New transfer pricing guidance on financial transactions

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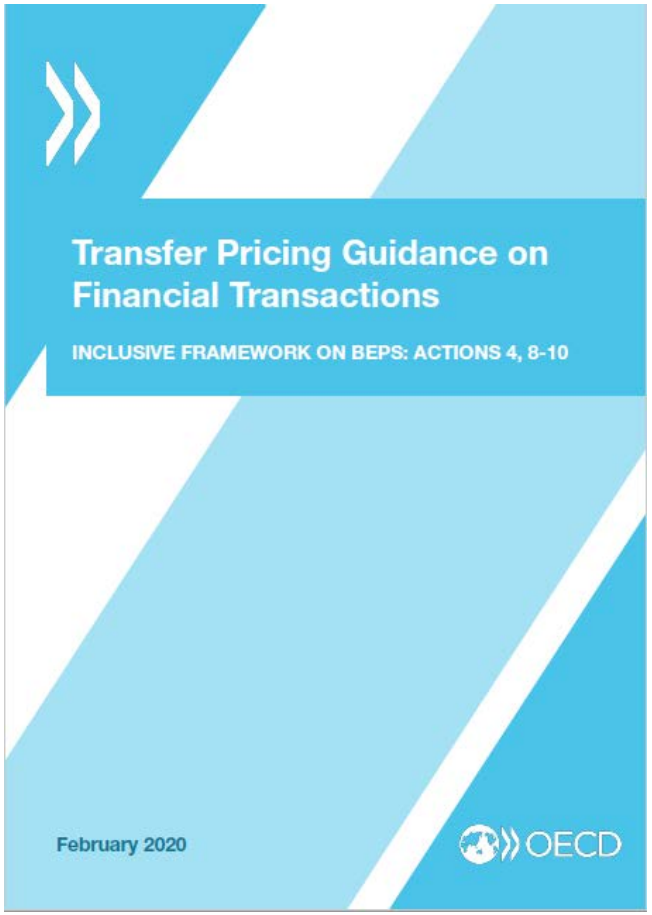
Contents

- Context and objectives
- The accurate delineation of loan agreements
- When different terms and conditions of a loan agreement may be imputed
- The calculation of the arm's length amount of debt
- The calculation of the arm's length interest rate
- Financial guarantee fees – delineation and pricing
- Cash pooling – delineation and pricing
- Captive insurance and reinsurance – delineation and pricing
- Group treasury functions
- The impact on typical Luxembourg investment structures
- Summary of considerations and recommendations for taxpayers

Context and objectives

- In February 2020 the OECD issued new guidance on financial transfer pricing
- The objectives of the webinar are to summarise the new guidance, explain the techniques referred to and show the impact on some typical investment structures



The accurate delineation of loan agreements - overview

- Interest payments may be treated as dividends and not deductible
- Potential application to transactions which were ongoing at that date
- However, more advisable to apply in taxpayers' financial years starting after 11 February 2020 when transactions can be adjusted
- Individual jurisdictions are still permitted to apply their own approaches through their domestic legislation
- However, guidance is now provided in the form of indicators of whether a purported debt should be treated as debt
- These indicators seem to fall into two broad types – the terms and conditions of the loan agreement and the context of the loan agreement (see next slide)

The accurate delineation of loan agreements - detail

	Economically relevant characteristics for debt qualification	Recommended approach for debt qualification
T&C	Fixed repayment date	Fixed repayment date (or bullet date) - No maturity upon demand, or perpetual maturity
	Obligation to pay interest	Interest must be payable and event of default clauses to be included in T&Cs – No (non-economically justified) waiver, no contingency
	Financial covenants and security	Financial covenants needed / security may be included (case-by-case analysis)
Context	Ability of borrower to obtain loans from unrelated lending institutions	Analysis of the other options realistically available for the borrower
	Lender profile / status	Comparability analysis with regular corporate creditors taking into consideration the non-regulated entity status and the strategy of the group in terms of lending
	Right to enforce payment of principal and interest	Ensure the lender may enforce its rights (in line with governing law of the contract) T&C: no limited recourse clause; no renunciation clause
	Source of interest payments / type of assets funded by the loan	Ensure flexibility of borrower to repatriate cash

