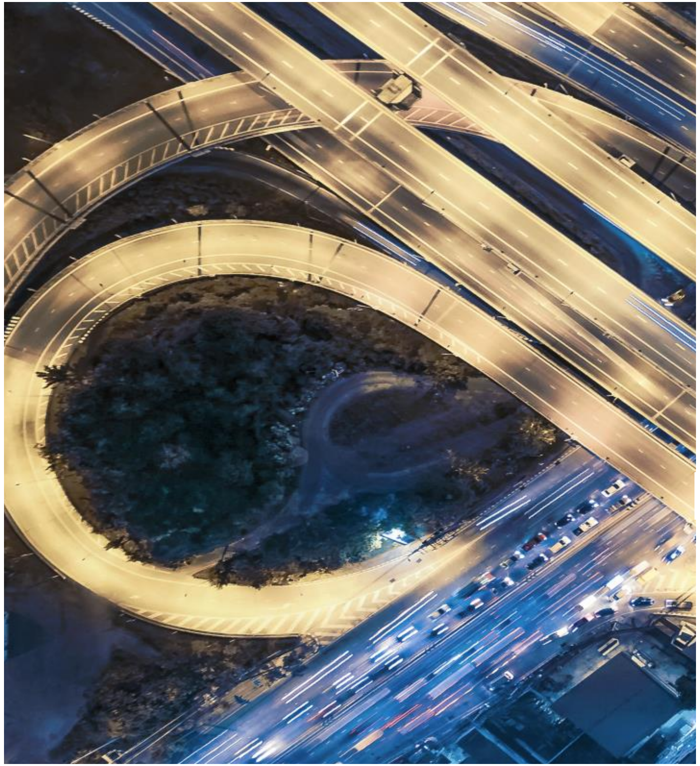

The OECD’s new guidance on financial transactions

Webcast

7 July 2020

pwc

The OECD's new guidance on financial transactions

Your PwC team presenting today

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Setting the scene

The OECD's new guidance on financial transactions

What has changed?

Final paper. Considered as Chapter X of the OECD Guidelines

- 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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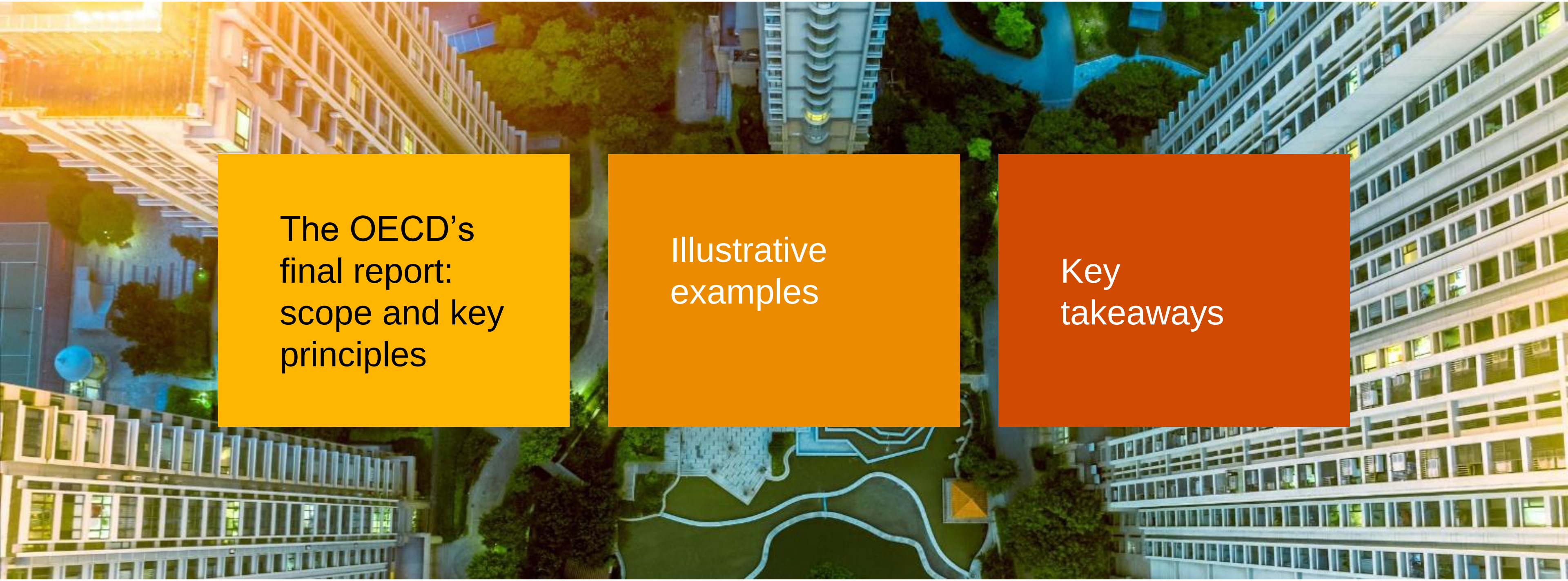
Agenda of the webinar



- 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 in-cludes 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)

