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REPORT

Transfer Pricing and Intragroup Cash Pooling

The authors assess the transfer pricing issues involved in an intragroup cash pooling arrangement from the perspective of both an external bank structure and an in-house bank structure and conclude that there are fundamental differences in the methods that would apply.

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Intragroup cash pooling is an arrangement commonly used by multinationals to efficiently manage intercompany lending among members of the group[1] by using surplus cash of some participating members of the cash pool to fund the operating requirements of other participating members without having to significantly draw down local bank credit facilities by one member of the group. Additionally, intragroup cash pooling structures are an effective means of reducing external—that is, third-party—financing costs to the group as a whole.

[1] The arrangement is an alternative to relying solely upon direct loans from the parent or a finance subsidiary to finance operating subsidiaries.

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However, intragroup cash pooling structures can be highly complex and will present the tax departments of multinationals with many potential transfer pricing issues—including determining the arm's-length deposit interest rates and lending interest rates—as well as operational challenges in pricing the large volume of transactions. The complexity of these structures can be directly related to the many different functional characterizations of each of the participating entities. In particular, when analyzing these structures, from a transfer pricing perspective, it is important to consider which participating entities are assuming the credit risk as well as determining the credit risk being assumed.

The focus of this article is on the transfer pricing issues involved in an intragroup cash pooling arrangement from two structural perspectives: first, within an external bank structure, and second, within an in-house bank structure.

External Bank Structure

First, it is helpful to examine how a multinational manages its intercompany financing requirements before it considers or establishes an in-house bank structure. Essentially the multinational parent or its finance subsidiary would, in addition to making direct loans to

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its operating subsidiaries for specific purposes (such as acquisitions, capital expenditure programs, or projects), likely set up an intragroup cash pooling agreement with a third-party bank involving all or most of its operating subsidiaries.

Specifically, a multinational's treasury group enters into a cash management services agreement with a third-party bank, which sets up a cash pooling arrangement. Under the arrangement, the bank accounts of the participants—different legal entities—are netted out for purposes of determining the balance on which the external bank must pay deposit interest (or alternatively to determine the overdraft balance and lending interest amount that the external bank will charge to the cash pool). The netting feature in a cash pooling agreement means that some of the bank accounts can be in overdraft (debit balances) while other accounts will have credit balances.

As long as the header or master account in the cash pooling agreement has an overall or net positive balance, there usually is no physical transfer of funds. If the header account is in overdraft, it is typical for the multinational to transfer funds from some other source (such as drawing down on external credit facilities with a bank) to cover the net overdraft position. The nature of this arrangement provides the multinational with an efficient way, on a global basis, to minimize overall borrowing costs.

But what are the transfer pricing implications, if any? Consider the following example.

First, assume that the parent entity has negotiated and entered into the cash management services agreement with Bank of America (BoA), which involves a cash pooling arrangement for the participants.

In this example there are 20 participants in the external cash pooling agreement with BoA but only five of the participants have bank accounts that are in debit balances. Further, assume that the aggregate credit balances are $2 billon while the aggregate debit balances are $500 million. The net balance for this cash pooling arrangement therefore is a $1.5 billion deposit. BoA would pay the cash pool deposit interest amount based on the net deposit balance ($1.5 billion) at the agreed upon deposit interest rate.

Further assume that under the agreement with BoA the net deposit balance of the cash pool is paid a deposit interest rate set (and re-set) at one-month London interbank bid rate (LIBID) less a fixed spread, say 10 basis points (bp). Sometimes, but not always, the external cash pooling agreement may state a scale of deposit rates (actually the negative spreads) tied to the size of the net deposit balance of the cash pool where a higher deposit rate is paid on higher levels of deposit balances. For this example, however, assume that there is only one deposit interest rate paid by the bank to the cash pool—no matter the size of the net deposit balance. The market deposit interest rate offered by the bank, however, most likely would be higher than the bank's retail deposit rates to reflect the expected (larger) size of the deposit balance.

In the event that there is a net overdraft in the cash pool, BoA would charge the London interbank offered rate (LIBOR) plus a spread, say 50bp to the participant that has the header account—in this case the parent entity. This lending interest rate likely has the same spread or lending margin that the bank would offer to the multinational's parent or group as the lending margin is reflective of the short-term credit risk of the parent and not necessarily reflective of the credit risk of individual participants to the cash pool that are in overdraft.[2]

So, what are the transfer pricing issues? First, the borrowing participants would need to pay an arm's-length interest rate on the overdraft balances to the parent or finance subsidiary within this structure. The deposit interest paid by BoA on the net deposit balance in the cash pool is not an arm's-length borrowing rate. Second, the deposit participants would need to be paid an arm's-length interest rate on their deposit balances, which rate may be lower (or higher) than the deposit rate paid by BoA to the cash pool.

