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Global Transfer Pricing Conference

The end of ambiguity: Will the OECD redefine the fundamentals of pricing intercompany financial transactions?

Fit for the future

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Today's presenters

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Agenda

- New framework requirements in a changing environment
- Interest rates
- Guarantee fees
- Cash pooling
- Accounts receivables factoring
- Documentation

The environment

The environment

- Tax audit disputes and litigation
- Action 2: Neutralising the effects of hybrid mismatch arrangements
- Action 4: Limit base erosion via interest deductions and other financial payments
- Action 8: Guidance on transfer pricing aspects of intangibles
- Action 13: Guidance on transfer pricing documentation and Country-by-Country Reporting
- Guidance on financial transactions transfer pricing?

Interest rates

Interest rates
TP considerations

Determination of credit rating

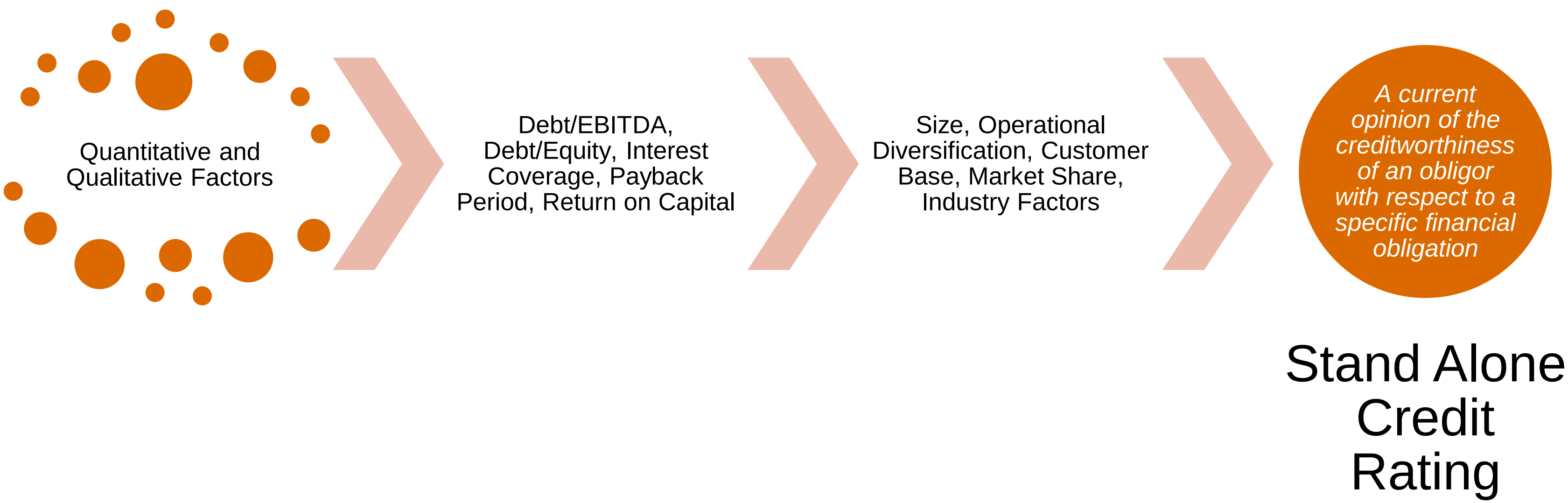
Taking care of additional tax considerations
- Thin cap/ characterization
- PE, WHT

Key transfer pricing issue: rating and terms and conditions

Determination of arm's length pricing method

Consideration of terms and conditions

Credit rating
Principles



Credit rating

Approaches

Parent Rating

- In isolation, does not consider stand alone risk at affiliate
- May use notching guidance/ principles, but provides broad estimate
- Misses entity specific attributes

Credit Scoring Tools

- Primarily based on quantitative information
- Provides ‘backing’ of rating agency mechanics and mapping
- Black-box benefit and limitation
- May not allow for addressing sector and qualitative elements that can be significant determinants

Replication of Rating Methodologies

- Most detailed and robust
- Has transparency to approach
- Considers both quantitative and qualitative factors
- Information available from rating agencies on grid- vs. actual rating bias

Interest rates
Pricing

Rating

- Entity level rating obtained above needs to be mapped to issue vs. issuer ratings in benchmarks
- Important to start with representative transactional data around the determined rating and refine based on steps below

Comparability

- While rating is the starting point, key comparability features need to be used to refine sample
- Relevant comparability factors include duration, currency, industry/ sector, security

Adjustments

- Adjustments are performed to account for differences between subject debt and market comparables
- Common adjustments include term adjustments, market adjustments, currency adjustments (if comparables are of different currency), etc.

