Intra-group loans under the arm's length principle
- 10 things to know

TRANSFER PRICING
2 JUL 2018
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Funding arrangements are an essential consideration for multinationals (MNEs) expanding their businesses, either through acquisition or organic growth. This can include funding arrangements from within an MNE group.

Regardless of the complexity of these funding arrangements, one area often overlooked by MNEs as they structure their financial affairs is the transfer pricing aspects of intra-group loans. The risks of getting transfer pricing aspects wrong could lead to non-deductible interest expense, double taxation, penalties or other more serious sanctions.

While OECD has published a draft discussion draft on this issue for public consultation on July 3, unilateral actions have already been taken by countries to challenge the transfer pricing aspects of intra-group loans, resulting in some landmark court cases, such as the *Chevron* case in Australia and the *GE Capital* case in Canada, and specific guidance has been issued by the Dutch, Australian and UK tax authorities.

Below we highlight 10 important things to know in order to significantly reduce the risk of exposure to sanctions:

1. **Consider the loan from both perspectives.** Any transfer pricing analysis of intra-group loans needs to be undertaken from both the lender's and the borrower's perspective. A two-sided analysis involves a review of risks borne by the lender when lending monies and requires consideration of the cost of obtaining these funds by the borrower. Analysis based on a solitary point of view carries significant controversy risks.

2. **Consider the debt capacity of the borrower.** A debt capacity analysis ascertains how much debt the borrower can service without defaulting on its obligations. This is important because any excess debt undertaken by the borrower will be considered non-arm's length, and interest deductions on that part of the debt could be denied for tax purposes. A debt capacity analysis is generally undertaken by analyzing the liquidity and solvency ratios of the borrower.

3. **Ensure the terms and conditions of the agreement are at arm's length.** The legal agreement is the starting point for any transfer pricing analysis and the economic and legal realities must be in sync. Further, arm's length pricing is dictated by the agreement, and if the terms and conditions do not reflect third-party behavior and genuine economic circumstances, there may be a risk of transaction re-characterization by the tax authorities.

4. **Consider withholding taxes.** From an economic standpoint, it is important to consider which party will bear withholding taxes and then consider its impact on the pricing of the interest rate. This consideration needs to take into account the fact that treaty protection is only available for the interest component that is consistent with the arm's length principle and is not unduly influenced by special relationships between the parties.

5. **Ensure interest rates are based on the terms and conditions of the agreement.** The interest rate is the lender's rate of return for lending monies to the borrower and is determined by pricing the risks borne by the lender. Therefore, it is important that each risk can be clearly identified from the intra-group agreement. Often the
most overlooked items are embedded options such as an early prepayment option, conversion option and on-demand option (among others) that provide flexibility to the parties of a loan. Some embedded options may have a significant impact on the interest rates, including the value of the intra-group loan. Thus, it is important that such options, including all the risks are identified and priced appropriately, and are consistent with the arm's length principle.

6. **Consider implicit support when determining the risk profile of the borrower.** Implicit support refers to the benefit received by the borrower from being part of a larger group. The OECD and a number of tax authorities advocate the application of implicit support adjustments to determine the risk profile of the borrower. Thus, interest rates on intra-group loans that do not consider implicit support would carry controversy risks. One approach to account for implicit support is to adjust the credit rating of the borrower, taking into account the importance of the borrower within the group.

7. **Ensure the lender has adequate substance.** One important principle emerging out of the international fight against tax avoidance is the substance requirement for entities that are involved in financing arrangements. Under this principle, lenders need to have management and control of risks with respect to the intra-group transaction. In case of inadequate substance, access to double tax treaties might prove difficult and may impact the arm's length pricing of interest rates.

8. **Ensure transfers of loan assets are at market value.** In an intra-group setting, there are instances where a loan or a portfolio of loans is transferred between entities. Such transfers need to take place at market values to reflect third-party behavior, given that values can change with time as interest rates change. To do this, all relevant terms and conditions of the loan need to be considered because they can impact the value of the loan significantly. A general approach is to perform a discounted cash flow analysis to value a loan or a portfolio of loans.

9. **Determine arm's length interest before interest cap rules are applied.** Many countries have introduced stricter interest limitation rules under their domestic tax laws following OECD's recommendation in Action 4 of the OECD Base Erosion and Profit Shifting (BEPS) Action Plan. These rules limit interest deductions to an amount equivalent to between 10 percent and 30 percent of earnings before interest, taxes, depreciation and amortization. However, this does not imply that interest deductions up to the pre-set threshold are automatically allowed. These deductions need to be justified from an arm's length perspective, or there is a risk of challenge from the tax authorities.

10. **Develop a consistent financing policy.** As intra-group loan transactions within a MNE group increase, it is essential that a consistent financing policy is developed and followed. Such a policy defines the parameters, processes and approaches to intra-group loans from a transfer pricing perspective. A strategic approach to develop such a financing policy provides an opportunity to involve all internal stakeholders from treasury, legal, tax and operations. A consistent financing policy is important, since a description of the overall financing policy now needs to be included in a group's transfer pricing Master File documentation.

As the global tax environment changes, it is essential to ensure that financing arrangements within MNE groups are consistent with the arm's length principle to mitigate controversy risks. In this respect, consideration of these 10 points could prove useful in minimizing MNE exposure to sanctions on intra-group loans. In order to proactively mitigate risk and reduce uncertainty on the tax treatment of intra-group loans, it may also be worthwhile exploring the use of Advance Pricing Agreements or Mutual Agreement Procedures as tools that strengthen the MNE group’s transfer pricing strategy.

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