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## Current State and Trends in Intercompany Financial Transactions

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New regulatory guidance and sharpened scrutiny from tax authorities have added complexity and urgency with respect to transfer pricing analyses of intercompany financial transactions in recent years. Not surprisingly, the responses to these developments differ across major tax jurisdictions, as reflected in a recent survey of KPMG transfer pricing practitioners around the world.

### HISTORICAL CONTEXT

Historically, tax authority interest in intercompany financial transactions, including loans and financial guarantees, could be described as sporadic at best. While there had been some interesting court cases in

this area, specific and formal transfer pricing guidance was lacking.

Starting around 2010, dovetailing with tax authorities' focus on base erosion and growing public interest in taxes paid by multinational corporations, the regulatory landscape began to shift. The United States issued new Treasury regulations, under Section 385 of the U.S. Internal Revenue Code, designed to limit intercompany debt financing for certain transactions. Around the same time, the OECD released several "action plans" arising from its Base Erosion and Profit Shifting (BEPS) project. In particular, BEPS Action 4 recommended limiting tax deductions for interest paid for intercompany loans; Action 2 focused on combating hybrid mismatches such as double non-taxation on intercompany financial transactions; and Actions 8–10 spoke to the role of economic substance in supporting transfer pricing policies.

The BEPS project eventually resulted in the release of draft guidance on financial transactions in 2019, which became the new Chapter X in the revised *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* in 2022 ("Chapter X").

### CHAPTER X OF THE OECD GUIDELINES

Chapter X, for the first time, provides a common framework of detailed guidance and specific methods for many types of financial transactions — including loans and guarantees.<sup>1</sup> The guidance touches on several issues that are being increasingly raised by tax authorities in transfer pricing analyses of these transactions, such as "accurate delineation of the transaction," impact of implicit parental support, the func-

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<sup>1</sup> Chapter X also covers other types of financial transactions, such as cash pooling and captive insurance, which were not addressed in the KPMG survey.

tions of the parties involved, and the sharing of benefits from cash pooling. Chapter X also describes alternative approaches to pricing of these financial transactions.

Of particular interest to many practitioners has been the impact of implicit parental support on credit ratings — i.e., the incidental benefit realized by a borrower by virtue of group affiliation. This issue was at the core of the *General Electric Capital Canada Inc v. The Queen* court decision of 2010. Given the complexity of this issue, it is no surprise that Chapter X does not provide prescriptive guidance but rather highlights the issue. Still, the days of automatically treating a related borrower purely as a stand-alone entity appear to be over.

One of the key contributions of Chapter X is the attention paid to the accurate delineation of the transaction — which asks whether a transaction should in fact be treated as a loan, for example. Practitioners and certain tax authorities are often focused on the arm's-length interest rate of a loan — without considering whether that loan, particularly a large one, could in fact have been obtained in a transaction between unrelated parties. Chapter X highlights tax authorities' ability to recharacterize part or all of the loan as equity.

In the context of a financial guarantee, an accurate delineation analysis leads to the questions of whether the borrower could have secured the funding without the guarantee and what is the value provided by the guarantor to the related party, and therefore what compensation is due. Also, the presence of implicit support, for instance, can significantly cut into any benefit accruing from a guarantee.

Chapter X also highlights the importance of establishing a lender's (or guarantor's) ability to assume and manage the risks inherent in the transaction. A lender of record which lacks the economic substance to assume and manage such risks may be entitled to no more than a risk-free return.

Lastly, Chapter X touches on bank opinions. While some jurisdictions have historically been somewhat accepting of opinions or quotations from banks for interest rates on intercompany loans (and from insurance companies for intercompany insurance transactions), Chapter X makes it clear that opinion letters or interest rate quotations from banks are not evidence of arm's-length pricing.

