

Financial Transactions

Transfer Pricing

August 2010



Contents

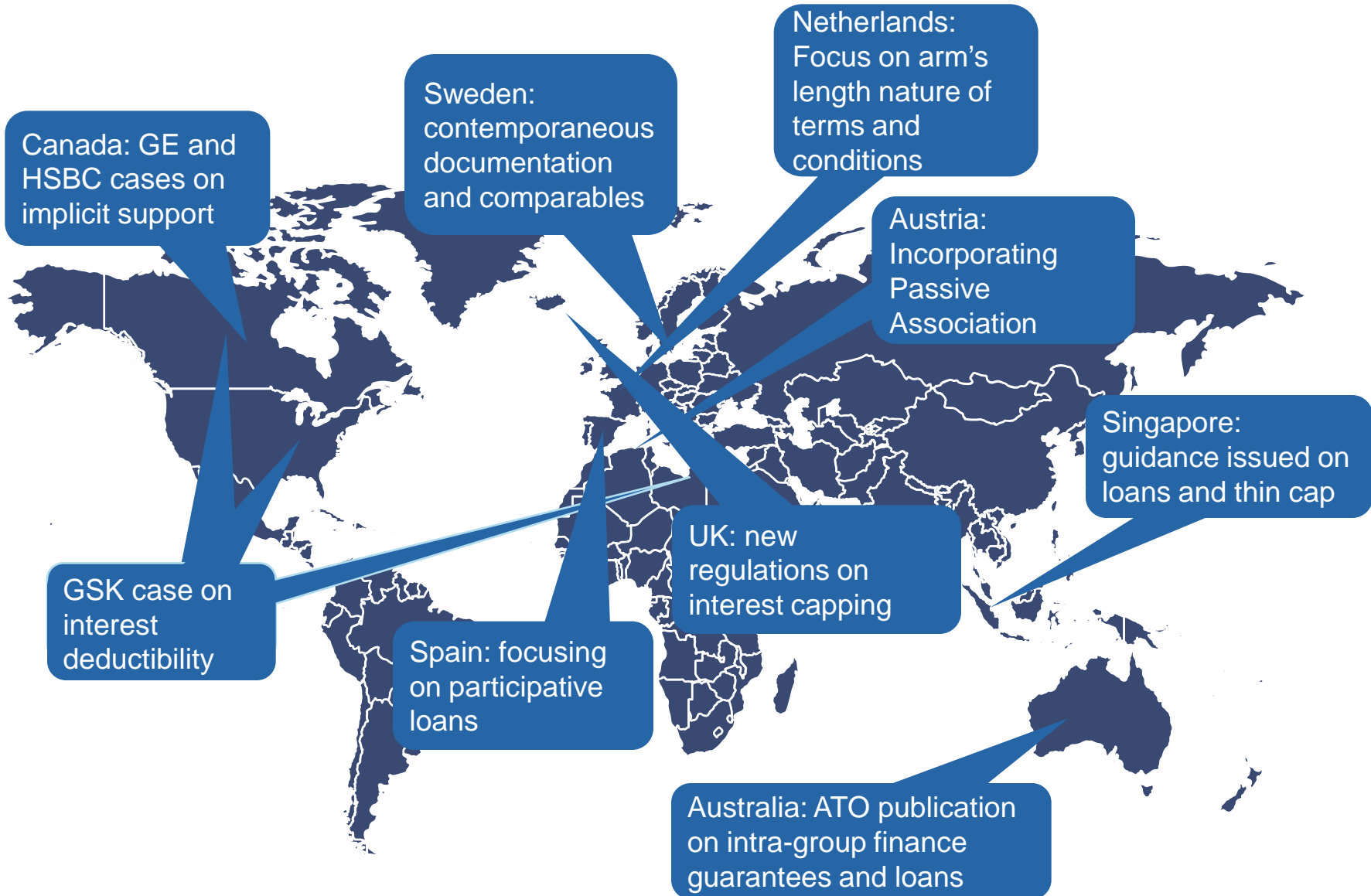
- Background to inter-company financial transactions
- Inter-Company Loans
 - Issues and pricing case study
- Guarantee Fees
 - Issues and Pricing Methodologies
- Thin capitalisation
- Way Forward



Transfer Pricing for Financial Transactions - Why is this relevant today?

