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Arm’s length interest on related party loans 3/7/22

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Related companies sometimes make loans to each other, and those must be arm’s length just like any other transaction between related parties. A benchmarking study can use both internal and external comparable data, yet it is not always clear what period those should be selected for. This article explores various types of loan analyses with benchmarking examples based on external sources of information.

Availability of comparables

To demonstrate that an interest rate is arm’s length, both theory and practice point to the comparable uncontrolled price method, which uses internal or external comparables. Internals can be identified if the taxpayer has made a comparable loan to a third party. Yet it is important to check that the internals are comparable and reliable for analysing the controlled loan transaction. This can be done by assessing whether economically significant conditions (e.g. the date, repayment term and amount of the loan) and the functions performed and risks assumed by the parties are similar enough. If no internals are available, the taxpayer should alternatively assess externals, such as interest rates published by the Bank of Latvia (BOL) or comparables offered by commercial databases.

The date that comparables are obtained

When it comes to proving that a loan is arm’s length, you may run into situations where you are unsure what period the externals should be selected for. Unfortunately Latvian legislation fails to shed light on this issue as there are no special rules to tell us how and when comparables should be selected for a transfer pricing analysis. In such situations the Cabinet of Ministers’ Rule No. 677, *Application of Provisions of the Corporate Income Tax Act*, paragraph 19 allows us to take the *ex-ante* and the *ex-post* approach recommended by the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.

The *ex-ante* approach: determining the price between unrelated parties at the time of the transaction

To make sure the price (interest rate) applied on the controlled loan transaction is arm’s length, the taxpayer can prepare a benchmarking study and an arm’s length range of interest rates at the time of the transaction. Yet the transfer pricing documentation should be able to demonstrate that the taxpayer made reasonable efforts to meet the arm’s length principle at the time of the transaction according to the information that was reasonably available before the transaction.

To better understand the *ex-ante* approach, let’s look at a theoretical example based on the BOL interest rate statistics.

Let us assume the taxpayer was about to make a loan to a related foreign company in January 2021 and wanted to make sure the interest rate would be arm’s length. Having assessed the facts and circumstances of the proposed transaction, the taxpayer selected for comparison the BOL statistics for average interest rates on loans made by credit institutions. Since the *ex-ante* approach is based on historical data, the taxpayer selected the last published interest rates for a 12-month period. It is important to note that the BOL publishes aggregated interest rate statistics with a two-month delay, so the data for December 2020 to November 2021 was selected for comparison.

The *ex-post* approach: testing the circumstances (actual results) of unrelated parties

Unlike the *ex-ante*, this approach tests the circumstances or actual results of unrelated parties by comparing the proposed interest rate with the ones that unrelated parties applied during the period the transaction in fact took place.

Again, using the BOL statistics for average interest rates on credit institution loans and knowing that the taxpayer made the loan in January 2021 with a repayment term of up to one year, we need to select comparables for the period the loan was made available for use. Thus, to demonstrate that the interest rate is arm's length, comparables for the period from January 2021 to December 2021 should be selected in the transfer pricing documentation.

While our experience suggests that the *ex-post* approach is taken more often, it does not always guarantee a favourable outcome because a test of the actual results may find that the taxpayer's interest rate falls outside the arm's length range. On the other hand, the *ex-ante* approach determines an arm's length interest rate at the time of the loan and guarantees a higher degree of reliability and comfort.