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Intra-Group Financing

Unraveling Transfer Pricing Expectations

December 2020

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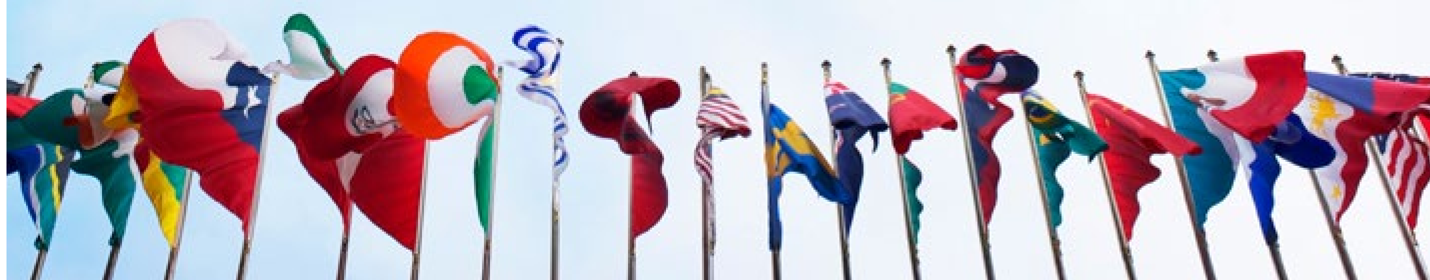


Intra-Group Financing is an evolving landscape with varied interpretation and divergent views. MNE's should revalidate their funding approaches considering applicable methodology and trends.

Introduction

Financial transactions are often the most extensive and material transactions within multinational groups. These transactions are central to financing multinational groups and service liquidity provision, long term funding, and other operational and tax needs. While many companies raise money on the capital markets but are on the lookout to efficiently capitalize their businesses around the globe. Over the last few years, a recently increased focus on the transfer pricing of financial transaction is driving a new phase of tax disputes. However, there are emerging trends in the consistency of treatment between jurisdictions, despite the work of the Organisation for Economic Co-operation and Development (OECD) to address this complex issue.

Financial transactions are an important part of the operating procedures of MNEs to support their value creation process. Owing to the growing needs of financing as well as additional guidance issued, in an intra-group situation, consideration of the tax consequences of the financial transactions assumes greater importance. Tax authorities are taking a greater interest in transfer pricing for financial transactions, particularly where a jurisdiction is a 'capital importer' and so would tend to have interest expense paid out of that jurisdiction.

Economies and markets have been heavily impacted by the COVID-19 outbreak. While the businesses are planning their revival for their operations to continue, consequences of this pandemic are quite adverse, including reduction of consumer demand, supply chain disruption, and an increase in risk aversion in financial markets (driven by an overall downturn in business and consumer confidence).

Due to this unforeseeable event, Multinational Enterprises (MNEs) that were operating at decent business levels, maybe now facing a substantial reduction in profitability. Accordingly, a need to reorganize, reduce or relocate businesses may be felt by MNEs.

Businesses may have to adopt extraordinary measures in order to secure funding to keep their business going. While some measures may be in the form of cost cutting measures such as reducing employee costs and shutting down non-profitable lines, some may be in the form of securing additional funding. An inordinate need to undertake intragroup financing and cross guarantees may be experienced.

While MNEs may enter into these intra-group financial arrangements to foster stability, growth and survival; it shall at the same time be imperative to ensure compliance with Transfer Pricing Guidelines. This economic crisis shall have a wide-ranging impact on transfer pricing and will pose many challenges and questions for tax practitioners.

OECD’s Guidelines on Financial Transactions

As a part of the OECD's and G20's Base Erosion and Profit Shifting (BEPS) Action Plan, initiated in 2013, a specific workstream was charged with developing detailed guidance on the most frequent transfer pricing issues in the area of financial transactions. More concretely, the 2015 report on Aligning Transfer Pricing Outcomes with Value Creation pursuant to BEPS Actions 8-10, and the 2015 report on Limiting Base Erosion Involving Interest Deductions and Other Financial Payments pursuant to BEPS Action 4[1] mandated follow-up work on the transfer pricing aspects of financial transactions.

