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Cross border Intragroup Financing- Increased TP Focus post COVID-19

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COVID-19 epidemic is catastrophic, black swan event with an unprecedented impact on our societies and economies. Nearly half of humanity is living under some form of lock down and GDP of G-20 nations is estimated to shrink by 5% in 2020 vs. the pre-Covid estimates. The economic impact across different industry sectors and geographies is evolving; airlines, hospitality, traditional retail etc. have taken the brunt of the first wave impact. As consumption and production shrink dramatically, the impact will ripple through second and third order industries. Governments have been urgently evolving monetary and fiscal policy responses, besides scrambling on strengthening public health, develop social measures, and keeping supply chains running.

This dynamic, volatile situation creates significant push and pull factors for increased inter-company transactions for Multinational Enterprises (MNEs). The volatility from significant demand and supply shocks, massive price movement for commodities and currencies creates the 'push' for inter-company financing. MNE's will need increased cross-border financing support to meet liquidity and even structural needs. On the other hand, differences in the scope and timing fiscal & monetary interventions by Governments create arbitrage in interest rates and resultant impact to FX rates, creating 'pull' for inter-company financing. The need, frequency and complexity of intragroup financing is likely to increase many folds.

Intra-group financing is a complex and high-scrutiny topic even in normal times, accentuated by the recently released OECD guidelines on their pricing. The possibility of tax authorities closely scrutinizing such transactions is rather high. All this, in my opinion, warrants an urgent fresh look at group's transfer prices, analysis and documentation. This discussion paper focusses on cross border intragroup financing:

A. What is cross border intra-group financing

B. Transfer Pricing and Guidance issued by the OECD for its pricing,

C. Planning or documentation required in view of the OECD guidance,

D. Impact/ challenges for TP on these transactions post COVID-19,

E. Role of tax authorities in these challenging times, and

F. Key takeaways

A. What is Cross border Intra group financing and its relevance- good to be ALL IN THE FAMILY:

As the name indicates, cross border intragroup financing refers to any financing arrangement that crosses national borders and participants are related. Typically financing arrangements are:

- Intra-group/ company loans
- Collateral and guarantee arrangements
- Cash pooling
- Hedging mechanisms & instruments
- Captive Insurance

Intragroup financial transactions are an intrinsic part of almost all companies with global presence. Companies leverage towards intragroup/ intercompany financing, inter alia, for the following reasons:

- To maximize their borrowing capacity and managing repayment terms;

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· To access resources for M&A and other competitive market actions;

· To support cash flow or working capital needs of other entities in the group in a timely and effective manner

· To manage liquidity risk- ability to shift cash to a business unit with cash needs to avoid potential cash shortfall situations;

· To eliminate credit risk- controlled ownership helps to manage and control repayments;

· For efficiency- shift and concentrate cash in specific entities for maximizing returns on short term cash deployment;

· To avoid bank spreads and fees- the bank spread typically includes the market spread (LIBOR – LIBID), the cost of balance sheet (regulatory and shareholders cost of capital) and the profit margin. Although corporates will have administration and execution costs, these will still be lower than the bank spreads;

· To have a balance management tool- an intercompany loan results in an intercompany balance rather than a bank balance.

· A belief in the notion, 'All in the Family' helps.

However, there are tax and regulatory considerations to these arrangements. For instance,

i) While most countries allow intercompany loans, many impose withholding tax on interest on cross-border loans.

ii) BEPS Rules have accentuated the need of having such transactions at acceptable pricing and also documenting it properly.

iii) Thin capitalization rules can limit the deductibility of interest for tax purposes. In many countries, interest deductibility is limited to specified debt to equity ratios.

Many corporates centralize intercompany financing activities to Treasury centers to concentrate cash & risk management, gain economies of scale, process efficiencies, and not the least, better controls. Operating entities deposit excess cash with the treasury center and borrow from the treasury center to cover deficits. Inversely treasury centers help in taking intercompany deposits and making intercompany loans. These treasury centers also offer intercompany derivatives for hedging, and transact net positions with banks for risk management and reducing bank spread costs. They also help in concentrating foreign exchange positions, manage risk and execute FX hedging transactions.

