Treasury Operations and Transfer Pricing Working Group

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1 Introduction

We will attempt in this guide to answer a number of questions.

- What is transfer pricing?
- How do we set and test transfer prices?
- How do we support the prices when the tax audit arrives?

So what exactly do we mean by the term "transfer pricing"? In summary it is the terms, conditions and price placed on a cross-border transaction between two related entities. From an international tax perspective group transactions should be conducted on an "arms length" basis, a term we will explain in greater depth later in this article.

Why is transfer pricing relevant to the corporate treasurer? The answer is that the corporate treasure is involved on a regular basis with transfer pricing issues. All operations performed daily, or regularly by Corporate Treasurers such as funding, services, guarantee fees, risk management, debt factoring, asset management, cash management, leasing can trigger transfer pricing issues if they cross country borders.

These are often for relatively high values making these intra group transactions very visible to the outside world i.e: the tax authorities.

Globalization of financial markets, their worldwide integration, the development of dematerialized banking services, and management trends such as break-up of the value chain, centralisation of support services, have made international cash pooling, and centralised payments factories, in particular and intra group cross border treasury operations like funding, hedging, guarantee fees between associated enterprises an every day practice among the Corporate Treasurers world.

By providing services and/or funds intra-group a group centralised treasury generates transfer prices which affects the group taxable income and individual countries tax bases. Tax authorities around the world are increasingly aware that transfer pricing of transactions between connected parties can affect their tax yield. In 1999, only 6 countries had transfer pricing regulations, in 2008 more than 50 have now implemented regulations that could impact the Group Treasury operations.

Getting transfer pricing wrong can trigger a tax audits of the Treasury operations. These audits can create legal uncertainty for businesses and can generate tax assessments impacting both the way the company's cash flow the P&L and the balance sheet. Such audits are often long and difficult and they could be expensive. As audits always come after the fact, it is difficult to produce enough information to justify an enterprise's transfer pricing practices.

Despite the evolution of the Corporate Treasurer role over the past 15 years from mere cash management to group funding policies. Corporate Treasurers are very often not fully aware of the transfer pricing issues and the compulsory documentation to support the pricing policy. But the Corporate Treasurer is in the perfect position to set the group transfer pricing policy for Treasury operations and support the documentation of this group policy.

The French Association of Corporate Treasurers Local Chapter from North of France in Lille is the parent of this Book. The French Association of Corporate Treasurers National Chapter has voted to create the Commission to write this Book. The European Association of Corporate Treasurers has gathered all national Chapters, especially the UK and Belgian Associations and allowed the Book to have a true European approach. All these associations have come together to propose the first Guide on Treasury operations and Transfer Pricing for its members. Our objective is twofold:

1. Address the transfer pricing issues relating to Treasury operations in a practical manner and
2. Prepare our fellow Corporate Treasurer members for CFO position in international groups where transfer pricing is of growing importance.

This Guide makes reference, when necessary to the common "rules" which govern the Transfer pricing best practices within Europe: they provide comprehensive guidelines for multinational companies. These are the Transfer Pricing Guidelines for Tax Authorities and Multinationals published in 1995 by the OECD, as well as various other reports on transfer pricing issued by the OECD. We will also like to refer you to the Guide à l'usage des PME on Les Prix de Transfert published by the French Tax Authorities in November 2006. This is a short and practical summary of the best practices in a readable and accessible format but only available in French at the moment.

2 Basic Principles

What is the Risk Exposure run by operations managed by the Corporate Treasurer? Where does the corporate Treasurer find guidance on the basic principles used in setting his transfer pricing policies?

Transfer pricing risks for the corporate treasurer

What are the transfer pricing risks a treasurer faces? One risk is where a treasurer lends from a parent company to a subsidiary on a non-arms length basis i.e. at an excess rate of interest rate or the amount of the loan is excessive. There are two examples below which illustrate this issue.

Example 1
A parent lending from country A to a subsidiary in country B at say 6% pa. The tax authority in country B determines that this rate of interest is too high and deny the subsidiary a tax deduction for any amounts paid over 5%. In country A the taxman will welcome the additional income and be only too pleased to tax it as profit. The group overall has end up paying two tax on that extra 1% interest with no corresponding tax deduction.

Example 2
The same loan is made but in Country B the authorities say that the loan to the subsidiary is not something that any commercial bank would make but is really quasi equity and they deny any tax relief on the 6% paid. The result tax on the full 6% with no corresponding adjustment.

So what guidance is available to the corporate treasurer to help in setting treasury transfer pricing policies and minimise transfer pricing risks?

Guidance issued by the OECD

Outside of local country legislation the main sources of reference for transfer pricing have been produced by the Organisation for Economic Co-operation and Development (OECD), based in Paris. It is a forum for member countries (19/27 EU countries are members of the OECD) to discuss and compare policy approaches to a wide range of issues, including international taxation and transfer pricing. It is a forum where peer pressure can act as a powerful incentive to improve policy and implement non-binding instruments (soft laws) that can occasionally lead to binding treaties or introduction of changes into local legislation. Recent EU works on transfer pricing as well as national rules and regulations follow the OECD views on the subject.

[The corporate treasurer should be aware that although the USA follows the OECD arms length principles, it has its own set of very detailed transfer pricing rules which are not covered in this report].

In the course of its work, the OECD has developed a number of key international standards, including:

- the Model Tax Convention on Income and on Capital (last update on May 2005) is a model tax treaty, devised by OECD members to form a basis for double taxation agreements between member countries;
- the Transfer Pricing Guidelines (from 1979 and last updated in 1995) for Multinational Enterprises and Tax Administrations are a set of recommendations to assist in dealing with transfer pricing issues, either from the point of view of a company trying to devise or improve its own transfer pricing policy or for a tax administration;
- it has also issued a number of authoritive documents on transfer pricing. These include Attribution of profits to permanent establishments and guidance on comparability.

