TAXATION

Recognising intra-group loans following the OECD's FTTP guidance

Christos Theophilou **Costas Savva**

of Taxand Cyprus consider how the OECD's guidance on financial transactions and transfer pricing (FTTP) can be interpreted in consideration of intra-group loans

On February 11 2020, the OECD released transfer pricing rules with respect to financial transactions, namely "Transfer Pricing Guidance on Financial Transactions: Inclusive Framework on BEPS: Actions 4, 8-10" (FT Report). The guidance provided in the FT Report is to be included in the OECD transfer pricing guidelines (TPG) as Chapter X. Notably, the FT Report provides comprehensive guidance to all stakeholders (i.e. taxpayers, tax authorities, tax advisors etc.) on pricing intra-group financial transactions. Furthermore, the FT Report is of great importance as the TPG tend to have a retroactive application, as the TPG are presented as 'clarifications'.

Recognising the accurately delineated transaction

Typically, from the TPG, a four-step analysis can be derived in order to price an intra-group transaction:

Step 1: Identifying commercial and financial relations;

Step 2: Recognising the accurately delineated transaction;

Step 3: Selecting the most appropriate transfer pricing method; and

Step 4: Applying the most appropriate method.

This article focuses on recognising the accurately delineated transaction (i.e. step 2) with respect to intra-group loans.

Once an intra-group loan has been accurately delineated, in exceptional circumstances tax authorities are allowed to either replace (i.e. re-characterise and therefore replacing it with an

alternative transaction) or even disregard (i.e. both designated under the term 'non-recognition') the actual transaction (see TPG paras 1.119-125). Notably, the FT report on paragraph 10.8 incorporates this general exception "arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner in comparable circumstances, the guidance at Section D.2 of Chapter I may also be relevant."

It is worth noting that, apart from transfer pricing rules, intra-group loans may also be subject to other specific or general anti-avoidance rules. This is noted in the FT Report on paragraph 10.9 which states that: "this guidance is not intended to prevent countries from implementing approaches to address the balance of debt and equity funding of an entity and interest deductibility under domestic legislation, nor does it seek to mandate accurate delineation under Chapter I as the only approach for determining whether purported debt should be respected as debt."

Practical application and planning points

To take a simple example, assume that a company being tax resident in State A is the parent entity (parent) of a multinational enterprise (MNE) group, and decided to take a project in State B. Assume further that according to the financial position of the MNE group, parent decided to incorporate a wholly-owned subsidiary (subsidiary) in State B, and fund this start-up subsidiary primarily with debt. Normally, the start-up subsidiary would not be expected to generate sufficient cash flows to repay the loan in the early years of its operations and further remembering that the subsidiary does not have any assets to provide as collateral or access to guarantees, so that a third party (e.g. a bank) would not be willing to provide such a lending.

In case the tax authorities decide to either not recognise or re-characterise an intra-group loan, at least two implications might arise. To begin with, if the intra-group loan is not recognised, then the interest expense is disallowed. Likewise, if the intra-group loan is recognised but eventually re-characterised, then it could be considered as equity rather than debt, and therefore the interest expense treated as a constructive dividend. Another consequence would arise in relation to tax treaties. That is, as the interest payment is considered to be dividends and not interests, then a different tax treaty reduced withholding tax rate may be applicable (i.e. OECD Model Article 10 Dividends and not Article 11 Interest).

In order to avoid such unwanted implications, an intra-group loan needs to be analysed from both perspectives (i.e. lender and borrower, see FT Report paragraph 10.51) and effectively, answer the following two questions:

Could the borrowing entity as an independent enterprise obtain access to similar level of debt from third-party lender such as a bank?

Would the borrowing entity be willing to obtain such a loan under such terms and conditions from a third-party lender?

Consequently, on one hand, the borrower should establish that an independent borrower, behaving in a commercially rational manner, is considering the options realistically available to financing an existing need and what it is willing to pay. On the other hand, the lender should establish whether a third-party lender, would be willing to provide a comparable loan under comparable terms and conditions or would be willing to provide such loan in light of its options realistically available for investment, including the option of not investing or lending. In doing so, the lender would analyse the borrowers' financial, operational, market and economic factors such as level of credit risk. Notably, the FT Report at paragraph 10.62 emphasises that "the creditworthiness of the borrower is one of the main factors that independent investors take into account in determining an interest rate to charge".

In light of the above, taxpayers entering in cross-border intra-group transactions, need to analyse their capital structure (i.e. the balance of debt and equity funding), in order to ensure that they comply with the FT Report.

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