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### INSIGHT: Debt Characterization and Application of OECD Accurate Delineation Analysis



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On Feb. 11, 2020, the Organization for Economic Cooperation and Development (OECD) released its highly anticipated transfer pricing guidance on financial transactions (OECD (2020), *Transfer Pricing Guidance on Financial Transactions: Inclusive Framework on BEPS Actions 4, 8-10*, OECD, Paris). Sections A to E of that report have been added to the OECD Transfer Pricing Guidelines as Chapter X.

This is the first time the OECD Transfer Pricing Guidelines include guidance on the transfer pricing aspects of financial transactions.

The matter was the subject of public consultation back in July 2018 when the OECD released a “non-consensus” discussion draft on financial transactions as mandated by the OECD/G20 reports on Action 4 (*Limiting Base Erosion Involving Interest Deductions And Other Financial Payments*) and Actions 8-10 (*Aligning Transfer Pricing Outcomes with Value Creation*) of the 2015 BEPS Action Plan published in October 2015.

Subsection B.1 of the OECD report provides guidance on the application of Article 9 of the 2017 OECD Model Tax Convention (which relates to the taxation of the profits of associated enterprises) to determine the balance of debt and equity funding of an entity within a multinational enterprise (MNE) group and in particular, how the accurate delineation analysis under Chapter I of the *OECD Transfer Pricing Guidelines* applies in determining the amount of debt to be priced for tax purposes.

This guidance is consistent with the Commentary on Article 9 which notes at paragraph 3(b) that Article 9 is

relevant “not only in determining whether the rate of interest provided for in a loan contract is an arm’s length rate, but also whether a prima facie loan can be regarded as a loan or should be regarded as some other kind of payment, in particular a contribution to equity capital.”

In accurately delineating an advance of funds, Section B1 (paragraph 10.12) of the OECD report outlines the following characteristics that may be useful indicators, depending on the facts and circumstances: “the presence or absence of a fixed repayment date; the obligation to pay interest; the right to enforce payment of principal and interest; the status of the funder in comparison to regular corporate creditors; the existence of financial covenants and security; the source of interest payments; the ability of the recipient of the funds to obtain loans from unrelated lending institutions; the extent to which the advance is used to acquire capital assets; and the failure of the purported debtor to repay on the due date or to seek a postponement.”

Notably, the guidance indicates that countries are not prevented from implementing other approaches to address the issue of capital structure and interest deductibility under domestic legislation. These alternative approaches include a “multi-factor analysis of the characteristics of the instrument.” Room is also clearly left for countries to adopt formulaic approaches to limit interest deductions, such as rules that reflect implementation of Action 4 of the BEPS project (including, for example ratio-based thin capitalization rules).

This might seem at odds with the stated mantra of the OECD’s BEPS project to “give businesses greater certainty by reducing disputes over the application of international tax rules and standardising compliance requirements” (<https://www.oecd.org/tax/beps/about/>); however, this should not be surprising. Achieving con-

sensus among 36 member countries with different perspectives and competing motivations is difficult. Allowing flexibility in implementation mitigates this problem.

In this article we explore perspectives from select countries on their approach to debt-equity characterization and their alignment to Chapter X of the OECD Guidelines, including interaction of the local transfer pricing rules with other parts of local income tax law dealing with debt such as case law, thin capitalization rules, and debt-equity rules where relevant.

The relationship among these sets of rules can be complex and raises a number of questions about the hierarchy of the relevant competing provisions, such as:

- Do debt-equity rules prevail (in which case the price of a debt transaction might be affected, but not its characterization); or

- Do thin capitalization rules prevail (in which case the price of a debt transaction might be affected, but not its amount); or

- Do transfer pricing rules prevail (in which case the characterization, amount and price of a debt transaction might be affected)?

Notably, as the OECD report only covers transactions between associated enterprises in the context of Article 9, it does not address debt attribution issues that arise in the treatment of branches and permanent establishments (PEs) under Article 7, which is the subject of the Report on the Attribution of Profits to Permanent Establishments that was adopted by the OECD Council in July 2010. Accordingly, special considerations applicable to the recognition and attribution of interest-bearing debt in a PE context is beyond the scope of this article.

