T.P. Alfa Services

“Transfer Pricing considerations: Is it a loan or is it an equity contribution”

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Despite the intentions and decisions of related companies within a Multinational Enterprise (MNE) group to enter into a loan arrangement, in many situations there is the risk that the purported loan may not be considered as being at arm's length and be re-characterised as a capital contribution. This risk can materialise if it can be demonstrated that the lender was not able to borrow funds from an unrelated party and therefore the purported funding was only possible to be provided as capital and not as loan.

The OECD provides guidance on this area under the OECD Model Tax Convention and the Transfer Pricing guidelines (the "Guidance"). Under OECD Model Tax Convention Article 9 paragraph 3(b) mentions that "**the Article is relevant not only in determining whether the rate of interest provided for in a loan contract is an arm's length rate, but also whether the *PRIMA FACIE* loan can be regarded as a loan or should be regarded as some kind of payment, in particular a contribution to equity capital;**".

In many cases the proportion of debt to equity funding of a company under the role of the borrower which is part of a MNE group, differs from the proportion of debt to equity that would be expected to incur in an independent entity which operates under the similar or same circumstances.

It should be noted that it is not in the intention of the Guidance to prevent states from implementing approaches in addressing the abovementioned proportion of funding of an entity and the interest deductibility under the local legislation or make the Guidance the only approach acceptable in resolving the matter in question.

Every single case must be assessed based on its own unique facts and apply an approach that will be able to determine whether a purported loan should be considered as a loan or a capital contribution.

Useful characteristics in delineation of an advancement of funds

According to the Guidance there are characteristics which can be identified after delineating a transaction that will help to assess whether an advancement of funds is in substance a Loan or a Capital Contribution.

<u>Economic relevant characteristics:</u>

The Guidance mentions several economic relevant characteristic, which can be relied upon in order to delineate a specific advancement of funds. These include the:

1. Presence or absence of a fixed repayment date
2. Obligation to pay interest

3. Right to enforce payment of principal and interest
4. Status of the funder in comparison to regular corporate creditors (e.g banks)
5. Existence of financial covenants and security
6. Source of interest payments
7. Ability of the recipient of the funds to obtain loan from unrelated lending institutions
8. The extent to which the advance is used to acquire capital assets
9. Failure of the purported debtor to repay on the due date or to seek a postponement

It should be noted that in conjunction with the above economic relevant characteristics the following characteristics which are specific to the transaction in questions should also be taken into consideration when delineating a financial transaction.

Characteristics of the specific transaction:

As per the Guidance, the first step in accurately delineating a financial transaction should be the in-depth identification of the characteristics of the specific transaction from an economic point, consistent with the application to other transactions. Points to view are listed below:

1. Examine the contractual terms of the specific transaction;
2. What functions performed, assets used and risks assumed;
3. The characteristics of the financial services/products;
4. The economic conditions of the involved parties as well as the market conditions present;
5. The business strategies pursued by the involved parties.

Industry Characteristics:

The Industry specific characteristics are also vital in making a correct assessment. For each industry, a different level, amount or type of financing is required due to differences in capital intensity levels or where there are different levels of short-term cash balances required, due to different commercial needs between industries.
In regulated industries any constraints that are caused due to the existence of those regulations should be considered as well. Therefore the following issues must be taken into consideration:

1. Particular point of an economic, business or product cycle
2. Effect of government regulations
3. Availability of financial resources in a given industry

<u>Group's policy:</u>

An understanding of how the particular MNE group responds to factors identified is required to accurately delineate the actual transaction.

The group's policies may inform the delineate of the actual transaction by taking into consideration the below:

1. How group prioritises the funding need among different projects
2. The strategic significance of a particular MNE in the group
3. If the MNE group targets to a specific credit rating or debt/equity ratio
4. Whether the MNE group adopts a different funding strategy compared to the one observed in the industry sector where it operates

Once the financial transaction is delineated and the above characteristics are identified it can be assessed and documented whether an advance of funds is a Loan or a Capital Contribution.

Case Law

There are no legal proceedings in Cyprus on this matter for debt VS capital cases however an abundance of cases can be found internationally. Our article will deal with several cases on this matter.

1. **Blackrock Holdco 5 LLC Vs HMRC**

On 03 November 2020 a decision was published by First Tier Tribunal (FTT) on the case of Blackrock Holdco 5 LLC vs HMRC.

The brief facts of the case are as follows:

- A UK tax resident US LLC, Blackrock Holdco 5 LLC (5 LLC), acquired a US business of Barclay's Global investor. The total investment was $13.5 bn. out of which $4 bn were financed through loans provided by the parent company of 5 LLC a US LLC that resulted in an interest deduction of $ 200 mn per year.

- HMRC challenged the fact that a UK tax resident company was used in a US business chain based on the transfer pricing legislation and the loan relationship rules for unallowable purposes. Also, HMRC argued that the purpose of the structure of the transaction was to eliminate the cost of the UK finance.

