INTERCOMPANY LENDING ARRANGEMENTS INSIDE MULTINATIONAL ENTERPRISES ARE AT RECORD LEVELS, AND THEY ARE COMING UNDER INCREASING SCRUTINY FROM TAX AUTHORITIES ACROSS THE WORLD. SILVINA ALDECO-MARTINEZ AND ERNEST BREITSCHWERDT EXPLAIN

AT ARM’S LENGTH

For large multinational enterprises, intercompany lending offers the possibility of an ideal allocation of debt versus equity within the wider group to support shareholder value creation, an optimal capitalisation of entities within that group to meet investment requirements and the opportunity of leveraging these various entities’ different levels of funding access.

However, the lack of a formalised framework for assessing and reporting intercompany financing has led tax authorities to identify a major risk stemming from it: that corporations are organising these transactions in ways that could be interpreted as ‘thin capitalisation’, ‘profit shifting’ or other tax-avoidance practices (See The Treasurer, October 2015, page 34). Although various national authorities have taken different approaches to such transactions, and there is a lack globally of a formal framework for their assessment, one common theme emerging, certainly in the advanced economies, is that such arrangements ought to be arranged according to the ‘arm’s length principle’.

In other words, the aim is that the financing in question is conducted in the most objective way possible. In showing that this is indeed the case, corporate groups in developed-economy jurisdictions are increasingly expected to demonstrate their compliance with two subsidiary principles.

The first is that the borrowing entity could and would potentially get access to a similar level of debt, with similar terms and conditions, from a third-party lender. The second is that the interest rate is priced in accordance with arm’s length transactions in which comparable, unrelated parties would enter into similar agreements.

The benefit of such an approach is noted in the 34-nation Organisation for Economic Co-operation and Development consultation paper published in December 2014: “An arm’s length test... allows a tax administration to focus on the particular commercial circumstances of an entity or a group.” The arm’s length principle has therefore been found to be the most complete approach to formalise a framework for intercompany financing.

Risk assessment

Passing this arm’s length test is a two-part process. Firstly, the enterprise concerned has to show that its credit risk assessment of the affiliated company is transparent, objective and comparable to that which would have been conducted by an unrelated third-party lender. Secondly, and assuming that the
Assessing the credit risk and the appropriateness of the associated pricing is not without its challenges

approach, namely quantitative credit risk assessment models – effectively treating the affiliate as an entirely independent entity from the multinational business – to arrive at a far more credible credit rating.

Increasingly, auditors and companies have shifted to examining credit risk ‘in the round’ rather than focusing on financial ratios, with the most effective models looking at measures such as ‘probability of default’ and credit scores through the business cycle. These measures are more likely to produce robust and provably independent risk assessments of the sort that would emerge were the subsidiary or affiliate to be entirely unconnected to the main group.

The key role played by credit risk assessment in satisfying the arm’s length criterion increasingly insisted upon by tax authorities is underlined by our own research into the risk landscape of the top 15 subsidiaries or affiliates of the five largest corporations, measured by revenue, with their headquarters in Luxembourg. These are ArcelorMittal, Tenaris SA, RTL Group SA, Regus plc and Eurofins Scientific SA.

These companies’ interests range across five main industry groups: materials, energy, consumer discretionary, industrials and healthcare. These subsidiaries operate in at least two of these sectors and in a minimum of seven national markets.

Further approaches

This industrial and geographical variety can be shown when using a quantitative credit-risk assessment model calculating ‘through-the-cycle’ metrics in the form of probabilities of default or credit scores.