## SELECT JURISDICTIONS' APPROACH TO DEBT-EQUITY CHARACTERIZATION

### U.S.

In the U.S., the transfer pricing rules presented in tax code Section and its associated Treasury Regulations do not address debt characterization, but rather start with a presumption that a purported debt instrument has already been appropriately characterized for federal income tax purposes. Specifically, Treasury Regulation 1.482-2(a)(1)(ii)(A) states “. . . *this section applies only to determine the appropriateness of the rate of interest charged on the principal amount of a bona fide indebtedness between members of a group of controlled entities. . .*”

[Section 385](#), enacted by Congress in 1969, grants the U.S. Treasury authority to issue regulations that could be used to determine whether an “interest” in a corporation is to be treated as equity or debt (or as part equity and part debt) for federal income tax purposes. However, these regulations were not promulgated and finalized for over 45 years, and in the meantime debt characterization was instead based on factors embodied in U.S. common law.

This changed in 2016 when U.S. Treasury promulgated a set of regulations under Section 385. At the time the regulations under Section 385 were finalized, it was noted that as it stood, it “*effectively implements the common law factors,*” meaning the regulations were

generally consistent with the prevailing common law framework for evaluating debt characterization. Following the passage of the Tax Cuts and Jobs Act (TCJA) in 2017, these regulations were scaled back and the documentation requirements under Section 385 (Treasury Regulation 385-2) were repealed. According to the U.S. Federal Register published in November 2019, “. . . *the benefits of the Documentation Regulations in reducing foreign acquisitions of U.S. assets and interest stripping were reduced by the TCJA.*”

One clear example is that as part of TCJA, interest deductibility limitations in the U.S. under [Section 163\(j\)](#) were significantly modified. Specifically, for tax years beginning after 2017, the Section 163(j) limitation applies to all taxpayers who have business interest expenses, other than certain exempt small businesses and excepted trades or businesses. When Section 163(j) applies, the amount of deductible business interest expense in a taxable year cannot exceed the sum of the taxpayer’s annual business interest income, adjusted taxable income times 30%, and floor plan financing interest expense (which may exist in limited situations). In practice, this effectively caps net interest income as a proportion of adjusted EBITDA (through 2021) or EBIT (for 2022 on).

That said, Treasury Regulation 385-1(b), the general rule that effectively implements common law factors, still stands. As such, U.S. common law persists as a source of guidance for debt characterization issues in the U.S. Therefore, U.S. taxpayers should continue to consider the precedents set by U.S. court cases to support the intercompany debt characterization of an instrument issued by a U.S. entity. High profile cases in the last decade (e.g., Scottish Power, PepsiCo, HP, and Dow Chemical) demonstrate U.S. tax authorities’ continued willingness to apply these precedents in an intercompany financing context.

Many practitioners reference the lists of “factors” indicating debt or equity characterization that were established successively in cases such as [O. H. Kruse Grain & Milling v. Commissioner](#) and [Tyler v. Tomlinson](#). The table below presents the 13 factors employed in Tyler vs. Tomlinson, 1969 (and several other U.S. court cases):

- The names given to the certificates evidencing the indebtedness
- The presence or absence of a maturity date\*
- The source of payments\*
- The right to enforce payment of principal and interest\*
- Participation in management
- A status equal to or inferior to that of regular corporate creditors\*
- The intent of the parties
- “Thin” or adequate capitalization
- Identity of interest between creditor and stockholder
- The payment of interest only out of dividend money
- The ability of the corporation to obtain loans from outside lending institutions\*
- The extent to which the initial advances were used to acquire capital assets\*
- The failure of the debtor to pay on the due date or to seek a postponement\*

These factors generally align with some of the “economically relevant characteristics” for accurately delin-

eating an advance of funds in Chapter X. Specifically, the items asterisked in the above list are also included in the OECD guidance, near-verbatim.

U.S. common law is also generally aligned with the OECD guidance on downplaying such criteria as being no more than a means to address the question of whether the purported debt seems to have features one would expect for debt. The OECD guidance describes the aforementioned factors as economically relevant characteristics that “*may be useful indicators, depending on the facts and circumstances*” and later endorses a perspective of whether a given transaction, if classified as debt, would be attractive to an independent lender weighing all realistic alternatives. This bears some resemblance to a reasoning made by the U.S. Court of Appeals for the Third Circuit in *Fin Hay Realty Co. v. United States*, that the purported loan under review should be treated as equity because a “prudent outside businessman” would not have made the investment for a fixed interest return, given the facts and circumstances at the time.