B. Transfer Pricing and Guidance issued by the OECD for their pricing for such transactions

For transfer pricing purposes, any intercompany financial transaction is called controlled transaction and needs to be priced according to arm's-length principle i.e. lender will receive an arm's length return on their investment in all situations.

Over the past several years, tax authorities across geographies have given extra attention to cross border intercompany financing arrangement for their tax treatment and pricing considerations. Such intercompany financial transactions are complex for both the taxpayer and the taxing authority to determine a reasonable arm's length transfer price (ALP). Usually ALP is determined based on traditional transaction-based methods where a comparison is made with similar transactions between unrelated parties and needs to commensurate with the risks and responsibilities (like decision making) of the respective parties.

Many of us were looking up to the Organization for Economic Co-operation and Development (OECD) to provide assistance and clarifications for Transfer Pricing in relation to intra group financing transactions.

On 11 February 2020, the OECD released its long-awaited Transfer Pricing Guidance on Financial Transactions. This is a seminal change in the transfer pricing landscape as this is the first time the OECD has produced final definitive guidance on transfer pricing for financial transactions. It should bring consistency in the interpretation of the arm's length principle and mitigate transfer pricing disputes and double taxation. Chapter X of the OECD Transfer Pricing Guidelines and cover areas like intercompany loans, cash pools, financial guarantees, hedging transactions, and captive insurers.

The report primarily builds on the themes from its non-consensus Discussion Draft on Financial Transactions published in July 2018, though there are some notable changes too.

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The guidelines are quite broad and provide numerous examples of different scenarios to illustrate the principles outlined therein. A synthesis of the guidelines on 5 key focus areas is mentioned here.

i) Accurate delineation of financial transactions

Guidance is provided on how to apply the accurate delineation principles to determine whether a prima facie loan/ advance should be regarded as a loan for tax purposes. If financial transactions that MNEs claim to be debt does not have the characteristics of debt in substance and form, they could be recharacterized as some other kind of payment, in particular as Equity in whole or in part. Till now, debt characterization analysis was done taking cognizance of non-transfer pricing measures like Thin Capitalization rules, but the Chapter X guides to employ a more holistic debt characterization analysis.

Chapter X stresses the importance of accurate delineation of financial transactions and lists these five economically relevant indicators to form the analysis of the terms and conditions of financial transactions.

· Contractual Terms between the parties

· Functional Analysis

· Characteristics of Financial Instruments

· Economic Circumstances

· Business Strategies

It also clarifies that the guidance included therein does not prevent countries from employing different approaches to address capital structure and interest deductibility under their domestic legislation.

ii) Treasury Functions

The Guidance analyses the Treasury functions performed within an MNE group and outlines the considerations which arise from three common treasury activities performed within MNE groups.

· Intra-group loans

· Cash pooling

· Hedging

The guidance suggests that generally treasury functions are a support service to the core value creating business operations and that strategic treasury decisions and the control of associated risks are usually undertaken at a group level, rather by the treasury function. Hence a treasury function should only receive a limited level of remuneration. However, in practice the organization of the treasury will depend on the structure of a given MNE group, level of concentration, the complexity of its operations and control of risks associated with financial transactions. Treasury function that are more complex (e.g. of banks) should be compensated accordingly.

Transactions involving centralized treasury operations also need to be accurately delineated, especially on identification and allocation of the economically significant risks. This allocation, as well as the characterization of the treasury functions in general, will largely depend on the structure of the treasury organization.

Intragroup loans- The guidance is provided on use of credit ratings tools and methodologies while pricing an intragroup loan and determining the arm's length rate of interest. Impact of group membership or the implicit support an entity derives from being part of MNE group needs to be considered.

