

OECD has finalised guidelines on transfer pricing in financing transactions (2) (3/14/20)

To pick up where we left off about the final version of the OECD transfer pricing ("TP") guidelines for financing transactions, this article explores the rest of the conditions to be considered in terms of accurately defining a proposed financing transaction between related parties before setting its price (value). It is necessary to clearly define the transaction itself as well as its substance, purpose and conditions, and whether it meets the criteria for a financing transaction.

- *The economic context of the transaction.* To accurately define a financing transaction, we need to conduct a detailed analysis of its circumstances against five comparability factors: contractual terms, functional analysis of the transaction, financing terms, economic (market) conditions, and strategy. Unlike the draft guidelines, their final version emphasises the significance of circumstances surrounding the business strategies adopted by the parties to the transaction. For example, an independent lender might be willing to lend money to a company undergoing a reorganisation or merger on terms that would not be offered in a different situation, i.e. if the company continued in business unchanged.
- *Credit rating.* The final guidelines describe in more detail the steps to be taken as part of a credit rating analysis, including information on how the lender's and the borrower's credit ratings are determined and any circumstances affecting them (reorganisation, startup etc). The OECD emphasises the scope for using credit ratings issued by independent credit rating agencies and analysing the qualitative and quantitative criteria by using publicly available tools and methodologies to replicate the process applied in determining a credit rating according to the guidelines:

"If a member of a multinational group has access to a credit rating published by an independent credit rating agency, this may play a major role in analysing intragroup financing transactions. However, such credit ratings are mostly available only to the entire group or the holding company. An approach often taken in determining a company's credit rating involves conducting quantitative and qualitative analyses of the company's individual characteristics and circumstances, using publicly available financial instruments or the methodology of independent credit rating agencies to replicate the process applied in determining the group's overall credit rating. This approach involves considering any creditworthiness improvement the company might obtain from its group membership."

It is also possible to extend the group's overall credit rating to its members, but this is considered appropriate only if the following conditions are met:

1. The company's individual credit rating and indirect guarantees from its group membership do not produce an objective outcome;
2. The company receives a significant benefit from indirect group support;
3. The company's creditworthiness is not substantially different from the group's overall indicators.

Key takeaways and recommendations

- The OECD TP guidelines for financing transactions offer support when it comes to setting an objectively reasonable price (value) for a transaction. Publication of the guidelines underlines the topicality of intragroup financing transactions and the need for correct TP.
- Credit rating is a key factor in determining the interest rate applicable to a financing transaction and is increasingly scrutinised by the State Revenue Service during a TP audit. With no single format

adopted for determining a credit rating, companies have some objectively reasonable room for manoeuvre.

- If the borrower has obtained a credit rating from an independent credit rating agency (such as Moody's or Standard & Poor's) this can be used in the TP analysis of financing transactions. Unfortunately very few companies in Latvia have obtained such a credit rating – those are mainly listed multinationals. There are also some other ways to determine a company's credit rating, for example, the multinational group can devise its own credit rating methodology to be used in determining the creditworthiness of the group companies. In that case, all credit rating calculations must be reasonable and the group must be able to explain why each of the quantitative or qualitative criteria was selected. PwC has extensive experience in devising credit rating methodologies, yet one size does not fit all, in particular where the group companies have diversified their business into various industries.
- As with other types of related-party transactions, the main measure of objectivity of prices applied in intragroup financing transactions is the ability to validate them, but the validation must be based on relevant facts and circumstances.