DETERMINIG ARM'S LENGTH INTEREST RATE ON INTER-COMPANY LOANS IN NIGERIA

For most companies, the transfer of funds in form of loans from one business unit to another is a common phenomenon. The advantages of intercompany loans are favourable to the company as they largely control the terms of such loan. To this end, companies involved in intercompany loans are expected to stay compliant with established rules guiding these transactions especially within the frameworks on transfer pricing and base erosion and profit shifting. Laudably, there are existing springboards – for instance, the OECD guidelines on transfer pricing by the Organization for Economic Cooperation and Development (OECD), a legal framework that meets international best practices for the assessing of transfer pricing amongst inter-related entities, These guidelines have shaped the regulation of transfer pricing in most countries including Nigeria which has enacted the Income Tax (Transfer Pricing) Regulation 2018. This new regime has widened the scope of Transfer Pricing in Nigeria.

This article is therefore focused on evaluating tax concerns on inter-company loans and considerations for determining the arm's length interest rate on intercompany transactions.

INTER-COMPANY LOANS

Generally speaking, intercompany loans are the provision of loans from one business unit of a company to another business unit of related companies usually with the intention of shifting cash to the business unit with a likelihood of experiencing cash shortfalls or which requires aggregated loans for investments or to avoid unnecessary exchange rate fluctuations where the situation involves foreign currency. By the nature of inter-company loans, the inter-relation between both business units may result in granting such loans on terms that may appear suspicious to regulatory bodies especially with respect to taxes to be paid, since offering entities ought to record income interest on loans while receiving entities should also record expense interest on loans. The problem that arises from this is often where these loans are made with disregard to commercial terms for the issuance of loans and against the *arm's length* principle which should guide transactions of inter-

related entities. In essence, the likely informality in issuing these loans have often triggered tax audit on entities involved in intercompany loans.

NIGERIA IN PERSPECTIVE

The regulation of inter-company transactions is guided by several laws in Nigeria, although it is chiefly regulated by the Income Tax (Transfer Pricing) Regulations of 2018. Nigeria's position with respect to intercompany transactions which are referred to as "Controlled transactions" is one that compels the implementation of the arm's length principle". In other words, where the parties involved in a transaction are related, then the transaction should be guided by the *arm's length principle*. **Part 2 of the Income Tax (Transfer Pricing) Regulations, 2018** is dedicated to the compliance with arm's length principle which provides the following:

1. Where a connected person has entered into a transaction or series of transactions to which these Regulations apply, the person shall ensure that the taxable profits resulting from the transaction or transactions are ascertained in a manner that is consistent with the Arm's Length Principle.

2. A controlled transaction is at arm's length if the conditions of the transaction do not differ from the conditions that would have applied between independent persons in comparable transactions carried out under comparable circumstances.

3. Where a connected person fails to comply with the provisions of this regulation, the Service shall make adjustments, where necessary, in order to bring the taxable profits resulting from the transactions in conformity with the arm's length principle.

TAX CONCERNS

Notwithstanding the law guiding Nigeria's transfer pricing, taxpayers are often more concerned about how taxes can be avoided and how they can cut down on their taxes. These desires have tendencies to cause leakages in the tax system and could be detrimental to the parties involved. Upon tax assessment by tax authorities, they may become liable in interest and penalties which are incurred from the unpaid tax sum.

A common instance with inter-company loans is the exploitation of tax deductible on interest. Basically, the more loan a company gives, the lesser its tax bills. Entities involved in inter-company loans are likely to exploit the movement of a Company's profit to another of its related party in form of loans to reduce their tax liabilities since loans are deemed as allowable deductions.

What may be troubling is that, the relationship between these entities may tempt companies to reduce the interest upon which the loan is granted thereby further shrinking the tax base since what is taxed is the interest on loan and not the loan itself. This act frustrates the tax system by cutting down necessary taxes from two ends:

1. The exclusion of loaned sum from profit in the entity's financial books.
2. The reduction of interest rate implies that, what is taxed is from a reduced rate.