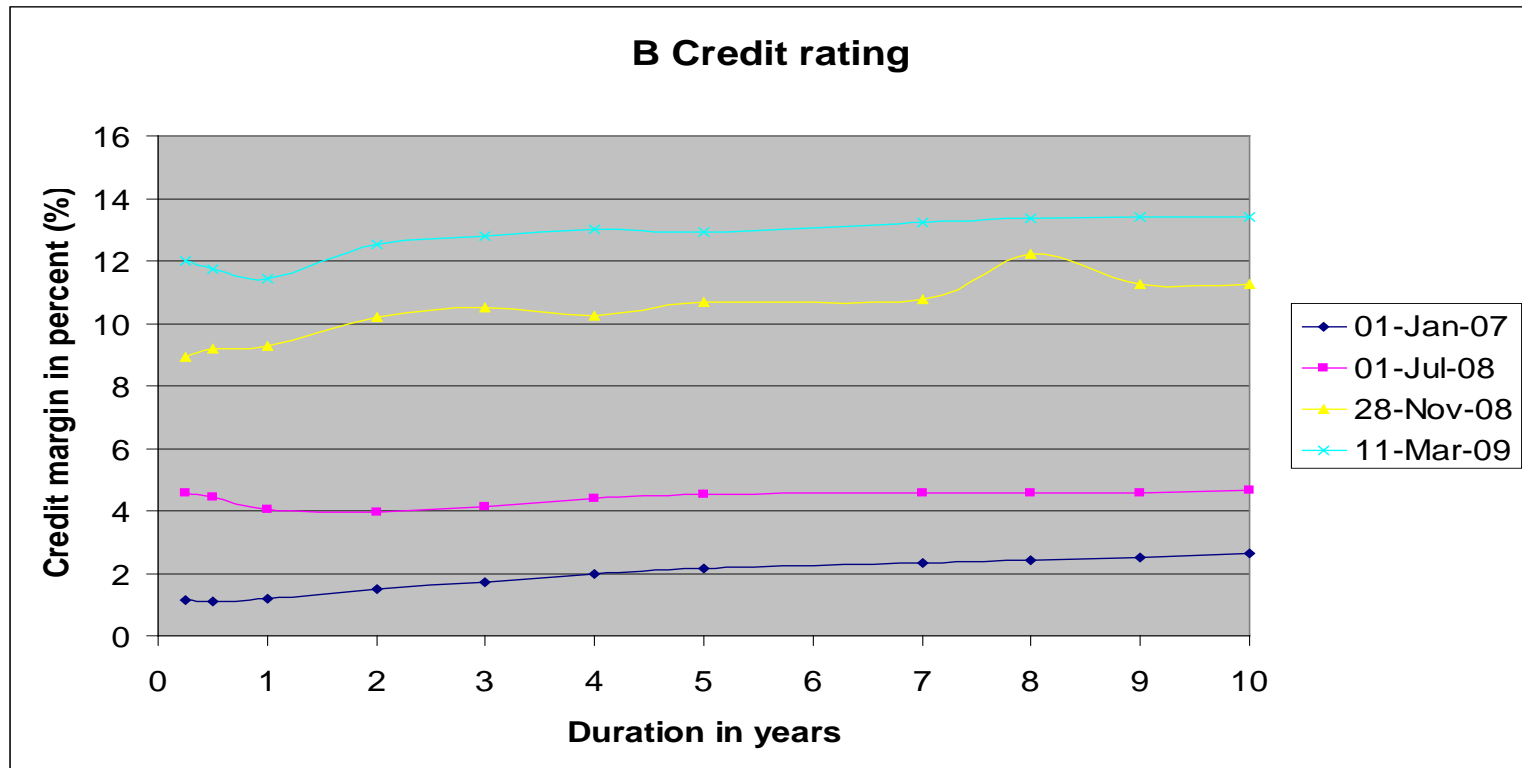


- Robust economic growth in India leading to innovative inbound funding structures
- Indian MNCs expanding overseas through offshore debt and SPVs
- Large exposures mean increased need for sophistication in compliance
 - Authorities have taken notice
 - Ad-hoc approaches unlikely to remain sustainable
- Well conceptualised capital structures can play an important role in tax planning





