



# What's News in Tax

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## COVID-19 Transfer Pricing Implications for Intercompany Loans

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The COVID-19 crisis has had a significant impact on financial markets, as bond yields spiked and primary issuances slowed to a crawl during March of this year. While markets have since recovered somewhat, the impact on the quantum of supportable intercompany debt, as well as loan terms and interest rates, is likely to be with us for some time.

Multinational companies use intercompany loans to fund their group entities and to move available cash to where it is needed. Private equity firms frequently use it to finance purchases of portfolio companies. Moreover, related-party debt can be a key tax-planning tool, a fact not lost on tax authorities around the world. The Organisation for Economic Cooperation and Development (“OECD”) base erosion and profit shifting (“BEPS”) initiative recommends limiting the tax deductibility of interest expense, and many countries have adopted conforming rules. Further, the OECD’s recent guidance on financial transactions opens the door for tax authorities to challenge the characterization of intercompany loans as *bona fide* debt, not just the arm’s length nature of the interest rate.

To avoid possible adjustments to taxable income and associated penalties, a transfer pricing study is typically prepared to support intercompany debt financing. A comprehensive study usually has two components:

- Debt capacity analysis. The debt capacity analysis evaluates the amount that a related party borrower could have borrowed from an unrelated lender on the basis of its own financial strength.

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This is also one factor looked at by tax authorities and courts in determining if the intercompany debt should be respected as debt.<sup>1</sup> Also important is the ability of the related party borrower to pay interest on a timely basis and to repay the principal at maturity.<sup>2</sup>

- Benchmarking of the arm's length interest rate. Benchmarking involves the selection of comparable debt transactions, with appropriate adjustments for key terms, to set the interest rate on the intercompany loan.

Debt market instability has significant implications for both of these components when evaluating new intercompany loans. In addition, pre-existing debt may need to be restructured due to liquidity issues arising from the economic situation. Guidance from past financial crises, and current expectations that the global economy faces a long and uncertain path to recovery,<sup>3</sup> suggest that these consequences will not be short-lived.

Furthermore, thin cap regulations in many countries combined with falling corporate profitability will affect tax deductibility of interest expense, further raising the cost of intercompany debt funding.

### Impact on Quantum of Intercompany Debt Financing

Over the decade-long economic expansion following the 2008 financial crisis, investors' appetite for corporate debt increased significantly. Further, the table below demonstrates a general upward trend following the depth of the crisis in the percentage of loans to more leveraged corporates, i.e., those with debt-to-EBITDA multiples greater than six.<sup>4</sup> In 2008, only 10.7 percent of large corporate<sup>5</sup> loans were to borrowers with multiples of six or higher; by 2019, the last year before the COVID-19 crisis, that percentage had risen to 33.3 percent—one-third of all large corporate debt.

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<sup>1</sup> In the United States, the Internal Revenue Service ("IRS") has litigated the debt nature of intercompany financing in a number of cases. Given the lack of specific legislative or administrative guidance, the courts have established their own criteria. The most famous is the Mixon factors (*Estate of Mixon*, 464 F.2d 394 (5th Cir. 1972)), which other court cases have relied upon in whole or in part. Among the roughly dozen Mixon criteria is the question of whether the borrower could have received funding from third-party lenders. In February 2020, the OECD issued its *Transfer Pricing Guidance on Financial Transactions: Inclusive Framework on BEPS: Actions 4, 8-10*, which discusses the need to evaluate factors such as ability of the recipient to obtain a loan from unrelated parties in delineating intercompany financing between debt and equity.

<sup>2</sup> The ability to repay a loan in full is not required, but the ability to reduce significantly the outstanding balance and to refinance the remaining balance should be considered.

<sup>3</sup> See, for example, the KPMG publication, *A Bridge Past COVID-19: The Path for the Economy* (April 2020), which states "more fallout is yet to come in both fixed income and equity markets as the reality of job losses and the health tragedy play out".

<sup>4</sup> Standard & Poor's Leveraged Commentary & Data, *Quarterly Leveraged Lending Review: 4Q 2019*.

<sup>5</sup> Defined as companies with EBITDA of \$50 million or more.

