Discontinuance of LIBOR will affect transfer pricing

April 17, 2019

In brief

The London Interbank Offered Rate (LIBOR) serves as the benchmark for an estimated US$370 trillion in financial transactions worldwide. The discontinuance of LIBOR at the end of 2021 will require alternative base rates to be used by market participants. Emerging alternative rates differ by region, currency, tenor, and basis.

This pending change has transfer pricing implications for multinational enterprises (MNEs) across all industries that have intercompany financing arrangements tied to LIBOR. MNEs should evaluate the impact on existing transactions and policies and prepare a transition plan that addresses the anticipated impact from LIBOR's discontinuation.

In detail

Alternative rates

LIBOR is an interest rate based on the average reported interest rate at which major global banks can to borrow from one another on an unsecured basis. It is published for five currencies across different maturities. LIBOR is used to price many types of financial products, from plain-vanilla loans to interest rate swaps and other complex derivatives.

Several alternative rates have emerged in different countries with characteristics that differ from LIBOR. In the United States, the Secured Overnight Financing Rate (SOFR), introduced by the Federal Reserve in April 2018, appears to be gaining acceptance at an exponential rate, as measured by daily trading in SOFR-linked futures and volume of SOFR-linked debt. (Based on data from Bloomberg, as of January 22, 2019, firms have issued more than US$46 billion in floating rate debt tied to the SOFR — an increase of over 25% from December 2018.) SOFR is based on the interest rate charged for banks to borrow overnight in the market for repurchase agreements where lenders such as money market funds make short-term loans to bond brokers, often using government debt as collateral.

The LIBOR alternatives also have key differences among each other. For example, unlike SOFR, the leading alternatives in the United Kingdom — the Reformed Sterling Overnight Index Average or SONIA — and in Europe — the Euro Short-term Rate or ESTER — both are unsecured overnight rates. The Swiss Average Rate Overnight (SARON) — an overnight secured rate — is based on a mix of transactional and survey data.

MNEs that price intercompany financing transactions or have financing structures — e.g., in-house banks, cash pools, and back-to-back lending arrangements — based on

LIBOR will be impacted by the move to an alternative rate. While many of the aspects of these changes will depend on how capital markets adopt and adapt to these changes, below we present a list of key transfer pricing items that require attention before LIBOR is discontinued.

Intercompany agreements

Parties to existing intercompany loans that apply LIBOR as a base rate and that mature after 2021 (when LIBOR is set to be discontinued) should consider amending their intercompany agreements to include fall-back language with the agreed actions and timeline by the parties to adjust the pricing in order to determine the equivalent interest rate based on the new alternative base rates available.

Observation: Companies should be mindful that certain amendments may be considered a "significant modification" of the debt for tax purposes under Treas. Reg. Sec. 1.1001-3 and potentially trigger a taxable gain or loss, or impact the interest rate limitations.

Parties to new intercompany loans issued between now and the end of 2021 should consider including fall-back clauses as well.

Transfer pricing policy

Under transfer pricing rules, intercompany loans need to be priced contemporaneously and on an arm's-length basis. The differences in information contained in LIBOR and the new proposed rates — e.g., secured vs. unsecured, historical vs. prospective, overnight vs. terms quoted, surveyed vs. based on actual executed transactions — may create comparability differences with the benchmarks applied to price intercompany financing arrangements that currently apply a LIBOR base rate. MNEs therefore should re-assess their transfer pricing policies to evaluate consistency with — and produce — arm's-length results.

Debt capacity

In the event MNEs make amendments to the pricing or terms of the agreements that trigger a significant modification, they should re-establish the *bona fide* debt nature of these loans under IRC Section 385 — e.g., evaluating and supporting whether the borrower could have obtained such debt at arm's length under the market conditions at the time of issuance — or equivalent thin capitalization rules in other countries.

Observation: Even if this issue may have been evaluated at the time the original loans were issued, if the change in pricing could be considered a significant modification and a new debt instrument, MNEs should document that prior conclusions remain applicable in the current market environment.

Hedging

MNEs with in-house banks often enter into hedging contracts to mitigate foreign currency risk on behalf of other affiliates or as part of managing the risk they bear as part of their funding functions. Given the common use of LIBOR as a reference rate, hedging contracts often also are tied to this rate. Treasury groups and in-house banks thus should plan for the discontinuance of LIBOR and the resulting impact on their existing intercompany funding and hedging structures.

Systems and processes

The aforementioned change in transfer pricing policies required once LIBOR is replaced will impact the systems and processes for calculating intercompany interest rates. Depending on the degree of automation, this may include re-programming enterprise resource planning systems, updating process manuals, and training finance or tax individuals involved in transfer pricing execution.

In addition, MNEs that rely on a labor-intensive process to manage intercompany financing and liquidity will need to re-evaluate existing models, define the sources from which market information will be retrieved, and identify the corresponding adjustments that may be needed to convert to rates that will be consistent with the new arm's-length policies. This process will require coordination among Treasury, Tax, Transfer Pricing, Legal, Finance, and Technology.

The takeaway

While 2021 may seem far away, the transfer pricing impact from the discontinuance of LIBOR will require analysis and planning on how to adapt to that change. To allow for a smooth transition, MNEs should start identifying the impacted transactions and structures and develop a transition plan before LIBOR no longer is available.

Let’s talk

For a deeper discussion of how this issue might affect your business, please contact:

Transfer Pricing

Krishnan Chandrasekhar, *Chicago*
+1 312 298 2567
krishnan.chandrasekhar@pwc.com

Frank Douglass, *New York*
+1 646 471 2739
frank.douglass@pwc.com

Mac Calva, *New York*
+1 646 471 2368
mac.calva@pwc.com

Zachary Noteman, *San Francisco*
+1 415 498 6105
zachary.j.noteman@pwc.com

Transfer Pricing Global, Americas, and US Leaders

Isabel Verlinden, *Brussels*
Global Transfer Pricing Leader
+32 2 710 44 22
isabel.verlinden@be.pwc.com

Horacio Peña, *New York*
Americas Transfer Pricing Leader
+1 646 471 1957
horacio.pena@pwc.com

Paige Hill, *New York*
US Transfer Pricing Leader
+1 646 471 5192
paige.hill@pwc.com