

UAE CORPORATE TAX

–EXPERT TAX INSIGHTS



DETERMINING ARM'S LENGTH INTEREST RATES ON LOANS

Areas Covered:

- UAE Transfer Pricing Guidelines on Loan
- Comparison of Loan and Bond Approach
- Loan Benchmarking
- Determination of Arm's Length Interest Rate
- Case Study

Interest Rate Benchmarking for Transfer Pricing Purposes

OVERVIEW

This section offers guidance on determining an arm's length interest rate for both Intercompany and Director's loan. The guide covers two widely accepted methods: the loan approach and the bond approach, focusing primarily on the loan approach which is in accordance with UAE Transfer Pricing Guidelines. This guide also includes a comparison of both approaches as well as advantages and disadvantages of using Loan Approach. Additionally, a case study is provided, for determination of an arm's length interest rate using the loan approach.

LOAN APPROACH

Pricing an intercompany loan based on third-party loans, known as the Comparable Uncontrolled Price (CUP) approach, is considered the most precise method from a transfer pricing perspective. To ensure comparability, the terms and conditions of the tested transaction—whether it's a loan from a related party (Intercompany loan) or a connected person (Director loan)—must align with those of third-party transactions.

BOND APPROACH

The bond approach in intercompany transactions involves using the yield to remaining maturity (YTRM) of bonds to determine the appropriate interest rate for intercompany loans. By assessing the YTRM, which reflects the total annual return for bondholders, this method provides a reliable measure for setting interest rates. The YTRM considers the time value of money and the present value of future coupon payments, ensuring a fair and consistent interest rate for the intercompany loan based on market conditions.

COMPARISON OF LOAN WITH BOND APPROACH

ASPECT	LOAN APPROACH	BOND APPROACH
Comparability	Highly based on similar instruments.	Moderate, influenced by market conditions.
Market Conditions	Less reflective, based on historical data.	Highly reflective of current market prices.
Data Availability	Limited, especially for complex features.	Abundant, especially for large amounts.
Flexibility	High, tailored to borrower/lender needs.	Low, standardized and less tailored.
Liquidity	Low, not easily tradeable.	High, easily traded in secondary markets.
Suitability	Better for poor credit ratings and small amounts.	Better during economic downturns and for large amounts.

KEY CONSIDERATIONS USING LOAN APPROACH

ASPECT	CONSIDERATION
Creditworthiness of borrower:	<p>The creditworthiness of the borrower is crucial for independent lenders when setting an interest rate. Credit ratings measure creditworthiness and help identify potential comparables or apply economic models in related-party transactions.</p> <p>To determine the borrower's credit rating:</p> <ul style="list-style-type: none">Determine the borrower's stand-alone credit rating.Determine the credit rating of the entire group (if applicable).Determine an appropriate credit rating for the borrower based on the above information. <p>Two methods to estimate the borrower's credit rating are using online tools that assess credit ratings through financial ratios, macroeconomic data, and other quantitative inputs, or by manually replicating the methodologies of independent credit rating agencies.</p>
Loan Type:	The interest rate varies with the loan term (short-term, medium term, or long-term). The risk to the lender decreases with loan tenure, leading to a lower interest rate over time.
Loan Purpose:	Loans can be issued for various purposes such as working capital, refinancing, repaying existing debt, acquisitions, and more. Third-party lenders usually offer more favorable terms when the loan is intended for an investment with high expected returns.
Issuance Currency:	Loans issued in weak or unstable currencies that fluctuate significantly involve higher foreign currency exchange risks for both the lender and the borrower. These loans carry greater exchange risks.
Interest Type:	Interest rates can be fixed or floating. From a lender's perspective, floating rates are less risky as they adjust according to prevailing market conditions. From a borrower's perspective, fixed rates are preferable as they provide greater certainty. Floating rates are less risky for lenders, while fixed rates offer certainty for borrowers.
Loan Term:	Long-term loans typically have higher interest rates than short-term loans due to the increased credit risk the lender incurs from the borrower's higher probability of default over a longer period.
Seniority:	Subordinated loans have higher interest rates to compensate for the increased risk borne by the lender.
Collateral:	Secured loans have lower interest rates than unsecured loans.
Other features:	Early repayment clauses, financial covenants, and the option to convert to shares impact interest rates.

