

Now More Complex than Ever: Intercompany Loan and Financial Guarantee Pricing Considerations

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The impact on financial markets from the COVID-19 pandemic and related interest rate volatility has attracted increased scrutiny of intercompany loan pricing by taxing authorities. The use of financial guarantees has also become more pervasive as external lenders are more inclined to request parent company guarantees. The Organisation for Economic Cooperation and Development (“OECD”) recently issued guidance regarding the transfer pricing for intercompany financial transactions. This OECD guidance has made validating intercompany financial transactions a more complex process. Transfer pricing analysts are often asked to develop transfer pricing studies necessary to support the pricing for intercompany loans and financial guarantees. These studies provide economic support for a multinational corporation’s transfer pricing decisions in the event of challenge or dispute by the Internal Revenue Service or other national tax authorities. This discussion focuses on Internal Revenue Service and OECD guidance with regard to the transfer pricing considerations for multinational corporation intercompany loans and financial guarantees.

INTRODUCTION

Intercompany financial transactions between related members of multinational entities may be documented by a variety of financial agreements. Such multinational corporation transactions include related-party loans, financial or performance-based guarantees, cash pooling, and factoring arrangements.

When multinational companies engage in intercompany financial transactions, the Internal Revenue Service (the “Service”) and other national taxing authorities typically require that a transfer price be established for the subject transaction. Whatever form the intercompany financial transaction takes for local country income tax purposes, these arrangements are considered “controlled” transactions.¹

Intercompany transfer pricing rules, for federal income tax purposes, require that these arrangements be structured at an arm’s-length comporting with how comparable, unrelated parties would structure similar agreements.

This discussion focuses on the issues, factors, and constraints that transfer pricing analysts (“analysts”) and other tax practitioners should consider when pricing intercompany loans and financial guarantees for federal income tax purposes.

Navigating the technical guidance from the Service and the Organisation for Economic Cooperation and Development (“OECD”) for pricing intercompany loans and financial guarantees is not easy. Some of the guidance is vague and open to interpretation, and it may also be challenging in

certain cases to identify arm's-length transactions that are reasonably comparable.

This discussion also examines how the passive benefit bestowed on a subsidiary² based on its relationship with the parent company is a factor when pricing an intercompany transaction.

This discussion also references guidance from the Service and recent OECD guidelines regarding transfer pricing for multinational corporation intercompany loans and financial guarantees.

ARM'S-LENGTH PRICE AND "BEST METHOD" REGULATIONS

The purpose of Internal Revenue Code Section 482 ("Section 482") is to ensure that taxpayers clearly report the income attributable to controlled transactions and prevent tax avoidance.

Section 482 essentially requires that a controlled taxpayer mirror the vantage point of an uncontrolled taxpayer by the "true taxable income."

Section 482 provides rules and guidance for the determination of true taxable income of controlled taxpayers in specific situations—including loans, advances, or the use of tangible property or intangible property.

Regulations 1.482-2 through 1.482.7 discuss the methods used to evaluate whether transactions between or among members of a controlled group meet and satisfy the arm's-length standard to determine the true taxable income of a controlled taxpayer.

While Section 482 does not provide direct guidance regarding the appropriate method to estimate an arm's-length price for related-party loans, the Section 482 Regulations do provide general information for selecting the most appropriate arm's-length price under the best method rule based on the specific facts and circumstances surrounding a related-party loan transaction.

The best method rule (under the Section 482 Regulations) is discussed in the following paragraph:

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 subsequent-

ly 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.

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As described in the Regulations, the best method rule requires use of whatever method provides the most reliable measure of an arm's-length result.

Although Regulation 1.482-3(a) defines applicable methodologies for tangible property, and Regulation 1.482-9(a) defines applicable methodologies for controlled services transactions, a definition of applicable methodologies for intercompany loans and financial guarantees is not provided within the regulations.

The services cost method is specifically excluded for use when pricing financial transactions, including guarantees.