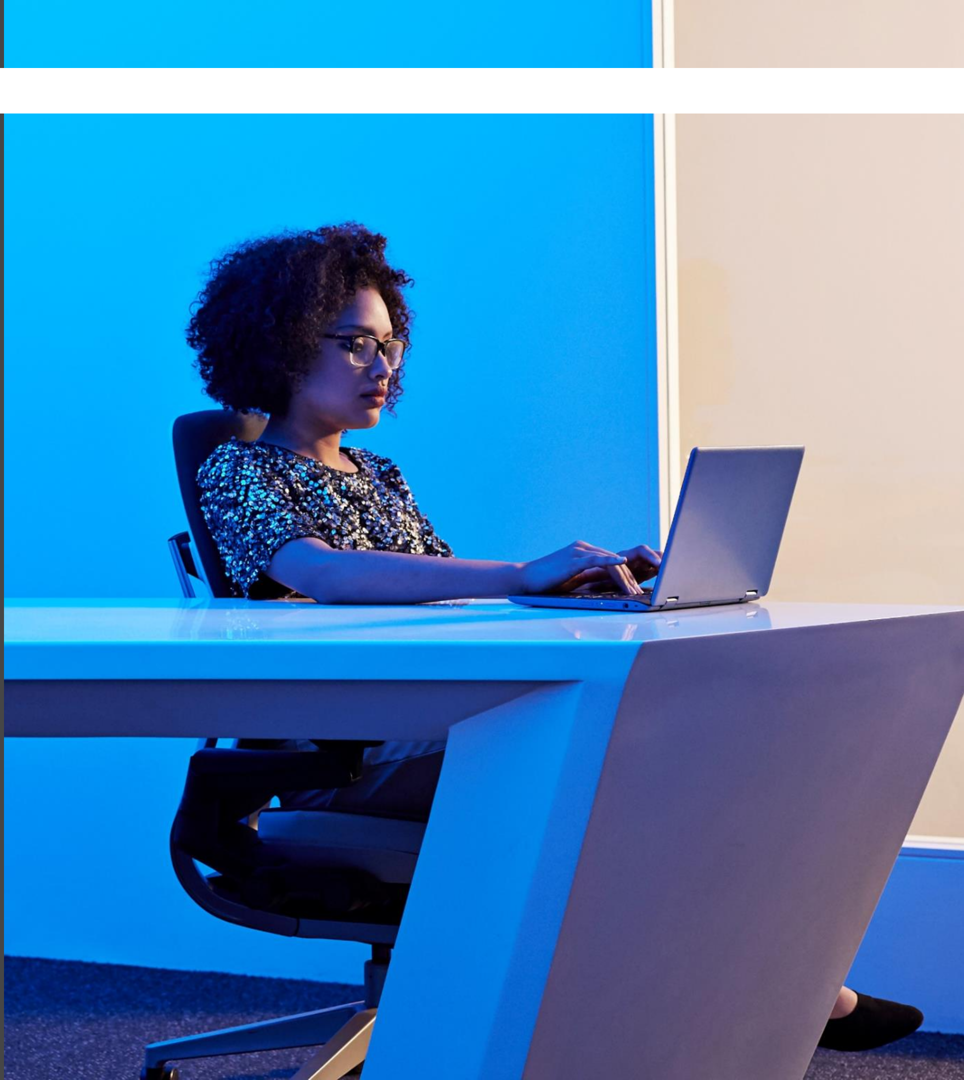
Financial guarantees:

- 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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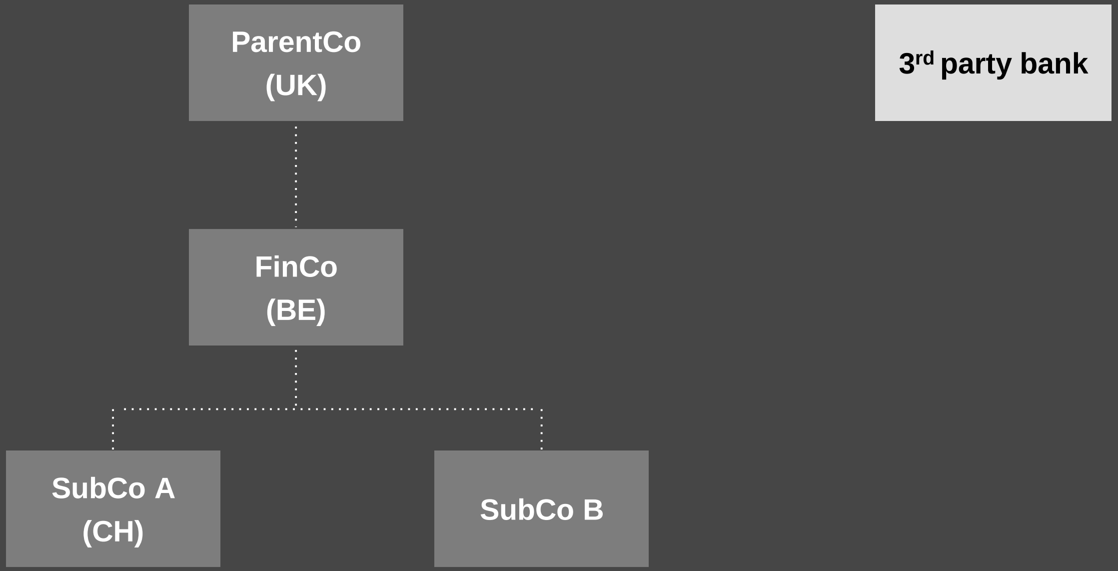
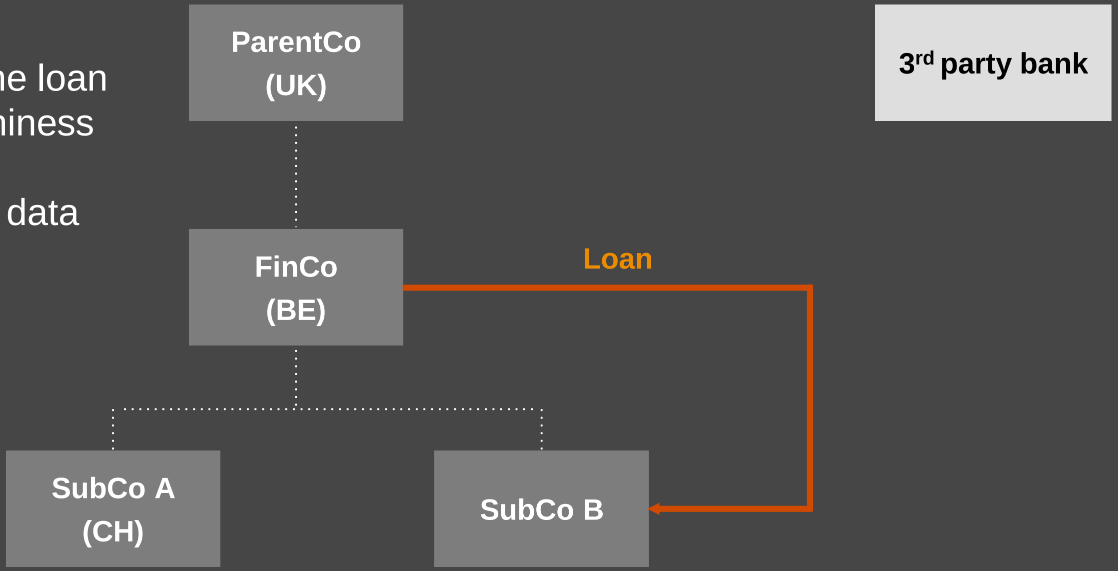
Practical example



