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Transfer pricing during the lifecycle of a related party financial instrument

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Two years on since Chapter X of the OECD Transfer Pricing Guidelines (**Chapter X**) was published in February 2020, the practical transfer pricing aspects of financial transactions are due another look. While financial transactions were often ignored once put in place, administrative practice, case law, interaction with interest limitation rules and new guidance have elevated them to the same level as other intercompany transactions. Tax authorities are increasingly requesting taxpayers to provide financial information and transfer pricing documentation for financial transactions involving related parties.

This article discusses the key transfer pricing aspects that may become relevant during a related party financial instrument's lifespan; before entering into the transaction (**birth**), after having entered into the transaction (**life**) and when terminating the transaction (**demise**).

Birth

Various elements must be considered before entering into a related party financial transaction. The planning phase is essential; thoroughly documenting the discussions and decisions taken upfront may help the taxpayer sustain the arm's length nature of the transaction for tax authorities' potential inquiries. The transaction's purpose should be clear and objective, meaning that a neutral, well-informed person would recognize the need for funding. Chapter X emphasizes the importance that the lender's and the borrower's perspectives on the transaction are aligned[1]. In a third-party context, both the borrower and the lender should perform a careful evaluation of the options realistically available to borrow and lend money, respectively.[2]

From a borrower's perspective, this means being clear about the amount needed, the flexibility required and the cost limits. Given the funding needs, a rational borrower would compare different offers and choose the most cost-efficient and flexible one. Regarding flexibility, different terms like convertibility or early-repayment may be beneficial.

The lender should also thoroughly evaluate the investment before providing funds to the borrower. As part of this process, the lender assesses the borrower's creditworthiness, often expressed as a credit rating.

Since creditworthiness *is one of the main factors* to be considered when determining an appropriate interest rate,[3] Chapter X provides extensive guidance on the use of credit ratings. Transfer pricing practitioners typically rely, if available, on credit ratings published by one of the three credit rating agencies: Moody's, Standard & Poor's, and Fitch. Rating agencies assign credit ratings to multinational enterprises as a whole ("corporate family rating"). However, in some cases, it is appropriate to deviate from the corporate family rating when assigning a credit rating to the borrowing entity. This is typically done based on the strategic importance of a single entity to the group.[4]

If neither of the three agencies has published a credit rating, transfer pricing practitioners typically try to assess a rating based on qualitative and quantitative figures, by either (i) using a designated tool provided by one of the rating agencies, or (ii) relying on rating methodologies published by rating agencies for numerous industries.

A unique feature of related party financial transactions is that the lender often has either control over the borrower, or both entities are controlled directly or indirectly by one entity. Therefore, for tax and transfer pricing purposes, it may be relevant to demonstrate that the (full amount of the) loan should be regarded as a loan and not as a form of contribution to equity.[5]

To demonstrate this, a **debt capacity analysis** is recommended, aiming to determine the maximum amount of debt that the borrower would obtain in a third-party context, given the financial instrument's agreed terms and conditions.

It is also essential to determine the financial instrument's terms and conditions before entering into the transaction. The involved parties are basically free to agree on any terms and conditions while respecting the arm's length principle. The market features numerous types of financial instruments adapted to the borrowers' needs and the lenders' expectations.

Three examples of these instruments are:

- **Plain vanilla interest-bearing loans**, for which the borrower pays a fixed interest rate over the principal at fixed dates;
- **Profit participating loans**, which bear higher risks for the lender if the borrower makes poor investments, but also provide higher returns if the borrower makes very profitable investments; or
- **Convertible loans**, which give either the lender, the borrower or both parties the right to convert the debt into equity of the borrower.

A vital element of the terms and conditions and essential to the debt capacity analysis is the financial instrument's price (i.e., the interest rate). This rate is mainly affected by the borrower's credit rating and industry and some of the loan's key terms and conditions, such as the currency, maturity and repayment modalities. Typically, selecting the transfer pricing method is not an issue, as there is usually enough data available to use the comparable uncontrolled price (CUP) method, which is the OECD's preferred method.[6] Some taxpayers perform a **debt pricing analysis/interest rate benchmark** on a case-by-case basis, whereas others implement a pricing policy that helps them comply with the arm's length principle and documentation requirements while reducing costs and effort.

Finally, the taxpayer should prepare the transfer pricing documentation by gathering all of the beforementioned elements in one place in case of any tax authorities' queries.

Life

This stage typically requires less effort from a transfer pricing perspective, with the parties' responsibilities varying depending on the financial instrument's type. A plain vanilla loan with no specific clauses (e.g., penalty-free early repayment) would usually require only the monitoring of interest collection, whereas instruments with clauses (e.g., a convertibility clause) may need regular updates of the borrower's evaluation and its underlying business.

As unrelated lenders would implement a monitoring process for risk mitigation purposes, this is also required from a transfer pricing perspective. This may generate questions such as, would an unrelated lender/borrower have exercised the convertibility option at point X in time? And, would an early repayment clause or refinancing option have been executed?

"Unusual" circumstances, such as the current sanitary crisis, may lead to extraordinary situations where one or both of the engaged parties could be interested in re-negotiating the financial transaction's terms and conditions. Such re-negotiation between related parties must adhere to the arm's length principle, and an updated transfer pricing study may be required.

Regarding the ongoing management of an intercompany financial transaction, the relevant functions should be performed by people who understand the different aspects of a financial transaction, such as risk mitigation.

From a lender's perspective, the people in charge should be able to grasp and re-assess the borrower's creditworthiness to potentially control the increased risk and make well-informed decisions, for example:

- Transfer the loan to another entity that can better absorb the risk;
- Convert the loan into equity to increase the level of control over the borrower; or
- Demand early repayment to minimize the level of losses.

