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Treasury Operations and Transfer Pricing

Technical commission
" Transfer Pricing
in Treasury"

EUROPEAN ASSOCIATION
OF CORPORATE TREASURERS

TREASURY, RISK
AND FINANCE
PROFESSIONALS
ACT

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Foreword

The role of the corporate treasurer has evolved over the past 15 years from dealing with cash management to setting and applying group funding policies. Therefore the Corporate Treasurer is in the perfect position to set the group transfer pricing policy for Treasury operations and support the documentation of the group policies.

There are two categories of intra-group transactions which potentially require the Corporate Treasurer to apply transfer pricing principles.

Intra-group transactions where Corporate Treasurers have limited influence on the pricing, for example:

- sales of semi-finished and finished goods;
- use of intellectual assets such as patents, trademarks, and know-how;
- provision of centralized and regionalized services.

These transactions have a direct effect on group entities earnings before interest and tax and therefore impact on the entities cash flows and balance sheet cash position.

Intra-group transactions where Corporate Treasurers have a direct influence on the pricing:

- cash management;
- guarantee fees;
- interest rates;
- forex management.

This technical guide looks to explain some of the General Principles of Transfer Pricing and links those principles to the treasury operations. In addition we have added appendix 1 which looks at more general transfer pricing issues for goods and services.

Acknowledgements

In March 2007, the French Association of Corporate Treasurers Local Chapter from North of France started to work on this book. In June 2007, the Board of the French Association of Corporate Treasurers has voted to create the Commission to write this book. During a year, the European Association of Corporate Treasurers has gathered all national Chapters, especially Belgian, French, UK Associations and allowed the book to have a true European approach. All these associations have come together to propose the first Guide on Treasury Operations and Transfer Pricing for its members. Our objective is twofold:

- address the transfer pricing issues relating to Treasury operations in a practical manner; and
- prepare our fellow corporate treasurer members for CFO position in international groups where transfer pricing is of growing importance, by making a bridge between the operations that the Treasurer performs every day and transfer pricing general principles.

INTRODUCTION

In this guide we will attempt to answer a number of questions.

- What is transfer pricing?
- How do we set and test transfer prices?
- How do we support the prices when the tax audit arrives?

So what exactly do we mean by the term "transfer pricing"? In summary it is the terms, conditions and price placed on a cross-border transaction between two related entities. From an international tax perspective group transactions should be conducted on an "arm's length" basis, a term we will explain in greater depth later in this technical guide.

Why is transfer pricing relevant to the corporate treasurer? The answer is that the corporate treasurer is directly involved on a regular basis with transfer pricing issues. All operations performed daily, or regularly by corporate treasurers such as funding, services, guarantee fees, risk management, debt factoring, asset management, cash management, leasing can trigger transfer pricing issues if they cross country borders. These are often for relatively high values making these intra-group transactions very visible to the outside world including the tax authorities.

In addition there are many other intra-group transactions taking place where the corporate treasurer has no influence on pricing e.g. transactions on semi-finished or finished goods, royalties for use of intellectual assets and provision of services. Nevertheless the corporate treasurer is affected by the pricing as it impacts entity cash management and balance sheets. In this article we have not directly addressed this wider topic but have analysed some of the general principles that equally apply to these types of transactions as well as the treasury operations.

Globalization of financial markets, their worldwide integration, the development of dematerialized banking services, and management trends such as break-up of the value chain, centralisation of support services, have made international cash pooling, and centralised payments factories, in particular and intra-group cross border treasury operations like funding, hedging, guarantee fees between associated enterprises an every day practice within the corporate treasurers world.

By providing services and/or funds intra-group a group centralised treasury generates transfer prices which affect the group taxable income and individual countries' tax bases. Tax authorities around the world are increasingly aware that transfer pricing of transactions between connected parties can move profit from country to country and so affect their tax yield. In 1999, only 6 countries had transfer pricing regulations, in 2008 more than 50 have now implemented regulations that could impact the Group Treasury operations.

Getting transfer pricing wrong can trigger a tax audit of the Treasury operations. These audits can create legal uncertainty for businesses and can generate tax assessments impacting the company's cash flow, the P&L and the balance sheet. Such audits are often long and difficult and they could be expensive. As audits always come after the fact, it can be difficult to produce enough information to justify an enterprise's transfer pricing practice.

When necessary, this guide makes reference, to the common "rules" which govern the transfer pricing best practices within Europe: they provide comprehensive guidelines for multinational companies. These are the Transfer Pricing Guidelines for Tax Authorities and Multinationals published in 1995 by the OECD, as well as various other reports on transfer pricing issued by the OECD. We will also like to refer you to the Guide à l'usage des PME sur Les Prix de Transfert published by the French Tax Authorities in November 2006. This is a short and practical summary of the best practices in a readable and accessible format but only available in French at the moment.

1. BASIC PRINCIPLES

What is the Transfer Pricing Risk Exposure run by operations managed by the corporate treasurer? Where does the corporate treasurer find guidance on the basic principles used in setting his transfer pricing policies?

1.1 Transfer pricing risks for the corporate treasurer

What are the transfer pricing risks a treasurer faces? One risk is where a treasurer lends from a parent company to a subsidiary on a non-arm's length basis i.e. at an excess rate of interest rate or the amount of the loan is excessive. There are two examples below which illustrate this issue.

Example 1
A parent lending from country A to a subsidiary in country B, where transfer pricing principles apply, at 6% pa. The tax authority in country B determines that this rate of interest is too high and denies the subsidiary a tax deduction for any amounts paid over 5%. In country A the taxman will welcome the additional income and be only too pleased to tax it as profit. The group overall has end up paying tax on that extra 1% interest with no corresponding tax deduction[1].

Example 2
The same loan is made but in country B the authorities say that the loan to the subsidiary is not something that any commercial bank would make but is really quasi equity and they deny any tax relief on the 6% paid. The result is tax on the full 6% with no corresponding adjustment[2].

So what guidance is available to the corporate treasurer to help in setting treasury transfer pricing policies and minimising transfer pricing risks?

1.2 Guidance issued by the OECD

Outside of local country legislation the main sources of reference for transfer pricing have been produced by the Organisation for Economic Co-operation and Development (OECD), based in Paris. It is a forum for member countries (19/27 EU countries are members of the OECD) to discuss and compare policy approaches to a wide range of issues, including international taxation and transfer pricing. It is a forum where peer pressure can act as a powerful incentive to improve policy and implement non-binding instruments (soft laws) that can occasionally lead to binding treaties or introduction of changes into local legislation. Recent EU works on transfer pricing as well as national rules and regulations follow the OECD views on the subject.

[1] Subject to relief under the relevant double taxation treaty or under the EC arbitration convention.
[2] See 1 above.

The corporate treasurer should be aware that although the USA follows the OECD arm's length principle, it has its own set of very detailed transfer pricing rules which are not covered in detail in this report.

In the course of its work, the OECD has developed a number of key international standards, including:

- The Model Tax Convention on Income and on Capital (last updated on May 2005) is a model tax treaty, devised by OECD members to form a basis for double taxation agreements between member countries.
- The Transfer Pricing Guidelines (from 1979 and last updated in 1995) for Multinational Enterprises and Tax Administrations are a set of recommendations to assist in dealing with transfer pricing issues, either from the point of view of a company trying to devise or improve its own transfer pricing policy or for a tax administration.
- It has also issued a number of documents on transfer pricing. These include Attribution of Profits to Permanent Establishments, Guidance on Comparability and Guidance on business restructuring.

Below we discuss the key basic transfer pricing principles that the corporate treasurer should be aware of.

1.3 Arm's length principle

The OECD in its Transfer Pricing Guidelines has adopted the "arm's length" principle. The alternate approach of global apportionment was rejected. This principle is enshrined in chapter 1 of the Transfer Pricing Guidelines and in Article 9 of the Model Tax Convention[3]. In summary the arm's length principle means that group companies when dealing with each other should transact as if they are third parties. Where transactions are not at arm's length it is open to tax authorities to adjust the taxable profits of the companies.

