12TH ANNUAL NABE

TRANSFER PRICING SYMPOSIUM

JULY 19-21, 2022

FOUR SEASONS HOTEL | WASHINGTON, DC

NABE

National Association for Business Economics

The End of LIBOR: The Y2K of Transfer Pricing

Background

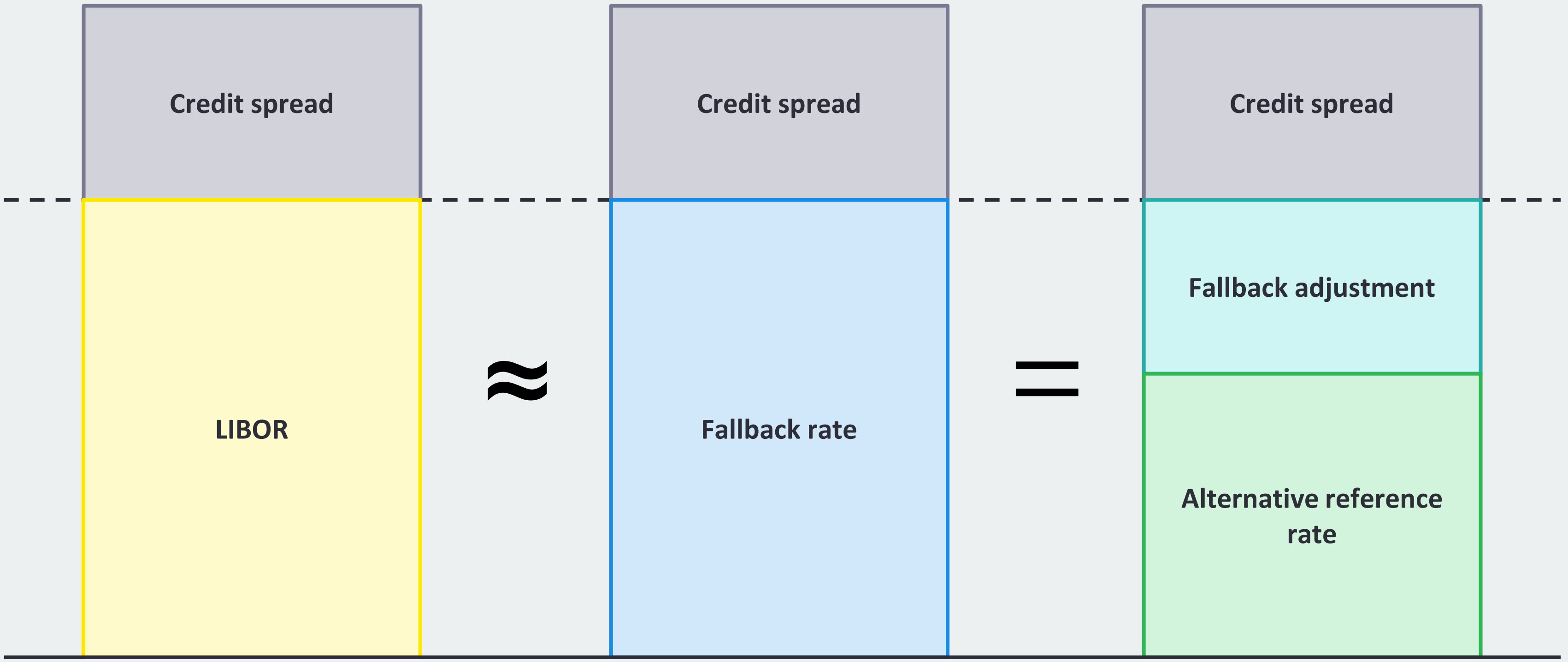
- **Why are certain Interbank Offered Rates (IBORs) being retired?**
  - **No longer representative/viability questioned**
    - LIBOR, for example, was said to be increasingly based on the expert judgment of panel banks due to the declining amount of unsecured, wholesale borrowings by banks since the financial crisis
  - **Rate fixing scandal (2012)**
    - Banks misreported LIBOR data to benefit their derivatives desks

  → **Enhanced global appetite for changing from quoted rates to directly observable market rates**

