

“Future of Intercompany Financing – Survive or Disappear?”

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Speakers



Virender Sharma,
Partner, TPA Global (NL)
v.Sharma@tpa-global.com



Avisha Sood,
Associate, TPA Global (NL)
a.sood@tpa-global.com

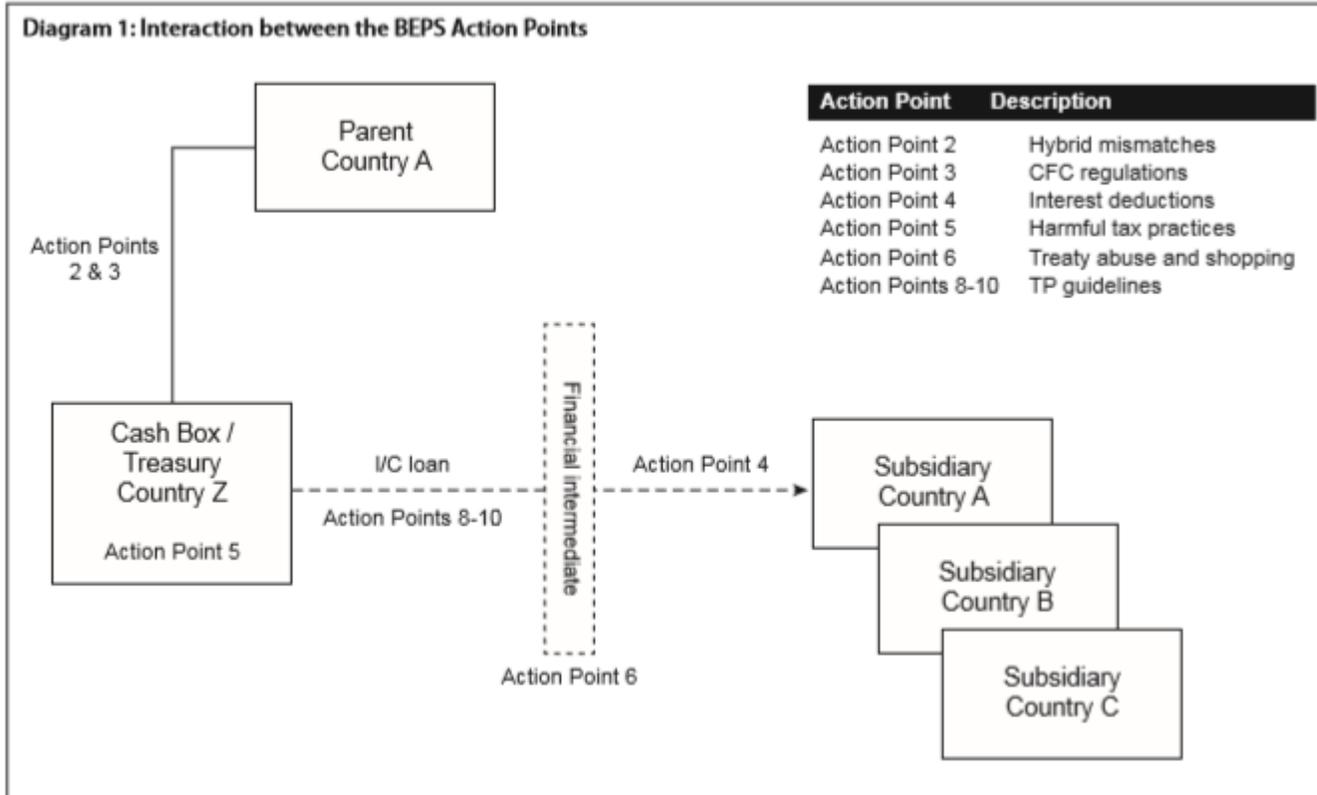
- **Changes seen in the post-BEPS world**
 - Brief overview of BEPS Action plans impacting financing companies;
 - Brief overview of local country regulations suggesting changes to existing structures (e.g.: Luxembourg, Australia);
 - What options are available to restructure the financing?
- **Changing market dynamics**
 - Overview of interest rates seen in the market;
 - Overview of types of investments favoured by banks;
 - What are the types of comparables available to support intercompany financing activities?
- **What does it mean for financing companies?**
- **Case studies**