The FTT had to consider among other disputed issues whether for transfer pricing purposes the loan was going to be granted if the parties were independent.

The HMRC argued that it was appropriate to consider the group as a whole, however FTT preferred to use a "single entity approach" and focus on the ability of 5 LLC to borrow the $4 bn and on what terms. The experts from both sides (5 LLC and HMRC) concluded that 5 LLC would have been able to borrow the $4 bn with the inclusion of relevant covenants. However, the experts disagreed on whether an unrelated borrower would have accepted such type of covenants. HMRC's experts argued that the covenants needed in this case where too complex and costly for 5 LLC. On the other hand, taxpayer's experts argued that these covenants would have only had an impact on the cost of borrowing and not on whether a loan was going to be granted or not.

The FTT ruled in favour of Blackrock Holdco 5 LLC with regards to this issue.

2. PepsiCo v Commissioner IRS

PepsiCo Inc in the process of restructuring, transferred notes that were issued by a part of its US subsidiaries, (issue by other US subsidiaries) to two newly formed subsidiaries in Netherlands, in exchange for advance agreements. Under this structure, the Dutch subsidiaries paid a preferred return on the advanced agreement in exchange for interest payments of the notes from the US subsidiaries. From a Dutch point of view the advance agreements where treated as debt (which was accepted by the Dutch tax authorities), and from the US point of view the advance agreements were considered as equity, a fact that was challenged by IRS in their attempt to re-characterizing the equity as debt.

The below factors were taken into consideration by the court to rule on the matter. We also indicate their view on each factor considered:

1. Names or labels given to the instruments- **neutral**
2. Presence or absence of a fixed maturity date- **equity indication**
3. Source of payments- **debt indication**
4. Right to enforce payments- **equity indication**
5. Participation in management as a result of the advances- **neutral**
6. Status of the advances in relation to regular corporate creditors- **equity indication**
7. Intent of the parties- **equity indication**
8. Identity of interest between creditor and stockholder- **not relevant to debt/equity analysis**
9. "Thinness" of capital structure in relation to debt- **equity indication**
10. Ability of the corporation to obtain credit from outside sources- **equity indication**
11. Use to which advances were put- **debt indication**

12. Failure of debtor to repay- **neutral**
13. Risk involved in making advances- **equity indication**

After considering all the above 13 factors, the court came to the conclusion that the characterisation of the advance agreements as equity was correct and thus ruled in favour of the tax payer.

3. Germany vs "Waiver KG"

In this case the issue was whether the waiver of a trade receivable can be considered as tax allowable expense.

The brief facts of the case are listed below:

- Waiver KG had an outstanding (non-interest-bearing and unsecured) trade receivable of EUR 2,560,000 from a wholly-owned subsidiary in China related to deliveries made in FY 2004 and 2005. Waiver KG had first issued a partial waiver (EUR 560,000) on the receivable and then a complete waiver in December 2008.
- The initial partial write-down did not effect to the taxable income, but in the course of a tax audit Waiver AG requested that the partial write-off to be taken into account for tax purposes as well. The tax office refused to do so and instead applied an interest rate of 3% on the outstanding receivable.

A complaint was then filed by Waiver KG to the tax court.

The tax court issued a decision in favour of Waiver KG with reference to German jurisprudence on the blocking effect of Art. 9 of OECD. However, at the same time, the tax court increased the interest rate on the outstanding receivable to 10.5%.

This decision was appealed to the Bundesfinanzhof by the tax authorities.

Judgement of the Bundesfinanzhof

The Court found that Art. 9 (1) OECD does not limit arm's length adjustments, but also allows for tax adjustments based on non-recognition of a loan receivable or a partial write-down. The Court considered that lack of collateral can be at arm's length, depending on facts and circumstances of the transaction in question.

The case was referred back to the tax court, as it had not been sufficiently clarified whether an independent party would have waived collateral in the specific case, e.g. in order to avoid the bankruptcy of a functionally important company.

4. UK vs CJ Wildbird Foods Limited

In this case the issue was whether a related party loan should be treated as a loan for tax purposes.

The brief facts of the case are listed below:

- There was a loan agreement between the parties and the agreement specified that there was an obligation to repay the loan and interest.
- However, no interest had actually been paid and a tax deduction had also been claimed by the tax payer on the basis that the debt was a bad debt.

The tax authorities argued that the loan did not have the characteristics of a loan. The borrower was loss making and did not have the financial capacity to pay any interest. The tribunal found that there was a legal obligation to repay the loan and interest. Whether the loan or interest was actually repaid was irrelevant.

Hence, the tribunal found in favour of the taxpayer.

Concluding Comments

Based on the cases that reached the courts until now, the Tax Authorities across the world have failed in the majority of the cases, to reclassify intercompany debt as equity in order to deny tax deductions. The transfer pricing guidance on financial transactions issued by OECD in February 2020 which discuss the debt-versus-equity issues will further clarify this area, however the Tax Authorities will continue to challenge such transactions.