INSIGHT: Transfer Pricing of Financial Transactions

Stuck between a Rock and a Hard Place

The EU earnings stripping rules are expected to come into force by January 1, 2019, and multinationals will be faced with a fixed ratio rule that determines to what extent borrowing costs are deductible for tax purposes. Similar rules have already been introduced in the U.S. Also, as a result of the Organization for Economic Cooperation and Development’s (“OECD”) Final Report on BEPS Action 4, more countries are expected to follow.

The authors explore the impact of these new earnings stripping rules on taxpayers, and discuss the interplay of relevant developments with the transfer pricing aspects of financial transactions.

BEPS Action 4 Final Report and ATAD I

Companies expected that the OECD’s base erosion and profit shifting Action 4 final report would address how to deal with inter-company financial transactions from a transfer pricing perspective. However, so far, the OECD has only recommended that countries introduce interest deductibility limitation rules by means of a fixed ratio rule.

More detailed guidance from the OECD on intercompany financial transactions is expected in the Summer of 2018, though indications are that any initial paper will not represent a consensus view of the delegates.

The fixed ratio rule proposed by the OECD limits deductions of net financial expenses up to a range between 10% and 30% of the taxpayer’s earnings before interest, taxes, depreciation and amortization (EBITDA). A summary overview of the final report on BEPS Action 4 is illustrated in Figure 1 below. The definition of net financial expenses goes beyond interest expenses (e.g., guarantee fees) and also includes thirdparty financial expenses.

The final report on BEPS Action 4 also said that countries could adopt an optional earnings-based worldwide group ratio rule. The rule allows a subsidiary of a multinational group, which files statutory consolidated accounts, to use the overall group’s indebtedness at the worldwide level to deduct borrowing costs.

Following the OECD’s recommendations, the European Commission (“EC”) in 2016 released an initiative heading in a similar direction. The Anti-Tax Avoidance Package which included the Anti-Tax Avoidance Directive, commonly referred to as ATAD I, seeks to prevent forms of aggressive tax planning. See Article 4, paragraph 1 of Directive 2016/1164/EU of European Parliament and the Council of 12 July 2016 on laying down rules against tax avoidance practices that directly affect the functioning of the internal market.

Figure 1 Overview of OECD BEPS Action 4 Final Report

| Objectives |
| Develop recommendations regarding best practices in the design of rules |
| To prevent base erosion through the use of interest expense |

| If adopted, the rules should apply to: |
| All forms of debt |
| Payments equivalent to interest |
| Expenses related to financing |

| Fixed ratio rule (10%-30% cap) |
| Allow a deduction for interest up to a specified proportion of the entity’s earnings or assets. |
| Some flexibility: cap at country level, do=minimis rule, etc |

| Group ratio rule (optional carve-out) |
| Allocation of the group’s actual net 3rd party interest expense across jurisdictions based on a measure of economic activity (e.g. EBITDA) |

Source: OECD

One of ATAD I’s measures includes an interest limitation rule to discourage artificial debt arrangements designed to minimize taxes. The mechanics of the earnings stripping rule included in ATAD I are generally in line with the ones proposed under the final report on BEPS Action 4. In essence, the earnings stripping rules under ATAD I dictate that ‘exceeding borrowing costs’ (including third-party interest), or net interest, shall be deductible in the tax period in which they are incurred only up to a maximum 30% of the taxpayer’s EBITDA. Tax exempt income (such as dividends in case of the application of a participation exemption) is excluded from the EBITDA definition. The ‘exceeding borrowing costs’ mean the amount by which the deductible borrowing costs of a taxpayer exceed taxable interest revenues and other economically equivalent taxable revenues that the taxpayer receives according to national law.

ATAD I also considers a de minimis rule under which exceeding borrowing costs are deductible up to the absolute amount of 3 million euros. However, we have seen that countries will generally apply a more stringent de-minimis rule. Spain, Portugal, and the Netherlands, for instance, implemented, or announced a threshold of 1 million euros for companies in their jurisdictions.

A country could, however, decide to calculate the ratio at the level of the group and use the results for all the domestic group members (together). In that case, the absolute amount of exceeding borrowing costs that are deductible of 3 million euros should be considered for the entire domestic group, within a specific country. This application of the de-minimis rule has been implemented or announced by the U.K. and Sweden. In the case of Sweden, the rule applies to an amount of 10,000 euros for the entire domestic group.

ATAD I also considers timing limits and differing amounts of unrelieved borrowing costs to carry back or forward. The Netherlands, Spain, and the U.K. announced or implemented rules that allow for an indefinite carry forward whereas other countries capped the time period up to a specific number of years, generally up to five years.

