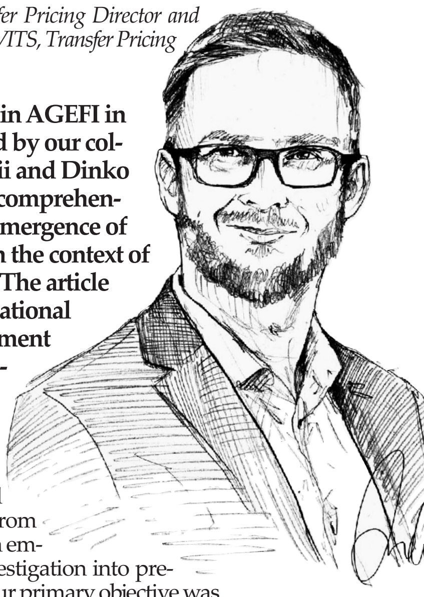
Debt capacity under review across Europe – emergence of a new transfer pricing reality

By Michal STEPIEN, Transfer Pricing Director and Karolina IBRANYI-MATKOVITS, Transfer Pricing Manager, Deloitte



In an article featured in AGEFI in May 2023[1], authored by our colleagues Oleg Tupchii and Dinko Dinev, we conducted a comprehensive exploration of the emergence of debt capacity analysis in the context of related party financing. The article delved into how multinational corporations and investment funds can effectively navigate and address this newfound focus.

In alignment with the presented insights, and prompted by inquiries from numerous clients, our team embarked on a thorough investigation into prevailing market practices. Our primary objective was to examine the specific regional requirements prevalent across Europe. Consequently, we initiated a survey aimed at gaining a deeper understanding of the escalating significance of debt capacity analysis, particularly for borrowers. This heightened importance is set against the backdrop of a business landscape where such analysis coexists with the, at times, mechanistic application of thin capitalization, commonly referred to as “thin cap” rules.

Thin capitalization rules essentially delineate the allowable interest deductions based on predetermined statutory financial ratios. These ratios often involve fixed debt-to-equity ratios or maximum interest coverage ratios, and their implementation holds significant implications for businesses in the European context.

What are the current requirements regarding justification of the arm’s length quantum of debt?

As we mark the three-year milestone since the release of Chapter X of the OECD Transfer Pricing Guidelines in February 2020, a noteworthy trend has emerged. Tax authorities are increasingly seeking debt capacity analysis for loan transactions in addition to the customary debt pricing assessments.

To gain comprehensive insights into debt capacity analysis practices across Europe, we reached out to 36 Deloitte Transfer Pricing member firms specializing in financial transactions. The objective was to gather valuable information on the impact of thin capitalization, or “thin cap” regimes, on arm’s length indebtedness, the prevalent methodologies in use, and any shifts in the stance of tax authorities. Our survey centered on five key questions designed to illuminate these aspects.

Below, we present a succinct summary of the key takeaways from our survey. It is important to note that this summary provides an illustrative snapshot of the current transfer pricing landscape and does not consider the specific facts and circumstances of individual cases.

We conducted a comprehensive examination of the interplay between transfer pricing regulations, specifically the economic analysis of maximum indebtedness, and thin cap rules across various countries. Our findings reveal distinct patterns in how these rules interact within different jurisdictions.

In eight countries (Bulgaria, Greece, Hungary, Italy, Luxembourg, Portugal, Sweden, Switzerland), transfer pricing rules generally take precedence over thin cap rules. Conversely, in six countries (Albania, France, Germany, Macedonia, Serbia, Turkey), thin cap rules hold sway over transfer pricing regulations. This implies that, even under arm’s length conditions where higher interest deductions may be warranted, the strictures of thin cap rules remain paramount.

In an additional 14 countries (Austria, Belgium, Czech Republic, Denmark, Estonia, Ireland, Latvia, Lithuania, Norway, Poland, Slovenia, Spain, Ukraine, United Kingdom), there is no distinct thin cap regime separate from transfer pricing rules. Here, the two concepts are intertwined in a unified framework.

In Croatia, Cyprus, Finland, Kosovo, Moldova, Netherlands, Romania, and Slovakia, the legal practice either restricts the application of either transfer pricing or thin cap rules, or the practice is still evolving. Notably, countries, such as Cyprus and Finland have reported regulatory changes in transfer pricing that commenced in 2022, while Moldova is set to introduce such changes starting in 2024, indicating a shift toward transfer pricing rules gaining precedence.

It becomes evident that in countries where thin cap rules yield mechanically calculated debt-to-equity ratios, there may be limited necessity for economic analysis concerning debt capacity, unless a taxpayer surpasses the thin cap ratio. In such cases, an economic analysis supporting higher indebtedness can potentially be employed to justify increased interest deductions.