INTEREST RATE REGULATIONS

When pricing a related-party loan or financial guarantee, benchmarking an appropriate arm's-length interest rate against an uncontrolled, comparable transaction is considered the appropriate starting point.

The Regulations provide the following guidance for the selection of an arm's-length interest rate:

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.

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.

1.482-2(a)(2)(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.

The Section 482 Regulations provide guidance for pricing U.S.-dollar-denominated loans, which includes a "safe haven" interest rate based on the applicable federal rate ("AFR").

Multinational taxpayers sometimes rely on the safe haven provision and use the AFR (1) due to its simplicity and (2) to avoid the time and effort required to determine and document a true arm's-length rate of interest.

Multinational corporation taxpayers should beware the pitfalls of using the AFR safe haven, which is limited to three maturity ranges: 0–3 years (short-term rate), 3–9 years (mid-term rate), and 9+ years (long-term rate). Additionally, the AFR rates make no distinction or differentiation for entity-specific characteristics such as size, industry, type of business, and so forth.

The use of the AFR is particularly troublesome for intercompany loans to foreign entities where additional political, economic, and currency risks typically exist. Because the AFR does not capture the true credit risk associated with foreign subsidiary operations, foreign currency loans are excluded from the safe haven provision.

Furthermore, because AFRs tend to be relatively low due to their composition of blended U.S. Treasury rates, these rates are highly unlikely to be accepted by foreign tax authorities with respect to potential intercompany transfer pricing disputes.

PASSIVE ASSOCIATION BENEFIT GUIDANCE

The benefit derived from a subsidiary's relationship with its parent company is called a "passive association benefit." For example, a subsidiary may enjoy greater access to credit markets, even in the absence of explicit backing from its parent.

The relationship between a subsidiary and its parent entity, and any benefits derived from the relationship, are considered to be passive. This relationship is widely recognized in intercompany transfer pricing cases.

This passive benefit is an important factor. The subsidiary's association with, and implicit backing from, a multinational parent may exact credit terms for a multinational subsidiary that are more favorable than if the subsidiary were a stand-alone entity.

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 considered for purposes of evaluating comparability between controlled and uncontrolled transactions.

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

Example 15 presents a scenario involving a recently acquired subsidiary which won a contract shortly after acquisition. The contract was much larger and more complex than any project the foreign subsidiary had previously executed. In this example, it was determined that the foreign subsidiary did *not* receive a benefit.

Chapter 7.13 of the OECD guidelines contains language specific to the impact that passive association may have on a related entity's ability to obtain credit on more favorable terms due to the association.³

For example, if no service would have been received in which an associated enterprise, by reason of its affiliation alone, had a credit rating higher than it would have if unaffiliated, but whereby an intra-group service would usually exist where the higher credit rating was attributed to a guarantee by another group member.

From a transfer pricing perspective, the passive association benefit can have significant implications for a subsidiary. For instance, a stand-alone firm's ability to access the credit markets would be entirely dependent upon its own ability to generate sufficient cash flow to make 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 encountered financial difficulty. Even if this is deemed implicit support—no formal guarantee is made—the credit markets will likely evaluate the controlled subsidiary differently than if it were a stand-alone entity.

The upshot of all this is that the related-party subsidiary may carry a *de facto* higher credit rating and will likely have access to more funds at lower comparable rates of interest.

OECD GUIDANCE

On October 15, 2015, the OECD issued a report under its Base Erosion and Profit-Sharing (“BEPS”) initiative. The BEPS report and related guidance changed the transfer pricing outcomes in a number of situations and now requires additional analysis and documentation.

The OECD transfer pricing guidance revised the interpretation of the arm's-length principle based on an expanded view of the economic substance of a controlled transaction. The new guidance requires additional functional and risk analysis referred to as “accurately delineating the actual transaction.”