On 3 July 2018, the OECD released its first public discussion draft on the transfer pricing aspects of financial transactions[2]. This draft attracted a strong response from both the nonfinancial and financial services sectors. The discussion draft provided the first official OECD comments and proposals on the transfer pricing aspects of financial transactions. Although the Discussion Draft was a non-consensus document, it provided insight into the OECD's direction of thinking. The response of multinationals to the 2018 Draft Report was largely to express concern about several key aspects of it, but to adopt a 'wait-and-see' strategy. Many commentators hoped that the OECD would retract some of the more problematic requirements.

On 11 February 2020, the OECD issued its final Transfer Pricing Guidance on Financial Transactions (‘FT Guidelines’), of which Chapters A through E will be incorporated as Chapter X of the OECD Transfer Pricing Guidelines (Chapter X)[3]. The Guidance aims to clarify the application of the principles of the 2017 OECD Transfer Pricing Guidelines, in particular the accurate delineation analysis, to financial transactions. It covers not just loans and guarantees (which have attracted the majority of discussion in the past) but also includes cash pooling, risk-free and risk-adjusted rates of return, and captive insurances. The Report is a significant step by the OECD towards providing more comprehensive guidance on financial transactions, and makes it clear that the OECD expects to see significant progress by multinationals in updating their existing transfer pricing policies on financial transactions to comply with the Guidance.

Some of the most pressing issues that were discussed in the OECD final report are:

- Loans that may be subject to re-characterization because the lender does not exercise sufficient control over the borrower's credit risks;
- Interest rates that are not linked through analysis to the risks inherent in the loan;
- Financial guarantees that are not accurately delineated, and which do not differentiate between the implicit support that associated enterprises receive as a result of their membership in a group and the additional benefit that results from the explicit contractual guarantee;
- Guarantees that increase the borrowing capacity of a lender leading to the potential re-characterization of the portion of the loan that would not have been made without the guarantee;
- Cash pool models in which the reward to the cash pool leader is inconsistent with its delineation and that do not consider whether there is a group synergy benefit that should be shared with the pool participants; and
- Captive insurance arrangements for which there is little commercial rationale or where the captive lacks substance to control the risks and is therefore only providing a service rather than assuming the insurance risk.

Tax authorities also have more information than ever, as a result of disclosure requirements such as Country by Country Reporting (CbCR), and Master files and Local files.

The disputes also continue to become more common, with court cases progressing through many judicial systems and often into the Mutual Agreement Procedure (MAP) program. But at the same time, taxpayers are struggling to make full sense of the changing environment and to understand what is or is not now acceptable. The dissimilar approaches adopted by the various tax authorities within transfer pricing audits, and the need to have distinct transfer pricing solutions for specific industry sectors have both highlighted that taxpayers need to be proactive in managing their transfer pricing risk in this area.

The said guidelines covers the following key intra-group financing arrangements:

Intra-group loans – These tend to be the most common source of intragroup funding. Typically, the group treasury is responsible for raising funds from capital markets and then disbursing them to subsidiaries in the form of loans. The primary benefit of this activity is that it upgrades the potential lack of purchasing power of individual entities who may otherwise have to raise funds independently; the higher credit risk or limited access to liquid markets for these entities would typically increase the overall cost of borrowing.

1. https://www.oecd.org/tax/beps/beps-actions/action4/
2. https://www.oecd.org/tax/transfer-pricing/BEPS-actions-8-10-transfer-pricing-financial-transactions-discussion-draft-2018.pdf
3. https://www.oecd.org/tax/beps/oecd-releases-transfer-pricing-guidance-on-financial-transactions.htm

Guarantees – These commonly take the form of financial guarantees but may also include performance guarantees from the parent or a highly capitalized affiliate. Such guarantees may help a subsidiary secure a loan or a specific contract at favorable terms and conditions (e.g., the lower interest rate on a loan or lower reserve requirement for a higher risk project).

Cash pooling – This is also a popular cash management tool. Pooling excess cash available in various subsidiaries and then reallocating such funds to operations in need of funds creates an efficient structure for managing working capital.