Below we discuss the two key basic transfer pricing principles that the corporate treasurer should be aware of.

Arms length principle

The OECD in its Transfer pricing guidelines has adopted the "Arms length". The alternate approach of global apportionment was rejected. This principle is enshrined in chapter 1 of the guidelines and the model taxation convention in article 9. In summary the arms length principle means that group companies when dealing with each other should transact as if they are third parties. Where transactions are not at arms length it is open to tax authorities to adjust the taxable profits of the companies.

Special relationship and withholding tax on interest.

The key article in the OECD Model tax convention of relevance to the corporate treasurer is article 11. Article 11 primarily determines the rate of withholding tax on interest and is incorporated in local treaties.

It also dis-applies the benefit of a reduced (or zero) rate of withholding tax on interest where there is a special relationship between payer and recipient if the amount exceeds the amount that would have been paid if the parties were not in a special relationship. (Similar special relationship provisions apply in the EU parent-subsidiary directive which is an alternative method of obtaining a zero rate of withholding taxes).

Nothing is said about other factors such as the reasonableness of the debt itself and in practice those words allow only a consideration of whether the interest is at market rate. However, most double taxation agreements have modified wording, which allow other features of the loan arrangement other than simply the interest rate to be taken into account. This effectively enables the tax authority the benefits of the treaty when there is a loan to a thinly capitalised subsidiary. The tax authority can consider:

- the question whether the loan would have been made at all in the absence of the relationship;
- the amount which the loan would have been in the absence of the relationship; and
- the rate of interest and other terms which would have been agreed in the absence of the relationship.

In addition to denying the benefit of the treaty for the recipient of the interest, a lack of economic substance, may also mean the borrower has a reclassification of an inter-company loan into capital. This would remove the positive impact of interest deduction on the taxable income of the operating company.

Thin Capitalisation

Thin capitalisation tends to be driven by local tax rules interacting with the international taxation treaties and there is little guidance in the OECD guidelines. Nevertheless it is a very important topic for corporate treasurers looking to capitalise subsidiaries and in some jurisdictions where there is no “safe harbour” legislation it is very much a transfer pricing issue.

Historically tax authorities looked at balance sheet ratios such as debt to equity but as more and more fully leveraged private equity deals have taken place there is more of a focus on interest coverage.

Local guidance

In addition to the guidance given by the OECD there are a number of information sources issued by local tax authorities.

The guide for PME’s in France
This guide was published in November 2006. The 53 pages booklet provides an accurate overview of the Transfer Pricing issues. Written in French by the APA team leaders and the former Head of Transfer Pricing Audit squad, it provides examples, theory and useful comment in a French easy to read language.

The UK manuals for tax inspectors.
The UK revenue authority publishes their internal transfer pricing guidance used by their own staff. This information is available on the internet and is very useful information resource.

We will invite members to provide local examples

Illustration of the application by Tax authorities of these basic principles: Case law on treasury operations:

For example this will include:

Guarantee fees provided free of charge by the guarantor to the recipient:

Carrefour provided guarantees, free of charge, to foreign subsidiaries: it was considered that there was a transfer of profit outside France in the terms of the article 57 of the General Tax Code. The fact that the guarantee increased the shareholder value of the Carrefour subsidiaries and increased the dividends from these subsidiaries did not convince the French Supreme Court. (CE 17 F2vrier 1992, n°81690-82782, Carrefour: RJF 4/92 n°433).

Lainière de Picardie provided a guarantee, free of charge, to its foreign subsidiary in Brazil: it was not considered as a transfer of Benefit outside France in the terms of the article 57 of the General Tax Code. Because this guarantee allowed local funding which supported the important development of sales from Lainière de Picardie to its subsidiary? The principle that a guarantee fee should be compensated has been satisfied by the fact that Brazilian rules exclude the possibility to compensate intra-group foreign guarantee fees that are compensated through other transactions. The amount of a guarantee fee not charged is insignificant when compared to the 100% increase of sales from France to Brazil. (CE 3 mars 1989, n°77581,7e et 9e s.-s., Lainière de Picardie : RJF 5/89 n°538)

Loans granted at conditions different than market conditions:

A French parent company granted an interest free of charge to its foreign subsidiary. It was not considered as a transfer of benefit outside France as the loss of revenue related to the loan was small compared to the benefit provided by the sales development of the foreign subsidiary which has materialised into significant foreign sales and significant related profits

Conclusion

These French law cases appear to indicate that in order to provide funding free of charge without creating a transfer pricing problem, a compensating operating income (not dividends) has to be generated (a form of transfer pricing set off) . This in itself is very difficult to do and suggest adopting an “arms length” approach is preferable to having to demonstrate a compensating operating income benefit. Again we emphasise that these are French tax cases and different jurisdictions may not follow this approach.

3 Documentation

What is documentation?

Documentation is often a misunderstood concept when discussing transfer pricing. To lawyers it means the legal document to economists it means the economic justification. In fact it can be both and indeed more than that. Although the main reference document for transfer pricing the OECD guidelines does not specifically detail what is required there is a format generally accepted (and expected in some cases) by tax authorities.

If one were to specify the components of good transfer pricing documentation, the list could look like the following:

- details of inter group transactions;
- company and group information (history, products, markets, legal entity chart, organization, strategy);
- industry analysis (market analysis, trends, threats, opportunities);
- a functional analysis covering the group transactions;
- details of the transfer pricing setting and testing policy and methods;
- economic support for the prices;
- financial analysis of the results of the group transactions;
- explanation of results in the context of industry and/or company analysis.