## ACTIONS TAKEN BY COUNTRIES

In some jurisdictions, the new guidance in Chapter X has contributed to further development of transfer pricing rules and approaches with respect to financial transactions, while in others it has validated practices already in place. For the most part, the new / revised

rules and additional guidance have been broadly consistent with the BEPS action plans and Chapter X with some idiosyncratic variations that leave room for interpretations and local implementation. For example, the Practical Compliance Guidance (PCG) issued by the Australian Taxation Office (ATO) focusses on the cost of funding for the multinational group versus the entity-specific focus of Chapter X.

Along with these developments, and in line with BEPS Action 4, many countries have introduced or reinforced earnings stripping rules (also known as thin capitalization rules) that cap the tax deductibility of interest — generally at no more than 30% of EBITDA. Some countries have instituted even more complex rules — for example, intercompany interest in France is further limited when the taxpayer is deemed to be thinly capitalized (with debt-to-equity ratio above a certain threshold).

## KPMG SURVEY

The following discusses an informative KPMG survey that provides a comprehensive sampling of methods and conventions regarding some relevant aspects of transfer pricing analyses of financial transactions in light of the developments over the past few years.

Given the relatively short history of the BEPS Action plans and Chapter X of the OECD Guidelines, it is not unexpected that we observe differences in their interpretation by both practitioners and tax authorities. To help understand similarities and differences, the authors surveyed practitioners from 16 KPMG International member firms.<sup>2</sup>

The survey focused on a series of questions, including, whether there are country specific rules for financial transactions, common methodologies applied, and noteworthy audit activity. Some key takeaways are summarized below, with the caveat that these perspectives are of a general nature and the outcome in any specific case will depend on its facts and circumstances.

## Rules and Safe Harbors

The guidance governing transfer pricing of financial transactions in the countries surveyed are generally aligned with Chapter X, in some cases with fine-tuning enacted through local rules. One exception might be Australia, where the preferred ATO benchmarking approach looks to the interest rate on third-party debt of the multinational group.

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<sup>2</sup> Countries surveyed include Australia, Belgium, Canada, China, France, Germany, India, Ireland, Italy, Japan, Luxembourg, Mexico, Netherlands, Singapore, the United Kingdom, and the United States.

Safe harbor interest rates are not universal. Australia, Canada, France, India, Singapore, Switzerland, and the United States all have some version of a safe harbor rate which can be used under specific circumstances.

Many of the countries surveyed already had or have recently enacted some form of thin capitalization rules.

## Credit Ratings and Implicit Support

The notion of implicit parental support is generally well entrenched, but there are key differences in implementation. The standard in some countries is to assess the stand-alone credit rating of the borrowing entity then, if circumstances warrant, adjust up to account for group support. Alternatively, if financials for the borrower are limited and/or significant parental support can be asserted, start with the group credit rating and, if necessary, adjust down from there.

Noteworthy exceptions include Australia, where the ATO's default starting point in audits is to assume the Australian subsidiary has the same credit rating as the group and the burden of proof is on the taxpayer to justify why the specific subsidiary should be considered to have a weaker rating than the group. At the other extreme, French case law frowns on the use of the group rating as a starting point and requires a stand-alone credit rating be performed (though implicit support can be argued through a specific analysis).

The notion of implicit support is not specifically contemplated in the U.S. regulations, and the IRS has an inconsistent history of bringing up the issue. It has been raised in some exams, and taxpayers are increasingly considering it in their analyses.

## Credit Rating Tools

Most tax authorities are agreeable to any reasonable approach to credit ratings, although some have expressed concern about "black box" ratings models such as those marketed by rating agencies. Still, these tools are commonly used by both taxpayers and tax authorities, in part due to their reliance on pure financial data.

## Debt Capacity/Delineation of the Transaction

A debt capacity analysis provides support for a loan being characterized as debt rather than equity. In almost all jurisdictions surveyed, a debt capacity analysis is part of a transfer pricing study, particularly for larger loans, even if the transfer pricing rules themselves may not require it. In general, the form of the

debt capacity analysis was comparable in the jurisdictions surveyed and can include, among other factors, evaluating financial ratios of the tested borrower against financial ratios of comparable companies and assessing sufficiency of cash flows to support the debt.

