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## United States - Transfer Pricing Analysis – Guarantees

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### ABSTRACT

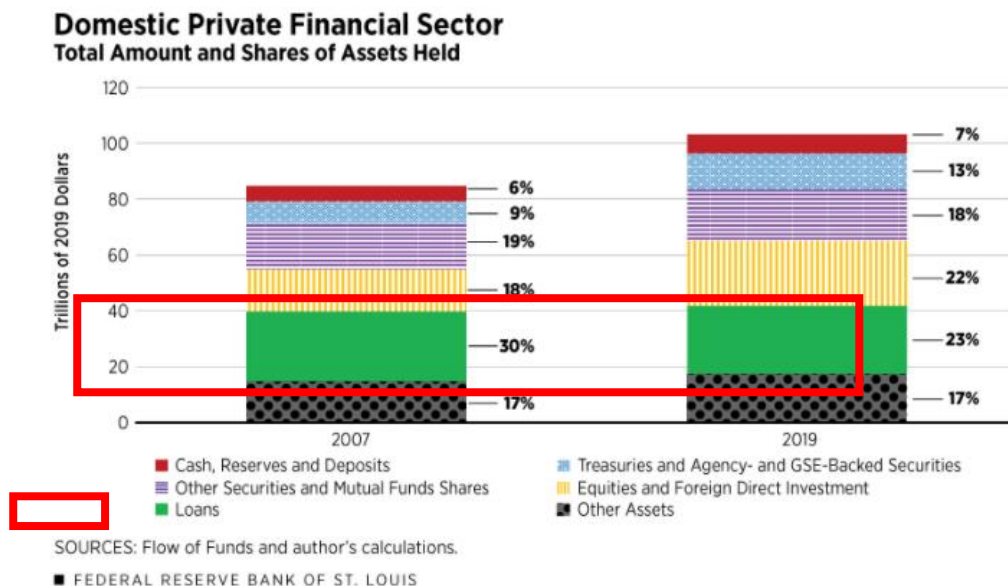
The United States (U.S) financial system is an integral part of the efficient operation of the U.S. economy. During the current COVID-19 pandemic, the Federal Reserve had to take aggressive steps to protect the U.S. financial system. As a result, new financial transactions, including debt securities, corporate loans, advances and guarantees, common stock or equity, and derivative securities such as options and futures contracts, were executed. This article focuses explicitly on U.S. transfer pricing analysis regarding financial guarantee transactions.

**Keywords:** Financial System, Economy, Covid-19

### 1. EFFECTS OF COVID-19 ON U.S. FINANCIAL MARKETS

In March 2020, the U.S. and the worldwide economies experienced the COVID-19 economic shock. The U.S. financial system is a critical driver of domestic and international economic growth and financial security. So inevitably, its smooth functioning and resilience to adverse shocks are essential for broader economic stability [1].

Specifically, the domestic private financial sector, which includes private depository institutions, insurance companies, private and public pension funds, mutual funds, government-sponsored enterprises, and various other financial entities, grew at the same pace as Gross Domestic Product (GDP) between 2007 and 2019 [2].



## 2. FINANCIAL TRANSACTION - FINANCIAL GUARANTEE

A guarantee is a legal promise made by a third party (guarantor) to cover a borrower's debt or other types of liability in case of the borrower's default. Guarantees take several forms, mainly bank guarantee, financial (loan) guarantee, and performance guarantee.

This article focuses on the arm's length valuation of financial (loan) guarantees for transfer pricing analysis.

Loans guaranteed by a third party are called guaranteed loans. An enterprise (guarantor) "lends" its creditworthiness to another party (borrower) for a fee, thereby enhancing the other party's ability to borrow funds. The guarantor may guarantee repayment of the borrower's obligation or may pledge specific assets that the creditor may claim in the event of the borrower's default.

In other words, a loan guarantee is an undertaking by a party with a good credit rating to guarantee the repayment of a loan, including principal and outstanding interest, made to the party seeking the loan from another party or, more generally, it gives the right to hold the guarantor liable for a failure on the part of the principal debtor to perform his contractual obligations. Thus, a loan guarantee lets a borrower act as though it has a higher credit rating by offering a loan at a lower rate than its standalone credit rating would merit. A loan guarantee typically involves two sets of fees: an initial fee due at the consummation and a continuing (annual) fee owing over the term of the guarantee.

Similarly, the Guarantee Fee consists of the following three key components -

### i. Commission fee: -

Commission fee will typically be a fixed or declining interest percentage calculated on the guaranteed amount. The actual percentage will depend on the amounts at stake, the credit rating of the guarantee, and the question of whether or not the guarantor has a right of recourse or obtained additional securities. Therefore, it covers both the statistical risk that the guarantee should be executed and a commercial margin.