Hybrid financing, derivatives, and other treasury services (e.g., foreign exchange risk management, commodity risk management, captive insurance, asset management, carbon trading), etc.

Hedges - An MNE may enter into hedging transactions for many reasons, including the protection of subsidiary cash flows from unexpected events. Similar to hedges, insurance captives help subsidiaries manage cash flows from unexpected events triggered by specific types of risks. To the extent that these group risks are centralized, intercompany transactions are created that in turn, require transfer pricing support.

Aligning FT guideline with fundamental TP principles under OECD guidelines

OECD Final guidelines on FT identifies the factors to be considered while determining the arm's length pricing policy in the given circumstance. The assessment of the arm's length nature of an intra-group financial transaction follows a similar approach as for other intercompany transactions. It requires the identification of commercial or financial relations, including an understanding of the economically significant characteristics of the controlled transactions leading to the accurate delineation and recognition of the actual transaction for selection and application of the most appropriate transfer pricing method. Some of the essential characteristics of the intercompany financing arrangements are:

Contractual terms: While the financial transactions between unrelated parties provide for explicit terms and conditions, for an intercompany arrangement, the contractual arrangements are typically less explicit. In that case, other documents and information would be essential to determine the terms and conditions of the transaction and whether the actual conduct of the parties is consistent with those terms and conditions.

Functional analysis: This analysis is relevant to determine what functions are performed by the respective parties (borrower and lender) in relation to the financial transaction. Some of the points that may assist in determining the functions and responsibilities of the parties to the financial transaction are:

Whether debtor can obtain credit/funding from other sources;

- Credit and other risk of the lender in providing funding to this borrower;
- Who conducts the monitoring of ongoing compliance with the terms of the funding agreement;
- Consideration of functions relating to ensuring the availability of funds to repay a loan when due, i.e., considering the source of funds for repayment of the financing obtained specifically from the borrowers perspective;
- Use of the funds/financing provided to the borrower;
- Purpose of the financial transaction in the context of the parties' businesses, what assets may be used, and what risks are assumed in relation to the financial transaction, and how those risks are controlled.

The above analysis should consider how those functions relate to the wider generation of value, the circumstances surrounding the transaction, and industry practices.

Characteristics of financial products or services: To accurately delineate the actual transaction, it is material that the characteristics of the specific financial transactions (or financial services) are defined and supported by the conduct of the parties and other facts.

Economic circumstances: Pricing of financial transactions would vary depending on the economic circumstances that apply when those financial transactions are entered into or take place. In such a case, the followings aspects need to be considered:

- the currency of the financial transaction;
- the geographic jurisdictions of the parties to the financial transaction;
- the specific business sector or industry in which the parties operate;
- the timing of the transaction;
- macro-economic trends will impact interbank lending rates and as such, may impact the (interest) cost of financial transactions.

Business strategies: The global financing policy of an MNE group may have an impact on how the intercompany financing transaction is structured. While accurately delineating the actual transaction, it will be helpful to have a clear understanding of the group's financing strategy. The intent of the parties with respect to the funding provided, participation in management, and voting power by the party extending the financing all may be relevant considerations in this respect.

Identification of the above factors, and then delivering coordination between the tax and treasury/finance departments is an important step towards well-informed decision-making in pricing financial transactions.

Intra-Group Loans – Challenges & Recommendations

The global crisis and consequent increase in risk aversion in financial markets has led to volatile credit spreads, changes in reference interest rates and thereby is likely to result in fewer debt transactions. For MNEs, these developments may lead to the rise of many significant challenges and questions.

The challenges can be in the form of:

- Whether one should review and amend interest rates on existing inter-company loans to reflect the current financial situation?
- Whether one should consider current circumstances to determine future lending policies within the group even when one expects such a crisis to subside?
- Whether one can determine related party interest rates on loans in such an environment, with the availability of few potential comparable transactions?

According to the OECD's FT guideline, specific measures that are relevant in analyzing arm's length nature of intra-group loan are:

Analyze Lender's perspectives:

The lender's perspective in the decision of whether to make a loan, how much to lend, and on what terms will involve evaluation of various factors relating to the borrower, wider economic factors affecting both the borrower and the lender, and other **options realistically available** to the lender for the use of the funds.