Interest rates

Impact of terms and conditions

Impact on interest rate	Repayment	Options	Guarantee	Term	Seniority/rank	Interest payment	Security	Currency	Conversion
Higher	Bullet	Pre-payment	Un-guaranteed	Long term	Mezzanine	On maturity	Unsecured	Higher risk currency	Non-convertible
					Junior				
Lower	Capital & interest	Demand	Guaranteed	Short term	Senior	Quarterly (regular)	Secured	Lower risk currency	Convertible

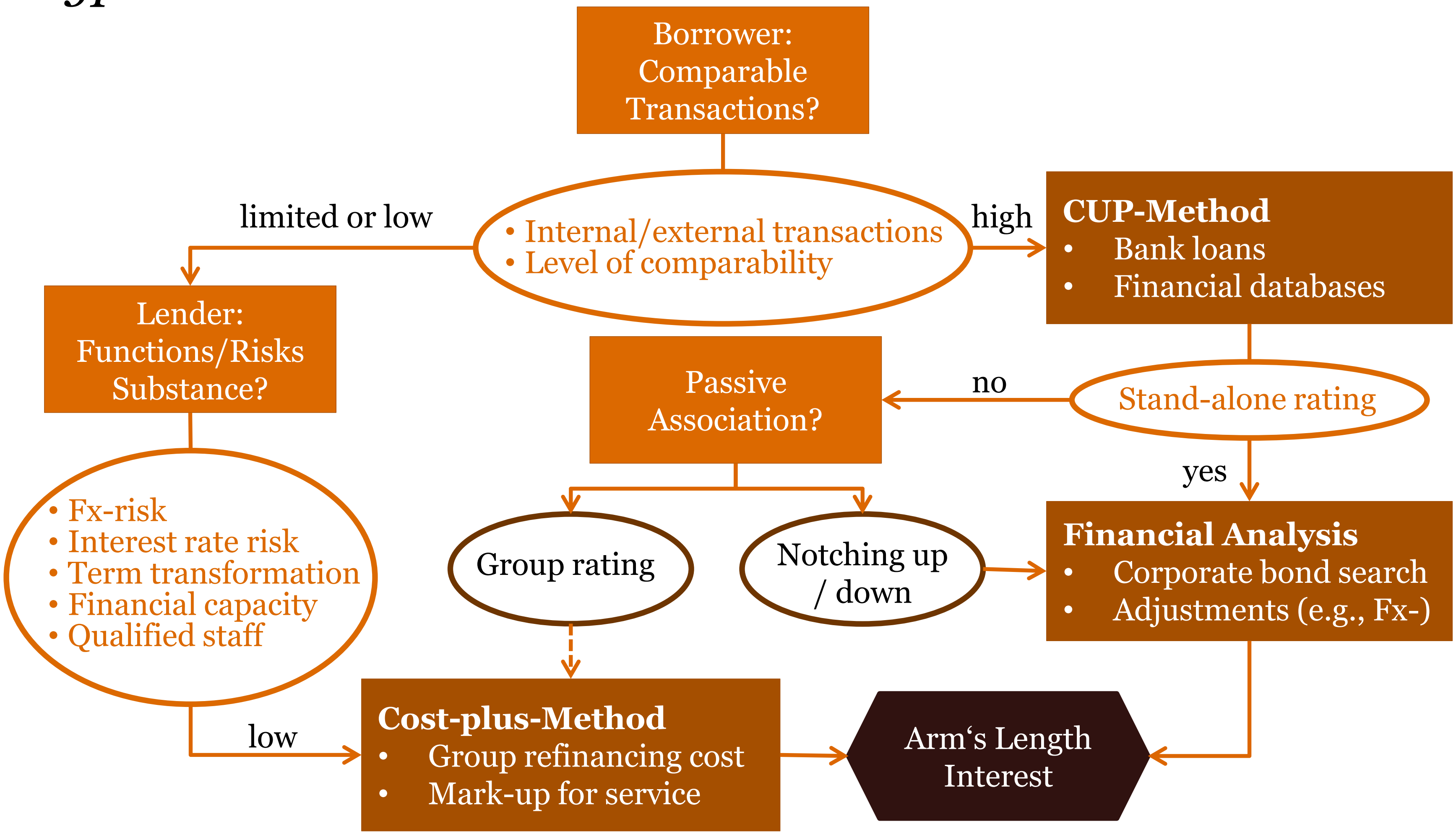
Impact of covenants ?

Commercial & economic rationale ?

Impact on fixed vs. floating loans ?