### ii. Administration fee: -

It is generally a limited fixed amount reflecting the administrative expenses incurred by the guarantor.

### iii. Commitment fee: -

The guarantor charges it to keep a credit line available. This is mainly applied when a guarantee is not granted for a specific transaction but is linked to a credit line that the guarantee can be called upon during a said period.

## 3. TRANSFER PRICING REGULATIONS UNDER SECTION 482

In taxation and accounting, transfer pricing refers to the rules and methods for pricing transactions within and between enterprises under common ownership or control. Because of the potential for cross-border controlled transactions to distort taxable income, tax authorities in many countries, including the U.S., can adjust intragroup transfer prices that differ from what would have been charged by unrelated enterprises dealing at arm's length (the arm's-length principle) [3].

Transfer pricing applies to a wide range of intercompany transactions such as:

- Tangible property
- Intangible property
- Services
- Financing (intercompany loans, guarantees)

The international standard for determining the appropriate transfer price is the arm's-length principle cited in the U.S. transfer pricing rules (Internal Revenue Code Section 482 and the Treasury Regulations thereunder, hereinafter referred to as '482 regulations').

The purpose of 482 regulations is to ensure that taxpayers reflect income attributable to controlled transactions and prevent the avoidance of taxes regarding such transactions. 482 regulations place a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer. Section 1.482-2 provides rules for determining the true taxable income of controlled taxpayers in specific situations, including controlled transactions involving loans or advances [4].

#### 4. CONTEXTUAL - TRANSFER PRICING AND GUARANTEE TRANSACTION

Currently, 482 regulations do not adequately address the application of transfer pricing where a company provides financial guarantees to a member of the same group of controlled entities. Treasury Regulations § 1.482-9 guides concerning controlled services transactions but do not include financial guarantees.

One member of a controlled group may guarantee another member's unrelated party debts instead of making an intercompany loan. For example - A third-party bank may ask the parent company to guarantee the debt of its subsidiaries or vice-versa. Additionally, guarantees can be from multiple parties coming together as one legal obligor - for example - cash pooling which is a system by which a company or group of companies concentrates their balances in order to obtain a global net position in a current account.

Firstly, in all situations, assess whether the guarantee transaction can be construed as a 'service,' secondly whether there should be a fee, and thirdly which valuation methodology to be adapted for ensuring arm's length price?

Another issue under review is whether the debt is the debt of the subsidiary. Depending on the facts, circumstances, including the existence of shareholder's guarantee, transactions could be re-characterized as shareholder's borrowing from unrelated lender followed by a capital contribution to the company.

#### 5. ARM'S LENGTH VALUATION METHODS - GUARANTEE TRANSACTION

The intercompany fee paid by the guaranteed entity to the guarantor should adhere to the arm's length principle.

##### **482 Regulations - Methods to determine taxable income in connection with a controlled services transaction [5]**

The arm's length amount charged in a controlled services transaction must be determined under one of the methods provided for in section § 1.482-9. Each method must be applied per the provisions of §1.482-1, including the best method rule of §1.482-1(c), the comparability analysis of §1.482-1(d), and the arm's length range of §1.482-1(e) [6]. The methods are -

- i. The services cost method (SCM) (could be a safe harbor for guarantee transaction also?)  
SCM is a safe harbor that allows taxpayers to charge for certain low value services at cost. Taxpayers have the option to apply the SCM when the specific requirements are met.
- ii. **The comparable uncontrolled services price (CUSP) method**
- iii. The gross services margin method
- iv. The cost of services plus method
- v. The comparable profits method
- vi. The profit split method
- vii. **Unspecified methods**

*We will analyze both CUSP and unspecified methods in detail for guarantee transactions based on comparability and reliability considerations. Any other approaches could be utilized based on additional available guidance and evidence and would fall within unspecified methods.*

**CUSP:**

The CUSP method evaluates whether the amount charged in a controlled services transaction is arm's length by reference to the amount charged in a comparable uncontrolled services transaction. Whether results derived from the application of this method are the most reliable measure of the arm's length result must be determined using the factors described under the best method rule in § 1.482-1(c). Specific examples of factors that may be particularly relevant to the application of this method include -

- a. Quality of the services rendered;
- b. Contractual terms;
- c. Intangible property (if any) used in rendering the services;
- d. Geographic market in which the services are rendered or received;
- e. Risks borne;
- f. Duration or quantitative measure of services rendered;
- g. Collateral transactions or ongoing business relationships between the renderer and the recipient, including arrangement for the provision of tangible property in connection with the services; and
- h. Alternatives that are realistically available to the renderer and the recipient

As always, the CUSP method would be the most direct way of determining an arm's length guarantee fee. It compares the price charged in a controlled transaction to that charged in a comparable uncontrolled transaction. Using the CUSP assumes that genuine comparable transactions do occur both between related and unrelated parties.

