Practice guide

Transfer pricing of financing arrangements

Speed read

A wide range of financing arrangements are used within groups, whether arising from day to day transactions or as an intentional part of structuring arrangements. Financing, in particular, is an area that often does not get the same attention from a transfer pricing perspective as other transactions. A new focus on the area is expected, stemming from a mixture of new documentation standards, high profile cases and updated OECD guidance. The following approaches may be relevant when considering the transfer pricing position of financing arrangements: direct comparison with arm's length offers or agreements; credit scoring and bond pricing; market studies and ratio-based approaches; covenant-based assessment; and peer group review. Specific considerations should be given to: leveraged corporate acquisitions; real estate backed loans; intra-group working capital loans; cash pooling arrangements; guarantees; and on-lending arrangements.

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The OECD/G20 BEPS programme acknowledged the potential impact of financing arrangements on multinational groups, with a potential for the erosion of tax bases resulting in the Action 4 recommendations to introduce limitations on interest deductibility. This action specifically sidestepped the question of transfer pricing. However, in doing so, it highlights some views that transfer pricing can be relatively hard to understand and police.

Even in the face of the prevalence of mechanical interest barriers, such as the UK's corporate interest restriction, transfer pricing remains a potent tool and at the heart of how tax treaties allocate taxing rights on related party interest amounts.

With this in mind, it is critical to understand the financing arrangements of a group and its interaction with the transfer pricing rules. This will enable businesses to set robust transfer pricing policies for financing arrangements and gain comfort from its supporting documentation. In this article, we outline the types of financing arrangement commonly found and the various factors and approaches that should be considered in dealing with them.

Financing arrangements: what, how and why?

Groups may find themselves with related party financing relationships in all manner of situations. Sometimes these arise entirely unintentionally; for example, if trading balances accumulate without payment or offset, as part of group structuring – for instance, an acquisition or reorganisation – or from commercial need.

We examine the following in this article:

- leveraged corporate acquisitions;
- real estate backed loans;
- intragroup working capital loans;
- cash pooling arrangements;
- guarantees; and
- on-lending arrangements.

Most of these are self-explanatory. Cash pools are arrangements that seek to make efficient use of a group's cash balances by balancing credit and debit positions across the group, and minimising external borrowing costs. They typically combine types of lending but are worthy of separate consideration due to the potential complexity of the overall arrangements.

Regardless of how a loan balance arises, the transfer pricing considerations are typically framed by the following questions:

- Would this amount of debt (or some of it) have been agreed between an independent lender and borrower?
- How much would a lender have charged and how much would the borrower be willing (and able) to pay?
- What terms would have been agreed for this arrangement?

These questions are specifically enshrined in UK legislation.

As with other transfer pricing areas, there is a broad consistency of approach globally. However, some countries will typically place more emphasis on assessing the pricing of a loan than the quantum, especially if other rules limit the amount of debt that can be taken into account (often referred to as thin capitalisation rules). Other countries tend towards fixed levels of permitted interest expense with less acceptance of an arm's length position.

OECD guidance and tax authority positions

The OECD transfer pricing guidelines provide the basis on which the UK and a significant number of countries globally interpret the application of the arm's length principle, but these guidelines do not currently contain considerations specific to financing arrangements.

The interpretation of how the arm's length principle applies for financing arrangements still benefits from many of the general aspects of this guidance, such as the need to consider various facts and comparability factors in the analysis of how independent parties might have acted. However, given that many transfer pricing methods do not naturally translate to this type of transaction, businesses and tax authorities typically resort to a range of 'other methods' and approaches.

The OECD has been working on updated guidance to include this area since the BEPS programme, but publication has been repeatedly delayed. This has led to suggestions that when guidance is eventually published, it may reflect a non-consensus view with some nations expressing reserved positions.

Potentially controversial areas may include the impact of intragroup guarantees: authorities and case law in some territories take the view that a subsidiary should expect to benefit from anticipated support from its parent company; others exclude any parental support to reflect a fully standalone position. The UK is, currently at least, in this latter position with legislation excluding the impact of related party company guarantees.