When different terms and conditions of a loan agreement may be imputed

- Review of other options realistically available to the borrower (to minimise its cost of capital), e.g.
  - Offering security over an asset (this could be imputed anyway for shareholder loans because of the shareholder relationship, provided that the asset is not needed for another purpose)
  - Borrowing with financial covenants
  - Borrowing for a shorter period
  - Borrowing without prepayment and other options

- Review of other options realistically available to the lender, e.g. other investment opportunities offering a better return

The calculation of the arm's length amount of debt - concepts

- The maximum debt which lenders are prepare to provide:
  - the ability of borrowers to repay the interest when due and the principal by the end of the term out of forecast profits
  - The default rate and expected loss and required return on this amount compared to the expected interest payments

- 'Could' versus would 'test' (the maximum debt which borrowers wish to take on):
  - e.g. to leave a sufficient liquidity margin
  - or a minimum target credit rating (e.g. the rating for the group as a whole or the average for the industry)
  - or the cost of the asset which the loan is being taken out to acquire

- The maximum gearing and minimum interest cover that independent lenders are prepared to accept and borrowers are prepared to take on - see loan agreements and/or recent financial statements of companies in the industry

The calculation of the arm's length amount of debt - difficulties

- Use of historic or forecast data
- Reliability of financial forecasts
- Time period of analysis – "steady state" borrowing capacity, arm's length investor's time horizon
- Differences between industries, e.g. acceptance of partial refinancing at the end of the term as a private equity industry norm

The calculation of the arm's length amount of debt – methods

- Financial statements, lending covenants, CAPM and other sources and methods may be used
- Some are more relevant to certain kinds of financing than others (e.g. real estate lending, financial intermediation)
- The simpler methods are less precise and more likely to be challenged (e.g. Basell III equity ratio)

The calculation of the arm's length interest rate

- Borrower-specific credit ratings should be calculated based on quantitative and qualitative factors, and after an implicit group support adjustment
- This is then adjusted to calculate the credit rating of the specific financial instrument, e.g. is it senior or subordinated, guaranteed, secured…
- Related party lenders may not need to charge the same loan fees as independent lenders because they have no costs of e.g. raising capital or meeting regulatory requirements
- However, if they charge no fees at all, this should be reflected in a higher interest rate
- Where a loan is borrowed from an unrelated party and passed on to a related party, the original interest rate can be used, plus administrative costs, and the necessary risk premium and a profit element
  - But if only agency functions are performed, the reward should only be a mark-up on the costs of the services
- Warning that credit default swaps are not reliable because their price depends on the volume of trades (i.e. their illiquidity premium)

Financial guarantees – delineation and pricing

- Accurate delineation:
  - Must be a legally enforceable commitment to meet the borrower's obligations
  - Does the guarantor have the financial capacity to meet it obligations?
  - Will the guarantor also default if the borrower defaults?

- Benefit to the borrower (and maximum fee):
  - Because of the guarantor's better credit rating
  - Or because the guarantor adds to the pool of funds available to service the loan, its risk is not perfectly correlated with that of the borrower, and it therefore reduces the expected loss given default

- Expected cost and required return for the guarantor and minimum fee (what is the probability of default and the expected loss given default?)

- Consider the impact of relative bargaining power when identifying a point in this range

Cash pooling – delineation and pricing

- Hostility to conventional "entrepreneurial cash pool leader" model and presumption that cash pool leaders are simple service providers

- However, if the cash pool leader controls and bears liquidity risk and credit risk in a physical cash pooling arrangement, then it may deserve part or all of the spread between the borrowing and lending positions. Relevant questions are:
  - Does it bear the risk from the mismatch between the maturity of credit and debit balances?
  - Does it bear the risk of cash pool members being unable to repay what they have borrowed?