First example: The basics

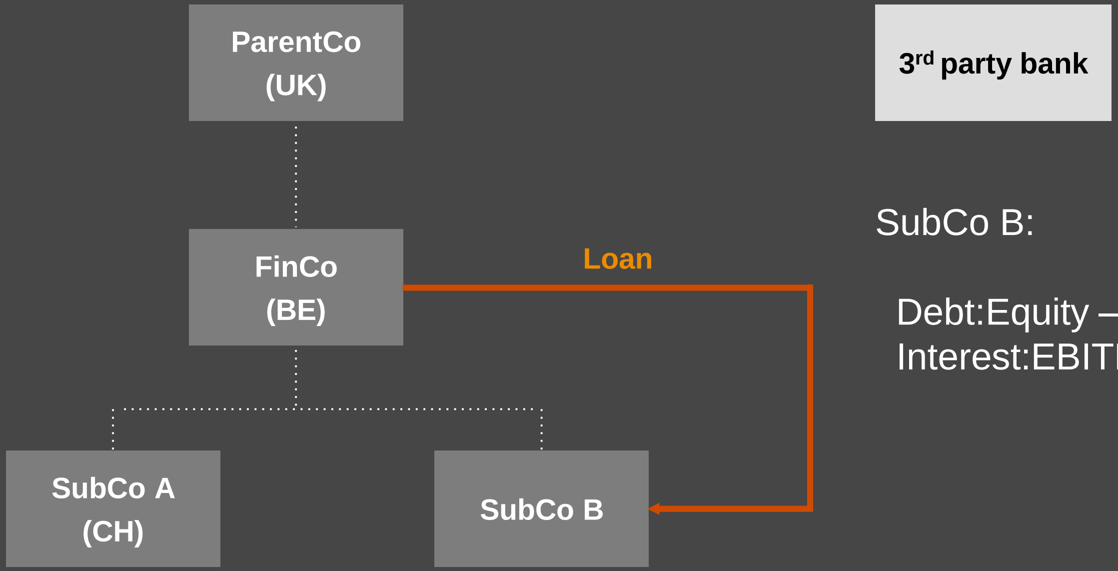
Interest rate benchmarking

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

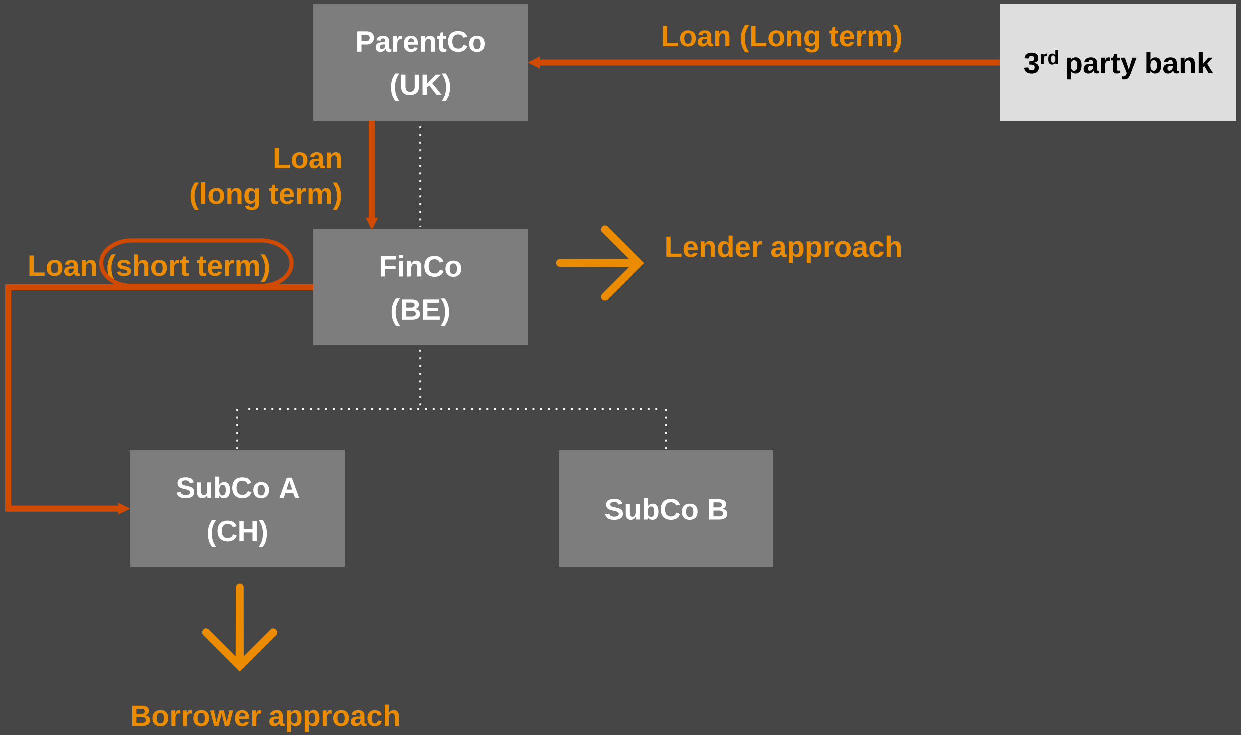


SubCo B:

Debt:Equity – 4:1
Interest:EBITDA – 2:1

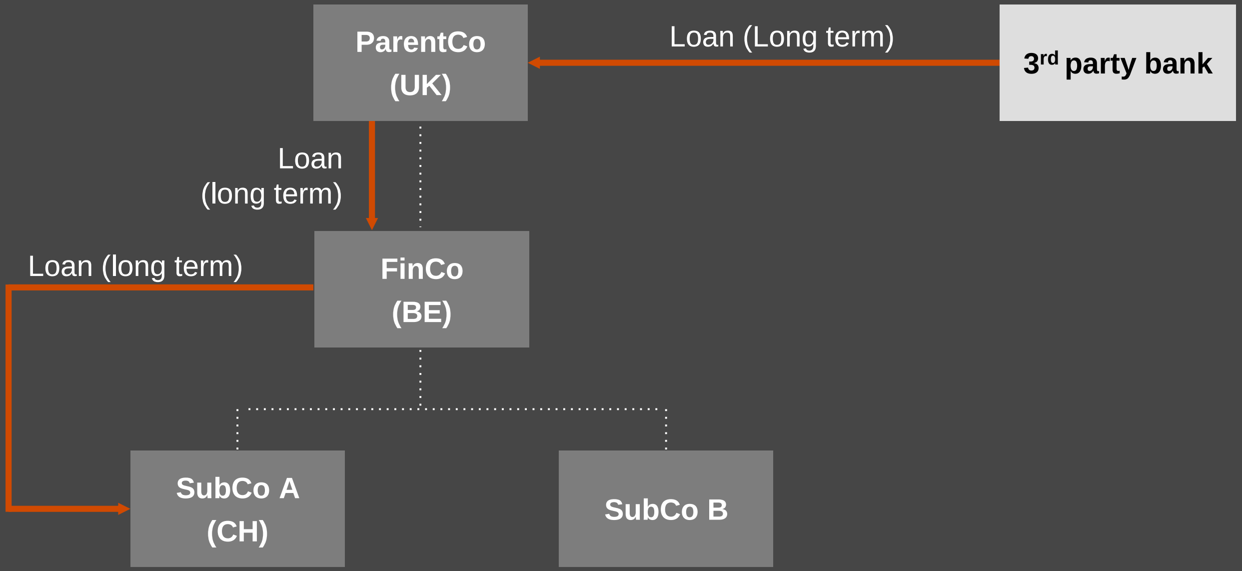
Third example: Two sided approach

Short term vs long term



Fourth example: Options realistically available

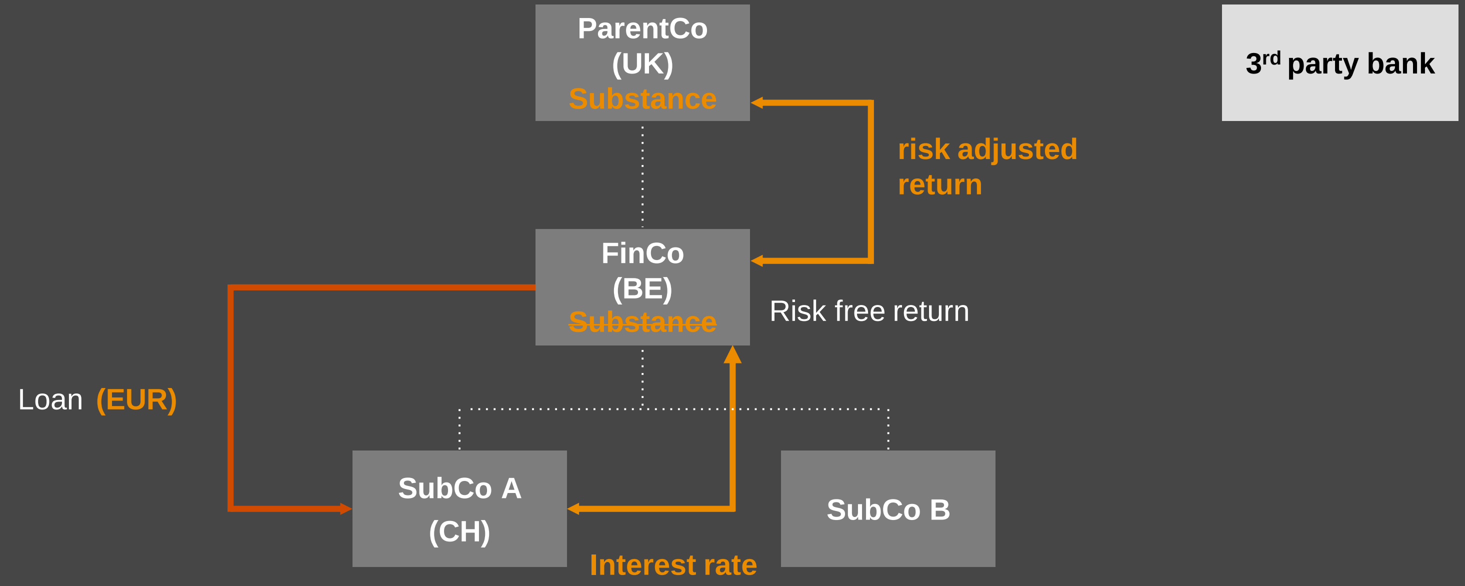
Options realistically available