1.4 Special relationship and withholding tax on interest

The key article in the OECD Model Tax Convention of relevance to the corporate treasurer is article 11[4]. Article 11 primarily determines the rate of withholding tax on interest and is incorporated in local treaties.

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[3] Article 9; OECD Model Tax Convention: *"When conditions are made or imposed between two associated enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly."*

[4] *Article 11 of the OECD Model Tax Treaty, the Interest Article states that:*
"Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest, having regard to the debt-claim for which it is paid, ***exceeds*** *the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention."*

It also dis-applies the benefit of a reduced (or zero) rate of withholding tax on interest where there is a special relationship between payer and recipient if the amount exceeds the amount that would have been paid if the parties were not in a special relationship. (Similar special relationship provisions apply in the EU Interest and Royalties Directive (Council Directive 2003/49/EC of 3rd June 2003) which is an alternative method of obtaining a zero rate of withholding taxes.)

Nothing is said about other factors such as the reasonableness of the debt itself and in practice those words allow only a consideration of whether the interest is at market rate. However, most double taxation agreements have modified wording, which allow other features of the loan arrangement other than simply the interest rate to be taken into account. This effectively enables the tax authority to deny the benefits of the treaty when there is a loan to a thinly capitalised subsidiary. The tax authority can consider:

- the question whether the loan would have been made at all in the absence of the relationship;
- the amount for which the loan would have been in the absence of the relationship; and
- the rate of interest and other terms which would have been agreed in the absence of the relationship.

In addition to denying the benefit of the treaty for the recipient of the interest, a lack of economic substance, may also mean the borrower has a reclassification of an inter-company loan into capital. This would remove the positive impact of interest deduction on the taxable income of the borrowing company.

1.5 Thin Capitalisation

Thin capitalisation tends to be driven by local tax rules interacting with the international taxation treaties and there is little guidance in the OECD guidelines. Nevertheless it is a very important topic for corporate treasurers looking to capitalise subsidiaries and in some jurisdictions where there is no "safe harbour" legislation it is very much a transfer pricing issue. There is no conformity on this issue and each country has to be examined separately.

Where tax authorities uses a transfer pricing approach historically they have looked at balance sheet ratios such as debt to equity but as more and more fully leveraged private equity deals have taken place there is more of a focus on interest coverage.

1.6 Tax authority guidance on transfer pricing

In addition to the guidance given by the OECD there are a number of information sources issued by local tax authorities.

The guide for SME's in France

This guide was published in November 2006. The 53 page booklet provides an accurate overview of the Transfer Pricing issues. Written in French by the APA team leaders and the former Head of Transfer Pricing Audit squad, it provides examples, theory and useful comments in easy to read language.

The UK manuals for tax inspectors

The UK revenue authority publishes its internal transfer pricing guidance used by its own staff. This information is available on the internet and is very useful information resource.

2. ILLUSTRATION OF THE APPLICATION BY TAX AUTHORITIES OF THESE BASIC PRINCIPLES

2.1 Case law on treasury operations

We have located several cases relating to French tax payers relevant to the pricing of Treasury operations.

Guarantee fees provided free of charge by the guarantor to the recipient:

Carrefour provided guarantees, free of charge, to foreign subsidiaries: it was considered that there was a transfer of profit outside France in the terms of the article 57 of the General Tax Code. The fact that the guarantee increased the shareholder value of the Carrefour subsidiaries and increased the dividends from these subsidiaries did not convince the French Supreme Court. (CE 17 Février 1992, n°81690-82782, Carrefour: RJF 4/92 n°433).

Lainière de Picardie provided a guarantee, free of charge, to its foreign subsidiary in Brazil: it was not considered as a transfer of benefit outside France under article 57 of the General Tax Code. This was primarily because the guarantee allowed local funding which supported the important development of sales from Lainière de Picardie to its subsidiary. In addition it was held that the principle that a guarantee fee should be compensated has been satisfied by the fact that Brazilian rules exclude the possibility of paying for intra-group foreign guarantee fees that are compensated for through other transactions. Finally the amount of a guarantee fee not charged was insignificant when compared to the 100% increase of sales from France to Brazil (CE 3 mars 1989, n°77581,7e et 9e s.-s., Lainière de Picardie : RJF 5/89 n°538).

Loans granted at conditions different than market conditions:

A French parent company granted an interest free loan to its foreign subsidiary. It was not considered as a transfer of benefit outside France as the loss of revenue related to the loan was small compared to the benefit provided by the sales development of the foreign subsidiary which has materialised into significant foreign sales and significant related profits.

Debt forgiveness:

A French parent company forgave the debts owed by the branches of a subsidiary company. These branches had no legal form. Overall, the subsidiary was profitable and had paid dividends to the parent.

The court in deciding for the tax authorities stated that the very nature of this debt forgiveness must be analysed in light with the parent subsidiary relation. In order to analyse the nature of the debt forgiveness, the company should show:

- the strategic and commercial rationale for a parent company in respect of the market where the branches of the subsidiary distribute the parent's products;
- the need for that subsidiary to show it required adequate level of equity in order to develop other markets for these products;
- an analysis of the nature of the debt forgiveness granted by the parent.

The existence of the need for financing by subsidiary linked to the commercial interest development of the parent company was not established by the parent company. This was because the subsidiary, which was profitable despite the financial situation of two of his branches, had paid significant dividends to the parent. Therefore the debt forgiveness in this case was a transfer of profits under article 57 of the General Tax Code. CE 11/04/2008 Guerlain.

2.2 Conclusion

These French law cases appear to indicate that in order to provide funding free of charge, without creating a transfer pricing problem, a compensating operating income (not dividends) has to be generated (a form of transfer pricing set off). This in itself is very difficult to do and adopting an "arm's length" approach is preferable to having to demonstrate a compensating operating income benefit. Again we emphasise that these are French tax cases and different jurisdictions may not follow this approach.

3. DOCUMENTATION

3.1 What is documentation?

Documentation is often a misunderstood concept when discussing transfer pricing. To lawyers it means the legal document, to economists it means the economic justification.

In fact it can be both and indeed more than that. Although the main reference document for transfer pricing the OECD guidelines does not specifically detail what is required there is a format generally accepted (and expected in some cases) by tax authorities.

If one were to specify the components of good transfer pricing documentation, the list could look like the following:

- details of inter group transactions;
- company and group information (history, products, markets, legal entity chart, organization, strategy);
- industry analysis (market analysis, trends, threats, opportunities);
- a functional analysis covering the group transactions;
- details of the transfer pricing setting and testing policy and methods;
- economic support for the prices;
- financial analysis of the results of the group transactions;
- explanation of results in the context of industry and/or company analysis.

So what documentation a corporate treasurer will be responsible for? In a multinational group it is usual to have documentation covering all group transactions. This documentation should already have the industry and business analysis. Therefore the treasurer should have responsibility for the following:

- details of cross border group transactions;
- details of group treasury's role in transaction (including allocation of risk);
- legal documentation of group transactions;
- financial analysis of the group treasury operations relating to group transactions (in particular hedging);
- choice of price testing and setting methods;
- economic support e.g. a bench marking study.

Please note: In this article all later references to documentation refers to the bullet points above.

3.2 Why do we have documentation?

In many countries there is an obligation backed up by a penalty regime to have documentation in place.

