Loyens & Loeff Transfer Pricing Series

Financial Transactions – Rogier Sterk/ Willem Bon/ Felipe Aquino

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Who are we?

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Counsel
Transfer Pricing Adviser

Rogier Sterk, is a member of the Transfer Pricing Team in Amsterdam. Rogier is specialised in advising on transfer pricing related issues, including advance pricing agreements, general audits, corresponding adjustments, mutual consultation procedures and tax controversies. Rogier frequently lectures and publishes on transfer pricing related matters.

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Willem has over 30 years of tax experience in the international markets of London, Tokyo and Sao Paulo and is a member of our Latin America region team.

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Who are we?

Felipe Aquino, CFP®

Head of Tax at Boehringer Ingelheim

Felipe Aquino is the Head of Tax at Boehringer Ingelheim (Brazil), a multinational pharmaceutical industry based in Germany. Felipe has 20+ years of experience dealing with tax matters, both domestic and international, mostly serving as a tax expert in a Big4 company, both in Brazil and in the USA. Felipe is currently the Chair of the Fiscal Council at INTERFARMA – Brazilian Association of the Pharmaceutical Research Industry,

Introduction

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Why Financial Transactions?

- Financial transactions are the most **frequently** used and the most **material** transactions within multinational groups. Hence, often pose material tax risks.
- Pricing financial transactions is a **complex process wherein considerable variables** need to be examined. Even with the OECD Guidelines there is a lot of grey area with respect to pricing financial transactions at arm's length, which leads to relatively more **differences between domestic tax systems** in comparison to other intragroup transactions.
- Due to the potential tax impact and recent revisions of the OECD Guidelines, financial transactions attract **greater scrutiny from tax authorities**. More transfer pricing cases regarding intercompany transaction loans have been litigated on a global basis in the past decade.

Financial transactions are an upcoming area of transfer pricing controversy and often pose material tax risks for multinational groups

Pricing A Financial Transaction: Overview step plan

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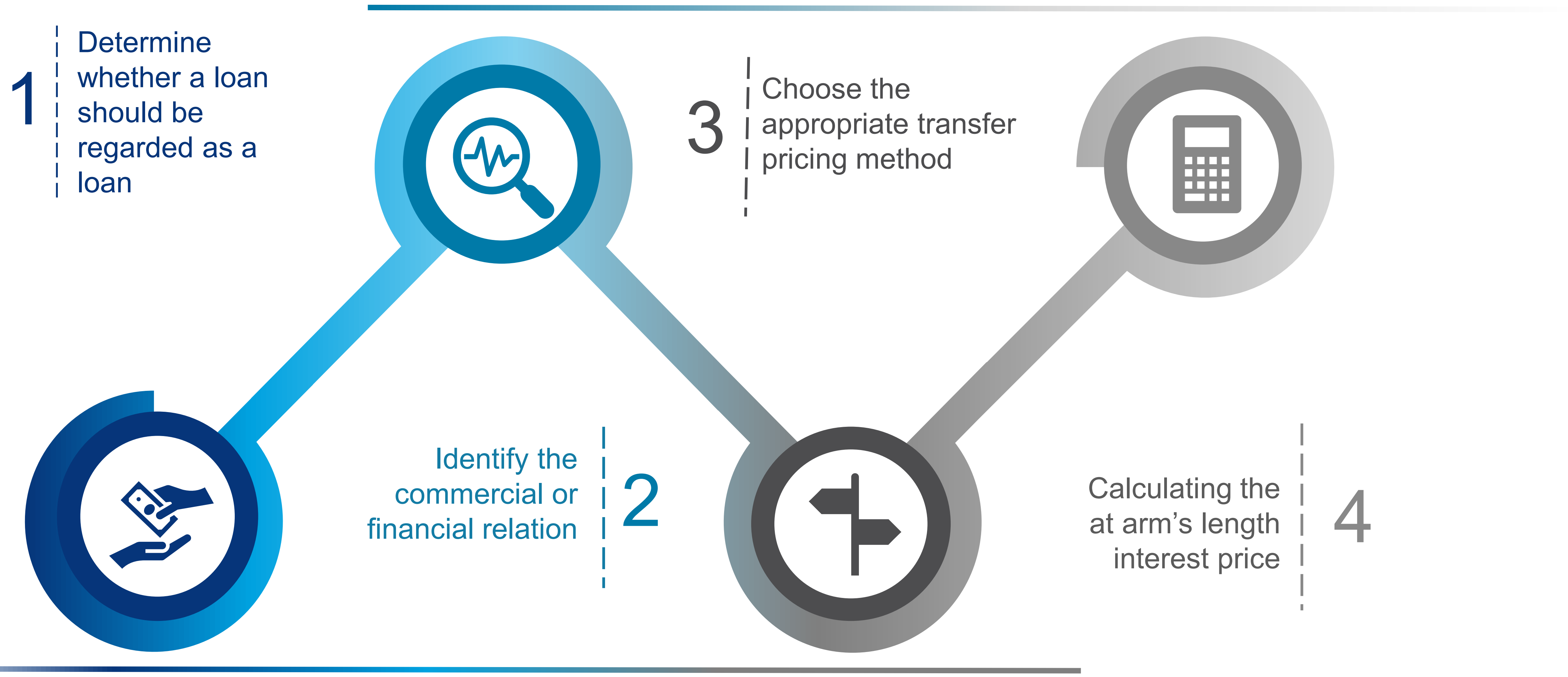