In the United States, the determination of the treatment of certain interests as stock versus indebtedness is covered by tax code §385 and not the transfer pricing regulations, though it is common for U.S. transfer pricing studies of intercompany loans to include a debt capacity analysis.

## Loan Terms

Roughly half of the surveyed jurisdictions said it was common for intercompany loans to include an option to repay the loan early (i.e., call option). Even fewer said that allowing for interest to be paid in kind ("PIK") was common. Possible inability to demonstrate the business need for such terms, as well as potential tax authority pushback, are cited as reasons for excluding them from intercompany transactions.

In the United States, however, call options are relatively common, while PIK features are most often seen in the context of shareholder loans in real estate and private equity transactions.

While most respondents indicated that interest rates should be adjusted when a loan has a call option, PIK feature, or other special attribute, some indicated the difficulty of doing so to the satisfaction of the tax authority.

## Functional Analysis

Chapter X states that a functional analysis is necessary for accurate delineation of the actual financial transaction in order to, for example, establish that the lender is exercising control over and has the financial capacity to assume the applicable risks. However, almost all jurisdictions surveyed indicated a functional analysis would not typically be relevant in an intercompany loan or guarantee context, except for cash pooling. It will be interesting to see if this changes in the future as countries continue to adopt the concepts of Chapter X.

The KPMG survey highlighted that tax authorities in Canada and Germany have raised this issue in audit, but without any noted success to date. In July 2021, the German Ministry of Finance issued Administrative Principles pursuant to which a foreign financing company is entitled to the current risk-free rate of return unless the financing company is "able and authorized" to control the financial investment and bear the corresponding risks. However, in October 2021, the German Federal Fiscal Court published a ruling which states that the interest rate should be based on

the economic circumstances of the borrower and not the lender, thereby contradicting the position of the Ministry of Finance.

## Financial Guarantees

There is widespread acceptance of guarantee fees, except in Australia, which is not surprising as the ATO has a strong preference for assuming a group credit rating for subsidiaries. There is preference across jurisdictions for analyzing the value of a guarantee using the “yield approach” whereby the maximum value of the guarantee is the savings on interest costs.

## Audit Activity

The survey responses indicate robust audit activity regarding intercompany financial transactions in several countries. For example, audits in Australia and Germany focused on the credit rating (including the role of implicit support) and resultant interest rate. In both Australia and Canada, tax authorities have asserted the importance of considering parental support for intercompany loans and guarantees. In Japan, the National Tax Agency has been known to question the lack of a payment for related-party guarantees. In Luxembourg, the historical attribution of fixed spreads to intermediary financing companies is being questioned, perhaps in favor of direct benchmarking of the loans with related parties.

Tax authorities have also challenged loan terms, such as call options or PIK features, particularly when accounting for their impact on the interest rate results

in a less favorable result for the local jurisdiction. Business rationale/purpose for loans has also been questioned (e.g., United Kingdom, Netherlands), and more generally arm’s-length behavior of the participants (e.g., Mexico).

Finally, it is not uncommon to see tax authorities take contradictory positions depending on whether the financial transaction is inbound or outbound. For example, in the United States, the IRS may be more focused on the safe harbor interest rate (i.e., the Applicable Federal Rate) for inbound loans. The same has been observed in some jurisdictions with regard to the role of implicit support in determining credit ratings for borrowing entities.

## SUMMARY

Recent OECD guidance has highlighted the fact that transfer pricing analyses of intercompany financial transactions need to be more robust than they might have been traditionally. Many tax jurisdictions have responded to the guidance, as well as to some high-profile court decisions that have espoused similar concepts, through new rules and practices for both tax authorities and taxpayers. While the KPMG survey highlights commonalities in how 16 major jurisdictions address some common issues pertaining to intercompany loans and guarantees, it also points to some gaping differences that contribute to the uncertainty and double taxation risks faced by multinational companies engaging in these transactions. This is an evolving landscape and significant developments are expected in the coming years.