These similarities indicate that there should be a reasonable level of alignment between U.S. common law and the accurate delineation analysis outlined in Chapter X, at least when taking a lender’s perspective. However, there are some key areas where the standards applied in U.S. common law may diverge from the OECD approach.

For example, while precedent set by U.S. common law primarily focuses on an application of factors to assess whether a counterparty would agree to the transaction if it were debt as opposed to equity (i.e., with upside returns to a lender/investor capped), the OECD guidance goes further by discussing at length the perspective of the borrower. Some of the most important criteria commonly cited could apply to both a lender’s and borrower’s perspective; for example, a borrower, like a lender, would perform an analysis of whether taking out a certain amount of debt would leave them overly capitalized and unable to pay interest.

However, the OECD guidance takes this further and includes “. . . broader considerations than the entity’s ability to service its debt, for example, the funds it actually needs to meet its operational requirements,” and adds that “. . . in some instances, although a company may have the capacity to borrow and service an additional amount of debt, it may choose not to do so to avoid placing negative pressure on their credit rating and increasing its cost of capital, and jeopardising its access to capital markets and its market reputation.”

## Canada

For Canadian taxpayers, income tax deductions for interest paid to related non-residents depend on several areas of tax law, including:

- Characterization rules under common law, as to whether an amount is interest;
- Deductibility rules under Paragraph 20(1)(c) of the *Income Tax Act* (the Act), as to whether that interest is deductible;
- Thin capitalization rules under Subsection 18(4) of the Act, as to whether the amount of underlying debt is excessive as compared to the taxpayer’s equity; and
- Transfer pricing rules under Section 247 of the Act, as to whether the interest rate or other “terms and

conditions” of the loan differ from what would have been used between arm’s-length parties, or (more rarely) whether the transaction itself can be recharacterized.

The Canada Revenue Agency’s (CRA) administrative policy has been to apply the transfer pricing rules in a manner consistent with the OECD Guidelines, and this is expected to continue with the OECD’s new financial transactions pricing guidance. Similarly, while the OECD Guidelines are not formally part of Canadian tax law, Canadian courts have shown willingness to consider them when evaluating whether transfer prices were arm’s-length.

By contrast, there has been less consistency between the OECD Guidelines and Canadian tax law on issues of debt characterization, recharacterization, deductibility, and thin capitalization.

In 2019, new legislation was proposed that would stipulate, in cases where both the transfer pricing rules and other tax provisions could apply, that the transfer pricing rules be applied first. For example, if an interest rate was higher than arm’s-length and the amount of debt was also excessive, then the transfer pricing rules would first apply to reduce the interest rate on all of the debt, then the thin capitalization rules would apply to disallow a portion of the (already reduced) interest that pertains to the excessive portion of the underlying debt.

One key implication of applying the transfer pricing rules first is that a greater portion of an income adjustment by the CRA becomes subject to potential transfer pricing penalties, which would not apply to the extent the income adjustment was made pursuant to other provisions of the Act. Exemption from these transfer pricing penalties is possible if a taxpayer meets the “reasonable efforts” standard, which includes a requirement for contemporaneous transfer pricing documentation.

On the issue of characterization, the Act does not define debt but it has been addressed in court decisions such as *Shell Canada Limited v The Queen*, [1999] 3 SCR 622, 99 DTC 5669; *The Queen v Sherway Centre Ltd*, [1998] 2 CTC 343, 98 DTC 6121 (FCA); and *Miller v The Queen*, [1985] 2 CTC 139, 85 DTC 5354 (FCTD).

These characterization and deductibility rules apply to all debt transactions, including domestic loans between arm’s-length parties. If the interest payments are being made to certain non-residents, such as companies owning at least 25% of the shares of the Canadian taxpayer by votes or value, then Canada’s thin capitalization rules also apply.

