THE PITFALLS OF DEBT TRANSFER PRICING

YOU CAN AVOID THE HAZARDS THAT COME WITH CREATING DEFENSIBLE INTERCOMPANY DEBT ARRANGEMENTS FOR US SUBSIDIARIES. MARK NICHOLS, GREG JOHNSON AND ROBERT WEISS EXPLAIN HOW

National tax authorities are under increasing pressure to capture 'lost' revenues, while multinational companies (MNCs) are expected to efficiently manage their global tax profile. The resulting tension explains why MNCs are under heightened scrutiny with respect to how they manage, structure and document their intercompany debt arrangements.

Despite efforts by the Organisation for Economic Cooperation and Development such as the Base Erosion and Profit Shifting initiative, MNCs are largely on their own when it comes to determining acceptable capital structures for, and accompanying interest deductions at, their US subsidiaries. The existence of relatively large, foreign-controlled US subsidiaries, coupled with significant differences in national marginal tax rates, create a high-stakes environment for disagreement.

While an MNC's home tax authority may be quite comfortable with significant debt at (and the taxable interest income from) a US subsidiary, the Internal Revenue Service (IRS) has made it very clear it will aggressively challenge what it considers to be excessive intercompany debt.

Extraordinary fiscal incentives are motivating the IRS to intensify its efforts against excessive intercompany debt. It could potentially reap billions from current cases against the likes of security company Tyco and manufacturer Ingersoll Rand. This is despite losing a similar $363m court case to soft drinks giant PepsiCo and a $932m case to utility company Scottish Power in 2012. MNCs are already painfully aware that the IRS is becoming more active and better armed to tackle these debt-equity disagreements.

Against this backdrop of a more aggressive IRS, MNCs must also navigate their US debt profile through a complex overlap of thin capitalisation rules and other tax code provisions. Interest expense of less than 50% of adjusted taxable income (ATI) and/or a debt-to-equity ratio of less than 1.5 to 1 provides some comfort, but these guidelines are not true safe harbours. The ultimate test of what constitutes an appropriate amount of intercompany interest expense – the 'arm's-length' basis – remains unchanged. Companies need to demonstrate and document that their intercompany debt could have been issued by the subsidiary as a 'stand-alone' entity to third-party investors (bank or bond) at the time, in the amount, at the price, and on the terms, indicated. The analytical sophistication required to establish this arm's-length basis has substantially increased over the past few years.

A few pages from a bank supporting indicative credit ratings or debt pricing no longer constitute cogent stand-alone documentary evidence. Putting together strong, convincing evidence of a subsidiary's ability to issue stand-alone debt at a given price requires the specialised focus of both rating and capital-markets professionals, working in sync with tax, legal and treasury specialists. While this array of talent may seem excessive for determining the arm's-length basis for a subsidiary financing, the costs of losing a tax dispute many years later dwarf the costs of getting it right at the outset.

Under any scenario, pitfalls abound in creating defensible debt-transfer pricing strategies. Here we highlight specific issues that MNCs and their foreign subsidiaries should focus on as they manage their intercompany debt positions.

Credit quality assumptions

A complete and accurate stand-alone credit assessment of the MNC's borrowing subsidiary is a vital first step in determining that subsidiary's current and future capacity for debt and interest expense.

An implied credit profile analysis begins with determining the business risk profile of the stand-alone entity. Real and expected changes in industry dynamics, market share, cost position, brand value, technological advantage, long-term contracts, material lawsuits, regulatory restrictions and actions, as well as the general economic and business outlook, affect the credit profile of a subsidiary long before its financials change, either positively or negatively. These considerations, along with the impact of fully loading a subsidiary with the costs and challenges of running a separate foreign organisation, must be taken into account before analysing its current stand-alone financial profile.

Simply using a rating agency's credit ratio statistics to derive an implied rating, however, will often lead to incorrect conclusions. Rating agencies make it very clear that while ratio comparisons are a vital tool, they are, by no means, the most important variable in deriving a credit rating. Ratio averages only establish norms, which, taken alone, can be misleading when determining an implied rating, resulting in the need to factor in additional considerations.

Volatility of results, recent and projected financial performance, management strategy, credibility, and financial policy – together with perceived financial and operational flexibility – all contribute to the ultimate, subjectively derived, implied credit profile. (This profile, meanwhile, will drive the implied pricing on the issuer's debt.) So these factors cannot be treated lightly and require the specific expertise of professionals with the experience and judgment to address them convincingly.

