Managing Liquidity in the Time of High Interest: Transfer Pricing Considerations

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The current macroeconomic landscape and financial market volatility push multinationals and investment funds to find alternative sources of cheap(er) liquidity, such as accelerating repayments through short-term upstream and parallel loans and providing financial guarantees to reduce funding costs. Such liquidity management has an impact on the transfer pricing policies adopted by market players, and must be carefully analyzed in view of a developing transfer pricing practice.

Interest rates rose steadily in the market throughout 2022, mainly due to central banks' monetary policies to regain control over worldwide inflationary pressure. Also, from January to December 2022, the 10-year yield of the US risk-free[1] rate increased by 203 basis points (bps), while the 1-year risk-free yield rose more than 427 bps. Similarly, the German risk-free rate[2] increased by 200 bps and 277 bps, respectively.

These developments motivate market players to search for other sources of less expensive financing to meet their liquidity needs. Therefore, it comes as no surprise that the current (re)financing strategies of multinationals and funds seeking liquidity are generally falling into the following categories:
- Upstream loans and parallel loans;
- Provision of financial guarantees to reduce funding costs and limit the interest rate risk of financial transactions; and
- Access to cash through cash-pooling arrangements.

Although it is natural for companies to limit the increase of their borrowing costs, if they fail to factor in the potential tax and transfer pricing aspects, it could lead to additional consequences:
i) Reclassification of upstream loans into profit distributions;
ii) Reclassification of short-term cash positions into long-term loans, in cash-pool arrangements in particular;
iii) Offsetting long-term shareholder loans with short-term upstream ones;
iv) Challenges related to the loans' terms and conditions and how the arm's length interest rates are implemented; and
v) Challenges related to the appropriate level of arm's length remuneration with financial guarantees.

Reclassification of upstream loans into profit distributions

When a multinational considers accessing cash through multiple levels of holding companies, there can be a material delay before the cash ends up where needed. Therefore, it is not uncommon for companies within groups to advance cash to the financing company using an upstream loan. If this loan is reclassified as a hidden profit distribution, the resulting tax cost can be material. As such, it is essential to support the debt nature of the instrument.

Chapter X of the OECD Transfer Pricing Guidelines lists the following characteristics of a debt instrument:
- Presence of a fixed repayment date;
- Right to enforce payment of principal and interest;
- Status of the funder versus regular corporate creditors;
- Source of interest payments;
- Extent to which the advance is used to acquire capital assets;
- Existence of financial covenants and security;
- Obligation to pay interest;
- Ability of the recipient to obtain loans from unrelated lenders; and
- Failure of the purported debtor to repay on the due date or to seek a postponement.

By aligning the upstream loan with these markers and documenting this alignment, taxpayers will be better positioned if they are questioned by tax administrations on transfer pricing.

Reclassification of short-term cash positions into long-term ones

When advancing funds, multinational groups must consider the nature of the entire transaction, or a group of transactions that can be combined. When groups use a cash-pooling mechanism, the cash pool leader, often the treasury center, offsets the excess and deficit positions across the group. Cash pools often have companies that are net borrowers from the pool, and other companies that contribute cash to the pool. These cash contributions are by design limited to the short-term placement of excess cash but can sometimes last for long periods, often materially growing over time.

Tax administrations may try to reclassify short-term cash pooling deposits into long-term loans, looking for higher interest rates and, consequently, higher interest income to be taxed. If successful, this can lead to a secondary adjustment, where the tax administration considers the difference between the short-term interest and the deemed long-term interest was distributed, and applies additional withholding tax that further increases the tax cost.

In another typical case, a financing company could consider financing a long-term loan receivable (e.g., a 10-year loan) with a short-term payable loan (e.g., a 1-year loan with the option of being automatically renewed annually). The tax administration of the country providing this financing may question the short-term nature of the loan payable, and potentially reclassify it as a long-term loan. Again, if successful, such a challenge can lead to secondary adjustments.

Offsetting long-term shareholder loans with short-term upstream ones

A company borrowing long-term funds from the treasury center may also be (temporarily) cash rich from its operations. To accelerate cash recirculation, it could decide to put the excess cash into the cash pool or on-lend it to the treasury center as a short-term loan. Naturally, the short-term interest rate would be lower than the one on the long-term loan.

