

Evaluating inter-company loans in Switzerland

Hendrik Blankenstein, Tom Lawson and Caterina Colling Russo of Tax Partner AG – Taxand Switzerland present a comparative study on how the OECD’s guidance on financial transactions will impact the characterisation and pricing of inter-company loans for MNEs in Switzerland.

On February 11 2020, the OECD published the long awaited report: Transfer Pricing Guidance on Financial Transactions (TPG FT). The guidance updates the 2017 OECD Transfer Pricing Guidelines (Guidelines). Sections A to E of the report will be included in the Guidelines as Chapter X and Section F will feature as a part of Chapter 1 of the Guidelines. The report’s focus is on the accurate delineation and pricing of inter-company financial transactions, such as loan transactions, financial guarantees, cash-pooling, hedging and captive insurance companies.

This article deals with the accurate delineation and pricing of loan transactions. It focuses on the TPG FT’s impact on multinational enterprise (MNE) groups, which engage in cross-border loan transactions. It also analyses which aspects a Swiss borrowing entity will need to consider when entering into a complex intra-group loan transaction in light of the impact of the TPG FT on the practices of the Swiss tax authorities.

Transfer pricing aspects of loan transactions

With respect to loan transactions, transfer pricing (TP) disputes often revolve around delineation and pricing.

Delineation

Delineation refers to the reclassification of a loan transaction into equity. For example, when loans are provided to a start-up, a loss making and/or highly leveraged entity and/or when the loan instrument has equity characteristics.

The reclassification of one debt instrument into another debt instrument with different characteristics can also be classified as delineation. For example, disputes with respect to the term of the loan, securities, rank, credit rating, implicit support, etc.

Pricing

Pricing refers to the determination of the applicable interest rates. For example, disputes with respect to the validity of the comparable uncontrolled prices (CUPs) or comparable uncontrolled transactions (CUTs), the selected risk-free rate, the use of yield curves to determine interest rates, the use of bank opinions, etc.

TPG FT: Delineation – debt versus equity

The TPG FT provides a detailed framework, the first step of which requires companies to analyse the advancing of funds through the so-called actual delineation of the financial transactions to be performed in accordance with the five comparability factors.

The TPG FT goes further and provides a checklist of relevant characteristics that may be useful while classifying the transaction:

- The presence or absence of a fixed repayment date;
- The obligation to pay interest;
- The right to enforce payment of principal and interest;
- The status of the funder in comparison to regular corporate creditors;
- The existence of financial covenants and security;
- The source of interest payments;
- The ability of the recipient of the funds to obtain loans from unrelated lending institutions;
- The extent to which the advance is used to acquire capital assets; and
- The failure of the purported debtor to repay on the due date or to seek a postponement.

However, the TPG FT specifies that the guidance does not prevent countries from addressing capital structure and interest deductibility under their domestic legislation. As a matter of fact, whether a financial instrument is to be treated as debt or equity is, in many countries, already addressed under domestic legislation through interest deduction limitation, debt/equity requirements and/or thin capitalisation rules. This will not change.

Switzerland: Delineation – debt versus equity

At present, Switzerland has no specific TP legislation. However, as a member of the OECD, Switzerland adheres to the OECD Guidelines. Further, the Federal Tax Administration has published various administrative directives that refer to the application of the arm's-length principle. The legal basis for applying the arm's-length principle can be found in the Federal Direct Tax Act and the Cantonal Tax Harmonisation Act (both acts relevant for corporate income tax) according to which the tax authorities can add expenses to a Swiss entity's taxable profit if they are not economically justified, for example non-arm's-length interest expenses.

The two abovementioned laws establish that interest on debt, which from an economical point of view is considered



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as equity, is also to be added to the taxable profit of a Swiss entity and that such debt, same as shareholders' equity, is subject to annual capital tax. These provisions form the legal basis for delineating the balance of debt and equity funding of a borrowing entity and stipulate that debt can only be reclassified to equity, if the debt from an economical point of view is considered as equity. In practice, this rule is rarely followed due to lack of guidance on what constitutes equity from an economical point of view and due to the well established safe harbour practice in Switzerland.

