Managing Transfer Pricing in Financial Transactions and Loans

Getting The Details Right

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The Organisation for Economic Co-operation and Development (OECD)'s Transfer Pricing (TP) Guidance on Financial Transactions released earlier this year has thrust intercompany financial transactions and loans back into the spotlight. In this guidance, OECD emphasised that, besides interest rates, all terms and conditions of the financing transactions (including the volume of debt) should be tested against the arm's length principle.

"Intercompany financial transactions are generally regarded as high-risk transactions by tax authorities. On the income side, tax authorities are concerned that excessive interest income may be allocated to jurisdictions with low (or no) tax, while on the expense side, excessive interest expense deduction may be claimed," shared Adriana Calderon, Director, Transfer Pricing Solutions Asia, at a recent webinar organised by the Singapore Chartered Tax Professionals. "OECD's latest TP guidance makes it clear that the days where a contract with little or no substance is sufficient (in supporting an intercompany financial transaction) is a thing of the past."

Managing TP in Financial Transactions and Loans

1. SUBSTANCE IS KEY

Substance is key when it comes to defending TP positions for financial transactions. Ultimately, the clauses and terms included in an intercompany loan contract should mirror that of a third-party loan contract. In addition, it should also clearly state the obligations of the loan, including the following:

- The presence or absence of a fixed repayment date;
- The right to enforce payment of principal and interest;
- The obligation to pay interest;
- The purpose of the debt;
- The existence of financial covenants and securities;
- The status of the funder in comparison with corporate creditors, and
- The liability should the borrower fail to repay on the due date or seek a postponement.

2. ENSURE THAT THE TRANSACTION IS A LOAN FOR DOMESTIC LAW PURPOSES

Different countries have different definitions of loans. As such, a financial transaction that exhibits both debt-like and equity-like features may be viewed differently in different countries. To be eligible to claim tax deduction on the interest expense, the borrower must first establish that the financial transaction is considered a loan for its domestic tax purposes based on the clauses and terms in the loan contract.

Besides ascertaining that the financial transaction is indeed a loan, companies should also be cognisant of domestic rules that limit interest deductions, as well as thin capitalisation rules (which typically limit the amount of debt that can give rise to deductible interest expenses, or limit the amount of interest that may be deducted). It should be noted that there is no thin capitalisation regime in Singapore.

3. CONSIDER SAFE HARBOURS

To reduce compliance and uncertainty on the pricing of intercompany loans, companies should first consider whether they can avail the safe harbours provided by tax authorities, where available.

The Inland Revenue Authority of Singapore publishes indicative margins for related party loans as an alternative for companies (to comply with the arm's length principle for their related party loans without having to perform a detailed TP analysis). Specifically, the indicative margin may be used for an intercompany loan not exceeding S$15 million at the time the loan is obtained or provided.

4. EXPLORE THE AVAILABILITY OF AN INTERNAL COMPARABLE UNCONTROLLED PRICE

It is important for companies to explore the availability of an internal comparable uncontrolled price (CUP), and where possible, apply the internal CUP method using internal data to determine or support the interest rate of intercompany loans.

In Singapore, the internal CUP method can be applied when a Singapore borrower or lender has loans with third parties. To illustrate, where a Singapore company (SG Co) who is not in the business of borrowing and lending provides a loan to its foreign subsidiary (Sub Co), SG Co can use a loan that it has provided to a third party (if any) as the internal CUP to determine the arm's length rate for its loan to Sub Co. Accordingly, SG Co may charge Sub Co using the same interest rate that it charges the third party.

Given that SG Co is not in the business of lending, the likelier scenario is for SG Co to rely on a loan that a third-party lender has provided to Sub Co as the internal CUP and accordingly, charge Sub Co the same interest that the third-party lender charges Sub Co.

5. CONSIDER OTHER AVENUES TO PRICE LOANS

In the absence of comparable uncontrolled transactions, the cost of funds approach could be considered as an alternative to price intercompany loans. This approach starts with the borrowing costs incurred by the lender in raising the funds to lend. The expenses of arranging and servicing the loan, a risk premium (to reflect the various economic factors inherent in the proposed loan), and a profit margin (which would generally include the lender's incremental cost of the equity required to support the loan) are then added on to arrive at the price for the loan.

It should be noted that the cost of funds approach would not be applicable if there are no external borrowings in the multinational enterprise (MNE) group.

6. PERFORM AN EXTERNAL CUP

Where it is not feasible to use the internal CUP method or the cost of funds approach, companies would have to perform a complete TP analysis. This comprises a credit-rating analysis (to establish the credit default risk of the borrower) and a benchmarking analysis (which involves the application of the CUP method using external data) to determine the arm's length interest rate for the loan.

Companies would also need to address compliance with Section 34D(1C) of the Income Tax Act, to ensure that it is able to demonstrate that the intercompany loan is entered into for legitimate commercial and financial reasons.

The TP analysis must be performed at the time the loan is entered into. Assuming that there are no key changes to the terms of the loans, the TP analysis can remain valid throughout the tenure of the loan.

CASH POOLING

Cash pooling is typically arranged within an MNE group as a mechanism to optimise cash and liquidity management. It can help the MNE group minimise the cost of external funding/ borrowing, maximise its return on cash (as better terms could be negotiated with external lenders and banks), centralise monitoring of cash position of the group, and improve administration and centralisation of treasury expertise.

In a cash-pooling arrangement, the global headquarter (or the financing company) of the MNE group would typically act as the cash-pool leader and maintain a master account, while related entities participating in the cash pooling would each maintain a separate bank account. The debit and credit balances in each account would be remunerated by applying an arm's length interest rate.

The key TP considerations for cash pooling is the arm's length interest rate used to remunerate the cash-pool leader and the respective cash-pool participants.

The arm's length interest rate for debit and credit balances generally depends on the individual credit rating of each participating company. The remuneration of the cash-pool leader, however, may vary depending on the circumstances of the case. If the cash-pool leader only performs an administrative or intermediary function, its remuneration should reflect the limited function that it performs. Conversely, if the cash-pool leader functions like a third-party bank, where it has the knowhow, bears the significant risks and has the capacity to bear these risks, it should be adequately remunerated with an arm's length handling fee (covering administrative functions) and a return for its equity at risk (covering risks related to the granting of funds within the cash pooling).

INTERCOMPANY FINANCIAL GUARANTEES

A financial guarantee is a legally binding commitment on the part of the guarantor to assume a specified obligation of the guaranteed debtor if the debtor defaults on that obligation. It can affect the terms of borrowing either by obtaining more favourable terms for borrowing or providing access to a larger amount of borrowing.

A guarantee fee may be chargeable if there is an explicit guarantee and a service contract between the guarantor and the guaranteed debtor. Otherwise, the benefit of such support would be simply regarded as a benefit arising from being part of a group (implicit support), which would not be regarded as a service provision for which a guarantee fee is due.

To effectively manage intercompany financial transactions and loans, companies need to identify their tax risks early and recognise that substance is crucial in defending TP positions for financial transactions. It would also be wise to always check for internal CUPs available as they are particularly important in supporting intercompany loan transactions.

In addition, companies should be mindful of the differences in each country's domestic tax laws, particularly on the limitations on interest deductions and thin capitalisation rules, when considering the lender's interest expense deduction. Lastly, it should be noted that compliance with the arm's length principle does not guarantee a deduction under general tax rules.

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