Interest Rate Benchmarking for Transfer Pricing Purposes

CASE STUDY

FACTS AND CIRCUMSTANCES	DESCRIPTION
Lender	XYZ LLC (Related party)
Borrower	ABC LLC (Related party)
Industry	Trading of goods
Type of loan	Term Finance
Loan purpose	General Purpose
Currency and amount	AED 20 Million
Issuance date	March 03, 2024
Maturity date	March 03, 2029
Term	5 years
Seniority	Senior
Collateral	Unsecured
Interest type	Floating

LOAN APPROACH

STEP #1: BASE RATE AND LOAN SPREAD

BASE RATE:

The interest rate of a loan is typically expressed as a base rate plus a credit margin (i.e., loan spread). The base rate compensates for the market risk of the loan. For loans with a floating interest rate, the base rate is determined by referencing the Emirates Interbank Offered Rate (EIBOR) in the respective issuance currency. These rates reflect the average interest rate applied for interbank loans with maturities ranging from 1 day to 1 year. The loan under review is denominated in AED and has a floating interest rate; therefore, the Emirates Interbank Offered Rate (EIBOR) is used.

LOAN SPREAD:

In addition to compensation for market risk, an interest rate also includes compensation for credit risk. To determine an arm's length compensation for the credit risk, a search was conducted to identify comparable loan agreements between independent parties with similar credit risk to the loan under review.

Loan Connector was used as the primary source for this search.

The following criteria were applied:

- Borrower's credit rating:** Borrowers with a credit rating of BBB- at the issuance date of their loans were selected.
- Borrower's industry:** Borrowers from the "Consumer Discretionary" industry was selected.
- Loan type:** Revolving loan facilities were selected.
- Loan purpose:** Loans for general purposes were selected.
- Loan active date:** Loans with a start date within 5 years prior to the pricing date were selected (i.e., between March 3, 2019, and March 3, 2024).
- Loan term:** Loans with a term between 4.5 and 5.5 years were selected.
- Currency:** Loans issued in AED were selected.
- Seniority:** Senior loans were selected.
- Security:** Unsecured loans were selected.
- Base/reference rate:** Loans having EIBOR as the base rate were selected.
- Spread/margin:** Loans with information on spread were selected.

STEP #2: SEARCH PROCESS SUMMARY

SEARCH CRITERIA	ELIMINATED COMPANIES	ACCEPTED COMPANIES
Total number of companies classified under "Trading" based on the pre-defined set	50	25
Data availability: Accepted companies that reported financial data in the current year if available or immediately preceding financial year	12	6
Application of basic quantitative filters: Accepted companies that passed filters	6	3
Application of basic qualitative filters: Accepted companies that passed filters	6	3
Companies that passed through all the above filters	3	

STEP #3: LOAN SPREAD CALCULATION

NAME OF COMPANY	LOAN SPREAD IN (BPS)
Company A LLC	110
Company B LLC	125
Company C LLC	138
Upper Quartile (25th percentile)	117.5
Median	125
Lower Quartile (75th percentile)	134.75

STEP #4: TOTAL INTEREST CALCULATION

INTERQUARTILE RANGE (BPS)	BASE RATE	LOAN SPREAD IN (BPS)	TOTAL INTEREST RATE
Upper Quartile (25th percentile)	EIBOR	117.5	EIBOR + 117.5
Median	EIBOR	125	EIBOR + 125
Lower Quartile (75th percentile)	EIBOR	134.75	EIBOR + 134.75

STEP #5: CONCLUSION

An interquartile range between EIBOR + 117.5 bps and EIBOR+ 134.75 bps with a median of EIBOR+ 125 bps was determined. This range reflects an arm's length total interest rate range for the Loan under review.

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