Rethinking intercompany pricing for in-house treasury operations – A 2022 scan approach

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Functions Assets and Risk

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- F/R/A in financial transactions
- Main/Central company – “entrepreneur”
- Is the central company entitled to the non-routine profit?
- Arm’s length compensation – cost plus? more aggressive?
- Allocations of profits
- Allocations of loses
- IP companies

Foreign Exchange Risk

- Treasury role
- Who should bear hedging costs?
  - Central company?
  - Allocation?
- Allocations of benefits
- Risks of several currencies
- Central risk allocation model

Full costing versus margin cost

Full costing versus margin cost

- Long term versus short term
- How to deal with historical loans
  - Existing loans when doing M&A's
  - Long dated loans
  - TP audits
- Risks
- Cash management

Transfer Pricing Study

Transfer Pricing Study

- SOFR
- TP Study
  - Comparables (bonds)
  - Fixed rate
  - Maturity
  - Swap
  - Margin

Choice of Method

Transfer Pricing Study

- Cup/Cut
- Additional methods
- TP Study should include a description of the search provided
- In the case CUP/CUT TP study should include list of the underlying bonds that have been used for benchmarking

Credit Rating

Credit Ratings

There are a few factors credit agencies take into consideration when assigning a credit rating to an organization.

- the entity's past history of borrowing and paying off debts. (Any missed payments or defaults on loans negatively impact the rating.)
- the entity's future economic potential.
- Historical financials (Balance sheet and Profit Loss)
- Implicit/Explicit Parent Company Support
- Country sovereign debt rating
- Note that there are tools such as Moody’s RiskCalc to determine credit rating

Credit Ratings – S&P Methodology

Long-Term Issue Credit Ratings*	
Category	Definition
AAA	An obligation rated 'AAA' has the highest rating assigned by S&P Global Ratings. The obligor's capacity to meet its financial commitments on the obligation is extremely strong.
AA	An obligation rated 'AA' differs from the highest-rated obligations only to a small degree. The obligor's capacity to meet its financial commitments on the obligation is very strong.
A	An obligation rated 'A' is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than obligations in higher-rated categories. However, the obligor's capacity to meet its financial commitments on the obligation is still strong.
BBB	An obligation rated 'BBB' exhibits adequate protection parameters. However, adverse economic conditions or changing circumstances are more likely to weaken the obligor's capacity to meet its financial commitments on the obligation.
BB, B, CCC, CC, and C	Obligations rated 'BB', 'B', 'CCC', 'CC', and 'C' are regarded as having significant speculative characteristics. 'BB' indicates the least degree of speculation and 'C' the highest. While such obligations will likely have some quality and protective characteristics, these may be outweighed by large uncertainties or major exposure to adverse conditions.
BB	An obligation rated 'BB' is less vulnerable to non-payment than other speculative issues. However, it faces major ongoing uncertainties or exposure to adverse business, financial, or economic conditions that could lead to the obligor's inadequate capacity to meet its financial commitments on the obligation.
B	An obligation rated 'B' is more vulnerable to nonpayment than obligations rated 'BB', but the obligor currently has the capacity to meet its financial commitments on the obligation. Adverse business, financial, or economic conditions will likely impair the obligor's capacity or willingness to meet its financial commitments on the obligation.
CCC	An obligation rated 'CCC' is currently vulnerable to nonpayment and is dependent upon favorable business, financial, and economic conditions for the obligor to meet its financial commitments on the obligation. In the event of adverse business, financial, or economic conditions, the obligor is not likely to have the capacity to meet its financial commitments on the obligation.
CC	An obligation rated 'CC' is currently highly vulnerable to nonpayment. The 'CC' rating is used when a default has not yet occurred but S&P Global Ratings expects default to be a virtual certainty, regardless of the anticipated time to default.
C	An obligation rated 'C' is currently highly vulnerable to nonpayment, and the obligation is expected to have lower relative seniority or lower ultimate recovery compared with obligations that are rated higher.
D	An obligation rated 'D' is in default or in breach of an imputed promise. For non-hybrid capital instruments, the 'D' rating category is used when payments on an obligation are not made on the date due, unless S&P Global Ratings believes that such payments will be made within five business days in the absence of a stated grace period or within the earlier of the stated grace period or 30 calendar days. The 'D' rating also will be used upon the filing of a bankruptcy petition or the taking of similar action and where default on an obligation is a virtual certainty, for example due to automatic stay provisions. A rating on an obligation is lowered to 'D' if it is subject to a distressed exchange offer.

