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FTTP policy approach for small and medium-sized enterprises

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Financial Transactions Transfer Pricing (FTTP) policy within small and medium-sized companies

Intercompany loans (ICLs) are a common funding mechanism within small to midsize companies. While these transactions can be limited in number and value, they can still give rise to transfer pricing and tax risks, particularly in cross-border situations.

For many organizations, preparing detailed transfer pricing documentation for each individual loan is not economically efficient. However, tax authorities increasingly expect taxpayers to demonstrate that intercompany financing is priced and structured in an arm's length manner.

The global EY organization has created a tailored solution for small and medium-sized companies that provides a practical framework for setting up and pricing intercompany financing transactions at arm's length. Our approach for creating a Financial Transactions TP policy provides a practical framework for pricing ICLs in line with the OECD guidance and relevant local regulations. The policy explains the key principles, methodologies and risk factors considered when determining arm's length loan terms and facilitate consistent application across the group.

The policy functions as a foundational framework in discussions with tax authorities and can be supplemented with transaction-specific documentation where required. It offers a proportionate and cost-effective way for small and midsize companies to manage transfer pricing risk while maintaining robust governance over intercompany financing.

Key components of a practical FTTP policy

To establish robust transfer pricing mechanism for providing ICLs, the policy is typically built around four essential pillars that work together to create a comprehensive framework. They typically include the following:

1 Debt capacity

First, understanding the debt capacity aspects within the group is vital. This involves determining an arm's length debt quantum that can be extended to the borrower, grounded in a debt to equity ratio based on financial projections and predefined inputs. An embedded cash flow analysis should focus on key financial ratios that demonstrate the property company's ability to service its debt, such as debt to equity, leverage and interest coverage. Additionally, benchmarking results should be updated annually to compare these financial ratios with a selected independent peer group for transfer pricing purposes.

2 Terms and conditions (T&Cs)

Next, the T&Cs of the ICLs must be clearly defined. Standardized arm's length T&Cs should be introduced for common scenarios, with the flexibility to tailor them as necessary. Aligning these T&Cs with those of any external financing is essential, and creating an audit trail for each new ICL will ensure transparency regarding the purpose and commercial rationale behind the arrangements.

3 Credit rating

The credit rating of both the borrower and the loan itself is crucial. This involves assessing the issuer rating, which utilizes available credit rating methodologies tailored for companies in various sectors. Consideration of implicit group support in the credit rating sphere may allow for a group rating approach, while additional adjustments to the issuer rating can reflect the specific T&Cs of the ICL.

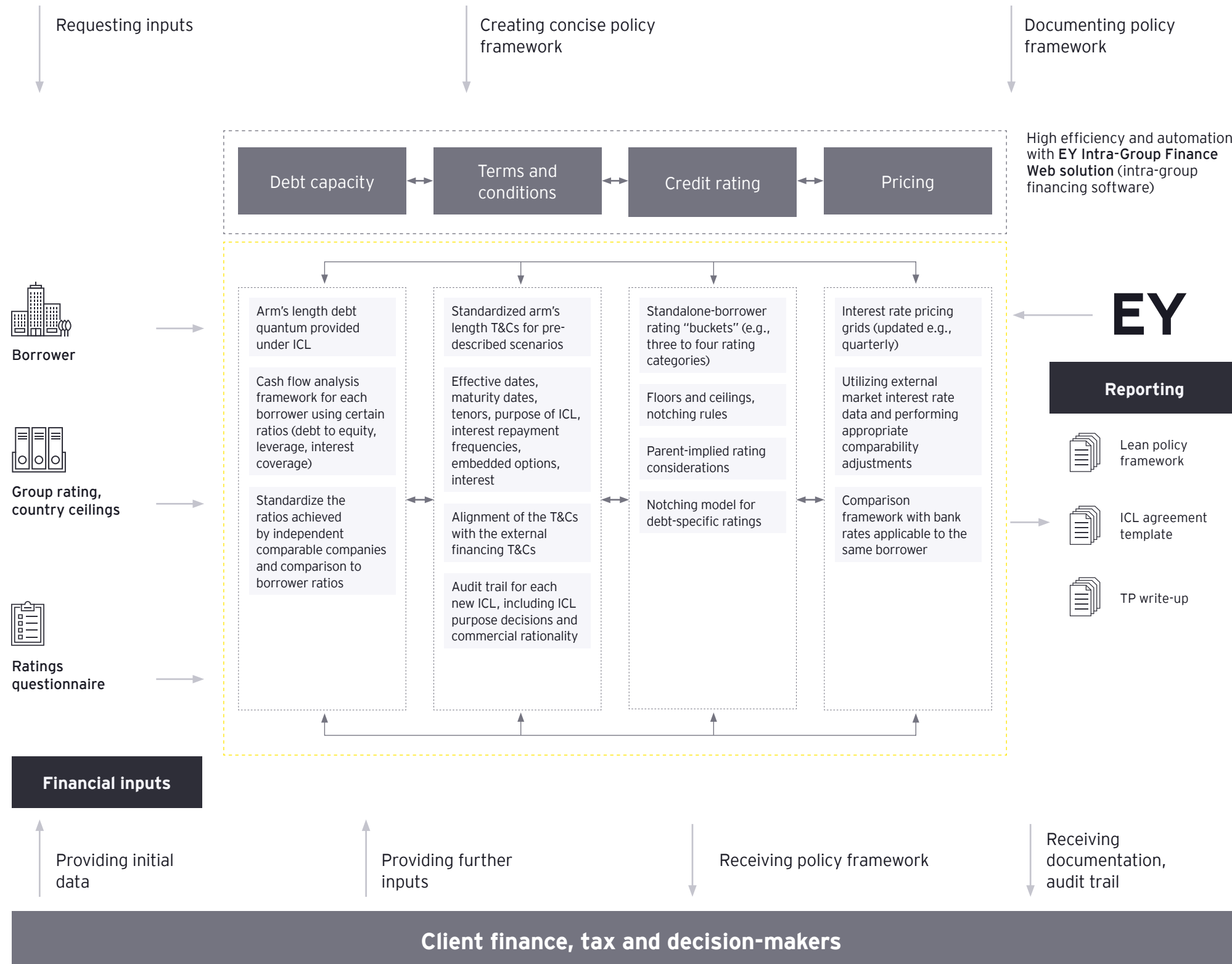
4 Pricing

Finally, The pricing of the ICL is another critical component. In case of larger amount of loans, establishing an interest rate pricing grid based on the latest external market data from independent databases will help maintain arm's length interest rate ranges. This grid should be regularly updated, and a comparison framework should be developed to evaluate the interest rates charged by external parties, such as banks, on loans to similar borrowers within the group.

When EY's transfer pricing policy tailored to small and medium-sized companies is applied to intercompany loans, it allows you to document the thinking once, apply it consistently, and go deeper where the risk or materiality justifies it.

The four components are intricately connected and should be viewed holistically within the policy framework. The accompanying flow chart illustrates the interactions among these components, providing a visual representation of their relationship. Together, these foundational elements will guide the development of a strong FTTP policy, ensuring clarity and compliance in financial transactions involving ICLs in a practical and cost-efficient manner, balancing the costs for the policy with the level of transfer pricing risks.

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EYG no.
2602-10245-CS
ED None

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