HMRC has had published guidance in place and a well embedded unilateral advance pricing agreement programme (the advance thin capitalisation agreement (ATCA) programme), which has primarily dealt with leveraged buyouts sponsored by private equity houses. Recently, additional guidance has been issued in relation to cash pooling and HMRC has increased its activity in investigating how these arrangements are structured.

Independence in a financing context

The UK transfer pricing rules have a significantly wider ambit in relation to financing arrangements than other types of transaction.

The reason for this is that it is quite feasible that a shareholder can influence the terms on which a lender might be prepared to offer finance by providing a guarantee or otherwise through wider relationships between the lender and the shareholder and/or its other investments.

In most cases, any independent lenders seen as 'acting together' with a shareholder in respect of financing can be clearly identified as not having their financing terms affected, allowing the lending terms to be waved through as 'arm's length'. It is, however, important to remember the reasons for this step and be alert to any factors that may cause apparently unconnected lenders to offer different terms.

Timing of analysis

An independent lender will consider the circumstances of the borrower ahead of advancing finance and will then commit funding for a period agreed under the loan terms, which may be a short term facility or a multiple year agreement. This leads to the key point in time for assessing a loan under the transfer pricing rules often being the inception of the financing, based on forecasts and other information that would have been available at that time.

Hindsight should not be used and so lower than expected results should not necessarily automatically result in the conclusion that less debt should be in place. However, conversely actual results are important in several ways.

Firstly, most long term loans at arm's length will have a series of financial conditions that alter the terms of the loan if breached. This can involve provisions to maximise the lender's ability to sweep cash from the borrower including penalty interest rates or mandatory repayment of some or all of the loan. There is not a single answer that represents what would happen for all loans in a default position and careful consideration is needed.

The position can be particularly awkward to unpick if an independent lender acquires some or all of the shares in a business as part of a severe default, leaving it to a potential adjustment under the transfer pricing rules on *existing* debt in place. (This is contrasted with the arm's length position that might arise where a new hypothetical lender considers whether to advance any funds at all and, if so, on what terms.)

Secondly, the use of hindsight can have some validity in providing a sense check as to whether the original forecasts were robustly prepared. Lenders are expected to be wary of overly optimistic forecasts and to form reasonable judgments for themselves, although of course this may be easier said than done. A significant variance from forecasts without identifiable and unforeseeable causes can lead to the conclusion that different figures would have been used in an arm's length assessment.

Assessing the arm's length provision: UK law

A key aspect of the UK transfer pricing legislation in respect of financing arrangements is that businesses need to consider both the quantum of debt and the interest rate that would have been agreed at arm's length. These must be combined to form a notional 'arm's length provision', against which the actual transactions should be tested.

An implication of this is that if the interest rate that would have applied at arm's length is higher than the actual rate of interest charged on a related party loan, this should be taken into account for a borrower. A transfer pricing adjustment is only then required to the extent that the actual financing costs exceed the notional arm's length cost.

Conversely when considering a lender's position, if a higher rate would have applied at arm's length, then any additional income that should be imputed under the transfer pricing rules will need to take into account any reduction in the amount of loan that would have been agreed at arm's length.

Example:

	Actual provision	Arm's length provision
Debt amount	£100m	£40m
Interest rate	2%	4%
Interest cost	£2m	£1.6m

Transfer pricing restriction on borrower is: £2m – £1.6m = £400,000

UK transfer pricing is 'a one way street' that, subject to compensating adjustments being available, only decreases deductible expenditure or increases taxable income. At least in some cases, HMRC is known to apply this principle to components of financing arrangements; for example, only considering reductions in either the interest rate or quantum for a borrower, rather than (as stated in law) the overall outcome. Therefore, taxpayers incorporating the above should be aware of potential challenges arising in this way.

