Important Considerations in the Pricing of Intercompany Loans and Financial Guarantees

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Over the past several years, taxing authorities have devoted increasing attention to intercompany loans and financial guarantees in terms of their tax treatment and pricing considerations. This attention is especially evident in the international arena, where cross-border financial transactions involving loan rates and guarantee fees can lead to profit erosion. For these intercompany financial transactions, there is a great deal of complexity for both the taxpayer and the national taxing authority in determining a reasonable arm's length transfer price. This discussion considers how the arm's-length standard is applied in the pricing of intercompany loans and financial guarantees, while recognizing the inherent benefits that come from being part of a multinational company.

Introduction

Intercompany financial transactions between related members of multinational entities can include a diverse range of financial agreements such as related-party loans, financial or performance-based guarantees, cash pooling, and factoring arrangements.

When companies engage in intercompany financial transactions, the Internal Revenue Service (the "Service") and other national tax authorities typically require that a transfer price be established for the subject transaction. Whatever the form of the intercompany financial transaction, for income tax purposes, these arrangements are considered "controlled" transactions.[1]

Intercompany transfer pricing rules indicate that for income tax purposes, these arrangements should be priced according to arm's-length transactions in which comparable, unrelated parties would enter into similar agreements.

This discussion focuses on what analysts (and other practitioners) should consider when pricing intercompany loans and financial guarantees for income tax purposes. The existing guidance from the Service and the Organization for Economic Co-operation and Development (OECD) for pricing intercompany loans and financial guarantees is somewhat vague and open to interpretation.

Additionally, it is often the case that finding an arm's-length comparable transaction may be difficult (or not feasible). This discussion also examines how the passive benefit bestowed on an entity purely based on its relationship with the parent company plays into the pricing of these financial arrangements.

While this discussion focuses on Service regulations, it also references OECD guidance due to the increasing worldwide attention of tax administrators on these matters.

Arm's-Length Price and Best Method Regulations

In general, Internal Revenue Code Section 482 ("Section 482") covers the distribution, apportionment, or allocation of income, deductions, credits, and allowances between related entities. At the highest level, Section 482 states that the price for a transaction between related parties (e.g., a guarantee provided by a domestic parent company for the benefit of its foreign subsidiary) should be the same as if unrelated taxpayers had engaged in the same transaction under the same or similar circumstances. This is the arm's-length price principle.

Specifically, the Section 482 regulations state the following:

> 1.482.1(b)(1) Arm's length standard—In general. In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer. A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result). However, because identical transactions can rarely be located, whether a transaction produces an arm's length result generally will be determined by reference to the results of comparable transactions under comparable circumstances.

Although Section 482 does not provide direct guidance regarding the appropriate method to estimate the arm's-length price for related-party loans, it does provide general information for choosing the most appropriate arm's-length method.

Under the best method rule, the most appropriate pricing method is the one that best approximates an arm's-length transaction given the specific facts and circumstances.

The Section 482 regulations state the following:

> 1.482-1(c) Best method rule—(1) In general. The arm's length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result. Thus, there is no strict priority of methods, and no method will invariably be considered to be more reliable than others. An arm's length result may be determined under any method without establishing the inapplicability of another method, but if another method subsequently is shown to produce a more reliable measure of an arm's length result, such other method must be used. Similarly, if two or more applications of a single method provide inconsistent results, the arm's length result must be determined under the application that, under the facts and circumstances, provides the most reliable measure of an arm's length result.

There is no guidance beyond the best method definition as to what particular pricing methodology should be employed for pricing intercompany loans and financial guarantees.

Applicable methodologies are listed specifically for tangible property (Regulation 1.482-3(a)) and controlled services transactions (Regulation 1.482-9(a)), but neither loans nor guarantees are defined as belonging to one of these categories. Regulation 1.482-2, which covers loans, does not include a similar list of applicable methodologies.

It is important to note that Regulation 1.482-9 indicates that the pricing of financial transactions, including guarantees, are excluded from using the services cost method. This method is sometimes chosen by taxpayers because the service can be priced at cost and without any markup.

Interest Rate Regulations

Whatever methodology is used to price a related-party loan or financial guarantee, an appropriate arm's-length rate of interest for an uncontrolled, comparable transaction should be the guiding benchmark.

