Transfer pricing in financial transactions during crisis (3/21/20)

COVID-19 may have a wide range of adverse implications such as falling consumer demand, supply chain disruptions, and heightened risks in financial markets. The economic downturn may result in many companies within a multinational group having lower cash flows, so other group members may decide to lend to them or to revise the terms of their existing loans and help them ride out the crisis. This article explores key transfer pricing issues and risks associated with intragroup financial transactions, which are especially topical in the present emergency situation.

Setting the price of a loan transaction (interest rate)

An arm's length price (interest rate) should be charged on any new loan to a related party. In these emergency circumstances, it is difficult to find a suitable interest rate for financial transactions.

Many of the comparable data sources that are commonly used for transfer pricing purposes (e.g. weighted average interest rates published by the Bank of Latvia) currently fail to reflect the economic reality. This is due to delays in the publication of updated information, which may cause the available data to be considerably different from the real market rates. Extra precautions should be taken when conducting a benchmarking study for loan transactions on international databases such as Bloomberg or Reuters. If information on loan transactions in the market is scarce or out of date, then it may be necessary to adjust the comparability of interest rates, using market indicators that at least partly consider the impact of the emergency situation, for example, using profitability curves in particular industries or the results of credit rating categories. The tax authority is likely to dispute the data used in the benchmarking study unless comparable financial transactions that took place before the emergency situation are adjusted to prevent transactional differences from substantially affecting the price of the transaction under review.

To mitigate risks, companies need to take preventive measures. For example, a clause could be inserted in a loan agreement to provide for revising the interest rate and the accrued (agreed) interest charges as soon as reliable information becomes publicly available about interest rates charged between unrelated parties at the time of lending.

A cap on the amount of a loan

When making a new loan to a group member whose business is facing financial difficulties because of COVID-19, it is important to assess whether the company will be able to repay the loan and whether an unrelated party would be willing to lend a similar amount. If the intragroup loan exceeds an amount that would have been agreed between independent parties, the excess does not fit the company's creditworthiness and may be considered unreasonable and incompatible with fair business practice. In this situation, the loan or the excess may be treated as a different kind of income, e.g. a contribution to share capital. To mitigate this risk, a debt capacity analysis is advisable to assess the borrower's ability to repay the loan when it matures. This factor is likely to be scrutinised by the tax authority as well.

When looking for a loan cap that an independent lender would be willing to lend and an independent borrower would be willing to borrow in comparable circumstances, it is important to consider the functions performed by each party and, more importantly, the risks they have assumed and their ability to control them.

Backing for a loan (a guarantee)

A possible implication of the COVID-19 crisis is that related parties increasingly tend to offer financial guarantees, with one group member acting as guarantor for another member's financial liabilities. As lending institutions become more cautious, they may decide to require guarantees for the loan in order to gain an assurance of the group member's ability to repay it. It is important to note that just like the interest rate applied on the loan, the backing for it (a guarantee) should also be explained in the transfer pricing documentation, which places an extra burden on the taxpayers.