Background to the session

- Debt Vs equity as a source of fund
- Changing regulation around financing companies
- Need to restructure operations of clients
- Increasing scrutiny of governments on these structures i.e. increasing importance of accurate comparability analysis
- Changing market outlook i.e. negative interest rates in the market – How do they impact comparability analysis
- Lack of appropriate comparables - Design of synthetic comparables

Changes seen in the post-BEPS world

Impact of BEPS and EU Directive on financing structures



The following lists how intercompany interest charges on intercompany loans become restricted through a series of BEPS and/or domestic measures:

1. hybrid instrument and/or entities being used by MNEs – BEPS Action 2;
2. CFC measures that target interest income in an MNE structure – BEPS Action 3;
3. excess debt-to-equity ratio and/or interest levels relative to market – BEPS Action 4;
4. preferential tax regime providing “low/no tax rates” to the treasury hub or cash boxes used by MNEs – BEPS Action 5;
5. group affiliates used as “flow stream entities” to obtain a benefit from “tax treaties” – BEPS Action 6; and
6. instances when the group entity acting as a lender does not actively manage the financial risks – BEPS Actions 8-10. These Actions take a different perspective in such scenarios, i.e. the maximum interest rate the lender can charge the other group entity is limited to a “risk-free interest rate”.

Impact of BEPS and EU Directive on financing structures – Risk free return?

Cash boxes: Risk Free return

- related parties that provide funding without exercising any control over the financial risk of providing that funding (so-called cash boxes) are treated as not assuming any risk at all.
- Thus, they are limited to a return that reflects the use of money without any risk element – that is, a risk-free return
- Example: typically 8c type companies but more and more so, a lot of financing structures without substance could fall under this category
- (Para. 1.103 and para 6.59, 6.60 , TPG 2017)

Smart Cash: Risk Adjusted return

- Another category of related parties that provide funding are those that “exercise . . . control over the financial risk associated with the provision of funding, without the assumption of, including the control over, any other specific risk.”
- These related parties provide cash funding with monitoring and strings attached (so-called smart cash)
- such a company can “generally only expect a risk-adjusted return on its funding,” also referred to as “an appropriate risk-adjusted return.”
- by definition, an appropriate risk-adjusted return is greater than a risk-free return, and if supported by the facts and circumstances, could presumably be a risky return akin to a return on equity
- Examples: Most intermediary financing companies with substance and potentially even some treasury attributes
- (para 6.61, 6.62, 6.63, 6.64 TPG 2017)

High risk substance: Non-routine return

- an implied third category includes those related parties that control risks beyond the financial risks of funding – for example, the operational risks of the business
- Those entities presumably would not be limited to an appropriate risk-adjusted return on capital, but rather, could enjoy some or all of the non-routine returns actually attributable to the exploitation of the funding
- Example: centralised treasury entities within groups, regulated banks
- (para 6.50, 6.56, 6.57 TPG 2017)

Impact of BEPS and EU Directive on financing structures – Chevron Case

Key Facts:

- CFC was a wholly owned subsidiary of CAHPL. CFC appears to be a resident of the United States and not a resident of Australia
- CFC borrowed an amount of USD2.5 billion from the commercial paper market at rates of interest at or below USD LIBOR (approximately 1 to 2%)
- CFC obtained a guarantee from Chevron Inc, the ultimate parent of the group
- CFC provided an intercompany loan to CAHPL for the AUD equivalent of USD2.5 billion, under the Credit Facility agreement
- The interest rate under the Credit Facility agreement was AUD LIBOR plus 4.14%
- CAHPL drew down funds of approximately USD2.5 billion in two tranches. Interest payments were also effected through “debits to the US dollar bank account ...calculated by reference to the AUD principal amount borrowed”
- It appears that there was no interest withholding tax on the interest payments from CAHPL to CFC, presumably as a result of Section 128F(8)
- During cross-examination, it was indicated that “CFC was not taxable in the US” on the interest income
- As a result of the interest differential, CFC generated profits and it paid dividends to CAHPL, which were exempt from tax in Australia
- CAHPL in turn paid dividends to its shareholder.

Key issues:

- Tax should not be the main driver of the structure
- Credit rating or commercial lender approach
- Implicit support of subsidiaries by corporate groups
- Currency of the loan and recharacterization of the terms
- Comparable uncontrolled transactions

Impact of BEPS Action Plans – LUX Example

The Luxembourg Tax Authorities issued an administrative Circular ('Luxembourg Circular') which is effective since 1 January 2017.