The regulations provide transfer pricing guidance that directly applies to interest rates established on an arm's length basis as follows:

> 1.482.2(a)(1)(i) Loans or advances—Interest on bona fide indebtedness—In general. Where one member of a group of controlled entities makes a loan or advance directly or indirectly to, or otherwise becomes a creditor of, another member of such group and either charges no interest, or charges interest at a rate which is not equal to an arm's length rate of interest (as defined in paragraph (a)(2) of this section) with respect to such loan or advance, the district director may make appropriate allocations to reflect an arm's length rate of interest for the use of such loan or advance.
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> 1.482-2(a)(2) (i) Arm's length interest rate—In general. For purposes of section 482 and paragraph (a) of this section, an arm's length rate of interest shall be a rate of interest which was charged, or would have been charged, at the time the indebtedness

arose, in independent transactions with or between unrelated parties under similar circumstances. All relevant factors shall be considered, including the principal amount and duration of the loan, the security involved, the credit standing of the borrower, and the interest rate prevailing at the situs of the lender or creditor for comparable loans between unrelated parties.

(ii) Funds obtained at situs of borrower. Notwithstanding the other provisions of paragraph (a)(2) of this section, if the loan or advance represents the proceeds of a loan obtained by the lender at the situs of the borrower, the arm's length rate for any taxable year shall be equal to the rate actually paid by the lender increased by an amount which reflects the costs or deductions incurred by the lender in borrowing such amounts and making such loans, unless the taxpayer establishes a more appropriate rate under the standards set forth in paragraph (a)(2)(i) of this section.

It is important to note that the regulations do provide guidance for pricing U.S. dollar denominated loans, which includes an associated "safe haven" interest rate based on the applicable federal rate (AFR). Many taxpayers rely on this safe haven provision because the interest rate calculation is straightforward and allows entities to avoid determining and documenting a true arm's-length rate of interest.

There are a number of pitfalls, however, with taking this approach. The AFR only covers three maturity ranges: 0-3 years (short-term rate), 3-9 years (mid-term rate), and 9+ years (long-term rate). The rates make no differentiation for differences in entity characteristics such as size, industry, type of business, and so forth.

Utilization of these rates is especially troublesome in cases of loans to foreign entities where additional political, economic, and currency risk may exist.

For these reasons, the limited AFR-based options typically will not fully capture the true credit risk of subsidiaries. Finally, loans made in foreign currency are excluded from utilizing the safe haven provision and the associated AFRs.

Many analysts have recommended expanding the array of AFRs to consider various entity and industry-specific risk characteristics. This would allow multinational entities to utilize the safe haven application while still reasonably accounting for necessary risk parameters. To date though, there has been no concrete action towards expanding and differentiating these rates.

Under the current regulations, the inherent contradiction is that while the regulations clearly state that the interest rates on intercompany loans should follow the arm's-length standard, the regulations also allow for safe haven rates that are often inconsistent with independent and unrelated entity transactions.

Furthermore, AFR rates that tend to be relatively low, because of their composition of blended U.S. Treasury rates, are unlikely to be accepted by foreign tax authorities in transfer pricing disputes.

Passive Association Benefit Guidance

A subsidiary generally receives some level of implicit benefit from its relationship with the parent company. This benefit is referred to as a "passive association benefit."

As an example, a subsidiary is likely to have easier access to credit markets than a stand-alone entity, even without any explicit backing from the parent. This type of association and related benefit is deemed passive in nature and is increasingly recognized in transfer pricing cases.

This passive versus explicit benefit can be an important distinction in instances where the general association and implicit backing from a multinational parent can lead to more favorable credit terms for a subsidiary based on that relationship as compared to a stand-alone, uncontrolled entity comparable.

Regulation 1.482-9(l)(3)(v) addresses the benefit of passive association among related party members of a controlled group, as follows:

A controlled taxpayer generally will not be considered to obtain a benefit where that

> benefit results from the controlled taxpayer's status as a member of a controlled group. A controlled taxpayer's status as a member of a controlled group may, however, be taken into account for purposes of evaluating comparability between controlled and uncontrolled transactions.

Examples 15 through 17 in Regulation 1.482-9 address whether or not a benefit is received by a foreign subsidiary due to specific actions of the domestic parent company or by a passive association with the parent company.