Intercompany loans

Typical TP audit scheme



Common pitfalls in practice

1 No (stand alone) credit rating of the borrower

2 Using one blended interest rate for all transactions

3 Including flexibility (call & prepayment options) without considering the impact on the interest rate

4 Using a one pager as loan documentation

5 Not addressing FX risks

Also look out for the following:

- Transfer of loans at par value (vs. fair market value)
- Lack of consideration for withholding taxes (for who's account/impact on price)
- Thin cap/ characterization issues raised by rating, terms or rate/ benchmark choices
- Long term funding within cash pools (see subsequent discussion)

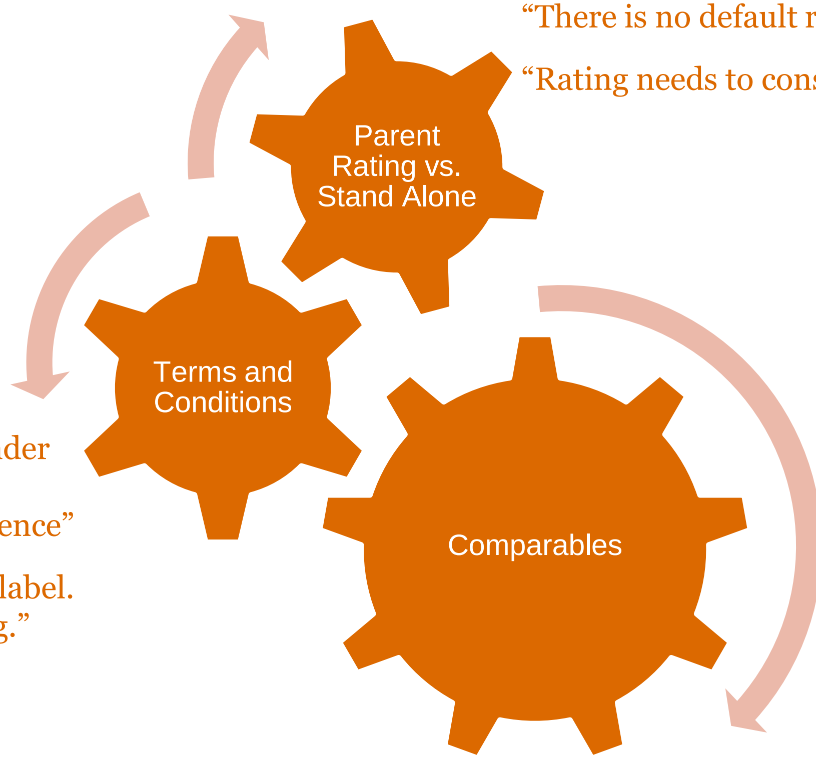
Interest rates
Audit challenges

“Parent is investment grade”

“RiskCalc has issues”

“There is no default risk”

“Rating needs to consider implicit support”



“The agreement is one-page”

“Agreement says you can prepay without penalty”

“The agreement notes need for [lender approval, maintenance of financial covenant, etc.]. Please show adherence”

“Subordination/ Mezzanine is just label. There is no consequence for pricing.”

“

“It’s a loan and you have used bonds”

“This is a much smaller loan than in any of the comparables”

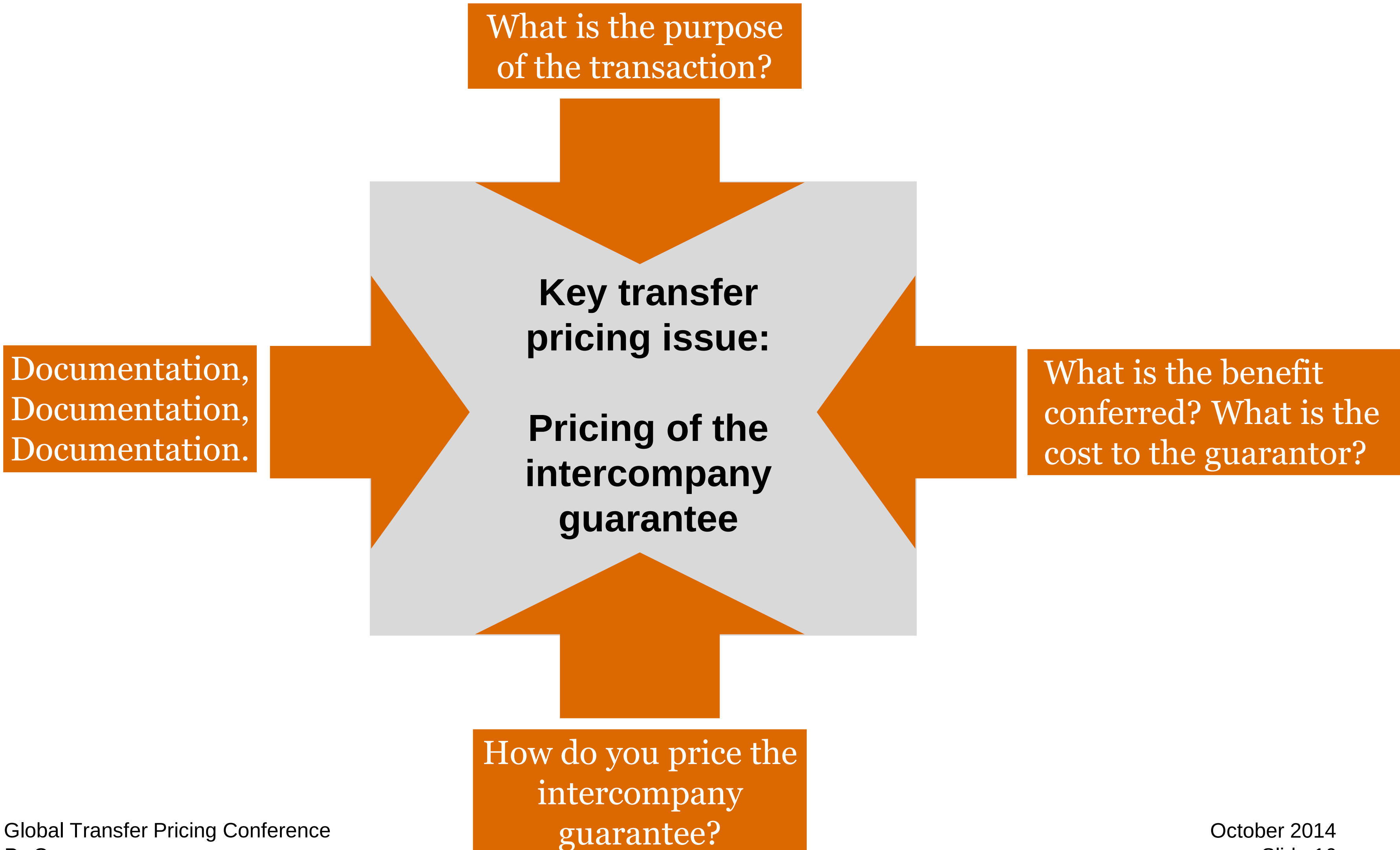
“The borrowers in the comparable transactions are not in the same industry”

