The OECD’s new guidance on financial transactions

Webcast

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The OECD's new guidance on financial transactions

Your PwC team presenting today

David McDonald
Partner
Leader Financial Services Transfer Pricing,
PwC Switzerland

Mobile: +41 75 413 1910
Email: david.mcdonald@ch.pwc.com

Michalis Louca
Senior Manager
Financial Services Transfer Pricing
PwC Switzerland

Mobile: +41 79 742 6762
Email: michalis.louca@ch.pwc.com
Setting the scene
The OECD's new guidance on financial transactions

What has changed?

• The OECD have been working on a paper over the past couple of years to outline how intercompany financing transactions should be priced.

• Released on 11th February

• Sets a new framework for multinational groups to be assessing their intercompany financing transactions.

• Impact: what groups were doing historically with respect to intercompany financing arrangements may no longer be aligned with the international tax framework.
Transfer Pricing and Financial Transactions

What has stayed the same?

Financial Transactions in a transfer pricing context:

1. Intercompany loans, cash pooling, guarantees, hedging or captive insurance.
2. Between related parties (i.e. members of a group)
3. Must be priced on an arms length basis using an OECD approved transfer pricing method
4. Requires an analysis of the terms of the transaction – for example, for a loan it requires knowledge of the currency, duration, seniority, security, interest payment schedule, size and special features such as convertibility.
5. And it requires an analysis of the borrower and its financial strength – often in the formal of a credit worthiness assessment (i.e. a credit rating)
6. Benchmarking must be performed to confirm the appropriate price. And the benchmarking process should include filters and adjustments.
   → An exception is transactions covered by safe harbours
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Agenda of the webinar

The OECD’s final report: scope and key principles

Illustrative examples

Key takeaways
Scope & key principles
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The scope of the final report

Accurate delineation of the actual transaction

Financial guarantees

Treasury functions (including intra-group loans, cash pooling and hedging)

Captive insurance
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Highlighting the key changes and principles (1)

**Accurate delineation of the actual transaction:**

- An assessment of options realistically available to borrower and lender including an assessment of market/economic conditions.
- The terms of a transaction must be demonstrably arm’s length (e.g. the duration/currency of the transaction).
- The volume of loan must not exceed the amount that the borrower could/would have borrowed at arm’s length.
- Only a small return can be justified to a lender/guarantor/treasury centre in situations where they do not have the people substance.

**Challenges and actions**

- Groups will need a process for new transaction that includes assessing (and documenting the assessment) of:
  - the arm’s length nature of key terms,
  - the quantum of the loan,
  - the lender perspective, and
  - the borrower perspective.
- Groups will also need to perform a one off review of existing transactions for compliance with the new requirements.
- Maintaining structures with limited people substance but booking large profits is going to be extremely difficult in the future – determining the appropriate degree of people substance for a treasury function (e.g. single loan, multi-loan, full treasury function) is critical.
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Highlighting the key changes and principles (2)

**Treasury functions – intra-group loans:**

- Pricing loans between group companies will generally require a relatively sophisticated credit rating analyses.
- Calculation of ratings should be transparent and utilise both quantitative and qualitative factors (black box models difficult to apply). Credit rating calculations must isolate the impact of passive association.
- Interest rates should be benchmarked if internal / external data is available.
- Bank quotes should not be used as benchmarks.

**Challenges vs existing approaches**

- Having heavily decentralised intra-group pricing policies is going to be difficult and easily open to challenge.
- Interest rate pricing analyses need to increase in sophistication.
- One size fits all credit worthiness assessments are a thing of the past.
- Borrower credit profile must be considered – and must take into account OECD guidance on passive association.
- Analyses that utilize bank quotes are not sustainable.
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Highlighting the key changes and principles (3)

Treasury functions – cash pooling (CP):

• Pricing must start with a functional analysis.
• The most important question is whether cash pool leader (even in physical pool) performs more than service function – i.e. whether there should be any significant spread retained in the center.
• Need to identify and monitor substance e.g. short term/long term balances.
• Requirement to split cash pool benefit between participants.

Challenges vs existing approaches

• Requirement to perform and document a functional analysis.
• Most cash pools provide synergy returns to cash pool leader – will need to amend/appropriately document the rationale for economic returns.
• Consider the mechanics of how to deliver/share a synergy benefit between pool participants (rebates/interest rates) while maintaining administrative simplicity.
• Requirement to test the rates that participants get from the pool versus local market rates.
• Requirement to monitor to ensure cash pool positions are only short term.
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Highlighting the key changes and principles (4)

Financial guarantees:

• No guarantee fees payable unless there is an explicit guarantee.
• Perform benefit assessment to analyse how the borrower benefits from the guarantee (with a different impact on pricing if the borrower benefits via a reduction in interest rate versus an increase in borrowing capacity)
• Four alternative approaches for calculating arm’s length guarantee fees, all of which require some level of benchmarking

Challenges vs existing approaches

• MNEs need to assess whether their current approach on when a guarantee fee is / is not charged is appropriate
• In some instances groups may choose to change the agreements covering the guarantee, rather than changing the pricing
• Need to take into account OECD guidance on credit ratings and passive association if utilising the most common (yield) approach
• Need to carefully consider the impact of the guarantee on the borrower/lender
Illustrative examples:
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Practical example