Under ATAD I, the member states of the European Union are required to implement domestic law incorporating these rules, effective as of January 1, 2019, the latest. An exception may apply to countries which have previously implemented national targeted rules, equally effective to the interest limitation rule. These countries may apply those targeted rules up to January 1, 2024. Ireland, for instance, indicated that it will make use of this exception. Corresponding grandfathering rules may be applicable to inter-company transactions concluded up to June 17, 2016 but are not applicable to their amendments. Also here, the implementation thereof is up to the various countries, with the Netherlands for instance announcing that it will not implement grandfathering rules, meaning that all existing debt that is still in place on January 1, 2019 will be captured under the new rules.

The group escape rules available under the ATAD I proposed rules—equity based or earnings based—have not been widely adopted. Germany and the U.K. have adopted the Equity and Earnings based rules, respectively, but other countries have announced they will not implement escape rules.

Overall, the earning stripping rules have been drafted in a comprehensive manner and implementation of the rules by countries seems to be more stringent than what would be allowed for under ATAD I. Further, it is worth noting that the use of earnings stripping rules is not just an EU phenomenon, as the recent tax reform in the U.S. also included similar earnings stripping rules. Under the U.S. rules, net interest-related to transactions with related as well as unrelated parties—would be deductible up to 30% of EBITDA, which in 2022 reduces to 30% of EBIT.

Impact of Earnings Stripping Rules on Inter-company Financial Transactions

The introduction of the fixed ratio rule initially triggered the expectation that the role and importance of substantiating inter-company financial transactions, especially loans, would become less relevant. However, upon closer examination, tax and transfer pricing practitioners noticed that if jurisdictions set the fixed ratio of financial expense closer to 30% of EBITDA (which seems to be happening in most countries) and also allow for carry forward of interest not yet deducted, the fixed ratio rule would mainly be about timing of financial expense deductions rather than resulting in nondeductibility of such expense and that it is
therefore still important that from a borrower’s perspective intercompany loans meet the arm’s length principle. This is also what the OECD seems to recognize and which is why, since 2016, they have been working on more specific transfer pricing guidance in relation to intercompany financial transactions.

Further, more lender jurisdictions will want to ensure that they continue to receive arm’s length interest income. Arguably, the tax authorities in the countries where a lender is located will closely monitor and scrutinize the charges applied especially if they are aware that part of the interest expense is not deductible by the borrower as a result of the fixed ratio rule application.

In order to comply with the earnings stripping rules, multinationals may consider revisiting their transfer pricing policies as well as the terms and conditions of the current transactions, given the following considerations:

- The fixed ratio rule may require revisiting intercompany loans linked to external funding; e.g., the group attracted bank funding (to meet the financing needs of the subsidiaries) and pushed down the funds as inter-company loans. The pricing and volume of the transactions were initially set according to the arm’s-length principle, however, the interest to EBITDA ratios of certain subsidiaries exceed 30% and the interest expense is no longer deductible fully.
- The fixed ratio rule may prevent a subsidiary from fully deducting a guarantee fee paid to the parent in connection with external funding; e.g., the subsidiary attracted bank funding assuming the associated interest and fees and a parent guarantee was issued to reduce the interest burden. The rationale and pricing of the guarantee followed the arm’s-length principle, but combined the burden of interest, bank fees, and guarantee fees exceeds 30% of the subsidiary’s EBITDA.

The above cases may trigger changes in the existing set up of the financial transactions. For instance, to avoid borrowers getting trapped in these rules and being confronted with non-deductibility of interest, multinationals may have to consider making their loan agreements ’flexible’, e.g., by making use of prepayment options in term loans, using credit facilities, roll-over loans, etc. Such features allow for early repayment of ‘excess’ debt when the earnings stripping rules come in to force but have an impact on what the arm’s length interest should be at execution of such loans.

Importantly, many of these changes also need to take account of recent developments that have occurred in the area of transfer pricing for financial transactions. Specifically, more emphasis has been put on structuring the actual terms of inter-company financing transactions at arm’s-length, including the type of loan, terms and conditions, principal amounts, going beyond just applying an arm’s-length interest rate. In addition, since the earnings stripping rules also impact thirdparty interest expenses, in many cases any seemingly quick changes may turn out to merely shift the problem of non-deductibility from the borrower to the lender.

