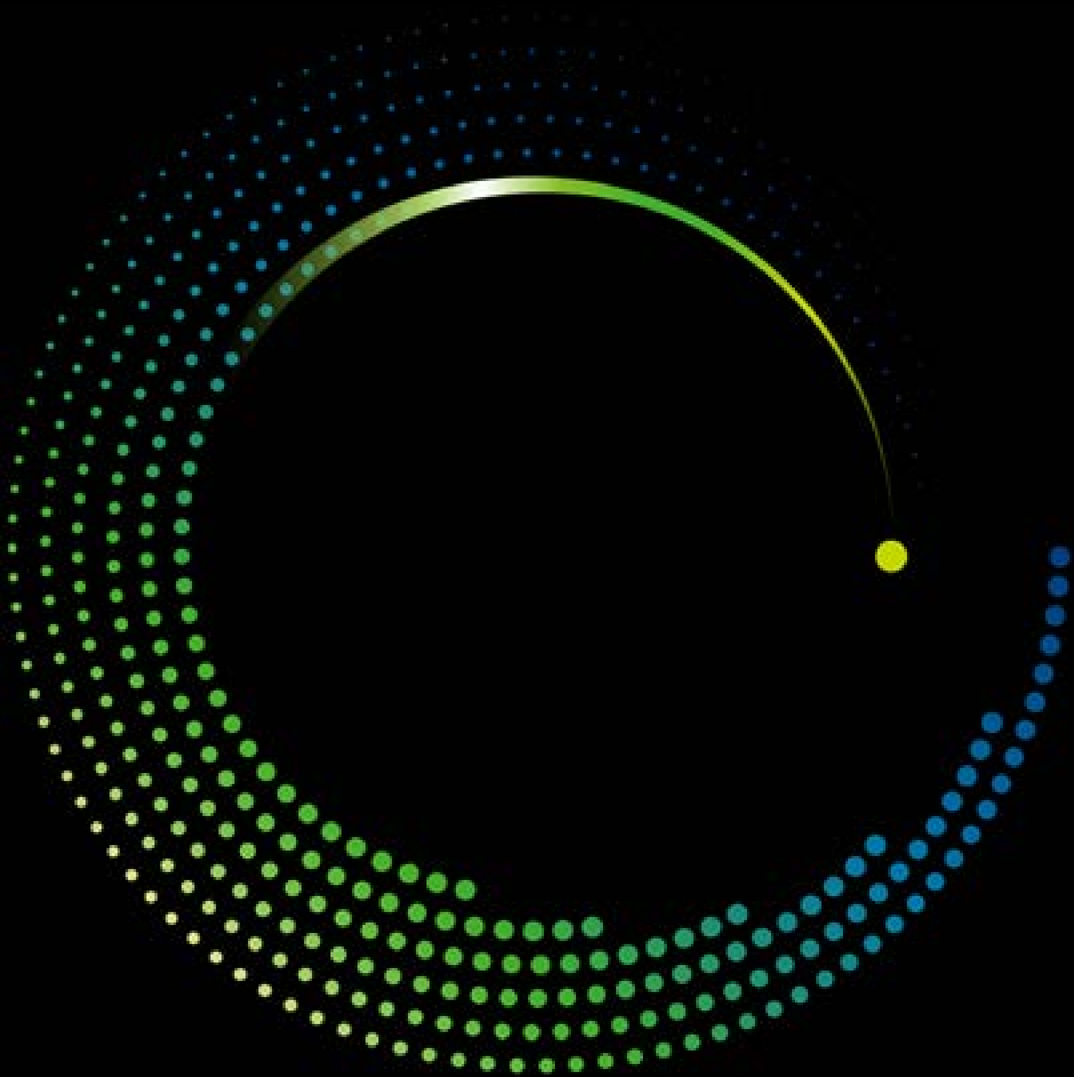

Responding to the challenges ahead

What Tax & Legal departments can do now

Transfer Pricing of Financial Transactions

Qualification of Loan as Debt/Review Loan Arrangements

1. Evaluate ability to serve existing debt commitments with potentially lower EBITDA levels

Companies facing challenges brought by the economic slowdown should examine how potentially lower EBITDA levels may affect the loans with related parties. Lower EBITDA levels typically imply lower amounts of sustainable debt and interest expense. This effect is reinforced by the observed increase in market interest rates.