“Show me the agreements for the comparable transactions.”

“Your external debt is the best comparable”

Guarantee fees

Guarantee fees
TP considerations



Intercompany guarantees
Overview

What is the purpose of the transaction?

- Critical building block

What type of guarantee is it?

- Financial guarantee?
- Performance (Operating) guarantee?
- Legal form?

What is the benefit conferred? What is the cost to the guarantor?

- OECD/G20 BEPS Action 8
- Shareholder service
- Beneficial service

Guarantee fees

Pricing

"Ask" Price

- Yield Approach - Price of credit guarantee = estimated arm's length interest rate without guarantee – actual interest rate with guarantee
- CUP approach - Adjusted standby letters of credit / letters of credit

"Bid" Price

- Return on the on-balance sheet liability
  - On-balance sheet liability = likelihood of having to pay x potential payment
  - Earn a return on the on-balance sheet liability

Cash pooling

Cash pooling
TP considerations

Selection of arm's length **TP Method**

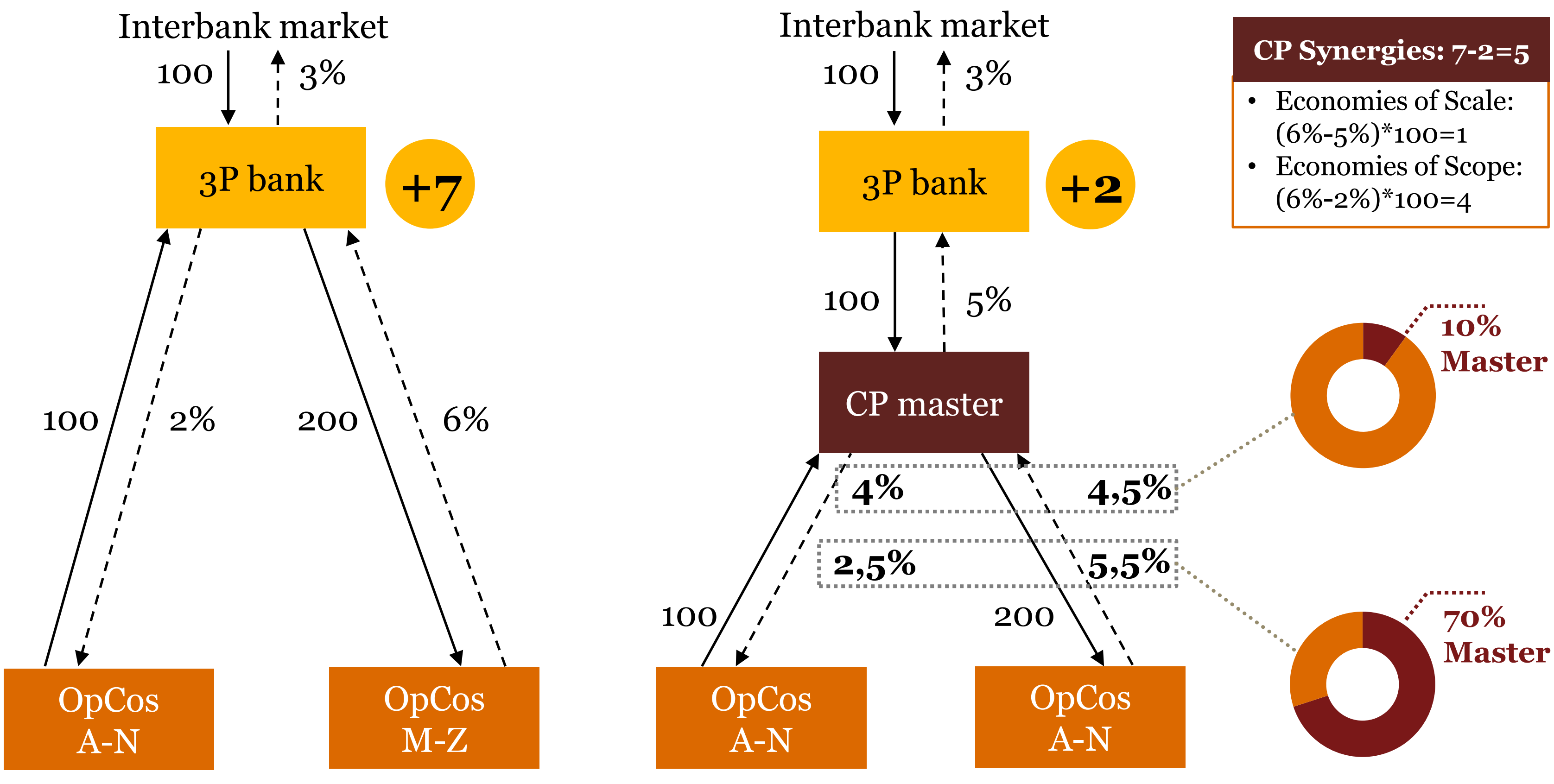
Taking care of additional tax considerations
- **Long term** cash position
- Thin Cap, WHT, VAT implications