So what documentation a corporate treasurer will be responsible for? In a multinational group it is usual to have documentation covering all group transactions. This documentation should already have the industry and business analysis. Therefore the treasurer should have responsibility for the following:

- details of cross border group transactions;
- details of group treasuries role in transaction (including allocation of risk);
- legal documentation of group transactions;
- financial analysis of the group treasury operations relating to group transactions (in particular hedging);
- choice of price testing and setting methods;
- economic support e.g. a bench marking study.

(Please note: In this article all later references to documentation refers to the bullet points above)

Why do we have documentation?

In many countries there is an obligation backed up by a penalty regime to have documentation in place.

Even if there is no penalty regime not having sufficient documentation has the following disadvantages:

- non-compliance with documentation requirements can mean that the burden of proof shifts to the taxpayer;
- transfer pricing penalties can be avoided by preparing transfer pricing documentation, in particular if the documentation shows that the taxpayer acted

in good faith about its compliance with the “arm’s length principle” when determining prices in inter-company transactions;

- if there is no documentation a tax authority can raise tax assessments based on their best judgement which then have to be defended. (Normally the authorities will request documentation that should already have been in place!)

Importance of contracting

Contractual terms affect the comparability of the transaction with third party transactions. This is especially the case with treasury transactions e.g. length of loan.
They can also define the functions and risks of the parties to the transaction.

Often during a tax audit the tax authorities will review contractual arrangements. The absence of contracts can mean that the auditors “dig” deeper into the transactions and raises the chances of receiving a tax assessment. There is one major practical issue with contracts. In practise the contract does not reflect what is actually happening in the transaction (sometimes because there has been a group reorganisation or because the contract is so complex no one can follow it). This then gives the opportunity to the tax authorities to re-characterize the transaction and raise a tax assessment.

Recent developments on documentation

The European commission has established a European forum to examine transfer pricing issues. In particular it has recently issued guidance on transfer pricing documentation which has the support of EU member tax authorities. This is an attempt to codify what tax authorities should expect from transfer pricing documentation. Although it clarifies a number of issues the basic definition of documentation requirements is between multinational groups the proposals for documentation are not materially different from the description contained above.

Should we document all transactions?

The OECD guidelines infer that only economically significant transactions need to be analysed and documented. Of course there is no definition of economically significant as it will vary from group to group. Nevertheless it is something that should be considered when looking at the administrative burden of transfer pricing documentation.

Business Benefits

Transfer pricing documentation and policies for treasury transactions can not only be used to defend and avoid tax audits it can also be integrated into the information required as part of the external audit process and can be used as part of the internal control policy.

Summary of Benefits to tax payers of documentation

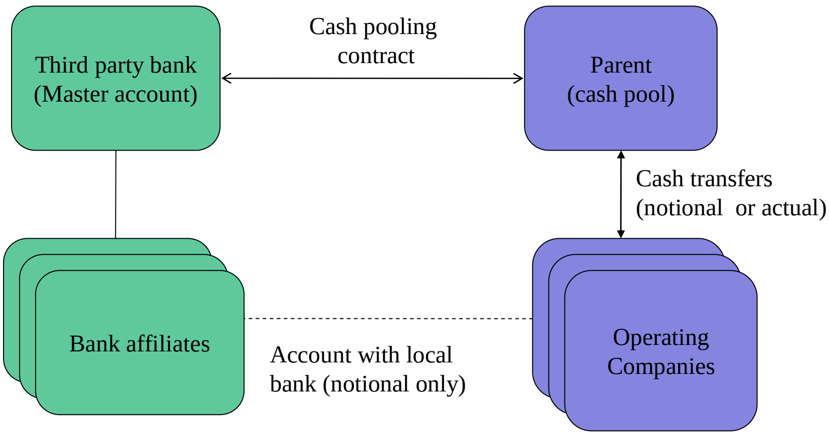
- The avoidance of penalties for not maintaining documentation and penalties on tax adjustments.
- The avoidance of the reversal of burden of proof from the Tax administration to the taxpayer.
- To structure the internal pricing process in a robust and defendable way.
- To create a communication tool that can be shared internally, with external auditors and with tax authorities.

4 Value chain of the treasury function and its link to transfer pricing

We will also ask for examples from the members

Below is a typical example of simple cash pooling structure between third party banks, a parent and his operating companies.

Based on what was presented earlier in the book, what are the transfer pricing issues at stake if any?



If all the transactions take place within the same jurisdiction it is unlikely that a transfer pricing audit will be triggered in practice.

Notional cash pool does not create intra-group transactions and therefore are irrelevant for transfer pricing purposes.

Actual cash pools create multiple intra-group transactions on a daily basis.

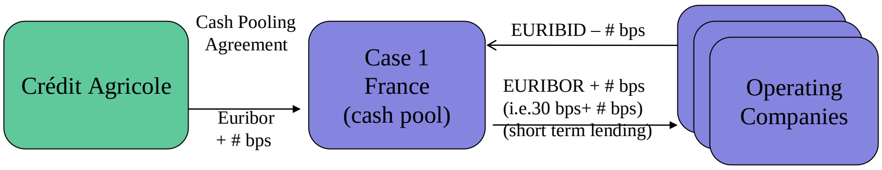
Below is a typical of simple cash pooling structure between third party banks, a group treasury based in France and group operating companies.