The Altman Z-score

- The Altman Z-score formula for predicting bankruptcy was initially published in 1968 by Edward I. Altman, an Assistant Professor of Finance at New York University. The formula was used to predict the probability that a firm will go into bankruptcy within two years.
- The firm's current Z-Score is based on its financial statements and market values (if available) and.
- combines a number of relevant financial ratios, each assigned a coefficient, or weighting, such that when you add-up the various measures and weights, the result is a single number, or indicator, which is the basis for assigning a bond-rating equivalent (BRE) and a probability of default (PD) for 1 to 10 years into the future.

Solvency of an MNE

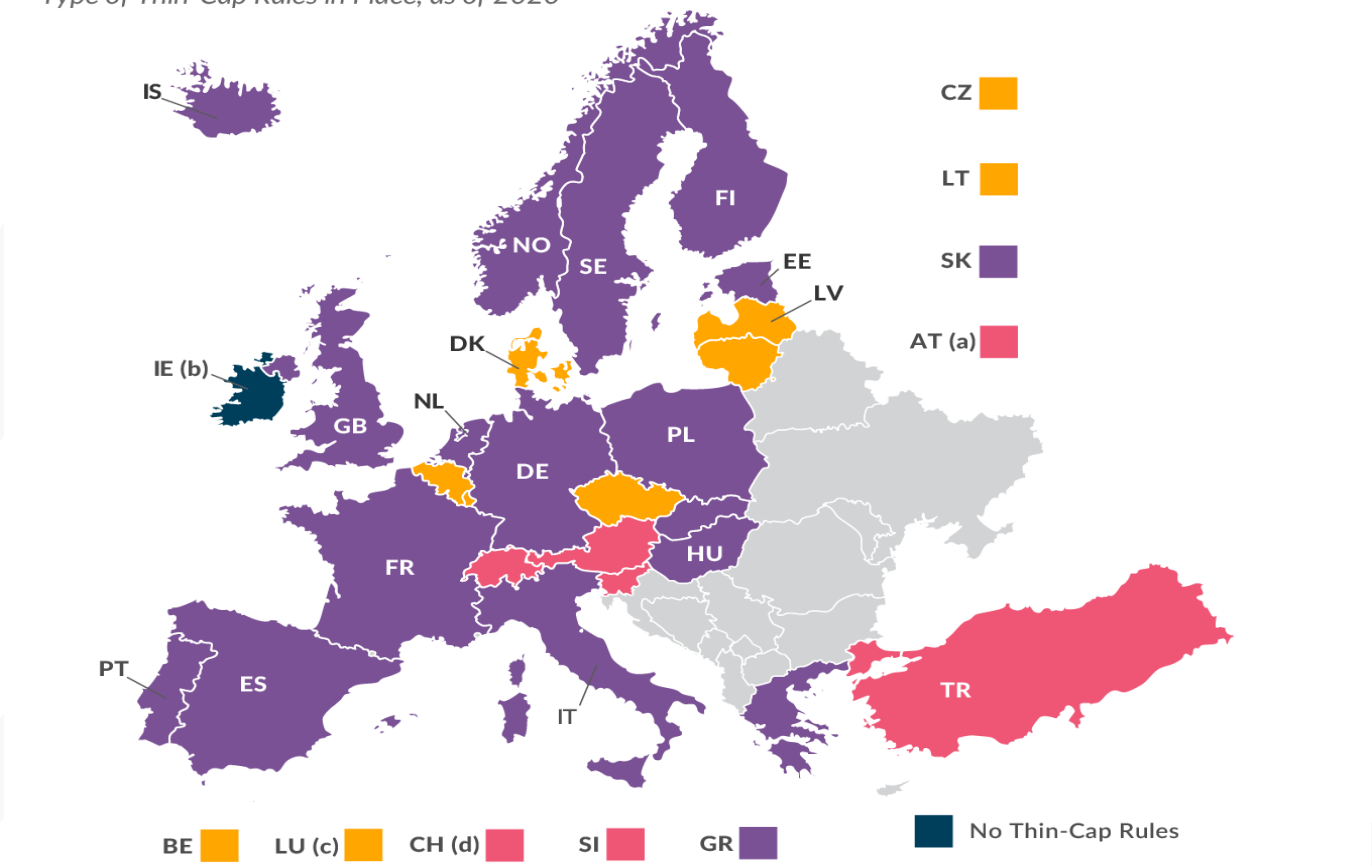
Solvency

Thin Capitalizations

- Thin capitalization occurs when the level of debt is much greater than its equity capital
- High-tax countries create an incentive for companies to finance investments with debt because interest payments are tax-deductible, which is usually not the case for equity costs. This may result in lending money internally from entities in low-tax countries to entities in high-tax countries and decrease the worldwide tax liability.
- Thin capitalization rules are intended to prevent excessive financing with debt capital in which only a small amount of equity is present.
- Safe harbor rules restrict the amount of debt for which interest is tax-deductible by defining a debt-to-equity ratio. Earnings stripping rules limit the tax-deductible share of debt interest to pretax earnings.
- Most of the European countries covered have interest-to-pretax-earning limits in place. Most commonly, the limit is set at 30 percent of EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization).

Thin-Cap Rules in Europe

Type of Thin-Cap Rules in Place, as of 2020



Notes:
(a) Austria uses the Arm's Length Principle to limit interest deductions.
(b) Ireland has no specific thin-cap rules but interest paid by a non-trading company to a nonresident parent can be reclassified as dividends under certain conditions.
(c) Luxembourg uses an informal 85:15 debt-to-equity ratio.
(d) Switzerland's debt-to-equity ratio varies by asset class.

Sources: Bloomberg Tax, "Country Guides: Anti-Avoidance Provisions - Thin Capitalization/Other Interest Deductibility Rules;" and PwC, "Worldwide Tax Summaries: Corporate - Group taxation."

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Guarantee Fee

Intra group Financial Guarantees

Lenders can require a guarantee for the following reasons:

- the lender does not want to provide a loan without a guarantee;
- the lender does want to provide a loan but offers the group company less favourable conditions without a guarantee

In conducting a TP analysis for a guarantee the following steps can be distinguished:

- Step 1. Accurate delineation of the guarantee;