We note that if the borrower and lender are both UK taxpayers, HMRC's preferred interpretation would potentially result in a slightly awkward series of adjustments. Using the example figures from above:

- Borrower: transfer pricing adjustment – reduce interest expense to £0.8m (£40m @ 2%)
- Lender: compensating adjustment – decrease income to the 'arm's length' £0.8m
- Lender: transfer pricing adjustment – increase income to £1.6m (£40m @ 4%)
- Borrower: compensating adjustment – increase interest expense to £1.6m

This route involves two figures for 'the arm's length provision' (or three, if you start from the lender's perspective) for the same financing arrangement.

General principles of analysis

There are several types of approach that can have relevance to considering the transfer pricing position of financing arrangements.

Direct comparison with arm's length offers or agreements

As with the use of the comparable uncontrolled price method in non-financial transfer pricing, directly contrasting the terms of finance offered by independent parties to the group can be a powerful tool, but ultimately the availability of this method is reliant on the exact facts and circumstances.

The multitude of ways in which financing terms can differ, such as the length or currency of the loan or the risk of the borrower, may cause obstacles for comparison but there is potential in some cases to apply adjustments to account for such differences.

In many cases, where a shareholder is providing financing to a company or group in addition to external debt, the related party funding will be subordinate to the external debt, presenting a significant difficulty in directly relating terms. In this type of situation, it may be possible to draw some useful inferences from the senior loan agreements, such as the type of factors considered or tested as financial covenants by the senior lender. It is likely that, to the extent any subordinated debt would be advanced at arm's length, it would be more expensive than the senior debt, due to increased risk and potentially decreased competition from other lenders, providing a floor to the pricing.

Financing offers can offer a tempting route to analysis, where they have been made by an independent party but where related party financing was ultimately used instead. Potentially, these can directly show the terms an independent lender would have been prepared to agree, but the following factors can limit the utility of this route:

- Where an offer has not been thoroughly processed by both parties, it may not be fully credit committee approved by the lender, leaving some doubt as to whether terms might have been altered through further negotiation.
- If the offer is based on a specific amount of debt requested in discussions, it does not show the amount of debt the lender might have been prepared to offer.
- If the offer is for a 'traditional' senior loan, this will not give context of what might have been advanced by other lenders.

Credit scoring and bond pricing

In the absence of directly comparable arrangements, a basket of broadly similar debts may be benchmarked.

One of the most widely used approaches to undertake this is to compare the yield to maturity on publicly traded bonds that are viewed as broadly equivalent to the loan in question. There are some intrinsic differences between bonds and corporate loans, such as the costs associated with issuing bonds, the typical size of bond issues (limiting comparability with smaller loans) and the potential liquidity of bonds or the impact of speculation on pricing.

Nonetheless, the underlying substance of the transaction involves a debt between two parties and the level of information publicly available makes benchmarking accessible and generally broadly consistent.

The 'yield to maturity' is a figure that takes into account both the coupon on a bond (equivalent to the interest rate paid by the borrower) and the market price of the instrument. In this way, the yield reflects the perceived market view of the appropriate return on the debt. For instance, a bond with a coupon that is seen as too high will trade at a premium and will have a yield lower than that coupon; and a bond with a below-market coupon will trade at a discount.

Key comparability factors will generally be determined that will include the currency of bonds, the credit rating of the instruments in question and the remaining term of the bond. The credit rating of an instrument is a key factor, and can vary from the borrower's credit rating. A lower rated debt, such as an instrument in the B– category, would be expected to yield a significantly higher return than a more creditworthy instrument, such as one in the BBB+ category.

In most cases, a formal credit rating of a related party instrument will not be available and estimates will need to be used in such a benchmarking exercise. This may be derived from an existing credit rating; for instance, if the overall group has a rating that is then adjusted or 'notched' to take into account differences between the group and the specific borrower, or assessed using a credit scoring approach.

Credit scoring can be undertaken under either:

- a quantitative approach with a numerical model based on an estimated probability of default; or
- a qualitative approach, often undertaken with references to the methodologies used by credit ratings agencies such as Moody's or Standard & Poor's.