Cash pooling– Such arrangements need to be looked at in totality. All cash pool participants are expected to be better off than in the absence of the cash pool. The appropriate reward of the cash pool leader will depend on the facts and circumstances, the functions performed, the assets used, and the risks assumed in facilitating a cash pooling arrangement. The remuneration of the cash pool members will be calculated through the determination of the arm's-length interest rates applicable to the debit and credit positions within the pool.

Hedging- It is generally driven by the group policy. The guidance states that treasury functions relating to hedging will often be centralized to improve efficiency and effectiveness. The central arrangement of a hedging contract by treasury, that an operating entity enters into, can be seen as the provision of a service,

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for which treasury should get an arm’s-length compensation.

iii) Financial Guarantees

Regarding financial guarantees on certain intragroup transactions, the guidance stresses the importance of accurately delineating the transaction by identifying the commercial/ financial relations before considering any transfer pricing for it. The discussion also focuses on:

· ensuring a guarantee fee is beneficial from the perspective of the borrower, or in other words, evaluating whether the borrower is in a better position paying both interest and a guarantee fee than they would be from just paying interest.

· implicit support needs to be considered when evaluating the interest rate a borrower would have gotten without the guarantee.

· an examination of the financial capacity of the guarantor, noting that a guarantee may not be accurately delineated as such if a guarantor, in practice, would be unable to fulfill their financial obligations in the case of default of the borrower.

In nutshell, the guarantee position needs to be considered in the context of the group, sustainability of the borrower and prior practices. The guidance also provides for 5 pricing methods that can be used in cases where, after accurately delineating the transaction, a guarantee exists.

· CUP method

· Yield approach

· Cost Approach

· Valuation of expected loss approach

· Capital support method

iv) Captive Insurance

Captive Insurance is an insurance undertaking or an entity which belongs to an MNE group and substantially all of its insurance business is to provide insurance policies for risks of entities within group. The OECD provides guidance on intragroup reinsurance (also referred as ‘fronting’, ‘reinsurance captive’) as well, which is distinguished from captive insurance.

The Report provides guidance as to how to determine assumption of risk by captive/ reinsurance and control of risk by the insured entity whether the captive insurance undertakes and controls risks. It also stresses the importance of identifying the relevant commercial and financial relations between associated enterprises and the conditions which are economically relevant before determining whether transfer pricing implications exists.

For pricing a transaction, the report analyses several approaches that can be taken on a case by case basis. It focusses on using CUPs from comparable arrangements to price insurance premiums, but comparability adjustments may be needed (e.g. a captive insurance entity will perform less functions like no distribution and sales functions as compared to an independent insurer).

The report acknowledges the difficulties of applying the CUP method in some cases and analyses potential alternatives like payments to external insurers or using actuarial analysis.

v) Risk free and risk adjusted rates of return

The OECD provides guidance on how to determine a risk-free rate of return and a risk adjusted rate of return.

A risk-free return is defined as “the hypothetical return which would be expected on an investment with no risk of loss.” So, a funder who lacks the capability or that does not conduct the decision-making functions to control the risks associated with investing in a financial asset should receive no more than a risk-free return as remuneration.

A risk-adjusted rate of return will consist of a risk-free rate and a premium reflecting the risks assumed by the funder. The risk adjusted rate of return is considered an appropriate remuneration for a funder that exercises control over the financial risks associated with the provision of funding without assuming or control

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any other specific risk. It is important to distinguish between the financial risk assumed by the funder and the operational risk assumed by the funded party.

A risk-adjusted rate of return can be determined based on various approaches, including comparable uncontrolled transactions, the return of a realistically available alternative investment (e.g., bond issuances or loans), adding a risk premium on the risk-free return, or the cost of funds.

C. Planning or Documentation required in view of the OECD guidance

Chapter X does not provide significant detail on documentation requirements for financial transactions. Indicative guidelines on documentation are:

· An accurate and clear understanding of each intercompany financial transaction.