Based on what was presented earlier in the book:

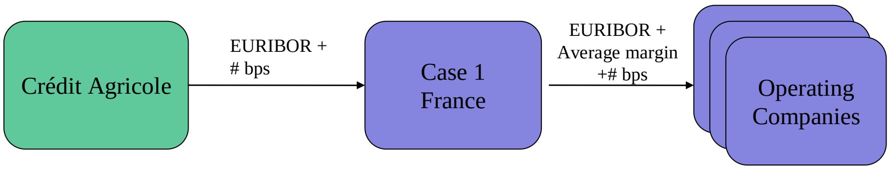
- Are the deposits compensated at an arm's length price?
- Are loans compensated at an arm's length price?

- Is the French cash pool holder a service entity or does it take forex[1], interest rates risks and therefore has created some features of profit centre[2]?
- What are the transactions made with third parties that can help the Corporate Treasurer to set the intra-group prices at arm's length conditions, if these transactions are comparable?

<u>Cash Pool</u>



<u>Long term financing</u>



The remuneration of the treasury entity in the example above is compensated via a number of basis points for short term and for long term borrowings. In this example the margins represent an arm's length remuneration for the functions, risks, assets of the Treasury entity. The method of setting the number of basis points is discussed further in Chapter VII (CHECK)

Below we have anonymised the value chain of real companies who published details their treasury organisation within our corporate publications. Although these were not originally intended to illustrate transfer pricing issues we have analysed on a high level theoretical basis some of the potential inter-company transactions and issues in order to demonstrate some of the thought process behind transfer pricing.

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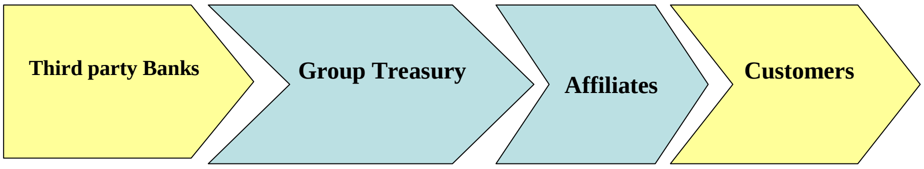
[1] Foreign exchange risk

[2] For reference to profiles such as cost centers or profit centers please refer to the responsibility centre approach page XXX.

The value chain of the Treasury department at Facilities Group giant



Roles	▪14 Commercial Banks ▪Provide financial instruments to manage a cash rich position ▪Provide financial hedging instruments via a group platform	▪Treasury and intragroup financing ▪Financial markets ▪Asset Management : 15billion euros in 2010. ▪85Full Time Equivalent ▪Centralised payments, receivings encaissement ▪Treasury variations 6billion euros	▪Limited information available	▪Main entities are in Europe ▪230 million prelevement ▪12 million transfers ▪30 million checks

Transfer Pricing analysis

Our initial thoughts were:

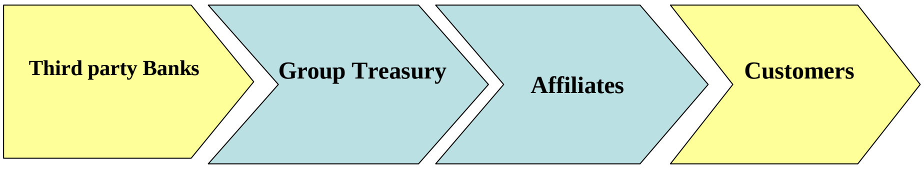
- there should be a lot of internal comparable prices available from the transactions with third party banks;
- there is a fully fledged Group Treasury entity with 85 full time equivalent delivering financial services to all group entities.

We then asked ourselves the following questions:

- Are the local entities benefiting from the services rendered?
- Is there any duplication of services with existing local treasuries?
- Is the Group entity properly compensated for what it provides?
- Are entities located in countries where documentation is compulsory, or highly recommended, or not an issue?
- Are there any penalties for absent or insufficient documentation?

The same questions could be asked for the example below which is of a treasury entity in a different industry sector and in different geographical area.

The value chain of the Treasury department at Industrial leader



	Third party Banks	Group Treasury	Affiliates	Customers
Roles	▪ABN AMRO elected a fixed project team understanding Group business needs. ▪Missing information	▪Mid 1990s : centralisation of financial operations. ▪Threes shared service centres ▪Group Treasury in the USA, Regional Treasury managers in Asia and Europe. ▪Cash pooling and the set up of an in-house bank allowed leverage and reduction of external funding.	▪Multilateral netting to reduce loss of value of external transactions. ▪Outsourced more routine and standardized functions to Treasury. ▪No more buffer cash position. ▪80% of cash is managed centrally ▪Standardisation makes post merger integration faster.	▪Deliver in 180 countries ▪Work in 80 ▪Sell to retail

Conclusion

A very high level analysis of the treasury operations reveal that potentially there are a number of prices that have to be set and documented.

5 Functional analysis of the business

What is a functional analysis?

In summary it is a description of the group value chain explaining the roles, risks and rewards of the group companies involved. In a treasury transaction this value chain may be fairly easy to determine the functionality. In a more complex treasury environment such as banking the value change and contributions of the respective companies in the chain can be less easy to determine.

A functional analysis concentrates on the economically significant transactions (as outlined above). It is recognised as key in determining the group transfer pricing policy as prices are driven by functions performed, assets used and risks assumed. i.e. analysis should try to determine where value is added in the business supply chain.

There is no prescribed format for this analysis. Practically a functional analysis usually consists of:

- a description each function, asset and risk and which part of the group is responsible for these;
- a summary table of the risks, assets and functions performed by legal entity.

The role of the functional analysis and choice of method

One of the main roles of the functional analysis is used to determine the pricing methodology. One way of doing this is to determine whether the functions performed are routine or non-routine. (or even a mix of these functions). This can be linked to use the management accounting concept of responsibility centres.