Even if there is no penalty regime, not having sufficient documentation has the following disadvantages:

- non-compliance with documentation requirements can mean that the burden of proof shifts to the taxpayer;
- transfer pricing penalties can be avoided by preparing transfer pricing documentation, in particular if the documentation shows that the taxpayer acted in good faith about its compliance with the "arm's length principle" when determining prices in inter-company transactions;
- if there is no documentation a tax authority can raise tax assessments based on their best judgement which then have to be defended. (Normally the authorities will request documentation that should already have been in place!);
- in a due diligence process, it is often necessary to prove that the related parties transactions of the company, or the group of companies bought or sold, were made at "arm's' length". Without documentation being available it would be very difficult to comply with due diligence request within the imposed time-frame.

In a group where there are continual changes in group entities and organisation, annually documenting transfer prices ensures a group can track the prior years pricing methods and justify them to tax authorities.

3.3 Importance of contracting

Contractual terms affect the comparability of the transaction with third party transactions. This is especially the case with treasury transactions e.g. length of loan. They can also define the functions and risks of the parties to the transaction. Often during a tax audit the tax authorities will review contractual arrangements. The absence of contracts can mean that the auditors "dig" deeper into the transactions and raises the chances of receiving a tax assessment. There is one major practical issue with contracts. If the contract does not reflect what is actually happening in the transaction (sometimes because there has been a group reorganisation or because the contract is so complex no one can follow it), this gives the opportunity to the tax authorities to re-characterize the transaction and raise a tax assessment.

It is usually very important that the documentation is created before the transactions start, not retrospectively. This is particularly important for comparative pricing information, which in any case is often easier to obtain at the time of the transaction.

Finally, the contract enables the company to emphasis the fact that the pricing is made on an "arm's length" basis describing the roles and functions of each of the parties. This could be seen as the minimal transfer pricing documentation that can be prepared.

3.4 Recent developments on documentation

The European commission has established a European forum to examine transfer pricing issues. In particular it has recently issued guidance on transfer pricing documentation which has the support of EU member tax authorities. This is an attempt to codify what tax authorities should expect from transfer pricing documentation. Although it clarifies a number of issues on the basic definition of documentation requirements between multinational groups the proposals for documentation are not materially different from the description contained above.

The EU Commission has created a code of conduct on "EU Transfer Pricing Documentation" [5] (EU TPD) that consists of two elements:

- the "masterfile" containing common standardised information of a MNC (functional analysis) relevant for all EU group members. The recommended intra-group funding policy could be part of the "masterfile" documentation;
- the country specific documentation: in our case amounts of transaction, terms and conditions and transfer pricing method used (comparability analysis). Full domestic documentation is not necessarily required for all financing transactions, but as the transactions increases in terms of materiality, then the greater the need for documentation.

According to the EU TPD, this definition of the "masterfile" should improve both the quality of the information provided by businesses and taxpayers' compliance with transfer pricing documentation requirements in the EU. It should thus reduce the risk for businesses of double taxation and exposure to documentation related penalties. At the same time, it should lead to increased transparency regarding the group's transfer prices and thus facilitate the work of tax administration.

However, companies are very carefully considering whether to use this documentation methodology because of the disclosure requirements.

[5] EU sources, Company taxation: Commission adopts Code of Conduct concerning transfer pricing (IP/05/1403), November 2005.

3.5 Should we document all transactions?

The OECD guidelines infer that only economically significant transactions need to be analysed and documented. Of course, there is no definition of economically significant as it will vary from group to group. Nevertheless, it is something that should be considered when looking at the administrative burden of transfer pricing documentation.

3.6 Business benefits

Transfer pricing documentation and policies for treasury transactions can not only be used to defend and avoid tax audits. It can also be integrated into the information required as part of the external audit process and can be used as part of the internal control policy.

3.7 Summary of benefits of documentation to tax payers

- The avoidance of penalties for not maintaining documentation and penalties on tax adjustments.
- The avoidance of the reversal of burden of proof from the Tax administration to the taxpayer.
- It can be used to structure the internal pricing process in a robust and defendable way.
- To create a communication tool that can be shared internally, with external auditors and with tax authorities.

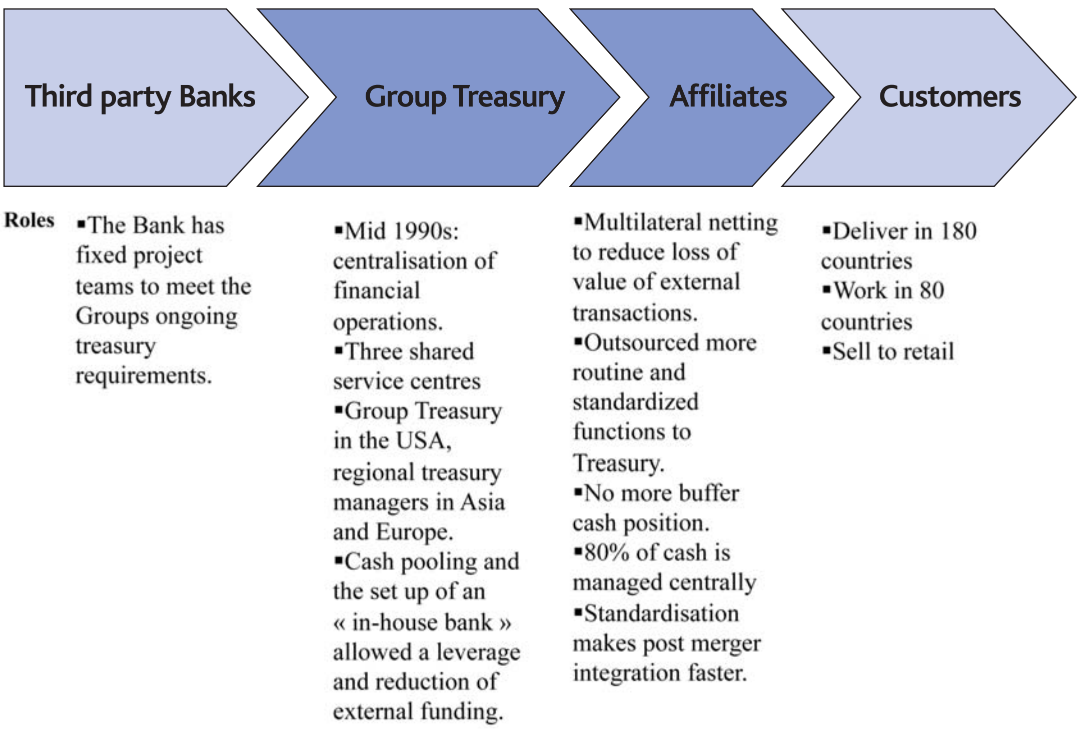
4. VALUE CHAIN OF THE TREASURY FUNCTION AND ITS LINK TO TRANSFER PRICING

In this section we start by examining two examples of treasury value chains. In addition we have examined an example of a group cash pooling operation.