- Cash pool participants should share in the synergy benefits of cash pooling only if the cash pool was created by a deliberate and concerted group action

- No guidance on how to allocate the synergy benefits but:
  - the synergy benefits should be allocated through the interest rates
  - consider the relative bargaining power of the cash pool participants
  - all participants should gain from being in the cash pool – credit and debt interest rates should be better inside than outside cash pool

- Long term "structural" positive or negative balances may be treated as term loans with a different interest rate
- Guarantee fees may need to be paid for some or all cross-guarantees

Captive insurance and reinsurance: delineation

- Covers insurance and reinsurance ("fronting") activities – see OECD Report on the Attribution of Profits to Permanent Establishments, Part IV
- General scepticism about these arrangements
- Accurate delineation:
  - The risks must exist and the captive must face a real possibility of loss. These risks could include insurance risk, commercial risk and investment risk (from investment of the premiums)
  - Captive must be able to diversity and pool the risk (i.e. the insured must be in different lines of business and there must be enough of them – could require also taking on third party business)
  - Captive must have the necessary skills and experience
  - Insured must be better off in terms of lower premiums, more stable premiums and/or more access to the insurance market
  - Captive must have adequate capital for the risks

Captive insurance and reinsurance: pricing

- **Premiums:**
  - Should be lower than for non-captives because captives perform fewer functions, e.g. no distribution and sales activities
  - Could be set to cover expected losses on claims, administrative costs and a return on capital (net of any investment income)

Benchmarking the overall profitability of the captive:

- May be more reliable approach because premium calculations are complex
- Relevant figure is profit on claims plus profit on related party investments (e.g. using the premiums to make related party loans)
- But the arm's length return should only be earned on the amount of capital necessary to cover the captive's actual risks
- If captive is used to place risk more cheaply with third party insurers, and this was a concerted action, captive should receive a reward for basic services but policy holders should share the synergy benefits (savings)
- If a related party acts as a sales agent at the point of sale, and the captive reinsures the risk with third party insurers, the captive should earn the normal return for insurers and the agent should keep any excess profit

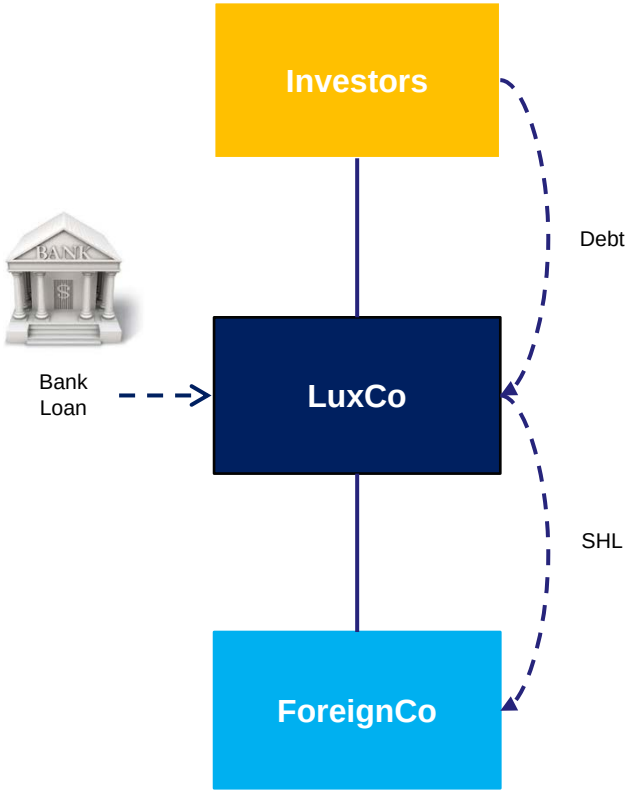
Group treasury functions

- Presumption that they will often be a low value support service, e.g. coordination role where it acts as a contact point for external borrowing
- Must be able to manage the financial risks to earn more than cost plus
- Suspicion that the treasury policies and group financial risk management strategy are set by the head office, not the treasury company which only implements them
- However, acceptance that a treasury function may conduct more complex activities (e.g. an in-house banking business), justifying a higher reward (e.g. a lending margin) for these activities