Key transfer pricing aspects:
- **credit risk**
- **synergies**

Considering individual facts and circumstances
- **Type** of cash pooling
- **Functions** and risks
- **Substance**
- **Contractual** framework
- **Nature** and **scope** of realized **synergies**

How to **measure** the cash pool advantage?

Cash pooling
How to measure synergies?



CP Synergies: 7-2=5

- Economies of Scale: (6%-5%)*100=1
- Economies of Scope: (6%-2%)*100=4

Cash pooling
How to deal with credit risk?

Cash pool advantage

- Cash pool advantage being allocated to cash pool leader, while cash pool leader is not having the **(financial) substance** to support this allocation

Debit and credit interest rates based on bank quotes

- Credit interest rate does not properly consider the **risk** associated to **depositing** cash in **cash pool** (which is **higher** compared to depositing with a bank)
- Debit interest rate does not consider the **differences in creditworthiness** of participants

Credit Risk

Long term positions in cash pool

- **Business reasons** may be available
- If not, and if clear upfront, **long term loan pricing** may have been more appropriate

Cash pooling

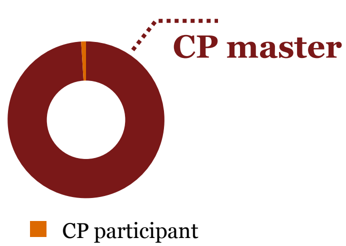
Selection of an appropriate transfer pricing method

"Comparable uncontrolled price method" ("CUP")

- Remuneration of the CP participants based on (standard bank) **market interest rates**
- Adjustments (**credit risk**)
- Market interest rates as a maximum price and **benchmark**

Benefit test vs. CUP

Profit allocation:

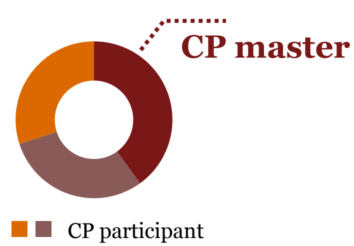


Profit Split

- **Function and risk** profile of CP Master
- Value added/ **synergies**/ efficiency gains (2.113 OECD)
- Measure and split synergies between CP Master & Members according to **relative contributions**

Substance of CP master

Profit allocation:

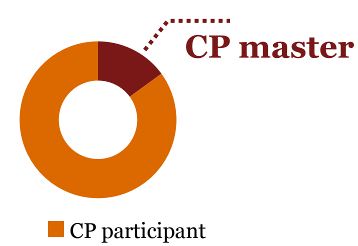


Cost plus method

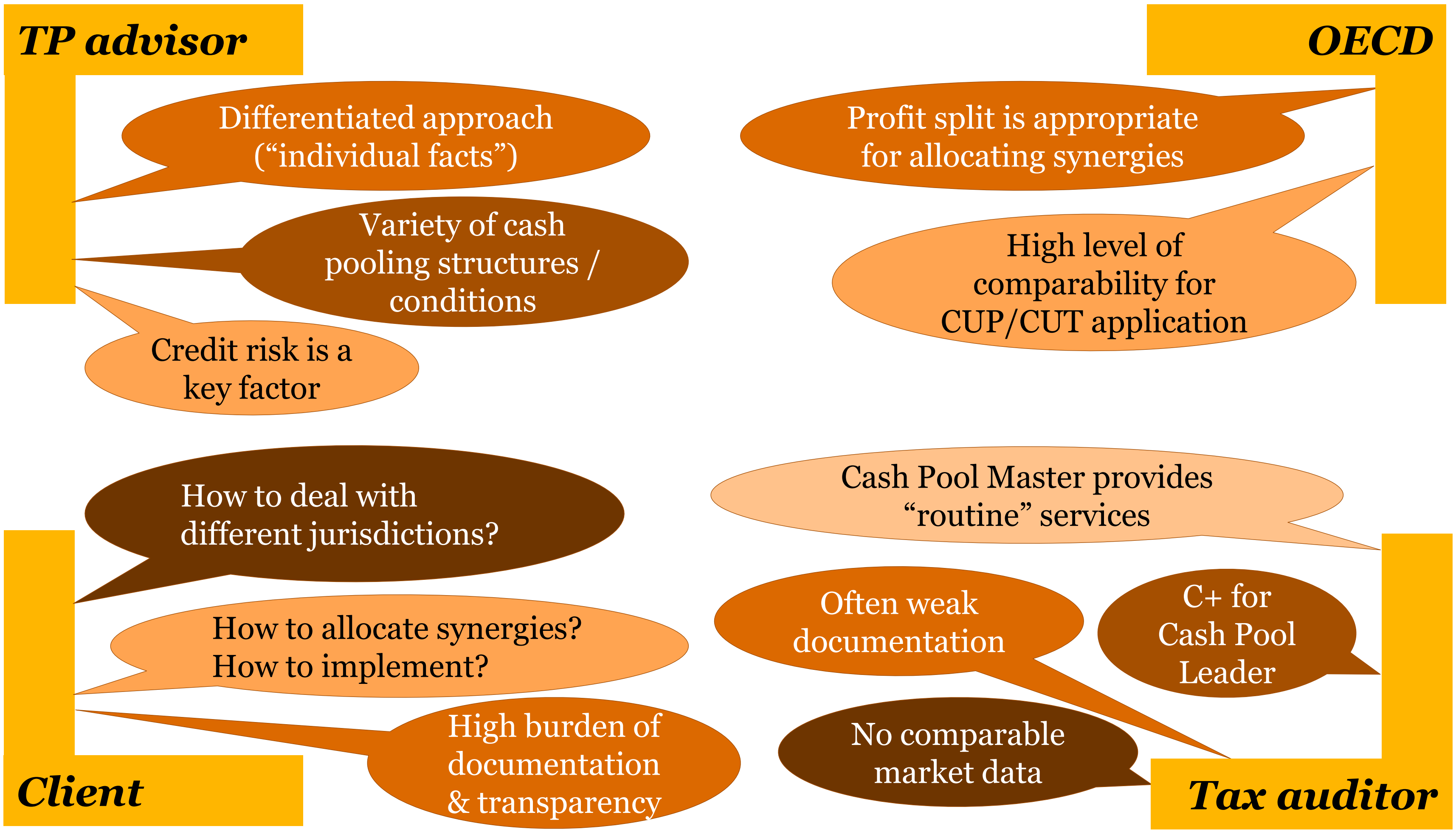
- **Routine functions** of CP Master
- No significant risks of CP Master
- Routine remuneration based on **admin costs**
- **Residual** allocated between CP Members

Implementation

Profit allocation:

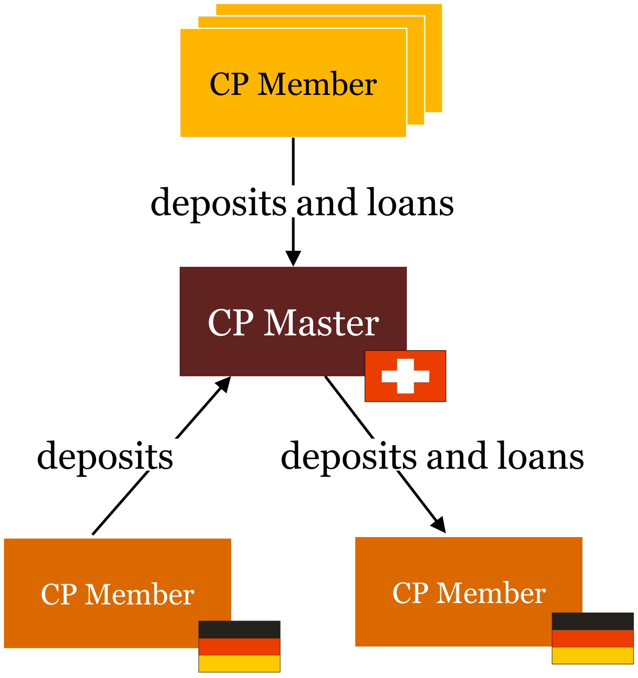


Cash pooling
Controversial debate



Cash pooling

Discussion topics during tax audits: "typical" case (1)



