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Is Interest-free Intragroup Financing Acceptable?

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Introduction

As a CEO or CFO of your companies, you often juggle with the resources available with the view of managing them efficiently, especially idle funds. One of the major decisions you need to make from time to time is that of shifting around sums of cash between these companies to meet their respective financial needs. Accounting-wise, inter-company balances would be created in the books of both the lender and the borrower companies. Have you ever wondered about these inter-company balances from the tax lens?

Intragroup financing ("IGF") arrangements are common phenomena in almost every group of companies. Whilst the IGF may have their commercial basis, IGF related tax issues have gradually morphed into a high risk area in the eyes of tax authorities in recent years. With planning, IGF could be deployed as a tool by taxpayers to achieve favorable tax results for them, which unfortunately, become tax leakages for the tax authorities. To counteract base erosion and profit shifting ("BEPS") issues, tax administrators around the world have stepped up their efforts to counter the act of profit shifting using IGF.

At the global level, the Organization for Economic Co-operation and Development ("OECD") formulated various anti-BEPS measures in the BEPS Actions 1 to 15. Specifically relevant to IGF are *Action 4 (Limit base erosion involving interest deductions and other financial payments), Action 3 (Strengthen controlled foreign company rules), Action 2 (Neutralise the effects of hybrid mismatch arrangements), and Actions 8-10 (Aligning transfer pricing outcome with value creation).* Those new developments have made IGF one of the most technically complex areas in the modern tax system.

What is IGF?

In the Malaysian context, IGF transactions are defined as *financial assistance between associated persons that could include loans, interest bearing trade credits, advances or debt and the provision of any security and guarantee* (Chapter IX of the Malaysian Transfer Pricing Guidelines 2012 as revised in July 2017).

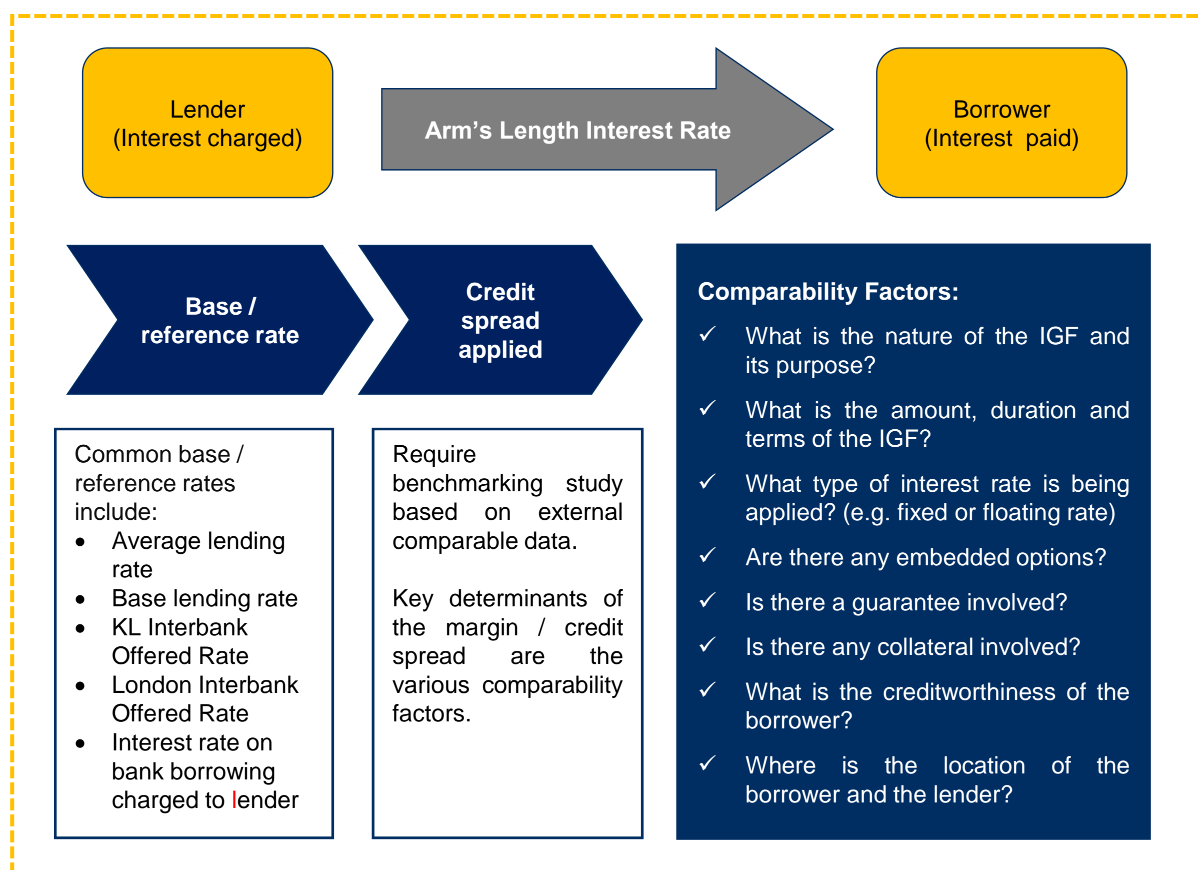
Financial assistance between associated persons involves a taxpayer that acts as a lender within either a multinational group or a domestic group of companies. The lender proceeds to extend financial assistance, using funds sourced internally or externally, to other members of the group for several commercial purposes. In such a transaction, the person receiving the financial assistance or the borrower is responsible for ensuring that all obligations pertaining to the financial assistance (e.g. the schedule of repayment, collateral provided and quality of any guarantee) are met on a timely basis.