The impact on typical Luxembourg investment structures

- Back-to-back related party financing through a LuxCo
- Investment in a third party debt portfolio through a LuxCo
- Investment in a third party debt portfolio through a Lux Securitisation Vehicle
- Investment in qualifying or non-qualifying participations through a LuxCo
- Investment in third party real estate through a Lux Special Purpose Vehicle

Analysis
Intragroup back-to-back financing



Transfer pricing implications:

LuxCo should comply with all the requirements of the TP circular LIR 56/1 and 56bis/1 :

- Determination of the necessary amount of **equity-at-risk** at its level;
- Arm's length **profit margin** to be realized;
- **Interest rate** under the SHL should also be substantiated (except if determined in the source country through a TP analysis or safe harbour rules);
- **Substance** requirements listed in the TP circular should be met.

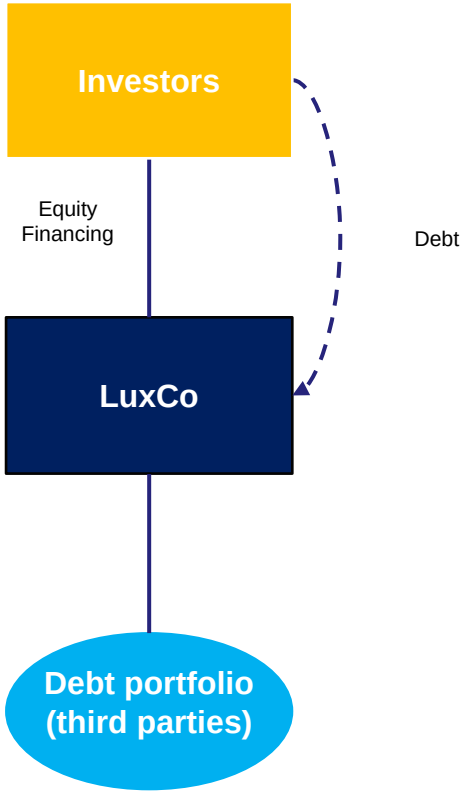
OECD Chapter X implications – applicable as from February 2020:

The transfer pricing analysis now involves:

- The determination of whether the Debt should be **regarded as a loan or as equity**
- The analysis of **qualitative factors**
- The analysis of the other **options realistically available**

Additional information to be requested

Analysis
Investment in a debt portfolio (unrelated) through a LuxCo



Transfer pricing (including OECD Chapter X) implications :

General approach:

TP analysis to be performed **as if transaction was in the scope of the TP circular**

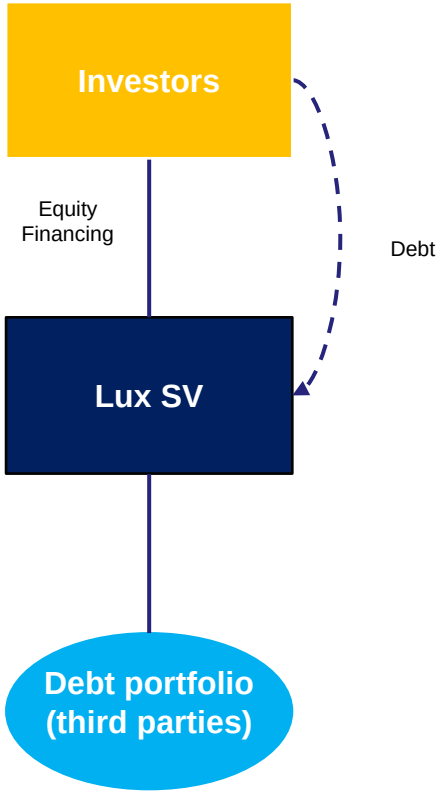
⇒ Applicable to fixed and variable interest bearing debt instruments. Profit participating remuneration approach may or may not be sustainable depending notably on the other characteristics of the debt

⇒ **99/1 debt / equity ratio no longer sustainable**, unless TP analysis allows to demonstrate it is at arm's length

To be considered

- Interest limitations rules
- Anti-hybrid mismatch rules

Analysis
Investment in a debt portfolio (unrelated) through a Lux SV



Transfer pricing (including OECD Chapter X) implications:

1. General approach - Agent:

Lux SV is by definition to be treated as a mere agent of the Fund, assuming:

(i) LuxCo is set up with minimum equity;

(ii) Insertion of a "full limited recourse" in the debt instrument so that LuxCo would not bear any risks on its financing activities;

Interest accruing under the debt instrument should be acceptable if fixed and variable interest correspond to the income realised by Lux SV less the fixed interest and the arm's length margin (i.e. cost-plus with a profit mark-up to be applied on the costs corresponding to 5-10% of LuxCo's overhead expenses).