**Arm’s-length Inter-company Financial Transactions**

With the latest revisions to chapter I of the OECD guidelines, the concept of options realistically available (ORA) is now central to dealing with the transfer pricing aspects of business restructurings. This concept requires taxpayers to structure the transaction in accordance with the economically relevant characteristics of the transaction and the parties involved. The thinking behind this concept is that independent enterprises, when evaluating the terms of a potential transaction, will compare the transaction to the other options realistically available to them and structure a transaction that is most beneficial to them. The ORA concept presupposes that unrelated parties, when evaluating the terms of a potential transaction, will compare the transaction to the other ORA and will enter into such transaction if they see no alternative offering better opportunities to meet their commercial objectives. In comparing one option with another, unrelated parties would generally take into account all the economically relevant differences between the ORA to them when valuing those options, including differences in the level of risk or other comparability factors.
In doing so, independent enterprises will generally take into account any economically relevant differences between the options realistically available to them (such as differences in the level of risk) when evaluating those options. Therefore, identifying the economically relevant characteristics of the transaction is essential in accurately delineating the controlled transaction and in revealing the range of characteristics taken into account by the parties to the transaction. This not only applies to the borrower but also to the lender.

In the context of inter-company financing transactions, the ORA concept would thus require a careful consideration of the financing needs of the borrowing entity, the purpose for which the loan is obtained, its financial forecasts, or debt service capacity, the impact of the loan and related interest payments on its financials and creditworthiness, the terms and conditions that would be agreed upon and, ultimately, how all these items would translate into an arm’s-length interest rate of the inter-company loan. The recent Chevron case in Australia, dealing with an inter-company loan, is a clear illustration of such developments. In Chevron, the related-party borrower could have borrowed funds at a lower cost if it had provided securities under the intercompany loan. The court found the loan was not made for arm’s-length terms and considerations, which resulted in a significant tax adjustment.

The identification of the economically relevant characteristics of the transaction under analysis is essential for accurately delineating it. The concept of ORA can be factored into the transfer pricing analysis of an intercompany loan by assessing:

- Whether the contractual terms and conditions agreed between the parties are consistent or not with their conduct, financing needs, financial forecasts, risk appetite and objectives;
- The borrower’s ability to service the debt under the agreed terms and conditions and (thus the lender’s willingness to make the funds available to the borrower); and
- The lender’s ability to manage and control the risks embedded in the inter-company loan (e.g., credit risk and foreign exchange risk). The assessment of the contractual terms and conditions (to-be) agreed between the parties plays an essential role in substantiating and documenting the arm’s-length nature of the transaction. Characteristics such as currency, tenor, securities, repayment schedule, and prepayment options are key to ultimately structuring the transaction at arm’s-length and greatly influence the arm’s-length pricing of the underlying transaction. The below figure illustrates how certain terms and conditions of two loans with similar principal, currency, and tenor may impact on the total interest expense—and arguably over the interest rate—and serves as an example of the application of the ORA concept.

In this simplified example, the ‘Envisaged Loan’ is structured as a bullet loan (repayment of principal at maturity) and contains a prepayment option, allowing the borrower to repay the loan (or part thereof) prior to maturity. Such options are commonly used in intercompany financial transactions (i.e., by treasury departments) as they allow for flexibility. However, from an arm’s-length pricing perspective, the bullet repayment and the prepayment option both have the effect of increasing the interest rate applied, as it takes longer for the lender to receive back its funds and a premium is paid by the borrower for having the option to prepay (which creates risk and uncertainty for the lender, as prepayment could also be triggered by lower interest rates in the market).

In contrast, if the financial forecasts of the borrower allow for it, the ‘Alternative Loan’ could be structured with an installment schedule and thus periodic repayments of the principal. This allows for a gradual repayment of the loan over the life thereof, which translates into a lower interest rate as the effective maturity of the loan is reduced and no prepayment option would be needed, hence, no option premium is to be paid, further reducing the interest rate as compared to the Envisaged Loan.
If the Alternative Loan would thus be an ORA, given the specific facts and circumstances of the parties involved, it can be argued that an independent party would have, at least assessed, if it could structure it financing, as such, as it would reduce its financial burden. It is to be noted, however, that even though such ORA might exist, the borrower might nevertheless decide upon a financially less beneficial financing arrangement because of specific business reasons. It would be prudent, however, that the reasoning for doing so is part of, and documented throughout the decision process.