Explosion of credit risk premiums



Specific characteristics of debt instruments could manifest this further

Inter-company Financial Transactions-

Issues which come up in practice



- Failing to document loan or credit guarantee agreements
- Loans without a final maturity date
- Using arbitrary interest rates/guarantee fees
- Basing interest rates/guarantee fees on casual analysis (e.g. high-level bank quotations)
- Failure to update interest rates (e.g. floating interest rate agreements with 'stale' rates)
- Failure to adhere to terms of credit agreements (e.g. not paying interest when due)



Step 1. Determine the Level of Risk for the Borrower

(credit rating on a “stand-alone” basis)



Step 2. Adjust the Risk for Specific Debt Characteristics

(e.g. term of loan, currency, rate base (fixed/ flexible), convertibility, options (call/ pre-pay), collateral, debt risk rating)



Step 3. Determine Interest Rate Based on Market Sources

(Comparable Uncontrolled Price (CUP) Analysis/ Benchmarking)

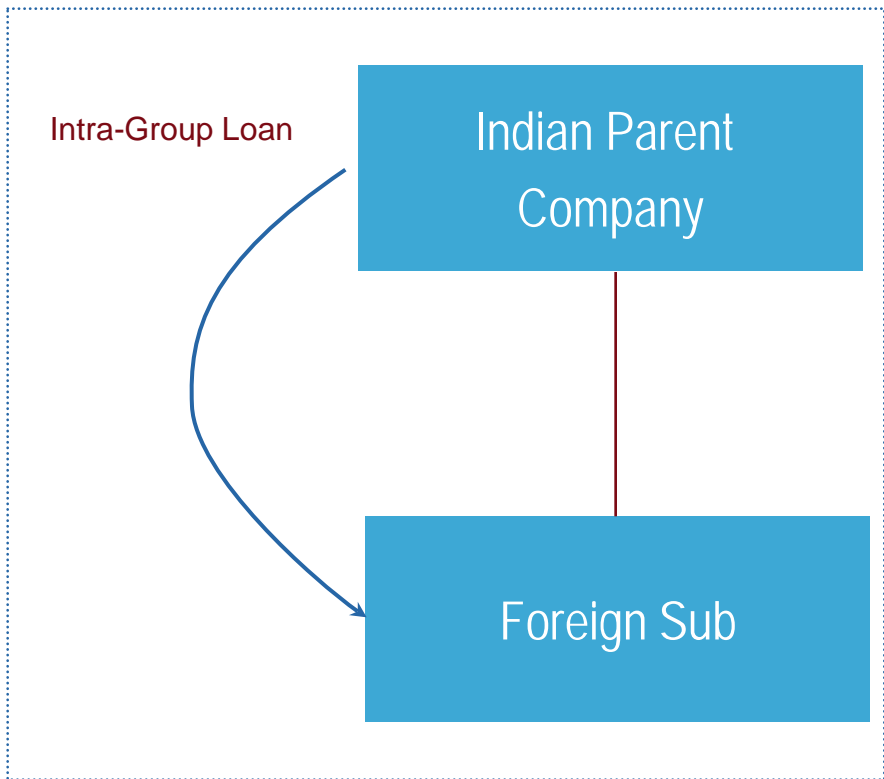
Setting arm's length interest rates on inter-company loans:



Case study

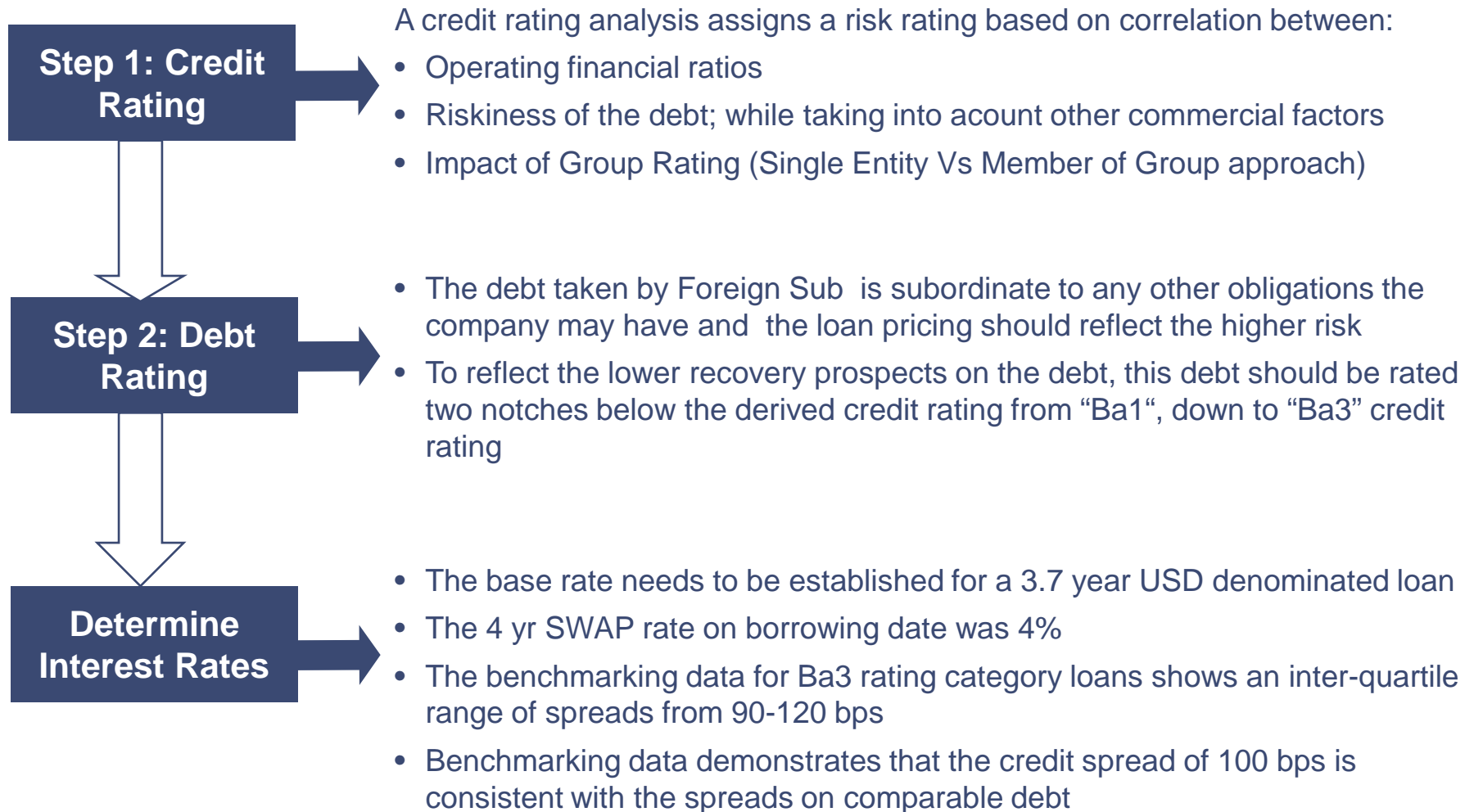
To finance its on-going business operations, Foreign Subsidiary received a loan from its Indian parent. The terms of the loan are the following:

Borrower:	Foreign Sub
Currency:	USD
Amount:	USD 100 mio
Issue Date:	1-May-07
Maturity Date:	31-Dec-10
Term / Maturity	3.7 years
Rate (Long term)	5%, fixed
Rating:	Not rated
Repayment:	On Maturity





Case study (Contd..)