The most common types of responsibility centres[3] applicable to Group Treasury functions would be:

- Cost centres performing routine functions;
- Profit centres performing non routine, risk taking value added functions.

Potentially a treasury entity can act as an investment centre e.g. by investing in share capital of subsidiaries. In this case there may be transfer pricing issues if the acquisition is funded by a mix of debt and equity (i.e if the subsidiary is thinly capitalised.)

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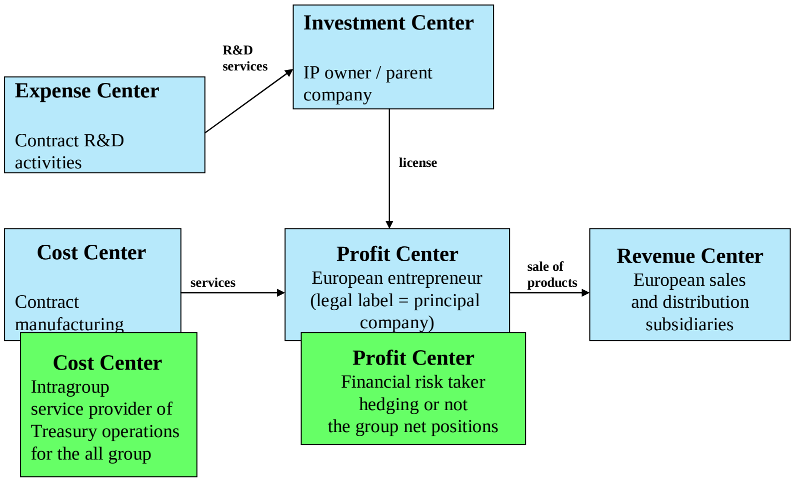
[3] For more on this approach on Responsibility Centre refer to Charles Lienard who contributed to this article.



Examples of choice of method:

Cost centre performing routine functions

A typical cost centre would perform operational activities. Transfer prices for this type of operation would usually be set either be using a comparable third party price or secondly by reference to cost. An example for then corporate treasurer would be where there is centralised cash management and the expenses of this are recharged to subsidiaries. Another example would be a flow-through entity with minimal risk with the function of loan administration. A pricing method for this type of entity would be cost plus (see XXX).

Profit centre performing non-routine functions

A typical profit centre would work with third parties and would take some risk in that market place. A corporate treasury example would be where a treasury operation provides a hedge facility to a subsidiary but does not fully hedge the position with a third party. The usual pricing method would be using a comparable third party price (see XXX).

For financial sector businesses a profit split analysis (see XXX) is frequently used as there is often more than one profit centre involved in the supply chain. This methodology is not discussed in details in the article.

Specific OECD guidance on functional analysis for treasury operations

The only guidance available from the OECD on Group's treasury functions is the OECD *Report on Attribution of Profits to Permanent Establishment*[4] in particular the sections relating to financial activities. This report is aimed at banks trading through permanent establishments. On the face of it this may not seem relevant but on closer analysis many of the functions performed in a banking operation are similar to group treasury functions. The report identifies the following main components of a financial transaction:

- Loan origination process;
- Loan management process;
- Risks incurred;
- Assets employed.

To illustrate how to complete this analysis an example is included below.

Cash pool Example

A group treasury company sets up and runs a cash pool. The pool members all sign cross indemnities and warranties therefore the risk of default is spread amongst the pool members.

In the functional analysis we would the involvement of the group treasury company in organising the pool following the headings used in the OECD Report.

Loan origination	Typically group treasury would be involved in originating the facility for the subsidiary and creating the relevant documentation
Loan management process	The group treasury might carry out the following functions: • external *loan support*, being day to day management of the cash pool borrowings • *monitoring and managing* risks. The principal risk related to managing the cash pool funding can be foreign exchange risk (discussed below). The role of group treasury is often to accumulate gross exposures, identify 'natural hedges' (i.e. internal set-offs) and manage the residual risk through hedging;

[4] *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration*, Chapter 1, OECD, 1995 and regularly updated; *Report on the Attribution of Profits to Permanent Establishment*, Part II: Special considerations for applying the working hypothesis to permanent establishments of December 2006.

	• day to day *treasury* functions in respect of the administration of the cash pool.
Risks incurred and assets employed	There is some foreign exchange risk which is borne by the group Treasury entity. The intercompany transactions expose the assets of the treasury entity to risk.

The results contained in the table above are then used to firstly determine the pricing method and then used to determine the level of compensation based on the relative contribution of the group treasury entity.

OECD pricing methodologies

Having carried out the functional analysis we have to link the results of the functional analysis to a pricing methodology.

The OECD guidelines describe the various transfer pricing methods. These methods are split into two types:

- The traditional transaction methods: the Comparable Uncontrolled Price (CUP) method; the re-sale price (or resale minus) method and the cost-plus method.
- The transactional profit methods: the profit-split method and the transactional net margin method, which are also considered to satisfy the arm’s length principle.

5.1 The Comparable Uncontrolled Price (CUP) method

The Comparable Uncontrolled Price (CUP) method[5] prices a transaction by reference to either third party external prices (third party comparables) e.g. Inter bank lending rates or by reference to prices between the group and third parties (internal comparables) e.g. internal cost of credit.

The word comparable must be emphasised. The OECD guidelines outline five key comparability factors

- Characteristics of the goods or services[6];
- Functions performed, assets used and risks assumed[7];
- Contractual clauses[8];
- Economic circumstances[9];
- Company strategy[10].

