Global Transfer Pricing Conference

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

October 2014
Today’s presenters

- Jeff Rogers
- Krishnan Chandrasekhar
- Jörg Hülshorst
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
- Guidance on financial transactions transfer pricing?
Interest rates
**Interest rates**
*TP considerations*

- Determination of credit rating
- Determination of arm’s length pricing method
- Consideration of terms and conditions
- Taking care of additional tax considerations
  - Thin cap/characterization
  - PE, WHT

**Key transfer pricing issue:** rating and terms and conditions
Credit rating Principles

Quantitative and Qualitative Factors

Debt/EBITDA, Debt/Equity, Interest Coverage, Payback Period, Return on Capital

Size, Operational Diversification, Customer Base, Market Share, Industry Factors

Stand Alone Credit Rating

A current opinion of the creditworthiness of an obligor with respect to a specific financial obligation
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

- Higher
  - Bullet
  - Pre-payment
  - Un-guaranteed
  - Long term
  - Mezzanine
  - On maturity

- Lower
  - Capital & interest
  - Demand
  - Guaranteed
  - Short term
  - Senior
  - Quarterly (regular)

Impact of covenants?
Commercial & economic rationale?
Impact on fixed vs. floating loans?

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Intercompany loans
Typical TP audit scheme

Borrower: Comparable Transactions?

Lender: Functions/Risks Substance?

- Fx-risk
- Interest rate risk
- Term transformation
- Financial capacity
- Qualified staff

Passive Association?

Limited or low

Internal/external transactions
Level of comparability

Cost-plus-Method
- Group refinancing cost
- Mark-up for service

Arm’s Length Interest

CUP-Method
- Bank loans
- Financial databases

Financial Analysis
- Corporate bond search
- Adjustments (e.g., Fx-)

Group rating
Notching up / down

Stand-alone rating

Group rating

Low

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## Common pitfalls in practice

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<tbody>
<tr>
<td>1</td>
<td>No (stand alone) credit rating of the borrower</td>
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<td>2</td>
<td>Using one blended interest rate for all transactions</td>
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<td>3</td>
<td>Including flexibility (call &amp; prepayment options) without considering the impact on the interest rate</td>
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<td>4</td>
<td>Using a one pager as loan documentation</td>
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<td>5</td>
<td>Not addressing FX risks</td>
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**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

Key transfer pricing issue:
Pricing of the intercompany guarantee

What is the purpose of the transaction?
What is the benefit conferred? What is the cost to the guarantor?
How do you price the intercompany guarantee?
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

Key transfer pricing aspects:
• credit risk
• synergies

Selection of arm’s length TP Method

How to measure the cash pool advantage?

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

Considering individual facts and circumstances
• Type of cash pooling
• Functions and risks
• Substance
• Contractual framework
• Nature and scope of realized synergies
Cash pooling
How to measure synergies?

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

CP Synergies: $7-2=5$
Cash pooling
How to deal with credit risk?

Credit 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

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

**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

**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

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Cash pooling Controversial debate

**TP advisor**
- Differentiated approach ("individual facts")
- Variety of cash pooling structures / conditions
- Credit risk is a key factor
- How to deal with different jurisdictions?
- How to allocate synergies? How to implement?
- High burden of documentation & transparency

**OECD**
- Profit split is appropriate for allocating synergies
- High level of comparability for CUP/CUT application
- Cash Pool Master provides "routine" services
- Often weak documentation
- C+ for Cash Pool Leader

**Client**
- How to allocate synergies? How to implement?

**Tax auditor**
- No comparable market data
- High burden of documentation & transparency
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

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**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-Notification
- Asset Sale

Transfer Pricing Methods
- Constructed CUP method
- TNMM/CPM
- Discounted Cash Flow (“DCF”)

Amount Advanced to Assignor

Invoice Face Value

Servicing Costs
Default/Dilutions
Financing Costs
Profit Element

Discount
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)
Transfer pricing and BEPS

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

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<th>Purpose</th>
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<tr>
<td>Master file</td>
<td>Risk assessment</td>
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<tr>
<td>Local file</td>
<td>Documentation</td>
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<td>Country-by-Country Reporting</td>
<td>Risk assessment</td>
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- What does this mean?
Evaluate and support your intercompany financial transactions – Do not ignore them!

Thank you!