- Step 2. Quantification of the benefit; and
- Step 3. Calculating the guarantee fee.

Financial Guarantees

The accurate delineation of financial guarantees requires initial consideration of the economic benefit arising to the borrower beyond the one that derives from passive association. The benefit should arise from the provision of a service for which a fee would be payable.

Important factors need to be considered when pricing a loan guarantee:

- Whether the guarantee confers a benefit
- Whether the guarantee is implicit or explicit
- Whether the guarantee should be considered a service or a capital contribution
- Whether the guarantor has enough financial capacity to fulfill its obligations in case of default of the borrower

For a loan guarantee to be considered as a compensable service, the guarantee must be explicit and confer a tangible benefit. An intercompany fee should only be charged if the benefit of the guarantee exceeds the benefit that would have been accrued through any implicit guarantees from the parent company.

Economic Benefit

Economic benefits arise for both the lender and borrower under an accurate delineation of financial guarantees:

Lender's Perspective

- Benefiting from the stronger credit rating of the guarantor (compared to the borrower's credit rating)
- Benefiting from guarantor's asset pool (in addition to the borrower's asset pool)

Borrower's Perspective

- More favorable interest rate since the lender has access to a wider pool of assets
- Enabling the borrower to access a larger amount of funds
- Reducing cost of debt-funding for the borrower

Determining the Arm's Length Prices of Guarantees

1- CUP method

Pricing approach	Consideration	Description
CUP	1. Risk profile of the borrower and lender 2. Terms and conditions of the guarantee, 3. Term and conditions of the underlying loan (amount, currency, maturity, seniority etc.), 4. Credit rating differential between guarantor and guaranteed party, 5. Market conditions, 6. etc.	Internal + external CUP Difficult to find.

Determining the Arm's Length Prices of Guarantees

2- Yield Approach (Maximum fee)

This approach quantifies the benefit that the guaranteed party receives from the guarantee in terms of lower interest rates.

Pricing approach	Consideration	Description
Yield approach (maximum fee)	1. Determine interest rate without guarantee + implicit support 2. Determine interest rate with explicit guarantee 3. Guarantee spread = (interest rate with non-guarantee + implicit support) – (interest rate with guarantee + arrangement fee)	External CUP for interest rate

Determining the Arm's Length Prices of Guarantees

3- Cost Approach (Minimum fee)

This method aims to quantify the additional risk borne by the guarantor by estimating the value of the expected loss that the guarantor incurs by providing the guarantee (loss given default).

