Current transfer pricing issues for Treasurers

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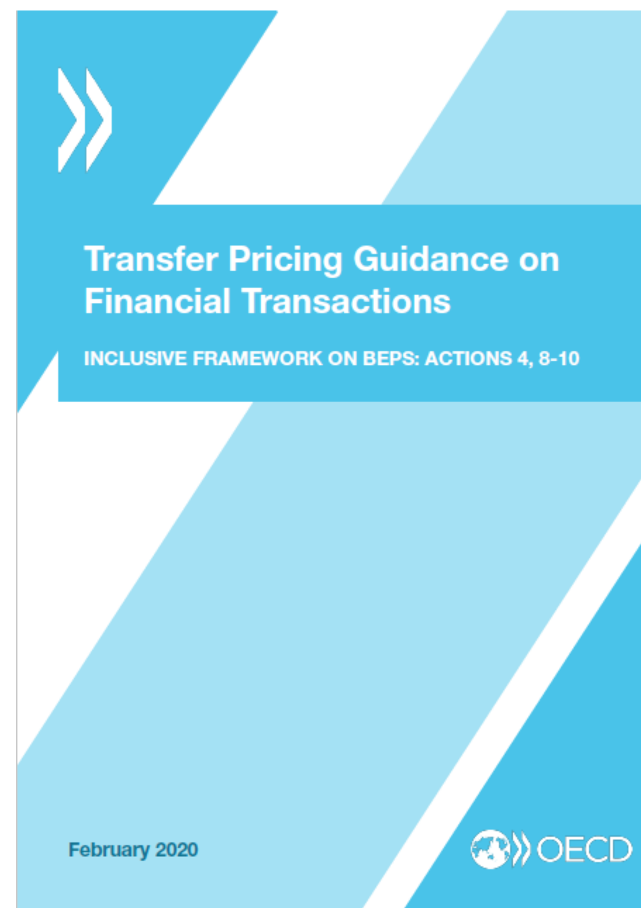
Context and objectives

- The OECD has commenced a project to prepare guidance on financial transfer pricing in the exceptional Covid-19 crisis situation
- Taxpayers have to anticipate that guidance by changing their transfer pricing policies now in an arm's length way
- In February 2020 the OECD issued new guidance on financial transfer pricing, requiring action for transactions occurring since then
- The objectives of this presentation are to:
  - identify the relevant considerations when adjusting transfer pricing for the crisis
  - summarise the new financial transfer pricing guidance
  - make appropriate recommendations on both issues



Transfer pricing in the crisis – the OECD response

- The OECD's Committee on Fiscal Affairs Working Party 6 are preparing new transfer pricing guidance relating to the Covid-19 situation
- The target was the end of 2020 but this has been moved back to early 2021
- It will be a consensus document, binding on all OECD member states
- It is likely on draw on existing Material on the Transfer Pricing Guidelines, e.g.:
  - Options Realistically Available (chapters I, VI (and its Annex), VII, IX and X)
  - Business Restructurings (chapter IX)
- Comments can be submitted to ctp.contact@oecd.org

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Possible transfer pricing adjustments for the crisis

- Problem:
  - The profit margins of companies are falling below the old arm's length range
  - Independent companies are reducing their prices and margins and current benchmark ranges are lower – how to respond?
  - Should limited risk companies be protected?
- Potential solutions:
- Change transfer pricing policies, despite current transfer pricing agreements:
  - What is possible under the current agreement (prices, terms)?
  - What is being done with or between third parties (e.g. prices, terms, despite their agreements)?
  - What are the options realistically available of both parties (e.g. more profitable alternatives, or need each other in the longer term?)
- Calculate compensation for early termination or transfers of assets in restructurings, e.g. closure and transfer or customer contracts

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Possible transfer pricing adjustments for the crisis (continued)

- Prepare (quick and simplified) new transfer pricing documentation to support any changes:
  - Why changes needed
  - Determination of new prices and terms
  - Valuations
- Change selection of benchmarks, and adjustments to benchmarks, e.g.:
  - Only accept profit margin comparables with similar ratios of fixed to variable costs
  - Adjustments based on the relationship between sales and profit margins for comparable companies
- Give more recognition to local market factors:
  - Impact of the virus different
  - Different government restrictions or support
  - Hence different benchmarks, different case for changing transfer pricing policies

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Possible transfer pricing adjustments for the crisis – treasury aspects

- Focus on cash and working capital - look more to internal sources:
  - Provide more related party loans
  - Give more related party guarantees for external borrowing
  - Defer related party interest payments and/or repayments of principal
  - Debt factoring/invoice discounting
  - Advance payments (at a discount)

- Adjust financial transfer pricing policies for new market conditions and company position, e.g.:
  - New interbank rate, treasury's marginal cost of funds, commercial risk spread, liquidity charge, etc.
  - New credit ratings for individual group companies – especially borrowers, guarantors
  - Loans, guarantees, in-house bank overdrafts and deposits, cash pooling, captive insurance/reinsurance, debt factoring
  - Recharacterisation of cash pool balances and short term loans as long term loans