Canada’s thin capitalization rules work on a fixed-ratio basis. In general terms, a taxpayer’s interest expense deduction becomes limited (proportionally) if its outstanding debt to related non-residents exceeds 1.5 times its equity. These thin capitalization rules do not require the debt amount to be consistent with what an arm’s-length borrower would have been willing or able to borrow, nor do they allow taxpayers to exceed the 1.5:1 ratio in cases where arm’s-length amounts could demonstrably be higher. To the extent a cross-border interest payment is limited under the thin capitalization rules, the disallowed portion is subject to 25% withholding tax as a dividend (with reductions available under applicable tax treaties).

Canada’s transfer pricing rules of Section 247, by contrast, are based on the arm’s-length principle. There are certain limited exceptions where the transfer pric-

ing rules do not apply, such as to loans from Canadian taxpayers to controlled foreign affiliates. However, where the transfer pricing rules do apply to financial transactions they are applied under the same law and standards as for every other type of intercompany transaction. The CRA has not issued any administrative guidance specific to the pricing of financial transactions.

Generally, the transfer pricing rules allow the CRA to either:

- Reprice the existing transaction, if its terms and conditions differed from what would have been agreed between parties acting at arm's-length; or

- Recharacterize the transaction, if it would not have occurred between arm's-length parties *and* was not undertaken primarily for bona fide business purposes other than to avoid tax.

Historically, the vast majority of transfer pricing disputes in Canada have been approached as matters of repricing, not recharacterization. The conditions required to allow recharacterization of a transaction (e.g., from debt to equity) are relatively restrictive, and Canada's recharacterization provisions have been applied relatively rarely.

When evaluating the arm's-length nature of interest rates, guarantee fees and other questions of pricing, the CRA's approach has been generally consistent with the views expressed in the new OECD report. Unless changes are made to existing Canadian legislation, less consistency is expected with the OECD Guidelines when it comes to matters of debt characterization, recharacterization, deductibility and thin capitalization.

## Australia

In Australia, the issue of debt-equity characterization involves interaction between multiple areas of domestic law, including:

- Australia's transfer pricing rules in Subdivisions 815-B and 815-C of the *Income Tax Assessment Act 1997*, (ITAA 1997), which negate an income tax or withholding tax benefit that an entity gets if a financing arrangement, or part thereof, is a debt interest (or an equity interest) under actual conditions, but would give rise to an equity interest (or a debt interest) had arm's-length conditions operated instead;

- The thin capitalization rules in Division 820 of the ITAA 1997, which disallow a deduction for a portion of an entity's debt deductions when either the entity's debt-to-equity ratio exceeds certain limits ("safe-harbor" and "worldwide gearing" tests), or when the entity's debt amount exceeds an arm's-length debt amount; and

- The debt and equity rules in Division 974 of the ITAA 1997, which classify financing arrangements as debt or equity for certain tax purposes.

Section 815-130 of the ITAA 1997 (so called 'reconstruction provisions') provides the Australian Taxation Office (ATO) with wide powers to disregard the actual terms and conditions and reconstruct transactions undertaken by Australian taxpayers where:

- The legal form of the transaction differs from the substance, or

- Independent entities would have entered into a transaction with different terms; or

- Independent parties would not have entered into the transaction at all.

The reconstruction provisions are consistent with the "exceptional circumstances" discussed at paragraphs 1.122-1.125 of the OECD Guidelines in the context of the non-recognition and alternative characterization of certain arrangements or transactions.

The identification of arm's-length conditions under the transfer pricing rules must be done in a way that best achieves consistency with the OECD Guidelines as last amended on May 23, 2016. As is stands, Subdivision 815-B does not include the amendments to the OECD TP Guidelines adding Chapter X that were approved by the OECD Council on Feb. 11, 2020. Accordingly, the updated guidelines currently do not apply in an Australian context; however, it's reasonable to assume that any future amendments to the law which refer the Feb. 11, 2020 edition of the OECD Guidelines will have retroactive application. For the time being, it can be expected that the existing ATO tax rulings and determinations will continue to be the primary source of guidance on matters concerning intercompany debt characterization within Australia.

Principal among these is Taxation Ruling 92/11 – Income tax: application of Division 13 transfer pricing provisions to loan arrangements and credit balances, released back in 1992.