NB - Significant
cash pool balances

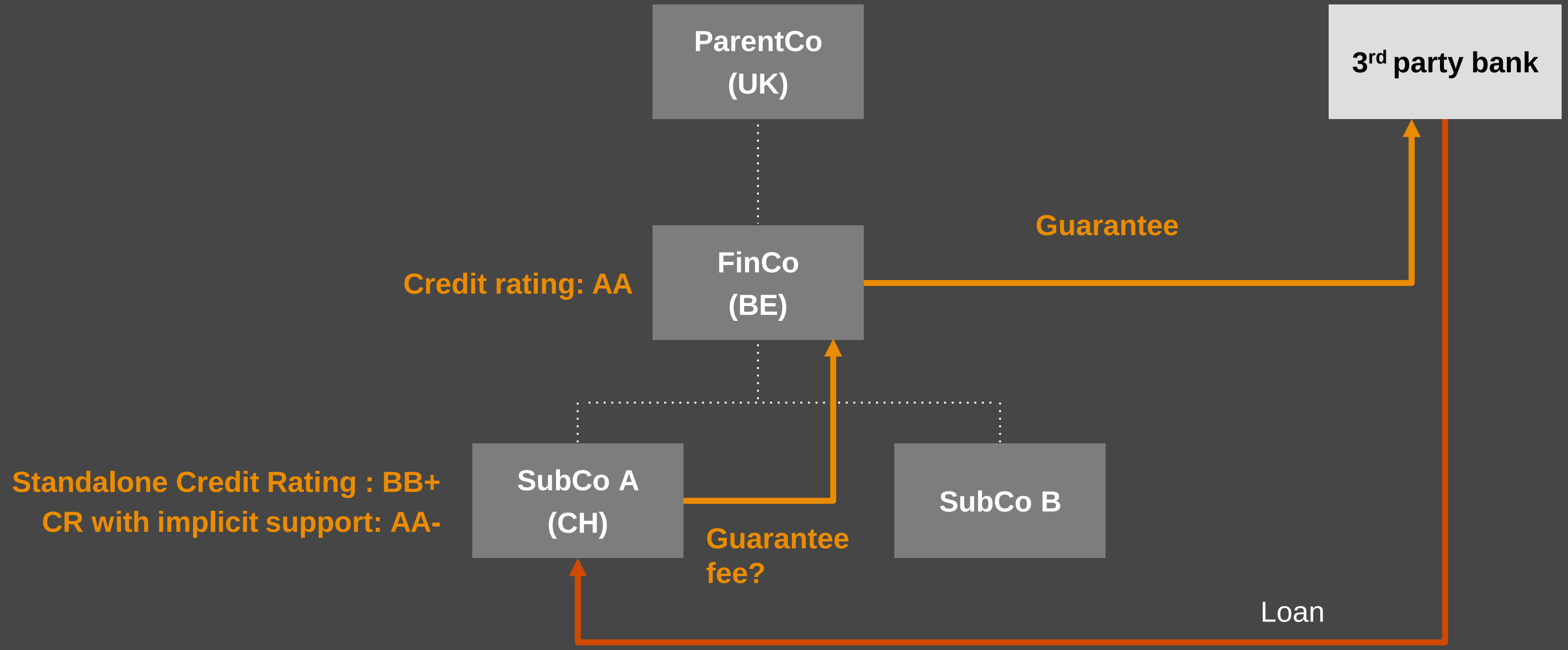
Fifth example: Control over risk

Substance



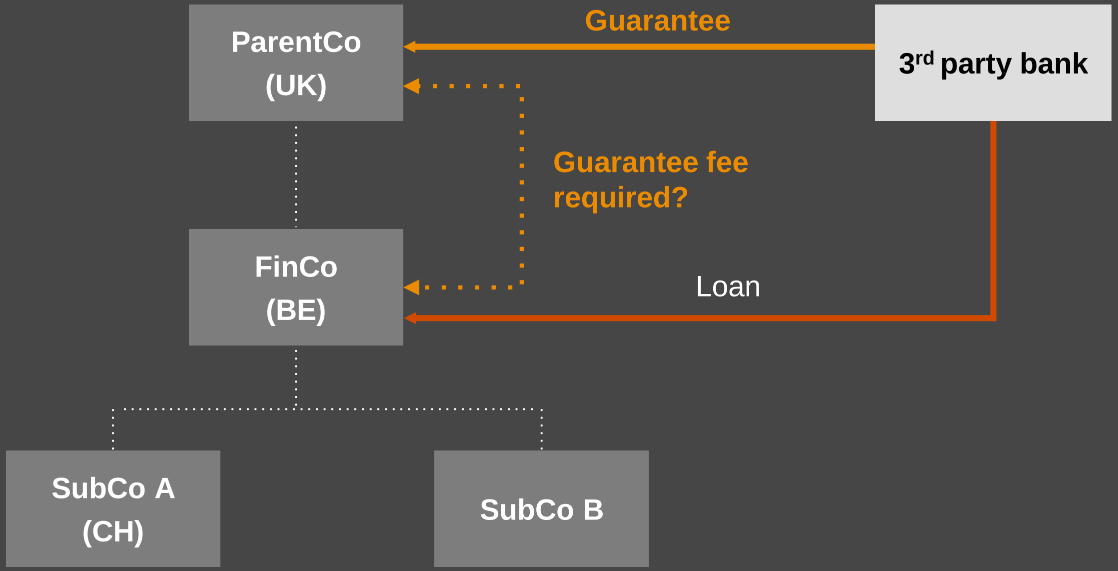
Sixth example: Guarantee fee

Driver: Better interest rate



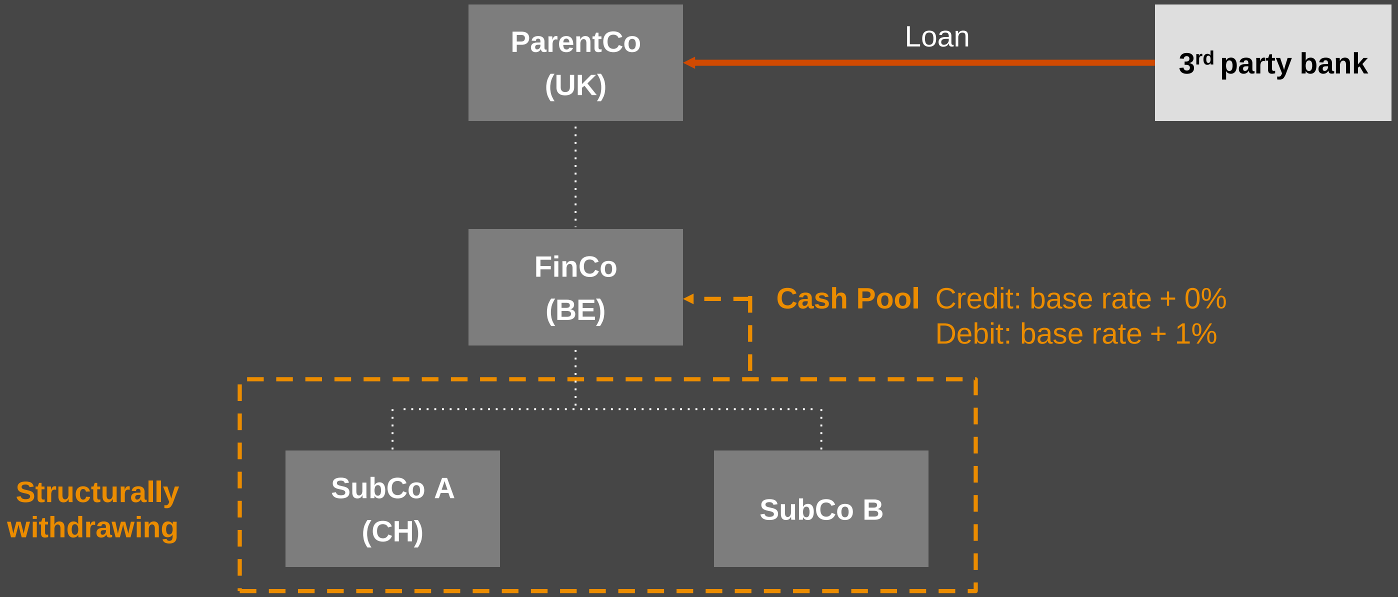