In these cases, the local tax administration may try to reduce the nominal of the long-term loan with the amount of the short-term one to reduce the interest charge. This is especially pertinent if the long-term loan has a clause allowing an anticipated prepayment that the taxpayer did not act upon.

Even if individual transactions are properly delineated, administrators could refer to paragraph 1.38 of the 2022 revision of the OECD Transfer Pricing Guidelines, which states that independent enterprises need to "compare the transaction to the other options realistically available to them" and would only enter into a transaction "if they see no alternative that offers a clearly more attractive opportunity".[3]

Challenges related to the loans' terms and conditions and how the arm's length interest rates are implemented

The terms and conditions of an intragroup loan need to be at arm's length and are considered when determining the arm's length interest rates. Some contractual clauses must be monitored to assess any consequences that could be triggered during the loan's lifetime.

Some examples include the option of the borrower to repay the loan early before the maturity date, the option of the lender to demand the repayment before the loan's maturity date, and options allowing the loan's outstanding amount to be converted into shares at the level of the borrower or the lender.

For example, if the borrower has the option to repay the loan early before maturity, not exercising this option when market rates benefit the borrower would be contrary to exploring the "next best option", because the borrower could repay the loan and look for financing against lower interest rates. Similarly, when a lender can demand early repayment from the borrower if the interest rate on the instrument is below market rates, the lender would be expected to exercise this option to receive a higher return on the market.

Given the market's current interest rate fluctuation, the set-up of contractual clauses is crucial, and loan agreements and standardized templates should be reviewed.

Challenges related to the appropriate level of arm's length remuneration with financial guarantees

Financial guarantees are often used to reduce financing costs. An often-discussed aspect of these transactions is the arm's length remuneration for the provision of this guarantee. Independent from the remuneration, financial guarantees and limited recourse clauses, especially their terms and conditions, may impact the functional profile of the taxpayer performing intragroup financing activities and the assessment of its arm's length remuneration. Where the loans' terms and conditions evacuate the risks of the financing activities, the taxpayer's expected remuneration may be affected, resulting in further tax exposure or undesired gaps between the entity's contractual position and the economic reality.

What can multinationals do in this current situation?

To better manage liquidity needs when market volatility is high and be better prepared in case of transfer pricing related requests from various tax administrations, taxpayers could consider proactively adopting the following steps:
- Monitor existing loans;
- Define, set up and document a clear financial transaction transfer pricing policy to strengthen the transfer pricing defense position in light of strengthened requirements around the world;
- Increase cooperation between treasury and transfer pricing teams to ensure the interest rates are applied according to the transfer pricing policy; and
- Set up a treasury management system (TMS) to improve monitoring, documentation, traceability and consistency between tax and treasury needs.

A TMS is a software-based system that automates a multinational's treasury operations. TMS solutions typically provide the following:
- Accurate cash visibility and modeling/forecasting
- Debt and investment modeling
- Financial instruments management
- In-house banking and external bank account management
- Multilateral netting
- Robust workflows
- Risk management
- Data analytics and reporting

They also provide task automation and integration with companies' enterprise resource planning (ERP) systems via API to facilitate accounting.

By deploying a TMS to manage their cash, multinationals and investment funds can better identify opportunities to redeploy their liquidity, leading to reduced cost of funding while increasing quality and better managing their risk.

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1) United States Government Benchmark Yield Curve, (0#USBMK=), Refinitiv Eikon Database.
2) German Government Benchmark Yield Curve, (0#DEBMK0=), Refinitiv Eikon Database.
3) OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022*, January 20, 2022.