[5] OECD Report, Paragraphs 2.6-2.13 and 6.28, 1995.
[6] OECD Transfer pricing guidelines para 1.19
[7] OECD Transfer pricing guidelines paras 1.20 and 1.27
[8] OECD Transfer pricing guidelines para 1.28
[9] OECD Transfer pricing guidelines para 1.30

In general, for the corporate treasurer all these are relevant. For example when setting a loan rate the treasury group will look at which party is taking the market risk. It will also look at the terms of the loan as the duration can affect the rate. It might also look at the location of the subsidiary (economic circumstances). In terms of company strategy the group gearing ratios may be relevant in setting rates.

5.2 The resale price method

This method is not usually relevant to treasury operations and is not discussed here.

5.3 Cost plus method

The cost plus method starts by computing the cost of providing the goods or services and adds an appropriate mark up. The cost plus method is often used where a group treasury functions performs routine functions.

5.4 The profit split method

This method is often used where there is a third party transaction generating a "group profit" that has been generated by routine functions and value added functions. Property performed by a number of group companies.

A profit split method works firstly allocates a reward for routine functions. This is usually calculated on a cost plus basis. The residual is split by reference to the respective contributions of the parties. This method is typically used in banking transactions where the loan originator is in a separate entity from the provider of capital and administration takes place in a third entity.

5.5 The Transactional Net Margin Method (TNMM)

A transactional net margin method is used to justify a level of net operating profit. It examines the net margin achieved on a particular transaction or group of similar transactions relative to a base such as turnover, costs or capital employed. This is compared with the result achieved by independent entities on a similar transaction or transactions. The method can only be used when either the CUP, the resale price or the cost plus cannot be used

5.6 Other OECD Method

The OECD guidelines permit the use of other method where none of the prescribed method apply.

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[10] OECD Transfer pricing guidelines paras 1.31 to 1.35

6 Practical pricing

6.1 Introduction

In this section we will look at the methods available for pricing inter company loans and guarantee fees. We are focusing on subsidiaries that have borrowing needs rather than those with cash balances (although of course transfer pricing applies equally to upstream loans). One of the key factors to also consider here are the local thin capitalisation rules which can determine the maximum level of indebtedness.

To assist in the pricing there are a number of commercial databases available. For determining the margin to be used in a cost plus methodology the Amadeus database (produced by Bureau van Dijk), is frequently used. This is an European financial database containing information on public and private companies filing accounts in Europe. There are a number of other similar databases for other regions e.g. Lexis Nexus for the USA.

For pricing the rates on loans the databases include *Webdeal scan*, which contains historic deal terms and conditions on loans, high yield bonds and private placements, Bloombergs and Reuters bond data. In addition various Central Bank studies can provide a useful local approach for certain type of transaction.

6.2 Setting interest rates

As mentioned above determining the risk of the treasury entity enables us to determine the price setting mechanism. For treasury entities purely providing services (a cost centre) such as loan administration the most appropriate method is a cost plus remuneration. For treasury entities taking risk (a profit centre) a comparable price method would be used. The issue with the risk taking approach is that most of the risk is measured by reference to controlled transactions (a transaction between two connected parties), the subsidiaries balance sheet and interest coverage. It is often the treasury entity that determines the risk level in the subsidiary and therefore the setting of the rates can appear circular.

Nevertheless we will work through the various approaches as both have merit and shortcomings.

A. One step approach: Cost plus

Where the loan is "flowing" through an entity then a one step approach could be used i.e. a cost plus method, taking the cost of the underlying loan then adding a margin for the functions performed by the flow through entity

The easiest example of this approach is used where there is an identifiable source of funding that is flowed through to the entity. The assets of the entity secure the funding. Therefore there is no recourse to the treasury entity. In this case the rate would be set by reference to the cost (both margin and underlying rate) with an additional margin to reward the entity for its costs in administrating and arranging the loan. The margin would be set by reference to third party data on loan arrangement fees measured against the functionality of the treasury entity.

B. Two step approach

The two step approach starts by determining the underlying rate and secondly the margin to be applied.

Step 1 Setting the Underlying rate: Comparable price
Where there is no direct relationship between sources of funding or where there is some element of interest rate market risk the underlying rate is usually set by reference to a third party comparable prices using publicly available indices. For short term rates this tends to be Libor or Euribor. For longer term rates the swap market gives prices that are do not include any significant the risk margin above inter bank lending rates.

Margin
All these methodologies assume that the treasury entity has access to funds at the group holding company margin.

The methodologies we have identified area as follows:

- Comparable price using the group credit rating;
- Cost plus;
- Cost plus adjusted for risk.

Comparable price method –using Credit rating approach

This methodology starts by evaluating the credit risk of the borrowing entities on a stand alone basis i.e. all operating company belonging to a group would be scored based on rating agency criteria. Therefore each operating company would pay a margin on its loans appropriate to its credit standing. An overriding assumption in credit rating is that subsidiary can not have a superior credit rating than the rating allocated to the group holding company. (Please note that this appears contradictory to the "arms length" guidance given by the OECD in that the parties should be treated as third parties nevertheless we believe this principle has to apply.) The margin is calculated by using party data. There are a number of third party data providers e.g. Loan maker, Reuters bond data that give indicative spreads matched to credit ratings.

Of course there a number of other factors other than financial ratios affect a credit rating in particular the degree of subordination, and the term of the loan that need to be built into the credit rating.

It has been suggested that an alternative is to ask external bankers to provide indicative quotes. However many tax authorities do not accept these quotes as providing comparable prices as a letter of intent is not a binding contract.

