

Financial transactions - Transfer pricing during times of market uncertainty

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In brief

The Tax function plays a critical role as companies refocus on their cash strategies in a downturn economy. In such times, Tax and Treasury functions need to align on financing and repatriation options to maintain sufficient levels of liquidity.

In connection with intercompany financing policies, transfer pricing becomes critical and should be refined or developed in light of the external financing activity in which the group is engaged. As access to cash has become more challenging, businesses are looking to draw cash from all existing facilities and resources, internal and external, expand capacity, and deploy cash where needed. The overall impact of this difficult economic period will vary by group as well as by industry and sectors, but most groups will be affected.

In detail

External financing in the current economic environment

In this environment, a group financing policy may have to change abruptly in order to meet the cash needs of the business. As operational cash flows faced volatility and potential sharp decreases, companies may rely on cash flows from financing activities in order to sustain their operational needs.

As a starting point, any intercompany financing policy should be aligned with the group's external financing approach, with emphasis on adjusting intercompany policies to the commercial conditions facing the overall group. For example, liquidity constraints could cause limits to be reached on existing lines of credit, with the result that corporate treasurers are negotiating increases to existing lines of credit or drawing on new credit lines. Furthermore, access to liquidity may become more difficult to obtain or may only be accessed at a premium or on less than favorable terms, especially in the case of non-investment grade borrowers where liquidity may be scarce or non-existent as credit is primarily reliant on the private credit market that has largely frozen. Conversely, well-positioned borrowers with stronger credit rating profiles may have opportunities to seek additional funding, although this will vary by borrower, terms of the instrument, and timing due to the volatility in credit markets.

Additionally, lenders to the group may require revised terms and conditions, such as increased use of financial covenants and mandates for collateral or similar pledges, as well as requirements for financial or performance guarantees from affiliate companies.

Similarly, existing terms and conditions, such as financial covenants, may be pressured, with any breaches of covenants triggering negotiation between borrowers and lenders, or less favorably, potential default of the borrower. On one extreme, lenders to groups may attempt to enforce material breaches of contract prior to actual default in order to recover expected losses in advance. However, in other cases, lenders may view short-term economic shocks as temporary and isolated events; thus some companies may avail of payment holidays or similar short-term adjusted covenant breaks to reduce the near-term impact of this period on cash flows. Finally, if business operations are forecast to continue to experience difficult trading and cashflow conditions, borrowers and lenders may agree to restructure the debt with fewer, less restrictive, covenants to allow greater operating flexibility, albeit potentially at a higher interest rate.

Further, borrowers may benefit from government intervention or relief programs, which may result in terms and conditions that are more favorable as compared to financing that is obtained under commercial circumstances (e.g., prior interest rates as well as interest-free or loan forgiveness). The level of negotiation and ultimate outcomes between market participants will vary based on sector, industry, and country.

In recent guidance issued by the OECD in its February 11, 2020 final paper with respect to the transfer pricing aspects of financial transactions (the OECD FT Paper), added as Chapter X of the OECD Guidelines, taxpayers must adopt methods of analysis that are in line with concepts known as the 'accurate delineation' of intercompany transactions as well as 'options realistically available' to the taxpayer. Both concepts require a view of the facts and circumstances in which a proposed intercompany transaction is to take place, which ultimately begins with the overall group financing policy.

Internal policy considerations in the current economic environment

Following an assessment of the group's financing objectives and considering the current economic environment, intercompany policies with respect to financial transactions should be examined in seeking to avail of cash tax and/or effective tax rate opportunities or to mitigate the downside tax and operational costs of maintaining the status quo. Furthermore, given the range of financing alternatives that may be available, consideration should be given to the type of financing, whether debt, equity, or a combination (e.g., preferred stock). The current exceptional market circumstances call for an evaluation of current financing policies and consideration of newly proposed transactions, with external financing providing an overarching guidepost on the impact to intercompany financing policies.

Observation: In general, subsidiaries may have difficulties with respect to meeting payment obligations on their existing intercompany financing instruments, which may create issues in supporting an arm's-length interest rate or the maintenance of the current capital structure positions (i.e., debt/equity characterization or thin capitalization). Restructuring the intercompany financing (where possible) also may help to mitigate adverse cash tax or effective tax rate consequences.

Any change or update to intercompany financing policies should be viewed through the lens of an accurate delineation of the transaction and the options realistically available to the taxpayer in order to align with the OECD FT Paper. In addition, modelling the tax impact of the existing and future positions on a holistic basis is key to managing the many interdependencies in the current framework.