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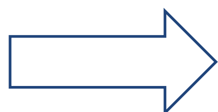
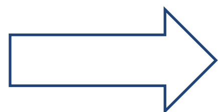
Relaxation of transfer pricing compliance requirements – examples of national responses

- Transfer pricing documentation and declaration form filing deadlines put back
- Extra time for responding to transfer pricing audit questionnaires
- Slowing down or suspension of filed audits, fewer new audits
- Extended period for dispute resolution and litigation
- More time for filing CbC notifications and Reports
- Delay in APA application process and negotiations
- Willingness to adapt existing APAs to reflect the crisis situation



Identify extensions in MNE’s jurisdictions



Use any additional time to adjust TP policies and prepare new documentation

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Key features of the new financial transfer pricing guidelines

- More scope to treat loans as equity
- Introduces the concept of an arm’s length amount of debt
- Requires consideration of both perspectives when deciding whether different terms and conditions would have been agreed
- Critically assesses whether guarantees, cash pool headers and captive insures/reinsurers add any significant value
- Gives detailed technical guidance on pricing loans, guarantees and captive insurance (but not cash pooling)
- Creates expectation or move extensive TP reports

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Adjusting transfer pricing policies for the new financial transfer pricing guidelines

- Amending, recharacterising or imputing different terms and conditions in loan agreements
- Limiting loans to the arm's length amount of debt
- Incorporating implicit support and qualitative factors into credit ratings
- Taking a two-sided approach to the pricing of guarantee fees
- Cash pooling – more work to show why leader deserves more than cost plus; scientific allocation of cash pool benefits through the interest rates
- Captive insurance/reinsurance – more work to show that captives bear and manage risk, and earn an arm's length reward on an arm's length amount of capital
- Be ready to defend against new scepticism about group treasury:
  - Presumption that they will often be a low value support service, e.g. coordination role where it acts as a contact point for external borrowing
  - Suspicion that the treasury policies and group financial risk management strategy are set by the head office
  - Must be able to manage financial risks to earn more than cost plus

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The accurate delineation of loan agreements

	Economically relevant characteristics for debt qualification	Recommended approach for debt qualification
T&C	Fixed repayment date	Fixed repayment date (or bullet date) - No maturity upon demand, or perpetual maturity
	Obligation to pay interest	Interest must be payable and event of default clauses to be included in T&Cs – No (non-economically justified) waiver, no contingency
	Financial covenants and security	Financial covenants needed / security may be included (case-by-case analysis)
Context	Ability of borrower to obtain loans from unrelated lending institutions	Analysis of the other options realistically available for the borrower
	Lender profile / status	Comparability analysis with regular corporate creditors taking into consideration the non-regulated entity status and the strategy of the group in terms of lending
	Right to enforce payment of principal and interest	Ensure the lender may enforce its rights (in line with governing law of the contract) T&C: no limited recourse clause; no renunciation clause
	Source of interest payments / type of assets funded by the loan	Ensure flexibility of borrower to repatriate cash

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When different terms and conditions of a loan agreement may be imputed

- Review of <u>other options realistically available to the borrower</u> (to minimise its cost of capital), e.g.
  - Offering security over an asset (this could be imputed anyway for shareholder loans because of the shareholder relationship, provided that the asset is not needed for another purpose)
  - Borrowing with financial covenants
  - Borrowing for a shorter period
  - Borrowing without prepayment and other options

- Review of <u>other options realistically available to the lender</u>, e.g. other investment opportunities offering a better return

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The calculation of the arm’s length amount of debt - concepts

- The maximum debt which <u>lenders</u> are prepare to provide:
  - the ability of borrowers to repay the interest when due and the principal by the end of the term out of forecast profits
  - The default rate and expected loss and required return on this amount compared to the expected interest payments

- ‘Could’ versus would ‘test’ (the maximum debt which <u>borrowers</u> wish to take on):
  - e.g. to leave a sufficient liquidity margin
  - or a minimum target credit rating (e.g. the rating for the group as a whole or the average for the industry)
  - or the cost of the asset which the loan is being taken out to acquire

- The maximum gearing and minimum interest cover that independent <u>lenders</u> are prepared to accept <u>and borrowers</u> are prepared to take on - see loan agreements and/or recent financial statements of companies in the industry

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The calculation of the arm's length interest rate

- Borrower-specific credit ratings should be calculated based on quantitative and qualitative factors, and after an implicit group support adjustment
- This is then adjusted to calculate the credit rating of the specific financial instrument, e.g. is it senior or subordinated, guaranteed, secured…
- Related party lenders may not need to charge the same loan <u>fees</u> as independent lenders because they have no costs of e.g. raising capital or meeting regulatory requirements
- However, if they charge no fees at all, this should be reflected in a higher interest rate
- Where a loan is borrowed from an unrelated party and passed on to a related party, the original interest rate can be used, plus administrative costs, and the necessary risk premium and a profit element
  - But if only agency functions are performed, the reward should only be a mark-up on the costs of the services
- Warning that credit default swaps are not reliable because their price depends on the volume of trades (i.e. their illiquidity premium)

Financial guarantees – delineation and pricing

- Accurate delineation:
  - Must be a legally enforceable commitment to meet the borrower's obligations
  - Does the guarantor have the financial capacity to meet it obligations?
  - Will the guarantor also default if the borrower defaults?
- Benefit to the borrower (and maximum fee):
  - Because of the guarantor's better credit rating
  - Or because the guarantor adds to the pool of funds available to service the loan, its risk is not perfectly correlated with that of the borrower, and it therefore reduces the expected loss given default
- Expected cost and required return for the guarantor and minimum fee (what is the probability of default and the expected loss given default?)
- Consider the impact of relative bargaining power when identifying a point in this range

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EU state aid safe harbours – a relevant simplified approach for loans and guarantees?