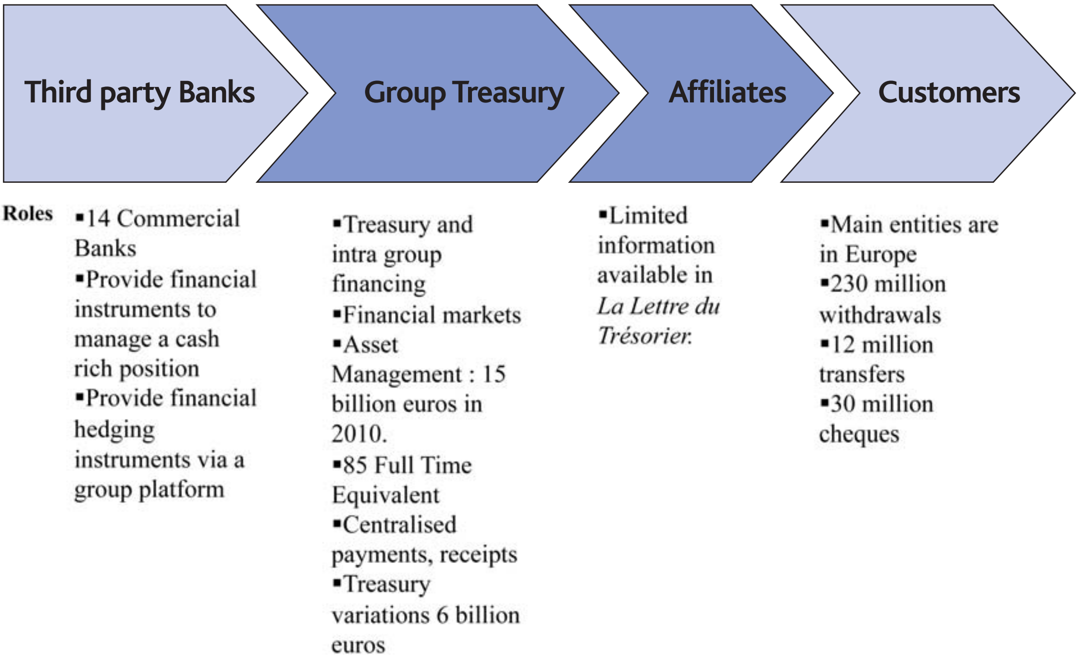
4.1 Group Treasury operations

Below we have included anonymous value chains of real companies who published details of their treasury organisations within their corporate publications. Although these were not originally intended to illustrate transfer pricing issues we have analysed on a high level theoretical basis some of the potential inter-company transactions and issues in order to demonstrate some of the thought process behind transfer pricing.

The value chain of the Treasury department at a leading multinational industrial group



The value chain of the Treasury department at a multinational group involved in facilities management



4.1.1 Transfer pricing analysis

Our initial observations are:

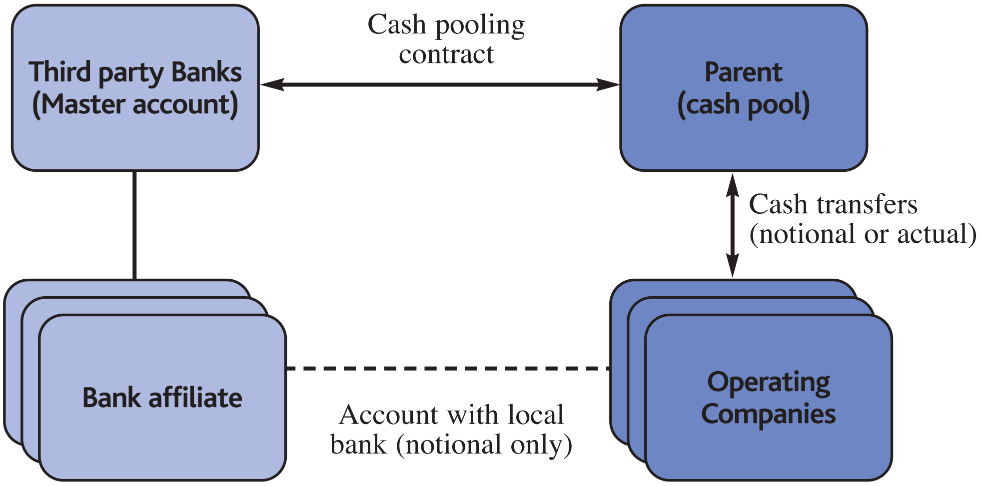
- there should be many internal third party comparable prices available from the transactions with third party banks;
- both companies have fully fledged group Treasury operations delivering financial services.

The following issues would have to be addressed in a transfer pricing study:

- Are the local entities benefiting from the services rendered?
- Is there any duplication of services with existing local treasuries?
- Are the treasury operations properly compensated for the services they provide?
- Are the interest rates on intra-group loans set at an arm's length rate?
- Are entities located in countries where documentation is compulsory, or highly recommended, or not an issue?
- Are there any penalties for absent or insufficient documentation?

4.2 Cash Pooling

Below is a typical example of simple cash pooling structure between third party banks, a parent and its operating companies.



4.2.1 Potential intra-group transactions

If this is a notional cash pool there can be an interest offset even though balances are not moved so this would need to be properly done at arm's' length. An actual cash pools create multiple intra-group transactions on a daily basis.

4.2.2 Transfer pricing analysis

The questions that will need to be answered in a transfer pricing analysis are:

- Are the deposits compensated at an arm's length price?
- Are loans compensated at an arm's length price?
- Is the cash pool holder a service entity or does it take forex[6], interest rates risks and therefore has some entrepreneurial risk?
- What are the transactions made with third parties that can help the corporate treasurer to set the intra-group prices at arm's length conditions, if these transactions are comparable?

4.3 Conclusion

A very high level analysis of treasury operations reveal that potentially there are a number of prices that have to be set and documented.

[6] Foreign exchange risk

5. FUNCTIONAL ANALYSIS OF THE BUSINESS

5.1 What is a functional analysis?

In summary, it is a description of the group value chain explaining the roles, risks and rewards of the group companies involved. In a treasury transaction this value chain may be fairly easy to determine the functionality. In a more complex treasury environment such as banking, the value change and contributions of the respective companies in the chain can be less easy to determine.

A functional analysis concentrates on the economically significant transactions (as outlined above). It is recognised as key in determining the group transfer pricing policy as prices are driven by functions performed, assets used and risks assumed. i.e. analysis should try to determine where value is added in the business supply chain.

There is no prescribed format for this analysis. Practically a functional analysis usually consists of:

- a description of each function, asset and risk and which part of the group is responsible for these;
- a summary table of the risks, assets and functions performed by legal entity.

5.2 The role of the functional analysis and choice of method

One of the main roles of the functional analysis is used to determine the pricing methodology. One way of doing this is to determine whether the functions performed are routine or non-routine (or even a mix of these functions). There will also be a link to the functional profile of the entity.

The most common types of profile applicable to Group Treasury functions would be:

- a service provider performing routine functions;
- an entrepreneur performing non routine, risk taking value added functions.

Potentially a treasury entity can act as an investor e.g. by investing in share capital of subsidiaries. In this case there may be transfer pricing issues if the acquisition is funded by a mix of debt and equity (i.e. if the subsidiary is thinly capitalised.).

5.3 Examples of choice of transfer pricing method

5.3.1 Service centre performing routine functions

A typical service centre would perform operational activities. Transfer prices for this type of operation would usually be set either by using a comparable third party price or secondly by reference to cost. An example for the corporate treasurer would be where there is centralised cash management and the expenses of this are recharged to subsidiaries. Another example would be a flow-through entity with minimal risk with the function of loan administration. A pricing method for this type of entity would be cost plus (see section 6.3).

5.3.2 Entrepreneur performing non-routine functions

A typical entrepreneur would work with third parties and would take some risks in that market place. A corporate treasury example would be where a treasury operation provides a hedge facility to a subsidiary but does not fully hedge the position with a third party. The usual pricing method would be using a comparable third party price (see section 6.1).

For financial sector businesses a profit split analysis (see section 6) is frequently used as there is often more than one profit centre involved in the supply chain. This methodology is not discussed in details in the article.

5.4 Specific OECD guidance on functional analysis for treasury operations

The only guidance available from the OECD on Group's treasury functions is the OECD *Report on Attribution of Profits to Permanent Establishment*[7] in particular the sections relating to financial activities. This report is aimed at banks trading through permanent establishments. On the face of it this may not seem relevant but on closer analysis many of the functions performed in a banking operation are similar to group treasury functions. The report identifies the following main components of a financial transaction:

- loan origination process;
- loan management process;
- risks incurred;
- assets employed.

To illustrate how to complete this analysis, an example is included below.

[7] *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration*, Chapter 1, OECD, 1995 and regularly updated; *Report on the Attribution of Profits to Permanent Establishment*, Part II: Special considerations for applying the working hypothesis to permanent establishments of December 2006.

Cash pool example

A group treasury company sets up and runs a cash pool. The pool members all sign cross indemnities and warranties therefore the risk of default is spread amongst the pool members.