Specifically, below are critical issues and considerations in light of financing policies in the current economic environment:

- **Accurate delineation:** Based on recent guidance in the OECD FT Paper, accurate delineation is as important as ever, with any financing decision needing to consider the relevant economic conditions and resulting impact on key terms of financial instruments. This involves mapping key terms from external financing arrangements to those of internal arrangements, which may include assessing if any key terms and conditions are missing from existing or newly proposed instruments. For example, external borrowings may trend toward shorter-term facilities as opposed to structured debt, which has cascading impacts to intercompany financing structures. Furthermore, as credit ratings may decline for many corporations in the current environment, it is important to consider how creditworthiness may impact the pricing of intercompany financing transactions.

- **Options realistically available:** It is important to consider the options realistically available in order to support current and ongoing positions (e.g., additional pledges, modified repayment terms, covenant positions or additions, payment holidays, or force majeure clauses in certain arrangements). Additionally, there may be valid business reasons for both the lender and the borrower to depart from their contractual rights if this gives better prospects for both parties given the current environment. Similar to third-party situations, maturities could be extended, there may be a temporary freeze on certain payments, covenant computations can be adjusted so to correct for temporary swings of certain ratios, etc.

Additional consideration should be given to the commercial reasonableness of the transaction in order to support the assertion that a borrower could obtain access to funding in the current environment, which will vary based on industry/sector and creditworthiness. Another consideration is in connection with prepayment terms within existing intercompany agreements, which could be exercised based on an assessment of the alternatives realistically available to the borrower, especially when a refinancing opportunity may decrease borrowing costs and/or result in terms and conditions that better reflect the new situation of the borrower.

- **Capital structure:** For many corporations, capital structures will become pressured as reliance on external debt funding accelerates, with downward impact on intercompany funding structures. In turn, current internal financing structures could become tainted as distressed external borrowings are placed under default or thin capitalization thresholds are breached. Due to these potential scenarios, businesses should utilize updated financial forecasts to calibrate and optimize capital structures at both the treasury center and the subsidiary level in light of current or modified positions. Given the uncertainty in forecasts, scenario modeling will be key in order to pressure-test the positions under consideration.
- **Cost of borrowing:** The impact of current market interest rates on intercompany loans, guarantees, or other commonly employed financing instruments also must be considered. In particular, market rates of interest are subject to extreme volatility in today's environment, which makes the documentation and timing of the arm's-length rate of interest of critical importance. As transactions may be delayed, interest rate benchmarking may need to be refreshed so that it is representative of the market as of the execution date. Furthermore, intercompany borrowing rates will be impacted as base rates decline due to actions taken by central banks. In addition, many borrowers (particularly sub-investment grade) in the near term may face increased net borrowing costs due to rising credit margins.
- **Debt modification rules:** It is important to consider refinancing of existing transactions or any modifications to terms in light of debt modification rules (e.g., US Treas. Reg. sec. 1.1001-3) that could create adverse or other unintended tax consequences, such as cancellation of indebtedness (COD) income. Likewise, in the EU, certain loans are grandfathered from the interest limitation rules to the extent there are no substantial modifications to the contract.
- **Foreign exchange volatility:** Companies should consider current policies with respect to hedging of foreign currency risk, in seeking to mitigate adverse impact on gain/loss positions via intercompany hedging policies. Additional consideration to such instruments should be given for applicable taxpayers for purposes of the base erosion anti-abuse tax under IRC Section 59A.
- **Government stimulus:** Government incentives can play a key role in external financing in the coming months. As a result, affiliate companies may obtain financing on terms more favorable than otherwise available in the market, which requires an evaluation to determine if such terms can be mirrored in intercompany financing arrangements (or adapted as necessary). Incentives will vary based on local country, but may include interest-free loans or loans on favorable terms as well as debt forgiveness. Non-market-based terms and the arm's-length intercompany transfer price will need to be considered. For example, the arm's-length question could be: As a standalone subsidiary with a strong credit rating, could it have been eligible for the government-supported programs?
- **Guarantee arrangements:** External lending institutions may require additional financial and/or performance guarantees from parent or affiliate companies. When considering a guarantee fee between affiliate companies as a result of external lender requirements, the first step often is to consider if the internal borrower has the ability to borrow on a stand-alone basis, absent the guarantee (i.e., this is a characterization issue of whether the debt is for the

borrower or the guarantor). Secondly, and assuming *bona fide* indebtedness, pricing of the guarantee must be considered based on the benefit received (based on the facts and circumstances), which can include additional risk being borne by the guarantor, a potential rate benefit, or it may be more of an administrative purpose (e.g., more direct access to assets during bankruptcy). There are varying pricing approaches that can apply, as highlighted in the OECD FT Paper, such as the yield approach (interest savings) and cost approach (risks borne by the guarantor).