Sixth example: Guarantee fee

Driver: Formal bank requirement



Seventh example: Cash pooling

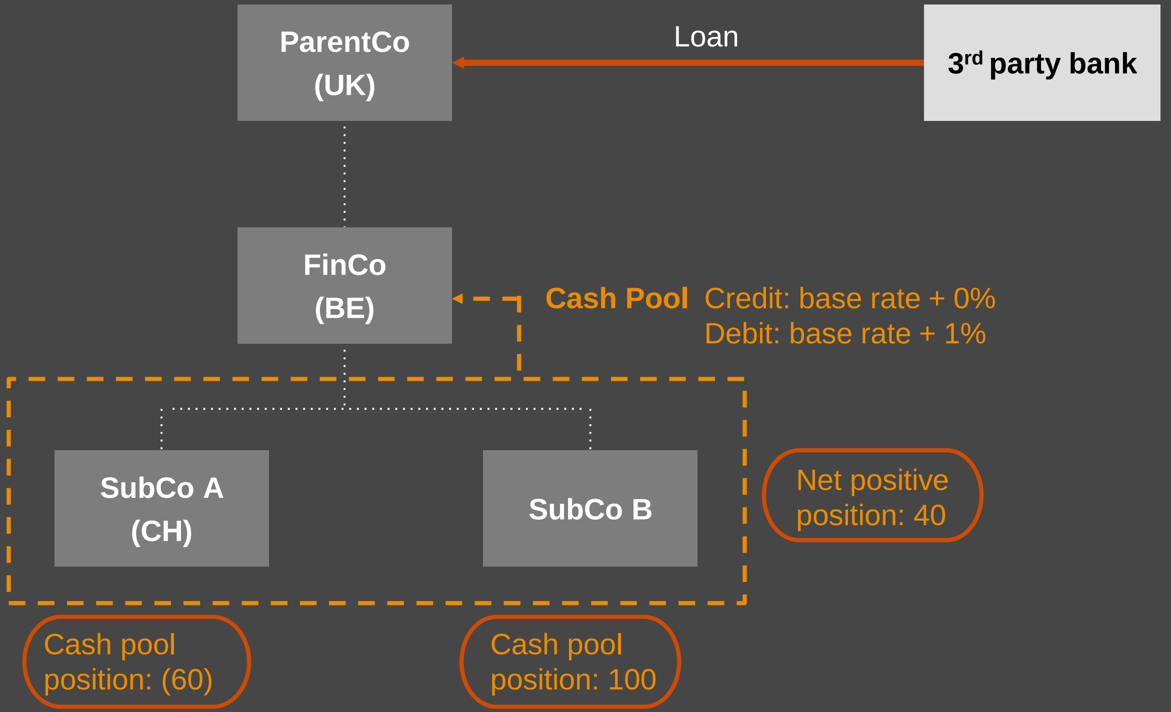
Risk of recharacterization: ST vs LT



EUR million	Year 1	Year 2	Year 3	Year 4	Year 5
SubCo A	50	(100)	(100)	(150)	(200)