**Unspecified Method:**

Consistent with the specified methods, an unspecified method should take into account the general principle that uncontrolled taxpayers evaluate the terms of a transaction by considering the realistic alternatives to that transaction, including economically similar transactions structured as other than services transactions, and only enter into a particular transaction if none of the options is preferable to it.

As with any method, an unspecified method will not be applied unless it provides the most reliable measure of an arm's length result under the principles of the best method rule.

The CUSP method compares a controlled services transaction to similar uncontrolled transactions to directly estimate the price to which the parties would have agreed had they resorted directly to a market alternative to the controlled services transaction. Therefore, in establishing whether a controlled services transaction achieved an arm's length result, an unspecified method should provide information on the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled services transaction.

**Example:** A special purpose vehicle (SPV) is created to issue debt instruments in the international capital market. The parent company guarantees the debt instruments, and the SPV compensates an arm's length consideration determined contractually. A SPV or special-purpose entity is a subsidiary company that is formed to undertake a specific business purpose or activity. SPVs are commonly utilized in certain structured finance applications, such as asset securitization or to isolate the parent company's financial risk.

**Organization for Economic Co-operation and Development (OECD) / Group of Twenty (G20) Base Erosion and Profit Shifting (BEPS) - Transfer Pricing Guidance on Financial Transactions (OECD) [7]**

G20 is an international forum for the governments and central bank governors from 19 countries and the European Union (EU).

With no or limited guidance in the 482 regulations, this article also analyzed OECD. In general, 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. At one end of the spectrum is the formal written guarantee and at the other is the implied support attributable solely to membership in the Multinational corporation (MNE) group. OECD specifies a two-step approach:

### 1) Accurate delineation of financial guarantees:

- **The economic benefit derived from a financial guarantee arising to the borrower beyond the one that derives from the passive association:**

In considering the borrower's overall financial position due to the guarantee, its cost of borrowing with the guarantee (including the cost of the guarantee and any associated costs of arranging the guarantee) would be measured against its non-guaranteed cost borrowing taking into account any implicit support.

Evaluation of the guarantee fee should be limited to a fee on the portion that has been accurately delineated as a loan. The remainder of the loan granted should be regarded as effectively a loan to the guarantor, followed by the guarantor's equity contribution to the borrower.

- **Effect of group membership:**

A borrower would not generally be prepared to pay for a guarantee if it did not expect to obtain an appropriate benefit in return. The benefit of support attributable to the borrower's MNE group member status would arise from passive association and not from providing a service for which a fee would be payable.

- **Financial capacity of the guarantor:**

The examination of financial guarantees under accurate delineation also needs to consider the guarantor's financial capacity to fulfil its obligations in the borrower's default. This requires evaluating the guarantor and the borrower's credit rating and the business correlations between them.

### 2) Determining the arm's length price of guarantees: This section describes several pricing approaches for those circumstances where a guarantee is appropriate. However, when the accurate delineation of the actual transaction indicates that the purported guarantee is not a guarantee, other pricing approaches should be considered.

- CUP method (*similar to CUSP under 482 regulations*)
- **Yield approach** quantifies the benefit that the guaranteed party receives from the guarantee in terms of lower interest rates. The method calculates the spread between the interest rate that would have been payable by the borrower without the guarantee and the interest rate payable with the guarantee.
- **Cost approach** aims to quantify the additional risk borne by the guarantor by estimating the value of the expected loss that the guarantor incurs by providing the guarantee (loss given default). Alternatively, the expected cost could be determined by reference to the capital required to support the risks assumed by the guarantor. Popular pricing models for this approach work on the premise that financial guarantees are equivalent to another financial instrument and pricing the alternative, for example, treating the guarantee as a put option and using option pricing models, credit default swap pricing models.
- **Valuation of expected loss approach** would estimate the value of a guarantee based on calculating the probability of default and making adjustments to account for the expected recovery rate in the event of default. This would then be applied to the nominal amount guaranteed to arrive at the cost of providing the guarantee. The guarantee could then be priced based on an expected return on this amount of capital based on commercial pricing models such as the Capital Asset Pricing Model (CAPM).
- **Capital support method** It would be first necessary to determine the credit rating for the borrower without the guarantee (but with implicit support) and then to identify the amount of additional notional capital required to bring the borrower up to the credit rating of the guarantor. The guarantee could then be priced based on an expected return on this amount of capital to the extent that the expected return so used appropriately reflects only the results or consequences of the provision of the guarantee rather than the overall activities of the guarantor enterprise.