Should a loan be regarded as a loan?

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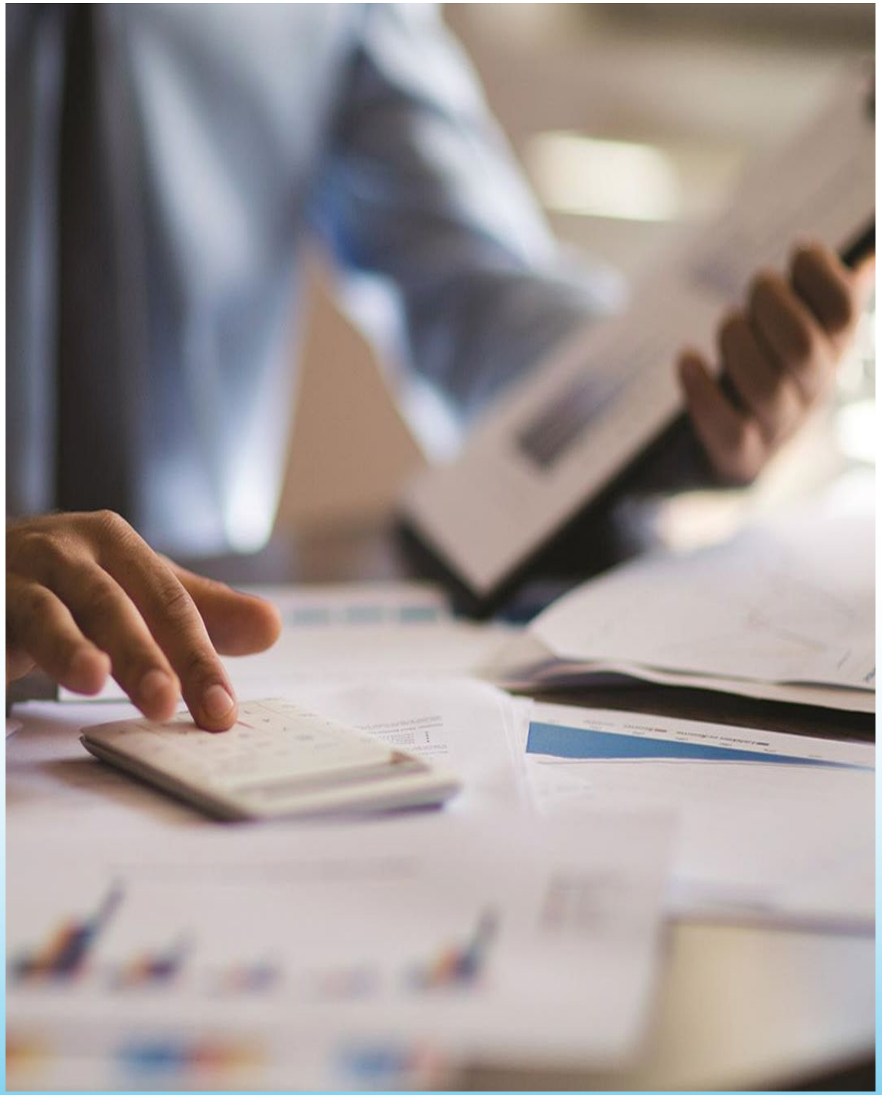
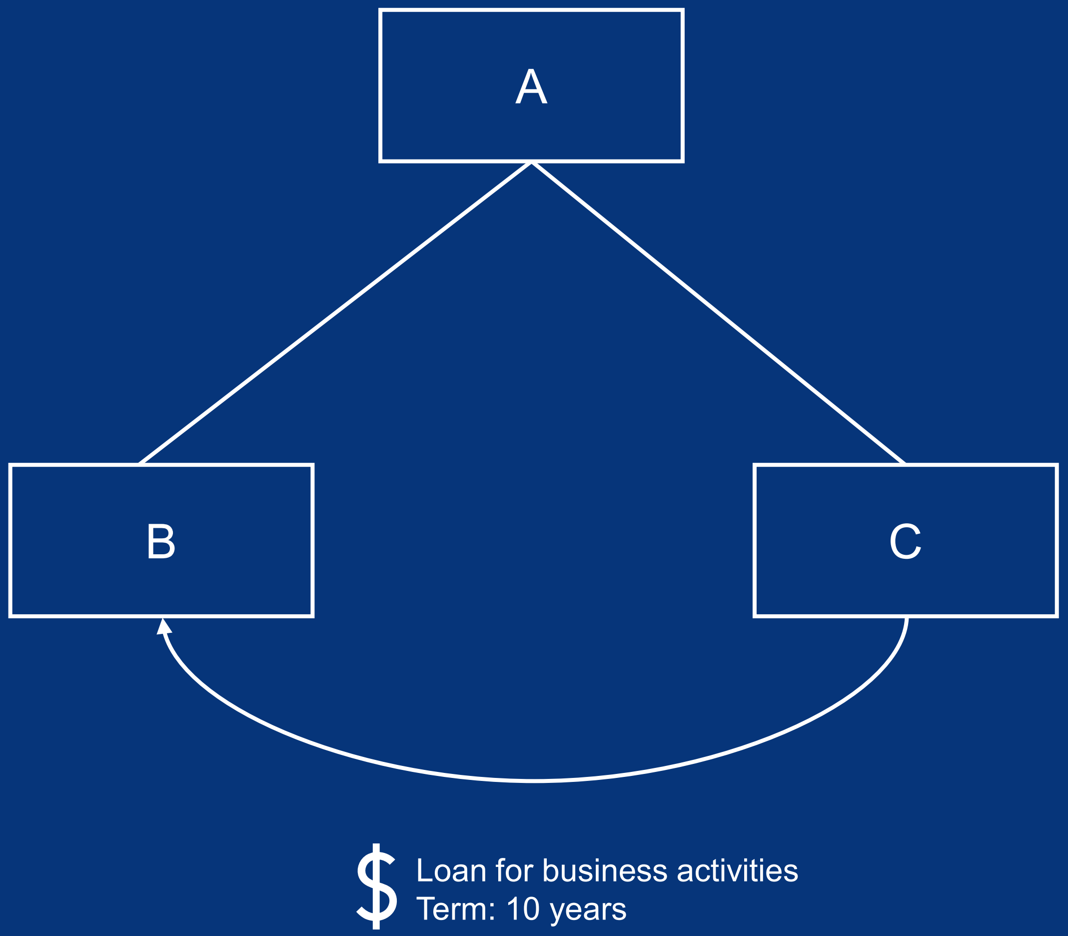
- It may be the case that the **balance of debt and equity funding of a borrowing entity that is part of an MNE group differs from** that which would exist if it were **an independent entity operating under the same or similar circumstances**. This **situation may affect** the amount of **interest payable** by the borrowing entity and so may **affect the profits** accruing in a given jurisdiction.