2. Review ability to serve existing debt commitments at higher market interest rates

In the case that intercompany loans have been set at floating interest rates – e.g., using Euribor as base rate – existing loan arrangements are already affected as the base rate has increased significantly over the course of 2022: All Euribor rates, which have been negative for the last years, have increased significantly above 0% in 2022. While drafting new contracts, companies may consider including automatic adjustment clauses for crisis situations to be able to react quickly and ensure flexibility – i.e., by adopting floating rates.

3. Increased relevance with respect to choice between fixed and floating interest rates

By the base rate, floating interest rates do contain an element that automatically accounts for market interest rate developments over the term of a loan. Hence, the potential disadvantage stemming from a lower predictability of interest expenses over the term of a loan (for the purposes of liquidity planning and/or tax deductibility of interest) for the borrower may be more than offset by the potential that market rates might decrease over the term of the loan in the current environment when using a floating interest rate and resulting interest savings.

4. Monitor implications of financial covenants of bank debt on intercompany loans

As a result of decreasing earnings and increasing interest rates, financial covenants in loans from unrelated banks may come under stress. The violation of such covenants (typically involving leverage [=Debt/EBDITA] and interest coverage [EBITDA/Interest expense]) may have widespread implications on the financing of a whole group, inclu ding existing intercompany loans (e.g., pressure to raise funds in order to meet bank loan covenants or with regard to the potential applicability of the internal CUP method).

5. Proactively manage extension/renewal of expiring intercompany loans

For intercompany loan transactions maturing in the near term and needing refinanceing, this refinancing should be managed proactively, as debt levels which might have been sustainable in a low interest environment (which was in particular experienced for EUR rates) may not be sustainable in an environment with increased (and potentially even further increasing) interest rates. Given the dynamics of market interest rates, it should be made sure that debt capacity analyses for planned loans reflect the most recent developments.

6. May the capitalization of interest payments be (brought) in line with the arm's length principle?

Capitalizing interest payments when they cannot be paid, when this option is not provided for by the underlying loan agreement, may be met with skepticism by tax auditors. Hence, proactively providing a rationale why this may be in line with the arm's length principle in a given case is recommended.

7. Lower target levels of debt going forward

In the light of the above and as a rule of thumb, setting lower target levels of debt is recommended, where possible. Adjusting intercompany financing conditions may be necessary during periods of economic downturn to ensure and manage liquidity. Companies may wish to consider renegotiating loan terms as third parties would (or might be expected to) do.

8. Review of prepayment/early termination clauses in existing loan agreements

Loan agreements should be reviewed specifically with respect to their option/early termination structure. While the prudent business manager at the borrower's level typically is not interested in an early termination of existing loan agreements in times of rising interest rates, prudent business managers at the level of the respective lender do have such an interest. While such early termination clauses for lenders are not very common, respective considerations become relevant in loan agreements concluded for a fixed term with an automatic extension (typically at the same interest rate), unless one of the parties terminates the agreement in writing.

Cash Pools

9. Review interest rates applicable in the cash pool

In most cases, cash pool rates and spreads for deposits and withdrawals have been set at a time when prevailing market interest rates were significantly lower. Hence, a thorough review is recommended.

10. Monitor the impact of non-effectiveness of interest rate floors regarding the appropriate term (and interest rate) for deposits

For deposit rates, the floor at prevailing negative reference rates in combination with the observed (very) low market deposit rates in general has provided some buffer, as a deposit rate of 0.0% (or marginally above) established by the floor could be shown to also reflect longer deposit terms beyond overnight. A thorough review and action (i.e., eliminate/convert long-lasting stable deposits) has become more important.

11. Monitor the profit of the cash pool leader

The spread between deposit and withdrawal rates can be expected to increase. Hence, the profit of the cash pool leader may also increase compared to profits observed in the past at similar balances (and thereby as well, the tax authorities' potential interest in the profit and its potential allocation across cash pool participants).

Loans in Real Estate

12. Debt capacity considerations in particular for real estate through LTV

The amount of permissible debt in the real estate sector is typically based on loan-to-value ('LTV') considerations. Higher interest rates are being used as discount factors for valuations, whereas other variables (expected future rental income) typically are not expected to change as much. Hence, valuations should decrease and may do so significantly implying that LTV percentages for existing fixed loan amounts will increase. This puts emphasis and pressure on the question of whether a particular intercompany loan should qualify as debt or as equity. Bank loans in the real estate sector often have LTV-based financial covenants.

13. Establish a back-up using alternative measures to LTV

Consider – e.g. – loan-to-cost approaches as back-up/corroboration to LTV bench-marks as these inputs (and consequently also the respective outputs) are not so severely affected.

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