In the functional analysis we would analyse the involvement of the group treasury company in organising the pool following the headings used in the OECD Report.

Loan origination	Typically group treasury would be involved in originating the facility for the subsidiary and creating the relevant documentation.
Loan management process	The group treasury might carry out the following functions: • External *loan support*, being day to day management of the cash pool borrowings. • *Monitoring and managing* risks. The principal risk related to managing the cash pool funding can be foreign exchange risk (discussed below). The role of group treasury is often to accumulate gross exposures, identify 'natural hedges' (i.e. internal set-offs) and manage the residual risk through hedging. • Day to day *treasury* functions in respect of the administration of the cash pool.
Risks incurred and assets employed	There is some foreign exchange risk which is borne by the group Treasury entity. The inter-company transactions expose the assets of the treasury entity to risk.

The results contained in the table above are then used to firstly determine the pricing method and then used to determine the level of compensation based on the relative contribution of the group treasury entity.

6. OECD PRICING METHODOLOGIES

Having carried out the functional analysis we have to link the results of the functional analysis to a pricing methodology.

The OECD guidelines describe the various transfer pricing methods. These methods are split into two types:

- The traditional transaction methods, or *direct methods*:
  - the Comparable Uncontrolled Price (CUP) method;
  - the re-sale price (or resale minus) method and
  - the cost-plus method.
- The transactional profit methods, or *indirect methods*:
  - the profit-split method and
  - the transactional net margin method.
- Other.

6.1 The Comparable Uncontrolled Price (CUP) method

The Comparable Uncontrolled Price (CUP) method[8] prices a transaction by reference to either third party external prices (third party comparables) e.g. inter-bank lending rates or by reference to prices between the group and third parties (internal comparables) e.g. internal cost of credit.

The word comparable must be emphasised. The OECD guidelines outline five key comparability factors:

- characteristics of the goods or services[9];
- functions performed, assets used and risks assumed[10];
- contractual clauses[11];
- economic circumstances[12];
- company strategy[13].

In general, for the corporate treasurer all these are relevant. For example when setting a loan rate the treasury group will look at which party is taking the market risk. It will also look at the terms of the loan as the duration can affect the rate. It might also look at the location of the subsidiary (economic circumstances). In terms of company strategy the group gearing ratios may be relevant in setting rates.

[8] OECD Report, Paragraphs 2.6-2.13 and 6.28, 1995.
[9] OECD Transfer pricing guidelines para 1.19
[10] OECD Transfer pricing guidelines paras 1.20 and 1.27
[11] OECD Transfer pricing guidelines para 1.28
[12] OECD Transfer pricing guidelines para 1.30
[13] OECD Transfer pricing guidelines paras 1.31 to 1.35

6.2 The resale price method

This method is not usually relevant to treasury operations and is not discussed here.

6.3 Cost plus method

The cost plus method starts by computing the cost of providing the goods or services and adds an appropriate mark up. The cost plus method is often used where a group treasury function performs routine service functions.

6.4 The profit split method

This method is often used where there is a third party transaction generating a "group profit" that has been generated by routine functions and value added functions, properly performed by a number of group companies[14].

A profit split method works firstly by allocating a reward for routine functions. This is usually calculated on a cost plus basis. The residual is split by reference to the respective contributions of the parties. This method is typically used in banking transactions where the loan originator is in a separate entity from the provider of capital and administration takes place in a third entity.

6.5 The Transactional Net Margin Method (TNMM)

A transactional net margin method is used to justify a level of net operating profit. It examines the net margin achieved on a particular transaction or group of similar transactions relative to a base such as turnover, costs or capital employed. This is compared with the result achieved by independent entities on a similar transaction or transactions. The method can only be used when either the CUP, the resale price or the cost plus cannot be used.

6.6 Other OECD Methods

The OECD guidelines permit the use of other methods where none of the prescribed methods apply.

[14] It is common to find that the functions of group members are inter-related so that a manufacturer bears a share of the selling expenses or a selling company contributes towards the research used by the manufacturer. While it might be possible to make the traditional price-based methods work in such circumstances, there are times when group functions are so intertwined that the safest way forward is to look at the whole process from initial manufacture to end sale and work out the real economic contribution made by each individual company. This is what is frequently referred to as a "functional analysis", in which account is taken of the functions performed, risks assumed by and property used by each group member.

7. PRACTICAL PRICING

7.1 Introduction

In this section, we will look at the methods available for pricing inter-company loans and guarantee fees. We are focusing on subsidiaries that have borrowing needs rather than those with cash balances (although of course transfer pricing applies equally to upstream loans). One of the key factors to also consider here are the local thin capitalisation rules which can determine the maximum level of indebtedness.

To assist in the pricing there are a number of commercial databases available. For determining the margin to be used in a cost plus methodology the Amadeus database (produced by Bureau van Dijk), is frequently used. This is a European financial database containing information on public and private companies filing accounts in Europe. There are a number of other similar databases for other regions e.g. Lexis Nexus for the USA.

For pricing the rates on loans the databases include *Webdeal scan*, which contains historic deal terms and conditions on loans, high yield bonds and private placements, Bloombergs and Reuters bond data. In addition various Central Bank studies can provide a useful local approach for certain type of transaction.

7.2 Setting interest rates

As mentioned above determining the risk of the treasury entity enables us to determine the price setting mechanism. For treasury entities purely providing services such as loan administration the most appropriate method is a cost plus remuneration. For treasury entities taking risk a comparable price method would be used. The issue with the risk taking approach is that most of the risk is measured by reference to controlled transactions (a transaction between two connected parties), the subsidiaries balance sheet and interest coverage. It is often the treasury entity that determines the risk level in the subsidiary and therefore the setting of the rates can appear circular.

Nevertheless, we will work through the various approaches as both have merit and shortcomings. Please note we have assumed that the group entity providing the group loans obtains the funds from a third party lender without a guarantee from other group companies. There will other structures where the risk of lending is supported by another group entity which would be liable for any default risk.

7.2.1 One step approach: Cost plus

Where the loan is "flowing" through a treasury entity then a one step approach could be used i.e. a cost plus method, taking the cost of the underlying loan then adding a margin for the functions performed by the treasury entity.

The easiest example of this approach is used where there is an identifiable source of funding that is flowed through to the borrowing entity in the same currency and under similar of the loan. The assets of the borrowing entity secure the funding. Therefore there is no recourse to the treasury entity. In this case, the rate would be set by reference to the cost (both margin and underlying rate) with an additional margin to reward the treasury entity for its costs in administrating and arranging the loan. An alternative would be to charge out these costs under a service fee arrangement. If a margin is applied it would be set by reference to third party data on loan arrangement fees measured against the functionality of the treasury entity.

7.2.2 Two step approach

Where the loan can not be directly linked to the external funds or lent in a different currency from the external funding we would use a two step approach. The two step approach starts by determining the underlying rate and secondly the margin to be applied.

Step 1 - Setting the underlying rate: comparable price

Where there is no direct relationship between sources of funding or where there is some element of interest rate market risk the underlying rate is usually set by reference to a third party comparable prices using publicly available indices. For short-term rates this tends to be Libor or Euribor. For longer-term rates the swap market gives prices that do not include any significant risk margin above inter bank lending rates.

Step 2 - Margin

All these methodologies assume that the treasury entity has access to funds at the group holding company margin.

The methodologies we have identified are as follows:

- comparable price using a credit rating approach;
- cost plus;
- cost plus adjusted for risk

7.2.2.1 Comparable price method – using Credit rating approach

This methodology starts by evaluating the credit risk of the borrowing entities on a stand-alone basis i.e. all operating companies belonging to a group would be scored based on rating agency criteria. Therefore each operating company would pay a margin on its loans appropriate to its credit standing.