- In accurately delineating an advance of funds, the following **economically relevant characteristics may be useful indicators**, depending on the facts and circumstances:
  - the presence or absence of a fixed repayment date, the obligation to pay interest the right to enforce payment of principal and interest;
  - the status of the funder in comparison to regular corporate creditors;
  - the existence of financial covenants and security;
  - the source of interest payments;
  - the ability of the recipient of the funds to obtain loans from unrelated lending institutions;
  - the extent to which the advance is used to acquire capital assets;
  - and the failure of the purported debtor to repay on the due date or to seek a postponement.



Example: identifying a loan



If financial projections show that Company B would be ***unable to pay the loan for the next 10 years****, Company C's loan to Company B for transfer pricing purposes would be* ***the maximum amount that an unrelated lender would have been willing to advance*** *to Company B, and the maximum amount that an unrelated borrower would have been willing to borrow from Company C.*

The ***remainder of*** *Company C's* ***advance*** *to Company B* ***would not be delineated as a loan for the purposes of determining the amount of interest*** *which Company B would have paid at arm's length.*

Identifying the commercial or financial relations

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Contractual terms

Contracts, other documents, the actual conduct of the parties and the economic principles that govern relationships between independent enterprises in comparable circumstances should be assessed.

Functional analysis

This analysis identifies the functions performed, the assets used, and the risks assumed by the parties to that controlled transaction.

Characteristics of financial instruments

It is important to document the transactions' features and attributes, when pricing a controlled transaction.

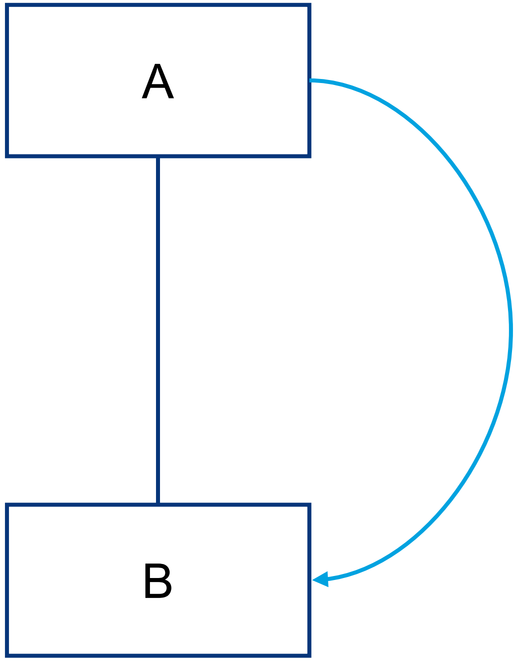
Economic circumstances

The prices of financial instruments may vary substantially on the basis of underlying economic circumstances (e.g. currencies, geographic locations, local regulations, the business sector of the borrower/lender and the timing of the transaction).

Business strategy

The analysis of the business strategies will also include consideration of the MNE group's global financing policy, and the identification of existing relationships between the associated enterprises such as pre-existing loans and shareholder interests

