MOODY'S ANALYTICS

Best Practices for Transfer Pricing

A Conversation with Dell Technologies

ABOUT SRINI LALAPET

Srini is a key senior member of Dell's transfer pricing team. He focuses on design, management, and implementation of the company's worldwide transfer pricing policy involving the use of intangible property and other intercompany transactions. Prior to joining Dell Technologies in 2015, he spent almost six years at Queen's School of Business, serving as advisor for new venture project courses in the Queen's Executive MBA programs.

ABOUT DELL

Dell Technologies is an American multinational information technology company, incorporated after the merger of Dell, Inc. and Dell EMC. The combined annual sales are about $76 billion with around 140,000 employees around the world in about 180 countries. Dell Technologies is a unique family of businesses that provides the essential infrastructure for organizations to build their digital future, transform IT and protect their most important asset, information.

During this Q&A, Jim Sarrail, Senior Director of Credit Risk Solutions at Moody's Analytics, talks with Srini Lalapet, Transfer Pricing Specialist at Dell Technologies. Srini shares his transfer pricing experience, specifically the benefits of using Moody's Analytics RiskCalc™ software within Dell's transfer pricing process.

Jim Sarrail:

To provide some structure and some specific uses of RiskCalc software at Dell, perhaps you could start with the objectives of your transfer pricing functions in terms of establishing or evaluating arm's length financial transactions and how RiskCalc software supports that business objective. Then perhaps you can discuss the regulatory environment and some other considerations.

Srini Lalapet:

Dell has a global footprint, so we have a transfer pricing group that looks at Dell entities across the world. We use RiskCalc software and it is critical for all our transfer pricing transactions. Our whole objective is to emulate the market best practice in pricing intercompany loans within Dell. We approach intercompany financing the way a third-party bank would when it is providing a loan to a prospective borrower. The first part of the process involves assessing the credit rating or the credit quality of the borrower, and then the next part of the process involves the loan pricing process. If you think about the credit quality of a borrower, think of the important determinants of interest rates. There are other determinants as well, but think about all the factors that are involved in pricing a loan. That is probably the key challenge, and RiskCalc software provides an efficient mechanism to assess the credit quality of the borrower.

Now you have an established credit rating from a leading credit rating agency. The interesting thing about RiskCalc software is that because it has country-specific models, we can use the RiskCalc software solution to come up with the credit ratings for all our Dell loans wherever they are situated. By doing that, we are able to have a systematic way to compare credit ratings and credit quality of borrowers across the world, after solving the problem of uniformity of assessment of credit quality of borrowers across the world. After solving the problem of uniformity of assessment of credit quality as well the comparability of the credit quality of our borrowers, we look at the various functionalities that RiskCalc software provides.

For instance, we use both the financial statement only and credit cycle adjusted modes to look at Expected Default Frequency (EDF). There might not be much difference between these two modes, the credit cycle does not normally affect the credit rating as much unless there is an extraordinary financial situation like 2008.

The other interesting thing is that RiskCalc software provides us both qualitative and quantitative assessment metrics. We do occasionally use qualitative data but we do not use that as a standard because using quantitative data is easily defendable in front of tax authorities. Qualitative factors are less defendable so we try to emphasize transparency to the extent possible because these assessments ultimately can buy you tax security and so, if you think about the process, RiskCalc software is fairly critical to take on the assessment. The other way we would think about factors that would affect the standard of rating of the borrower would be the parent's credit rating. We do look at that and see if for instance there is any kind of inclusive or explicit support provided by the parent and if we should be taking that into consideration in assessing the credit quality of the individual borrower. This is something that we have discussed extensively internally within our group and with external advisors. We set up a policy that we use a parent company's credit rating because the parent company has full access to a subsidiary's cash and assets and therefore we generally look to the parent company as a ceiling unless we have special circumstances.

Jim Sarrail:

In the absence of RiskCalc software, what would be your approach to estimate the credit rating?