An overriding assumption used by credit rating agencies is that a subsidiary can not have a superior credit rating to its parent[15]. This appears contradictory to the "arm's length" guidance given by the OECD i.e. the parties should be treated as third parties; nevertheless we believe this principle has to apply.

The margin is calculated by using third party data. There are a number of third party data providers e.g. Loan pricing corporation, Reuters bond data or Damodaran[16] that give indicative spreads matched to credit ratings.

Of course, a number of other factors other than financial ratios affect a credit rating, in particular the degree of subordination, and the term of the loan that need to be built into the credit rating and calculation of the margin.

There is also the issue whether the credit rating should be adjusted for country and political risk or whether this is a "double count". Our view is that the financial ratios used in the credit scoring process already reflect this risk and no additional adjustments need to be made.

It has been suggested that an alternative is to ask external bankers to provide indicative quotes. However, many tax authorities do not accept these quotes as providing comparable prices as a letter of intent is not a binding contract.

There is the issue that the margin used for the inter-company loan or credit line should be comparable with the rate the subsidiary could borrow in its local market. However, often local banks, because they provide other services, disregard the overriding rule of credit agency rating rule that a subsidiary's credit rating can not exceed that of its parent (i.e. there is a cross subsidy). Therefore we believe in many cases this can not be treated as a comparable price.

Credit rating weaknesses

The key transfer pricing weakness as discussed above is that the credit ratings is based on a controlled balance sheet i.e. the parent (treasury entity) has the ability to determine the strength of the local balance sheet. The parent can also determine many of the features of the loan e.g. the term and the degree of subordination.

7.2.2.2 Cost plus method

We have discussed above flowing through the cost of external funding. Where there is no identifiable flow through the method will use the groups weighted margin on debt to set the funding rate for subsidiaries. If the group has short-term funding and long-term funding it is appropriate to use two weighted averages. A margin is added to the underlying rate to recompense the treasury entity for arranging the loan. This additional margin can be calculated by reference to external data bases and by reference to the amount of work performed by the treasury entity.

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[15] Moody's rating guidelines.

[16] Loan pricing corporation: www.loanpricing.com/
Damodaran: http://pages.stern.nyu.edu/~adamodar/ and navigate to 'Updated Data' and then 'Ratings, spreads and interest coverage ratios' which is a sub section of "Capital structure"
Reuters bond: www.bondsonline.com/Todays_Market/Corporate_Bond_Spreads.php

Cost plus weaknesses

The major weakness is if the group has an historic debt structure where the cost of debt is out of line with the current market rates.

In addition the cost plus approach is potentially not compliant with the OECD guidelines as it not an arm's length transaction. This is because it does not reflect the risks incurred by the parties to the transaction i.e. if the subsidiary margin was evaluated on its own its risk rating this would be different from the group margin.

In the defence of this method the subsidiary companies balance sheet and interest cover are controlled transactions i.e. the parent/treasury entity determines the strength of the subsidiaries balance sheet. Therefore the implicit rating of the subsidiary is potentially the same as the rating of the group.

7.2.2.3 Cost plus adjusted for identified risks

A third potential approach is to evaluate the risks that are not controlled by the parent i.e. the country risk and project risk. The solution then is to use the group margin as the starting point for setting a rate. This margin is the adjusted for identifiable third party risks borne by the subsidiary. Guidance on this can be found on the Damodaran web site and reference can be made to the Basle banking guidelines[17].

7.2.3 "Work back" approach using comparable data

A pragmatic approach adopted by some tax authorities when determining the maximum amount of tax deductible interest is to use a "work backwards" approach.

The earnings before tax and interest (EBIT) of the subsidiary are forecasted over a reasonable funding period. Using comparable public data a ratio of interest to profit is used to calculate the maximum interest payable. The term of the loan is set based on profit forecast. The group interest rate plus a small margin is used to calculate back to the principal of the loan.

This methodology has its merits in that it determines a maximum amount of interest that a third party would pay if it had a comparable profits flow.

7.3 Guarantee fees

In this section we look at the pricing of guarantees. We are restricting ourselves to guarantees issued by a treasury entity supporting a third party borrowing and ensuring the loan credit rating is set at the same rate as the provider of the guarantee. The OECD guidelines identify guarantee fees as a service a subsidiary receives and would expect to recompense the provider. The OECD gives no guidelines on how to set prices.

[17] International Convergence of Capital Measurement and Capital Standards issued by the Basel committee on banking supervision.

It appears there are three potential methods. Calculate the cost of providing the guarantee and add a margin (cost plus methodology), calculate the benefit to the subsidiary (a form of comparable price method), locate a comparable price.

7.3.1 Cost of providing the guarantee

For a company that is not a regulated financial entity there is no immediate direct balance sheet cost of providing the guarantee. Potentially from an entity accounts perspective IAS 37 (accounting for provisions and liabilities) could apply and the potential cost of meeting the guarantee may have to be recognised. To recognise the provision three criteria have to be met:

- there must be a present obligation as a result of a past event,
- a reliable estimate can be made,
- there will be a probable outflow of a resource.

Unless it is likely the guarantee will be called no accounting provision will be required.

Nevertheless the potential cost to guarantor is the payment of any outstanding loan amount on default of the borrower. To evaluate the default risk the following methodology could be used:

- Calculate the value of the assets of the borrower that would be available to pay off the loan on default. This can also be compared to recovery rates published in pubic databases.
- Evaluate the default risk. This can be done by using loan default data issued by the credit agencies (of course the issue with all credit rating methodologies is that the balance sheet of the subsidiary is controlled by the parent company).
- Apply the default risk to the amount of the loan that would be irrecoverable in the event of a default. This would give an estimation of the potential cost of default.
- Apply a mark up to the cost (a suggested basis of calculating the mark-up would be to use a calculated cost of capital).

Another way of approaching this is to look at how financial institutions price guarantees.

7.3.2 How do banks price guarantee fees[18]?

We have analysed how banks account for these types of instruments.

Banks have to maintain solvency ratios (following recommended practises and regulations). Recognition of an asset on its balance sheet has an impact on the banks ability to lend and has a measurable cost. On February 17th of 2006, the International Affairs department of the French Banking Commission published the guidelines on the calculation of the international solvency ratios.

[18] http://www.banque-france.fr/fr/supervi/supervi_banc/communiq/modalites.htm
select « Modalités de calcul du ratio de solvabilité » to download the 2009 guidelines.

Pages 26 to 30 provide some practical guidance on how to evaluate the off-balance risks such as guarantee fees. This guidance reflects the treatment outlined in International Convergence of Capital Measurement and Capital Standards issued by the Basel committee on banking supervision (Basel II). This is a step by step methodology that approximates an arm's length calculation performed by a bank when granting a guarantee to a third party.

The first step converts the off-balance item into a credit risk equivalent. The second step is designed to reflect the risk, which is the probability of transfer of these items from off-balance into the balance sheet. This is evaluated based on the status of the counterparty.

During the first step the conversion of the instrument into a credit risk equivalent is based on the type of off-balance instrument:

- for "financial standby letter of credit[19]" 100% of the amount is converted to an equivalent credit risk;
- for "performance standby letter of credit[20]", or "note issuance Facilities", 50% of the amount is converted to an equivalent credit risk;
- for some guarantee fees such as "administrative guarantees", 20% of the amount is converted to an equivalent credit risk;
- for revocable facilities or those which can be cancelled due to a deterioration of the borrowers credit standing nothing is converted to an equivalent credit risk.

So how useful is this evaluation? It shows us that banks have to account for certain guarantees as credit equivalents i.e. take them onto their balance sheet with an inherent cost of doing this. It does not however lead us directly to a pricing methodology.

From the guidance it appears that a revocable guarantee for under a year has no balance sheet cost and that an irrevocable guarantee over a year has a 20 to 100% credit equivalent cost to a bank dependant on its exact nature. Therefore the bank will price the guarantee in the same way as a loan i.e. basis points added as an arrangement fee and a spread calculated by reference to the credit risk.