These approaches relate to the pricing of the debt and generally do not contribute towards considering whether the level of debt in place is reasonable, which should be taken into account before undertaking any credit scoring analysis.

Market studies and ratio-based approaches

Certain market data is gathered and published in a way that can be relied upon in transfer pricing analysis. Typically, single points of market data are not identifiable but ranges of positions and/or averages are published.

This is notably different from confidential data that may be available but cannot be shared, for example a specific loan agreement, as the use of 'secret comparables' is disapproved of by the OECD guidance and limited reliance can be placed on such an approach. A statement beginning: 'In our experience, the terms seen are…' – without verifiable evidence to back it up – can be set aside by the tax authority or the taxpayer (although this may still be helpful in situations where public data is difficult to obtain). Where data is coordinated with rigour by an unbiased third party, the outcome is more likely to be accepted for transfer pricing purposes.

As with other methods, comparability remains important. Where data is cut into multiple parts, care should be taken to identify the most appropriate areas for analysis.

Market data can range from the exceedingly high level, such as the aggregated monetary financial institutions (MFI) statistics typically prepared by national banks, which show data such as the average lending and deposit rate for new loans/deposits in a particular period, to more granular analysis.

The market data may only contain information regarding pricing, or it could extend to statistics pertinent to identifying the level of debt in place as well. Common metrics include interest cover (often the ratio of interest to EBITDA), debt to EBITDA ratios, and loan to value ratios. Confirmation that arm's length financing has been agreed with relevant ratios in a certain range can provide a strong indication that a similar level of each ratio may be reasonable for related party finance.

Care should be taken to understand the limitations of the data sets in question. A prime example often encountered is when using market data for leveraged buy-outs (see below). It is common to find this only includes details of senior financing, providing limited guidance on arm's length terms for subordinated debts.

Covenant-based assessment

Arm's length loan agreements will generally contain financial covenants in order to protect the lender's position. Where a bank loan is in place within the group, these covenants can inform the levels of lending that might be considered reasonable at arm's length.

This approach has clear limits. In particular, it is notable that covenants are typically set to allow headroom over the ratios that are expected to occur and therefore to come into force if performance is below expectations. This does not mean that the lender would necessarily be prepared to intentionally advance funds up to the limits (for instance, if a lender has advanced the maximum it is prepared to lend, the covenants will reflect a higher debt position). Nor, though, does it mean that the lender would not consider advancing debt outside covenant levels (if the lender is well within its comfort levels).

Where a related party debt is subordinate to a senior bank loan, analysis can consider a 'relaxation' of the senior covenants as an indication of what might have been advanced as subordinated (mezzanine) debt. For example, if a bank advances a senior loan at 3.5 x a company's annual EBITDA, it might set a financial covenant so that the borrower will default if the senior debt exceeds 4 x EBITDA in a period. A 20% relaxation might suggest a 5 x EBITDA maximum for the total debt, including subordinated loans.

The rationale and level of relaxation is generally derived from historical observations that covenants on mezzanine debt have been observed to typically be more relaxed than senior covenants in the same circumstances (as might be expected where the mezzanine covenants consider the entire debt and senior lenders typically exclude subordinated debts).

This can be a useful basis for discussion in the absence of other data, but has limited robustness. In particular, difficulties arise in justifying the level of relaxation that is appropriate, due to limited data that tends to relate only to mezzanine covenants and not actual mezzanine debt levels. Further complications are caused if the senior lender for the actual transaction has advanced less than it would be prepared to do.

Peer group review

Another approach that can be taken is to consider the debt terms, including the level of debt and interest rate that have been put in place for other companies based on their accounts or other published information.

Where there are good levels of comparability between the businesses in question, this approach can be good justification for what is possible, but does not necessarily show what might have been possible if the business had sought different terms. There is also generally limited information on what the expectations of both parties were on entering into the facility.