A substantial part of TR 92/11 is devoted to a discussion of the factors to be taken into account in determining whether any agreement that is in legal form a loan may be treated as equivalent to a contribution of equity (quasi-equity). These are:

- The legal effect of the transaction,
- Repayment of principal,
- Purpose of contribution,
- Debt equity ratio,
- Investment regulations affecting the form of investment in a particular country, and
- Ability to obtain finance from an unrelated third party (independent lender test).

Some of the above factors broadly align with the "economically relevant characteristics" for accurately delineating an advance of funds in Chapter X, including the presence or absence of a fixed repayment date, the status of the funder in comparison to regular corporate creditors, the ability of the recipient of the funds to obtain loans from unrelated lending institutions, and the extent to which the advance is used to acquire capital assets.

TR 92/11 clarifies that while the above and other factors are of relevance, "*what is important is the total picture that emerges from the transaction*". The tone of the ruling reflects the fact that in 1992, the leading authority in relation to quasi-equity was the 1979 OECD Guidelines, which expressed strong support for the need to distinguish between a loan and equity on a case-by-case basis.

TR 92/11 relates specifically to the application of the old transfer pricing rules in Division 13 of the *Income Tax Assessment Act 1936* which applies to transactions or arrangements that occurred before June 29, 2013. The ATO is currently working on new guidance on cross-border related party interest-free loans setting out factors for determining whether an interest-free loan between related parties could be either debt or equity. Until then, the guidance in TR 92/11 remains the most relevant for the characterization of international related party funding arrangements.

*Interaction with thin capitalization rules*

Where taxpayers rely on the a safe harbor established under the thin capitalization rules, the transfer pricing rules require the rate on a debt interest to be determined having regard to an arm's-length amount of debt. However, this rate is applied to the entity's actual amount of debt up to the safe harbor amount instead of the (lower) arm's-length debt amount (in the case where there is a difference between the two) in order to determine the interest deductions. In other words, the debt amount is modified so that only the rate may be adjusted. This rule ensures that the transfer pricing rules do not prevent the operation of the thin capitalization rules.

Where a taxpayer that is not an authorized deposit-taking institution relies on the arm's-length debt test (ALDT) under the thin capitalization rules, draft Practical Compliance Guideline (PCG) 2019/D3 provides guidance to taxpayers in the determination of an arm's-length debt amount under the ALDT with effect from July 1, 2019. The PCG sets out a structured series of qualitative and quantitative factors that must be considered from both an independent borrower and independent lender perspective, which echo the "lender's and borrower's perspectives" in the OECD guidance.

The PCG is at pains to stress that while the ALDT "in some respects draws upon arm's length concepts that are common to transfer pricing, the test itself is not a transfer pricing analysis, nor does it necessarily proxy an outcome consistent with the arm's length conditions under Subdivision 815-B" (Paragraph 5). This is because the ALDT focuses only on the Australian business of the entity (i.e. excluding holding of associate entity debt, controlled foreign entity debt or controlled foreign entity equity) and any guarantees, security, or other form of credit support (explicit or implicit) provided by associates are ignored. Nevertheless, the concepts outlined in the PCG provide a useful framework to assess the balance of debt and equity funding.

In considering how the transfer pricing rules in Subdivision 815-B interact with the thin capitalization rules in Division 820, it is first necessary to consider how Subdivision 815-B interacts with the debt and equity rules in Division 974 which are referenced in Division 820 to identify whether financing arrangements constitute debt for thin capitalization purposes.

#### Interaction with debt and equity rules

Unlike the thin capitalization rules, the transfer pricing rules can override Division 974's 'bright line' test, in determining whether an instrument is considered debt or equity for Australian tax purposes.

This was affirmed by the ATO in Taxation Determination TD 2019/10, published on July 3, 2019, which provides guidance on the interaction between the Australian debt and equity rules and the transfer pricing rules. TD 2019/10 states that the transfer pricing rules prevail over the debt-equity rules and that the debt-equity rules apply to classify financing arrangements as either debt or equity by reference to the arm's-length conditions under Australia's transfer pricing rules, not the actual conditions. This is on the basis that Subdivision 815-B explicitly states that the transfer pricing rules prevail over the rest of the income tax legislation (with the exception of the thin capitalization rules as noted above).