Potential consequences
⇒ Lux SV is not treated as the beneficial owner of the interest derived from the debt portfolio
⇒ Re-characterisation of the debt into equity, however commitments should still be tax deductible

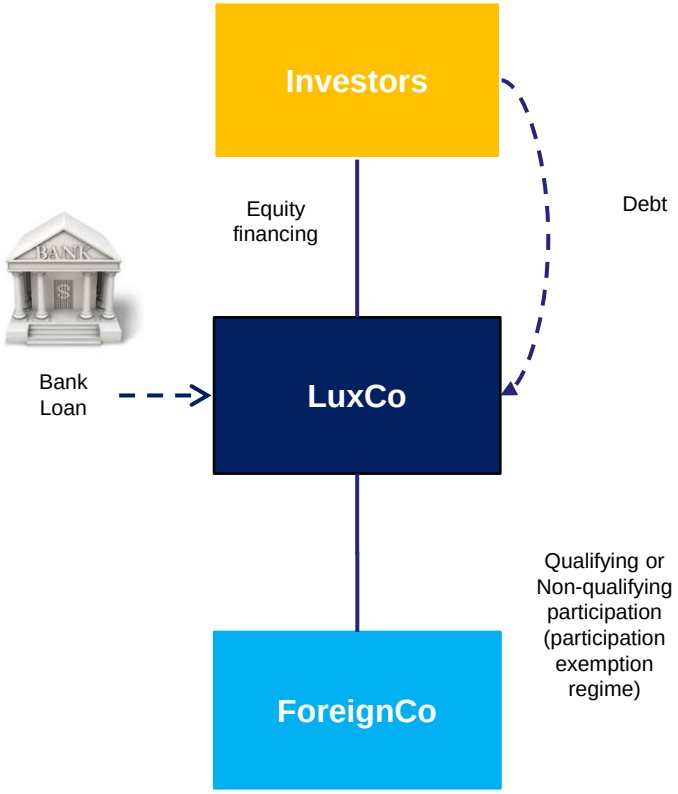
2. Possible approach:

TP analysis to be performed **as if transaction was in the scope of the TP circular**

To be considered

- Interest limitations rules
- Anti-hybrid mismatch rules (hybrid instruments)

Analysis
Investment in qualifying / non-qualifying participation(s)



Debt-to equity ratio

- **85:15 D/E ratio no longer** considered as a safe harbour
- Applicable D/E ratio to be determined through a **financial analysis**
- **Possible methods for a financial analysis** :
  1. Cost of Equity
  2. Use of Basel III ratios
  3. Discounted cash flow
  4. Minimum rate of return for investors

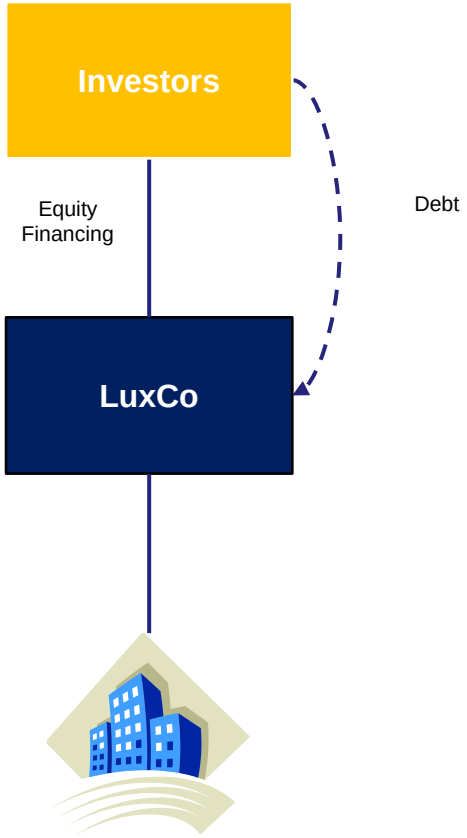
Transfer pricing (including OECD Chapter X) implications