For the above reasons, both the OECD and UN have implemented the arm's length principle as a yard stick measure in regulating transactions between controlled entities and this principle is further enshrined under the provisions of Nigeria's Income Tax (Transfer Pricing Regulation) 2018.

FACTORS IN DETERMINING ARM'S LENGTH FOR INTER-COMPANY LOANS

With respect to legal and regulatory compliance of inter-company loans, particularly with respect to related entities, most jurisdictions have adopted the OECD and UN manual framework on Arm's Length Principle as a guiding precept for moderating transactions between related entities. Nigeria has not been an exception to this. The principle suggest that when two entities who are related are parties to a transaction, both parties are to transact as though they were unrelated. That is, charges, rate and interest should be applied in similar measurement as it would have been if the entities were unrelated.

Relating the above to inter-company loans, where two companies who are related in a manner that their activities may be referred to as controlled transactions, and one of them extends a loan facility to the other, the arm's length principle is used to ensure that the terms of the loan are neutral to their relationship and the terms are similar to terms of loan between unrelated entities. Where the terms of the loan is not in equilibrium with the usual terms of granting loans, there is a likely presumption that the loan may have been given for the purpose of evading tax burdens, thereby triggering a tax assessment on the loan facility.

The OECD through its transfer pricing guidelines have laid principles for determining arm's length in inter-company loans amongst inter-related entities. The following variables are to be considered in deriving applicable Transfer Pricing method;

1. **COMPARABILITY ANALYSIS**: This seeks to compare what is obtainable for loans given between related entities and unrelated entities. It is concerned with the credit rating of the borrowing companies, the characteristics of the loan facility, which includes maturity date of loan, security on loan, etc. This method enables entities involved to comparatively place these factors alongside available data on similar transaction which are between unrelated entities. The effect of this is to

ensure that entities involved in inter-company loans are aware of the average accepted interest rate and other necessary variables.

2. **LOANS, FEES AND CHARGE**: Loan fees and charge are often placed in inter-company loan. Most Independent commercial lenders will sometimes charge fees as part of the terms and conditions of the loan. For example, arrangement fees or commitment fees in relation to an undrawn facility. This would mean that, where the loan is one with loan fee and charges, the involved parties must take consideration of loan fee and charges of other similar transaction before arriving at theirs.
3. **COST OF FUNDS**: This is where the cost expended on funds for raising the loan by the lending company is included in the loan and recorded in the expenses corner of the lending entity and so, where this is the case, what entities must bear in mind with the cost of funds approach is that it should be applied by considering the lender's cost of funds relative to other lenders operating in the market.
4. **ECONOMIC MODELLING**: This is the use of an agreed model as proxy for the arm's length interest rate by a particular industry. i.e., where an industry has an industry loan interest rate of 20% on loans between companies in the industry.

It is important to note that economic models' outcomes do not represent actual transactions between independent parties. Therefore, comparability adjustments is required. However, in situations where reliable comparable models for transaction between unrelated entities cannot be identified, economic models may represent tools that can be usefully applied in identifying an arm's length interest rate for inter-company loans.

CONCLUSION

Understanding the methods for determining the arm's length interest rates will help in tying up loose ends for entities involved in inter-related company loans. It is often the case, that controlled transactions will be subjected to tax assessment by Tax Authorities and so there is the need to understand the possible leakages that may warrant steep tax penalties. This understanding is as imperative as the need to cut down tax liabilities. The Income Tax (Transfer Pricing) Regulations, 2018 empowers the Nigerian Tax Authorities to assess controlled transaction using the transfer pricing method used by the entities involved or any other method the tax authorities feel most appropriate. Entities cannot afford to dabble into transfer pricing for inter-company loans without a full grasp of the Arm's Length Principle and the various Transfer Pricing methods.

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