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Dates prévisionnelles d'application	Nouvelles publications Décembre 2022
Projet initié	**Réforme Edinburgh – Royaume-Uni** Mi-décembre 2022, les autorités anglaises ont publié un vaste programme de réformes du secteur financier, appelé « Edinburgh Reform ». L'idée sous-jacente à ce programme est de faire évoluer la réglementation anglaise post Brexit et ainsi de se réapproprier sous un angle national les différents textes de réglementation et organisation financière qui ont été introduits aux cours des ans via leur participation à l'Union Européenne. Cette réforme vise en pratique à une refonte substantielle et à un ajustement aux besoins du Royaume-Uni des différentes réglementations. Toutefois, il s'agit bien d'un programme de réformes et non pas d'une révolution du jour au lendemain. Ces réformes nécessiteront des adaptations légales, notamment de la loi sur le secteur financier (FSMA), ainsi que de nouveaux positionnements de la FCA et/ou PRA, les deux autorités majeures Outre-Manche. Ce programme est naturellement très impactant pour les entités financières basées sur le territoire. Elles verront les règles du jeu évoluer, tant dans leur organisation/structure de gouvernance que dans leurs relations clients. Même si les programmes de réformes européens peuvent impacter les entités anglaises, il ne faut pas sous-estimer les conséquences pour les banques, assureurs ou sociétés de gestion (Manco/AIFM) de l'Union qui ont de fortes relations avec le Royaume-Uni, que ce soit via la présence d'une succursale, filiale, distribution locale voire accès au marché pour trading, produits dérivés, ou encore délégation/outsourcing d'activités. En termes de planning, le programme est initié, mais les réformes sous-jacentes devraient s'étaler sur plusieurs années. Nous pouvons identifier des impacts sur le ring fencing (protection en cas de faillite), la qualification des dirigeants, la revue des PRIIPs, l'organisation des marchés (dérivés, clearing…), ainsi que des ajustements dans mifid, crédits, titrisations, solvency. Et enfin une revue du rôle des autorités FCA et PRA qui en sus de leur rôle de protection et organisation du marché anglais auront un mandat complémentaire visant à assurer la compétitivité de la place financière. En conclusion, ces réformes et ce package s'inscrivent dans la continuité de mesures déjà prises ou en voie d'être prises dans les domaines ESG et digitaux par exemple, mais ici réunis sous une bannière commune dans un programme qui n'est pas sans rappeler les différents plans européens tels que CMU, ou le plus ancien FSAP (financial services action plan).
Nouveau projet Commission Européenne	**Revue des règles et procédures en matière d'insolvabilité** Au même moment où le projet « Edinburgh Reform » sortait, la Commission européenne initiait pour sa part plusieurs réformes importantes dont une revue de EMIR (produits dérivés, visant à rapatrier le clearing et trading dans la sphère de l'Union), une revue des règles d'insolvabilité. Nous nous proposons ici de nous pencher sur cette dernière, qui est potentiellement un élément important visant à faciliter les activités transfrontalières. Sur le plan calendaire tout d'abord, le projet est ici initié par la Commission, ce qui signifie son passage par les différentes étapes inter-institutionnelles, transpositions etc. donc un délai avant la « live date » (probablement 3 ans), mais au moins le projet est initié. Ce projet vise à répondre à un problème récurrent en Europe qui présente un frein important aux activités transfrontalières, entre autres dans les activités de crédit. En effet les procédures en matière de gestion des faillites et d'insolvabilité restent très nationales, ainsi une banque prêtant à une entité dans un autre état membre est soumise à un risque important en cas de faillite de sa contrepartie. L'idée de ce projet est d'aligner les pratiques, processus et communications de sorte qu'un créditeur dans un état membre ne soit ni avantagé ni désavantagé par rapport à un autre situé dans un état membre différent. Concrètement, la proposition prévoit : • d'harmoniser les modalités des actions révocatoires, • d'améliorer la traçabilité transfrontière des actifs en facilitant l'accès des administrateurs judiciaires aux registres des actifs, • de permettre la préparation et la négociation de la vente de l'entreprise ce qui contribuera à empêcher la dépréciation rapide de l'entreprise (effet « fonte du glaçon »), • d'exiger des dirigeants d'entreprises qu'ils demandent l'ouverture d'une procédure d'insolvabilité sans retard injustifié, • d'améliorer la représentation des intérêts des créanciers par la création de comités de créanciers, • et enfin de rendre plus transparentes pour les créanciers les principales composantes des régimes nationaux d'insolvabilité, et notamment les critères de déclenchement d'une procédure d'insolvabilité et la hiérarchie des créances, afin de réduire les coûts de la recherche d'informations pour les investisseurs transfrontières. Ce dernier point est dépendant de la manière dont le texte final sera concocté, et potentiellement intéressant pour les acteurs luxembourgeois actifs crossborder.

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