In some cases, credit rating announcements made in advance of a bond issue can provide similar guidance based on expectations. Similar considerations as discussed above should be made when comparing bond issues to loan terms.

Specific considerations

Leveraged corporate acquisitions

Corporate acquisitions often involve a degree of debt finance; this is often a feature of an investment fund that may increase its anticipated return on capital by using relatively inexpensive bank debt to cover part of its acquisition cost.

Given the number of such transactions that occur annually and the announcements that typically accompany them, there is a reasonable degree of market information available from several providers, showing factors including:

- debt to EBITDA;
- interest cover;
- proportion of debt to deal value; and
- interest rates.

The deals for which data is available, in particular debt to deal value, tend to be at least mid-market deals, meaning that there are some limits on their use to support the analysis of smaller transactions. Subject to this, the analysis of senior lending terms, relevant in particular for intragroup transfers funded by related party debt, can be strongly supported by this type of market analysis.

In recent years, there has been very little evidence of mezzanine finance included in these market statistics. This can give limits to its usefulness in supporting terms for subordinated debts. However, it also leads to questions as to whether mezzanine debt is available.

Mezzanine lenders, in particular specialist debt funds, do exist and are active but there is generally little information publicly available on their terms and these are often not announced as part of deals, making analysis of this type of debt a potentially contentious area.

Some published details on 'unitranche' lending may also be found, which can provide further analysis of loans above normal senior levels. This data is typically limited in depth and so provides comparability challenges.

Real estate backed loans

Surveys are regularly undertaken in respect of the UK commercial lending market, with one of the most widely used market reports on this area being the twice annually published De Montfort University report (now the Cass Business School report).

These property lending reports provide detailed data for the terms on which lenders are prepared to advance funds across a range of property types and include information from debt funds and other non-bank lenders, in addition to more traditional lenders. This provides a strong level of information on the types of debt and terms available.

Property backed lending is typically measured by reference to loan to value levels, or loan to cost for developments, and the typical value and stability of real estate generally allow higher debt levels than are seen for general trading businesses, with significantly lower interest cover terms required.

A range of comparability factors need to be considered for property-backed lending. Specific factors such as short lease terms in place should be taken into account. Where a senior bank loan is in place with subordinated shareholder funding, it is important to compare the senior lending terms with market information to identify any differences and whether these have implications on the subordinated debt terms that would be agreed.

Intra-group working capital loans

Working capital facilities tend to be relatively short term instruments and can be akin to bank overdrafts, but can develop into longer term systemic funding depending on how a business develops.

If balances are relatively small (for example, materially below the average ratios seen for corporate acquisitions), then it may be appropriate to take a 'light touch' in addressing the question of whether the quantum of debt could be advanced, with the principal focus being on support for interest rate applied.

In the absence of other more specific support, this is the situation to which data from the MFI statistics is best suited.

Cash pooling arrangements

There are a range of different types of cash pooling arrangements. The main categories are those that operate using an external party, usually a bank, and those that are run internally to a group.

For an externally run cash pool, group members may operate their own bank accounts and can have credit or debit balances. The bank will then aggregate and offset positions across the group and only charge interest on debits to the extent that the overall group is drawing against its facilities. In this way, the group only pays for its net debt and, given that its borrowing costs will (subject to foreign exchange) be higher than the deposit returns, the group achieves a lower cost of borrowing. An internally run cash pool achieves the same end through internally sweeping balances to offset surplus cash against working capital deficits. The principles that need to be considered in both cases are broadly similar.

It is important to maintain a clear view of which 'arm's length' legs of the transactions might still lead to repricing. For an external cash pool, this may involve internal reallocations to pass benefit from entities benefiting from an interest-free bank loan to those depositing cash into their pooled account without a return from the bank.

The character of each company's involvement in the cash pool should be considered – identifying members with fluctuating requirements from systemic borrowers or lenders, each of which might be treated differently at arm's length.