It is imperative for taxpayers to be aware that the term "financial assistance" has a rather broad definition from the perspective of the Inland Revenue Board of Malaysia ("IRBM"). For example, a simple trade credit facility between associated persons, or one person acting as a guarantor on behalf of an associated person, payment of expenses made on behalf, etc. could potentially be labeled as "financial assistance" and therefore the requirements under Section 140A must be observed in those cases.

Evaluation criteria – The Arm's Length Principle

The arm's length principle remains the global standard in determining the prices (in this case, interest rates) for any controlled transaction. As IGF transactions fall within the scope of transfer pricing provisions under Section 140A of the Malaysian Income Tax Act 1967, the lender and the borrower are required to observe the arm's length principle. The application of the arm's length principle involves the assessments of the lender and the borrower party, and making reference to the market place for similar financial arrangements. The end result is an arm's length interest rate, which is arguably the interest rate that would have been adopted had the entity been dealing entirely with third parties.

Under the application of the Comparable Uncontrolled Price ("CUP") method, the arm's length interest rate consists of two components, i.e. a reference rate which is used as a base, and a credit spread or "margin" to compensate the lender for the assumption of risk in the provision of financial assistance. The determination of an appropriate spread requires an assessment of various comparability factors. An analysis of these factors would enable the taxpayer to determine the risks involved within the transaction and aim to recover these risks via an appropriate spread. Once the spread is determined, adjustments are then made to the chosen base / reference rate in order to arrive at the arm's length outcome. An illustration of the application of the interest rate and comparability factors is outlined below:



Whilst the above methodology in determining the appropriate arm's length interest rate is one that is prescribed in the Malaysian Transfer Pricing Guidelines and is a common approach adopted around the world, the underlying analysis to arrive at an arm's length interest rate is a complex one, making the determination of an arm's length interest rate a time consuming process and with unguaranteed results.

Evaluation criteria – The Earning Stripping Rules ("ESR")

Section 140A is not the only legislation in place on IGF. In line with Malaysia's commitment to fulfill the BEPS Action 4 and address the issue of excessive interest, the Earning Stripping Rules ("ESR") has been codified through the introduction of Section 140C of the Malaysian Income Tax Act 1967. Despite lacking in details, ESR is effective on 1 January 2019. This provision essentially limits tax deductions on interest expense in the borrower company arising from IGF. Under the ESR, it has been suggested that the interest deduction on IGF be limited to a ratio of between 10% and 30% of the borrowers' earnings. Essentially, ESR is a simplified rule to ensure that an entity's interest deductions are directly linked to its profits generated from its economic activities, and excessive interest over the profitability will be penalised.

Reading both Section 140A and Section 140C together, while Section 140A does not prevent a borrower entity from claiming an interest deduction on IGF to the extent that the arm's length test is met, the ESR under Section 140C creates another hurdle for tax deduction in circumstances the borrower's profits are relatively lower vis-à-vis the interest costs.

Do interest-free loans meet the evaluation criteria?

Now, you ask the question: '*what about interest-free loans and do they meet the criteria?'.* These are logical questions because you do not find benefits of going through the trouble of finding an answer for arm's length interest rates. To the taxpayer, it is a matter of putting the money from the right pocket to the left pocket, and vice versa.