While an independent lender will carry out a thorough credit assessment of the potential borrower, in case of an inter-company loan, all processes necessarily followed by an independent lender may not be adopted by a related party lender.

Considering, the parent already has control and ownership of the subsidiary, granting of security becomes less relevant to its risk analysis as a lender. Therefore, in evaluating the pricing of a loan between group companies, it is important to consider that the absence of contractual rights over the assets of the borrowing entity does not necessarily reflect the economic reality of risk inherent in the loan.

Analyze Borrower's perspectives:

The borrowers seek to optimize their weighted average cost of capital and to have the right funding available to meet both short-term needs and long-term objectives.

The borrowers will also consider the potential impact of changes in economic conditions such as interest rates and exchange rates, as well as the risk of not being able to make timely payments of interest and principal on the loan if the borrower's business encounters unexpected difficulties, and the risk of not being able to raise more capital (either debt or equity) if necessary.

Identify commercial/financial relations:

While accurately delineating financial transactions, one needs to analyze factors affecting the performance of businesses in the industry sector in which it operates. Such factors may be in the nature of economic, business or product cycle, effect of government regulations, or availability of financial resources in a given industry.

The process also considers how the MNE group responds to identified risks and changes. It must be considered that unrelated parties will evaluate all options available to them and choose the most commercially viable option. In some instances, although an entity may have the capacity to borrow and service an additional amount of debt, it may choose not to do so to avoid placing negative pressure on its credit rating and increasing its cost of capital.

Owing to the current scenario, the financing costs may be impacted due to macroeconomic factors, which may lead to higher interest rates, tightening of credit markets, etc., making it difficult for borrowers to afford interest rates.

The pandemic may put subsidiaries under financial stress, while some may struggle to meet their payment obligations on inter-company loans.

In such a case, it may be reasonable to renegotiate more favorable terms than would usually be available, delay interest payments on a temporary basis, or re-characterize short-term loans as long-term loans. These measures would need to be well documented, though, demonstrating close consideration of the options realistically available to both the borrower and the lender.

Use of credit ratings

The creditworthiness of the borrower is one of the key factors that independent investors consider in determining an interest rate to charge. Credit ratings is a useful measure of creditworthiness and to identify potential comparable, and to apply economic models in the context of related party transactions.

Though credit rating depends on a combination of various quantitative and qualitative factors, variance in creditworthiness between borrowers with the same credit rating is still probable. It is also important to note that when making comparisons between borrowers using the kind of financial metrics such as debt-earnings or debt-equity ratios, the same financial metrics will not necessarily result in the same credit rating if there are other differences between the rated parties.

For example, it may require stronger financial metrics to obtain a given rating in some industries than to obtain the same rating for a borrower in other industries. More intrinsically risky industries and those with less stable revenue streams tend to require better financial ratios in order to obtain the same rating.

Credit ratings can be computed using publicly available financial tools. These tools calculate credit rating based on approaches such as calculating the probability of default and likely loss that shall be incurred if a default occurs.

The MNE group shall have to appropriately document the reasons and selection of credit rating used for a particular MNE when pricing intra-group loans and other controlled financial transactions. However, there may be a need to revisit the credit rating of the borrower as a result of COVID-19 since there may be substantial changes to key ratios like liquid ratio, capital gearing ratio, etc., which will have a cascading effect on the credit rating of the entity.

Effect of group membership

The effect of group membership is relevant for taking into consideration the conditions under which an MNE would have borrowed from an independent lender at arm's length.

This can be in the form of considering group's external funding policies and group practices, including the pricing and economically relevant characteristics (type of loan, its term, currency, security, covenants, business strategies) to determine arm's length rate.

The guideline acknowledges that the same can be in the form of group support that MNE may receive to meet its financial obligations in the event the borrower gets into financial difficulty, referred to as implicit support. Implicit support from the group may affect the credit rating of the borrower or the rating of any debt which it issues.

