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Newsflash:
Interest rate on intra-group financing

Introduction

Based on the arm's length principle, all intra-group financing must be set on arm’s length terms and conditions for tax purposes. These are the terms and conditions under which independent third parties (e.g. banks) would provide financing. This article compares the loan approach and the bond approach, being the most common Comparable Uncontrolled Price methods of setting an arm’s length interest rate for intra-group financing. Although the OECD has concluded that both approaches can be valid and the approaches are to a large extent substitutes, the bond approach seems to be the preferred alternative.

Loan approach

With the loan approach, an arm's length interest rate is set through a comparison of interest rates on comparable loans between third parties which have been set under similar circumstances. The main considerations for application the loan approach are:

- A comparison between similar instruments, loans with loans, is generally the most accurate way of setting an arm’s length interest rate, since it is the same instrument. A disadvantage may however be that the number of transactions available is limited compared to bonds, for which reason it may be more difficult to find sufficient qualifying comparables. E.g. the number of current loans available in Bloomberg is 65,310, while the number of current bonds available is 406,917. [1]

- For companies with relatively low (poor) credit ratings, there are relatively more loans available in commercial databases. E.g. the number of current non-investment grade loans available in Bloomberg is 4,199 out of 65,310 (6,4%), while the number of current non-investment grade bonds available is 11,871 out of 406,917 (2,9%). This is because companies with low credit ratings have difficulty entering the public bond market. Thus, the gap in available transactions may be relatively smaller for this category of companies.

Bond approach

With the bond approach, an arm's length interest rate of an intercompany loan is set through a comparison to the yield to maturity of bonds with similar volumes and other characteristics. The main considerations for application of the bond approach are:

- There are much available comparable data related to bonds in the databases, since bonds, unlike loans, are tradable in the secondary market. As a result, a relatively large number of comparables are available to provide tailoring when setting an arm's length

[1] These figures were extracted from the Bloomberg Terminal on 15-2-2022.

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interest rate. This may allow you to find comparable transactions within the same industry, volume, tenor, credit rating, seniority, collateral, etc.
- In addition, bonds better reflect the current market price than loans, since bonds are tradable instruments. According to the OECD, information regarding the terms of similar transactions between third parties conducted during the same period as the linked transaction is the most reliable information to use in a comparability analysis. As a result, the bond approach is the best approach in a market where interest rates fluctuate highly, as it takes into account the most recent market conditions.
- Regarding bonds yield to maturity information is available, which is de facto the total compensation. Therefore when one compares bonds to a loan that is structured with base rate and margin (e.g. USD LIBOR 12 months + 2%), one needs to carve out the base rate to determine an arm’s length interest margin. The latter is not applicable when the loan approach is being followed. It is also possible to perform comparability adjustments for currency differences with currency swap rates.

Conclusion

Despite the fact that the loan approach seems the most accurate way of setting an arm’s length interest rate on a loan, there are much more available comparable data related to bonds. In addition, bonds best reflect the current market price because of its tradability. Therefore, it can be concluded that especially in a highly fluctuating market (due to e.g. Covid), the bond approach is the most reliable way in setting an arm's length interest rate for intra group financing. It however depends on the transaction details and the parties involved what the most appropriate approach is in a specific case.