Example: business strategy



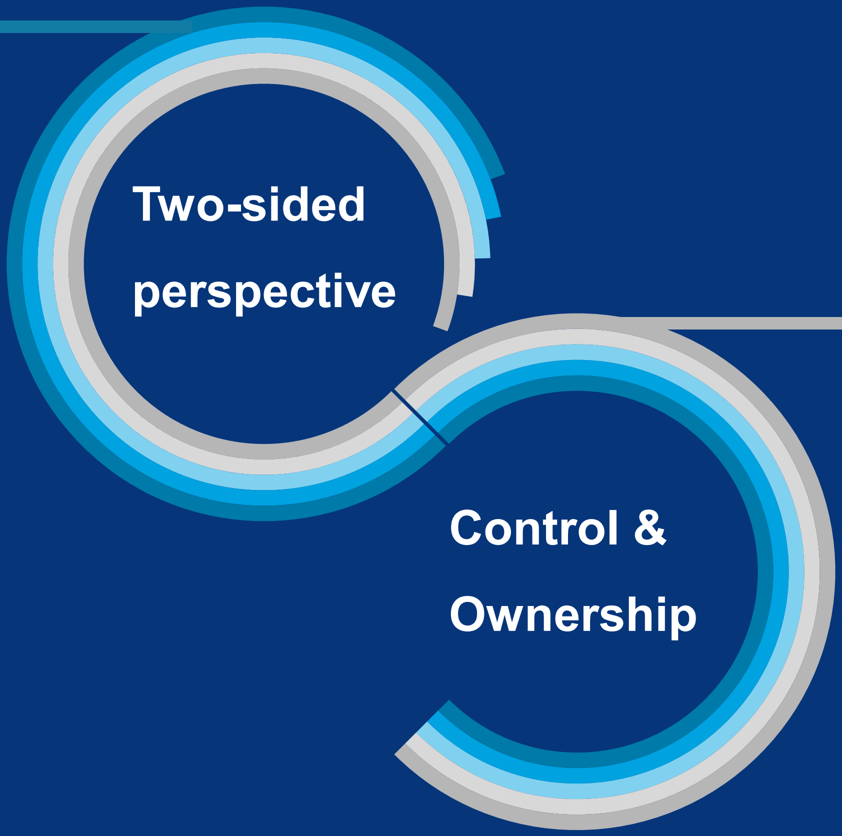
$ Loan for short-term working capital purposes
Term: 10 years

*"In this scenario, under the prevailing facts and circumstances, the accurate delineation of the actual transaction may conclude that an unrelated borrower under the same conditions of Company B would **not enter into a 10-year loan agreement to manage its short-term working capital needs and the transaction would be accurately delineated as a one-year revolving loan** rather than a 10-year loan.*

*The consequences of this delineation would be that assuming the working capital requirements continue to exist, the **pricing approach would be to price a series of refreshed one-year revolver loans**." This would generally result in a lower interest rate.*

Intragroup Loan: General Considerations

When accurately delineating a transaction, both the lender's and borrower's perspectives should be considered. This includes their **options realistically available** to provide or attract a loan.



While pricing a shareholder loan, the specific term can be less relevant. This is due to the fact that the lenders are also the shareholders and have (indirect) **access to the underlying cash-flows and are able to issue "control"** over the subsidiary.

This can be considered **contradictory** to the main concept of the at arm's length principle.

