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Decoding Financial Transactions Transfer Pricing: An Unveiling with Uber

One of the most common transactions in a multinational company is intercompany lending, with multinationals using loans to fund group entities and move cash to where it is needed most. New OECD (Organisation for Economic Co-operation and Development) guidance and increased scrutiny by tax authorities globally has made transfer pricing more complex while heightening the risks and consequences of not being able to justify whether such loans are priced in line with the arm's length principle. We apply the EDF-X solution for transfer pricing to an example intercompany loan. EDF-X leverages Moody's transparent, time-tested credit risk methodologies, helping transfer pricing professionals establish credit ratings and interest rates consistent with OECD guidance.

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Challenge

Intercompany lending by multinational companies is not a new phenomenon, and the OECD Transfer Pricing Guidelines that provide guidance on how to establish arm's length pricing of intercompany transactions were first released in 1979, so why is this kind of transaction so contentious in the world of transfer pricing?

Under the arm's length principle, the price of an intercompany transaction should not differ from the price at which independent enterprises enter a comparable transaction. Historically, there has been limited formal guidance regarding how this principle applies to pricing intercompany loans. Moreover, tax authority scrutiny of financial transactions has typically not been a priority in many jurisdictions globally. However, this has now changed. In 2022, the OECD released updated formal guidance on financial transactions, and tax authorities' continued quest to "close the tax gap" has meant that intercompany financing is now a key focus area of compliance activities.

This means that the bar has been raised in terms of what needs to be considered, analyzed, and documented when justifying the arm's length nature of intercompany financing arrangements. Failure to do so exposes companies to risks of audits, financial penalties, double taxation, and reputational damage.

Insights

The OECD outlines a range of factors to be accounted for in assessing and pricing intercompany financial transactions, with two crucial elements being credit ratings and the effects of group membership. The OECD states that credit ratings serve as a useful measure of a borrower's creditworthiness and are one of the main factors that independent lenders take into account when determining interest rates.[1] Further, the OECD's view is that the reliability of credit ratings that are derived from publicly available tools is improved when the following criteria are met:

1. Both quantitative and qualitative factors are considered
2. There is transparency regarding the credit rating process
3. The tool closely matches the process and outcomes of independent credit rating agencies

The OECD notes that the effect of group membership on a borrower should also be considered in arriving at an appropriate credit rating. A number of factors are listed to consider in determining the degree of implicit group support enjoyed by a borrower, with the assessment of any implicit support ultimately being a matter of judgement in the OECD's view.

In light of the OECD guidelines, the need for an objective, comprehensive, and transparent credit risk and interest rate pricing solution has never been greater to help meet the increased complexity of financial transaction transfer pricing in this current heightened risk environment. EDF-X offers precisely such a solution. Leveraging Moody's time-tested credit risk modelling methodologies, EDF-X provides pre-determined credit risk assessments for over 450 million public and private companies, both rated and unrated, across over 200 countries and territories. Whilst these credit risk scores are based on quantitative factors, such as financial statement information or trade payment data, they can be refined by accounting for qualitative factors where appropriate. Once standalone company credit risk is determined, implicit support may be considered in line with Moody's parent/group support framework. This analysis arrives at a borrowing firm's point-in-time one-year probability of default (PD) that informs a credit rating, which is used to determine a credit spread.[2]

> "EDF-X provides tax professionals with an objective, comprehensive, and transparent credit risk and interest rate pricing tool to help meet the increased complexities involved in appropriately considering, analyzing and documenting the arm's length nature of intercompany financial transactions."

[1] The OECD notes that an issue-specific rating, when available, would be the most appropriate basis to use in pricing a loan.
[2] The credit spread is the difference between the prescribed effective interest rate on the loan and a chosen reference rate corresponding to the same tenor and origination date.

Analysis

To see EDF-X in action, we consider the case of Uber and some recent cross-border corporate restructuring activities undertaken by the group. In 2019, as part of an internal restructuring, Uber's Singapore holding company advanced a USD 16 billion intercompany loan to its Dutch subsidiary to purchase some intellectual property within the group. Naturally, the sheer quantum of this loan raised the tax risk associated with this transaction. Determining an accurate and appropriate credit rating for Uber's Dutch subsidiary is paramount in arriving at an arm's length interest rate for this loan.

To demonstrate the importance of the credit rating in an intercompany loan arrangement, we consider the potential impact of different credit rating approaches for the Dutch subsidiary Uber NL Holdings 1 B.V. (henceforth Uber NL) in taking out a 10-year loan on December 2, 2019. Three different approaches are as follows:

1. Group rating:[3] The long-term agency rating by Moody's Investors Service (MIS) for the corporate group, Uber Technologies, Inc. as of December 2, 2019.
2. Standalone rating: The PD-implied rating of the subsidiary Uber NL as of December 2, 2019. This rating is determined using EDF-X's pre-loaded quantitative data and refined using qualitative analysis (including factors relating to the industry/market, company, management, and balance sheet, shown in Table 1).
3. Comprehensive rating: The PD-implied rating of the subsidiary Uber NL adjusted for implicit support of the corporate group.[4] This approach is considered most closely aligned with OECD guidelines.