Scenarios

The external cash pooling agreement provides two different types of pricing: the deposit rate and the lending rate. But can these prices be considered comparable uncontrolled prices for the purposes of pricing the intercompany deposit and lending transactions within the cash pool? Consider the following scenarios and what transfer pricing issues they might raise.

1. All borrowing participants pay the same lending interest rate on overdrafts—the deposit rate as set out in the external cash pooling agreement—so that deposit participants earn the same amount of deposit income they would have earned if the third-party bank had paid deposit interest on the gross, rather than net, deposit balance. In this scenario there is only one interest rate—the third-party bank's deposit rate—which is used as both the deposit interest rate paid to deposit participants and the lending interest rate paid by borrowing participants.
2. All participants within this structure pay the lending interest rate on overdrafts and receive the deposit rate on deposits as is set out in the external cash pooling agreement with the third-party bank. In this scenario, there are a lending interest rate and a deposit interest rate as stated in the third-party cash management services agreement.
3. Borrowing participants pay an arm's-length lending rate based on a credit risk analysis of each of the borrowing participants. Deposit participants receive the deposit interest rate on deposits in their bank accounts as set out in the external cash pooling agreement with the third-party bank.
4. Borrowing participants pay an arm's-length lending rate based on a credit risk analysis of the borrowing participant. Deposit participants receive an arm's-length deposit rate on deposit balances.

In the first scenario, the approach is simplistic in that the parent entity or finance subsidiary earns zero profit or return on the transactions—lending interest received equals deposit interest paid out. Thus there are no residual profits to be split between the participants and parent entity. But is this pricing structure arm's-length?

For the internal deposit interest rates the question is whether the individual deposit participants would have negotiated higher or lower deposit interest rates based on their own anticipated level of deposit balances. This

[2] Usually, the bank would expect a net deposit balance and that any overdrafts in the cash pool would be covered within a relatively short time—usually a day or few days.

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same question also must be answered for the second and third scenarios. Additionally, in scenarios 1 and 2 the lending rate charged to the borrowing participants is not based on the individual credit quality of those entities. It is likely that if one were to consider each of the borrowing participants on a stand-alone basis, the arm's-length lending rate would be higher than both the external deposit rate (which is based on the credit quality of the external third-party bank) and the external lending rate (which is based on the credit quality of the parent entity or the group as a whole). The fourth scenario is based on the arm's-length principle being applied to both the borrowing and deposit transactions.

It should be noted that in every scenario but the first, the pricing structures will result in a net profit to the parent entity because of the spread between the lending rate and deposit rates. Consequently, a full contribution analysis of the functions and likely the capital at risk for each of the participants and the parent entity should be performed to determine an appropriate profit split.

Arm's-Length Overdraft Interest Rate

The netting feature within the external bank's cash pooling agreement raises a transfer pricing issue as the financial asset of one group member—the cash balance in its bank account—is being used by another member to cover overdraft in its bank account.

Thus, what is the arm's-length compensation that should be paid to the owner of this cash balance in an intercompany lending transaction? If there is no intercompany charge to a borrowing participant (which is a member of the group that has an overdraft in its bank account within the intragroup cash pooling structure), then the borrowing participant is essentially receiving an interest-free loan within the external cash pooling structure from the deposit participants. This obviously is not an arm's-length result. Therefore, on an arm's-length basis, the borrowing participant would need to pay interest on its overdraft to the intragroup cash pool.

So, for this intercompany financial transaction, the transfer pricing issue is what overdraft interest rate should be charged. Is it the same interest rate the third-party bank would charge the parent when the header account, within the cash pool, is in overdraft? While this may seem to be a potential answer, it is not necessarily an arm's-length result. As always, the transfer pricing answer depends on the functional and risk analysis of the parties involved in the intercompany financial transaction.

In the intercompany lending transaction—with respect to the external cash pooling agreement with the bank, in which deposit participants are lending to borrowing participants—it must be determined whether the depositor participants assume the risks (mainly credit risk) of the borrowing participants related to the intercompany lending. If so, the deposit participants should earn an arm's-length interest rate that compensates them for the lending risk (that is, the credit risk of the borrowing participants).