Did the practitioners observe an increase in demand for economic analysis for debt cap purposes by the tax authorities?

An indicator of the evolving landscape in tax compliance and transfer pricing is the heightened focus on debt capacity levels by tax authorities. Our analysis shows that 10 countries have already reported an uptick in scrutiny from tax authorities in this regard, while an additional 12 jurisdictions anticipate a surge in interest over the coming years. This trend is supported by the introduction of guidance in Chapter X, leading many taxpayers to reevaluate their positions. This is primarily due to the limited experience of tax authorities in most countries regarding debt capacity analysis. Consequently, taxpayers may encounter uncertainties and challenges when engaging with tax authorities, prompting many to proactively fortify their debt capacity positions to ensure defensibility.

Of particular significance is the shift observed in local audit practices, where tax authorities are increasingly scrutinizing the application of thin capitalization rules during transfer pricing audits. For instance, Polish practitioners have reported a significant demand for economic analyses related to debt capacity, especially in real estate industry. Polish tax authorities’ standard approach is to not only analyze whether the level of interest is at arm’s length, but also whether level of debt can be considered arm’s length, particularly for heavily indebted Special Purpose Vehicles (SPV).

Austria has also witnessed heightened scrutiny, with tax authorities demonstrating a keen interest in potential debt capacity issues and the underlying concepts. Consequently, questions pertaining to debt capacity and requests for documentation have become commonplace in ongoing tax audits. Similarly, in the United Kingdom, the request for economic analyses has become a pivotal component of HMRC’s audit process. Furthermore, respondents from Belgium, Germany, Italy, the Netherlands, Poland, Portugal, and Spain have all reported a noticeable increase in such practices in recent years. These observations underscore the evolving and dynamic nature of transfer pricing and tax compliance in an era where debt capacity analysis has assumed greater prominence.

Which methods can one apply to demonstrate arm’s length quantum of debt?

Across Europe, practitioners use various methodologies for the debt capacity analysis. Notably, tax authorities have generally not provided specific guidance on preferred methods or specified sources of market data. While some jurisdictions may have their preferred databases and tools, practitioners are not bound to adhere to a specific local database.

In light of this absence of standardized guidance, local practitioners have operated under the assumption that as long as the analysis adheres to the arm’s length principle and is robustly supported, the chosen methodology should be deemed acceptable. The two most prevalent methodologies are peer analysis, which involves the assessment of indebtedness levels of comparable entities through financial ratios, such as debt-to-equity ratios or loan covenants, and financial modelling. The latter involves an evaluation of the borrower’s capacity to secure loans in consideration of current and projected cash flows. This method is gaining increasing relevance in the field.

However, it is worth noting that, even in the absence of specific rules under local regulations, taxpayers should carefully consider the prevailing local practice and approach of tax authorities. For instance, some jurisdictions, like Poland and Turkey, may require the use of local comparables. Thus, while a range of methodologies is available to practitioners, understanding and aligning with the specific expectations of local tax authorities remains a critical consideration in debt capacity analysis.

Can one continue to apply a thin-cap or other ratio stemming from a historical practice?

In countries where thin capitalization rules result in the establishment of a mechanically calculated debt-to-equity ratio, effectively constraining interest deductibility, the necessity for conducting economic analysis for debt capacity assessment is relatively minimal. This holds true unless the taxpayer surpasses the prescribed thin capitalization ratio.

Conclusion

In summary, the findings from the survey underscore a discernible trend wherein tax authorities are aligning themselves with the principles outlined in Chapter X. This chapter emphasizes the importance of accurate delineation of transactions that advance funds, including justification of a financing instrument’s debt nature, as well as a borrower’s ability to repay the advance by having sufficient capacity for debt service.

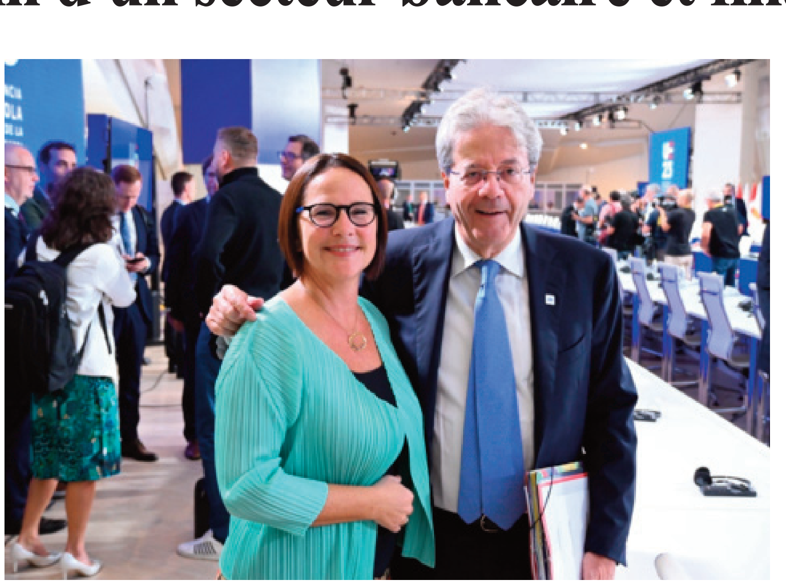
Across various jurisdictions, we have observed a notable uptick in requests for debt capacity analysis, marking this as a prominent emerging trend. It is noteworthy that there is no definitive guidance for Chapter X application, either by OECD or local jurisdictions. Nevertheless, many taxpayers are proactively taking steps to establish sustainable positions well in advance of potential engagement with tax authorities.