- **Out with the Old … in with the New**
    - LIBOR phased out in December 2021 (USD, EUR, GBP, CHF, JPY currencies were impacted)
      - O/N, 1M, 3M, 6M and 1Y USD LIBOR continued synthetically through June 2023
      - 1M, 3M and 6M GBP and JPY LIBOR continued synthetically in the near-term
    - Euro Overnight Index Average (EONIA) also phased out (2022)
    - The US is asking market participants to consider the Secured Overnight Funding Rate (SOFR) as an alternative for use in new products and as a fallback for existing contracts that reference USD LIBOR

- **Alternative Reference Rates and Fallbacks….What's the difference?**
    - An **alternative reference rate (ARR)** is a substitute benchmark rate used to set other interest rates among market participants. E.g., new loan might be written at SOFR+150 rather than LIBOR+100
    - **Fallback language** refers to the legal provisions in a contract that apply if the underlying referenced rate (e.g., LIBOR) is discontinued or unavailable. (e.g., automatically converting a LIBOR loan to a SOFR loan, with a specified spread adjustment, as soon as LIBOR is discontinued)
      - In the absence of Fallback terms in existing agreements, the International Swaps and Derivatives Association (ISDA) developed a voluntary Fallback Protocol effective January 25, 2021. Market participants can voluntarily agree to the protocol automatically amending their contract

Background (cont.)



Tax and Transfer Pricing Considerations

- **Impact on existing loans**
  - Fixed interest rate loans largely unaffected
  - Floating interest rate loans affected
    - Select new reference rate
      - Alternative reference rate vs. fallback rate
      - Compound (backward-looking) vs. term (forward-looking)
    - Adjust spread
      - Alternative reference rates have different absolute values to LIBOR
      - Fallback LIBOR rates in theory do not
      - Economically equivalent result to avoid deemed refinancing
      - Quantification: fallback adjustments vs. historical adjustments vs. swaps vs. targeting (deposits)
      - Data availability
  - Precedent established by transition treatment of external debt
  - Tax treatment of changes in terms & conditions
    - Does amending a loan agreement to economically equivalent interest terms constitute a refinancing?
    - Mixed reassurance from jurisdictions*
      - US proposed regulations at Treas. Reg. § 1.1001-6(a)(3) and Rev. Proc. 2020-44
      - France, Japan and UK reassurances
      - No formal guidance elsewhere
      - No jurisdiction has yet asserted that a refinancing *would* be deemed to occur
  - Legal implementation of amendments
- **More complex cases (treasury centers, cash pools)**

** Jurisdictions last surveyed March 2022*

How are MNEs Addressing the Transition?

- **Just a topic for the Tax Department?**
- **Process:**

1. **Identify affected intercompany transactions**
   - **Commonly affected transactions**
     - External debt (floating) – may be "passed through" or referenced for intercompany transactions
     - Intercompany debt (floating)
     - Cash pooling arrangements
     - Factoring
     - Hedging & derivatives
     - Late payment terms in ordinary trade (goods and services) agreements
   - **List key data for each, incl. currencies and maturity/settlement dates**
2. **Readiness assessment**
   - **Decide: Do I want a big bang (all currencies at once) or stepped cutover?**
   - **Tax & accounting**
     - Evaluate the available alternative or ISDA fallback reference rates for each currency
     - Evaluate available tax authority guidance
     - Evaluate possible accounting implications and disclosures
   - **Systems**
     - Evaluate the systems implications for interest accrual, forecasting, reporting, and internal processes
     - Ready for cutover?
3. **Tax & transfer pricing analysis**
4. **Implement (incl. legal) & monitor**

What Could Go Wrong?

How to Fix it?

Problems in existing agreements

- Existing agreements do have fallback language, but it is unclear/ out of sync with market norm/etc.
- Reference rate discontinues but agreement has no fallback language

"Foot faults"

- Wrong fallback rate/language amended in
- Calculation error on reset
- Implementation missteps

Attracting controversy

- Backdating changes
- Appearing to "smuggle in" unrelated changes
- Mismatch with market practice

Lack of guidance

- Some countries won't have any clear rules/guidance when it's time to transition
- Some tax authorities may audit without clear understanding

"Black Swan" events

- The ARRs "should work," but what if they don't?
- No way to predict any specific problem, but conceivably one or more ARRs could disconnect from the real economy, become illiquid, or be discontinued
- How to respond if "something goes wrong" with the transition?

Speakers

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