ParentCo (UK)

FinCo (BE)

SubCo A (CH)

SubCo B

3rd party bank
First example: The basics

Interest rate benchmarking

Step 1: Identify key terms of the loan
Step 2: Assess the creditworthiness of the borrower
Step 3: Identify benchmarking data
Step 4: Filter data
Step 5: Adjust data
Step 6: Select interest rate
Second example: Arm’s length debt

Arm’s length debt capacity

ParentCo (UK)

FinCo (BE)

SubCo A (CH)

SubCo B

Loan

3rd party bank

SubCo B:
Debt:Equity – 4:1
Interest:EBITDA – 2:1
Third example: Two sided approach

Short term vs long term

ParentCo (UK) -> Loan (Long term) -> 3rd party bank

ParentCo (UK) -> Loan (long term) -> FinCo (BE)

FinCo (BE) -> Loan (short term) -> ParentCo (UK)

FinCo (BE) -> Lender approach

SubCo A (CH) -> Borrower approach

SubCo B

Short term vs long term
Fourth example: Options realistically available

Options realistically available

ParentCo (UK)

Loan (long term)

FinCo (BE)

Loan (long term)

SubCo A (CH)

SubCo B

3rd party bank

Loan (Long term)

NB - Significant cash pool balances
Fifth example: Control over risk

### Substance

- **ParentCo (UK)**
  - **Substance**

- **FinCo (BE)**
  - **Substance**

- **SubCo A (CH)**

- **SubCo B**

- **3rd party bank**

- **Loan (EUR)**

- **Interest rate**

- **Risk free return**

- **Risk adjusted return**
Sixth example: Guarantee fee

Driver: Better interest rate

- ParentCo (UK)
- FinCo (BE)
- SubCo A (CH)
- SubCo B
- 3rd party bank

Credit rating: AA

Standalone Credit Rating : BB+
CR with implicit support: AA-

Guarantee fee?

Loan
Sixth example: Guarantee fee

Driver: Formal bank requirement

- ParentCo (UK)
- FinCo (BE)
- SubCo A (CH)
- SubCo B
- 3rd party bank

Flow:
- ParentCo guarantees FinCo's loan to 3rd party bank.
- Guarantee fee required?
- Loan from 3rd party bank to FinCo.
- FinCo guarantees SubCo A and SubCo B.
Seventh example: Cash pooling

Risk of recharacterization: ST vs LT

<table>
<thead>
<tr>
<th>EUR million</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
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<tbody>
<tr>
<td>SubCo A</td>
<td>50</td>
<td>(100)</td>
<td>(100)</td>
<td>(150)</td>
<td>(200)</td>
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Seventh example: Cash pooling

Allocation of synergies

ParentCo (UK) → Loan → 3rd party bank

FinCo (BE) → Cash Pool

- Credit: base rate + 0%
- Debit: base rate + 1%

Cash pool position:
- SubCo A (CH): (60)
- SubCo B: 100

Net positive position: 40
Tools
A 30 minute risk assessment

FTTP - Chapter X impact assessment

<table>
<thead>
<tr>
<th>Topics</th>
<th>Background/Purpose</th>
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<tbody>
<tr>
<td>1. Group financing policy</td>
<td>The process of &quot;accurate delineation&quot; of a transaction, a concept the OECD has introduced in Chapter I of the 2017 OECD TP Guidelines, should begin with an informed view of an MNE’s policies and strategies towards financial transactions.</td>
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<td>2. Treasury Function</td>
<td>The OECD FT Paper draws the distinction between a decentralised versus a centralised treasury function. Emphasis is put on the accurate delineation of the transaction. Treasury approach to risk Vladimir on MNE Group policy.</td>
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<td>3. Credit Rating</td>
<td>The OECD acknowledges that there are multiple approaches to estimate the creditworthiness of the borrower but notes that it is important that the MNE group appropriately documents the reasons and selection of the credit rating used for a particular MNE.</td>
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<td>4. Long term Intercompany Loans</td>
<td>The OECD draws the distinction between the lender’s and borrower’s perspectives, including the options realistically available, in which the alternatives of both parties are considered, including the economic rationale behind the transaction, the contractual terms and conditions to be agreed by them, etc.</td>
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<td>5. Cash Pooling</td>
<td>Accurate delineation of transactions prevails, whereby the benefit for each of the participants in the cash pool has to be identified. Relevant control and management functions to be considered in allocating the credit and liquidity risk.</td>
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<td>6. Guarantees</td>
<td>The OECD defines a financial guarantee as an explicit and legally binding commitment on the part of the guarantor to assume a specified obligation of the guaranteed debtor if the latter defaults. Accurate delineation of guarantees (economic benefit or shareholder reasons) is required to price it.</td>
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Instant benchmarking

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Key takeaways
Key takeaways

- TP is not only about interest rate
- Test all term & conditions
- Look beyond tested transaction
- Look beyond TP
Contact us:

David McDonald
Partner
Leader Financial Services Transfer Pricing,
PwC Switzerland

Mobile: +41 75 413 1910
Email: david.mcdonald@ch.pwc.com

Michalis Louca
Senior Manager
Financial Services Transfer Pricing
PwC Switzerland

Mobile: +41 79 742 6762
Email: michalis.louca@ch.pwc.com
Thank you!