As per Para 20 of the Luxembourg Circular, a group financing company is considered to manage the risks if it fulfils both of the following conditions:

- **Decision-making capacity** to enter into a commercial relationship (i.e., Loan Origination) that gives rises to such risks and has the capacity to take the decisions to negotiate the related risks and is effectively exercising such decision-making functions (i.e., Loan Monitoring).
- in the case it outsources the daily activities of risk management, the group financing company still has the **capacity to determine the objectives** of the outsourced activities, decide to call on the provider responsible for the risk management functions when necessary, is able to assess whether the objectives are properly respected and, if necessary, to decide to adapt or terminate the contract with the service provider concerned and that it exercises that function effectively itself (i.e., be in control over the whole process despite having outsourced parts of the risk management functions).

Under Para 21 of the Luxembourg Circular, a group financing company should have a physical presence in Luxembourg in order to perform risk management functions:

- The majority of the members of the board of directors, the directors or the managers who have the capacity to engage the group financing company are either **residents or non-residents carrying on a qualifying professional activity in Luxembourg and taxable in Luxembourg** on at least 50% of their income. In the event that a legal person is a member of the board of directors, it must have its registered office and its central administration in Luxembourg.
- The company must **have qualified personnel able to control the transactions** carried out by the company. It may nonetheless outsource the functions that do not have a significant impact on the control of the risk. Key decisions relating to the management of the company must be made in Luxembourg. In addition, for companies, which are required to hold general meetings, at least one general meeting must be held each year in Luxembourg.
- The company must not be considered tax resident of another State.

SIMPLIFIED MEASURES

- **Para 24** of the Luxembourg Circular- In case a company has a functional profile comparable to that of the regulated entities (for example financial institutions) then a net (after tax) return of **10%** on the equity at risk (i.e., as determined by applying the relevant EU Solvency Regulations for Regulated Financial Institutions) would be considered as compliant with the arm's length principle.
- **Para 27** of the Luxembourg Circular - In case companies have a purely intermediary financing functional profile (i.e., they do not directly deal with third party Lenders and Borrowers at the same time) and fulfil the substance requirements listed in Section 3.4, then the transactions entered into by such companies will be considered to be compliant with the arm's length principle if a minimum net (after tax) return on the assets financed of at least **2%** is achieved.
- Alternatively, the group finance company may document its equity at risk and the return thereon along with a compensation for its financing activities by conducting a proper professional transfer pricing analysis.

What does it mean for financing companies?

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Non-Regulated entities

Regulated entities

Financial Administrator

Set up in order to facilitate a related party transaction. Mere support role.

DVL Light

Entities performing <50% of financing related tasks in a loan syndication process, while dealing with related entities at both ends. **Typically traditional structures lacking substance and people functions**

DVL Heavy

Entities performing almost all of financing related tasks in a loan syndication process, while dealing with related entities at both ends. **Entities with relevant people functions and substance**

DVL +

Entities performing limited cash management type functions in addition to the financing related tasks in a loan syndication process, while dealing with related entities at both ends. **Certain risks swapped with another group entity**

DVL ++

Entities performing complete cash management type functions in addition to the financing related tasks in a loan syndication process, while dealing with unrelated and related entities at both ends. **Assumes risks (and bears consequences) and have control over risks**

Banks/ Other credit institutions

Entities performing financing and management related tasks in a third party/ external market segment.

What does it mean for financing companies?

Type of company	Responsibility centre profile	TP Method	Economic Analysis	Expected ranges
Financial administrator	Cost centre	TNMM/ Modified cost plus	MOTC on external comparables providing financial support services	Approx. cost plus 5% applied on own costs such as cost of regulatory filings, maintaining bank accounts etc.
DVL Light	Revenue centre	CUP	Annual fee + return on equity at risk (typically limited equity at risk and therefore limited corresponding return)	Annual fee (5bps – 15 bps) – 50% to be allotted Return on equity at risk, assuming either the EUR 2,000,000 or 1% of loan rule (5 bps – 15 bps)
DVL Heavy	Revenue centre	CUP	Annual fee + return on equity at risk (typically limited equity at risk and therefore limited corresponding return)	Annual fee (5bps – 15 bps) - >50% to be allotted Return on equity at risk, assuming either the EUR 2,000,000 or 1% of loan rule (5 bps – 15 bps) -> allotted in proportion of equity at risk/total loan amount
DVL +	Revenue centre	CUP/TNMM	Annual fee + return on equity at risk (typically limited equity at risk and therefore limited corresponding return) + Cash management fee	Annual fee (5bps – 15 bps) - >50% to be allotted Return on equity at risk, assuming either the EUR 2,000,000 or 1% of loan rule (5 bps – 15 bps) -> allotted in proportion of equity at risk/total loan amount Cash management fee (5% - 10% on total costs)
DVL ++	Profit centre	CUP	Spread margin	Spread margin (150 bps – 350 bps)