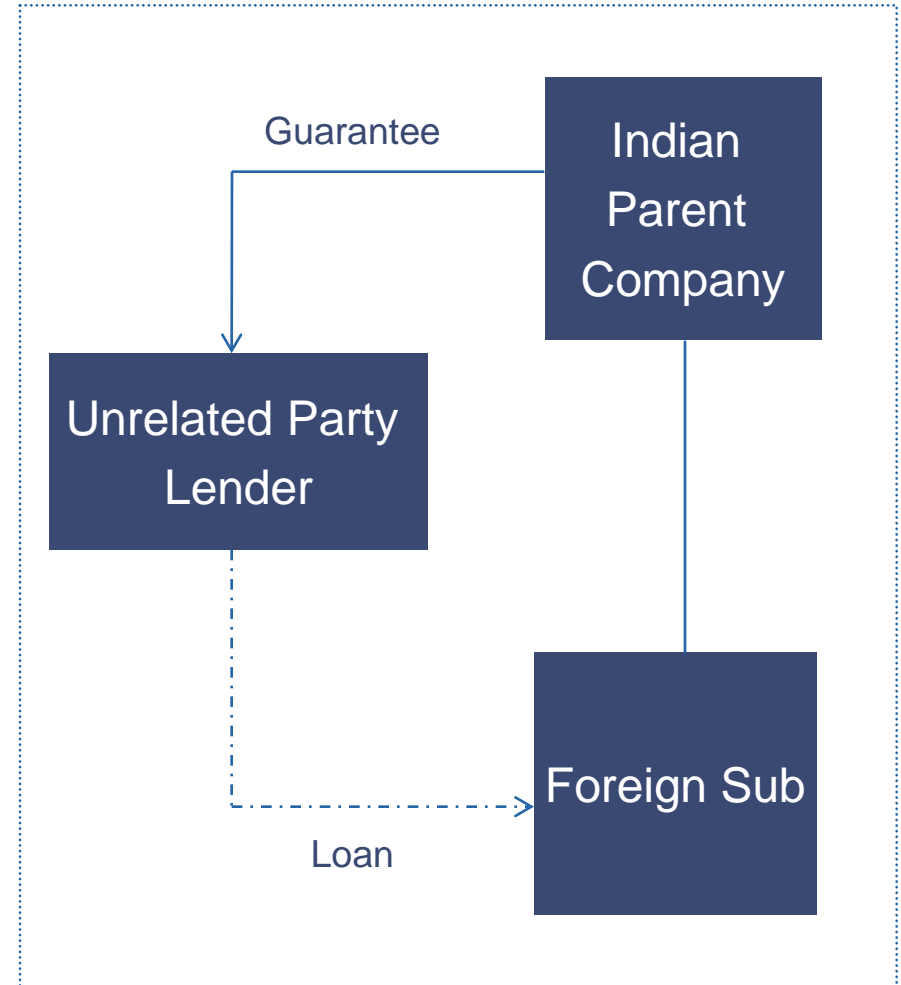
- Credit / Financial guarantee provides credit enhancement to the guaranteed party, either:
 - to access cheaper funding or
 - to access capital markets

- Types of guarantee in an inter-company context:
 - Explicit Guarantee – direct benefits
 - Implicit Guarantee – implicit benefits

Setting fees for Guarantee transactions – Case study



Guarantee to :	Foreign Sub
Currency:	USD
Amount:	USD 100 mio
Issue Date:	1-May-07
Maturity Date:	31-Dec-10
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Approaches for determination of arm's length price – Guarantee Fees



- No prescribed regulation across the world for benchmarking guarantee fees
- Most appropriate approach
 - CUP Approach
 - Risk of Loss Approach
 - Valuation of benefit Approach / Interest Savings approach



- Debt : Equity mix in relation to arm's length borrowing capacity
- Revenue focus on gearing ratios and interest coverage
- Recharacterization of debt as equity in terms of OECD guidelines
- Tax Impact of Debt-Push down Structure



- Global guidance and recent Indian rulings clearly emphasise the relevance of the subject
- The proposed Direct Tax Code contains anti avoidance provisions including re-Characterisation of transaction, leading to thin capitalization
- Robust analysis using scientific pricing models would be critical towards a defensible strategy in structuring financial transactions and planning
 - India and overseas angles relevant to factor

Thank You