Seventh example: Cash pooling

Allocation of synergies



Tools

A 30 minute risk assessment

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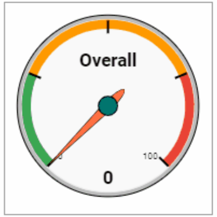
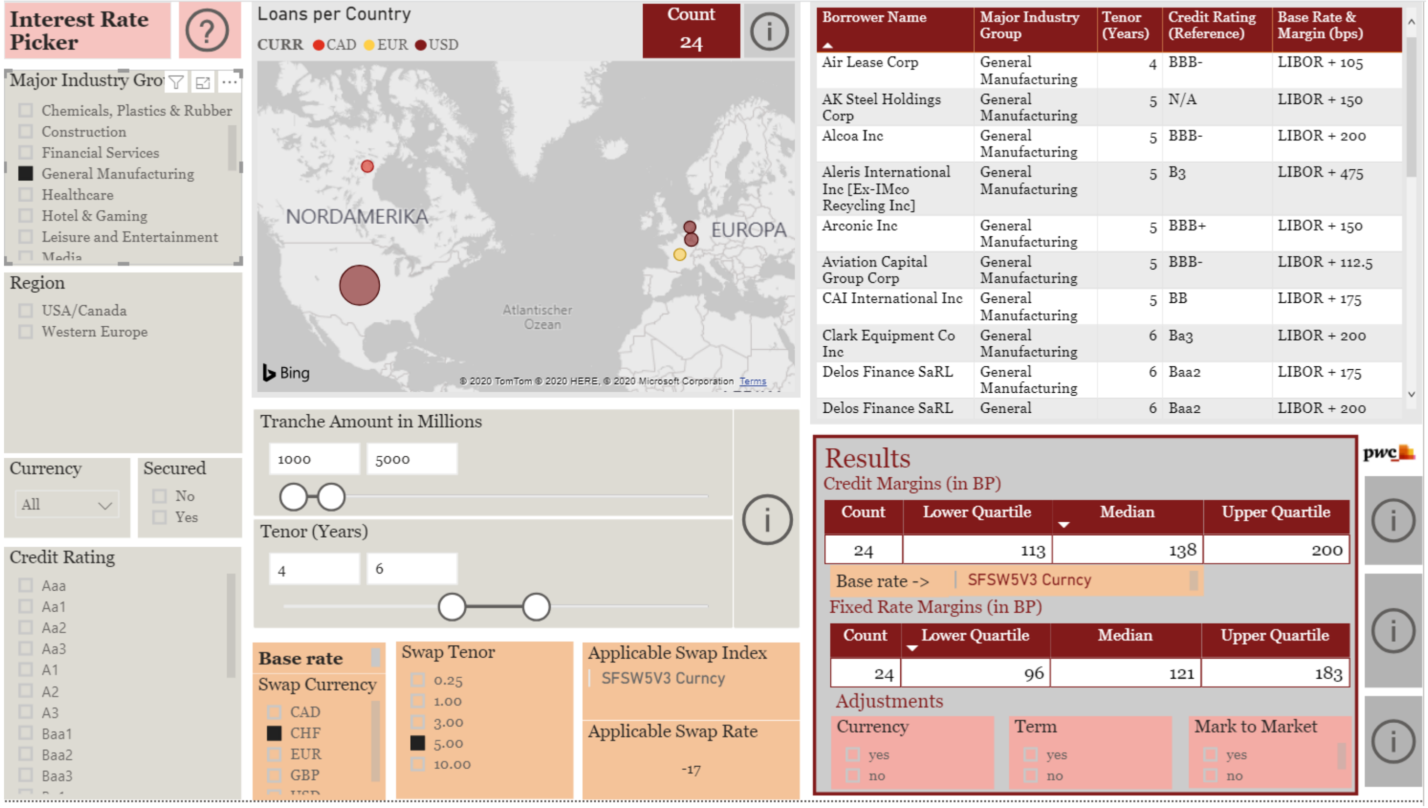
FTTP - Chapter X impact assessment



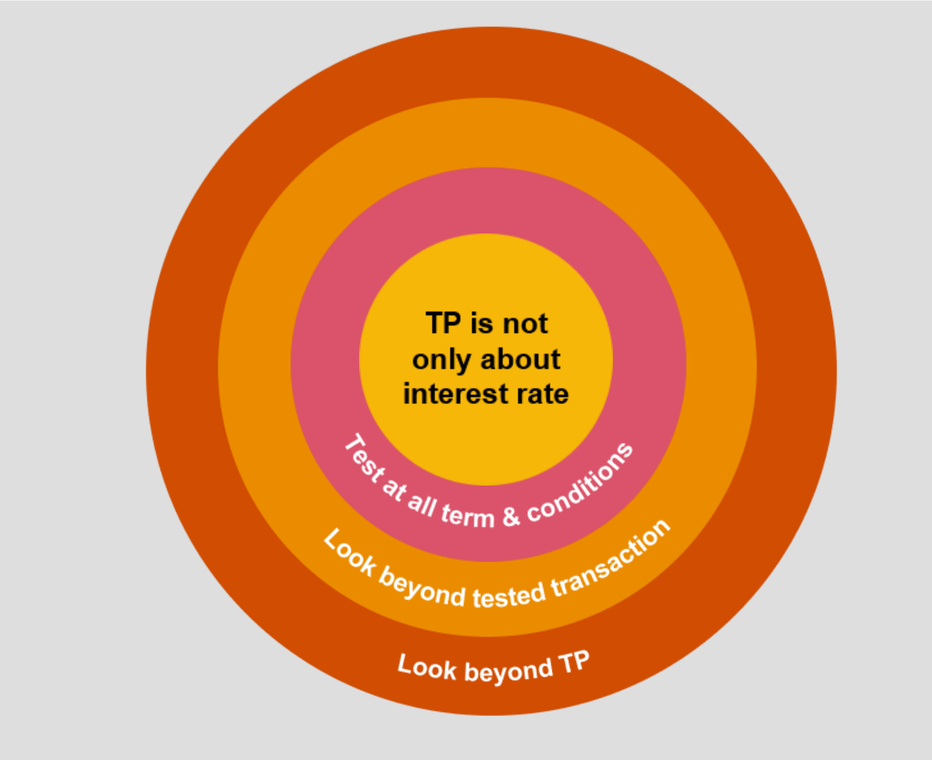
Topics	Background/Purpose
1. Group financing policy	The process of "accurate delineation" of a transaction, a concept the OECD has introduced in Chapter I of the 2017 OECD TP Guidelines, should begin with an informed view of an MNE's policies and strategies towards financial transactions.
2. Treasury Function	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 willdepend on MNE Group policy.
3. Credit Rating	The OECD acknowledges that there are multiple approaches to estimate the credit worthiness 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.
4. Long term Intercompany Loans	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.
5. Cash Pooling	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.
6. Guarantees	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 guarantee (economic benefit or shareholder reasons) is required to price it.

Instant benchmarking



Key takeaways

Key takeaways



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Thank you!

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