

# Transfer pricing trends: arm's length level of debt (3/15/19)

Following our series of articles on the OECD's BEPS public discussion draft on financial transactions (the "Green Paper") this article explores an arm's length level of debt for transfer pricing (TP) purposes. Taxpayers are invited to evaluate whether interest charges on a loan made to a related party and the debt itself meet the arm's length standard.

## Arm's length lending

The Green Paper focuses on giving an accurate description of the financing transaction being analysed. When measuring an arm's length interest charge, we should also analyse the maximum amount the borrower is considered to receive in the TP analysis. This maximum is an amount that an independent lender would have been willing to lend and that an independent borrower would have been willing to borrow (the arm's length level of debt) in comparable circumstances, i.e. considering the functions performed and, more importantly, the risks taken by each party. So the analysis of a loan between related parties will focus on challenging the loan itself. Where an intragroup loan exceeds the amount that would have been agreed between independent parties, the excess will be ignored in the TP analysis. The loan or part of it should be viewed as some other kind of payment, e.g. a contribution to share capital.

## Example

Suppose company B needs more funding for its business activities and borrows €10m from its related company C, repayable in five years. B's good faith financial projections for the next five years make it clear that B would be able to administer and repay a loan of €8m only. This is the arm's length amount an unrelated party would willingly lend to B, and the balance of €2m would not be recognised as a loan in measuring an arm's length interest charge for B. So the interest charge exceeding the arm's length loan may create an extra tax liability for the taxpayer. This risk will be even higher if the parties decide to convert the loan into equity when it matures.

With no guidance on defining an arm's length level of debt, it is important to accurately describe the transaction and assess the borrower's ability to service his debt, and the borrower's credit rating is always useful in such assessments. Independent enterprises thinking about entering into a financial transaction will consider various factors, including the borrower's capacity, the impact of more borrowing on his credit rating, the cost of capital, access to capital markets, market reputation, and all other options realistically available to them. Independent enterprises will only enter into that transaction if they see no alternative offering a clearly more attractive opportunity to achieve their commercial objectives. Each situation should be examined on its own merits and subject to an accurate description of the actual transaction, with a functional analysis preceding any pricing attempt.

With the Latvian State Revenue Service taking part in developing OECD papers, this approach to TP analysis might also be considered in Latvia, but it is likely to create additional tax liabilities in local companies and cause disputes between the taxpayer and the tax authority, as well as between the local tax authorities of the parties to a cross-border transaction over loan reclassification. Commentators on the Green Paper mostly admit that reclassification should take place only in very limited circumstances and

that clearer guidance on the limits and conditions for arm's length debt is needed. The guidance on TP analysis of financial transactions is to be finalised in April 2019.