Changing Market Dynamics

Types of companies covered – Changing Market Dynamics

- Negative interest rates in the market:
 - UK LIBOR (12 months): 0.81%
 - EUR LIBOR (12 months): 0.26%
 - EURIBOR (12 months): -0.19%

(<http://www.global-rates.com/>)
- Expected interest rates for types of loans:
 - Difference in interest rate per grade of credit rating
 - AAA -> AA: 30
 - AA -> A: 40
 - A -> BBB: 60
 - BBB -> BB: 60
 - BB -> B: 70
 - B -> CCC -> C and below: More than 100 bps per notch down
- Decreasing number of mezzanine/ subordinate loans by bank (increased regulatory inconvenience etc.)
 - Since 1/1/2016 – 31/12/2017: 7 mezzanine loans on LoanConnector
 - Interpretation of trend
 - Banks not appropriate comparables for these transactions
 - How to find comparable margins;; Crowdfunding?

Types of companies covered – Changing Market Dynamics

3. COUNTRY SNAPSHOTS: THE NETHERLANDS

Table 3.25. Scoreboard for the Netherlands, 2007-15

Indicators	Units	2007	2008	2009	2010	2011	2012	2013	2014	2015
Debt - new loans										
New business loans, SMEs	EUR billion	21.8	20.7	15.7	16.5	19.4	18.7	18.8	18.0	16.8
Renegotiated business loans	EUR billion	-	-	-	-	-	-	-	-	7.1
Short-term loans, SMEs (new loans)	EUR billion	12.1	11.3	8.9	7.9	10.2	9.2	9.4	8.7	7.1
Long-term loans, SMEs (new loans)	EUR billion	9.7	9.4	6.7	8.6	9.2	9.5	9.4	9.3	9.7
Share of short-term loans, SMEs (new loans)	% of new SME business loans	55.5	54.6	57.1	47.9	52.6	49.2	49.8	48.3	42.2
Debt - outstanding amounts										
Business loans, total (outstanding amounts)	EUR billion	258.5	304.8	313.5	325.7	341.1	350.0	346.5	330.3	351.6
Business loans, SMEs (outstanding amounts)	EUR billion	-	-	-	-	-	-	-	-	130.4
Short-term loans, SMEs	EUR billion	-	-	-	-	-	-	-	-	23.1
Long-term loans, SMEs	EUR billion	-	-	-	-	-	-	-	-	107.3
Non-performing loans, SMEs	EUR billion	-	-	-	-	-	-	-	-	12.4
Debt - other										
Government loan guarantees, total	EUR million	634	647	1 060	1 318	1 161	687	415	516	591
Government loan guarantees, SMEs	EUR million	409	400	370	945	1 040	590	415	480	554
Loans authorised, SMEs	% of SMEs which requested a bank loan and received it in full	-	72	49	60	66	60	54	64	89
Loans requested, SMEs	% of SMEs requesting a bank loan	-	19	29	22	18	22	21	21	16
Interest rate, SMEs	%	-	-	4.50	6.00	6.40	5.10	4.30	4.10	4.40
Interest rate, large firms	%	-	-	-	-	3.50	3.60	3.40	2.80	2.40
Collateral, SMEs	% of SMEs required to provide collateral for last bank loan	-	-	47.0	45.0	44	47	50	43	29
Alternative finance										
Venture capital	EUR million	508	601	418	388	575	391	341	434	607
Venture capital, growth	Year-on-year growth rate, %	-	18.3	-35.0	-7.2	48.2	-32	-12.8	27.3	39.8
Crowdfunding	EUR million	-	-	-	-	-	14	32	63	128
Crowdfunding, growth	Year-on-year growth rate, %	-	-	-	-	-	-	129.0	96.9	103.1
Other										
Payment delays	Average number of days	13.2	13.9	16.0	17.0	18.0	18.0	17.0	16.0	6.0
Bankruptcies, total	Number	-	-	6 942	6 162	6 117	7 349	8 376	6 645	5 271
Bankruptcies, growth	Year-on-year growth rate, %	-	-	82.1	-11.2	-0.7	20.1	14	-20.7	-20.7
Bankruptcies, total	Per 10 000 firms	58	56	189	169	168	203	237	188	150