To calculate the credit risk the credit rating methodology can be used to evaluate the lost margin.

Again the shortcomings of this method are those inherent in all credit rating methodologies in that the balance sheet of the subsidiary is a controlled transaction.

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[19] Standby letter of credit (SLC) is similar in nature to a bank guarantee. It may be used as necessary to cover non-payment of a financial obligation. A SLC is normally only intended to be drawn on in the event of non-payment of an underlying transaction. The SLC is issued by a bank and held by the seller, who in turn provides the buyer credit terms. If payment is made according to the seller's terms, the L/C is never drawn on. However, if the buyer is unable to pay, the seller presents a draft, and all other documents as required under the SLC, to the issuing bank for payment.

[20] A Commercial or Performance Standby Letter of Credit is an irrevocable commitment [undertaking] on the part of a bank to guarantee performance in an underlying contract between a Buyer and Seller or a service provider. This type of Standby can be used to insure many types of transactions from international trade to buying or selling a house or other major purchase.
The Standby stands as a guarantee that the parties to an underlying contract will perform as agreed. Used in this matter, the Standby serves as a performance bond and may be called a Performance Standby Letter of Credit.

7.3.3 Credit default swaps

It has been suggested by some economists that a comparable price would be the price of a credit default swap. However because of the other functions of credit default swaps such as arbitrage and hedging we do not consider that they are sufficiently comparable transactions.

7.3.4 Calculation of benefit to subsidiary

A guarantee can be priced by calculating the saving to the subsidiary borrower benefiting from a guarantee granted by the treasury entity. In transfer pricing terms this would be a comparable price method.

This would be done by evaluating the credit rating of the subsidiary without the guarantee using third party data such as Reuters and setting the margin. The calculated margin would then be compared to the guaranteed margin paid. The interest saving would be the value of the guarantee.

The shortcomings of this method are those inherent in all credit rating methodologies in that the balance sheet of the subsidiary is a controlled transaction.

The other alternative is to assume that the loan would not have been granted without the guarantee and therefore the benefit to the subsidiary is obtaining the loan. We do not believe this can be substantiated and would result in a very high guarantee value. We would then suggest that the guarantee is effectively acting as a partial equity substitute. Alternatively it could be argued that all the guarantee does is protect the bank against the parents controlled transactions reducing the banks security e.g. abnormal dividends, incorrect transfer pricing. This is very much like a bank dealing with a Small & Medium Enterprise (SME) and demanding a guarantee from its directors to protect the bank from the excess withdrawal of profits by the SME directors. In either case the guarantee relates to the ownership and management of the company and not a service to the subsidiary.

7.3.5 Conclusion on guarantee fees

There are potential transfer pricing issues with pricing methods which evaluate the credit rating of a subsidiary whose balance sheet is controlled by the parent.

An alternative approach would be to examine the non-controlled risks (those not set by a connected party) e.g. country risk and project risk and calculate the guarantee fee based on these risks. In addition an arrangement fee could be added.

There is also a thin capitalisation issue that some tax authorities examine when dealing with guarantee fees. It is argued that a guarantee means that a subsidiary obtains a larger loan from a third party than a company operating on a stand-alone basis. Therefore part of the interest on the loan can be disallowed as excessive.

7.4 Services

If a treasury centre is providing services to group companies it should be recompensed for the provision of those services. The recognised OECD approach is firstly to see whether there is a comparable third party price for the service either available to the company (an internal comparable) or available in the public domain (external comparable) third party price available for these services. If no CUP (Comparable Uncontrolled Price) is available then the recommended method is to use a cost plus methodology.

When calculating costs these should not include any stewardship expenses (e.g. costs relating to acquisition of subsidiaries). A mark-up is then applied to these costs. The mark-up is obtained either from third party comparables or by use of publicly available databases (as discussed above).

If loans are provided by the treasury company it would be possible to convert the cost plus charge into basis points if practical.

8. APA'S AND PENALTIES & SOLUTIONS

Having put together our pricing models is there anything we can do to strengthen our position vis-à-vis the tax authorities? What can we do if things go wrong and the tax authorities adjust the pricing and raise a tax assessment?

8.1 Advance pricing agreement (APA)

The alternative to waiting for a tax audit is to obtain an advance pricing agreement (referred to as an APA).

These can be agreed on a unilateral (involving one tax jurisdiction) or on a bi-lateral basis (agreement is reached with more than one tax authority). The unilateral agreement obviously only secures the tax position in one jurisdiction. This is particularly useful if the other party to the transaction is:

- either a tax haven,
- or a country with no tax treaty offering this procedure,
- or where several countries are involved in one transaction and either a bi-lateral or multi-lateral APA is not possible in practise.

Bi-lateral agreements are more obviously complex as they have to be agreed between two potentially competing tax authorities, but are for that reason much more valuable.

The OECD Guidelines outlines the APA procedure in Chapter 4 and details what is expected from the taxpayer requesting the APA.

The taxpayer has to approach the tax authority in the jurisdiction where he is located relating to the transaction in question. The tax authority (if it agrees to take the case) will then contact and negotiate with the other tax authorities.

The advantages of an APA are that the taxpayer can obtain certainty in his transfer pricing for usually 5 years with a potential roll-back to earlier years. The disadvantage is that the taxpayer has to open his books to the tax authorities and the procedure can be burdensome, time consuming and maybe costly for the company.

However some countries are starting to offer advance transfer pricing transactions clearance procedures for taxpayers. This is less burdensome than an APA procedure and can secure the tax treatment of a particular pricing transaction, without the need for the company making the request to prepare a complete study of the transfer pricing policies. The actual procedure varies country per country.

8.2 Remedies

What remedies are available to the Treasurer and the Tax Director after a tax audit has taken place and the local tax authority has made a transfer pricing adjustment to taxable income? There are two possible procedures available.

8.3 Competent authority procedure (Article 25 of the model Tax convention)

Article 25 of the OECD model taxation convention covers the mutual agreement procedures and is a mechanism for resolving transfer pricing issues. This mechanism is known as "competent authority". This remedy will be available where a tax treaty exists and this article is in that treaty.

The procedure is that the tax payer submits his case to the tax authorities. The two tax authorities are then required to resolve the double taxation issues. The problem of the competent authority is that there is neither a time limit for reaching agreement nor a commitment to eliminate the double taxation.

In addition if penalties were initially applied, these are not covered by this mechanism and can remain as a final cost.

8.4 EU arbitration convention

A preferable alternative to using the competent authority procedure is to use the EU arbitration convention governed by the code of conduct issued in 2006. This can only be used where both parties are resident in the EU. Under this procedure the tax authorities are targeted to agree on double taxation issues within a two year time frame.

The main features are:

- a three year deadline for companies to present their case;
- there is two-year period during which Member States' tax administrations must attempt to reach an agreement to eliminate the double taxation;
- detailed administration procedures;
- arbitration procedures if the member states can not agree; and,
- suspension of tax collection during the resolution procedures.

9. THIN CAPITALIZATION

There are several approaches that tax authorities take when dealing with thin capitalisation. One is a transfer pricing methodology analysing the transaction using arm's length principles i.e. what is the maximum loan that a subsidiary could borrow from a third party and at what rate of interest could that company borrow. The maximum amount would not be by reference to the balance sheet of the subsidiary itself but by reference to market data.

A second approach would by applying maximum debt/equity or interest cover ratios set in legislation.

EC legislation

The European court of justice considered in the Lankhorst Hohorst case whether thin capitalisation rules applied by Sweden applied only to non residents companies was in breach of the freedom of establishment clause contained in article 43 of the European treaty. The court found in favour of the taxpayer ruling that there was a breach of the freedom of establishment.