Srini Lalapet:

In my experience, some companies have in-house models. So the way we would build a model is to follow the Moody's industry position papers on this particular subject. For example, if we were evaluating credit ratings of companies in the technology industry, we would refer to the Moody's industry methodology and try to build an in-house model from scratch. Now that is a time consuming and probably also expensive process in terms of the amount of effort involved. One of the challenges with having an in-house model is that you must explain the in-house model and the more sophisticated it is, the more difficult it is to explain. The other alternative is to get one of the academic models and you need a high level of expertise to build and work with these academic models. In commercial operations such as ours, we do not have the luxury, the time, or the resources to build in-house models and more importantly we are a little worried about building these models and trying to explain them to the tax authorities. Some tax authorities are sophisticated and perhaps they understand and some tax authorities might not. Also, they might feel that perhaps we are doing something with these models that is not entirely transparent. I think RiskCalc software is a good tool because we tell the tax authorities that we are using this tool that is provided to us by Moody's, therefore this is an unbiased evaluation of our credit ratings. One of the most critical components of loan price analysis is that we can be as transparent as possible to the tax authorities and convince them that this is an unbiased analysis of credit quality. Our default has been RiskCalc software. We can use RiskCalc software because it is efficient, we can use it multiple times, and we can use it in many parts of the world.

Jim Sarrail:

I think we are moving on to the second category of questions which relates more to regulatory challenges as you must be interacting with many different countries' tax authorities. I can imagine that the process of justifying your approach has to be recognized and accepted by not just one tax authority but at the country level to operate around the globe. Are there more specific challenges that were raised by the OECD requirements that would cause you to reevaluate any part of your process or have triggered more effort on your part in terms of being compliant?

Srini Lalapet:

We think that we have an excellent process with low complexity. We focus our efforts on documentation and also on transparent methodology.

RiskCalc software helps with both of those aspects. What we have tried to do on a systematic basis is have specific documentation for each of our company loans. For instance, that involves credit rating output from the RiskCalc solution that is attached to a file so the credit rating is adequately demonstrated to be unbiased and transparent. We create a loan analysis file where we outline how we have priced the loan, what components we need, and then document that in a form, so that any tax authorities looking at know it meets the OECD requirements today. Using RiskCalc software as part of our process has helped us in obtaining adequate documentation to convince our auditors and tax authorities that we have an excellent process in place.

Jim Sarrail:

What are the particular areas of concern for tax authorities?

Srini Lalapet:

It depends on the sophistication of the tax authorities. Many sophisticated authorities do already have access to RiskCalc software and are comfortable with the process and with the product so they understand exactly what you are doing. Sometimes, we must explain the process and how we are using RiskCalc software. Generally speaking, I think the two main aspects are if they are convinced about the credit quality of the borrower, which is the primary hurdle, then the conversation does evolve into appropriateness of the comparable and whether the adjustments have been made correctly to come to arm's length. And the one other thing that we are recently seeing, which we have not seen in the past, is the whole idea of why this loan is being put in place. So I think what we are seeing uniformly across the world, it does not matter which part of the world you are looking at, now you are seeing the tax authorities are getting more sophisticated about how to complete financing in general, and they are beginning to understand the methodology. We also get questions about if we take into account any qualitative factors, or we take into account any parent company support, and so on. I am happy to say that RiskCalc software helps us get on the right side of auditors and we found that they are also fairly happy with the level of transparency that we provide, so that is always a good start because ultimately we want to have a productive relationship with the tax auditors.

To hear the full interview, please visit moodysanalytics.com/transferpricing

About Moody's Analytics

Moody's Analytics, a unit of Moody's Corporation, helps capital markets and credit risk management professionals worldwide respond to an evolving marketplace with confidence. The company offers unique tools and best practices for measuring and managing risk through expertise and experience in credit analysis, economic research and financial risk management. By offering leading-edge software and advisory services, as well as the proprietary credit research produced by Moody's Investors Service, Moody's Analytics integrates and customizes its offerings to address specific business challenges.

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