- European Commission Communication 2020/C 91 1/01, 20.3.2020 (updated in 2020/C 112 1/01 of 4.4.2020)
- Minimum interest rates for public loans (margin over 1 year IBOR on 1 January 2020, minimum all-in rate 10 bps)/ minimum guarantee fees:

Type of recipient	Credit risk margin/guarantee fee for a 1-year maturity loan	Credit risk margin/guarantee fee for a 2-3 years maturity loan	Credit risk margin/guarantee fee for a 4-6 years maturity loan
SMEs	25 bps	50 bps	100 bps
Large enterprises	50 bps	100 bps	200 bps

Comment: only the guarantor's perspective is considered for the guarantee fees (i.e. the credit margin is assumed to be the expected loss plus the arm's length return on that equity)

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Cash pooling – delineation and pricing

- Hostility to conventional "entrepreneurial cash pool leader" model and presumption that cash pool leaders are simple service providers
- However, if the cash pool leader controls and bears liquidity risk and credit risk in a physical cash pooling arrangement, then it may deserve part or all of the spread between the borrowing and lending positions. Relevant questions are:
  - Does it bear the risk from the mismatch between the maturity of credit and debit balances?
  - Does it bear the risk of cash pool members being unable to repay what they have borrowed?
- Cash pool participants should share in the synergy benefits of cash pooling only if the cash pool was created by a deliberate and concerted group action
- No guidance on how to allocate the synergy benefits but:
  - the synergy benefits should be allocated through the interest rates
  - consider the relative bargaining power of the cash pool participants
  - all participants should gain from being in the cash pool – credit and debt interest rates should be better inside than outside cash pool
- Long term "structural" positive or negative balances may be treated as term loans with a different interest rate
- Guarantee fees may need to be paid for some or all cross-guarantees

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Captive insurance and reinsurance: delineation

- Covers insurance and reinsurance ("fronting") activities – see OECD Report on the Attribution of Profits to Permanent Establishments, Part IV
- General scepticism about these arrangements
- Accurate delineation:
  - The risks must exist and the captive must face a real possibility of loss. These risks could include insurance risk, commercial risk and investment risk (from investment of the premiums)
  - Captive must be able to diversity and pool the risk (i.e. the insured must be in different lines of business and there must be enough of them – could require also taking on third party business)
  - Captive must have the necessary skills and experience
  - Insured must be better off in terms of lower premiums, more stable premiums and/or more access to the insurance market
  - Captive must have adequate capital for the risks

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Captive insurance and reinsurance: pricing

- **Premiums**:
  - Should be lower than for non-captives because captives perform fewer functions, e.g. no distribution and sales activities

  - Could be set to cover expected losses on claims, administrative costs and a return on capital (net of any investment income)

Benchmarking the overall profitability of the captive:

- May be more reliable approach because premium calculations are complex
- Relevant figure is profit on claims plus profit on related party investments (e.g. using the premiums to make related party loans)
- But the arm's length return should only be earned on the amount of capital necessary to cover the captive's actual risks
- If captive is used to place risk more cheaply with third party insurers, and this was a concerted action, captive should receive a reward for basic services but policy holders should share the synergy benefits (savings)
- If a related party acts as a sales agent at the point of sale, and the captive reinsures the risk with third party insurers, the captive should earn the normal return for insurers and the agent should keep any excess profit

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Summary of recommendations: Responding to the crisis

- Submit questions, suggestions and comments to the OECD drafting team
- Change transfer pricing policies if independent parties would do so
- Pay compensation where due
- Prepare amended agreements and transfer pricing documentation to support the changes
- Change how this year’s transfer pricing benchmarks are selected and adjusted
- Reflect the local Covid-19 situation in the annual transfer pricing compliance documentation

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Summary of recommendations: responding to the new financial transfer pricing guidance

- New loan agreements should have arm’s length features
- Research should be documented to confirm the feasible amount of debt
- The commercial rationality of the loan terms and conditions should be explained
- Interest rates should be consistent with the results of a quantitative and qualitative credit rating exercise and take into account an implicit group support analysis
- Guarantee fees should reflect the perspective of both parties and their relative bargaining power
- Cash pool leaders must be shown to have important risk management responsibilities
- The synergy benefits of the cash pool participants should be allocated scientifically and this should be expressed through the interest rates
- Captive insurance companies must be shown to have the ability to pool uncorrelated risks for a large number of policy holders
- The in-house banking function of a treasury company must be documented carefully, and its responsibility for setting the group treasury policies

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