

# Preferred shares and transfer pricing

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*Gordon Hands of CUFTanalytics explains how taxpayers can assess the arm's length dividend rate for intercompany preferred share issuances.*

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If the capital structure decision, on a tax effective basis, is made, as part of a multinational's overall intra-group financing strategy, to have a member of the group issue preferred shares to a related party then there is a transfer pricing issue; what is the arm's length dividend rate for the intercompany preferred share issue?

Publicly available data can be relied upon in the prospectuses of third-party preferred share (and subordinated notes) issues to perform the analysis. First the credit risk measure, a one-year forward probability of default (PD), for the tested party (the preferred share issuer) is estimated based on credit risk estimation models from the external credit rating agencies. Second, a search for companies with similar levels of one-year forward PD (the credit risk measure) that have recently issued preferred shares is performed. Third, a detailed review of the prospectus is performed to obtain dividend rate (and margin) pricing data.

In most cases there will be major differences in the terms of the third-party preferred share issue compared to the tested instrument. Once the dividend margin is derived or observed, meaning the credit spread or rate that is added to an appropriate market interest rate is found, it is then possible to complete a comparability analysis and make adjustments to dividend margins of the comparable preferred share issues which reflect changes in the level of credit risk due to differences in execution date, tenor of the issue, country related factors, embedded optionality (call/redemption, put, and convertibility features) and so on.

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