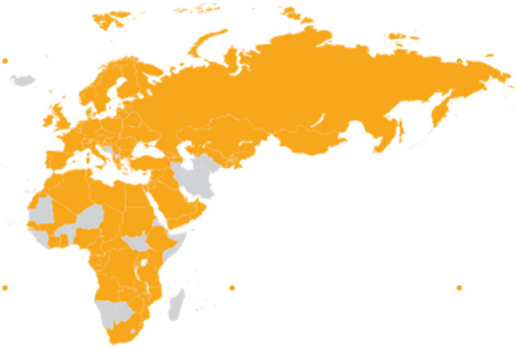
Crowe

Crowe Transfer Pricing Wednesday

New OECD Guidance on Financial Transactions



06/03/2020

On 11 February 2020, the OECD published the “Transfer Pricing Guidance on Financial Transactions” document (hereinafter “Report”).

The Report, which will constitute the new chapter 10 of the OECD Transfer Pricing Guidelines, provides specific guidelines on how to apply the arm’s length principle for financial transactions.

The publication of the Report is of greater relevance in view of the period of crisis triggered by Covid-19.

As such, one of the main impacts for multinational groups concerns liquidity management.

In order to ensure full operability, companies need to manage their financial resources in the best possible way. This is performed by:

- taking actions by increasing the management efficiency of the receivable and payable accounts;
- the utilisation of public support such as:
    - tax measures (i.e. suspension of tax obligations, suspension of the terms of the activities of collection offices, tax credit)
    - financial support measures (i.e. wage compensation funds, access to public sector subsidies to businesses).
- taking actions aimed at finding additional resources of private financing.

At intercompany level, financial management is carried out through instruments such as loans, cash pooling and guarantees.

The use of these instruments cannot be separated from accurate analyses that must be employed taking into account the recent OECD Report in order to ensure compliance with the arm's length principle of interest rates and any other financial charges associated with these instruments.

Some of the main innovations introduced by the Report

Determining the capital structure: debt or equity?

One of the main innovations introduced by the Report concerns the correct determination of the capital structure.

The proper application of the arm's length principle to an intercompany financing transaction requires that the right determination of the capital structure of the borrowing entity be verified in advance, in order to assess whether the loan granted should be considered as a loan for tax purposes or more properly as a contribution to equity capital ("accurate delineation").

Therefore, before assessing the conformity of the interest rate with the arm's length principle, it is necessary to evaluate:

- how much an independent lender would be willing to lend (“what could you borrow”)
- how much the independent borrower would be willing to borrow ("what would you borrow")

in comparable circumstances in order to calculate the maximum allowable debt (commercially supportable debt quantum).

In practice, the OECD Guidelines introduce the concept of arm’s length debt alongside the arm's length price concept.

The Report also provides useful indicators for the correct framing of an intercompany financing transaction and its possible re-characterization into equity.

It is, however, considered the alternative that every countries decide to adopt alternative regulations to define the right balance between equity and debt.

Identification of commercial or financial relations

In order to verify the compliance of financial transactions with the arms' length principle, the Report, similarly to any controlled intercompany transaction, highlights the need to identify, the economically relevant characteristics of the commercial or financial relations existing between the associated enterprises, in order to accurately outline the transaction.

In addition to the five comparability factors, specific elements that must be assessed are:

- sector: lifecycle analysis, regulation, availability of resources, short/long term needs; constraints of regulated entities (e.g., Basel requirements);
- business strategies: financial needs on different projects, strategic importance for the group, credit or debt ratio (equity ratio) objective, different funding strategies in the sector;
- comparability: the possibility to make adjustments on quantitative factors with good qualitative data (e.g., exchange rate differences).

Determination of the creditworthiness

According to the OECD, the borrower's creditworthiness is one of the main factors that independent investors consider when determining the interest rate to be applied to a loan.

In the case of intra-group loans and other financial instruments that are the subject of controlled transactions, the effect of group membership may be an economically relevant factor that affects the pricing of these instruments.

For this reason, the OECD Report suggests a different approach to be used to determine the credit rating depending on the strategic importance that the borrower assumes within the Group and in particular:

- credit rating stand-alone: in cases where the company (borrower) does not assume a high strategic importance within the Group, support in the event of default is highly unlikely. The borrower's credit rating should be assessed on a stand-alone basis.
- group credit rating: if the borrower takes on a high strategic importance within the group, it is very likely that the company will receive support in the event of default. In that case, the borrower should be assigned a rating closely related to that of the group.
- credit rating and implicit support from the group: where support can be considered probable, but only in limited circumstances, might be appropriate starting from a stand-alone rating assessment and then improving the rating on the basis of the same criteria used to assess the probability of support.