Table 1 Qualitative factor framework

CATEGORY	VARIABLE
Industry/Market	Customer power
	Diversification of products
Company	Years in relationship
	Supplier power
	Conduct of account
Management	Experience in industry
	Financial reporting and formal planning
	Risk appetite
Balance Sheet Factors	Audit method
	Debtor risk / accounts receivable risk
	Pro-forma interest coverage
	Pro-forma liquidity

[3] The OECD notes that it may be appropriate to use the group rating if a standalone analysis is not reliable.
[4] Moody's parent/group support framework is used to assess and quantify the impact of being part of the corporate group.

Once a credit rating has been determined, EDF-X provides a simple interface to determine a credit spread according to origination date of the loan, tenor, currency, reference rate, and any potential additional costs[5] (Figure 1).

Figure 1 **EDF-X inputs for determining credit spread**

Instrument Spread & Cost

Rating*

Currency*

Reference Rate*

Origination Date *

Tenor (Years)*

Origination Costs (bps)

Overhead Costs (bps)

Margin (bps)

Other Costs (bps)

The output is a credit spread calibrated to a dataset of over 16,000 globally collected Moody's rated bonds that have been filtered by rigorous bond inclusion criteria.[6] An effective interest rate for a comparable loan can then be obtained by adding the spread to the corresponding reference rate.[7]

For the Uber NL example, Table 2 shows the resulting credit spreads (denominated in Euro, taking a European Treasury yield as the reference rate[8]) across different ratings and tenors. Poorer ratings and longer tenors are generally associated with larger spreads, as expected. Based on this analysis, even the relatively small difference in median credit spreads between a credit rating of B2 and Caa-C of 67.74 basis points on a USD 16 billion 10-year loan would result in a difference of over USD 108 million in interest per year, or potentially in excess of USD 1 billion over the term of the loan!

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[5] Origination costs, overhead costs, margin, and other costs are directly added to the resulting credit spread.
[6] The PD range associated with each rating bucket is fairly consistent across countries, so integrating globally collected bonds into a single framework is practicable. An alternative to using bonds is using historical loan transaction data, which would allow for matching spreads according to the size of the loan as well. However, transaction data on comparable loans are often limited and thus suffer from small sample bias. In contrast, the global bond universe is substantially larger. Bonds also have more standardized terms and offer updated pricing along with greater liquidity.
[7] After the denominations of all bonds have been changed to USD, the spread is obtained as a value that is approximately representative of the median spread of all the bonds in the corresponding tenor-rating bucket. Finally, the spread is converted to its counterpart in the chosen currency (Euro in our example) by leveraging daily updated market-observed FX rates using the principle of interest rate parity along with a no-arbitrage condition. For further details on the derivation of the credit spreads, see Wang, Y., Moore, D. and D. Dwyer (2019). Moody's Market Implied Ratings: Description and Methodology. Moody's Analytics.
[8] For a tenor of 10 years, the reference rate in our example is –28.6 bps.

Table 2 Median credit spreads (bps) for Euro loan originating on December 2, 2019

	Rating	1 Year	2 Year	3 Year	4 Year	5 Year	6 Year	7 Year	8 Year	9 Year	10 Year
Group →	B2	293.6	370.25	422.2	455.56	482.08	510.12	533.94	552.51	567.88	576.74
Comprehensive →	B3	350.3	426.04	477.05	509.45	534.02	561.1	582.98	600.58	614	622.88
Standalone →	Caa-C	362.03	440.72	492.72	527.08	552.64	580.71	603.57	622.16	635.59	644.48

Key Takeaways

» New OECD guidance and increased regulatory scrutiny has only added to the risks of ensuring intercompany financing arrangements are appropriately and robustly considered, analyzed, and documented.

» Determining an appropriate credit rating for a borrowing firm is key to arriving at an arm's length interest rate and can have a substantial impact on tax outcomes.

» Leveraging Moody's transparent, time-tested credit risk modelling methodologies, EDF-X offers a bespoke solution targeted to help transfer pricing professionals determine credit ratings and interest rates of intercompany loans that are consistent with OECD guidance.

Learn More About EDF-X

EDF-X, Moody's flagship solution for accelerated financial risk insights and early warning signals, pre-calculates credit measures for 450+ million companies globally – public and private, rated and unrated – using the best data available and provides customized views for a range of business and credit decisions.

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