The foreign subsidiary in example 15 was determined not to have received a benefit because the ability of Company Y (the foreign subsidiary) to obtain the contract, or to obtain the contract on more favorable terms than would have been possible prior to its acquisition by Company X [the domestic parent] controlled group, was due to Company Y's status as a member of the Company X controlled group and not to any specific activity by Company X or any other member of the controlled group.

Chapter 7.13 of the OECD guidelines has similar language, and it is even specific to the impact that such association may have on a related party's entity's ability to obtain credit on more favorable terms.

> For example, no service would be received where an associated enterprise by reason of its affiliation alone has a credit-rating higher than it would if it were unaffiliated, but an intra-group service would usually exist where the higher credit rating were due to a guarantee by another group member.

From a pricing perspective, this passive association benefit can have significant implications for a subsidiary. In such a case, a stand-alone firm's ability to access the credit market would be entirely dependent upon its own ability to generate sufficient cash flow to cover the required loan payments.

In the case of a controlled subsidiary, the credit markets would likely make some assumption regarding the parent company's likelihood to intervene if the subsidiary encounters financial difficulty. Even if this is just implicit support—that is, no formal guarantee is made—the credit markets will likely regard the entity differently than a stand-alone comparable.

In effect, the related-party subsidiary will carry a de facto higher credit rating and will likely have access to more funds and/or at lower comparable rates of interest.

OECD Guidance Distinctions

While the OECD guidance and the Treasury regulations on transfer pricing generally follow one another in terms of language and viewpoint, it is important that analysts be aware of substantive differences that could lead to separate transfer pricing rates for the domestic parent and foreign borrower.

While the OECD guidelines are not mandatory for its member countries, numerous member and nonmember countries adhere to the OECD guidance and incorporate the OECD guidelines into their own tax laws. The differences between OECD guidance and regulations for transfer pricing in terms of intercompany loans and financial guarantees are primarily semantic in nature.

For example, the Section 482 regulations specify the "best method" while the OECD guidelines specify the "most appropriate method." The OECD guidelines, like the Treasury regulations, give priority to transactional methods and are more specific by stating in Chapter 2.14 the following:

> Where it is possible to locate comparable uncontrolled transactions, the CUP method is the most direct and reliable way to apply the arm's length principle. Consequently, in such cases the CUP method is preferable over all other methods.

As noted above, while the regulations do allow for safe haven pricing based on AFRs in certain cases, the OECD guidelines make no reference to safe haven or other default-type pricing. The focus, instead, is solely on the arm's-length price approach.

The OECD guidelines make it clear that loans and financial guarantees are intercompany services, while the regulations do not consider them to be in any particular category.

Except for the disallowable use of the services cost method under the regulations, there is no further indication that these categorization differences would lead to significant pricing differences.

Except for the regulations' permissible use of safe haven rates, there are no substantial differences between the Treasury regulations and the OECD guidelines in terms of the underlying methods, rules for which methods to use, or how the methods should be applied in pricing intercomapny loans and financial guarantees.

Loan Pricing

As previously stated, the regulations do not provide direct guidance related to the transfer price of intercompany loans and financial guarantees.

If the analyst determines that a transfer price adjustment is appropriate for an intercompany loan or financial guarantee—that is, the analyst determines that the interest rate on the intercompany loan or the parent company guarantee confers an economic benefit to the recipient and that the recipient would be willing to pay an unrelated party for that benefit—then the analyst should consider the appropriate method.

While there are many different methods an analyst may consider, the following typically are the most applicable for determining arm's-length interest rates and related guarantee fees:

1. Comparable uncontrolled prices (CUP)
2. Price quotations
3. Insurance pricing models
4. Standby letters of credit
5. Credit default swaps
6. Put options

The first two methods are based on direct comparable market indications, while the later four methods are equivalent to the pricing of a hedge on the underlying loan that would effectively eliminate default risk.

In a survey of financial professionals in 40 countries by PricewaterhouseCoopers, the CUP method was the most used pricing methodology for establishing arm's-length interest rates for related party loans.[2]

According to this survey, and as shown in Figure 1, 84 percent of respondents said they used the CUP method based on external transactions.

Whatever approach is taken, typically, the first procedure in pricing an intercompany loan is to estimate the borrower's credit rating.