There is the issue that the margin used for the inter-company loan or credit line should be comparable with the rate the subsidiary could borrow in its local market. However often local banks because they provide other services disregard the overriding rule of credit rating that a subsidiary's credit rating can not exceed that of its parent (i.e. there is a cross subsidy.) Therefore we believe in many cases this can not be treated as a comparable price.

The key transfer pricing weakness as discussed above is that the credit ratings is based on a controlled balance sheet i.e the parent (treasury entity) has the ability to determine the strength of the local balance sheet. The parent can also determine many of the features of the loan e.g. the term and the degree of subordination

Cost plus method

We have discussed above flowing through the cost of external funding. Where there is no identifiable flow through the method will use the groups weighted margin on debt to set the funding rate for subsidiaries. If the group has short term funding and long term funding it is appropriate to use two weighted averages. A margin is added to the underlying rate to recompense the treasury entity for arranging the loan. This additional margin can be calculated by reference to external data bases and by reference to the treasury entities functionality.

Risk weighted cost plus method

The weakness of the cost plus approach is that potentially it is not compliant with the OECD guidelines as it not an arms length transaction. This is because it does not reflect the risks incurred by the parties to the transaction i.e. If the subsidiary margin was evaluated on its own its risk margin this would be different form the group margin. The reason for the lower margin is a implicit guarantee from the parent,

In the defence of this method the subsidiary companies balance sheet and interest cover are controlled transactions, therefore the implicit rating is the same as the rating of the group. There are however risks that are not controlled by the parent i.e the country risk and project risk. Therefore a potential solution is to adjust the margin for these identifiable third party risks.

“Work back” approach using comparable data

A pragmatic approach adopted by some tax authorities when determining the maximum amount of tax deductible interest deductible is to use a “work backwards” approach. This approach is tied in to local thin capitalisation rules.

The earnings before tax and interest (EBIT) of the subsidiary are forecasted over a reasonable funding period . Using comparable public data a ratio of interest to profit is used to calculate the maximum interest payable. The term of the loan is set based on profit forecast. The group interest rate plus a small margin is used to calculate back to the principal of the loan.

This methodology has its merits in that it determines a maximum amount of interest that a third party would pay if it had a comparable profits flow.

6.3 *Guarantee fees*

In this section we look at the pricing of guarantees. We are restricting ourselves to guarantees issued by a treasury entity supporting a third party borrowing and ensuring the loan credit rating is set at the same rate as the provider of the guarantee. The OECD guidelines identify guarantee fees as a service a subsidiary receives and would expect to recompense the provider. The OECD gives no guidelines on whom to set prices.

It appears there are three potential methods. Calculate the cost of providing the guarantee and add a margin (cost plus methodology), calculate the benefit to the subsidiary (a form of cost plus), locate a comparable price.

Cost of providing the guarantee

For a company that is not a financial institution there is no immediate direct balance sheet cost of providing the guarantee. Potentially from an entity accounts perspective IAS 37 (Accounting for provisions and liabilities) could apply and the potential cost of meeting the guarantee may have to be recognised. To recognise the provision three criteria have to be met:

- there must be a present obligation as a result of a past event;
- a reliable estimate can be made;
- there will be a probable outflow of a resource.

Unless it is likely the guarantee will be called no accounting provision will be required. Therefore another way of approaching this is to look at how financial institutions price guarantees.

How do banks price guarantee fees[11]?

We have analysed how banks account for these type of instruments.

As many of you are aware Banks have to maintain solvency ratios (following recommended practises and regulations). Recognition of an asset on its balance sheet has an impact on the banks ability to lend and has a measurable cost. On February 17th of 2006, the International Affairs department of the French Banking Commission published the guidelines on the calculation of the international solvency ratios. Pages 26 to 30 provide some practical guidance on how to evaluate the off balance risks such as guarantee fees. This guidance reflects the treated outlined in International Convergence of Capital Measurement and Capital Standards issued by the Basel committee on banking supervision (Basel II). This is a step by step methodology that approximates an arm's length calculation performed by a bank when granting a guarantee to a third party.

The first step converts the off balance item into a credit risk equivalent. The second step is designed to reflect the risk, which is the probability of transfer of these items from off balance into the balance sheet. This is evaluated based on the status of the counterparty.

[11] http://www.banque-france.fr/fr/supervi/telechar/supervi_banc/cooke.pdf
http://www.bis.org/publ/bcbs128.pdf

During the first step the conversion of the instrument into a credit risk equivalent is based on the type of off balance instrument:

- for "financial standby letter of credit[12]" 100% of the amount is converted to an equivalent credit risk;
- for "performance standby letter of credit[13]", or "note issuance Facilities", 50% of the amount is converted to an equivalent credit risk;
- for some guarantee fees such as "administrative guarantees", 20% of the amount is converted to an equivalent credit risk;
- for revocable facilities or can be cancelled due to a deterioration of the borrowers credit standing nothing is converted to an equivalent credit risk.

So how useful is this evaluation? It shows us that banks have to account for certain guarantees as credit equivalents i.e. take them onto their balance sheet with an inherent cost of doing this. It does not however lead us directly to a pricing methodology.

If the calculation assumes the treasury entity is acting as a third party bank. In transfer pricing terms it would be classified as a comparable price. From the guidance it appears that a revocable guarantee for under a year has no balance sheet cost and that an irrevocable guarantee over a year has a 20 to 100% credit equivalent cost to a bank dependant on its exact nature. Therefore the bank will price the guarantee in the same way as a loan i.e. basis points added as an arrangement fee and a spread calculated by reference to the credit risk.

To calculate the credit risk the credit rating methodology can be used to evaluate the lost margin.