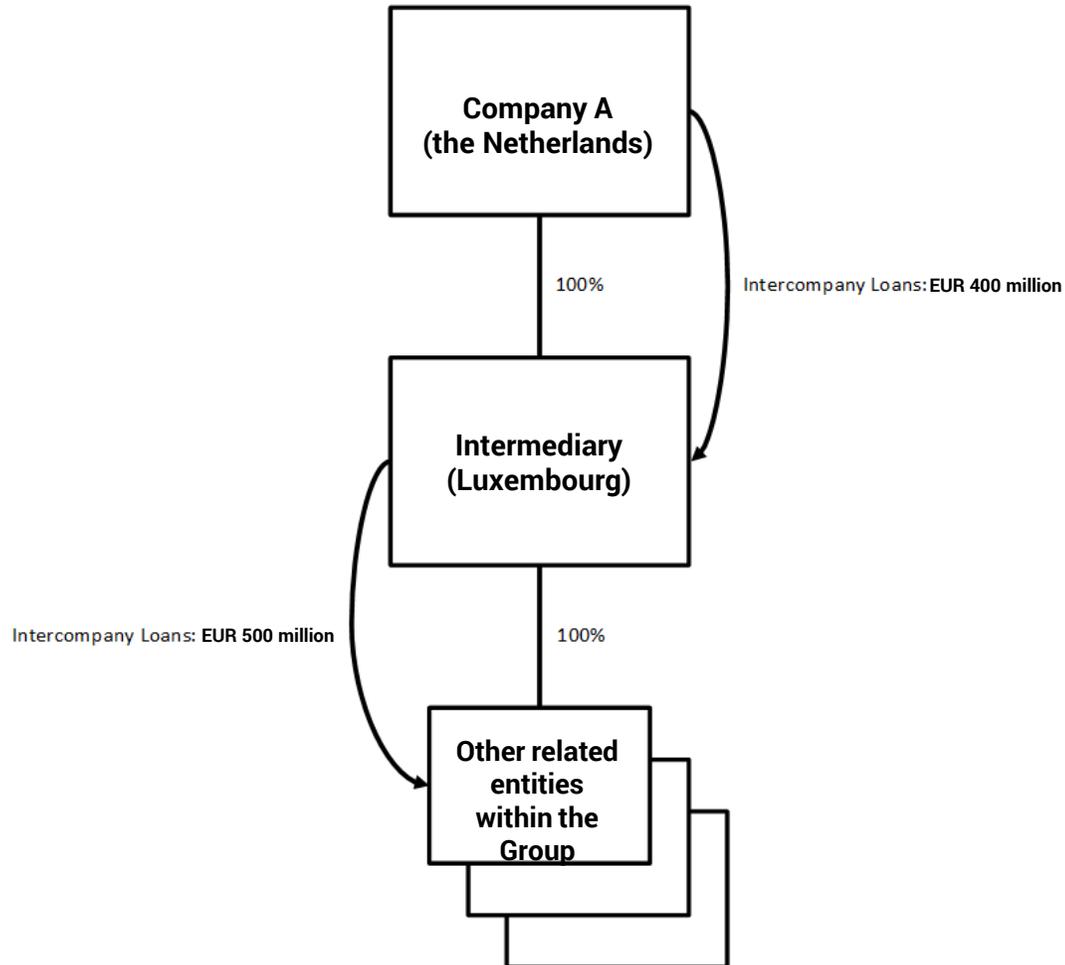
Source: See Table 3.25.2 of the full country profile.

