How to make intercompany loans BEPS proof

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Debt as intercompany financing with excessive interest deductions has come under greater scrutiny of the tax authorities after the OECD published its final work on Action Points relating to intercompany financing in October last year. In the light of the aforementioned, and the current practice of MNEs on intercompany loans, this article delves into 4 "true or false" statements which are relevant for various stakeholders including MNEs to ponder over.

Introduction

Equity and debt are two important sources of funds for an MNE. The interest on debt is generally tax deductible that incentivizes a borrower to claim maximum possible deduction in its tax return.

Debt financing can come with different levels of risk. For example, it can include loans which are either subordinated or senior debt, mezzanine loans with a relatively high interest rate due to little or no collateral for the lender, and profit participation loans with significant portion of the return linked to profits of the borrower. In other words, as the lender moves up from a mere passive lender to a lender who also manages financial risk of the funding to the one who manages operational risk related to the business for which funding was provided, the lender expects a higher interest rate. The current weak economic climate across the globe has impacted the risk appetite of lenders as more and more companies are defaulting on loan repayments due to falling profits, although the current monetary policy from central banks across developed markets, like Europe, the US, and Japan is driving interest rates to record low levels to boost economic activity by encouraging lending. Such higher risk of default with low interest rate environment is bringing its own challenges for MNEs to justify the arm's length nature of intercompany loans, besides putting them under a greater scrutiny of the tax authority.

In October 2015, the OECD delivered its final package on Base Erosion and Profit Shifting Action (BEPS) which also includes guidance of intercompany funding, particularly on excessive interest deductions, such as Action 4 that directly targets inappropriate or excessive interest deductions; Actions 8-10 help to ensure that "cash box" entities, not performing relevant economic activities, will be entitled to retain no more than a risk-free return on intercompany financing; Action 6 prevents treaty abuse, making it complicated to structure the payments to the country where 'cash box' is a tax-resident for avoiding withholding taxes; and last but not least, Action 3 on CFC rules looks into 'cash box' with limited or no economic activities and accordingly any passive income including interest is taxed in the lender's (being parent) country. In the light of the above, we provide following four "true or false" statements on how the intercompany debt financing has become vulnerable and how to resolve the transfer pricing issues around that.

Statement 1

At least 50% of today's intercompany loans concluded are "under water", i.e. non-OECD compliant.

A company having significantly more debt than equity is considered to be highly leveraged.
Many of the existing intercompany loans were agreed between group companies during growth years. Although, such structures are already regulated by thin capitalization rules in various countries, the prevailing weak economic climate has eroded the profitability of some MNEs and consequently in certain cases has eroded equity position, making their existing debt position highly leveraged. In addition, some MNEs were refinanced through new debts which triggered a similar too high debt leveraged position.

Particularly, most 3:1 debt/equity positions reflect a beyond BBB- rating, i.e. at a "below investment grade" where company cannot attract loans anymore. That raises serious concerns on MNEs' compliance with new OECD rules and requires them to review their current debt positions. Loans, which are creating such "under water" position in terms of their inability to fulfil the debt obligations, require a reset in terms of level and conditions of debt instruments.

Statement 2

Today's 'ceiling' for intercompany loan interest rates is 10%.

Theoretically, the riskier the investment is, the higher the return will be expected by the lender. In a weak economic climate, the policy-makers create monetary conditions to lower general level of interest rates to stimulate growth. This creates a low interest rate environment overall, also impacting interest rates on intercompany loans. The third party data available on interest rates on financial databases shows that anything beyond 8-10% interest rate cannot be supported anymore by empirical evidence. There are few exceptions. In the profit participation loans interest rates are higher but the empirical evidence in the public domain – even databases – is lacking. In case a higher than 10% interest rate is being used, in today's set of rules and empirically available data points, such payment will easily obtain a hybrid nature. In other words, the 8-10% interest rates found in the public domain are heavily biased by the regulatory defined "reference rates" e.g. LIBOR, EURIBOR, etc; and therefore are not a fair reflection of the "true economics" of most intercompany loans. However, tax authorities, mostly based on a political ground, claim these "biased" references are solid and the best evidence in today's markets.

Statement 3

Transfer pricing reports often support intercompany interest rates by using synthetic interest rate calculations which are not acceptable to tax authorities. A typical empirical approach followed by an MNE to justify intercompany interest rates is to identify and select comparables from financial databases by applying standard quantitative filter, such as loan amount, seniority of tenure of loan, country of the borrower, etc. A 'synthetic' approach uses a theoretical concept (higher risk – higher interest rates) to extrapolate the interest rate which would have been applied between third parties.

The 'synthetic approach' has a very low acceptability by the tax authorities and/or courts. As the judge in the Australian Chevron case has stated: "In my opinion, whatever the technical merits of Dr. Webbers analyses, his evidence was too abstract to be persuasive"; and "In my opinion, the correct perspective is that of a commercial lender. A commercial lender would not approach the question of the borrower's creditworthiness in the same way as would a credit rating agency". The judge rejected the interest rate based on the assumed circumstances surrounding the loan, while, not taking into account economic reality of the case.

BEPS Action plan requires the taxpayer to support the arm's length nature of intercompany loans beyond the 'synthetic approach' by providing empirical evidence and audit trails relating to people functions and corresponding risks in relation to intercompany funding.

Statement 4

In the absence of an 'audit trail' that the lender is managing the financial risks of a loan, BEPS Action plan determine that only a “risk-free rate” will be applied. BEPS Action 8-10 provide: “If this associated enterprise does not in fact control the financial risks associated with its funding (for example because it just provides the money when it is asked to do so, without any assessment of whether the party receiving the money is creditworthy), then it will not be allocated the profits associated with the financial risks and will be entitled to no more than a risk-free return, or less if, for example, the transaction is not commercially rational and therefore the guidance on non-recognition applies”.

Therefore, it would be important for the lender to maintain an audit trail on critical functions and risks assumed in relation to the intercompany loan. For instance, the number of FTEs on the payroll of the lender; a creditworthiness analysis of the borrower conducted by the lender; evidence of negotiation of the clauses to the intercompany loan agreement, etc.

The inability of an MNE to provide the evidence to support the functionality of the lender over the whole period of the loan could either leave the lender with risk-free return and/or disallow interest deductions beyond a risk-free rule at the level of borrower.

Conclusion

The prevailing weak economic climate and a series of biased data points from publicly available databases has exposed many existing intercompany loan arrangements to be not in line with the arm’s length principle. The changes in tax and transfer pricing rules brought by the OECD under the BEPS project has created a sense of urgency for MNEs to revisit their loan arrangements in order to be sustainable going forward.

To be able to defend the pricing of the intercompany loans, MNEs are expected:

- to evaluate their existing highly leveraged positions;
- to examine closely loan arrangements with the interest rate higher than 10%; and
- to move away from the ‘synthetic approach’ to a new approach involving “audit trails with empirical evidence” such as a description of people functions involved and evidence on management of risks by relevant parties to the intercompany loan.

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