While incomplete or inaccurate credit analyses create obvious problems, outdated assessments are equally concerning. Reliable, stand-alone credit assessments must incorporate both quantitative and qualitative components in determining a subsidiary's credit profile. Such assessments must factor in underlying trends and be ongoing to evaluate potential changes in the subsidiary's credit should there be serial financings.

Credit profile analyses can be challenging for MNCs with multiple subsidiaries in a single tax jurisdiction. Such entities may have intercompany financials that do not consolidate into a single tax-paying entity at the country

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level. Operationally, they may not even have a centralised management team with a traditional head-office support function. This creates challenges in assessing the issuer's implied stand-alone credit profile, while explicitly accounting for the expected costs of having such a structure. Challenges aside, at the time a subsidiary borrows from its MNC parent, credible, current and complete credit profile assessments will form the critical base from which any defence of intercompany financings begins.

Timing and economic rationale errors

Courts have been clear on the need to associate long-term borrowings from a parent with a subsidiary's appropriate capital expenditure and financing needs. Whether related to procurement of fixed assets, expansion of the overall business, or funding of a distribution or acquisition, it is necessary to establish the use of proceeds that is 'appropriate' for the incurrence of intercompany debt. Companies should not approach intercompany debt as an annual budgeting occurrence, but as financings that are directly related in a demonstrable fashion to the subsidiary's capital needs.

That said, a true stand-alone issuer might well decide to annually access long-term capital markets to extend short-term financing activity. Likewise, high-yield issuers are often on the lookout for opportunities to term out short-term debt, knowing the window of opportunity to secure medium- to long-term financing may be fleeting. In such instances, the tax statutes and court decisions may not perfectly reflect modern corporate finance practice, despite their espoused reliance on stand-alone, third-party pricing practices. The key to mitigating debt transfer pricing risks lies in proactively evaluating all options well before the financing. Strategically targeting a single B credit profile is vastly different from targeting a BB profile, both in terms of the size of deal the market could absorb as well as the coupon required for those deals. While more debt at a higher coupon rate may seem an attractive tax strategy, it is important to consider deemed increased execution risk, greater volatility, and refinancing risk, combined with the scarcity of pricing 'comparables'.

Structural problems

Many intercompany debt transactions are put in place using vaguely comparable public benchmarks to justify amounts and pricing. Insufficient attention is often paid to, or inadequate adjustment is made for, differences in secured versus unsecured financings, off-balance sheet liabilities, pension liabilities, securitisation activity, maturity, covenants, ranking, enforceability and prepayment provisions. Prepayment provisions are often overlooked but remain important given the need for the subsidiary's management to act in an intelligent fashion to refinance outstanding debt should such refinancing provide economic value.

One of the most important structural considerations that is often overlooked is the adjustment or 'notching' for the structural subordination present in the capital structures of most high-yield issuers. Non-investment-grade issuers often reserve their senior debt capacity to fund critical working capital needs via secured bank lines, relegating long-term unsecured bondholders to a structurally subordinated position. MNCs with foreign subsidiaries that have an implied stand-alone non-investment-grade 'enterprise' rating would be expected to have senior secured bank loans and/or credit facilities. Proper analysis assumes that unsecured debt issues could be notched one or two levels lower than that of the 'enterprise'. This adjustment is often overlooked by analysts who are employing simplistic, ratio-driven assessments of issuer credit profiles.

Market miscalculations

Finding and documenting evidence that supports both the amount and interest rate at which a subsidiary could theoretically issue long-term debt is a complicated endeavour. Infrequent comparable 'new issues', combined with historically low secondary trading activity, has made it more challenging to 'tie' a subsidiary's new intercompany debt issue with comparable stand-alone issues in the debt capital markets.

For their part, MNCs would much prefer to fund their subsidiaries as needed and not when a competitor in the same industry happens to be doing a public debt deal. This reality places a premium on retaining debt capital market specialists who bring their professional judgment to bear in assessing the appropriate size, structure and pricing of an impending issue, based on:

- Careful analysis of current market conditions.
- Actual transactions from issuers with similar business and credit profile characteristics (even if not direct comparables), combined with –
- Knowledge of current investor preferences/appetites.