## U.K.

Debt is not defined in U.K. statute but case law has held it to be "a sum of money which is now payable, or will become payable in the future, by reason of a present obligation" (*Webb v Stenton* (1883) 11 QBD 518). Whether the future amount to be paid is ascertainable affects whether the sum is legally considered a debt in the U.K.

The loan relationships code, Part 5 of the *Corporation Tax Act 2009* (CTA 2009), governs the treatment of debt. It applies to companies subject to U.K. corporation tax, where the company is in a loan relationship, i.e. stands in position of creditor or debtor with respect to any money debt and the debt arises from a transaction which lends money. Subject to certain exceptions, a money debt is a debt to be settled by the payment of money, by the issue or transfer of shares in a company, or by the transfer of a right to another money debt.

HM Revenue and Customs' Corporate Finance Manual gives examples of money debts which do not arise from lending (thereby falling outside the loan relationships code), including guarantees for loans. In addition to traditional lending relationships, the code also covers, at Part 6 CTA 2009, what it terms "relevant non-lending relationships" and other financial arrangements which, for accounting purposes, are equivalent to debt finance but which do not satisfy the legal definition, such as shares with guaranteed returns.

The U.K. transfer pricing regime, Part 4 of the *Taxation (International and Other Provisions) Act 2010* (TIOPA 2010), which contains both the transfer pricing rules and the thin capitalization rules, operates to ensure that deductions for interest payments only arise where the payments are on an arm's-length basis. HMRC's International Manual (INTM413260) makes clear that, with respect to companies that are thinly capitalized, the U.K. allows tax deductions for the amount of debt that could be obtained on the open market and the balance, the "excessive debt," is treated as though it were provided in some other way, for example, as equity. An agreed debt/equity ratio may form part of an advance thin capitalization agreement (governed by Part 5 TIOPA 2010). Strictly speaking, however, the treatment of debt as equity is not a recharacterization, since the interest remains interest for tax purposes; it is simply disallowed in the calculation of deductions.

In exceptional circumstances, HMRC may consider recharacterizing a transaction, but HMRC states in the International Manual (INTM502020) that the starting point is that, if the funding has been provided in the form of, say, a loan, the form and substance of the provision are assumed to be the same. HMRC states that it is "committed by statute to follow the OECD guidance on transfer pricing, and where necessary to adjust the actual provision to the arm's length provision. It is only if this adjustment cannot be achieved by gradual adjustment that the transaction is recharacterized as something of a different nature. If the actual provision is a loan, recharacterization as equity should not be an immediate response."

As indicated above, the U.K.'s approach to characterization of transactions is informed by the OECD Guidelines: the transfer pricing rules in Part 4 of TIOPA 2010 incorporate a provision stating that they are to be interpreted so as best to secure consistency with the latest

version of the OECD Guidelines, such that the OECD Guidelines are automatically incorporated into U.K. national law, including the concept of “accurate delineation” as an approach to characterizing a transaction. Hence, recharacterization, though a last resort, is permitted.

While Chapter X of the OECD Guidelines acknowledges that accurate delineation is not the only approach by which a country may characterize debt, it is clear from the guidance provided in HMRC’s International Manual that it does follow the OECD approach in applying the arm’s-length principle, referring to a comparability analysis whose first step is accurate delineation (INTM485021/2).

## Latin America

Latin America, unlike the EU, has no cohesive instruments to apply tax regulations uniformly through the different countries. There are common communication channels, such as the Inter-American Center of Tax Administrations (CIAT), and substantial efforts by many Latin American countries to join the international tax arena through OECD initiatives. However, in the end, each jurisdiction will set its own tax rules as they see fit for their economy and their systems.

Court case guidance and regulations are limited in the region. Still, thin capitalization and transfer pricing rules have been in place for many years, and regional tax authorities consider intercompany financial transactions a primary concern. Only a handful of countries are OECD members, and few have implemented BEPS Action 4. Most countries that have implemented Action 4 have done so only partially.

