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# Tax Analysis

## PBOC reforms calculation of loan prime rate

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The People's Bank of China (PBOC) issued guidance (Bulletin [2019] No. 15) on 17 August 2019 that revises the calculation of the loan prime rate (LPR) and requires commercial banks in China to use the LPR as the pricing benchmark for newly-issued fixed and floating rate RMB-denominated loans. These changes, along with the ongoing OECD BEPS project, are expected to impact transfer pricing for intercompany financial transactions by multinational enterprises (MNEs). Bulletin 15 came into effect on 20 August 2019.

### Background

Interest rates on commercial bank loans in China traditionally have been based on a benchmark interest rate published by the PBOC, with the rates falling within a limited range around the published benchmark interest rate. This government-guided approach has been criticized for failing to reflect the true status of the supply and demand of loanable funds in the Chinese financial markets. Consequently, in 2013, the government relaxed the regulations over the interest rates on commercial bank loans and launched the LPR. The LPR was a one-year loan interest rate based on an average of quoted rates offered to prime customers by a select group of leading banks (referred to as "quotation banks").

Bulletin 15 expands the qualifications necessary for a bank to be a "quotation bank," introduces a five-year rate in addition to the one-year rate, and introduces a new mechanism to compute the LPR. Under the new mechanism, a quotation bank must quote an interest rate using the open market operation rate (notably the rate of medium-term lending facility), plus the applicable risk premium. The risk premium depends on the bank's business model, capital costs and market forces, as well as the risk attributed to its high credit rating customers. Compared with the historical PBOC benchmark interest rate, the new LPR is derived from market quotations and thus is considered more reflective of market conditions.

## Limitations in using PBOC benchmark rate for related party loans

For loans between non-financial institutions, the enterprise income tax (EIT) law and its implementing regulations stipulate that the interest expenses of non-financial institutions borrowing from other non-financial institutions are deductible only if the expenses do not "*exceed the amount calculated according to the interest rate of similar loans of financial enterprises in the same period*." The EIT law also requires financial transactions between related parties to be on arm's length terms and requires qualifying parties to prepare appropriate transfer pricing documentation.

In practice, taxpayers and the tax authorities tend to use the PBOC's benchmark interest rate as the basis for evaluating related party financial transactions (often using the PBOC benchmark rate as the arm's length rate). This simplified practice is easy to implement for both taxpayers and the tax authorities, but not without significant limitations from the perspective of a transfer pricing comparability analysis.

Accepting the PBOC benchmark rate as the arm's length rate ignores the credit risk of borrowers (including default probability and default loss). Other transactional factors are not considered, such as foreign currency risk, the duration of the contract and other conditions of the financial transaction. Therefore, related party financial transaction pricing based on the PBOC benchmark rate likely would not withstand scrutiny under a transfer pricing comparability analysis.

The simplified practice also may trigger examination by the tax authorities in jurisdictions where the transaction counterparty is located in a foreign jurisdiction. Following the implementation of the OECD BEPS action plan, tax authorities worldwide have been paying increased attention to the internal financial transactions of MNE groups. For example, the Hong Kong Inland Revenue Department released new transfer pricing regulations in July 2018, which require that interest rates of intragroup loans should align with the arm's length principle. Previously, some MNE groups established platforms in Hong Kong to perform financing activities and then loaned the funds raised to the group's Chinese affiliates with low-interest rate or interest-free loans to lower withholding tax and indirect tax costs associated with interest payments. These arrangements may face more scrutiny and be challenged as not being on arm's length terms if the PBOC benchmark rate is used.

Following Bulletin 15, the LPR may replace the PBOC's benchmark rate to become a major pricing benchmark for financing transactions. As a result, a more market-reflective approach using the LPR (as opposed to using the PBOC benchmark rate) may become commonplace in transfer pricing studies for financing transactions.

## Impact of new LPR on interest rate pricing for related party loans

The impact of the new LPR pricing mechanism may be more than simply introducing a new benchmark rate for related party loans; it also provides an opportunity to improve how comprehensive transfer pricing analyses are performed. For example:

- The competent tax authorities of the lending party may consider the LPR as the interest rate floor.
- The competent tax authorities of the borrowing party may consider the LPR as the benchmark rate, especially for borrowers with good credit ratings and strong businesses.