This procedure requires two ratings. The first being a true stand-alone rating with no implicit benefit for passive association (either with a parent corporation or a related subsidiary), and the second being a stepped up rating reflecting the implicit benefit provided by any passive association. These two ratings can then serve as a floor and ceiling for pricing the subject intercompany loan.

If a credit rating has already been assigned for the borrower by a rating agency, such as Standard & Poor's or Moody's, then the primary question is whether it already reflects the benefit of passive association. If a rating has not been assigned, it is necessary to determine a hypothetical rating.

This procedure can be achieved through the use of a credit model based on the borrower's industry, size, and key financial ratios. A passive benefit step up can then be applied, if appropriate.

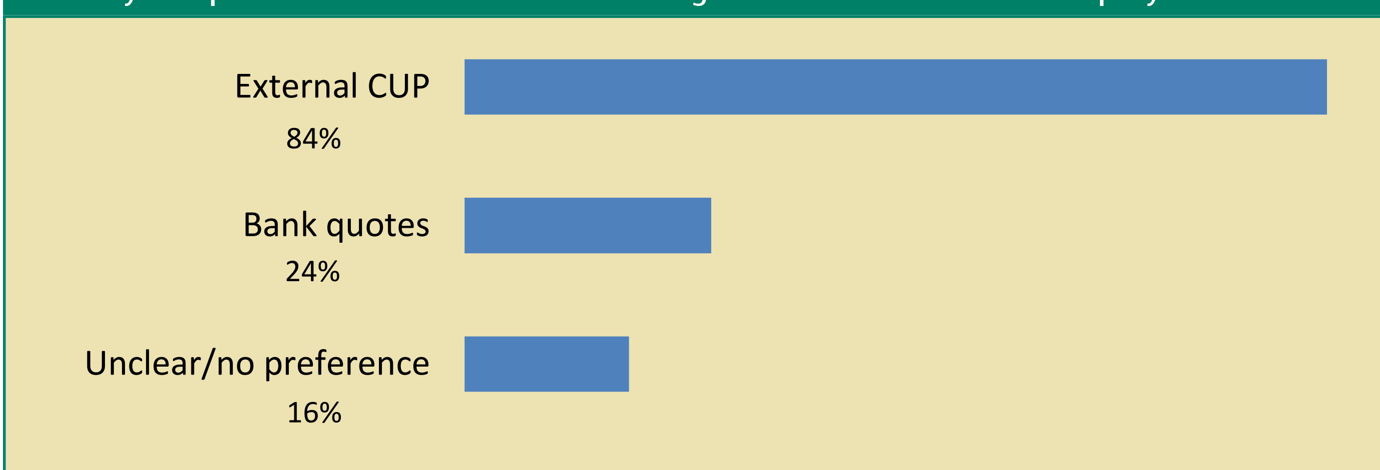
Once the credit ratings are determined, choosing market comparables is the next step. The bond yield market and corporate loan data are common sources which can be aggregated in order to make a best effort at mirroring the financial standing of a particular entity.

These stratifications may include the following attributes depending on the specifics of the subject transaction:

1. Currency
2. Timing of the transaction
3. Principal amount
4. Duration of the loan
5. Embedded loan rights

While an entity's credit rating gives a good indication of its borrowing cost, the loan-specific

Figure 1
Generally Accepted Methods to Evaluate Arm's Length Interest Rates on Intercompany Loans



factors above may also exert a strong influence on the interest rate of a given loan. An analyst searching for comparable loans may attempt to match the entity credit rating and as many of the above-listed loan attributes as possible.

Loan Guarantee Considerations

A guarantee on a particular loan has the effect of raising the creditworthiness of the borrower via a pledge of security by a third party for that loan.

A partial guarantee will raise that creditworthiness to some point between the borrower's standalone credit rating and that of the guarantor. A full guarantee should, in theory, raise the borrower's credit rating up to the level held by the guarantor.

Three important factors need to be considered when pricing a loan guarantee:

1. Whether the guarantee confers a benefit
2. Whether the guarantee is implicit or explicit
3. Whether the guarantee should be considered a service or a capital contribution

For a loan guarantee to be considered a compensable service, the guarantee must be explicit and confer a tangible benefit. Even if the guarantee is explicit and confers a benefit, an intercompany fee should only be charged if the benefit of the guarantee exceeds the benefit that would have been accrued through any implicit guarantees from the parent company.