The impact of implicit support of the group on the credit rating of a subsidiary was confirmed by the Federal Court of Australia in a landmark judgment delivered in the case of Chevron Australia involving intra-group financing in the nature of intra-group loan:

Australia | Chevron Australia Holing Pty Ltd.[4]

Sophistication expected in a transfer pricing analysis to determine an appropriate interest rate

A US subsidiary borrowed externally in US dollars at an interest rate of around 1.2%, with the benefit of a guarantee from the ultimate parent, Chevron Corporation. It then on-lent the funds to an Australian subsidiary at an effective interest rate of around 9% in the period under review. This interest rate was based on a stand-alone credit rating of the Australian subsidiary. The Australian subsidiary was issued with transfer pricing assessments on the basis that the interest rate on the loans was considered to be in excess of an arm's length rate. The Australian Court concluded that it was reasonable to assume that at arm's length, the borrower would have provided the customary security and covenants, which would have significantly decreased the cost of funding of the borrower. Had the Australian subsidiary sought to borrow money from an unrelated third party, it would have likely attempted to undertake all reasonable measures to secure a lower rate. In not doing so, the subsidiary had artificially inflated its 'arm's length' cost of borrowing.

This case is important beyond the context of pricing financial transactions as it considers a taxpayer's arm's length behavior. Specifically, it is necessary to consider all the reasonable alternatives to a transaction that could be entered into instead.

The relative status and importance of an entity within the group may determine what impact that potential group support has on the credit rating of a debt issuer. The FT guideline suggests that an MNE group member with stronger links important to the group's future strategy would be more likely to be supported by other MNE group members, consequently having a credit rating more closely linked to that of the MNE group. Conversely, an entity would be likely to receive limited support from the rest of the MNE group where linkages are weaker. In such a case, it may be appropriate to consider the entity on the basis of its own stand-alone credit rating only.

The impact of an assessment of implicit support is a matter of judgment. The MNE group would apply this judgement while deciding whether or not to provide support to a borrower. On the other hand, the tax administration may not be privy to such an event (applying judement), which may affect the ability of tax administrations to establish the likelihood of support.

Furthermore, changing facts and circumstances affecting the willingness or ability of the MNE group to provide support may mean that there is no decision by the MNE group itself until the eventuality for such support arises. The FT guideline acknowledges that the past behavior of an MNE group providing support may be a useful indicator of likely future behavior, but an appropriate analysis should be undertaken to identify whether different conditions apply.

The financing costs are impacted on account of this pandemic leading to higher interest rates and difficulty in obtaining loans.

To manage these increased costs at the time of obtaining new loans or renegotiating existing, MNEs may need to avail such implicit support of the group to meet their financial obligations. Implicit support may be in the nature of improved credit rating, more closely aligned to that of the MNE group. In the case of sourcing an external funding, implicit support from the group could be combined by explicit intra-group guarantees, thus enabling the group entities to survive in this situation.

4. https://tpcases.com/australia-vs-chevron-2017/

Use of MNE group credit rating

The guidelines recommend that It may be appropriate to use the credit rating of the MNE group for the purpose of pricing loan where the borrower entity is strategically important to the group and where the MNE's indicators of creditworthiness do not differ significantly from those of the group.

At this stage, it is relevant to discuss the findings of the landmark judgment of the Federal Court of Canada in the case of General Electric in the intra-group financing arrangement involving corporate guarantee.

Canada | General Electric Capital Canada Inc.[5]

Preference to assess the credit rating of an entity based on its position in the overall group rather than its stand-alone financial strength

In the said case, the issue was in relation to 1% guarantee fee paid by General Electric Capital Canada Inc. to its AAA-rated US parent company that satisfied the arm's length test. The Canadian tax administration argued that implicit support resulted in General Electric Canada having a AAA credit rating so that the guarantee provided by the US parent had no value. The taxpayer argued that the 1% guarantee fee did not exceed arm's length pricing and that implicit support from the US parent should be ignored since it stemmed from the non-arm's length relationship. The Tax Court agreed with the tax administration that implicit support should be taken into account and applied a 'yield approach,' comparing the interest rate the Canadian company would have paid with and without the guarantee. The Tax Court found that the credit rating of the Canadian company – with implicit support but without the guarantee – was at most BBB-/BB+ and the 1% guarantee was at arm's length.