Intercompany financing

The Report illustrates the most suitable methods to determine the "arm's length pricing" in a financial transaction:

- Comparable uncontrolled price (CUP): this is the easiest method to apply to financial transactions compared to other types of transactions because of the greater availability of information. The interest rate of an intercompany loan can be determined on the basis of the interest rates applied in the market in comparable loans granted to parties with the same credit rating as the associated debtor.
    - Alternatively, arm's length rates may be estimated on the basis of returns observable in other transactions with comparable economic characteristics (i.e. bond issues). Using this approach it is often necessary to make adjustments to ensure the highest possible comparability.
- Cost of funds approach: in the absence of comparables, an alternative method is to examine the cost of financing of lenders plus a profit margin. The Report stresses the need to analyse the transaction from the point of view of both parties involved (in particular, a borrower would not enter into a transaction if he can obtain financing on more favourable terms in an alternative transaction available on the market).
- Credit default swaps: The Report mentions credit default swaps and related instruments such as potential comparable transactions to determine the risk premium for an intra-group loan.
- Economic models: according to these models, the arm's length rate is constructed on the basis of a risk-free rate and a risk premium that reflects the specific characteristics of the financing transaction, such as default risk, liquidity risk, maturity or expected inflation.
- Bank opinions: The use of bank letters or bank opinions as proxies for determining the transfer prices of an intra-group loan is not considered to be a consistent approach to the arm's length principle since it would not be based on a comparison with actual transactions and because these opinions would not represent binding offers to the bank.

The definition of an interest rate of an intercompany loan: application modalities

The determination of an interest rate for an intercompany loan, based on international best practices, is carried out according to the following steps:

1. *Credit rating assessment of the borrower*

The analysis should begin with the determination of the borrower's credit rating.

In case in which there are no readily available public ratings from a rating agency (i.e., Standard & Poor's, Moody's, Fitch), commercial tools are available to estimate the credit ratings of borrowers, however, it is recognized that such tools differ considerably from the credit rating methodologies applied by rating agencies to determine official ratings (due to lack of review of qualitative as well as quantitative factors, the management's ability to manage the company, etc.).

2. *Verification of borrowing rates applied in existing loans (internal CUP)*

The second step of the analysis involves examining the borrowing rates and any additional costs applied by financial institutions in financing already contracted by one of the parties involved in the intercompany loan (i.e., internal CUP).

In order to identify a comparable financing, it is necessary to analyse the following elements:

- Type of transaction (i.e., term, bridge loan, revolving)
- Maturity
- Issue Dates
- Currency
- Notional
- Type of rate applied (i.e. Floating Rate vs. Fixed Rate)
- Payment frequency
- The existence of financial guarantees

However, the presence of such financing may require adjustments to be made to make the transaction more comparable (i.e., differences in currency or maturity may be adjusted using the Swap Manager function of Bloomberg or Swap Pricer of Thomson Reuters Eikon).

3. Verification of information available on the funding market (external CUP)

It may be advisable to analyse the information available on the funding market (i.e., verification of the potential application of the external CUP) using specific databases (e.g., Bloomberg, Thomson Reuters, Moody's).

In particular, through Bloomberg it is possible to observe, with the help of the Loan/Bond Search function of Bloomberg (or alternatively through the LoanConnector DealScan function of Thomson Reuters), the rates of loans (or corporate bonds) stipulated by parties with ratings consistent with those identified for borrower companies.

Alternatively – and in some cases also for corroboratory purposes – it is possible to make comparisons with observable market yields for debt operations consistent in terms of maturity and risk profile with intercompany loans.

For this purpose, the information observable on the Moody's Market Implied Ratings - Bonds Over Libor financial database, which contains information on observable spreads on all bond issues subject to Moody's ratings, sorted by maturity and rating class, may be valid instruments.

4. Result of the analysis

The analysis conducted according to the above steps allows to determine a range of rates that will be deemed compliant with the arm's length principle.

Contacts Crowe Italy

Federico Vincenti
f.vincenti@crowevalente.it

Filipa Correia
f.correia@crowevalente.it

Tiziana Cavallo
t.cavallo@crowevalente.it