Issue: Cash pools and Finance/Treasury Centers

Many companies have cash pooling and/or centralized treasury centers whose policies should be evaluated to take into account current market changes. It is expected that the mobility of short-term cash around a group becomes critical to fund working capital and other needs, which previously would have been serviced via cash flow from operations.

While Euro interest rates have been low for years, the base rates for US dollar and other currencies also have steeply declined. This can impact the overall economics of the pool, if for example, for a long pool (i.e., there is excess group cash) where USD cash is invested externally, the return that could be earned by the treasury center on these deposits is significantly decreased. Similarly, there also are short pools (i.e., negative cash position) whereby companies are going to the market to access capital, increasing the overall costs to the treasury center. If deposit and draw margins with cash pool participants are not adjusted, this could lead to structural losses at the treasury center. There are further questions with how cash pool synergies or support payments should be adjusted and whether support payments should be made from pool participants if the pool is in a loss position, including how those payments are determined.

In conjunction with the release of the OECD FT TP Paper, companies may wish to consider the overall treasury center role within the group, and, in conjunction with the current market climate, to test and re-evaluate current policies. For example, if the treasury center follows an entrepreneurial model, the company could evaluate the substance (i.e., decision-making) as well as the current ability to bear risk (i.e., capital buffers, overall liquidity, and availability to obtain financing if needed). For long-term funding, the OECD expects that the lender also assesses the credit risk when granting the loan and monitors these risks during the life-time of the loan, taking mitigating actions if required.

Local country interest limitations and capital structure tests

The current market turmoil may create challenges for a company to deduct interest for tax purposes, as based on not only arm's-length tests but also local country interest limitation rules and/or bright line limits on debt levels. As earnings levels potentially shrink, the value of deductions may diminish due to the mechanics of interest stripping rules and increased use of leverage. However, alternatives may exist from a structure perspective, and new legislation may relax limits on the deduction of interest.

Governments around the world are beginning to consider tax relief for corporations in the form of easing interest deduction limitations in light of decreasing profitability levels. For example, legislation was recently enacted in the United States (the CARES Act) to modify the Section 163(j) interest limitation rules by increasing the 30% Adjusted Taxable Income (ATI) limitation to 50% for 2019 and 2020, as well as allow a taxpayer to elect to use its 2019 ATI for its 2020 limitation. Other international and domestic tax measures also are under underway in various jurisdictions in order to provide taxpayer relief, such as relaxation of net operating loss carryback rules.

Furthermore, it will be important to assess interest limitation rules against revised forecasts and subsequently determine if any lost deductions are temporary or permanent differences in order to then determine if structural changes are desirable.

Transactional tax implications

Due to changes in intercompany financing structures and policies that are certain to result from the current economic environment, companies need to evaluate the corollary impact on transactional taxes, namely withholding taxes, which may be predicated on prior capital structure positions. Withholding taxes often are subject to foreign tax credit restrictions or limitations; however, if properly structured, interest withholding taxes may be alleviated through the use of domestic tax law provisions, double taxation treaties, or the EU Interest & Royalty Directive. Consideration also should be given to compliance with documentation requirements with respect to withholding taxes as well as foreign currency control restrictions, which may add additional complexity based on local country rules and regulations.

The takeaway

Tax and Treasury functions need to work together on internal financing policies in lockstep, with external financing strategies of the group serving as a starting point for driving intercompany financing policies. Further, based on recent guidance on financial transactions in the form of the OECD FT Paper, an increasing trend toward local country adoption of OECD guidance, and new tax measures taken in response to current economic conditions, any internal financing policy should align with the regulatory landscape, in addition to availing of cash optimization strategies.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

Transfer Pricing

Bob Ritter, *Chicago*
robert.ritter@pwc.com

David Ledure, *Brussels*
david.ledure@pwc.com

Edwin Baghdasarayan, *Sydney*
edwin.baghdasarayan@pwc.com

Dan Pybus, *London*
daniel.j.pybus@pwc.com

Transfer Pricing Global, Americas, and US Leaders

Isabel Verlinden, *Brussels*
Global Transfer Pricing Leader
isabel.verlinden@be.pwc.com

Horacio Peña, *New York*
Americas Transfer Pricing Leader
horacio.pena@pwc.com

Paige Hill, *New York*
US Transfer Pricing Leader
paige.hill@pwc.com

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