On June 6 1997, the Federal Tax Administration published Circular Letter No. 6 regarding hidden equity. This circular letter serves as a safe harbour rule according to which hidden equity is assumed if a Swiss entity's debt exceeds a certain percentage of the market values of the entity's balance sheet assets. The relevant percentage varies depending on the type of asset (e.g. cash balances can be

financed through debt up to 100%, receivables 85%, factory buildings 70%, etc.).

On average, roughly 85% of a Swiss entity's balance sheet assets (valued at market value) at most can be financed through debt. If the Swiss borrowing entity's debt exceeds the relevant threshold, then hidden equity is assumed. However, only debt provided from shareholders or related parties and debt from third parties guaranteed by shareholders or related parties can be reclassified to equity. Importantly, the circular letter explicitly states that no reclassification will occur if the Swiss entity can prove that its debt financing is at arm's length.

Due to its simple and practical application, the hidden equity safe harbour rules have played an important role in Swiss tax practice when delineating the balance of debt and equity funding of a borrowing entity. We, therefore, do not expect that the TPG FT will bring significant changes to the existing safe harbour practice in Switzerland applied by tax authorities, taxpayers and courts.

However, there may be exceptions. For example, a Swiss borrowing entity that is in a start-up position generating losses, having a low equity and few valuable assets is likely in a position that its interest deduction would be limited by the impact of the hidden equity safe harbour rules. The framework may provide a basis to such borrowing entity to prove that its debt funding should not be reclassified to equity. That position should be properly documented and be based on an accurate delineation of the loan, and include arguments why the loan meets the economically relevant debt characteristics as described in the TPG FT, as well as evidence that the borrowing capacity and borrowing willingness of the borrowing entity is not exceeded.

TPG FT: Delineation of the loan transaction and pricing

In addition to the characterisation of debt versus equity, the TPG FT provides further guidance on how to analyse the loan transaction. After having considered all relevant facts with respect to that transaction, the transaction can be priced accurately, i.e. the interest rate will be determined.

Below, some relevant aspects are summarised.

The lender's and borrower's perspectives

The TPG FT requires both the lender's and borrower's perspectives and all realistically options available to both parties to be considered. The lender has to assess the borrower's credit risks before deciding whether to grant a loan, how much to lend, and on what terms.

A thorough credit assessment of the potential borrower will enable the lender to identify and evaluate the risks involved. That credit assessment includes understanding the business itself, as well as the purpose of the loan, how it is to be structured and the source of its repayment that may



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include analysis of the borrower's cash flow forecasts and the strength of the borrower's balance sheet.

An estimation of the credit rating of the borrower and the debt instrument is recognised by the TPG FT as an approach to compare the conditions of transactions between transacting parties with conditions which would apply to those between independent parties.

The TPG FT includes guidance on how to estimate the borrowing entities' credit ratings. The standalone credit rating, possibly adjusted for the impact of the implicit support, is preferred to the MNE's group one. The MNE's group rating may be a useful starting point only in some circumstances, for example, when the group rating is considered to be a valid proxy for companies within the group.

The TPG FT provides specific factors that may influence the stand-alone credit rating, such as through implicit support. The FTG FT mentions that implicit support from the multinational group "may affect" the credit rating of a borrowing entity. The TPG FT does not provide detailed guidance on how to measure its impact. It is a case-by-case determination. The importance of the entity to the multinational group and or the strength of the link between the borrowing entity and the overall multinational can be relevant indicators.

On the other side of the transaction, the borrower will be considering optimising its weighted average cost of capital and



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having the right funding available to meet both short-term and long-term needs when entering into a loan transaction.

For example, the borrower will compare the envisaged loan transaction with other realistic alternatives available. A borrower may prefer offering collateral, assuming that the business has suitable collateral to offer, which due to the intra-group nature of the loan may not be offered.

Not only is the business rationale for entering a particular loan transaction in the scope of these considerations, but also the rationale for entering or not entering into a transaction during the term of the loan, for example, the decision not to repay the loan while having the right to do so according to the loan agreement.

Our take is that the 'analysis bar' for the taxpayer has been raised due to the emphasis on the two-sided approach, which involves considering both the perspective of the borrower and lender, as well as having to analyse the options realistically available to each of them, as well as to the elaborate analysis required when determining a credit rating.

