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OECD's guidance on financial transactions: Evaluating the transfer pricing impact on shareholder loans to fund real estate ventures in Switzerland

Stephan Pfenninger and Hendrik Blankenstein in the following discuss the recently published OECD Transfer Pricing Guidance on Financial Transactions (OECD) and evaluate the transfer pricing impact on shareholder loans to fund real estate ventures in Switzerland. The OECD report covers the transfer pricing aspects of various intercompany finance transactions, such as loans, financial guarantees, cash-pooling, hedging and captive insurance companies. The OECD now provides detailed guidance supporting taxpayers as well as tax authorities in analysing shareholder loans and in determining arms' length interest rates.

Introduction

Real estate companies fund their acquisitions or development projects generally through a combination of:

- bank loans (often senior, secured/asset-backed and having a shorter maturity),
- loans from non-financial institutions (often junior and non-secured), and
- loans from shareholders (often non-secured, subordinated and having longer maturity), and
- equity.

Shareholder loans (SHL) are often under scrutiny of the tax authorities. Tax disputes range broadly from tax authorities deeming the character of SHLs to be (interest free) equity rather than debt funding to challenging arm's length interest charges. The absence of clear tax and transfer pricing guidance leads often to cross-border and national tax disputes and non-recoverable tax charges (such as non-deductible interest expenses and dividend withholding tax on deemed dividend distributions).

In Switzerland, the Federal Tax Administration's Circular Letter No. 6 (June 6, 1997) regarding hidden equity serves as a safe harbour rule according to which hidden equity is assumed if a Swiss entity's intercompany debt exceeds a certain percentage of the market values of the entity's balance sheet assets. Interest paid on such deemed equity is not tax deductible. In addition, the Federal Tax Administration annually publishes Circular letters providing inbound and outbound safe harbour interest rates.

However, when determining the interest rates of debt instruments such as SHLs, the interest safe harbour rates generally do not reflect the parameters normally taken into account in connection with a property financing such as specific credit risks.

Hence, the safe harbour rates often deviate from realistic interest rates in a specific case. The Circular letters do mention that the taxwise accepted interest rate may deviate from that safe harbour interest rate but it is up to the taxpayer to prove that the interest rate applied is at arm's length. The Circulars do not mention how to establish such evidence though. It is, however, our experience that - in practice - it is often difficult to convince the tax authorities of the arm's length nature of such alternative interest rate even when documented through a detailed transfer pricing analysis.

Our observations

In the context of funding real estate ventures with SHLs, our observations are as follows:

1) The determination of the arm's length interest rates ultimately requires the identification of comparable transactions.

   Real estate ventures are generally funded through a combination of debt instruments including debt from unrelated parties. The OECD mentions that these latter transactions should at least be considered as potential comparable transactions. The OECD, however, also acknowledges that comparability adjustments may be required due to the different features of debt instruments: SHLs generally have a longer maturity, lower priority and/or subordination compared to, for example, a bank loan, and therefore, a premium or margin may need to be added to a bank loan interest rate to determine the interest rate of the SHL. The OECD mentions that also loan transactions between two unrelated parties (of the taxpayer) as well as other financial transactions such as bonds, deposits, convertible debentures and commercial papers could be considered as potential comparable transactions.

We actually have observed an (international) tendency that tax authorities reject the use of external comparables in real estate funding claiming that the SHL is best to be compared with the (senior) bank loan. Even comparability adjustments to this generally lower bank interest spread are sometimes rejected, despite of the higher credit risks that the SHL is exposed to.

It is our take that it is therefore critical that the taxpayer, when establishing proof of the interest rates applied, can explain in detail why he has rejected or accepted potential comparables, which comparability adjustment were made and how they were quantified. The OECD mentions that a detailed transactional analysis should be the start of such comparability analysis.

2) The OECD states that a transactional analysis should cover both the perspective of borrower and lender as well as all options realistically available to each of them, and should consider:

- Description of the terms of the SHL

- An assessment of the borrower's credit risks and the risks related to the particular loan and/or real estate project as typically considered by lender before deciding whether willing to grant a SHL, how much to lend and on what terms. Typically, a Loan-to-Value Analysis is included providing a reliable quantification of the credit risk associated with the SHL, detailing which part of the SHL is likely and which is less likely to be repaid in full upon default.

- Due to the intragroup nature, typically the SHL is structured as an unsecured loan. The OECD mentions that the absence of contractual rights of the lender over the assets of the borrower does not necessarily reflect the economic reality of the risk inherent in the SHL. If assets are available to act as collateral for the otherwise unsecured SHL, this may have consequential impact upon the pricing of the loan.

- An analysis of the borrower's considerations in optimising its cost of capital and in having the right funding available to meet both short-term and long-term needs.

- A comparison of the SHL with other realistic alternative funding options available. For a lender, the SHL would have to be a more attractive investment than other comparable investing opportunities. The borrower may consider the option to offer collateral or prefer to keep such collateral for other future third party financing.

3) In summary, the OECD now provides more detailed guidance which supports taxpayers as well as tax authorities in analysing SHLs and in determining arms' length interest rates. Our take:

- Swiss taxpayers which do not wish to apply the Swiss interest safe harbour rules will be in a better position to support the arm's length interest rate by referring to the outcome of an OECD conform transfer pricing analysis (performed contemporaneously). It should be easier for tax authorities to confirm the arm's length test for interest rates based on such transfer pricing analysis as they can better assess if the analysis is in line with OECD guidelines.

- Taxpayers which have SHLs are recommended to perform a thorough review assessing whether their transactions and pricing were properly structured and documented and if they are exposed to tax risks. They may want to contemplate which actions are available to reduce that exposure.

- Written opinions from independent banks stating what they believe would be an appropriate interest rate for a specific loan (if such banks were to make a loan to that entity) were often used in Switzerland to evidence the arms' length nature of the interest rate. Such bank opinions are now rejected by the OECD as representing a departure from an arm's length approach. Taxpayer which have such bank opinion as their sole evidence of the arm's length interest rate are urged to perform a comparable price analysis to complement their transfer pricing defence.

4) The OECD does not provide details on documentation requirements for financial transactions. In view of the above, it is our take, that it is in the taxpayer's own interest to proactively analyse his structure and prepare documentation to support the arm's length interest rate, covering the most critical aspects in the transfer pricing analysis:

- Description of the terms of the SHL;

- Credit risk assessment of the borrower;

- Analysis of cost of capital of the borrower;

- Analysis of potential CUPs, the reasons why potential CUPs were rejected and others accepted, comparability adjustments and their quantification;

- Reasons why the SHL was structured in that way and discussion of reasonable alternatives from the borrower's and lender's perspectives.

5) We do not specifically address the consequences of the COVID-19 in this Newsletter but it is expected that real estate investments will also be adversely impacted by the crisis. For real estate ventures with a higher risk profile, bank loans may in the future be more costly and/or more difficult to obtain. SHLs may then become an even more important alternative source of funding.

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