Intra-group loans: credit ratings

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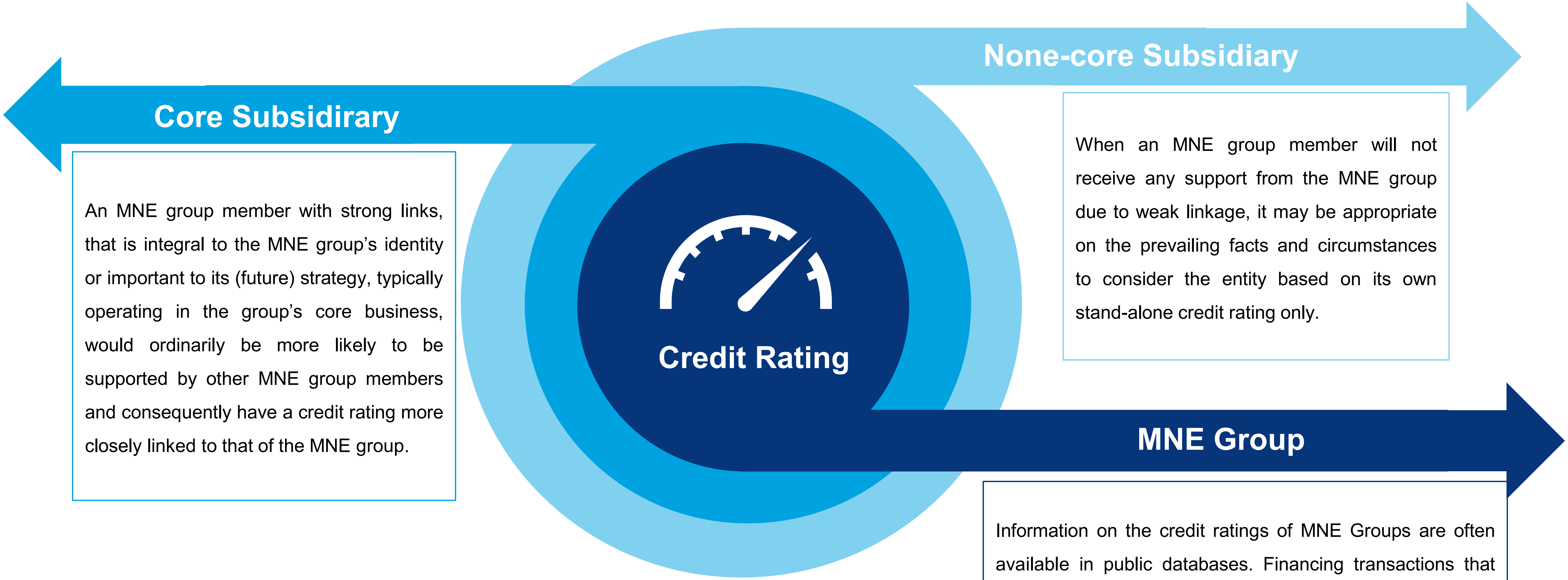
- The credit rating of an MNE is a **main factor** that independent investors consider when determining an interest rate.
- Determining credit ratings requires consideration of **quantitative factors** (e.g., financial information) and **qualitative factors** (e.g., industry and jurisdiction in which the MNE or MNE group operates).
- Group membership may affect the price of a financial instrument. The majority of MNEs have a **group funding policy that set or influence the terms and conditions of the debt** the MNE would have entered into with an independent lender, including the pricing and all economically relevant characteristics.
- An MNE may **receive support from the group to meet its financial obligations** in the event of the borrower getting into financial difficulty.
- This incidental benefit that the MNE is assumed to receive solely by virtue of group affiliation, is referred to **as implicit support**.

Implicit support



Core Subsidiary

An MNE group member with strong links, that is integral to the MNE group's identity or important to its (future) strategy, typically operating in the group's core business, would ordinarily be more likely to be supported by other MNE group members and consequently have a credit rating more closely linked to that of the MNE group.

None-core Subsidiary

When an MNE group member will not receive any support from the MNE group due to weak linkage, it may be appropriate on the prevailing facts and circumstances to consider the entity based on its own stand-alone credit rating only.

MNE Group

Information on the credit ratings of MNE Groups are often available in public databases. Financing transactions that the borrowing MNE or another MNE within the group has with external lenders can be reliable comparables for interest rates charged by associated enterprises or relevant for the comparability analysis.

Determining and calculating the arm’s length interest price: commonly applied methods