The risk to depositors needs to be understood. Often, this risk will be higher than a straightforward bank deposit due to links to the group-wide position. If there is a leading party to the cash pool (there usually will be for an internal cash pool and may be by guarantee for an external pool), then this entity might, or might not, protect depositors from risks associated with borrowers.

In this way, the deposit rate payable by banks locally might or might not be a fair proxy to how much a cash pool depositor should be paid.

Any treasury management roles need to be taken into account and remunerated fairly in the overall arrangement. It is possible that this can be achieved out of a margin achieved by a cash pool leader through the ordinary course of pooling transactions, or that a separate service fee is paid.

Guarantees

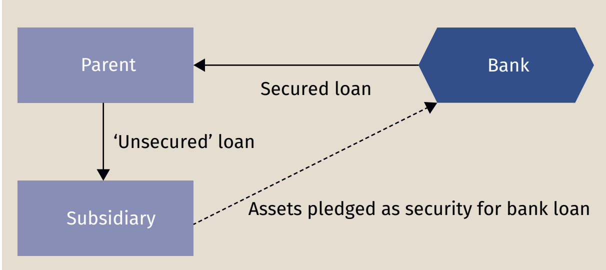
As well as causing difficulties in the assessment of other transactions, guarantees can result in guarantee fees being levied.

A difficult question to address in such cases is whether a guarantee would be agreed at arm's length. In practice, it is convenient to assume that, as long as a sufficient reward is given, the guarantor would agree.

The appropriate fee for a guarantee can be a complex matter, involving consideration of the benefit to the borrower, through reduced interest rates and/or increased debt levels, and the potential exposure to the guarantor, including the likelihood of the guarantee being called upon.

Not all guarantees will actually add value, as in some cases a lender will insist on a guarantee from a shareholder more to provide comfort that the shareholder will not seek to disadvantage the lender – for example, by collapsing the borrower and reviving its trade in a new subsidiary – than to change the terms on which the business could borrow.

The following example illustrates a scenario where the legal form of transactions can potentially 'mislead' those considering the transfer pricing position:



If a subsidiary has pledged its assets in support of a related party bank facility, it may technically not be able to use its assets as security for a loan it then borrows from its parent. Viewing this in the round, it is highly unlikely that a subsidiary would allow its assets to be used in this way if it was to result in a higher borrowing cost for itself. This is either resolved by the 'unsecured' loan from the parent company being priced taking into account full security over the subsidiary's assets or by a guarantee fee being payable by the parent to make good the difference.

On-lending arrangements

Acquisition structures and other group arrangements may often involve loans flowing via a number of companies.

A question usually considered for each such step is whether there is any appropriate margin between the lending and borrowing cost of each intermediate company. There are a range of factors to consider, including the reason for the company being included in the financing structure, the relative terms of loans to and from the company, and its functions, risks and assets relating to the provision.

If a company has a matching inbound and outbound loan in terms of quantum and no other assets, it may be difficult to justify a margin on a loan, as the company will be able to service its debt to the extent the company it is lending to can service its debt. Conversely, a holding company with a diverse portfolio may be expected to present a reduced lending risk in comparison to each of its subsidiaries.

Conclusion

The transfer pricing of financing arrangements is moving up the agenda for tax authorities, with greater transparency of transactions expected in transfer pricing documentation.

As with other areas of transfer pricing, businesses need to understand the exact nature of the transactions and circumstances in which they take place, including where important people functions are located indicating where associated lending risk is managed and controlled, and other factors indicating where capacity to bear that risk sits.

This understanding will allow businesses then to best use the many potential sources of information and routes to assessing transactions and determining comparability, and adjusting for differences where possible, to arrive at and document robust pricing terms. ■

Note: as this article went to press, the OECD released its consultation document on financial transactions. For the details, see bit.ly/2zbc5gD.

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- The substance of transfer pricing (Paul Daly & Duncan Nott, 27.7.17)
- Intra-group services and transfer pricing (Paul Daly, Duncan Nott, 2.11.17)