Regional tax authorities will usually apply thin capitalization rules to limit the deductibility of intercompany interest expense. The transfer pricing rules only apply to determine an arm’s-length interest rate and do not override the thin capitalization provisions in determining debt deductions on bona fide debt. Below a brief description is provided of the rules in place in a sample of countries that exemplify the different approaches taken within the same region with respect to debt characterization and interest deductibility.

### Mexico

In Mexico, thin capitalization rules were recently updated to implement BEPS Action 4 recommendations. The deductibility of interest will be limited to 30% of “adjusted tax profits” (a modified version of EBIDTA) starting with the fiscal year 2020. The calculation includes local and foreign third-party and intercompany debt. It also includes several caveats, like applicable minimum thresholds and a 10-year carry forward period for amounts disallowed as a result of the calculation. In addition to the new rule, Mexico retained its old thin capitalization metric on debt to equity ratio of no more than three to one for foreign-related party loans and other targeted measurements.

Transfer pricing rules have been applicable in Mexico since 1997. Although there is no significant mention of financial transactions in the tax code, it is one of the few regulations in the region that expressly adheres to the most recent OECD Guidelines, so long as they are consistent with the tax code and Mexican treaties. The application of Chapter X will provide more tools for the tax authorities to recharacterize the trans-

action under the accurate delineation principle for transfer pricing and thin capitalization purposes.

### Colombia

Colombian thin capitalization rules have been applicable since 2013, which require a debt to equity ratio of no more than three to one. For purposes of the calculation, debt includes only local and foreign related party debt. The regulations also include back-to-back loans, while excluding specific industries like financial services and large infrastructure projects.

Transfer pricing rules were first introduced for the fiscal year 2004, with several amendments since then. The last meaningful changes were issued in association with the 2016 tax reform, which incorporated elements of the BEPS Actions 10 and 13 but did not address Action 4 or other BEPS actions. Although the OECD Guidelines are not mentioned in the Tax Code, it does describe certain economically relevant characteristics for accurately delineating an advance of funds, including the amount of the principal and term of the loan, risk-rating and creditworthiness of the borrower, guarantees, and the interest rate. No further background or explanation of these factors is currently provided in the Tax Code so it’s unclear how it will be interpreted by the Colombian tax authorities or courts.

Although the OECD Guidelines are not part of the tax code or the regulatory decree, Colombia became an official OECD member on May 31, 2018. In the past, local tax authorities and the courts accepted the OECD Guidelines as non-binding technical references. Still, with Colombia’s formal accession to the group, it is expected that local tax authorities will more formally use the guidelines, including the newly issued Chapter X.

### Brazil

Brazil has not modified its existing thin capitalization rules as a consequence of the BEPS Action 4 report. Currently, a debt to equity ratio of 2:1 is used to calculate deductible intercompany interest expense. A more severe debt to equity ratio of 0.3:1 is used to determine the deduction for interest payments to low tax jurisdictions or to businesses with special or preferred tax regimens.

Transfer pricing rules related to interest payments are set as a series of safe harbors establishing ceilings for allowed deductions or floors for the recognition of minimum revenues. The calculations include different base rates depending on the currency of the loan and the term of the rate (fixed or variable) plus a 3.5% spread rate if the local entity is borrowing funds (deductibility ceiling) or a 2.5% spread rate if the local entity is lending funds (revenue floor). Newly expressed interest by Brazil to join the OECD may dramatically change the tax regulatory environment around financial transactions.

## CONCLUSIONS

The differences between the accurate delineation approach outlined in Chapter X of the OECD Guidelines and the select countries’ approach to debt-equity characterization and thin capitalization outlined above only exemplifies the fact that there is still considerable variation on how to deal with debt-equity characterization. As such, taxpayers will need to consider the domestic laws in the country of the borrower as well as the lender and any inconsistencies between them. While it’s still too early to tell how the OECD guidance will be imple-

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mented by tax authorities or interpreted by courts, it is clear that there will be increased scrutiny on the characterization of intra-group funding by tax authorities going forward. The consequence of this is that taxpayers will need to consider the impact of the terms of any cross-border related party financing arrangement not just on the pricing but also the debt-equity classification of the arrangement for transfer pricing purposes.

*This column does not necessarily reflect the opinion of The Bureau of National Affairs, Inc. or its owners.*

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