StatLink  <http://dx.doi.org/10.1787/888933468147>

The full country profile is available at
http://dx.doi.org/10.1787/fin_sme_ent-2017-35-en

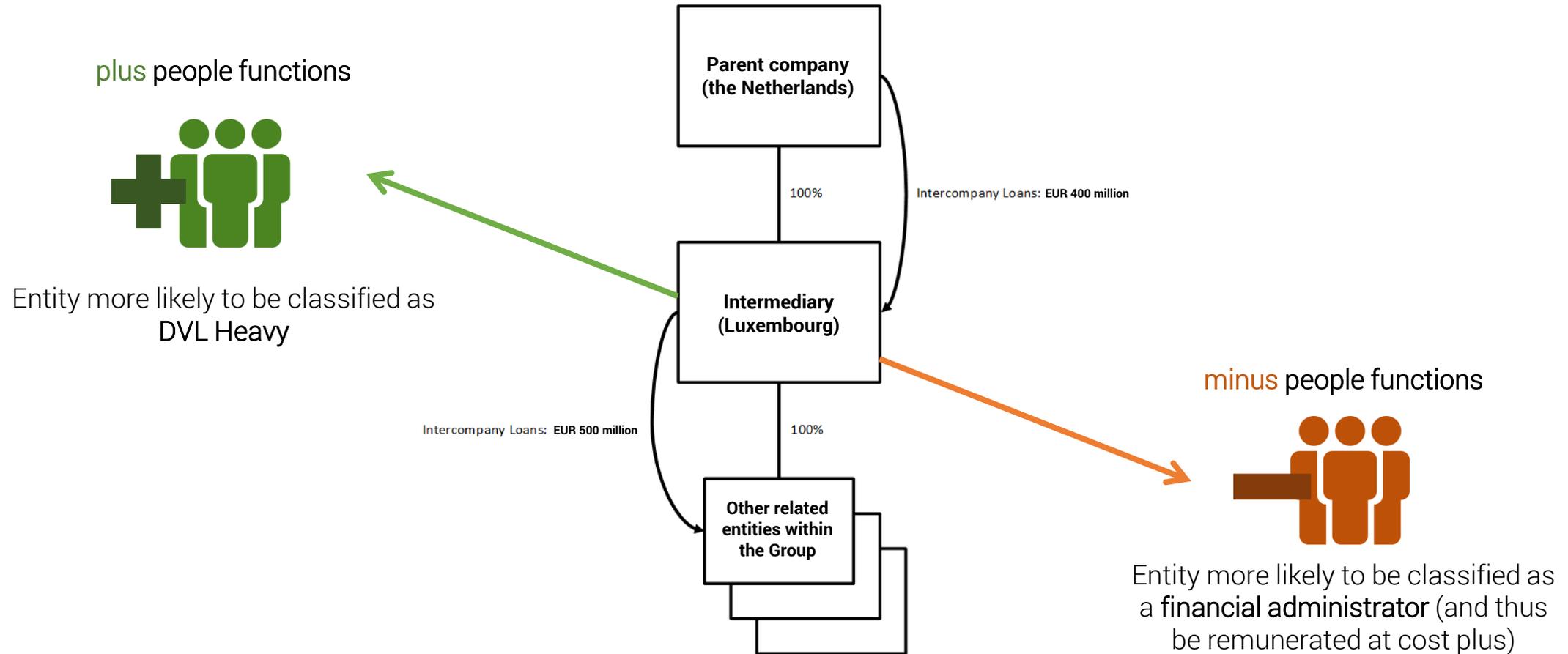
Case study 1

Case Study 1 – Future of DVL Light



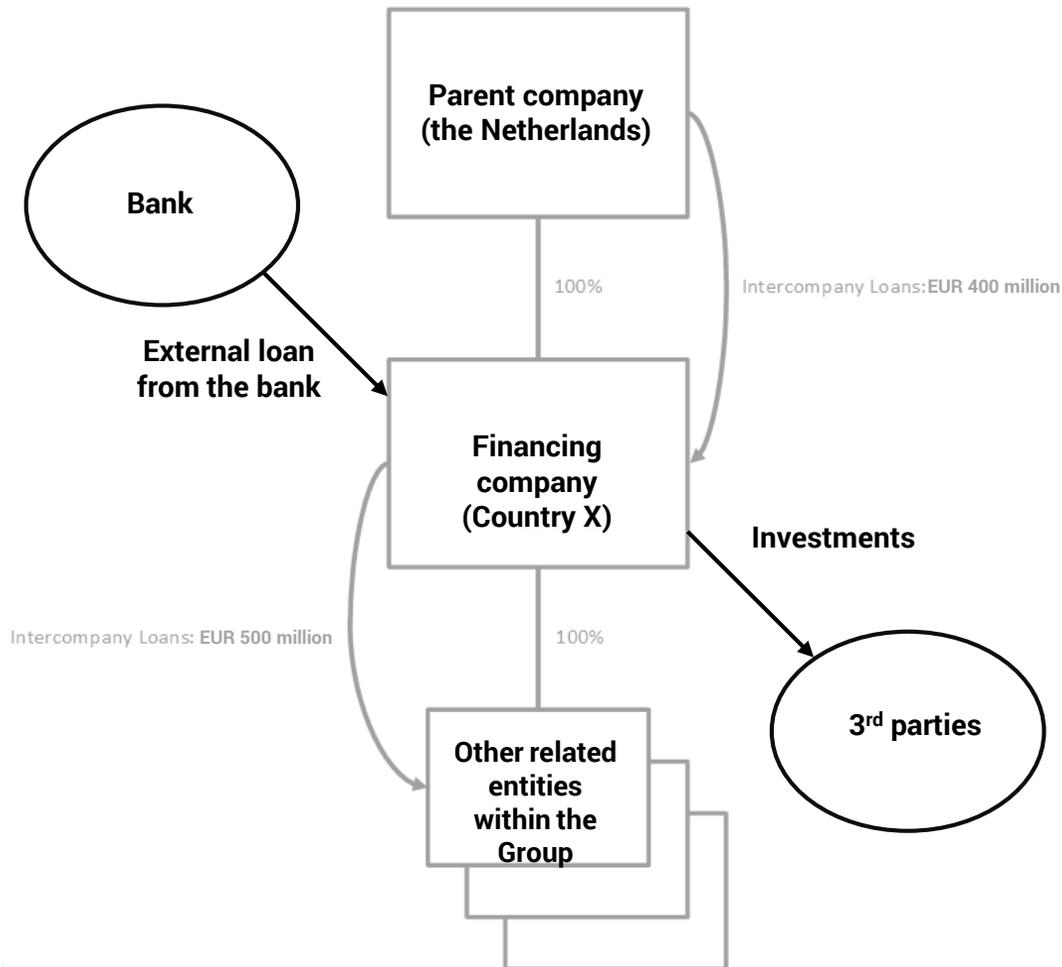
1. The Group is active in the agriculture industry
2. All shares of the intermediary (LUX) will be held by Company A (NL);
3. Company A provides loans to the intermediary currently amounting to EUR 420 million in total ;
4. The entities referred to as “Other related entities within the Group” are located in other European countries
5. All shares of “Other related entities within the Group” are held by the intermediary (LUX);
6. The intermediary (LUX) provides loans to “Other related entities within the Group” currently amounting to EUR 500 million in total ;
7. Of the total amount of EUR 500 million of loans, EUR 70 million of the loans is classified as subordinated and EUR 430 million is classified as unsubordinated;
8. The Group expects the total loan amount to “Other related entities within the Group” to increase by EUR 945.54 million from 2018 to 2022 (EUR 351.10 in 2018, EUR 188.74 in 2019, EUR 210.08 in 2020, EUR 173.84 in 2021 and EUR 21.78 in 2022);
9. Under this Transfer Pricing Report, it is assumed that the allocation between the loan values of subordinated loans and unsubordinated loans stays the same for future years;
10. The intermediary (LUX) runs risk on its equity equal to EUR 2,000,000. In case the intermediary's equity will exceed the above mentioned amounts the intermediary's risk will remain at EUR 2,000,000;
11. In case the intermediary (LUX) pays a guarantee fee in the future, the relevant margin will be increased appropriately as remuneration for this expense.

Case Study 1 – Future of DVL Light



Case study 2

Case Study 2



The financing company is involved in the following functions:

- Finding/negotiating opportunities to receive funding
- Centralized treasury/ cash management functions
- Finding/negotiating opportunities to invest excess funds
- Managing risks - assumes credit, interest and forex risks, and have control over those risks

Such an entity cannot be remunerated as DVL+ with a routine return as management fee on top of the remuneration provided for its intermediary financing function (annual fee + return on equity).

Spread margin needs to be provided to justify an appropriate return commensurate with a profit centre type functionality.

Questions?

TPA Global provides international businesses with integrated and value-added solutions in improving financial performance, operational efficiency, strategic development and talent coaching through a cross-border and cross-discipline team of professionals which identifies the right solutions for customers and targets; efficient and streamlined advisory and implementation processes which cut through operational complexities across functions and borders; and superior customer service and support which proactively anticipate the evolving needs of the clients.

H.J.E. Wenckebachweg 210 . 1096 AS Amsterdam . The Netherlands .
+31 (0)20 462 3530 . tpa-global.com

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