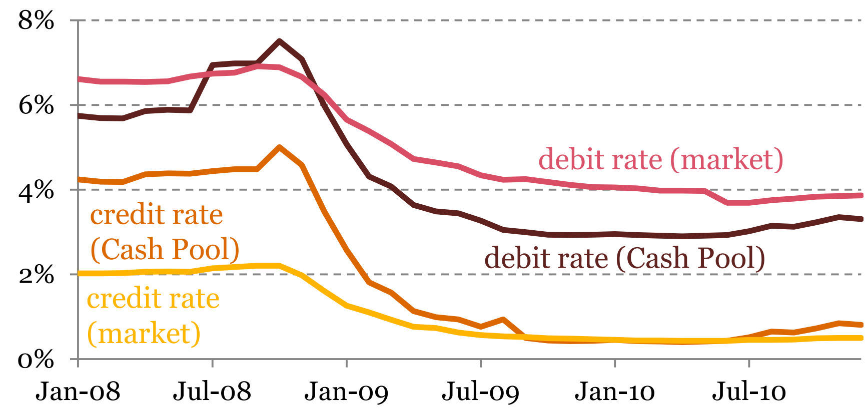
Transfer pricing method applied

Intercompany Cash Pool interest rates

- Deposits at CP Master:
  LIBOR ± 0 bp
- Loans from CP Master:
  LIBOR + 150 bp (before 2008)
  LIBOR + 250 bp (2008 and following)

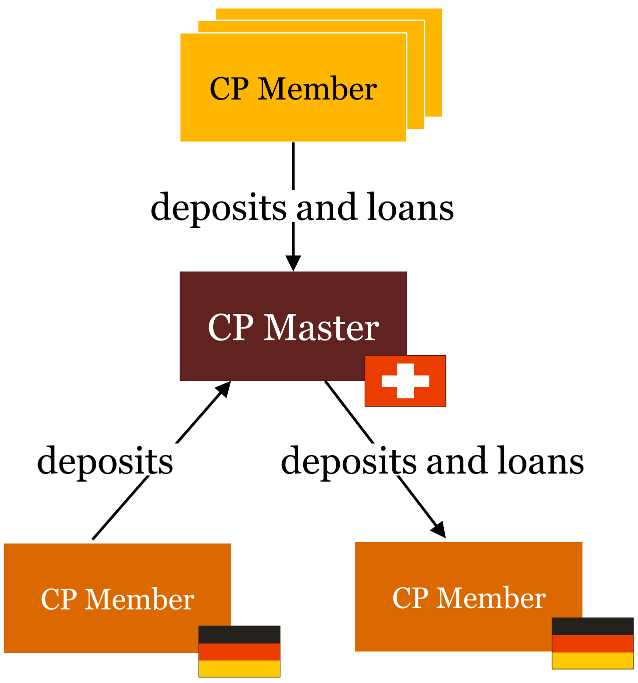
Arm's length analysis

Benefit analysis



Cash pooling

Discussion topics during tax audits: “typical“ case (2)



Rationale of the tax audit

Credit rate of depositing CP participants is too low

- No benefits resulting from applying **LIBOR** interest rate
- No appropriate reflection of **credit risk** on CP Master
- No appropriate reflection of other **intercompany benefits** resulting from liquidity supply
- **Increased CP Master** spread in 2008 inappropriate
- **Pass-through funding** of entities within one fiscal unity
- **Long-term** nature of deposits/loans

Possible lines of defence

- **Multiple-year-analysis** based on third party data
- LIBOR represents interbank interest rate (arm’s length)
- Banks only earn a profit margin if they offer **deposit rates below** the LIBOR rate
- Therefore, **LIBOR rate includes a benefit**
- Bank transactions are the **best alternatives available** in the **market**

Cash pooling
Core statements

Arm's length TP method for cash pooling

Allocation of cash pooling synergies (net interest savings)

