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Addressing Liquidity Issues during Covid-19 Using Intercompany Pricing Tools

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The Covid-19 pandemic has created economic instability and associated liquidity strains for businesses globally. Various transfer pricing strategies can be deployed to meet short-term and long-term operational, financial, and capital needs by conserving available cash, enhancing access to external sources of new liquidity, and tapping into cash reserves in multiple jurisdictions.

These strategies include:

1. Adjustments to working capital terms
2. Modification of debt terms
3. Initiating new financing arrangements
4. Use of parent company guarantees
5. Utilization of cash pools
6. Asset-based lending options
7. Reconsideration of non-financial intercompany transactions

Each of these approaches is discussed below.

Adjustment to Working Capital Terms

Effective management of working capital is important for a company's operational efficiency and its short-term financial health. Defined as the difference between current assets and current liabilities, working capital levels are an indication of whether a company has adequate cash flow to meet all its short-term obligations. Liquid assets such as cash and other assets that can be readily converted to cash are needed to service short-term obligations such as payroll and trade payables. If a company's current assets are short of its current liabilities, it may have trouble paying back creditors or meeting other financial obligations. Consequently, businesses have been negotiating payment terms with vendors to keep more cash on hand, including extensions of payment periods and forbearance on interest. These type of short-term fixes can effectively address any liquidity constraints resulting from the current economic situation.

Similar strategies can be used among related parties in order to keep cash in the entities that have the most significant short-term needs. For example, companies may extend their intercompany receivable payment terms and implement interest-free periods. When interest becomes due, holders of receivables may be able to charge lower rates, reflecting short-term market rates or possibly applying any available safe harbors, such as the U.S. applicable federal rate ("AFR"). The AFR closely mirrors risk-free rates and would usually be less than a rate negotiated between two parties transacting at arm's length. Other adjustments to payment terms agreed to with third parties can be used to support similar alternative arrangements among group entities.

Modification of Debt Terms

Many companies are seeking to modify their financing transactions with third party lenders as a means to enhance their cash position. For example, in some cases interest and principal payments on bank loans are being deferred or forgiven. More comprehensive restructurings or renegotiations of financial transactions are also possible. The same modifications could potentially be made for intercompany loans; in either situation, however, some potential tax pitfalls need to be considered.

In the United States, the section 1.1001-3[1] tax regulations state that a significant modification of debt—arising for example from a material change in yield or timing of payments—can trigger a deemed exchange of an existing debt instrument for a new one and lead to recognition of a gain or loss for tax purposes. Deferral of interest payments may not be considered a modification, so long as deferred payments are unconditionally payable no later than at the end of the safe-harbor period. This period begins on the original due date of the first scheduled payment that is deferred and extends for a period equal to the lesser of five years or 50 percent of the original term of the instrument.[2] Complete forgiveness of scheduled payments is not available through the safe-harbor provision and is therefore

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[1] Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

[2] Section 1.1001-3(e)(3)(ii).

more likely to lead to a tax recognition event. This also holds for a major restructuring of the loan, depending on facts and circumstances.

Whether or not adjustments to related-party loan payment schedules or other terms result in a significant modification under U.S. tax principles, there remains the matter of supporting the changes based on the arm's length standard. The fundamental question is whether unrelated parties would agree to the same adjustments. The key to supporting a change in the intercompany arrangement may be to find comparable modifications between unrelated parties. Failing that, it may be possible to demonstrate that the changes do not disadvantage the lender, i.e., that an unrelated lender could be expected to agree to them.

New Financing Arrangements

New intercompany financing arrangements might serve as a tool for accessing capital within a multinational group. Loan terms may include certain provisions that could be useful in case of continuing liquidity issues. For example, a payment-in-kind ("PIK") option would allow a U.S. borrower to defer interest payments in exchange for a higher interest rate, with the owed interest added to the principal of the loan on a schedule. This would enhance flexibility for the borrower's short-term cash needs, while the lender would be no worse off on a long term net present value ("NPV") basis, as a premium would be charged on top of the base interest rate.

Initiating a new financing arrangement can be challenging in the current market environment. Many intercompany loans are rated below investment grade, and the volume of speculative-grade debt issuance has been greatly reduced since the onset of the Covid crisis. Tax authorities could therefore take the position that the lack of market activity does not support the issuance of similarly rated debt among related parties, and that these financings should be treated as dividends or capital contributions. For industries such as retail, leisure and hospitality, and others in which long-term structural declines are expected, the market for newly originated debt may face longer-term headwinds.

In addition, speculative-grade credit spreads have widened and become more volatile since March, complicating efforts to price new debt. To enhance the credit rating and lower the cost of borrowing, companies may explore options to pledge collateral. Alternatively, a borrowing entity may be able to obtain a financial guarantee from its parent or another related party (see below). It should be noted, however, that even investment-grade spreads may not currently be representative of underlying market fundamentals. As with intercompany receivables, certain safe-harbor rates such as the AFR may be an option to reduce borrowing costs of affiliated entities. The spread between safe harbor and "market rates" is likely to grow as the tenor of a loan increases.