Under the updated OECD guidance, the contractual allocation of risk will be respected only if each party contractually allocates risk, is considered to control the allocated risk, and has the financial capacity to bear the allocated risk.



The accurate delineation of the intercompany transaction requires assessing the actual behavior or the “real deal” between the parties to a transaction compared to the written contractual terms and provisions.

An important element is the specific requirement that funding risk be distinguished from operational risk.

The OECD guidance prohibits the provider of financial capital to be the claimant to residual income unless it also manages and controls the operational risks. When the provider of the financial capital and the entity managing and controlling the operational and financial risks are one and the same, no adjustment is necessary.

When the management and control of operational and financial risks are not governed by the same entity, the guidance specifies who in fact (1) has access to or provided financial capital, (2) performs operations, and (3) manages and controls the risks of those activities.

When more than one entity controls the risks that drive the returns, each entity may be entitled to a share of the income, depending on its respective contributions to value creation.

The process is outlined as follows:

1. Review the contractual terms of the transaction.
2. Review the functions, assets, risks of each participant, including the assessment of how each of these relate to the generation of value with the multinational enterprise.

3. Review the characteristics of the property transferred or the services provided.
4. Review the economic circumstances of the parties and the market in which the parties operate.
5. Review the business strategies pursued by the parties.

In February 2020, the OECD issued additional guidance on transfer pricing for financial transactions. This guidance discusses the need to assess factors including the ability of the recipient to obtain a loan from an unrelated party as part of evaluating the nature of intercompany financing classified as debt or equity.

Although the ability to repay the loan in full is not required under the OECD guidance, the ability to reduce the loan balance and refinance the remaining balance should be considered.

The OECD guidance further identifies the following characteristics that should be considered in pricing intercompany loans:

- The contractual terms
- Functional analysis
- Characteristics of financial instruments
- Economic circumstances
- Business strategies

The OECD guidance on the pricing of intercompany loans is generally consistent with Section 482 Regulations and generally accepted transfer pricing practices—and highlights the following considerations:

- Delineating accurately the actual transaction between the related parties
- Determining the credit rating of the borrower and other economic circumstances of the transaction
- Benchmarking the interest rate by reference to transactions between unrelated parties

LOAN PRICING

The Section 482 Regulations do not provide direct guidance related to transfer pricing intercompany loans and financial guarantees. There are, however, a number of different methods that analysts typically consider when pricing intercompany loans and related guarantees.

These methods include the following:

1. Comparable uncontrolled prices
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 other four methods are equivalent to the pricing of a hedge on the underlying loan that would effectively eliminate default risk.

Whichever method is applied when pricing an intercompany loan, the first procedure is estimating the borrower's credit rating.

This procedure requires two ratings. The first is a true stand-alone rating with no implicit benefit for passive association (either with a parent corporation or a related subsidiary). The second is 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 by a commercial credit rating agency, such as Standard & Poor's or Moody's, it is important to understand if the assigned rating reflects the benefit of passive association.

If a rating has not been assigned by a commercial credit rating agency, it is then necessary to determine a hypothetical rating.

A hypothetical rating can be developed by using a credit model based on the borrower's industry, size, and financial ratios. An adjustment for the passive benefit step-up can then be applied, if necessary.

Once a hypothetical credit rating is determined, market guideline debt instruments are identified and selected for benchmarking. Market data regarding corporate loans and bond yields are common sources which can be used to assess the financial conditional and relative standing of a particular entity.

The following attributes are also considered when assessing comparability for a specific transaction:

1. Currency
2. Timing of the transaction
3. Principal amount

4. Duration of the loan
5. Embedded loan rights

Although an entity's credit rating can provide a good indication of its relative borrowing cost, loan-specific factors and attributes also need to be considered and reflected by the concluded interest rate.

LOAN GUARANTEE CONSIDERATIONS

A partial guarantee may elevate creditworthiness to a level between (1) the borrower's stand-alone credit rating and (2) the credit rating of the guarantor. A full guarantee should, in theory, raise the borrower's credit rating to the level held by the guarantor.