Pricing: Determining the arm's-length interest rate of intra-group loans

After considering all these relevant facts, the accurately delineated transaction can be priced, i.e. the interest rate will be determined.

An analysis of comparable transactions to determine the arm's-length interest rate starts with the identification of internal or external CUPs. In selecting these comparables, the TPG FT mentions that the most critical loan characteristics that drive the interest rate (such as credit rating of the instrument, the terms and subordination) should be considered. Also, other factors such as business performance and the industry sector (for example, impact of regulatory frameworks in insurance and banking industry) should be taken into account.

Not only uncontrolled loan transactions can be considered as comparable transactions, but also other uncontrolled financial transactions such as bonds, deposits, convertible debentures, and commercial papers. Ideally, the selected comparables are a 100% match in all respects – in practice, comparability adjustments will be required. Adjustments need to be based on good quality data easily available and care should be taken when including loans to borrowers with qualitative differences or where data to quantify the adjustments are not so readily available.

Next to the CUP methodology, other approaches are mentioned to determine the arm's-length interest rate. For example, a potential approach to loan pricing is to look at the lender's cost of funding plus a profit margin that, generally, would include the lender's incremental cost of equity. The TPG FT provides more guidance on how to determine the group's cost of funds, how credit default swaps can be used in pricing, and the use of economic modelling.

The TPG FT discusses potential issues with bank opinions because they are not transactions and, therefore, would generally not be regarded as providing evidence of arm's-length terms and conditions.

Switzerland: Delineation of the loan transaction and pricing

Each calendar year, the Swiss Federal Tax Administration publishes circular letters containing inbound and outbound safe harbour interest rates, one for loans denominated in Swiss francs and one for loans denominated in foreign currencies. These circular letters play an important role in determining interest rates on intra-group loans because they reduce the administrative burden of taxpayers resulting from preparing and maintaining TP documentation for their intra-group loans.

However, the circular letters do not differentiate the interest rate applied based on the characteristic of loan instruments such as credit risks, the term of the loan, or the level of seniority. Therefore, relying on the safe harbour interest rates in complex cross-border intra-group loan transactions will likely lead to challenges by the other country's tax authorities claiming that the Swiss safe harbour rates do not correspond with the arm's-length standard.

The circular letters do mention that the interest rate may deviate from the safe harbour interest rate, but the Swiss

borrowing entity must prove that the interest rate is at arm's-length. Previously, in the absence of specific OECD guidance, the arm's-length interest was often challenged by the Swiss tax authorities. The presence of the TPG FT's guidance should now offer taxpayers the comfort to go beyond or below the safe harbour. The taxpayer should prepare TP documentation to support its position.

Conclusion

The OECD has made a significant step towards providing more comprehensive guidance on financial transactions. The TPG FT allows for a more consistent interpretation of the arm's-length principle and should reduce the likelihood of TP disputes and double taxation.

However, more guidance implies that the 'analysis bar' for the taxpayer has been raised higher: taxpayers must follow a two-sided approach, while having to consider both the perspective of borrower and lender, analyse the options realistically available, and perform elaborate analysis when determining credit rating and pricing. Overall, Swiss MNE groups which engage in cross-border loan transactions should review whether their loan transactions are structured, priced and/or documented in line with the TPG FT.

Switzerland adheres to the OECD Guidelines. When Swiss tax authorities verify the arm's-length nature of a loan transaction and the interest rate, the TPG FT will need to be taken into consideration.

In our view, the safe harbour interest rate circular letters will remain relevant in Switzerland for determining interest rates of intra-group loans, for example, in pure domestic situations. Swiss taxpayers that do not wish to apply the safe harbour guidelines need to ensure that their loans are accurately delineated, priced and documented by performing an OECD conformed TP analysis. Only then can the transaction and its pricing be confidently presented as an arm's-length alternative, and chances are reduced that the Swiss tax authorities will challenge that position.

The TPG FT has increased the bar on the level of information and documentation to be provided by the taxpayers and it must be expected that the Swiss tax authorities will critically review the TP documentation in light of the guidance.

In the event that a taxpayer relies on bank opinions as their sole evidence of the arm's-length interest rate, they are urged to perform a comparable price analysis to complement its TP documentation as the OECD rejects bank opinions because they represent a departure from an arm's-length approach.

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