This has lead to several European countries changing their thin capitalisation rules. In December 2007 the European commission issued a further communication on the application of anti-abuse measures including thin capitalisation[21]. The commission is now looking to co-ordinate an approach on the introduction of tax anti-abuse rules.

Examples of Country specific thin capitalisation rules

United Kingdom

The UK thin capitalisation rules are contained within the transfer pricing legislation. The arm's length basis is applied not only to the rate of interest but also the quantum. In addition the UK will be introducing an interest cap in new legislation.

France

France applies an arm's length test to the rate of interest. Specifically it will be deemed to be arm's length if it does not exceed the average annual two year floating rate applied by banks. In addition there is a debt equity test plus a profit coverage test.

Germany

The German legislation imposes debt equity ratio and interest coverage tests.

[21] Memo/07/558 extracted from http://europa.eu/rapid (using the search engine, select *search complete database*, reference *MEMO/07/558* or *IP/07/1878* for the press release).

APPENDIX

1. Pricing of goods and services

The appendix builds on the information in the body of the guide and assumes the user has read the earlier sections. Please note the pricing described in the appendix follows the OECD guidelines. If pricing involves a US entity it would be necessary to follow the US Treasury Regulations Under Code Section 482 which apply. These are similar but in some cases slightly different rules when applying the choice of pricing method and the economic analysis.

The starting point is the functional analysis. This looks at the functions performed, risks incurred and assets utilised by the parties involved in the group transaction. The results of the functional analysis are firstly used to determine the appropriate pricing method and then with a business analysis the amount of remuneration the group entities should earn from the transaction.

A way of linking the results of the functional analysis to the choice of method is to build responsibility profiles for the entities. Typically there are four types of entities. These are a service provider, a distributor, an entrepreneur and investor. Some entities may fit more than one category dependant on the different functions and risks of the entity.

Having made this analysis we can then link the results with the choice of method. This is illustrated in the table below:

Entity	Methods available
Service provider	Cup, Cost plus or modified cost plus
Distributor	Cup, Resale minus, Net margin method
Entrepreneur	Cup, Residual profit split, Resale minus
Investor	Cup, Residual profit split

Usually there it is only necessary to use one method to set and test the prices. However there appears to be a move towards the use of secondary testing as a credibility check.

The methods are as further discussed below. Before proceeding to the choice of method it is necessary to have carried out a business and industry analysis as this is required when either determining a comparable price can be used or when using a third party data base.

2. Comparable price method

There are two types of comparable prices. These are external (public domain) prices e.g. traded commodities. Internal comparables are prices charged by external suppliers to the group or prices charged by the group to external customers.

In order to use a comparable price a number of factors have to be analysed. These are as follows:

- Is sufficient information available to make the evaluation?
- Functional: Is the company delivering the service performing similar functions and using similar assets?
- Economic circumstances: Is the market place the same?
- Business strategy: Is the business strategy the same?
- Contractual clauses: Are the contractual terms similar?
- Characteristics of the goods and services: Are the goods and services similar/the same?

3. Resale minus

The difficulty with this method is the availability of data in the public domain. Most data bases do not have that level of details. Unless a good internal comparable margin is found, in many cases this method can not be used.

4. Cost plus

Again the problem with this method is the availability of data at a gross margin level. What this usually means is that if no internal comparable mark up information is available then the method can not be used. What companies tend to adopt is what is called the modified cost plus method or net margin method using net margin/total cost as the profit level indicator. The other issue is how costs are calculated.

There are two methods of recharge (or a combination of both methods):

- the direct method : this method calculates the charge on an item by item basis, usually involving the use of time sheet;
- the indirect method : this method calculates the charges on an aggregated basis using an allocation key.

5. Net margin method

This method looks at the total net margin obtained by independent companies on an aggregated basis. These companies should be operating in a similar business sector with a similar risk profile. There is the possibility of using a number of profit level indicators. The most common are earnings before tax and interest/sales or net margin/total cost. The data is obtained from third party databases. The result of the data base searches is then applied either to set the net margin on an individual product/basket of products or to test the results of an entities inter-company business on an aggregated basis.

The results of the study will produce a range of net margin. It is possible in most tax jurisdictions to apply a statistical test to this sample and price at the median. If the results of the functional analysis indicate the low risk taking and low functionality you could chose a price in the lower quartile. Similarly if there is high functionality it is possible to take a margin in the upper quartile *(Note this is a predominantly European practise)*.

An alternative is to adjust the result of the comparability search for items such as stock, fixed assets, debtors and creditors. This adjustment is made to reflect the holding cost of these items.

6. Special considerations for services

6.1 Tests

When supplying a service there are a number of tests that have to be applied to ensure the recharge complies with the arm's length principle:

- the cost can not include any element of stewardship or shareholder costs;
- the service rendered must benefit the recipient;
- there must be no duplication of services except where there is a need for oversight or a temporary business reconstruction.

6.2 Other potential issues

What costs should a mark-up be applied if this is the chosen method? Specifically a mark up should not be applied to third party costs that are incurred by one group entity and then immediately on charged unless there is a significant cash flow cost.

It is possible to charge for on call services i.e. where a service is not used but is available and on call, it can be charged for.

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EUROPEAN ASSOCIATION OF CORPORATE TREASURERS

EACT – the European Association of Corporate Treasurers – includes 18 associations of corporate treasurers of 17 countries in Europe. It brings together about 8,100 members representing 4,600 groups/companies located in Europe.

EUROPEAN ASSOCIATION OF CORPORATE TREASURERS

History

When it was formally set-up in May 2002, EACT was named the Euro Associations of Corporate Treasurers and was restricted to associations of corporate treasurers of the euro area.

A few years later, EACT became the European Association of Corporate Treasurers and is open to any association of corporate treasurers and finance professionals in Europe.

Missions

The European Association of Corporate Treasurers (EACT) is a grouping of national associations representing treasury and finance professionals.

Speaking with a united voice, the EACT creates a greater impact than the sum of its individual component actions. This gives prominence to the issues faced by treasury and finance professionals across Europe with the European authorities, national governments, regulators and standard-setters.

Together we promote the value of treasury skills through best practice and education. We ensure that the treasury role continues to evolve as an essential component within a dynamic financial environment.

Technical Commissions

The Board of Directors selects the topics on which EACT will work as well as the general objectives. The EACT Board member in charge will in most cases set-up a Commission headed by a Chairman and with members in several EACT associations.

They are:

- Means of payment and SEPA: Gianfranco Tabasso
- Transfer pricing in treasury: Luc Vlaminck and Bruno Resseguier
- International accounting standards: François Masquelier and Mark Kirkland
- Rating agencies: John Grout and Patrice Tourlière
- Compliance and codes of conduct: Charles-Henri Taufflieb
- CAST: Gianfranco Tabasso.

Current EACT Members

The 18 associations are:

- ACT, The Association of Corporate Treasurers (UK)
- AFTE, Association Française des Trésoriers d'Entreprise
- AITI, Associazione Italiana Tesorieri d'Impresa
- ASSET, Asociacion Espanola de Financieros y Tesoreros de Empresa
- ATEB, Association of Corporate Treasurers in Belgium
- ATEL, Association des Trésoriers d'Entreprise au Luxembourg
- CAT, Czech Association of Treasury
- DACT, Dutch Association of Corporate Treasurers
- FACT, Finnish Association of Corporate Treasurers
- GEFIU, German Financial Executives Institute (Gesellschaft fûr Finanzwirtschaft in der Unternehmensführung e.V.)
- HTC, Hungarian Treasury Club
- IACT, Irish Association of Corporate Treasurers
- ÖPWZ, Forum Finanzen (Austria)
- PCTA, Polish Corporate Treasurers Association
- SACT, Swedish Association of Corporate Treasurers
- SAF, Slovak Association of Finance and Treasury
- SCTA, Slovenian Corporate Treasurers Association
- VDT, Verband Deutscher Treasurer.

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