Transfer pricing update for intragroup loans in aircraft leasing sector

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The release of new OECD guidance, changing local country practices and heightened tax audit controversies make transfer pricing an area of potential concern for aviation finance and leasing companies, suggests Deloitte's John Perry. He concludes that in light of the recent OECD discussion draft on transfer pricing of financial transactions and its potential impact on intragroup loans, aviation finance and leasing companies should taking a fresh look at their group structures and undertake functional analysis to identify where the current substantive economic functions relevant to financing are being performed, by which legal entities, and in what capacity.

The OECD issued a public discussion draft in September 2018 dealing with financial transactions. It is the first specific guidance provided by the OECD on the transfer pricing aspects of financial transactions including treasury activities, captive insurance, hedging, cash-pooling, guarantees and intragroup lending. It is also one of the few OECD discussion drafts that specifically references the 'aircraft leasing sector'. Although this is a non-consensus draft, the principles contained therein provide insight on how the transfer pricing aspects of financial transactions will be dealt with within the framework of the 2017 OECD Transfer Pricing Guidelines going forward.

John Perry

Intragroup financial transactions is one of the more technical and complex transfer pricing areas for aviation finance and leasing companies. The need to have a robust transfer pricing framework is becoming evident as tax authorities pay attention to the deductibility of interest paid by one aircraft owning entity to another group entity. In determining the arm's length interest rate on intragroup loans, according to the OECD, a number of factors should be considered including:

• The lender's and borrower's perspective;
• The borrower's credit rating;
• The effects of group membership (and associated implicit support);
• Guarantees; and
• Loan fees and charges associated with the transaction.

The most relevant factors for aviation lessors and their transfer pricing policies include considering the group lender's and borrower's perspective, the borrower's credit rating and the effect of associated implicit support from other group members.

In considering the lender's perspective, and in particular the decision of whether to advance a loan, an evaluation of various factors are relevant. These include wider economic factors affecting the borrower and lender and other options realistically available to the lender to use the funds. From the borrower's perspective, the discussion draft states that borrowers seek to optimise their weighted average cost of capital and to have the right funding available to meet short-term and long-term objectives. When considering options realistically available to it, a borrower seeking funding will seek the most cost-effective solution with regard to the business strategy it has adopted.

In line with OECD guidance, where the terms of a transaction between the lender and borrower is such that independent parties dealing at arm's length would not have entered into such an arrangement, the agreement could be disregarded and replaced by an alternative transaction for transfer pricing purposes. In other words, a key question is whether the loan entered into possesses the commercial rationality of arrangements that would be agreed between unrelated parties under comparable circumstances, bearing in mind both the lender's and borrower's perspectives.
The discussion draft further reinforces the key principles under BEPS Actions 8 to 10 that the legal lender and recipient of the interest is not necessarily the entity that is entitled to tax the full interest income. Where the lender (i.e. the legal entity that has advanced the loan) lacks the capability to perform the real risk controlling decision making functions, or if it has that capability but does not actually perform the decision making functions to control the risk associated with the loan, such company (effectively a 'cash box') is entitled to no more than a risk-free rate of return.
In addition, the lender must have the financial capacity to bear the risks associated with the borrower's potential to default on the loan before it is entitled to tax the full interest income. The financial capacity to assume risk can be defined as access to funding to take on the risk or to lay off the risk, to pay for the risk mitigation functions and to bear the consequences of the risk if the risk materialises.

Where a lender lacks the capability to control the risk associated with advancing a loan, or does not have the financial capacity to assume the risk, it will be entitled to no more than a risk free rate of return. The borrower should still be entitled to an interest deduction up to an arm's length amount in respect of the funding but the difference of those amounts would be allocable to the party exercising control over the investment risk. The entity that actually has the capability to control the risk and is actually exercising the risk control functions relating to the loan should be subject to tax on the interest income (even if such interest income is legally paid to another legal entity).

A further key point to be cognisant of is that lessors should consider the issue of implicit support in their transfer pricing documentation. Specific guidance is provided on the consideration of and conducting credit rating analyses of the borrower and performing comparability adjustments to account for influences of controlled transactions and the potential impact of passive association.

In line with, for example, the Standard's & Poor's approach, in cases where the borrower would be likely to receive support from other group members, the borrower's credit rating would likely be closer to the group credit rating. The impact of passive association, which a tax authority could use to adjust the credit rating of a borrowing subsidiary upwards toward that of the parent, has the potential to significantly influence the taxation outcomes in both jurisdictions of the parties of the transaction.

For example, the credit spread between what a borrower with a strong credit quality (eg. A) would pay and what a low/medium rated borrower (eg. BB-) would pay might be in excess of 500 basis points, depending on the term of the loan and its currency. In pricing intercompany loans, therefore, lessors that are part of a larger group with a strong credit rating should always take implicit support into account and should not rely purely on the standalone credit quality of the borrower aircraft owning entity (which is often highly leveraged and likely will have a poor credit rating on a standalone basis).

The public consultation on transfer pricing in Ireland as discussed in the Irish Tax Roadmap will commence in early 2019. This will provide an opportunity for stakeholders to provide input before next year's Finance Bill and also provide a sense of what changes are likely to happen. It is likely that most of the proposed changes in the Coffey Report will be implemented including extending Ireland's transfer pricing regime to non-trading and capital transactions and the potential application of transfer pricing legislation to pre 1 July 2010 grandfathered arrangements and bringing them within the scope of transfer pricing law.

In light of transfer pricing developments in the area of financial transactions, aviation finance and leasing groups should consider taking a fresh look at their entire group structures (and in particular their global cash deployment legal infrastructures) and complete a functional analysis to identify where the current substantive economic functions relevant to financing are being performed (as well as where the assets and risks are), by which legal entities, and in what capacity.

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