In the past, many taxpayers had resorted to not acting on the IGF and adopted the interest-free approach. This is in part due to the fact that much of the IGF transactions in domestic groups relate to movement of internally generated funds (e.g. funds from profits, owners, directors or shareholders). The tax authorities had been rather considerate on IGF in the past, as they probably focused on other types of controlled transactions. However, this is now history. The tax risk of interest-free IGF escalates day-by-day and the tax authorities are increasing scrutiny on IGF to ensure that IGF is not a tool to gain tax advantages, especially among multinational enterprises attempting to shift profit between jurisdictions. Therefore, interest-free loans rank on top of their wanted list and they will not hesitate to make the tax adjustment where circumstances warrant them to do so. In particular, when the tax adjustment is imposed at one of the parties, it will entail potential penalties and cash flow impact towards that entity, and a potential risk for an audit at the counter party in case the counter party wishes to gain tax deduction from the corresponding tax adjustment.

How to treat Quasi-Equity?

As mentioned above, taxpayers (particularly domestic groups) often utilize internally generated funds in their day-to-day business. This may involve entities within the domestic group seeking to lend money to other entities for various commercial purposes.

Hence, there are arguments by taxpayers that such movement of funds is not a form of financing, but rather potentially equity in nature. This question is somewhat addressed in the OECD's Model Tax Convention. Commentary paragraph 3(b) of Article 9 states that *"not only in determining whether the rate of interest provided for in a loan contract is an arm's length rate, but also whether a prima facie loan can be regarded as a loan or should be regarded as some other kind of payment, in particular a contribution to equity capital."*

From the OECD perspective, prima facie loans within a group of companies have the potential to be considered as equity based contributions to a particular entity. In such a scenario, these movement of funds might be considered as being equity in nature and therefore, may fall outside the scope of being treated as an IGF for Malaysian transfer pricing purposes. Given the complexities surrounding characterizing the movement of funds, proper assessment of each individual transaction is necessary before treating such transactions as being equity in nature.

These complexities are compounded by the fact that the IRBM has not provided clear guidance on the differences between equity and loans from a transfer pricing perspective. In this regard, taxpayers should follow the guidance of the OECD and the comparability factors addressed on the previous page in ensuring that these transactions are appropriately analysed and characterized before adopting an interest-free approach. This is to mitigate the risks that the IRBM may view the movement of funds as being akin to financing and seek to impute an arm's length interest rate in accordance with the prevailing Malaysian Transfer Pricing Guidelines.

How prevalent is this issue regionally?

It is reported in Action Plan 4 released in December 2016 that "*the use of third party and related party interest is perhaps one of the most simple of profit-shifting techniques available in international tax planning"*. BEPS risks on IGF had prompted the speedier implementation of more stringent rules in order to plug tax leakages.

Malaysia has jumped onto the bandwagon. Nearer to us, there have been numerous developments in recent years. In 2017, the Inland Revenue Authority of Singapore introduced an indicative margin that should be applied to an appropriate reference rate for selected cross-border IGF transactions thus indirectly highlighting to taxpayers the need for a spread to be applied. At the same period, Vietnam introduced its version of ESR by limiting the interest deduction at a rate of 20% of a company's earnings. In addition, Cambodia recently introduced new statutory forms that require the disclosure of related party loans.

What should you do as a taxpayer?

With the increased scrutiny by the IRBM on IGF, taxpayers can no longer afford to ignore the tax implications under Sections 140A and 140C of the Income Tax Act 1967. Ignorance of the law is not a defense and taxpayers must start taking proactive measures to ensure that IGF is not interest-free, and the interest rate on the IGF can withstand the arm's length test.

To mitigate such tax risks on IGF including, among others, interest-free loans and quasi-equity, taxpayers may consider the following actions:

- Performing a risk assessment to ascertain the tax positions of both the lender and borrower;
- Run a scenario analysis to determine the overall tax impact on both lender and borrower companies within the same group if the IRBM were to impute an arm's length interest rate;
- Ensuring proper transfer pricing documentation is put in place as a defence of the IGF practice being adopted within the group. This should include a proper analysis of the transaction including characterization of whether the transaction is a form of financing or equity contribution and the appropriate interest rate to be adopted.

Aside from the above, ESR considerations should also be contemplated. Given that ESR is another pitfall, taxpayers should review the need for inter-company loans on a more regular basis, comparing interest expense under the IGF vis-à-vis their earnings to minimize the tax impact thereof.

It is only with diligence and careful planning that taxpayers can avoid unwanted shocks to their business through costly tax adjustments and be better positioned to defend themselves in the event of any scrutiny from tax administrators within and beyond Malaysia.

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Disclaimer: *Aside from those mentioned above, where applicable, references have also been made to applicable legislations, regulations and guidelines thereunder with respect to the tax jurisdictions mentioned in this article.*

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