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HOW TO DETERMINE RELATED-PARTY LOAN RATES

LEADING THE WAY

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Multinational companies generally fund their subsidiaries either through debt or equity. When debt funding is used, the subsidiaries pay interest back to the parents. Since the interest payments are generally tax-deductible, different interest rates charged between related parties will result in different effective tax rates faced by group of companies. This article aims to explore existing regulations and address what should be the appropriate interest rates charged between related parties.

In Thailand, there is no specific provision regarding how the interest rates of related-party loans should be determined.

From a related-party lender's perspective, Section 65 bis (4) of the Revenue Code states that in the case where money is lent without any interest or with an interest lower than the market value without reasonable ground, the revenue officer has the power to assess the interest to be at the market value on the date of the lending.

From a related-party borrower's perspective, Thai regulations also do not mention how to determine the appropriate interest rate. The Revenue Code states that any expenses not exclusively expended for the purpose of acquiring profits or the purpose of business (Section 65 ter [13]) or for the purpose of the business in Thailand (Section 65 ter [14]) should not be tax deductible. One may interpret excessive interest payment as "not exclusively expended for the purpose of acquiring profits for the purpose of business or for the purpose of the business in Thailand."

Ruling Kor Khor 0811 (G.M. 07)/958 (dated June 28, 2002) suggests how the assessment can be made under two circumstances:

✦ In the case where the lender has excess cash and lends out its own money, the interest received should be assessed at the bank's fixed deposit rate at the time of the lending;

✦ In the case where the lender borrows money in order to lend, the interest received should be assessed at a lending rate applicable at the time of lending. It appears that the ruling only focuses on the lender's side but not on the borrower's side.

Departmental Instruction No. Paw. 113/2545 (Thailand's Transfer Pricing Guidelines) defines "market price" as the price of goods, service fee and interest that independent contracting parties determine in good faith commercially in case of transfer of goods, provision of service, or lending of money, which is the same type on the same date. Thus, the market interest rate would be the rate charged between independent contracting parties. This definition coincides with the arm's length principle advocated by the Organisation for Economic Co-operation and Development (OECD).

According to the arm's length principle, any transactions entered into by associated enterprises should be priced in the same way as the transactions entered into by unrelated parties under similar conditions. Thus, arm's length interest rate should be the interest rate that would be charged between unrelated parties under similar circumstances at the time of the lending/borrowing.

In general, credit worthiness of the borrower, along with other characteristics of the loan such as principal amount, duration, seniority, collateral, etc, need to be considered. The lower the credit rating of the borrower, the less likely that the borrower will be able to pay back the loan, thus, the higher the interest rate demanded by the lender. Larger principal amount, longer duration, lower seniority, smaller/no collateral are associated with higher risk and thus resulting in higher interest rate demanded by the lender.

From a related-party lender's perspective, charging an interest rate equal to the bank's deposit rate (in the case where the lender has excess cash) or charging an interest equal to a generic lending rate (in the case where the lender borrows money in order to lend) may not be sufficient. The creditworthiness of the borrower as well as other loan characteristics should also be taken into consideration. The riskier the loan, the higher interest rate the lender deserves.

From a related-party borrower's perspective, similar conditions apply in order to determine an arm's length interest rate. The riskier the loan, the higher interest rate the borrower should be prepared to pay to any independent parties. Complexities arise in the case where no independent parties in the market would offer the loan to the borrower.

There are no specified methods to determine an arm's length interest rate. One could try to determine the related-party borrower's credit rating and identify all relevant characteristics of the related-party loan. Ideally, one would want to search for third-party loans in the market in which the borrower has the same credit rating and other characteristics of the loans coincide to those of the related-party loan. Such information is not generally available, thus, sometimes one may use the information of the corporate bonds traded in the secondary market with similar characteristics as a benchmark.

It will be interesting to see how the arrival of the arm's length principle will affect the way the Revenue Department interpret Section 65 bis (4) and Sections 65 ter (13) and (14) with regards to interest on loans between related parties.

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