Pricing approach	Consideration	Description
Cost approach (minimum fee, not AL bargain price)	Guarantees = another financial instrument and pricing the alternative Estimating the value of the expected loss (default risk) Model 1) Option Pricing model (put option) Model 2) Credit default swap (CDS)	Publicly available data of credit default swaps spreads

Determining the Arm's Length Prices of Guarantees

4- Valuation of Expected Loss

The valuation of expected loss method would estimate the value of a guarantee on the basis of calculating the probability of default and making adjustments to account for the expected recovery rate in the event of default.

Pricing approach	Consideration	Description
Valuation of expected loss approach	Value of a guarantee on the basis of calculating the probability of default Guarantee = expected return on this amount of capital (use commercial pricing models e.g. CAPM) Additional formulas: • (Average annual probability of default * (1 – recovery rate)) * (1 + return on equity); or • Annual credit loss rate * (1 + return on equity).	CAPM

Determining the Arm's Length Prices of Guarantees

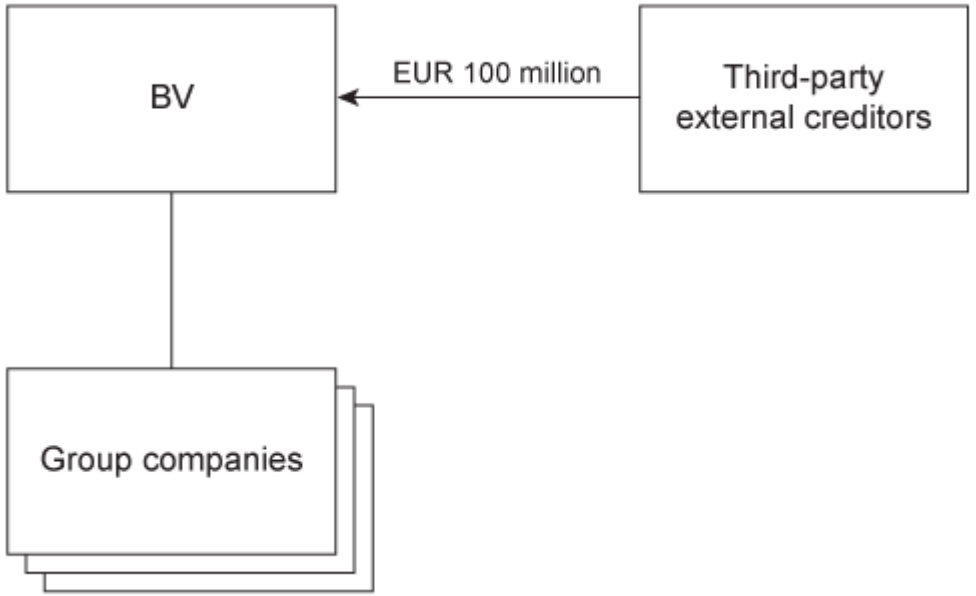
5- Capital Support Method

The capital support method may be suitable where the difference between the guarantor's and borrower's risk profiles could be addressed by introducing more capital to the borrower's balance sheet.

Pricing approach	Consideration	Description
Capital support method	1. Determine borrowers credit rating without the guarantee + implicit support 2. Identify additional notional capital required to reach to credit rating of guarantor 3. Guarantee fee = Expected return of the required capital Formula: Guarantee fee (in %) = return on equity * equity support (notional)	CAPM

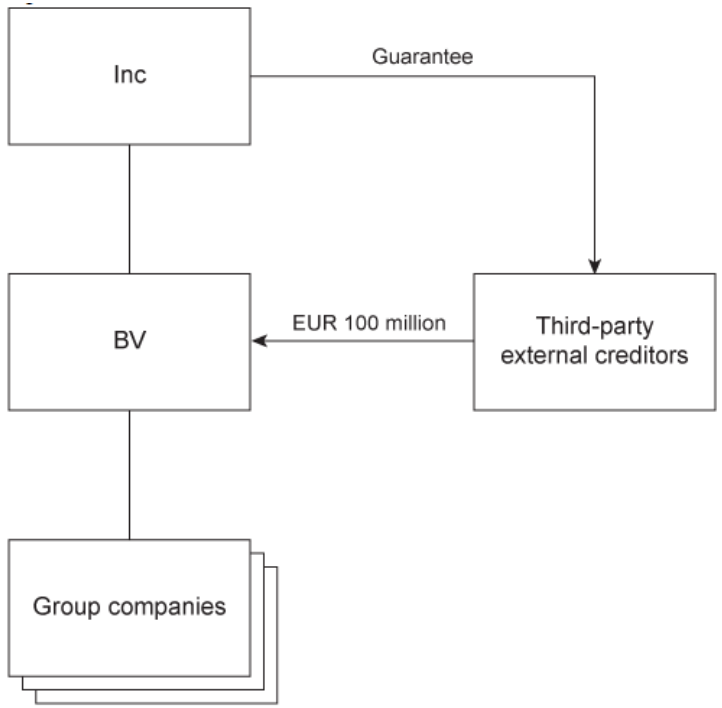
Practical Example

A Dutch Group headed by a BV was financed externally by a syndicate of third-party lenders at 5%.