The Federal Court of Appeal approved of both the Tax Court's yield approach and its conclusion that the guarantee fee did not exceed an arm's length price. On the issue of implicit support, the Court concluded that under the arm's length principle, implicit support had to be taken into account. Determining arm's length pricing "involves taking into account all the circumstances which bear on the price whether they arise from the relationship or otherwise." Hence, circumstances that are themselves inherently non-arm's length in nature must also be considered. Comparing prices of loans without regard to implicit support from the US parent fails to recognize all of the relevant economic circumstances of the controlled transaction.

During the current pandemic, a parent may more aggressively support its subsidiaries in order to obtain favorable financing terms. It may be appropriate to consider the credit rating of the group instead of the subsidiary's stand-alone rating.

Covenants

According to the FT guidelines, the purpose of covenants in a loan agreement is generally to provide a degree of protection to the lender and to limit its risk. In an intra-group loan scenario, lenders usually choose not to have any covenants on loans to its group companies. In such a case, it will be appropriate to consider the consequential impact on the pricing of the loan.

However, over a period of time, MNEs have revamped their intercompany loan agreements to be in line with terms contained in third-party loan agreements. These amended inter-company agreements clearly lay down the rights of the lender and obligations of the borrower with respect to the invocation of penalties if payments are missed and contain details of covenants as well. For example, one term of the agreement may be that breaching of covenants may result in a loan requiring immediate repayment.

While companies experiencing financial difficulties due to this pandemic may breach one or more covenants as mentioned in their inter-company agreements, it will be essential to consider the behavior of unrelated parties and take proactive steps to amend terms or refinance the intercompany debt as allowed by law.

In case a loan agreement includes a prepayment penalty clause, in a stable interest rate environment, the cost and administrative burden of refinancing debt may offset the benefits that can be realized on account of intra-group financing.

However, under the current rate environment, there is a possibility that certain borrowers may be able to take advantage of significantly lower rates, and companies should consider the implications of considering realistic alternatives of refinancing the debt.

Guarantees

A guarantee availed from the other party may be used as a support to the borrower's credit. A lender shall have to evaluate the guarantor in a similar way to that in which it evaluates the original borrower while placing reliance on guarantees. While the lender takes such a guarantee into account in setting the terms and conditions of a loan, it would need to be reasonably satisfied that the guarantor would be able to meet any shortfall in a case the borrower is unable to meet its obligations.

In light of this pandemic, there may be a need to re-analyze the credentials of the guarantor and to revisit the terms and conditions of the loan based on the current financial situation of the guarantor.

5. https://tpcases.com/canada-vs-general-electric-capital-november-2010/

Key Excerpts for Arm's Length Pricing

One of the most common financial transactions involves establishing the interest rate for an intercompany loan. However, this also involves determining the supportable 'arm's-length' quantum of debt, i.e., pricing the loan terms as if it had been made at arm's length, for which a debt capacity analysis is commonly performed. While some jurisdictions may have a specific thin capitalization regime that sets these parameters more definitively, the tax regulations in other countries support a more flexible spectrum of acceptable debt-to-equity ratios, so long as the taxpayer has undertaken an appropriate analysis that establishes their leverage parameters.

Intercompany guarantees, meanwhile, if not accompanied by appropriate transfer pricing support, can also have significant repercussions during a tax audit. Once detected, guarantees can be highly material and are some of the most difficult transactions to price. Performance guarantees, which are often issued as a business need, maybe especially neglected from a risk management perspective, especially when coordination with the tax function, is lacking. These often surface when the guarantor is called upon to make good on its obligation.

In relation to intercompany financial transactions described above, the most commonly used transfer pricing method to determine the arm's length compensation for the transaction is the Comparable Uncontrolled Price (CUP) method. However, the CUP method may only be employed when comparable transactions exist between one party to the intra-group loan transaction and an independent party (internal comparable) or between two independent parties, neither of which is a party to the intra-group loan transaction (external comparable). Additionally, treasury services rendered for the MNE group are likely to require an arm's length remuneration. For these services, the cost-plus method or cost-based TNMM can be utilized (or in certain circumstances, remuneration at cost). It is common that one entity of the group (e.g., the financing department/entity) is acting as a general service provider or intermediary for other entities in the group. Another method that could be used in some cases is the transactional profit split method. However, this method is rarely used in practice, especially for this kind of transaction.

