ARTIFICIAL LOAN RESTRUCTURINGS

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INTRODUCTION

The I.R.S. is currently faced with an increasing number of taxpayers who are prepaying their current intercompany loans and then entering into new loans with higher interest rates. A higher interest deduction is then available to the borrower. The I.R.S. is exploring strategies to tackle this issue.

HIGHER INTEREST DEDUCTIONS

As discussed in our previous article,[1] B.E.P.S. Action 4 stresses the need to address base erosion and profit shifting using deductible payments, such as interest, that can give rise to double non-taxation in both inbound and outbound transactions. The research shows that intragroup loans are commonly used by multinational groups to erode the taxable base in high-tax countries.

U.S. companies receive a deduction for interest payments, which reduces U.S. taxable income. If U.S. borrowers restructure their loans to increase interest expense to related foreign lenders, higher interest expense deductions to the U.S. borrower may reduce U.S. taxable income, and the interest income earned by the foreign lender may be subject to a lower rate of tax than it would be if earned in the U.S. Thus, when viewed on a worldwide basis, the multinational group may be subject to a reduced tax burden.

Although there are certain limits on interest deductions in the U.S. (such as thin capitalization and interest stripping), those limits may not apply to all U.S. borrowers. Thus, the I.R.S. may be limited to utilizing the transfer pricing rules under Code §482 when trying to combat artificial restructurings of intercompany loans.

Under Code §482, related parties must act on an arm's length basis, as though they were unrelated parties. If an unrelated borrower would not have agreed to enter into a new loan at a higher interest rate, then perhaps the increase in the interest expense should be disallowed.

Some commentators have claimed that restructuring a loan at a higher interest rate may be justified if the borrower needs more funds and the original loan does not allow for an increase. However, other commentators have suggested that a cost-benefit analysis should be performed to determine whether the borrowing entity is truly in a better position once the new loan has been made.

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1 *Insights*, Vol. 2 No. 1, "B.E.P.S. Action 4: Limit Base Erosion via Interest Payments and Other Financial Payments."

Treas. Reg. §1.482-1(d)(1) provides in part:

> Whether a controlled transaction produces an arm's length result is generally evaluated by comparing the results of that transaction to results realized by uncontrolled taxpayers engaged in comparable transactions under comparable circumstances.

Determining the degree of comparability between controlled and uncontrolled transactions requires a comparison of the significant economic conditions that could affect the prices that would be charged or paid, or the profit that would be earned in each of the transactions. These factors include, among other things, "[t]he alternatives realistically available to the buyer and seller."[2]

If a U.S. borrower agrees to pay a higher interest rate to a related foreign lender, when that same U.S. borrower could have borrowed from an unrelated bank for a lower interest rate, it puts into question whether the new loan charges an arm's length interest rate.

CONCLUSION

The I.R.S. is investigating whether recent loan restructurings between related taxpayers meet the arm's length standard. If related-party loans are being restructured and interest rates are increasing, companies should carefully document the reasoning that supports the increases in the interest rates.

[2] Treas. Reg. §1.482-1(d)(3)(iv)(H).