The following 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 regard to loan guarantees is the manner in which the transaction is structured. In some cases, the tax administrator may believe that the underlying economic substance of a transaction aligns more with a different classification of the transaction. This belief may be especially true for controlled transactions where a subsidiary is significantly undercapitalized or newly created with the sole purpose of undertaking a specific contract.

The recent guidance from the OECD describes financial guarantees in general terms, as follows:

10.155. A financial guarantee provides for the guarantor to meet specified financial obligations in the event of a failure to do so by the guaranteed party. There are various terms in use for different types of support from one member of a multinational entity group to another. At one end of the spectrum is the formal written guarantee at the other is the implied support attributable solely to membership in the multinational entity group.

10.156. The accurate delineation of financial guarantees requires initial consideration of the economic benefit arising to the borrower beyond one that derives from passive association.

10.157. From the borrower perspective, a financial guarantee may allow the guaranteed party to obtain a more favorable interest rate since the lender has access to a wider pool of assets or enabling the borrower to access a larger amount of funds.

10.158. From the perspective of a lender, the consequence of one or more explicit guarantees is that the guarantor(s) are legally committed; the lender's risk would be expected to be reduced by having access to the assets of the guarantor(s) in the event of the borrower's default. Effectively, this may mean that the guarantee allows the borrower to borrow on the terms that would be applicable if it had the credit rating of the guarantor rather than the terms it could obtain based on its own non-guaranteed rating.

LOAN GUARANTEE PRICING

The process for pricing related-party loan guarantees is similar 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 rate received by the subsidiary that has the attached parent company guarantee. It does not matter whether the loan originated from the parent or from an independent third party.

The point is, 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 is typically 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. This upper boundary represents the highest interest rate 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 procedure for 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 procedure, the transfer pricing floor is an estimated cost to the parent of providing the guarantee, and the ceiling is a stand-alone price that the subsidiary would have paid to an independent third party for the guarantee.

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

Another procedure used to calculate a lower bound for the related-party loan guarantee is to establish the amount of additional equity capital that a parent would need to contribute to the subsidiary. This amount would be at a level enabling the borrower to achieve a credit rating that would fetch the same interest rate for a controlled transaction as for an arm's-length 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.⁴

GENERAL ELECTRIC CAPITAL CANADA EXAMPLE

A 2009 high profile judicial decision that includes many of the topics addressed in this discussion is the *General Electric Capital Canada* ("GECC") decision.⁵

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 determined that the transfer price was not at arm's length, arguing that in the absence of the guarantee, the GECC credit

rating would have been 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 its 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 were 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.

SUMMARY AND CONCLUSION

There are a number of complex issues to consider in the determination of intercompany transfer pricing rates for multinational corporation 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 the borrowing subsidiary could feasibly obtain a loan from an independent third-party lender without a guarantee and an explicit benefit has been provided by the parent, then an intercompany transfer pricing rate should be established.

Guidance and regulations on transfer pricing for financial transactions continue to receive increased attention. Recent judicial decisions involving multinational entities often seem to provide 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 want to 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 may influence the respective tax administrators

The benefit that a borrower may achieve from related-party status 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 the OECD. However, 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 will certainly require adequate documentation and compelling 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. *Transfer Pricing Guidance on Financial Transactions: Inclusive Framework on BEPS Actions 4,8-10* (Paris: OECD, 2020). www.oecd.org/tax/beps/transfer-pricing-guidance-on-financial-transactions-inclusive-framework-on-beps-actions-4-8-10.htm 14 November 2013 no. IFZ 2013/184 M
3. *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, (Paris: OECD Publishing, 2017).
4. BNA, Inc., *Daily Tax Report* 8, No. 15 (January 24, 2008).
5. *General Electric Capital Canada Inc. v. The Queen*, 2009 TCC 563 (Dec. 4, 2009).

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