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- The new LPR mechanism takes into consideration credit ratings of borrowers, sources of funds, relevant capital costs, as well as supply and demand of capital markets. These factors may become more common as part of a comprehensive transfer pricing analysis (previously these factors were overlooked by taxpayers and the tax authorities who simply relied on the PBOC benchmark rate).
- The LPR is updated monthly, in contrast to the PBOC benchmark rate, which can remain static for several years. Accordingly, taxpayers may need to monitor in a similarly continuous manner the arm's length status of the interest rate.

Going forward, taxpayers may want to consider using appropriate market rates, including but not limited to the LPR, as benchmark rates for related party loan transactions. Furthermore, due to evolving global expectations, more comprehensive transfer pricing analyses likely will be necessary to mitigate transfer pricing risk.

## Specific intragroup financial transactions

For intragroup financial transactions with high frequency or large principal amounts, a change in interest rates may cause significant tax adjustments. In such situations, taxpayers should be more diligent when considering trading conditions and risk factors to ensure pricing reflects market interest rates.

In view of the above, the OECD discussion draft on financial transactions, issued as part of BEPS actions 8–10, is relevant. The discussion draft, although without consensus, outlines that further consideration should be given to the contractual terms of the financial transaction, the functions performed by the lender and the borrower in the transaction (taking into account the assets used and the risks assumed by each party), the characteristics of the financial product or service, and the economic environment at the time of contract formation.

Several key factors to consider when analyzing specific types of intercompany financing are the following:

- **Related party loans:**

  - For a lending entity, it is necessary to determine whether it is merely a bridging entity in a "back-to-back" financial transaction, or whether it bears credit, interest or foreign exchange risks based on a contractual and functional analysis. The result of the analysis may impact the rate at which it would on-lend funds (which may, for example, impact loans through Hong Kong funding platforms).

  - From the perspective of a borrowing entity, in order to search for comparable uncontrolled market interest rates, it is necessary comprehensively to consider the borrower's capital cost, credit rating, capital utilization and project risk, actual terms of the transaction, as well as the group's passive involvement and implicit credit support. In general, borrowing parties with a lower credit rating will have to pay a premium in addition to the prime rate. Determining the premiums will require additional work that may not have been performed in the past.

- **Cash pooling arrangements:**

  - Cash pools in the context of transfer pricing usually refer to short-term liquidity arrangements between related parties. Before performing a specific benchmarking analysis for cash pooling transactions, companies should consider first examining the actual liquidity status of each participant in the transaction arrangement. For example, if the funds provided by one party to another party would remain with the receiving party for a longer time period without the balance changing, this type of transaction may be delineated more appropriately as an intercompany loan and should be analyzed as such.

  - As another example, the cash pool header's functional and risk profile should be examined to assess whether it only undertakes the liaison functions or assumes the similar functions and risks of a financial company performing comprehensive fund management.

- After confirming the functions and risks of each participant in the cash pool arrangement, the core issue of interest rate pricing will be how to properly allocate the income and expenses of the arrangement among the participants, which will then determine the arm's length interest rate of each party in the cash pool.

- **Entrustment loans:**
  - Entrustment loans are loans made by a non-financial institution to another, using a bank as a servicing agent.
  - For such arrangements, the legal and economic obligations of the parties should be clarified and an assessment made as to whether the arrangements would constitute related party transactions requiring arm’s length compensation.
  - The relevant contracts for such arrangements should be carefully reviewed. The opportunity cost of the parties, as well as the potential credit loss (i.e. the amount of potential losses multiplied by the probability of default) should be considered, as well as the reasonableness of the transaction from the borrower’s perspective (i.e. whether there are better alternative financing options) so that the required related party compensation can be determined.

## Comments

Compared with purchases and sales of tangible goods and services, and intangible assets transactions, detailed reviews of related party financial transactions will be a relatively new area for the Chinese tax authorities. There is significant room to develop pricing methodologies and administrative supervision. Together with the ongoing development and opening up of China's financial markets, taxpayers should expect to face challenges if using a traditional simplified approach when analyzing the pricing of financial transactions. It is likely that more comprehensive and specific analysis will be required for these transactions in the future.

Considering the key role that contractual and functional analyses will take in the pricing of financial transactions, taxpayers looking to enter into or extend financing arrangements should ensure they prepare appropriate agreements and transfer pricing documentation to stipulate the rights and responsibilities of the parties. This upfront preparation will be beneficial if the tax authorities challenge their transactions.

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