Again the shortcomings of this method are those inherent in all credit rating methodologies in that the balance sheet of the subsidiary is a controlled transaction.

Calculation of Benefit to subsidiary

A guarantee can be priced by calculating the saving to the subsidiary borrower benefiting from a guarantee granted by the treasury entity. In transfer pricing terms this would be a comparable price method.

This would be done by evaluating the credit rating of the subsidiary without the guarantee using third party data such as Reuters and setting the margin. The calculated

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[12] Standby L/C is similar in nature to a bank guarantee. It may be used as necessary to cover non-payment of a financial obligation. A Standby L/C is normally only intended to be drawn on in the event of non-payment of an underlying transaction. The Standby L/C is issued by a bank and held by the seller, who in turn provides the buyer credit terms. If payment is made according to the seller's terms, the L/C is never drawn on. However, if the buyer is unable to pay, the seller presents a draft, and all other documents as required under the Standby L/C, to the issuing bank for payment.

[13] A Commercial or Performance Standby Letter of Credit is an irrevocable commitment [undertaking] on the part of a bank to guarantee performance in an underlying contract between a Buyer and Seller or a service provider.This type of Standby can be used to insure many types of transactions from international trade to buying or selling a house or other major purchase.
The Standby stands as a guarantee that the parties to an underlying contract will perform as agreed. Used in this matter, the Standby serves as a performance bond and may be called a Performance Standby Letter of Credit.

margin would then be compared to the guaranteed margin paid. The interest saving would be the value of the guarantee.

The shortcomings of this method are those inherent in all credit rating methodologies in that the balance sheet of the subsidiary is a controlled transaction.

Conclusion

The potential transfer pricing issues with both methods is that we are using the credit rating of a subsidiary whose balance sheet is controlled by the parent.

An alternative approach would be to examine the non-controlled risks (those not set by a connected party) e.g. country risk and project risk and calculate the guarantee fee based on these risks. In addition an arrangement fee would be added.

There is also a thin capitalisation issue that some tax authorities examine when dealing with guarantee fees. It is argued that a guarantee means that a subsidiary obtains a larger loan from a third party than a company operating on a stand alone basis. Therefore part of the interest on the loan will be disallowed as excessive.

6.4 Services

If a treasury centre is providing services to group companies it should be recompensed for the provision of those services. The recognised OECD approach is to firstly see whether there is a comparable price either available to the company (an internal comparable) or available in the public domain (external comparable) third party price available for these services. If no CUP is available then the recommended method is to use a cost plus methodology.

When calculating costs these should not include any stewardship expenses (e.g. costs relating to acquisition of subsidiaries). A mark-up is then applied to these costs. The mark-up is obtained either from third party comparables or by use of publicly available databases (as discussed above).

If loan are provided by the treasury company it is usual to convert the cost plus into basis points if possible (as discussed above).

7 APA’s and Penalties & Solutions

Having put together our pricing models is there anything we can do to strength our position vis-à-vis the tax authorities? What can we do if things go wrong and the tax authorities adjust the pricing and raise a tax assessment?

Advance Pricing agreement (APA)

The alternative to waiting for a tax audit is to obtain an advanced pricing agreement (referred to as an APA).

These can be agreed on a unilateral (involving one tax jurisdiction or on a bi-lateral basis(agreement is reached with more than one tax authority). The unilateral agreement obviously only secures the tax position in one jurisdiction. This is particularly useful if the other party to the transaction is a tax haven.

Bi-lateral agreements are more complex as they have to be agreed between two potentially competing tax authorities.

The OECD Guidelines outlines the APA procedure in Chapter 4 and details what is expected from the taxpayer requesting the APA.

The taxpayer has to approach the tax authority in the jurisdiction where he is located relating to the transaction in question. The authorities - if they agree to take the case - will then contact and negotiate with the other tax authorities.

The advantages of an APA are that the taxpayer can obtain certainty in his transfer pricing for usually 5 years with a potential roll-back to earlier years. The disadvantage is that the taxpayer has to open his books to the tax authorities.

Remedies

What are available remedies are available to the Treasurer and the Tax Director after a tax audit has taken place and the local tax authority has made a transfer pricing adjustment to taxable income? There are two possible procedures available.

Competent authority procedure (Article 25 of the model Tax convention)

Article 25 of the OECD model taxation convention covers the mutual agreement procedures and is a mechanism for resolving transfer pricing issues. This mechanism is known as “competent authority”. This remedy will be available where a tax treaty exists and this article is in that treaty.

The procedure is that the tax payer submits his case to the tax authorities. The two tax authorities are then required to resolve the double taxation issues. The problem of the competent authority is that there is no time limit for reaching agreement.

EU arbitration convention

A preferable alternative to using the competent authority procedure is to use the EU arbitration convention governed by the code of conduct issued in 2006. This can only be used where both parties are resident in the EU. Under this procedure the tax authorities are targeted to agree on double taxation issues within a two year time frame.

The main features are:

- a three year deadline for companies to present their case;
- there is two-year period during which Member States' tax administrations must attempt to reach an agreement to eliminate the double taxation;
- detailed administration procedures;
- arbitration procedures if the member states can not agree;
- suspension of tax collection during the resolution procedures.

8 Thin Capitalization

There are several approaches that tax authorities take when dealing with thin capitalisation. One is a transfer pricing methodology analysing the transaction using arms length principles i.e. what is the maximum loan that a subsidiary could borrow from a third party and at what rate of interest could that company borrow. The maximum amount would not be by reference to the balance sheet of the subsidiary itself but by reference to market data.

A second approach would by applying maximum debt/equity or interest cover ratios set in legislation (called safe harbours.)

We will invite members to provide local examples