January 2015

Transfer Pricing Methodology for Intra-Group Lending &Treasury Transactions

Strengthening your treasury organisation

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The increased focus on Base Erosion and Profit Shifting (BEPS) in the multi-national environment will have many corporate treasurers re-considering their pricing methodology on intra-group lending and treasury transactions. Pricing on intra group lending, FX, credit support, guarantees and options are all likely to once again come under the spotlight during 2015. Ensuring a robust, well documented and transparent transfer pricing methodology is in place will reduce your risk exposure on these transactions and ensure that you are fully compliant with transfer pricing guidelines.

We set out below the background to the concept of transfer pricing and suitable methodologies for applying intra-group transfer pricing practices that are compliant with OECD guidelines.

Transfer Pricing Guidelines

Transfer pricing rules are governed by the 'OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (22nd July 2010)'. The authoritative statement of the arm's length principle is found in paragraph 1 of Article 9 of the OECD Model Tax Convention:

- *"[Where] conditions are made or imposed between the two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.*
- *By seeking to adjust profits by reference to the conditions which would have obtained between independent enterprises in comparable transactions and comparable circumstances (i.e. in "comparable uncontrolled transactions"), the arm's length principle follows the approach of treating the members of an MNE (multi-national entity) group as operating as separate entities rather than as inseparable parts of a single unified business."*

OECD

This means that the **arm's length principle should apply** to transfer pricing structures.

Guidance for Applying Arm's Length Principle

A "Comparability Analysis" is a comparison of the conditions in a controlled transaction with the conditions in transactions between independent enterprises. The economically relevant characteristics of the situations being compared must be sufficiently comparable.

All methods that apply the arm's length principle can be tied to the following "comparability factors" (1.35):

1. characteristics of the property or services transferred – [an external loan]
2. the functions performed by the parties – [lending]
3. the contractual terms – [risk and benefits (reward/price)]
4. the economic circumstances of the parties – [different markets (e.g. geographic location)]
5. the business strategies pursued by the parties.

Transfer Pricing Methods

Traditional transaction methods are:

# = OECD Guide refs	Comparable uncontrolled price method (CUP)	Cost plus method	Profit split method
General	*2.13 Compares the price in a controlled transaction to the price in a comparable uncontrolled transaction in comparable circumstances*	*2.39 begins with the costs incurred in a controlled transaction. An appropriate cost plus mark up is then added to this cost, to make an appropriate profit in light of the functions performed and the market conditions regarded as an arm's length price of the original controlled transaction.*	*2.108 identifies the profits to be split for the associated enterprises from the controlled transactions in which the associated enterprises are engaged. It then splits those combined profits on an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm's length*
Preference	*2.14 Where it is possible to locate comparable uncontrolled transactions, the CUP method is the most direct and reliable way to apply the arm's length principle. Consequently, in*	*2.40 The cost plus mark up of the supplier in the controlled transaction should ideally be established by reference to the cost plus mark up that the same supplier earns in comparable uncontrolled transactions*	*2.109 not be used in cases where one party performs only simple functions and does not make any significant unique contribution, as in such cases a transactional profit split method typically would not be*

# = OECD Guide refs	**Comparable uncontrolled price method (CUP)**	**Cost plus method**	**Profit split method**
	such cases the CUP method is preferable over all other methods.		*appropriate in view of the functional analysis of that party.*
Intra-group lending	*Financial transactions have a high level of comparability*	*Difficult to distinguish between different credit quality of subsidiaries*	

Resale price method and transactional net margin methods are generally not applied to financial transactions.

The preferred method for intra-group treasury transactions is the **CUP method.**

Whilst the OECD guidelines state that the CUP method is the preferable method there may be instances where comparable transactions are not possible to identify. These instances should be rare as in most cases it will be possible to identify or derive a comparable transactions price by using proxy credit measures and applying shadow rating methodologies. However, if a comparable transactions cannot be identified corporates often default to a cost plus approach. This still requires a credit adjustment to reflect the credit variation between the combined corporate entity and the relevant company subsidiary. This credit adjustment needs to be based on objective criteria.