**Other Alternative Approaches - Option Pricing Model?**

A Put Option is a type of derivative contract wherein a person purchases the right (but is not obliged or liable) to sell a specified quantity of an underlying asset at an agreed price (strike price) on or before a specified future date (expiry date). Hence, from the guarantor's point of view, the cost of providing a guarantee is the value of the put option.

Value of Bonds = Value of Risk-free Bonds - Value of Put Option;

This means that: Value of Bonds = Value of Risky Bonds + Value of Put Option

Value of Put at expiration = Value of Call at Expiration + [Exercise Price / (1 + Risk Free Rate)<sup>tax rate</sup>] - Value of share at expiration

**6. AN ASSUMED EXAMPLE THAT OUTLINES BASIC PRINCIPLES FOR PRICING OF A GUARANTEE TRANSACTION**

- I. The “benefit test” generally involves ascertaining whether the recipient of a guarantee has benefitted financially from the arrangement. Therefore, it is generally assumed that the guarantee recipient satisfies the “benefit test”.
- II. Once it has been determined that an intra-group service has been rendered, the next step is to assess what would be an Arm’s Length Guarantee Fee.

**Information:**

*Note: The below assumptions and data evaluated for the year 2020*

**Credit Rating [8] -**

**Guarantor: AA**

**Borrower in the absence of a Guarantee: BBB**

**Probability of default of an AA rated entity: 0.5%**

**Probability of default of a BBB rated entity: 1.2%**

**Principal amount of the loan guaranteed: \$ 500 million**

**Actual Cost of Finance with a Guarantee: 6% p. a**

**Estimated Cost of Finance without a Guarantee: 7% p. a.**

**Guarantee Fee Calculation:**

**Yield Approach -**

**Expected Benefit of the Guarantee (%): 1% p. a (7% p.a. less 6% p.a.)**

**Expected Benefit of the Guarantee: \$ 5 million**

**(100bps i.e., 1% \* \$ 500 million)**

**Valuation of Expected Loss Approach -**

As a guarantee is effectively a contingent commitment of capital, the associated probability of whether the guarantor will have to inject that capital is 0.7% (1.2% less 0.5%)

**Expected cost to the Guarantor associated with Guarantee (\$500 million \* 0.7%) - \$3.5 million**

**Cost Approach -**

The arm’s length fee would usually be expected to fall between the cost to the guarantor and the total expected net benefit to the guaranteed entity. Per the calculation, the acceptable arms-length fee should fall between \$1.5 - \$3.5 million. Therefore, this Guarantee Transaction is at Arm’s Length.

<b>Expected Benefit of the Guarantee</b>	<b>\$ 5 million</b>
<b>Less: Expected Cost p. a. to the Guarantor</b>	<b>\$3.5 million</b>
<b>Net Benefit of the Group</b>	<b>\$1.5 million</b>
<b>Actual Guarantee Fee charged by the Guarantor (arm’s length)</b>	<b>\$1.8 million</b>

**Capital Support Method -** Guarantor to inject equity capital into the recipient entity to improve its credit rating to the level of the guarantor

**Additional equity capital required (Modelled) to boost the credit rating to AA [P] - \$80 million**

**Required return on equity (CAPM) for the parent company [Q] - 10%**

**Annual Fee [R] = P \* Q - \$8 million**

**Principal amount of the loan guaranteed [S]: \$ 500 million**

**Guarantee Fee Calculation - R / S \* 10,000 is 160bps**

The guarantee charges are expressed as a number of basis points applied to the principal value.

Note that the benchmarking of guarantee fee as per External CUSP and other approaches also involves performing external database comparable searches to substantiate the arm's length price, for simplicity purposes, external comparable' data is not considered in this example

## 7. CONCLUSION

With the global expansion of the workforce and product availability, MNEs often have to support their group activities by providing financial guarantees that allow their related parties to obtain loans at favorable interest rates from the global credit market. The effects of the recession and tightening credit markets have caused banks to demand more credit support from shareholders or affiliates of companies seeking loans. As a result, the proper tax treatment of financial guarantees is being encountered more frequently in audits of multinational corporations. Yet surprisingly, there is little guidance on whether section 482 applies to these transactions, and if it does, what is the proper pricing or valuation of financial guarantees [9]. To conclude, the simplest way other than using CUSP would be to determine the arm's length guarantee fee by considering the spread between the interest rate the borrower would have paid without the guarantee and the rate it pays with the guarantee.

## 8. DISCLAIMER

The views and opinions expressed in this article are those of the author. They do not necessarily reflect the policy of the U.S. government or any organization. Furthermore, examples within this article are only based on minimal information.

## 9. REFERENCES

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