Source: Transfer Pricing & Intra-Group Financing - IBFD

Dutch Group got acquired by a US Group. As part of the restructuring, US Inc provided an explicit guarantee to the third-party banks. All of the terms and conditions of the external facility remained the same, except the interest rate. The interest rate decreased to 2%.



Should there be a guarantee fee payable by BV to US Inc and if so, how can it be priced?

The end of LIBOR

What is the LIBOR

What is the London Interbank Offered Rate (LIBOR):

- is a widely used benchmark for short-term interest rates.
- LIBOR and other interbank offered rates (IBOR), such as the Euro Interbank Offered Rate (EURIBOR) and Tokyo Interbank Offered Rate (TIBOR), were intended to provide an indication of the average rate at which a panel of banks could obtain wholesale, unsecured funding for set periods in particular currencies (i.e. GBP, USD, EUR, CHF and JPY).
- LIBOR and the other IBORs are used globally to price many types of financial products, including loans, bonds, derivatives and consumer lending instruments such as mortgages.

Scandals

- The LIBOR Scandal refers to a major episode of financial collusion in which one of the world's most influential benchmark interest rates was manipulated by various banks.
- The scheme caused financial contracts to be mispriced throughout the world, in transactions such as mortgages, corporate fundraising, and derivative trades.
- The scandal left several regulatory changes, lawsuits, and fines in its wake, damaging public trust in the financial markets.

Alternatives to LIBOR

	SONIA	SOFR	LIBOR
Tenor	Overnight Backward-looking and historic	Overnight Backward-looking and historic	7 tenors from overnight to 12 months Forward-looking
Currencies	GBP	USD	GBP, USD, YEN, SFR and EURO
Publication Time	09.00 (London) on the following London business day (T+1)	08.00 (EST) on the following New York business day (T+1)	11.55 (London) on the London business day (T) for GBP and two London business days before (T-2) for the other currencies
Concept Measuring	Unsecured overnight borrowing	Secured overnight borrowing	Unsecured borrowing for the period in question

Source: https://www.wfw.com/articles/libor-transition-what-why-when-how/

Potential impacts of replacing LIBOR on Intercompany Agreements

- Contrary to third-party contracts, most intercompany agreements do not have a fallback provision in case of a discontinuation of LIBOR. Such fallback clauses generally specify
  (i) the trigger event for the new pricing to take effect,
  (ii) the alternative base rate to be applied, and
  (iii) the necessary adjustments to the pricing in order to apply an equivalent all-in interest rate.

- Applying such fallback clauses to intercompany agreements would allow these contracts to remain robust in an ever-changing environment. For example, without such a provision, the replacement of LIBOR in an intercompany contract could imply a significant modification of the contract. Under such circumstances, tax authorities might argue that it is not sufficient to solely renegotiate the base rate, as independent parties would be likely to also renegotiate other relevant terms and conditions of the existing contractual framework. A change of the spread to be applied on the new RFR is likely one of such items.

- Is this a Significant modification?
  - MNE makes amendments to the pricing or terms of an intercompany loan agreement that result in a significant modification, the modified agreement could be considered as new debt
  - Grandfathering-EU law

What Should MNEs Already do

Although the termination of LIBOR is a foregone conclusion, the successor rates remain a source of uncertainty. Luckily, companies can already start preparing a robust and smooth transition by taking the following action:

- Establishing a transition plan;
- Determining the group's LIBOR exposure;
- Evaluating and selecting alternatives; and
- Conducting a tax analysis.

Thank You

Our global network covers over 5,000 professionals who enable us to deliver scalable solutions in the area of tax & legal, digital transformation, running a compliance factory and effectively dealing with dispute resolution.
To ensure the highest quality and seamless service provision, thereby meeting international standards and regulations, a global team of dedicated professionals and specialists is a key and determining factor.
Through linking three ecosystems: Tax, Transfer Pricing and Valuation, Tax + Technology and Tax Litigation and Mediation – we deliver a world of tax in control.

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