CUP Methodology

The location of external comparables and sources of information is based on the following criteria (# = OECD guide references):

- 3.30 A common source of information is commercial databases
- 3.35 Non-domestic comparables should not be automatically rejected just because they are not domestic
- 3.43 Both quantitative and qualitative criteria are used to include or reject potential comparables
- 3.50 Comparability adjustments should be considered if (and only if) they are expected to increase the reliability of the results
- 3.55 because transfer pricing is not an exact science, there will also be many occasions when the application of the most appropriate method or methods produces a range of figures all of which are relatively equally reliable
- 3.60 If the relevant condition of the controlled transaction (*e.g.* price or margin) is within the arm's length range, no adjustment should be made
- 3.68 Transactions undertaken or carried out during the same period of time as the controlled transaction ("contemporaneous uncontrolled transactions") are expected to be the most reliable information to use
- 3.75 Multiple year data should be used where they add value to the transfer pricing analysis.

Corporate bond yields have good comparability features.

Yields on comparable corporate bonds can form a strong basis for credit based inter-company treasury transactions. However identifying comparable corporate bonds from the universe of bonds traded, particularly for a non-credit rated entity, requires the application and implementation of complex modelling solutions. Even in the case where the corporate entity does hold a credit rating it will still be necessary to derive a form of shadow rating on each group subsidiary in order to identify comparable bonds. In addition to credit standing industry, currency and tenor must be factored in to the calculation. Therefore developing the transfer pricing model requires both internal financial analysis and significant external data mining from the bond markets.

For non-interest based treasury transactions such as FX or commodity contracts comparable CDS curves can be observed and used to derive default probabilities over the maturity horizon of the transaction. These can then be applied to risk free pricing metrics to derive a reflective transfer pricing adjusted transaction.

Comparable Uncontrolled Transaction

As comparable corporate bonds can form a strong basis for credit based inter-company treasury transactions, the features of bond yield information required include:

- Typically USD and EUR bond yields
- Sourced from fixed income securities from different industry sectors
- Significant number of bond observations available
    - All maturities
    - All credit ratings
    - Exclusions - Convertible, callable bonds
- Available:
    - Yield to Maturities (YTM) using current rates
    - ‘Z’ spreads being the spread over the risk free rate. Risk free rate is the (zero coupon) sovereign bond yield.

Use the overnight index swap curve (OIS) as the risk free rate.

Results can be refined as follows:

- The **median** is the numerical value separating the higher half of a data sample from the lower half. The median gives a better representation of central tendency than average and reduces the potential impact of skewness.

- Refine non aligned rates through linear interpolation or straight averaging.

Shadow Credit Rating Scoring

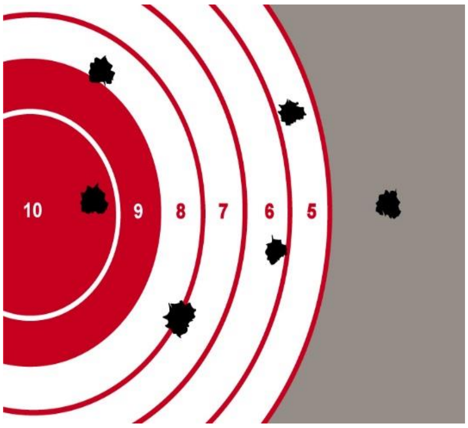
When deploying any transfer pricing methodology, it is necessary to apply a credit rating score to each individual subsidiary so that a comparable price can be assigned, the main elements of which are:

Rating Methodology

1. Apply a credit rating methodology that takes account of:
    a. Business profile – volatility
    b. Scale
    c. Profitability
    d. Coverage & leverage
    e. Financial policy

Credit Score

2. Determine a credit score that can be assigned to a specific credit rating either by:
    a. Directly calculating a credit score that can be applied to a credit rating
    b. A measurement relative to the group's credit rating.



Other Adjustments

3. Consider what adjustments should be made. e.g. country risk.

We work with companies on transfer pricing structures for treasury transactions by:

- Designing the TP model and solution specific to companies
- Documenting TP methodology to meet transparency and compliance requirements
- Data mining of relevant and acceptable external comparables
- Undertaking financial analysis and shadow credit scoring for subsidiary companies based on a well developed and accepted methodology.

Who We Are?

Our Personality

Trusted relationships, flexible, scalable, committed to making a difference

Our Clients

A diverse international client base who are corporate organisations, banks and public sector treasuries

Our History

Founded in 1988, FTI Treasury is an owner-managed independent private company

Our Record

Please speak to our clients about our real practical treasury expertise and best practice processes

Practical treasury advisor to global organisations

Processing transactions p.a.
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