

# Debt capacity analysis across Europe: emergence of a new TP reality

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I nbourg summarise crucial research on how debt cap

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## **managed across Europe, and outline how taxpayers are building sustainable positions.**

Three years since the publication of Chapter X of the OECD transfer pricing guidelines in February 2020 (“transfer pricing aspects of financial transactions”), we observe a growing trend among tax authorities, requesting a debt capacity analysis for loan transactions in addition to the standard debt pricing exercises.

Consequently, we examined current market practice, and local requirements in particular, for the way debt capacity is conducted across Europe. To this end, we surveyed the transfer pricing practices of 36 Deloitte member firms specialising in financial transactions in Europe to gather their insights, perspectives, and practices regarding debt capacity analysis.

The survey was submitted to Deloitte member firms in:

- Albania;
- Austria;
- Belgium;
- Bulgaria;
- Croatia;
- Cyprus;
- The Czech Republic;
- Denmark;
- Estonia;
- Finland;
- France;
- Germany;
- Greece;
- Hungary;
- Ireland;
- Italy;
- Kosovo;
- Latvia;
- Lithuania;
- Luxembourg;
- Macedonia;
- Moldova;
- The Netherlands;
- Norway;
- Poland;
- Portugal;
- Romania;
- Slovakia;
- Slovenia;
- Spain;
- Sweden;

- Switzerland;
- Turkey;
- Ukraine; and
- The UK

The survey focused on five questions related to the impact of thin capitalisation (“thin cap”) regimes on arm’s length indebtedness, common methodologies applied, and changes in tax authorities’ attitudes. Thin cap rules define the amount of allowed interest deduction based on predetermined (statutory) financial ratios, such as ratios of fixed debt-to-equity or maximum interest coverage. The key takeaways regarding the interaction between transfer pricing rules (economic analysis of maximum indebtedness) and thin cap rules are as follows:

- In eight countries (Bulgaria, Greece, Hungary, Italy, Luxembourg, Portugal, Sweden, and Switzerland), transfer pricing rules generally take precedence over thin cap rules;
- In six countries (Albania, France, Germany, Macedonia, Serbia, and Turkey), the thin cap regime overrules the transfer pricing regime. This means that, even though potentially more interest could be deducted under arm’s length conditions, the thin cap rules prevail;
- In 14 other countries (Austria, Belgium, the Czech Republic, Denmark, Estonia, Ireland, Latvia, Lithuania, Norway, Poland, Slovenia, Spain, Ukraine, and the UK), there is no distinct thin cap regime separate from transfer pricing rules;
- In Croatia, Cyprus, Finland, Kosovo, Moldova, Netherlands, Romania, and Slovakia, the legal practice either limits the application of transfer pricing or thin cap rules, or the practice is still evolving; and
- Cyprus and Finland reported changes in transfer pricing regulations as from 2022, and Moldova plans similar changes in 2024, indicating a move toward transfer pricing rules prevailing in these jurisdictions.

Therefore, in countries where the thin cap rules result in a mechanically calculated debt-to-equity ratio, limited economic analysis is needed for debt capacity purposes, unless the taxpayer exceeds the thin cap ratio and an economic analysis supporting a higher indebtedness can be used to justify a higher interest deduction.

## Is there an increased demand for debt capacity analysis?

Tax authorities have increased scrutiny in 10 countries, with more jurisdictions expecting a similar focus in the coming years. Notably, respondents reported changes in their local audit practices, with tax authorities verifying the application of either the thin cap rules or debt capacity analysis during transfer pricing audits. For example, Polish practitioners have seen a significant demand for economic analysis regarding debt capacity during transfer pricing audits, especially in real estate. The Polish tax authorities’ standard approach is to not only analyse whether the level of interest is at arm’s length, but also whether the level of debt can be considered to be at arm’s length, particularly for heavily indebted special purpose vehicles.

In addition to and following Chapter X’s guidance, many taxpayers are reconsidering their practices. Given tax authorities’ limited resources on this matter in most countries, it

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increased audit scrutiny, taxpayers may face uncertain and difficult interactions. Therefore, many are taking measures to ensure defensible debt capacity positions well before being approached by the tax authorities.

# Which methods can be applied to demonstrate an arm’s length quantum of debt?

Various methodologies are applied across Europe. In general, tax authorities have not provided any guidance on methods, nor indicated preferences for any method or sources of market data. In jurisdictions where the tax authorities are familiar with certain databases and have access to tools, practitioners are not restricted to following the same local choice of database. Local practitioners make the assumption that, as long as the analysis applying the arm's length principle is sound and well supported, the method should be acceptable. The most widespread methodology is peer analysis observing the level of indebtedness of comparable entities measured through financial ratios, such as debt-to-equity or loan covenants. Financial modeling to assess the borrower’s capacity to borrow in light of current and projected cash flows is relevant as well.

Overall, Chapter X emphasises the importance of accurate delineation of transactions that advance funds, including justification for the classification of a financial instrument as debt, as well as a borrower’s ability to repay the advance by having sufficient capacity for debt service.

Across jurisdictions, we observe increased requests for debt capacity analysis. There is no clear guidance for Chapter X application, either from the OECD or local jurisdictions. However, many taxpayers are taking measures to build sustainable positions, before the tax authorities approach them.

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Ibranyi joined Deloitte Luxembourg in 2018 from the London practice and provides transfer pricing (TP) advisory services for MNEs mainly based in the EU.

She focuses on TP planning, documentation, and policy implementation projects, predominantly in relation to the fund industry, private equity, and real estate, as well as consumer services. Karolina's main areas of expertise are global TP documentation; intra-group financing, including cash pooling and guarantees; and intra-group service arrangements.

She has additional experience in relation to the analysis and application of the revised OECD TP requirements, including the preparation of documentation in line with the new master file and local file guidelines, and reviewing and managing country-by-country reporting requirements globally. Karolina has extensive experience in project management, based on managing global teams on wider projects in a project management office role.



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