Today, divergent treatment across jurisdictions, limited data options for reliable benchmarking, and a significantly increased volume of intercompany financial transactions occurring have all converged to place taxpayers in a difficult situation. Considering the same, some of the important questions that may be addressed in respect of each type of transaction to enable appropriate determination of arm's length price are:

Intercompany loans

- Could the borrower have secured funds from an unrelated entity? And if so, could that have been done at a lower interest rate?
- What is the commercial viability of the terms and conditions of the intercompany note?
- Does the presence (or absence) of third-party or first-lien debt have a corresponding effect on the interest rate?
- Is the rating based upon the pure financial standing of the subsidiary, or is it based on its affiliation to a larger group?
- Does the long-term loan include a payable on demand feature, and does that affect its overall pricing (and therefore transfer pricing treatment)?

Cash Pooling

- Is the cash pool provider a pure service provider, or does it bear additional credit risk?
- Are the cash pool balances short term in nature, or are the balances outstanding over a prolonged period?
- Interest rate earned by excess cash depositors: do such interest rates earned accurately reflect the pooling benefits?

Financial guarantees

- Is there a need to determine if there is a reduction in the cost of borrowing, and if so, determined by how much, and what impact this may have on transfer pricing aspects?
- Is it possible to calculate the expected loss of the guarantor?
- Is it possible to measure the liquidity benefit from the guarantee? And is it possible to determine how to compensate for the liquidity benefit?

Hedging/captives and performance guarantees

- Do any regulatory issues exist (e.g., the capital requirement for a pension guarantee) that impact ongoing operations?
- Does the risk bearer have the capacity to bear the risk — and determine the arm's length remuneration as a result?

Recommendations to Reflect & Revisit

1. Identify all existing intercompany transactions as per the final report and ensure that this is regularly updated. This includes ensuring that the tax function has a close involvement in strategic investments by the business before such investments are actioned;
2. Prepare a checklist of questions against which each financing arrangement needs to be checked;
3. Develop and sustain closer connections between business units, the treasury, and tax functions - including protocols for identifying such transactions on an ongoing basis;
4. During this period in which tax treaties are changing at such a rapid pace, ensure that each transaction/arrangement includes both current and potential future treaty interaction, including known treaty changes as a result of the use of the OECD's Multilateral Instrument;
5. Document all transactions in a contemporaneous fashion;
6. Continue to closely monitor related developments in this area at both country and OECD levels;
7. Embed and document all of the above within the enterprises' transfer pricing policies, revisiting it periodically to check for relevancy and execution;
8. APAs and other non-litigative rulings - bilateral or even multilateral nature, if available.

Impact of COVID-19 on MNE Groups Financial Arrangements

The COVID-19 crisis has had a significant impact on financial markets, as bond yields spiked and primary issuances slowed to a crawl during March of this year. While markets have since recovered somewhat, the impact on the quantum of supportable intercompany debt, as well as loan terms and interest rates, is likely to be with us for some time.

The OECD's BEPS initiative recommends limiting the tax-deductibility of interest expense, and many countries have adopted conforming rules. Further, the OECD's recent guidance on financial transactions opens the door for tax authorities to challenge the characterization of intercompany loans as a bona fide debt, not just the arm's length nature of the interest rate.

The typical areas of impact due to COVID-19 are provided below:

- **Quantum:** Over the decade-long economic expansion following the 2008 financial crisis, investors' appetite for corporate debt increased significantly. COVID-19 has, however, significantly decreased investors' tolerance for leverage and has sparked a 'flight to quality.' The decline in the market's appetite for higher-leveraged debt can be expected to reduce the magnitude of intercompany debt that can be supported during this period because a significant portion of the intercompany debt is below investment grade. These conditions will make it particularly challenging for intercompany borrowers whose loans are maturing during this time of market disruption and may need to be refinanced.
- **Terms:** In times of economic downturns, the borrowers would typically favor shorter-maturity debt. This lack of depth in certain sectors of the loan market may constrain the type of intercompany debt that can be issued. It would not be supportable, for example, for 10-year intercompany debt with a credit rating of 'B' to be issued if market data shows that only investment-grade debt is being issued for such long maturities. In these times, shorter-term intercompany lending will be easier to justify, price, and document.