From a borrower's perspective, the people in charge should monitor the evolution of the market and regularly (re-)evaluate the options realistically available. This includes monitoring market interest rates and evaluating the own company's performance to assess the potential benefits of executing contracted clauses (e.g., early repayment, conversion into equity, re-negotiation of the price, etc.).

Demise

A financial instrument can face a planned demise—such as the end of the initially set maturity—or an extraordinary one—such as the transfer of the instrument, the exercise of a contractually agreed option (conversion, early repayment, etc.), or the default of the borrower. The instrument may also skip the demise stage if the borrower and lender consent to extend the agreement.

The different circumstances of an instrument's demise may require different transfer pricing analyses. The simplest situation is a repayment of the principal together with the interest accrued, where no additional transfer pricing work is required.

Extending the instrument's life likely requires additional transfer pricing work, as the market conditions and other elementary factors used to determine the instruments' price would be different than at the origination date. Therefore, if there is reasonable doubt that not all of the extension date's conditions are equal to the origination date's conditions, the debt pricing analysis/interest rate benchmark should be at least updated, if not wholly renewed.

If contractually allowed, the financial instrument may be transferred like any other asset to another (related) entity, which would become the new lender. Such a transfer may occur as a single asset transfer, part of a transfer, or an acquisition of an entire business. In any case, most jurisdictions' tax laws require that an asset is transferred at fair market value.

The OECD Guidelines do not mention a specific method to valuate a financial instrument. However, one valuation method that transfer pricing practitioners widely apply is the discounted cash flow method, referred to in the OECD Guidelines as a valid valuation technique. When a plain vanilla interest-bearing loan is valuated for transfer pricing purposes, the method is typically applied as follows:

1. Project the financial instrument's expected cash flows till maturity, representing interest payments and repayment of principal at maturity;
2. Perform a debt pricing study for the instrument at hand at the moment of the transfer, considering market conditions and the borrower's creditworthiness at that moment, as well as the instrument's terms and conditions and remaining lifetime. The debt pricing study would result in a current market interest rate that applies to the instrument, which can be used as a discount rate in the valuation exercise; and

- Discount the expected cash flows with the computed discount rate to determine the present value of the cash flows, which would collectively represent the instrument's fair market value at the time of the transfer.

Using the discounted cash flow method to value more complex financial instruments may require additional inputs and steps.

Conclusion

The focus on transfer pricing documentation of related party financial instruments has certainly heightened since the OECD published Chapter X. These instruments face numerous stages during their lifecycles where transfer pricing analyses are required. Financial instruments' complexity and uniqueness and the unpredictability of the market's evolution mean that continuous monitoring is indispensable.

[1] OECD (2022), *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022*, OECD Publishing, Paris, *https://doi.org/10.1787/0e655865-en. – p. 413, 10.51.*

[2] Ibid. p. 41, 1.38.

[3] Ibid. p. 415, 10.62.

[4] Guidance is provided by rating agencies, e.g., "*General Criteria: Group Rating Methodology, July 1, 2019*" – published by S&P Global.

[5] OECD (2022), *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022*, OECD Publishing, Paris, *https://doi.org/10.1787/0e655865-en. – p. 404,*

10.5.

[6] OECD (2022), *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022*, OECD Publishing, Paris, *https://doi.org/10.1787/0e655865-en. – p. 94, 2.3.*

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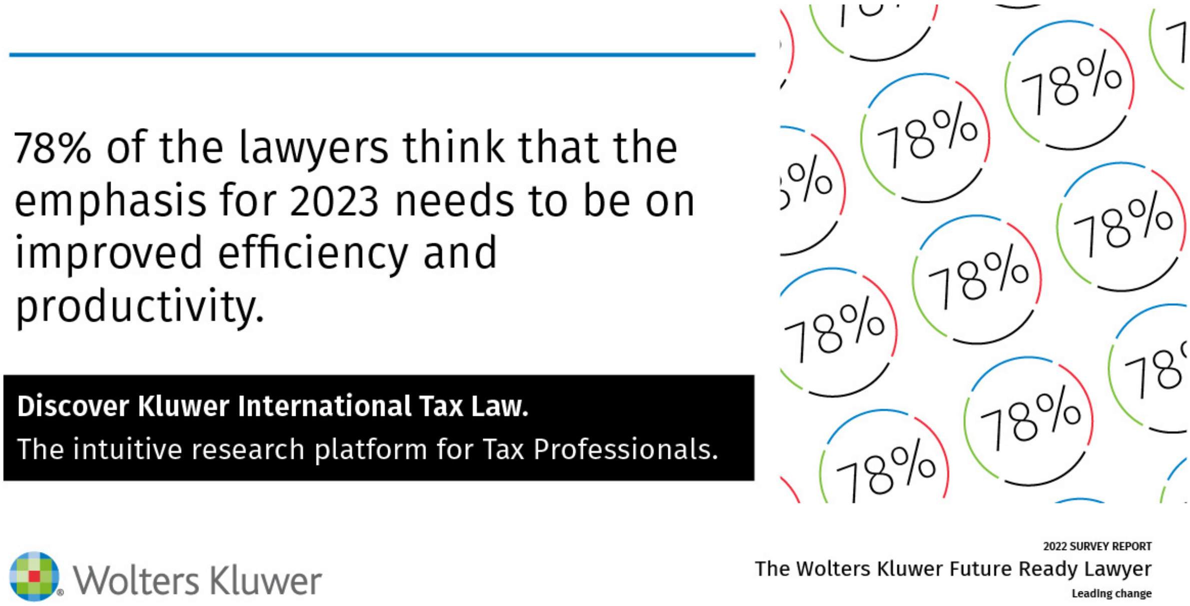

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