Debt-Equity Rules Shape Transfer Pricing Risk for Taxpayers

The classification of transactions as loans or equity has significant impact for multinational taxpayers, especially when loans exhibit equity-like features such as indefinite maturity, no securitization, or profit-participating loans. Accurate delineation of financial transactions is crucial to determine their proper classification and mitigate potential tax consequences

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CHARACTERIZATION AS LOAN OR EQUITY

When examining financial transactions in a transfer pricing context, tax authorities would normally seek to recharacterize a controlled transaction when the economic substance of the transaction differs from its form, in a "substance over form" approach. In doing so, transfer pricing rules need accurate delineation of the transaction—understanding the "real deal."

In practice, a commercial analysis would take into consider the economic reality of the financial instrument and its terms and conditions. The excessive interest paid from the borrower to the lender would normally be disallowed and could also be recharacterized as a hidden dividend distribution.

The 2022 OECD Transfer Pricing Guidelines and the 2021 UN Transfer Pricing Manual provide guidance on the characterization of financial transactions.

In a transfer pricing context, when tax authorities challenge a financial transaction—such as an intragroup loan—the recharacterization may have the following results.

FROM THE JURISDICTION WHERE THE BORROWER IS A RESIDENT:

- Full recharacterization—whole loan amount might be considered equity, and therefore all interest expense would normally be disallowed.
- Partial recharacterization—part of the loan amount to be treated as equity, so only the excessive interest expense would normally be disallowed. The arm's-length interest rate would be deductible on the portion of the funding that is a loan.

FROM THE JURISDICTION WHERE THE LENDER IS A RESIDENT:

- Characterization as "quasi equity"—an interest-free or low-interest loan (low risk or risk-free loan), and therefore low or no imputation of interest would be imposed.
- Characterization as a risk-bearing loan—the tax authorities may challenge whether the lender is properly identified.

CHALLENGES FROM THE JURISDICTION WHERE THE BORROWER IS A RESIDENT

In practice, tax authorities, when characterizing a financial transaction, would normally consider the following factors. This list isn't exhaustive, and no single factor is determinative:

- Presence or absence of a fixed repayment date
- Written agreement in place demonstrating indebtedness
- Obligation to pay interest
- Source of interest payments, for example, from earnings
- Increased participation in management as the result of the loan advance
- Right to enforce payment of principal and interest
- Subordination and the status of the funder in comparison to regular corporate creditors
- Thinness of the capital structure in relation to debt
- Existence of financial covenants and security
- Ability of the recipient of the funds to obtain loans from unrelated lending institutions
- Extent to which the advance is used to acquire capital assets or risk involved in making the advances
- Failure of the purported debtor to repay on the due date or to seek a postponement.

For example, assume a lender, Company L, provides a long-term loan (15 years) to Company B, the borrower. The result of the accurate delineation of the actual transaction is that Company B is unable to service the loan (in terms of both interest and

principal). Therefore, a third party (for example a bank) wouldn't be willing to grant such a loan to Company B.

Another example would be when the loan amount terms and conditions resemble equity characteristics such as profit-participating loans. For example, Company L provides a loan to Company B, and the loan agreement doesn't include a maturity date, there is no security or covenants, and the interest is contingent on the profitability of Company B. Therefore, the transaction might not be delineated as a loan, and the interest would normally be denied.

In practice, taxpayers would need solid documentation to support that the principal amount of a loan is arm's length. Such documentation should include the purpose of the loan, such as working capital requirements or to finance a specific project, and the basis for whether the controlled transaction is commercially rational.

Further, the borrower's financial capacity should be examined and clearly documented. Finally, an analysis from both perspectives of the so-called benefit test can be helpful.

In practice, from the borrower's perspective, the "would argument" should be established on whether the borrowing entity is willing to obtain such a loan under such terms and conditions from a third-party lender, taking into consideration the amount of debt, cost of borrowing, and other terms and conditions.

From the lender's perspective, the "could argument" should be established on whether the borrowing entity as an independent enterprise obtains access to a similar level of debt from a third-party lender such as a bank, taking into consideration the creditworthiness of such borrower.

CHALLENGES FROM THE JURISDICTION WHERE THE LENDER IS A RESIDENT

The first case, described above, is when a lender provides an interest-free or low-interest loan, and the tax authorities would be inclined to impute interest income. However, if the controlled transaction is a loan, recharacterizing the controlled transaction into equity shouldn't be an immediate response.

In practice, taxpayers who typically argue that the controlled transaction is considered equity, the "equity function argument," would normally prevent tax authorities from imputing interest income. In doing so, such taxpayers would normally argue that the borrower is thinly capitalized, and a third-party lender wouldn't be willing to lend such an amount.

The second case described above would be when the controlled transaction is respected as a loan pursuant to an accurate delineation. However, the tax authorities will challenge whether the lender has been properly identified.

Therefore, if the lender isn't exercising control over the risks associated with an advance of funds or doesn't have the financial capacity to assume the risks, such risks should be allocated to the enterprise exercising control and having the financial capacity to assume the risk. Consequently, the lender will be entitled to no more than a risk-free return.

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