Avoidance of long term funding within cash pools

Various international cash pooling cases

Think it through from the beginning

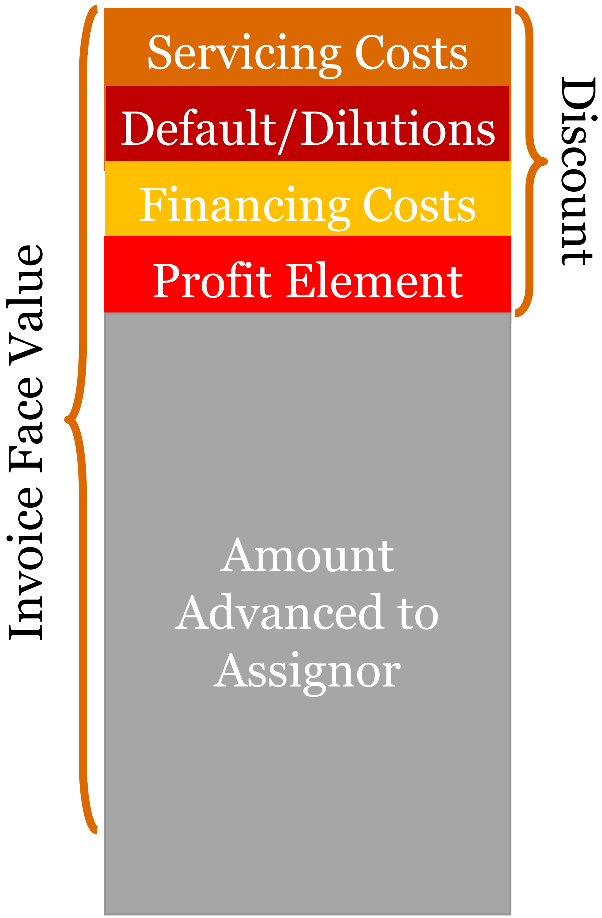
Accounts receivable factoring

Accounts receivable factoring

Overview and breakdown of the factoring "price"

Transaction Characteristics

- Recourse vs. Non-Recourse
- Notification vs. Non-Notifcation
- Asset Sale



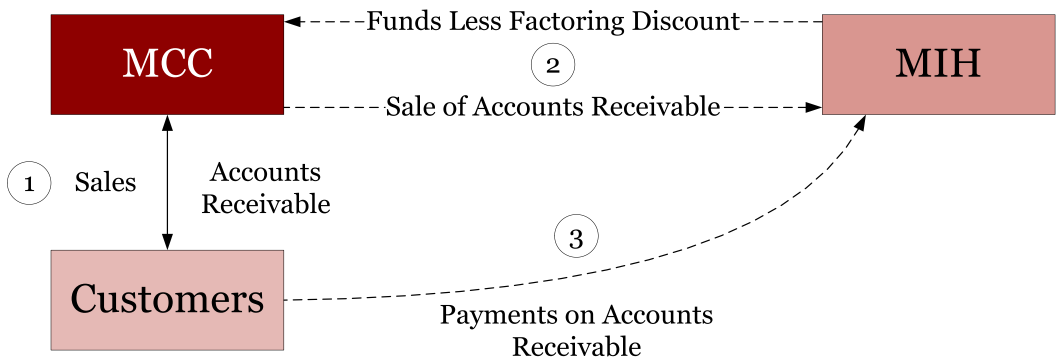
Transfer Pricing Methods

- Constructed CUP method
- TNMM/CPM
- Discounted Cash Flow ("DCF")

Intercompany factoring: A case study
The McKesson Canada case

Case facts

- In December 2002, McKesson Canada Corporation ("MCC") sold its trade receivables to a related party at a discount of 2.206% from the face amount
- Canada Revenue Agency reassessed based on the appropriate discount being 1.013%. This was equal to a transfer pricing adjustment of $26,610,000



- The question considered by the Court was the amount that an arm's length party would have been willing to pay for the rights and benefits obtained
- The Court rejected MCC's appeal
- MCC has appealed the Court's decision

Intercompany factoring: A case study
The McKesson Canada case (cont'd)

How did the Court reach its Decision?

- The Court determined that its decision should be based on the legal structure of the Receivables Sales Agreement ("RSA")
- Each component of the discount rate was considered (i.e. yield rate, loss discount, and discount spread)
- The Court concluded that the arm's length discount was between 0.959% and 1.17%
- As the taxpayer's discount rate of 2.206% was outside the range and the CRA's rate of 1.013% was in the range, the Court rejected the taxpayer's appeal

Other transfer pricing related comments raised by the Court

- The Court commented on a number of transfer pricing related issues without formally opining on any as part of his decision including the following
  - The relevance of the series of transactions that relate to the transaction
  - The scope of transfer pricing adjustments under 247(2)(a) and (c)
  - Consideration of factors that exist as a result of the non-arm's length relationship
  - The requirement of the Court to consider alternative options available to the taxpayer
  - The requirement of the Court to consider the purpose of the transaction and issues related to the "fair share of tax" debate
  - Contemporaneous documentation and "reasonable efforts" under 247(4)

Documentation

Transfer pricing and BEPS

- Three-tiered approach to transfer pricing risk assessment / documentation

Tier	Purpose
Master file	Risk assessment
Local file	Documentation
Country-by-Country Reporting	Risk assessment

- What does this mean?

Evaluate and support your intercompany financial transactions – Do not ignore them!

Thank you!