Such specialists may evaluate how changes in secondary trading and/or loss-recovery ratios are likely to impact a prospective issue. A form of 'comparable analysis' that evaluates rated companies within a similar industry and/or other rated companies with similar credit profiles is critical to the pricing process. Likewise, capital markets experts assess a given company's prospects in the light of actual market conditions, when opining on price and/or feasibility.

Documentation deficiencies

Incomplete and inaccurate documentation, including inconsistent nomenclature, has proven very costly to MNCs in the past. Legally enforceable, robust, market-based loan agreements running between the MNC parent and its borrowing subsidiaries are a necessity in today's tax enforcement environment.

Equally important is detailed and convincing documentation of the need for the borrowing, the expectation of repayment, the market justification for the amount, interest rate on the borrowing, and evidence that management of the subsidiary would consider such a borrowing appropriate and beneficial to their enterprise on an arm's length basis.

This last point addresses the concern that not only must the market be deemed willing to do the deal but management of the stand-alone subsidiary must find it a reasonable transaction as well.

Projections that establish the subsidiary's expected ability to repay the debt as scheduled are highly recommended. Inconsistency as to whether national tax authorities and courts expect debt to be fully amortisable, or not, unfortunately increases the defence risk for MNCs. Evidence exists that the IRS and US courts operate from the premise that intercompany debt should eventually be repaid. Put another way, they expect the company's cash flows to support the debt repayment over the term of the issue.

While fully amortising debt is contrary to the standard corporate finance practice of maintaining a 'tax-efficient' balance sheet with stable debt ratios over time, this perspective is consistent with the need of national tax authorities to not only maximise tax receipts, but also to maintain a bright line between 'debt' and 'equity'.

Carefully navigating the above will require that issuers are able to justify the debt (and subsequent refinancings) by using cash flow analyses and corporate finance theory while arguing what a 'reasonable' person would do in managing an issuer's debt position.

Risks, rewards and realities

The considerable gap between marginal corporate US tax rates and those of other developed countries compels MNCs to take full advantage of interest deductibility on inbound US intercompany debt.

This may or may not result in overall debt levels that conform to what is deemed appropriate by the IRS.

Unless there is Congressional action to overhaul the US tax system, it is almost certain that intercompany US subsidiary interest expenses will increase over the coming years.

Increased scrutiny by the IRS is sure to follow, given budgetary constraints and the massive revenue potential of successful disallowance.

While legal and accounting expertise can help to address many of the pitfalls that have been detailed above, an MNC with sizeable intercompany debt levels would also be well advised to retain credit rating and capital markets specialists. This is to assist in thoroughly documenting both the stand-alone credit profile and the pricing of its intercompany debt.

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occurrence, but as financings directly related to the subsidiary's capital needs

NOTEWORTHY COURT CASES

The vast majority of disputes between MNCs and national tax authorities are resolved out of court. That said, the larger the dollar amounts of intercompany debt and related interest expense, and the more complex the debt arrangements, the greater the chance there will be heightened tax scrutiny.

Within the last few years, there have been several large court cases that both highlight the risks involved and provide indications of the direction of current enforcement strategies. While a thorough discussion of these cases is beyond the scope of this article, we believe that much can be learned from the perspectives of the tax professionals involved in these cases. Below is a sample of their observations, taken from an article by Joe Dalton in the *International Tax Review* in February 2013:

HEATHER SELF, tax specialist at law firm Pinsent Masons and formerly director of group taxation at Scottish Power:
"It is important to understand what you want to achieve from the outset and make sure you have the advisors who could potentially take the case all the way through to litigation, if there is a possibility it could go that far."

MIRIAM FISHER, tax counsel at law firm Latham & Watkins. Acted for Scottish Power while at her previous firm Morgan Lewis & Bockius:
"We had an expert in the energy sector of the debt capital markets because, had Scottish Power gone out into the market to finance this acquisition with debt rather than doing it internally, we argued they would have done it through a debt capital markets transaction… We knew the IRS was obsessed with third-party lending so we had someone from the energy sector who said this would have made a very attractive offering."

PAUL MORTON, head of group tax at publishing company Reed Elsevier:
"This is a very technical area, especially in terms of how the financial world assesses credit and appropriate leverage… What is interesting is treasury people, credit experts, rating agencies and banks speak a very different language and have a different frame of reference from tax people and lawyers, and there is a bigger gulf to cross than I think is probably apparent to many people."