An example of a guarantee that does not meet the criteria of a compensable service for transfer pricing purposes is provided in example 18 of Regulation 1.482-9. In this example, Company X (the parent company) sends a letter to the financial institution in Country B, which represented that Company X had a certain percentage ownership in Company Y (the foreign subsidiary) and that Company X planned to maintain that ownership.

This allowed Company Y to obtain more favorable terms on its contract but, for taxation purposes, it is not considered a chargeable service because it was neither an explicit guarantee nor a tangible benefit. This type of implicit guarantee is often referred to as a "comfort letter" and no transfer price is necessary in this instance.

Another caveat with loan guarantees is the manner in which the transaction is structured. In some cases, the tax administrator may be of the opinion that the underlying economic substance of a transaction aligns more with a different classification of the transaction.

This is especially true for controlled transactions where a subsidiary is significantly undercapitalized or newly created with the sole purpose of undertaking a specific contract.

The OECD addresses this issue in its guidelines, while the Treasury regulations lack similar guidance. Paragraph 1.65 of the OECD guidelines includes the following:

> The first circumstance arises where the economic substance of a transaction differs from its form. In such a case the tax administration may disregard the parties' characterisation of the transaction and recharacterise it in accordance with its substance. An example of this circumstance would be an investment in an associated enterprise in the form of interest-bearing debt when, at arm's length, having regard to the economic circumstances of the borrowing company, the investment would not be expected to be structured in this way. In this case it might be appropriate for a tax administration to characterise the investment in accordance with its economic substance with the result that the loan may be treated as a subscription of capital.

On November 26, 2013, the Netherlands released a decree on transfer pricing that addressed the issue of guarantee fees in terms of whether they should be considered a chargeable group service.[3]

According to the decree, it is assumed an independent third party will generally not provide a loan to an entity that lacks an investment grade credit rating. To the extent that a borrower could not independently raise a loan on its own, either with or without a third-party guarantee, then the related party parent guarantee transaction does not involve a chargeable intercompany service.

Instead, the guarantee should be viewed as (1) provided in a shareholder capacity and (2) specifically as a constructive capital contribution from the parent to the subsidiary.

In the OECD action plan on base erosion and profit shifting, the organization specifically calls out the need for further development of guidance linked to related-party financial and performance guarantees as a means to limit excessive financial payment deductions.[4]

Changes to the OECD transfer pricing guidelines are expected in December 2015.

Loan Guarantee Pricing

The process for pricing related-party loan guarantees is analogous to the process for pricing intercompany loans. As with intercompany loans, the first procedure is to determine the subsidiary's stand-alone credit rating. Then, through the identification of third-party pricing data and the selection of comparable transactions, a benchmark for a comparable, uncontrolled interest rate can be established.

This interest rate should then be compared to the loan rate received by the subsidiary that has the attached parent company guarantee. It does not matter if the loan originated from the parent or was obtained from an independent third party.

The point is that the higher rate determined under an uncontrolled pricing methodology should serve as a benchmark for the combined pricing of the controlled loan interest rate and the pricing of the guarantee. Like an interest rate, the guarantee fee typically is in the form of an annual percentage rate on the unpaid principal balance of the loan.

The difference between the uncontrolled interest rate and the related-party loan rate obtained by the borrower sets an upper boundary for the pricing of the guarantee. The reason this serves as an upper boundary is that this would represent the most that the subsidiary would pay for the guarantee in an uncontrolled transaction.

It would, in effect, leave the subsidiary ambivalent as to whether it would choose to:

1. obtain a lower rate loan secured by a guarantee from the parent,
2. obtain a lower rate loan secured by a guarantee from an independent third party, or
3. obtain a higher rate loan without a guarantee.

The combined uncontrolled pricing conclusions would be equal for each scenario.

This approach of measuring the benefit conferred with and without the guarantee is commonly referred to as the "yield approach" or the "benefit approach."

Once the ceiling price for the guarantee has been estimated, establishing the transactional transfer price is less straightforward. At issue is the level of implicit benefit that should be factored into the equation.

It is reasonable to expect that the parent company would not charge the subsidiary the full uncontrolled price of the guarantee. The parent company's influence, via ownership control, of the subsidiary makes the security provided by the guarantee less risky and potentially less costly than the security provided by an independent third-party guarantee.