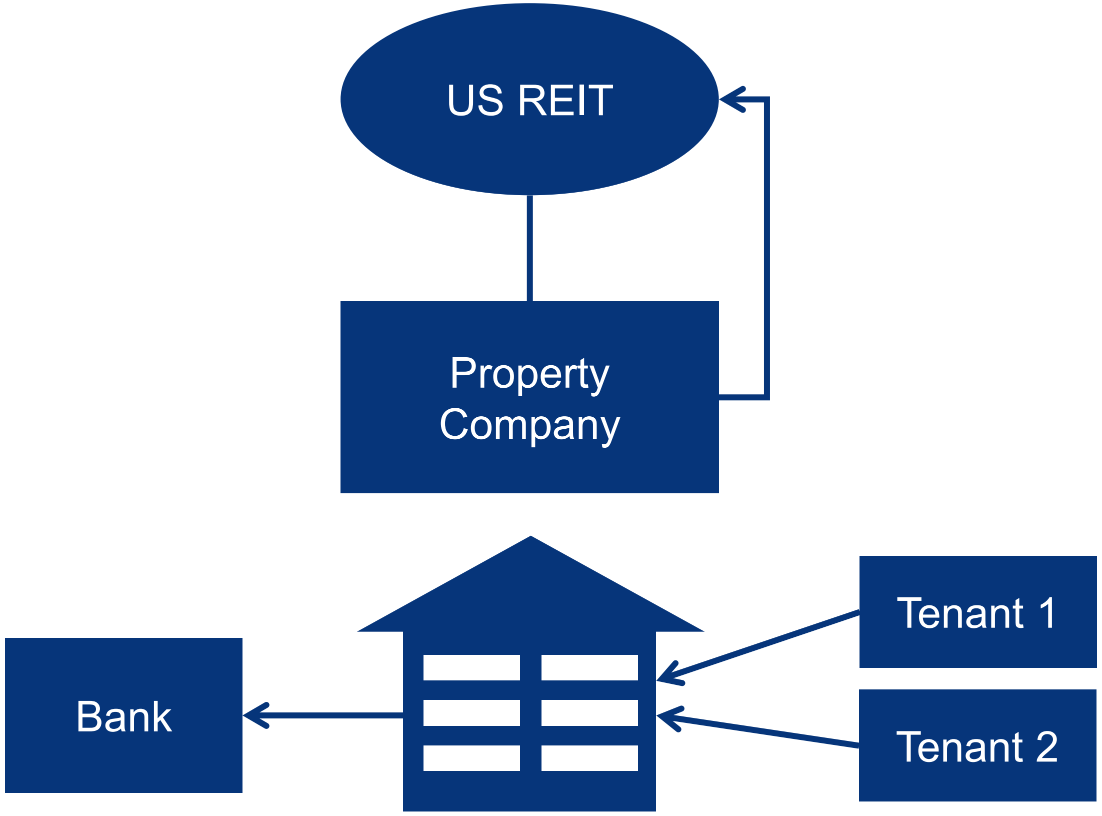
CUP

- External CUP: benchmark against publicly available data for other borrowers with the same credit rating for loans with sufficiently similar terms and conditions and other comparability factors.
- Internal CUP: Use potential comparable loans within the borrower’s or its MNE group’s financing with an independent lender as the counterparty.
- Both CUPs: Certain cases necessary to make appropriate adjustments to improve comparability
- If reliable internal or external comparables available, the preferred method.

Modeling

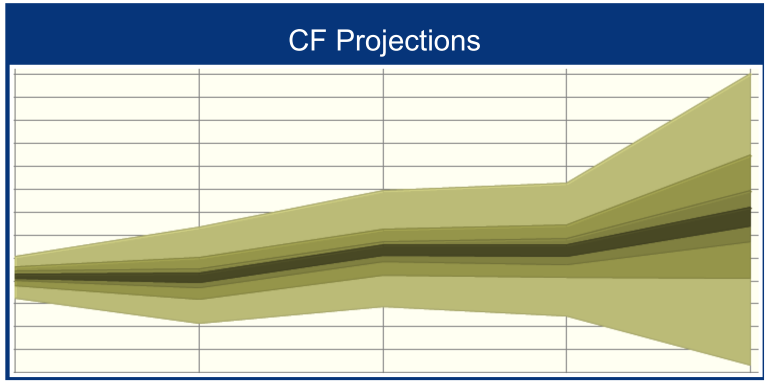
- If reliable CUPs are unavailable an economic model may be a tool that can be applied in calculating an at arm’s length price for intra-group loans.
- Certain industries (e.g., real estate) rely on economic models to price intra-group loans by constructing an interest rate as a proxy to an arm’s length interest rate.
- The reliability of economic models’ outcomes depends upon the parameters factored into the specific model and the underlying assumptions adopted.

Modeling: Project Finance



Risks

- Default
- Vacancy
- Price
- Location
- Regulatory
- Opex
- Capex
- Interest rate
- Market
- Black swans



Modeling: Cost of Capital Correlation