Grasp the Intricacies of Intercompany Loans

Intercompany Loans from a Transfer Pricing Perspective

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The proliferation of global transfer pricing (TP) rules and regulations is testament to the strong emphasis placed on the subject by tax authorities around the world in recent years.

Among the wide array of intercompany transactions, intercompany loans are generally deemed as high risk and are some of the most scrutinised transactions. Typically, the focus is on whether additional interest income should be imputed on the lender, or whether the interest expense deduction claim made by the borrower should be denied.

"Ideal Steps" to Set Up an Intercompany Loan

"A two-step process is recommended when establishing intercompany loans," shared Adriana Calderon, Director, Transfer Pricing Solutions Asia, at a recent *Tax Excellence Decoded* (TED) session organised by the Singapore Institute of Accredited Tax Professionals (SIATP). "A well-drafted intercompany loan agreement, coupled with a robust TP analysis to justify the interest rate on the loan, would no doubt help the company in future disputes with the tax authorities."

Step 1 Put in Place a Well-Drafted Loan Agreement

A well-drafted intercompany loan agreement is vital in supporting a company's TP position. The agreement should clearly state the obligations of a loan including the following:

- The presence or absence of a fixed repayment date;
- The obligation to pay interest;
- The right to enforce payment of principal and interest;
- The status of the funder in comparison with corporate creditors;
- The existence of financial covenants and securities;
- The source of interest payment;
- The purpose of the debt;
- The liability should the borrower fail to repay on the due date or to seek a postponement;
- The specific terms of the debt [including currency, interest rate (fixed or floating), start date, principal amount and interest period].

In practice, intercompany loan agreements are often too generic and do not adequately cover the key obligations of the parties. The lack of details in such loan agreements makes it difficult for companies to justify and defend their TP positions during tax controversies.

When drafting an intercompany loan agreement, it is important to ensure that each clause in the agreement is what a third party in a similar arrangement would agree to (or in other words, the intercompany loan agreement must be arm's length in nature).

Step 2: Conduct TP Analysis

Once the contract is prepared, a TP analysis should be conducted to justify that the interest rate on the intercompany loan is in line with the arm's length rate. There are generally three considerations, depending on the size and complexity of the intercompany loan.

Option 1: Consider Safe Harbours

Companies should first consider whether they are able to avail themselves to certain administrative concessions or safe harbours. In Singapore, one such safe harbour is applicable to domestic intercompany loans where the lender is not in the business of borrowing and lending. For such loans, the Inland Revenue Authority of Singapore (IRAS) will apply interest restriction (as a proxy to the arm's length principle) by limiting the taxpayer's claim for any interest expense to the interest charged on such loan. TP analysis is not required for such domestic intercompany loans.

Another safe harbour available to companies is the indicative margin which they can apply on their intercompany loans obtained or provided from 1 January 2017, provided that the loan quantum does not exceed S$15 million at the time the loan was obtained or provided.

It is not mandatory to use the indicative margin; it simply provides companies with an alternative to comply with the arm's length principle for their intercompany loans.

Option 2: Evaluate whether an Internal Comparable Uncontrolled Price (CUP) is Available

If the company is unable to avail itself of any administrative concessions or safe harbours, it should then consider the application of the CUP method using internal data to determine the arm's length interest rate for the loan.

The CUP method essentially compares the price for properties or services transferred in a related party transaction to the price charged for properties or services in an independent party transaction in comparable circumstances. The CUP method may be applied using an internal CUP (which is a transaction between the tested party and an independent party) or an external CUP (which is a transaction between two independent parties).

In the context of intercompany loans, the internal CUP method can be applied when the borrower or the 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 as the internal CUP to determine the arm's length rate for its loan to Sub Co, and accordingly charge Sub Co using the same interest rate that it charges the third party.

If internal CUPs are available to determine the interest rate but they are not entirely comparable to the intercompany loan, comparability adjustments can be made to the interest rate to eliminate the differences. A comparability analysis is conducted to ensure similarities in the actual characteristics of the transaction. The comparability factors that should be considered include:

- The credit standing of the borrower;
- The nature and purpose of the loan;
- The market conditions at the time the loan is granted;
- The principal amount, duration and terms of the loan;
- The currency in which the loan is denominated;
- The exchange risks borne by the lender or borrower;
- The security offered by the borrower;
- The guarantees involved in the loan;

The ranking of the loan (senior or subordinated).

Adriana Calderon, Director, Transfer Pricing Solutions Asia, shared her insights on the intricacies of intercompany loans.

Option 3: Perform a Complete TP Analysis

Where it is not feasible to use the internal CUP method, the company will have to perform a complete TP analysis to determine the arm's length interest rate for the loan. This generally comprises a credit rating analysis and a benchmarking analysis. The company will also need to address compliance with Section 34D(1C) of the Income Tax Act.

Perform Credit Rating Analysis of the Borrower

In determining an arm's length interest rate, the credit default risk of the borrower is typically the most important factor. In practice, the credit default risk of the borrower is the basis for determining the interest margin rate.

The most direct way of establishing the credit worthiness of a borrower is to check its official credit rating issued by credit rating agencies. If the borrowing company does not have a formal credit rating, it is also possible to apply the credit rating of the parent company if there is evidence of linkages between the borrowing company and its parent company.

Where no official credit rating is available, a credit rating analysis has to be performed. The credit rating analysis can be performed with models offered by credit rating agencies. However, such models have several shortcomings, such as its reliance on historical information and its exclusion of qualitative factors. It is also a time-consuming process.

The credit rating of a company is crucial as it is the most important factor impacting the pricing of intercompany loans. The higher the credit rating, the lower the effective interest rate due to lower risks of default.

Adriana Calderon, Director at Transfer Pricing Solutions Asia, provided insights on key considerations when applying various TP analyses.

Perform a Benchmarking Analysis

Once the credit rating is determined, the company can then perform a benchmarking analysis. The benchmarking analysis involves the application of the CUP method using external data. Based on the credit rating of the borrower, a search can be performed using databases to find the suitable interest rate margin to derive the arm's length interest rate.

Address Compliance with Section 34D of the Income Tax Act

The last step to the TP analysis is for the company to ensure that it is able to demonstrate (with supporting documents) that the intercompany loan is entered into for legitimate commercial and financial reasons.

While intercompany loan is one of the most common intercompany transactions, companies must recognise that each intercompany loan is unique and for TP purposes, avoid using one blended interest rate for all loan transactions. To manage their intercompany loan transactions, companies need to identify their TP risks early, review their intercompany loan agreements (and remembering that a one-page contract without key commercial terms is likely to be inadequate for TP purposes), and in general, be savvy in ensuring that their TP positions are sound.

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