A somewhat simplistic procedure would be to share the economic profit generated by the guarantee. In this approach, the transfer pricing floor is an estimated cost to the parent of providing the guarantee and the ceiling is a stand-alone price the subsidiary would have paid an independent third party for the guarantee.

A rate between these two benchmarks would likely be considered arm's length. This subject will be addressed further below in a judicial decision involving General Electric.

Another procedure to calculating a lower bound for the related-party loan guarantee is to establish how much additional equity capital a parent would need to contribute to the subsidiary in order for the borrower to achieve a credit rating that would allow it to obtain the loan in an arm's-length transaction at the same interest rate obtained through the controlled transaction.

Generally, a guarantor would charge a price that is at least large enough to cover the expected loss of equity in the event of default, plus a profit element.[5]

General Electric Capital Canada

A 2009 high profile judicial decision that includes many of the topics addressed in this discussion is the General Electric Capital Canada (GECC) decision.[6] In that matter, GECC issued commercial paper that was backed by an explicit guarantee from GE Capital US (GECUS), for which GECC paid GECUS 100 basis points.

Canadian tax authorities deemed this price to not be arm's length, arguing that in the absence of the guarantee, the GECC credit rating would have been

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equal to that of GECUS solely based on the subsidiary's status as an associated entity.

This view takes an extreme interpretation of the passive association benefit, whereby only the parent's credit rating is applicable in determining loan rates and guarantee fees. The decision was appealed by GECC.

In ruling on the appeal, the Tax Court of Canada used both a stand-alone approach and the concept of implicit support conveyed by the parent to determine an appropriate credit rating for GECC. The Tax Court of Canada recognized that implicit support has real, but limited value.

The explicit support provided by the guarantee that brought the rate down to a level in line with the parent's credit rating conferred a tangible benefit.

The Tax Court of Canada ruled that the interest cost savings to GECC was determined to be 183 basis points based on a purely stand-alone credit rating relative to the parent rating.

The Tax Court of Canada ruled that the guarantee fee of 100 basis points originally established by GECC and GECUS was arm's-length in light of the implicit support the subsidiary gained via its status as a related-party entity.

This judicial decision clarified that the implicit support provided by a parent to a subsidiary is economically relevant, but the extent of that value is limited and remains open to interpretation. A rate below arm's length was allowed in this matter, but the process of quantifying and applying an implicit support adjustment was not clarified.

Conclusion

There are many issues surrounding the determination of intercompany transfer pricing rates for loans and financial guarantees. At a base level, these issues relate to whether the subject loan or financial guarantee confers a benefit and whether the transaction merits transfer pricing consideration.

To the extent that the borrowing subsidiary could feasibly obtain a loan from an independent third-party lender without a guarantee and an explicit benefit that has been provided by the parent, then a transfer pricing rate must be established.

Guidance and regulations on transfer pricing for financial transactions continue to receive increasing attention and recent rulings in court cases involving multinational entities often seem to make their own interpretation of existing guidance.

Many countries have added regulations that go beyond the more general guidance offered by the OECD.

For these reasons, when establishing transfer pricing rates for loans and financial guarantees, analysts may consider each of the following:

1. Regulations in the parent company's country
2. Regulations in the subsidiary's country
3. OECD guidance
4. Relevant court cases that might influence the respective tax administrators

The benefit that a borrower may accrue from its status as a related-party entity in a multinational corporation may be considered in establishing transfer pricing rates for loans and financial guarantees.

This association benefit is recognized by both the Service and OECD, but there remains no standard method or guidance for quantifying that level of benefit. Any credit rating step up or other adjustment mechanism to reflect an association benefit may certainly require adequate documentation and a well-reasoned supporting rationale.

Notes:

1. A controlled transaction is a transaction in which a financial agreement is made between two or more enterprises that are associated enterprises with respect to each other. http://www.oecd.org/ctp/glossaryoftaxterms.htm.
2. http://www.pwc.com/managingthecomplexity.
3. 14 November 2013 no. IFZ 2013/184 M.
4. http://www.oecd.org/ctp/BEPSActionPlan.pdf.
5. BNA, Inc., *Daily Tax Report* 8, No. 15 (January 24, 2008).
6. General Electric Capital Canada Inc. v. The Queen, 2009 TCC 563 (Dec. 4, 2009).

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