Transfer pricing studies for newly originated debt should address these important dynamics, particularly as they apply to specific industries. A robust economic analysis should demonstrate that a market for the intercompany debt being considered in the current environment exists.

Parent Company Guarantee

Parent guarantees (or guarantees from other strongly capitalized affiliates) may provide for cheaper external funding as compared with when subsidiaries borrow directly from third-party financial institutions. If a guarantee has the impact of reducing the cost of funds of the borrower, then a guarantee fee may be due (or could be imputed) to compensate the related guarantor. However, if in addition to interest savings, a U.S. taxpayer cannot secure an external loan at all without a guarantee, or not the full quantum of the loan, then the loan (or part of it) could be deemed as a capital contribution by tax authorities and interest deductions may be disallowed.

Utilization of Cash Pool

Cash pooling enables members of a corporate group to make efficient use of available cash by reducing external funding costs, including transaction costs, and maximizing the group's total return on short-term cash. Consequently, existing or new cash pool arrangements can be a useful liquidity management tool in times of economic stress.

Taxpayers should be aware, however, that the analysis, benchmarking, and support of cash pooling structures can present challenges. The new chapter X of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines), released February 11, 2020, provides guidance for financial transactions, including cash pooling structures. Among the issues raised with respect to cash pools are:

- Consideration of whether certain debit or credit positions of the cash pool members should be treated as long-term deposits or loans;

- Measurement and, if appropriate, allocation of benefits realized by the group through the operation of the cash pool; and

- Arm's length remunerations for the cash pool leader.

Examination of these and other factors could result in a tax authority challenging the characterization, pricing, and tax impacts of a cash pool structure.

Other practical matters to consider include identification of the right jurisdiction to locate the cash pool leader, given the relevant tax rules and financial regulations, and the implications of negative short-term rates in many jurisdictions.

Asset-Based Lending Options

For taxpayers that transact in a significant amount of tangible goods to related parties, some relatively inexpensive forms of intergroup financing may be available. One arrangement is an inventory financing arrangement. An entity can sell its inventory to an affiliate with an explicit promise to buy back the inventory at a predetermined price, presumably by adding a market return to the amount financed, over a specified timeframe. While this transaction can be an appealing way to monetize assets to meet liquidity needs, considerations such as the valuation of inventory and counterparty risk may add complexity.

Another asset-based lending option is factoring of accounts receivable (“AR”), involving a transfer of title to the AR from the seller ("Assignor") to the factoring entity ("Factor"), which can be a related party. If obligators of the AR default, the Factor takes the loss instead of the Assignor. The fair market value (“FMV”) of the AR can typically be estimated based on expected future cash flow collection through the application of a discount rate that reflects the counterparty risk.

In both types of asset-based arrangements, the exchange of underlying collateral can lower financing costs. However, inventory surpluses and higher-than-expected delinquency rates could make these types of arrangements more difficult to administer or more costly during economic downturns.

Review of Non-financial Intercompany Transactions

Liquidity-stressed companies may also review the pricing policies for non-financial intercompany transactions such as royalty payments, management fees, and sale of tangible goods. Many taxpayers have prepared revised financial projections and have started to examine the impact of intercompany flows and associated transfer pricing policies on their cash positions. Some options to adjust intercompany pricing include payment deferrals, target profit reduction (i.e., for “routine” entities), and holidays/exemptions for royalty payments. These adjustments may start with assessing opportunities under existing intercompany contracts and could ultimately involve contract renegotiations or invoking the doctrine of “rescission”[3] for certain intercompany transactions that no longer make economic and/or business sense.

Again, it could also be useful to develop evidence of third-party behaviors and market comparable data. This evidence may be hard to come by, so a comprehensive analysis of the impact of any changes or renegotiations on the parties involved, in the context of arm’s length behavior, may be required.

In addition, relevant tax rules on the treatment of modifications and deferrals must be considered, even if they can be defended under transfer pricing principles. For example, changes to intercompany payment flows can have significant international tax implications, and therefore should be analyzed in conjunction with the overall tax position of the company. Also, in today’s global trade environment, any adjustments to pricing should also consider any impacts to tariffs or customs duties.

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[3] A revocation, cancellation, or repeal of an agreement. Invocation of this doctrine may provide relief for taxpayers who wish to undo, rather than modify, related party transactions.

Conclusions

In light of the current economic environment, there are various transfer pricing strategies available to help companies meet their liquidity needs. However, these general strategies can raise other technical or implementation issues and may affect other aspects of a company's overall tax profile. While there is not a one-size-fits-all strategy, the menu of options discussed above provides some practical economic options for taxpayers to consider when facing liquidity needs.

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