- Transfer pricing analysis to be performed to determine the applicable at arm's length rate
- OECD Chapter X implications

To be considered

- Interest limitations rules
- Anti-hybrid mismatch rules (hybrid instruments)

Analysis
SPV holding foreign / Luxembourg real estate



Debt-to equity ratio

- **85:15 D/E ratio no longer** considered as a safe harbour
- Applicable D/E ratio to be determined through a **financial analysis** via real estate external and internal CUPs (e.g., *DeMontfort* study can be used).

Transfer pricing (including OECD Chapter X) implications

- Transfer pricing analysis to be performed to determine the applicable at arm's length rate.
- OECD Chapter X implications

To be considered

- Interest limitations rules
- Anti-hybrid mismatch rules (hybrid instruments)

Summary of considerations for taxpayers (1): Risk issues for related party loans

- Recharacterisation as equity where a loan agreement does not have sufficient loan-like features;
- Imputation of a smaller loan where the borrower does not have the financial capacity to service the loan, or would have commercial reasons not to borrow so much;
- Imputation of a different loan if the terms and conditions are not commercially optimal for the borrower;
- Imputation of a lower interest rate where the credit rating of the borrower is relatively high taking into account qualitative factors and implicit group support;
- Imputation of a higher interest spread for back-to-back loans where the borrower is exposed to more risk than stated because of the scope of its risk management functions

Summary of considerations for taxpayers (2): Risk issues for financial guarantees and cash pooling

- Financial guarantees:
  - No legal obligation to honour the lender's commitments
  - Guarantor unable to honour the lender's commitments
  - Guarantee not providing enough financial benefit to the borrower to merit the minimum guarantee fee required
  - Guarantee fee not reflecting the relative bargaining power of the two parties

- Cash pooling:
  - Leader not controlling and bearing enough liquidity and credit risk to merit an interest spread reward
  - Synergy benefits not shared via the interest rates which reflects the relative bargaining power of the participants
  - Participants not better off by being in the cash pool
  - Structural balances in the cash pool not treated as term loans
  - Cross-guarantee fees not paid where they should be

Summary of considerations for taxpayers (3): Risk issues for captive insurance and reinsurance

- Risks not existing or risks but no real possibility of loss for the captive
- Captive not able to diversify or pool enough risks
- Captive not having necessary resources: skills, experience and capital
- Policy holders not better off using the captive
- Premiums not set to cover captive's expected costs plus an arm's length return on its capital
- Profitability of captive higher than arm's length return (including its claims business and its investment income)
- Captive is over-capitalised
- Fronting captive earns more than a basic service fee, especially where a related party sales agent is used

Summary of considerations for taxpayers (4): Risk of inconsistency of related party financing policies

- Similar building blocks may be involved in pricing long and short term loans and deposits, and cash pool balances
- These may include an interbank rate, treasury's marginal cost of funds, commercial risk spread, liquidity charge, etc.
- They should be consistent for positive and negative balances, short and long term, and so on

Summary of considerations for taxpayers (5): Documentation recommendations

- New loan agreements should have arm's length features
- Research should be documented to confirm the feasible amount of debt
- The commercial rationality of the loan terms and conditions should be explained
- Interest rates should be consistent with the results of a quantitative and qualitative credit rating exercise and take into account an implicit group support analysis
- Guarantee fees should reflect the perspective of both parties and their relative bargaining power
- Cash pool leaders must be shown to have important risk management responsibilities
- The synergy benefits of the cash pool participants should be allocated scientifically and this should be expressed through the interest rates
- Captive insurance companies must be shown to have the ability to pool uncorrelated risks for a large number of policy holders
- The in-house banking function of a treasury company must be documented carefully, and its responsibility for setting the group treasury policies

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