Functionally one could consider the intercompany lending (overdrafts) to be a set of syndicated loans where the deposit participants provide a pro rata share of the debt funding for each syndicated loan to a particular borrowing participant. So, as an example, if a specific depositor participant has 50 percent of the total cash pool deposits on a gross basis, then it is funding 50 percent of the intercompany lending to each of the borrowing participants.

Arm's-Length Deposit Interest Rate

For transfer pricing purposes, can the arm's-length deposit rate paid by the third-party bank to the cash pool be considered a CUP? If so, then all deposit participants to the cash pooling agreement should earn or be paid the same deposit rate. There is, however, one potential and major comparability issue. That is, the deposit balances between the depositing participants may vary significantly. Is the deposit interest rate paid by the bank based on the size of the deposit balances? If so, then a third-party bank would have offered a lower deposit interest rate to a deposit participant that had relatively lower deposit balance than the cash pool deposit balances in a stand-alone deposit taking transaction. Conversely, the bank may have offered a higher deposit rate on larger deposits of participants where the deposit balance is not reduced by the netting out of overdrafts in the bank accounts of other participants.

Clearly the deposit participants, in this external cash pooling arrangement, assume the credit risk of the external third-party bank for their deposit balances and so would earn a deposit rate that reflects the bank's credit risk.[3].

Norway Tax Case: *ConocoPhilips*

The first scenario (as mentioned above) is similar to the fact pattern, as stated in the recent tax case in Norway, of how ConocoPhillips set up the intragroup cash pooling arrangement with a third-party bank.

In the *ConocoPhillips* tax case the tax authority's position—that the deposit participants to the cash pool were not receiving an arm's-length deposit rate based on their respective contributions to the cash pool—was upheld by Norway's Court of Appeal in January 2010. In the fiscal years 2003 and 2004 the ConocoPhillips group had an external cash pooling agreement with BoA, which provided a favorable deposit rate (LIBID less 25bp) on the net deposit balance of the cash pool as well as a borrowing rate on net overdraft of the cash pool (LIBOR + 25bp).

The question is whether BoA provided a higher deposit rate under the cash pooling agreement than it would have provided to the individual depositor participants. It is entirely possible that the aggregation of smaller deposit balances (net of overdrafts) of the members of the group into a larger cash pool would have attracted a potentially higher deposit rate from BoA than what would have been obtained on the smaller deposit balances of each member.

Since the net deposit balance in the cash pool was in the billions of dollars and presumably would have been a significantly larger deposit than any of the individual depositor balances, it is likely that the bank would have provided a higher deposit rate to the cash pool than it would have to the individual participants with smaller deposit balances. This is, however, difficult to substantiate and quantify, especially on a retrospective basis. There would need to be some factual evidence that the

[3] A bank's credit quality also may be enhanced through deposit insurance plans provided by governmental or regulatory bodies.

bank required a minimum deposit balance or would have provided a scale of deposit interest rates based on the size of the deposit balance to conclude that the size of the deposit balance was connected to the level of the deposit rate. However, these facts were not evident in the tax case.

The court's decision in *ConocoPhillips* suggests that some of the participants are benefitting from the higher deposit balances provided by a few of the participants in that they are obtaining a higher deposit rate. First it must be shown that there is indeed a benefit. Is the deposit rate for the cash pool higher than what some of the participants would have obtained? If there is no difference in the market deposit rate, due to size of the deposits, then there is no benefit provided by the larger depositor participants to the smaller deposit participants. Second, assuming there is a benefit, the quantification of the benefit provided by the larger depositor participants would be based on performing a contribution analysis.

The second point above also relates to the lending rate and interest income that the cash pool would earn from borrowing participants. Did BoA provide a lower lending rate—one that was based on the parent's or group's credit risk—than it would have charged the individual borrowing participants that were in overdraft balances? As these cash pooling arrangements essentially are ''joint and several'' liabilities to BoA by all the participants, there is an embedded cross-guarantee of all participants to BoA. The lending interest rate explicitly considers the parent or group's credit risk profile. Within the structure the depositor participants are assuming the credit risk of the borrowing participants.

Thus, an arm's-length interest rate would need to consider the credit risk of each borrowing participant. It also is likely that implicit parental support would be a factor in influencing the quantum of the lending interest rate as the parent entity would be required under the cash pooling arrangement with BoA to cover any net overdrafts (which would occur if a borrowing participant defaulted on its overdraft).