	Large Corporate															
	All Loans															
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	4Q19
<b>&lt;4.00x</b>	41.8%	36.4%	31.2%	63.1%	53.1%	53.7%	43.8%	35.9%	31.5%	28.7%	30.3%	21.9%	22.7%	19.3%	19.3%	22.9%
<b>4.00x-4.99x</b>	25.1%	26.3%	23.7%	14.2%	17.7%	22.6%	26.6%	29.0%	22.6%	24.9%	32.6%	27.6%	24.2%	24.0%	24.0%	24.3%
<b>5.00x-5.99x</b>	25.1%	21.1%	17.5%	12.1%	11.5%	17.9%	19.2%	21.8%	23.1%	21.5%	26.2%	24.4%	27.6%	26.9%	23.4%	24.3%
<b>6.00x-6.99x</b>	6.8%	13.0%	16.0%	5.0%	5.2%	5.4%	10.4%	13.4%	12.3%	19.9%	16.5%	17.6%	18.6%	22.3%	24.0%	20.0%
<b>7.00x or Higher</b>	1.2%	3.3%	11.7%	5.7%	12.5%	0.4%	4.0%	2.4%	4.1%	7.3%	2.2%	3.4%	3.4%	7.3%	9.3%	8.6%
<b>Observations</b>	251	308	401	151	96	257	297	418	632	558	413	442	876	703	367	70

COVID-19 has, however, significantly decreased investors' tolerance for leverage, and has sparked a 'flight to quality.' A survey by Refinitiv LPC<sup>6</sup> points to a decrease in the willingness of banks to make highly leveraged first-lien loans during the first quarter of 2020, and that this trend will likely continue during the second quarter. For example, at the end of 2019, approximately 50 percent of lenders, considering both bank lenders and direct lenders, were willing to make loans with total debt to EBITDA greater than six times; a survey of those lenders by Refinitiv ahead of the second quarter of 2020 showed this proportion decreased to approximately 20 percent. The table below shows similar survey data for bank lenders only.

#### LEVERAGE TOLERANCE – BANK LENDERS ONLY

Tolerance of Total Leverage <sup>7</sup>	4Q19	1Q20	2Q20
Above 4x	100%	100%	85%
Above 5x	70%	50%	35%
Above 6x	20%	20%	15%

Furthermore, Standard & Poor's Leveraged Commentary & Data ("LCD") indicates that recent issuances of debt have been concentrated at the higher rungs of the credit ratings scale, with no sub-investment grade issuances from March 4 to March 30.<sup>8</sup>

The decline in the market's appetite for higher-leveraged debt can be expected to reduce the magnitude of intercompany debt that can be supported during this period because a significant portion of intercompany debt is below investment grade. These conditions will make it particularly challenging for intercompany borrowers whose loans are maturing during this time of market disruption and may need to be refinanced.

<sup>6</sup> Formally a unit of Thomson Reuters, Refinitiv provides information, insights and technology that drive innovation and performance in global financial markets.

<sup>7</sup> Sourced from Refinitiv LPC, showing bank lenders only. Leverage is measured as total debt to EBITDA.

<sup>8</sup> Standard & Poor's Leveraged Commentary & Data, *Yum Brands looks to re-open HY market with \$500M 5NC2 notes for GCP* (Mar. 30, 2020). Sub-investment grade is defined as debt rated below 'BBB-'.

## Intercompany Debt Terms

In times of economic downturns, it is common for borrowers to favor shorter-maturity debt as they become wary of locking themselves into long-term commitments. The economic crisis caused by COVID-19 is no exception; for example, during the three years or so prior to 2020, approximately 78 percent of high-yield issuances had maturities of greater than five years; in March 2020, there were no high-yield issuances with maturities of greater than five years.<sup>9</sup>

This lack of depth in certain sectors of the loan market may constrain the type of intercompany debt that can be issued. It would not be supportable, for example, for 10-year intercompany debt with a credit rating of 'B' to be issued if market data shows that only investment grade debt is being issued for such long maturities. For the time being, shorter-term intercompany lending will be easier to justify, price, and document.

Besides maturity, related party borrowers will have to consider other loan clauses. For example, a significant percentage of intercompany debt allows the borrower to repay the loan early, and often without penalty. In an era of volatile interest rates, however, it may not be a good idea to allow for early repayment without penalty. Tax authorities could call into question the arm's length nature of a fixed interest rate loan if rates fall and the taxpayer does not refinance the loan; or, refinancing could create added administrative burden for the taxpayer. One alternative could be to have the intercompany loan carry a floating interest rate instead of a fixed rate, which reduces the economic incentive for the borrower to refinance when market interest rates decline.<sup>10</sup>

In a similar vein, payment-in-kind features, which allow borrowers to convert scheduled interest payments into additional principal, might become more prevalent in the current environment as a way for borrowers to manage uncertain cash flows. These features would need to be taken into account when benchmarking arm's length interest for intercompany debt.

## Interest Rates on New Intercompany Debt Financing

The current turmoil in financial markets means that loan transactions or yields that are used to benchmark the interest rate on intercompany debt financing may not be available or may reflect (possibly transitory) distressed conditions. The U.S. transfer pricing rules state that "[u]se of data from public exchanges or quotation media may not be appropriate under extraordinary market conditions,"<sup>11</sup> casting doubt on the utility of current market data for benchmarking purposes.