Careful consideration of how to structure a finance transaction is therefore increasingly important for transfer pricing purposes. Similarly, the qualification of the financial transaction itself is to be considered for transfer pricing purposes. Specifically, the question pertains to whether the label debt financing is appropriately applied or if the transaction, or part thereof, should be deemed to be equity capital. For that purpose an assessment of the borrower’s ability to service the debt under the agreed terms and conditions is an important element of the transfer pricing analysis. A debt service capacity analysis serves to establish the quantum of debt that an entity would have been able to attract from a third party creditor, given its financial profile, forecasts, and creditworthiness. For that purpose the analysis could, for instance, develop and compare key financial ratios that are illustrative of the company’s liquidity and solvency position over the term of the loan, for example:

- The debt-to-EBITDA (or cash flow) ratio indicates the approximate amount of time that the borrower needs to pay off its debt, ignoring other factors such as interest, taxes, depreciation, etc.; and
- The interest coverage ratio measures how many times the borrower is able to service current interest payments with its available cash generation (ignoring other financial factors).

It is clear from the above that for transfer pricing purposes inter-company financing transactions nowadays are to be tailored to the specifics of the parties involved and the funding needs and abilities of such parties. The concept of ORA puts more emphasis on this aspect.

When the earnings stripping rules triggered a need for flexibility in inter-company financial transactions, developments in the area of transfer pricing counter that by requiring that the transaction is structured (and priced) at arm’s-length, leaving little room to taxpayers to incorporate ‘flexibility’ in such transactions without a clear justification.

**Increased Transparency**

In addition to the developments noted above, the developments in the area of transfer pricing documentation requirements have led to greater transparency about a taxpayer’s inter-company financial transactions and transfer pricing policies.

Up until recently, multinational transfer pricing documentation tended to mainly focus on intercompany transactions in relation to sale and purchase of goods, provision of services, and transactions involving tangible or intangible assets. Inter-company financial transactions were...
often not treated as a core transaction or were considered to be complex and in the domain of the multinationals’ treasurers. Where in the past financial transactions might thus not have been subject to (complete) transfer pricing documentation, the new documentation template introduced under the BEPS Action 13 final report (and being rapidly implemented in countries across the globe) makes sure that such financing transactions need to be documented and are thus visible for tax authorities.

The transfer pricing policies applied in relation to inter-company financial transactions are to be disclosed in the master file and specific details about finance transactions (including, amongst others, terms and conditions, parties involved, functional analysis, debt capacity and credit rating analyses) are to be included in the local file. These documentation requirements thus ensure that taxpayers are not creating ‘flexible’ financing transactions, for earnings stripping rules purposes that are not commercially robust for the particular facts.

**Stuck Between a Rock and a Hard Place?**

It is clear that tension can arise between the responses triggered as a result of the earnings stripping rules and the increasingly strict transfer pricing rules. For instance, consider the following case: What will happen if the local tax authorities in the country where the lender is located (with the benefit of hindsight) notices a short term loan, with a prepayment option, which was rolled over for a number of consecutive years? Also, what if the local tax authorities notice that the funds were used to cover long term financing needs of the borrower?

The local tax authorities will likely take the position that the rolled over short term loan should be, economically speaking, re-characterized as a long term loan for which one would expect a higher arm’s-length interest rate. This case illustrates that ‘flexibility’ for the parties and the arm’s-length principle might not go hand in hand.

Furthermore, if the discussion with local tax authorities ends up with adjustments, i.e., an increase to the interest rates applied, the situation could potentially lead to double taxation. Because even if the tax authorities in the country where the borrower is located make a corresponding adjustment, depending on the local application of the fixed ratio rule such an adjustment can lead to non-deductibility (for instance, because of a limit on the number of years the exceeding borrowing costs can be carried forward).

Knowing that start-up companies and entities with poor financial performance are typically the type of entities in need of funding, and that companies in a profitable position typically have less funding needs, the application of the EBITDA-based fixed ratio rule thus provides such companies with a disadvantage as compared to more financially healthy companies (assuming the borrowing costs exceed the de-minimis rule applied in local jurisdictions).

It is important for multinationals to realize that the tension between earnings stripping rules and transfer pricing is highly relevant, because interest paid on loans which are currently entered into may very well be subject to the application of these rules as of January 1, 2019 within the EU and already now in the U.S. In countries where the grandfathering rules are not adopted also any prior debt that is still in place as per January 1, 2019, will be captured.

From a transfer pricing perspective, it will be difficult to make changes to the terms and conditions of existing financial transactions by the time the fixed ratio rule enters into effect. But, multinational groups should start considering alternatives for the new transactions and see if, and how, flexibility can be included in their intercompany financial agreements while still acting at arm’s-length. Setting up a coherent and robust transfer pricing policy for inter-company financial transactions should assist multinationals in achieving this objective.

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