According to the facts of the tax case, if the header bank account for the cash pooling arrangement was in overdraft, the bank would have charged a lending interest rate of LIBOR plus 25bp. But for most arm's-length cash pooling arrangements, the bank would expect that the header bank account likely never (or rarely and for a short period of time) would be in overdraft. Of course, individual bank accounts of the participants could be in overdraft as long as the net balance was still in a credit position.

In the intercompany financial transaction, however, the borrowing participants that had an overdraft in their bank accounts within the netting arrangement paid a lending interest rate equal to the deposit interest rate the group had obtained from BoA. The related-party depositor(s) would get the interest income based on the deposit rate on its full deposit balance. If the lending and borrowing participants have different levels of credit risk from each other as well as from the parent or group as a whole, then the depositors, if they assume credit risk in the lending transactions, are not earning an arm's-length return.

In the *ConocoPhillips* case, the deposit participants with relatively smaller deposit balances are obtaining the full benefit of the higher deposit rate negotiated between the finance entity (based on the larger deposit balances) and the third-party bank, BoA. The taxpayers argued that this deposit rate for the cash pool was higher than the taxpayers could have negotiated and obtained on their own from a bank. Thus, the smaller depositor participants in the cash pool are benefiting from the larger deposit balances.

The borrowing participants paid interest at the lending rate on the outstanding overdraft balance. But is this an arm's-length approach? In the authors' opinion, it is necessary to consider each intercompany transaction as a short-term intercompany loan between the deposit participant and the borrowing participant. The determination of the arm's-length lending margin for each borrowing participant is based on a credit risk analysis and benchmarking the lending margin to comparable uncontrolled financial transactions (CUFTs).

In-House Bank Structure

The use of an internal or in-house bank structure is a relatively new development and is an evolution of the external cash pooling arrangement. Essentially the in-house bank performs most of the activities that an external third-party bank would perform under the cash pooling arrangement. Therefore, the in-house bank earns the fees and profit that would have been earned by the external bank.

However, whether the in-house bank earns the spread on the deposit and lending activity depends on the functional characterization of the bank. If it is solely a coordinator or manager of the cash pool then it is likely to be characterized as a limited-risk entity and it is the related deposit participants that are, in fact, assuming the credit risk in the intercompany lending transactions with related-party borrowers. In this case, the in-house bank would earn an administrative fee for its role in the intragroup cash pooling structure. Whether the in-house bank or the deposit participants in the cash pool assume the credit risk of the borrowing participants, the arm's-length overdraft or lending interest rates paid by the borrowing participants would need to be determined. (This is the same arm's-length approach described above for a cash pooling agreement with an external bank.)

The administrative difference between an in-house bank structure and an external bank structure is that the participants in the cash pooling arrangement have intercompany accounts with the in-house bank and do not have bank accounts directly with an external bank. The functional difference, however, is that the intercompany deposit participants have made deposits with the in-house bank (not with an external bank) and therefore the depositor participants are assuming the credit risk of the in-house bank for these deposits. Since the in-house bank is not a regulated financial institution with an AAA or AA credit rating, it is likely that the in-house bank would not attract deposits, on an arm's-length basis, at deposit rates as low as those offered by a bank.

But what is the arm's-length deposit rate? And what is the most appropriate transfer pricing method? Consider the following example.

Assume the in-house bank is a separate legal entity from the parent. The in-house bank accepts deposits from participating entities and provides intercompany lending via overdrafts all through intercompany accounts.

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It has been assumed that there are 30 participants in the in-house bank cash pooling agreement, with 15 participants having intercompany accounts that are in overdrafts and 15 having deposit balances. Further, assume that the aggregate deposit balance and aggregate overdrafts are equal at $900 million. Therefore, the net balance for this cash pooling arrangement is zero (no surplus funds).

The first step is to perform a credit risk analysis of the in-house bank using a credit risk estimation tool such as Moody's RiskCalc, Standard & Poor's CreditModel, or an internally developed model. With the application of this type of tool, the taxpayer can estimate the credit quality of the internal house bank based on an estimate of its one-year forward-looking probability of default (PD), which maps to an implied credit rating. In addition to considering the results from the credit risk estimation software it is necessary to consider other factors affecting the in-house bank's credit risk profile—for example, by evaluating the impact of the credit quality of money market investments (one potential use of the excess or net deposit funds) by the in-house bank.

Specifically, if most of the intercompany deposits are invested by the in-house bank in short-term investment-grade money market instruments (with a relatively small amount of the cash pool actually being used in intercompany lending), then this will have a significant impact on the overall credit risk estimation of the in-house bank and on the resulting determination of the arm's-length deposit rate. Conversely, if most of the intercompany deposits in the cash pool fund the intercompany lending activity, then the in-house bank's credit risk would reflect the overall portfolio credit risk of the intercompany lending. The latter is the assumption made for this example.

