similar structure of transactions between independent companies, it seems reasonable to conclude a guarantee agreement between the guarantor and the borrower, and to set a fee for such guarantee: the borrower benefits from the guarantee, and the guarantor bears the risk when providing the guarantee. In this respect, a parallel can be drawn with a bank guarantee: the bank always charges a fee for providing a guarantee for the obligations of an independent company.

Transfer pricing control means control of the price in a transaction. In financial transactions prices are payments for receiving benefits, taking risks or performing functions. For loans, the interest rate on the loan is subject to control, for guarantees – the payment for guarantee provision (for example, it can be calculated as a percentage of the secured amount).

Approaches to analysis of the arm's length range in financial transactions

A number of countries specify approaches to analysis of the arm's length range for tax purposes for certain types of transactions. For example, so-called «safe harbour» rule can be applied in relation to loan transactions (as in the Russian Federation), or only remuneration of an intermediary in financial transactions can be analyzed (as in the Republic of Cyprus).

At the same time, at least the following three basic steps are required for a comprehensive transfer pricing analysis:

1. **Functional analysis**: Functional analysis in relation to financial transactions is different from the typical analysis of commodity transactions. The key is the analysis of the structure of the transaction and the purpose of its implementation, the structure of the capital involved, the solvency of the parties, the benefits of the parties from the transaction, interconnection of different transactions (for example, an intra-group loan guarantee transaction from a bank and a subsequent intra-group loan transaction). Based on this analysis, a reasonable decision can be made about the transfer pricing method selection and specific approach to the analysis of the arm's length range in the transaction.
2. **Selection of the applicable method**: As a rule, in international practice, the most common transfer pricing method is the Comparable Uncontrolled Price method (the CUP method). The most common approaches for determining the arm's length range are:
   - for loans: information on rates in comparable transactions with independent companies, yield to maturity of comparable bonds, risk-free rate plus risk premium;

What is the subject of control in financial transactions?

Transfer pricing control means control of the price in a transaction. In financial transactions prices are payments for receiving benefits, taking risks or performing functions. For loans, the interest rate on the loan is subject to control, for guarantees – the payment for guarantee provision (for example, it can be calculated as a percentage of the secured amount).

- for guarantees: reduced cost of financing (comparing the loan rate without a guarantor with the loan rate if there is a guarantor) and the expected costs of the guarantor (estimating the probability of default of the borrower and the amount of the obligation covered by it).

3. **Benchmark study**: For the purpose of a benchmark study, it is often necessary to use third-party tools and databases for assessing solvency (for example, Moody's RiskCalc, S&P Credit Analytics) and for searching information on financial indicators (for example, Bloomberg, Refinitiv Eikon, Capital IQ).

Based on the abovementioned stages of analysis it is possible to decide on the most appropriate approach to analysis, taking into consideration all the circumstances, and calculate the arm's length range for a financial transaction.

OECD comments in Transfer Pricing Guidance on Financial Transactions

In 2020, the Organization for Economic Cooperation and Development (OECD) first published detailed financial transactions in Transfer Pricing Guidance on Financial Transactions. This document was released in February 2020 as a result of public discussions of the preliminary version of 2018 and after receiving feedback from professional market participants.