  Besides maturity, related party borrowers will have to consider other loan clauses. For example, a significant percentage of intercompany debt allows the borrower to repay the loan early, and often without penalty. In an era of volatile interest rates, however, it may not be a good idea to allow for early repayment without penalty.

  One alternative could be to have the intercompany loan carry a floating interest rate instead of a fixed rate, which reduces the economic incentive for the borrower to refinance when market interest rates decline.

  Additionally, payment-in-kind features, which allow borrowers to convert scheduled interest payments into additional principal, might become more prevalent in the current environment as a way for borrowers to manage uncertain cash flows. These features would need to be taken into account when benchmarking the arm's length interest for intercompany debt.

- **Interest Rates:** The current crisis in financial markets means that the data that is used to benchmark the interest rate on intercompany debt financing may not be available or may reflect (possibly transitory) distressed conditions. Therefore, benchmarking the arm's length interest rates on intercompany debt in this environment requires additional back-up and analysis. If data on individual market loan transactions is sparse or unreliable, one may have to adjust using market indices.
- **Restructuring existing debt:** Many related-party borrowers may have difficulties paying interest or principal on outstanding intercompany debt. As a result, they may seek options to at least delay scheduled payments (e.g., assuming the loan does not have a payment-in-kind feature). If these options are not available under the current terms of a contract, then borrowers could be incentivized to seek a renegotiation of the agreement. Before changing the interest rate, terms of payment, or otherwise modifying an existing loan, taxpayers need to consider any potential tax consequences. Taxpayers should also take into account transfer pricing rules when modifying the terms of an existing loan. For example, unrelated lenders generally ask for something in return in exchange for deferring interest payments, such as a higher interest rate going forward or a penalty. Deferral of interest without financial penalty is not likely to mirror the arm's length behavior.
- **Use of Financial Gurantees:** There may be an increase in the use of related-party financial guarantees owing to the current crisis wherein external lenders may increase their demand for explicit parental guarantees due to less confidence in the ability of any single group entity to service a loan. These guarantees can present transfer pricing issues, including a need to distinguish their benefits from any implicit support already present within the multinational group.

  Also, in light of the recent OECD guidance on financial transactions, if a guarantee increases the debt capacity of a borrower during tough economic times, a loan could be re-characterized for tax purposes as partly a loan to that borrower and partly a loan to the guarantor, significantly complicating the transfer pricing and tax analysis of the transaction.

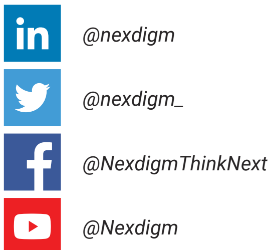
About Nexdigm (SKP)

Nexdigm (SKP) is a multidisciplinary group that helps global organizations meet the needs of a dynamic business environment. Our focus on problem-solving, supported by our multifunctional expertise enables us to provide customized solutions for our clients.

Our cross-functional teams serve a wide range of industries, with a specific focus on healthcare, food processing, and banking and financial services. Over the last decade, we have built and leveraged capabilities across key global markets to provide transnational support to numerous clients.

We provide an array of solutions encompassing Consulting, Business Services, and Professional Services. Our solutions help businesses navigate challenges across all stages of their life-cycle. Through our direct operations in USA, India, and UAE, we serve a diverse range of clients, spanning multinationals, listed companies, privately owned companies, and family-owned businesses from over 50 countries.

Our team provides you with solutions for tomorrow; we help you *Think Next.*



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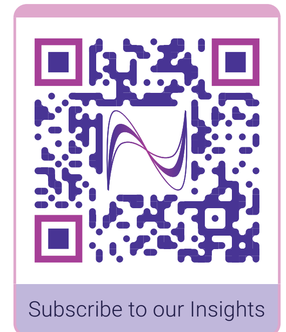

USA Canada India UAE Japan Hong Kong

Reach out to us ***ThinkNext@nexdigm.com***

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