As stated above, for credit risk estimation purposes the estimated one-year forward-looking PD is used as the most appropriate credit risk measure for the in-house bank (or alternatively its implied credit rating). Assume for this example that the in-house bank's one-year forward-looking PD is 0.35 percent (which maps to an estimated implied credit rating of BBB+/Baa1) and that most of the deposits are used in intercompany lending.

As this is an internal cash pooling structure, there is no pricing data on the deposit rate (or for that matter the lending rate) from an external cash pooling agreement with a bank that could be a potential CUP. In the absence of any comparable uncontrolled deposit-taking transactions involving cash pooling agreements, how can the arm's-length deposit rate be determined?

The next step is to determine the arm's-length deposit rate by calculating the price of the credit risk being assumed by the intercompany depositor participants in the deposit transaction with the in-house bank based on the bank's credit risk profile (that is, its one—year forward-looking PD).

One method is to calculate the two components of a return on credit risk (ROCR) as the price of credit risk based on well-established and applied credit risk pricing methods used by banks and supervisory bodies (such as Bank for International Settlements and local country financial institution regulators). Essentially, credit risk consists of the sum of two fundamental components: expected loss (EL) and unexpected loss (UL). This can be referred to as a return on credit risk (ROCR) and is expressed in the equation ROCR = EL + UL.

Furthermore, EL and UL can be calculated using these formulas:

$EL(\%) = PD \times LGD$

$UL(\%) = \sqrt{[PD \times SD_{LGD}{}^2 + LGD^2 \times SD_{PD}{}^2]}$

where

PD = the probability of default (%) by the internal house bank over a specific time horizon,

LGD = the loss given default, or the proportion (%) of credit exposure that would be unrecoverable by the depositor in the event of default by the internal house bank (equivalent to 1 – recovery rate) over the same specific time horizon,

SD_{LGD} = standard deviation of LGD, and

SD_{PD} = standard deviation of PD.

Since credit risk data (that is, PD and LGD) for most publicly traded companies is published by the credit rating agencies, such as Moody's and Standard & Poor's, the EL and UL—and therefore ROCR—can be calculated for comparable uncontrolled companies, or those that have a credit risk profile comparable to that of the in-house bank.

In this example, the taxpayer would search for and identify public companies that have levels of PD similar to that of their internal house bank—say between 0.30 percent and 0.40 percent (that is, +/– 0.05 percent from the in-house bank's estimated one-year forward-looking PD). Next, the credit risk data (PD and LGD) is obtained on these comparable public companies and the ROCR is calculated for each of the comparable companies. This results in an arm's-length range for the ROCR, or equivalently the arm's-length range of deposit margins. This method, referred to as the ROCR, is comparable to a transactional net margin method (TNMM) or comparable profits method (CPM), except that instead of using the financial results of comparable companies and benchmarking to an appropriate profit-level indicator, the ROCR uses the publicly available credit risk data of comparable companies (based on the credit quality of the internal house bank) to determine an arm's-length range of ROCR (that is, the arm's-length range of deposit margins).

Based on an analysis performed as at Aug. 31, 2010, the authors selected 54 comparable companies (with levels of PD similar to that of the in-house bank) and calculated the ROCR range (expressed in basis points) as follows:

	PD Range							
	Min	Max	Count	Minimum	Lower Quartile	Median	Upper Quartile	Maximum
BBB+/Baa1	0.3	0.4	54	36.9	45.4	48.4	53.2	61.3

The resulting arm's-length deposit margin (which is the ROCR range) is then added to a short-term market reference rate that is appropriate to the currency of the deposits to determine the short-term deposit interest rate on the intercompany deposits. In this example, the deposits are in U.S. dollars and are repriced every month. Therefore, using the one-month LIBOR rate of 0.26 percent as at Aug. 31, 2010, plus the arm's-length deposit margin, the arm's-length full range of deposit rates is calculated as between 0.63 percent and 0.87 percent, with a median of 0.74 percent.

Conclusion

There are fundamental and significant differences in transfer pricing methods between the external bank structure and the in-house bank structure with respect to intragroup cash pooling. Additionally, there is no standard cash pool structure, and therefore the taxpayer must consider the functional characterization of all participants in order to select the most appropriate method and benchmarking data for pricing each transaction.

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