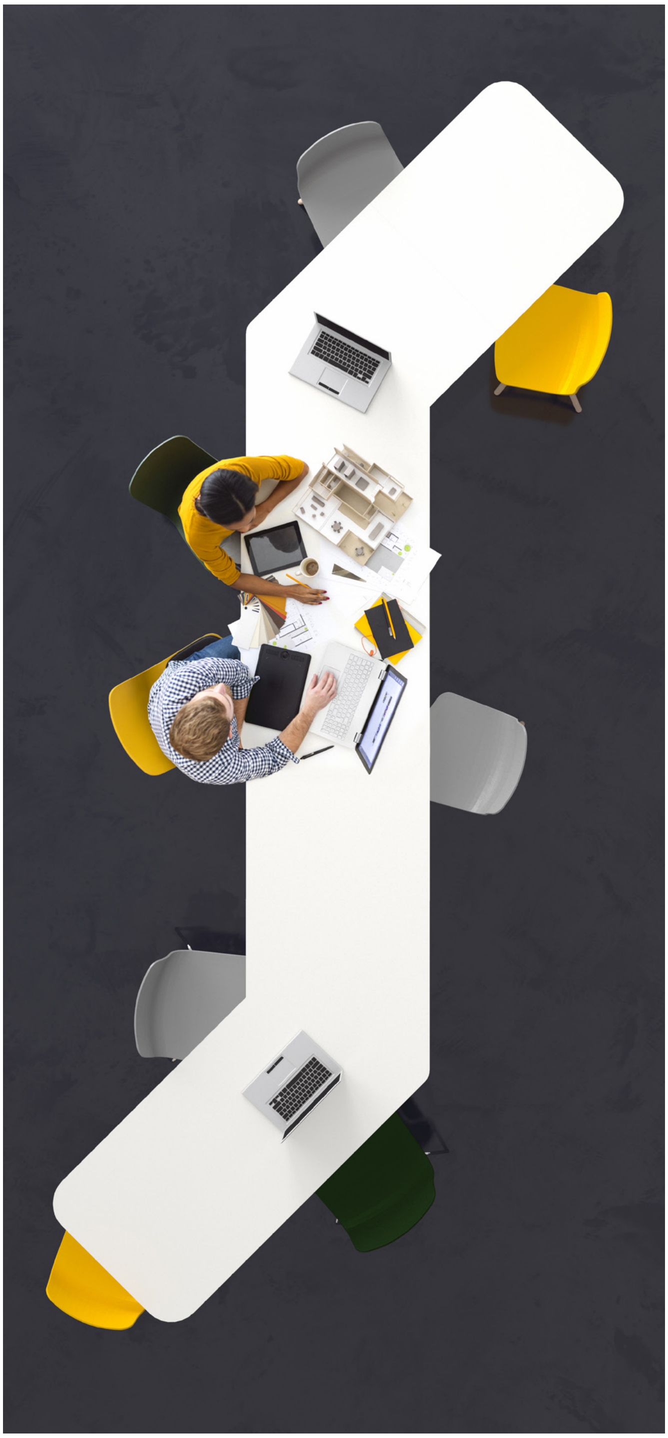
The purpose of this document is to ensure consistency of approach in the analysis and avoidance of double taxation with respect to various financial transactions such as loans, cache pooling, financial guarantees, treasury functions, hedging and captive insurance. The provisions of this document are intended to be incorporated directly into the text in the relevant sections of the OECD Transfer Pricing Guidelines.

Transfer Pricing Guidance on Financial Transactions highlights the following key aspects:

- Determination of the risk-free rate and premium to the risk-free rate (this approach is applicable to loan transactions in the first instance). The comments provide guidance on sources of information for the risk-free rate and approaches for determining the risk-free rate premium.

- Comparability of transactions for analysis. For these purposes, the document considers feasibility of taking industry specifics into consideration, contractual terms and conditions, functional analysis, characteristics of financial instruments, economic circumstances and the business strategy of the group.
- Analysis of the intra-group financing. In this regard, it is necessary to consider the alternatives of the parties to the transactions, as well as the availability of information about both the rating of the borrower and the rating of the debt issue and the importance of the borrower for a particular group. Applicable approaches include the CUP method: intermediary function analysis (funding method), risk-free rate plus risk premium and economic modeling.
- Guarantee analysis. Analysis of the economic benefits of the parties from the guarantee should be provided, and the document describes cases when payment may not be made, for example, under simultaneous guarantee (cross-guarantee) of the parties for each other. It is suggested to use the CUP method as the most applicable one: reduced cost of financing, expected expenses of the guarantor, approach to estimation of expected loss and capital support method (economic modeling).
- Analysis of captive insurance. The document suggests applying the CUP method in order to estimate the arm's length range of insurance premiums (with a proper level of comparability or possibility of applying adjustments).

Therefore, Transfer Pricing Guidance on Financial Transactions provides a summary of transfer pricing practices in respect of different types of financial transactions and may serve as a basis for analysis of arm's length range within them. In the absence of detailed requirements and recommendations on the approaches to these transactions in the national legislation, it would be appropriate to refer to the recommendations of this document in the analysis of financial transactions, taking into consideration the significant relationship between national legal principles and transfer pricing principles provided by the OECD Transfer Pricing Guidelines.



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