1) https://urlzs.com/bqiw4

Yuriko BACKES aux réunions de l'Eurogroupe et de l'ECOFIN informel à Saint-Jacques-de-Compostelle

«L'UE a besoin d'un secteur bancaire et financier robuste et compétitif»

La ministre des Finances, Yuriko Backes, s'est rendue à Saint-Jacques-de-Compostelle, les 15 et 16 septembre 2023, pour participer aux réunions de l'Eurogroupe et du Conseil des Affaires économiques et financières (ECOFIN) informel, organisées sous la présidence espagnole du Conseil de l'UE. Les prévisions économiques d'été de la Commission européenne étaient au centre de l'agenda de l'Eurogroupe. Dans ce contexte, les ministres ont échangé sur les récents développements économiques et monétaires ainsi que de leur impact sur les finances publiques.



Yuriko BACKES, ministre des Finances, et Paolo GENTILONI, commissaire européen chargé de l'Economie © MinFin

La ministre Backes a partagé ses observations : «Les évolutions hétérogènes au sein de la zone euro — qui, tout en montrant des signes de ralentissement, reste résiliente — illustrent la nécessité de suivre de près les développements dans les économies respectives et l'importance de nos efforts de coordination au sein de l'Eurogroupe. Tout en restant optimistes, nous devons adopter une approche réaliste et prudente, prenant en compte les risques à moyen et long terme, y compris les défis climatiques évoqués pendant nos discussions. Dans ce contexte, nous devons notamment continuer à relever les défis posés par les prix de l'énergie et le rôle qu'ils jouent à la fois pour les finances publiques, la compétitivité et la transition verte.»

Lors de l'ECOFIN, la première session de travail intitulée «Interaction de la Politique Budgétaire et Monétaire» a exploré comment concilier les objectifs politiques à court terme tels que la maîtrise de l'inflation, la croissance soutenue et la performance robuste du marché du travail, avec la définition d'un mix politique monétaire pour atteindre des priorités politiques communes.

Les ministres ont procédé par ailleurs à un échange de vues sur les discussions en cours au sujet des propositions législatives visant à réformer le Cadre européen de gouvernance économique (EGR) et se sont concertés sur la succession de Werner Hoyer à la présidence de la Banque Européenne d'Investissement.

Une seconde session de travail, sous le thème «Autonomie Stratégique, Sécurité Économique et Biens Publics de l'UE», a offert aux ministres l'occasion d'échanger sur la perspective future du projet européen face à un paysage international en constante évolution, marqué par l'émergence de nouveaux acteurs dans les domaines économique, commercial et financier, des bouleversements majeurs dans l'équilibre géopolitique et une série de chocs significatifs accompagnés d'innovations technologiques.

Yuriko Backes a commenté : «Dans un contexte géopolitique marqué par une fragmentation accrue, l'UE ne doit pas négliger sa résilience. Mais le protectionnisme ou une politique agressive de relocalisation ne constituent pas des solutions. L'UE doit continuer à s'engager en faveur du multilatéralisme et de l'ouverture des marchés et développer ses relations avec des partenaires de confiance. En même temps, l'UE a besoin d'un secteur bancaire et financier robuste et compétitif pour mobiliser les investissements nécessaires dans l'innovation, les technologies et la transition verte et numérique. Une approche plus intelligente à la réglementation, avec une attention systématique à la limitation des charges administratives, serait essentielle pour assurer une utilisation efficace des ressources disponibles et débloquer la croissance.»

Enfin, une réunion conjointe avec les ministres et les institutions financières internationales de la zone Amérique latine et Caraïbes a eu lieu pour la première fois, organisée en collaboration avec la CAF-Banque de développement de l'Amérique latine et des Caraïbes.

Ces réunions se sont tenues sous le thème : «Vers une économie verte et numérique mondiale.»

Source : ministère des Finances