· Identification of key aspects and their relative risk.

· Cash flow analysis demonstrating borrower ability to repay.

· An overview of the terms and character of the loan.

· A transfer pricing policy. This can be drafted or revised to reflect the current status and adjust areas where attention points are not yet accommodated. For instance, an overview why a loan was structured in a particular way.

· A functional analysis mentioning clearly entities with decision-making authority and risk & responsibility undertaken.

· An analysis of any potential internal CUPs.

· Contractual terms between the parties and the borrower's and lender's perspectives.

D. Impact/ challenges for TP on these transactions post COVID-19

As mentioned earlier, it's a very dynamic situation making it extremely hard to assess the economic impact of this pandemic. Different sectors and geographies are impacted with varying levels of pain; going forward also the pain will spread unevenly as the impact makes its way to second and third order sectors/ geographies. Volatility has increased exponentially, hence the need, frequency and complexity of intragroup financing will only increase.

The pivotal point is that transfer pricing for financing transactions need to be at the arm's length and arm's length cues need to be taken from the prevailing conditions. A few comments or possibilities in the post COVID-19 scenario are:

· Associate enterprises like independent organizations to have losses, cash flow issues, etc.

· Enterprises to rely on intragroup financing more.

· Need for financial support, delayed payment terms, etc.

· Need to move cash in and out of affected areas to pay for certain COVID related expenses.

· Need to increase their intercompany financing/ lending for better working capital management within the group.

· Need to reevaluate cash pools.

· Impact of credit rating deterioration.

· Need for financial guarantees to enable group entities to secure borrowing.

· Need for performance guarantee from the parent company by a customer of its group entity.

For transfer pricing, the entities should consider doing a detailed planning, maintaining a document evaluating transfer pricing activity and documenting the movements/ reactions of the market in typical third-party interaction, review its tax planning for 2020, relook at its transfer pricing strategy etc. The critical point is detailed documenting to demonstrate to the tax authorities the real situation and intent that such practices are consistent and in line with their dealing with third parties.

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E. Tax authorities' objectivity:

The role of tax authorities is very crucial in transfer pricing scenario post COVID-19. Given the unprecedented societal and economic times businesses are facing, the tax authorities need to be open and be aware of upcoming difficult market conditions and challenges tax payers are facing.

Transfer pricing is increasingly becoming an area of focus and is seen as an alternate source of tax revenue by tax authorities across countries. Over the last several years, the tax authorities are evolving and becoming more sophisticated. With their increasing maturity, awareness and expertise of transfer pricing, it is likely that intercompany financing arrangements will be scrutinized with higher frequency and with a greater level of detail in the near future.

In a normal scenario, various risks, costs, revenues, market scenarios can be forecasted with reasonable level of confidence but current scenario is way too different. Risk profiles within the group entities will change, comparable need to be revisited (in certain situations, even identifying a comparable will be a challenge…. world is being shut for more than a month and opening might be in different timeframes for different states/ countries). Also impact of COVID-19 might not be all be quantitatively possible. These variables are unique and different to each industry. So, the normal process of comparable will change. Tax authorities' objectivity in understanding these changed and unusual circumstances will be highly appreciated.

Governments across the globe have acted with decisiveness on monetary and fiscal policy to counter COVID-19's impact on businesses. I am hoping tax authorities will also carry that principle forward.

F. Key Takeaways

1. The timing of the OECD guidance is almost a god send, it provides structure and guidance just before the world lost its 'normal'.

2. With dramatic change to business circumstances, use of Intragroup financing arrangements should be significantly higher than BAU.

3. For businesses, it's an imperative to revisit the existing intercompany financing arrangements, re-strategize the group's transfer pricing policy in line with the new market situations.

4. Documentation, documentation, documentation are the 3 critical steps.

5. Tax authorities might take a pragmatic view of TP considerations given the exceptional situation.