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<sup>9</sup> Sourced from Standard & Poor's Leveraged Commentary & Data, High Yield Pipeline database, accessed April 20, 2020.

<sup>10</sup> There is may still be an incentive to refinance if market risk tolerance increases and spreads for a given level of credit risk decline. For example, a BB-rated loan that was priced at a spread of 400 basis points to LIBOR may trade in the future at a spread of 350 basis points.

<sup>11</sup> See section 1.482-3(b)(5)(ii). Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

For example, Commercial Mortgage-Backed Security (“CMBS”)<sup>12</sup> data is often used to benchmark the interest rates on shareholder debt used to capitalize blocker corporations that invest in U.S. real estate. Given the lack of real estate transactions in recent months, there is limited CMBS data that reflects current market conditions.

Benchmarking arm’s length interest rates on intercompany debt in this environment requires additional care and analysis. If data on individual market loan transactions is sparse or unreliable, one may have to adjust using market indices that at least partially correct for the impact of the current environment. For example, using overall yield curves, by industry and or rating categories, to supplement individual observations, or real estate investment trust (“REIT”) loan market indices to adjust whatever CMBS data that may be found. When benchmarking a real-estate-related shareholder loan, in the absence of recent originations, one could begin with data on originations from the most recent available period (e.g. year-end 2019) and examine the movements in interest rates observed for REIT bonds from the issuance period to the analysis date. The change in the REIT bond interest rates could then be used to adjusted the most recent origination rates.<sup>13</sup>

If market observations are left unadjusted, the current volatility in yields could lead tax authorities to argue that taxpayers cherry-picked the date of issuance of an intercompany loan to maximize the interest rate. Borrowers would be well advised to have sufficient documentation, such as board meeting minutes or internal memorandums, supporting the business purpose of the funding, and/or that the selection of the date for the loan issuance was made in advance.

## Restructuring Existing Intercompany Debt

Many related-party borrowers may have difficulties paying interest or principal on intercompany debt already outstanding. As a result, they may seek options to at least delay scheduled payments (e.g., assuming the loan does not have a payment-in-kind feature). If these options are not available under current terms of a contract, then borrowers could be incentivized to seek a renegotiation of the agreement.<sup>14</sup>

Before changing the interest rate, terms of payment, or otherwise modifying an existing loan, taxpayers need to consider any potential tax consequences. In the United States, tax regulations state that a significant modification of debt, arising for example from a material change in yield or timing of payments, can lead to a gain or loss for tax purposes.<sup>15</sup> These tax regulations apply to both related and

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<sup>12</sup> CMBS are debt securities collateralized by mortgages on commercial properties.

<sup>13</sup> This is a simplified description. In an actual benchmarking, additional considerations would be that the REITs specialize in similar property types, the level of seniority of the shareholder debt compared with the REIT bonds, and whether the individual REIT bonds are subject to company-specific factors such as margin calls.

<sup>14</sup> Tax regulations in many countries limit tax deductibility of interest greater than 30 percent of EBITDA / taxable income which in an era of reduced corporate profitability may provide an added incentive to restructure existing intercompany loan terms.

<sup>15</sup> See section 1.1001-3.

unrelated party debt. It is important to consider whether any change is consistent with the existing terms of the contract or, if not, whether it's significant enough to lead to a tax recognition event.

Taxpayers should also take into account transfer pricing rules when modifying the terms of an existing loan. For example, unrelated lenders generally ask for something in return in exchange for deferring interest payments, such as a higher interest rate going forward or a penalty. Deferral of interest without financial penalty is not likely to mirror arm's length behavior.

## Use of Financial Guarantees

One potential outcome of the COVID-19 crisis may be an increase in the use of related-party financial guarantees. External lenders may increase their demand for, say, explicit parental guarantees due to less confidence in the ability of any single group entity to service a loan. These guarantees can present tricky transfer pricing issues, including a need to distinguish their benefits from any implicit support already present within the multinational group. Also, in light of the recent OECD guidance on financial transactions, if a guarantee increases the debt capacity of a borrower during tough economic times, a loan could be re-characterized for tax purposes as partly a loan to that borrower and partly a loan to the guarantor, significantly complicating the transfer pricing and tax analysis of the transaction. (Depending on the guarantor, there may also be other tax consequences, for example under section 956.)

## Conclusion

The COVID-19 crisis has had significant effects on financial markets, including increased interest rate volatility and reduced debt issuances in broad sectors. As a result, greater care must be taken when implementing or modifying intercompany debt funding to ensure that the financing is respected as debt and the interest expense is deductible for tax purposes.



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