STATE BAR OF CALIFORNIA
TAXATION SECTION
CORPORATE AND PASS-THROUGH ENTITIES COMMITTEE

THE APPLICATION OF SECTION 482 TRANSFER PRICING PRINCIPLES TO FINANCIAL TRANSACTIONS, INCLUDING GUARANTEES AND CREDIT SUPPORT ARRANGEMENTS

This proposal was prepared by Steven L. Walker, Chair of the Corporate and Pass-through Entities Committee of the State Bar of California's Taxation Section.[1] The author wishes to thank William H. Quealy, Jr., Director, Tax Controversy Services, KPMG LLP, for his valuable insight, support and comments.[2]

Contact Person: Steven L. Walker, Esq.
The Law Office of Steven L. Walker
303 Almaden Blvd., Suite 500
San Jose, CA 95110-2712
(408) 828-9989
swalker@walk-law.com
www.walk-law.com

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[1] The comments contained in this paper are the individual views of the author who prepared them, and do not represent the position of the State Bar of California or of the Los Angeles County Bar Association.
[2] Although the participants on the project might have clients affected by the rules applicable to the subject matter of this paper and may have advised such clients on applicable law, no such participant has been specifically engaged by a client to participate in this project.

EXECUTIVE SUMMARY

The issue is the proper tax treatment of a financial guarantee from a parent company to a wholly-owned subsidiary for Federal income tax purposes. The Service issued Treas. Reg. § 1.482-9 to provide guidance with respect to controlled services transactions, but the regulations carve-out financial guarantees from the regulations' applicability.[3] This raises the question as to how to treat guarantees under Section 482. Because financial guarantees are relatively common transactions, taxpayers need specific guidance as to the proper tax treatment of guarantees for tax planning and compliance. This paper explores the following issues:

1. Under what circumstances does a financial guarantee from a parent company to a wholly-owned subsidiary trigger the application of section 482; and

2. If section 482 is triggered, what is the proper valuation method to apply for purposes of valuing a financial guarantee under section 482?

To provide some background, multinational companies often support the activities of their subsidiaries by providing financial guarantees or other forms of comfort that allows their subsidiaries to access debt funding at favorable interest rates from the global credit market. Where a parent company guarantees a subsidiary's borrowings, the subsidiary may be considered to have a similar creditworthiness of the parent because the borrowings are being supported by the group's consolidated balance sheet and operations. This increased creditworthiness allows the subsidiary to obtain more advantageous financing. It is not unusual for banks and other third-party lenders to require some sort of financial guarantee in light of the effects of the recession and tightening of the credit markets.

A subsidiary may be required to pay an arm's length fee to a parent company in exchange for receiving a financial guarantee under the transfer pricing rules of Section 482. The idea is that the subsidiary has received a benefit (a notch up in its credit ratings) as a result of receiving a

[3] Treas. Reg. § 1.482-9(b)(3)(ii).

service from the parent company (*i.e.*, providing the financial guarantee). However, there is minimal guidance as to when a financial transaction should be compensable, what the effect of the affiliation should be when considering the economic benefit of the financial guarantee, and the proper method for valuing the transaction.

This paper explores the key issues relating to financial guarantees and provides a framework for discussion in promulgating guidance on this pressing issue. This paper proposes the following specific recommendations:

1. No compensation should be imposed with respect to a financial guarantee arising merely from passive affiliation. This occurs where a subsidiary receives an incidental benefit in the form of credit support entirely due to its status as a member of the parent company's controlled group and not to any specific activity by the parent or any other member of the controlled group.

2. No arm's length service fee should be imposed where a parent company merely provides a letter of comfort or similar statement of intent, which does not constitute a contractually binding commitment.

3. For purposes of valuation, the Service should adopt a simplistic approach that is easy to implement and not unduly burdensome or costly. One suggestion would be a safe harbor election based upon the services cost method. Another suggestion would be to allow the arm's length fee to be determined by taking into consideration the spread between the interest rate the borrower would have paid without the guarantee and the rate it pays with the guarantee, less an arm's length discount. This approach is consistent with the Australian Tax Office and *General Electric Capital Canada Inc. v. Her Majesty The Queen*, 2009 TCC 563 (Dec. 4, 2009).

DISCUSSION

I. BACKGOUND

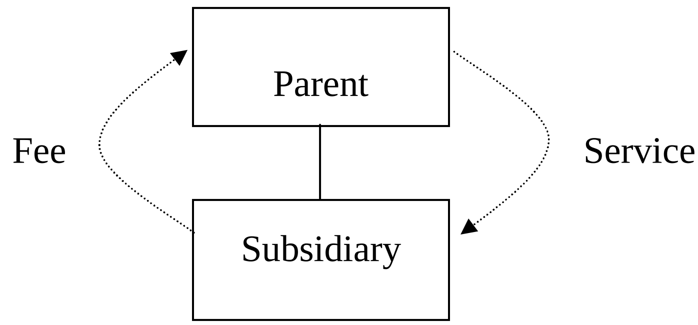
The existing IRS Treasury regulations and guidance issued under Code Section 482[4] clearly do not adequately address the application of Section 482 transfer pricing principles in circumstances where a company provides financial guarantees or other forms of credit support services to a member of the same group of controlled entities. To illustrate the uncertainty of the application of Section 482 to these types of financial transaction, consider the following relationships and examples among members of the same group of controlled entities.

A. Example 1: Parent Company as Service Provider

If one member of a group of controlled taxpayers (the renderer) performs a service for, or on behalf of, another member of the same group of entities with no compensation or compensation below an arm's length charge, the Commissioner has the authority under Section 482, and the transfer pricing regulations, to make appropriate allocations of income and expenses as necessary to reflect an arm's-length charge for the service.[5]

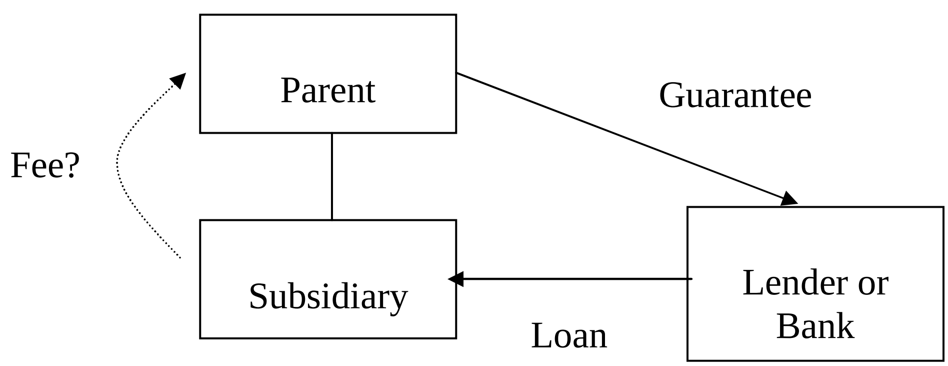
This can best be illustrated by example. Assume that a U.S parent company provides a service to a wholly-owned subsidiary in Country B. In this instance, the subsidiary may be required, in certain circumstances, to pay a fee to the parent in exchange for the services.

[4] All Section references are to the Internal Revenue Code of 1986, as amended, and the Treasury Regulations promulgated there under unless otherwise provided.
[5] Treas. Reg. § 1.482-2(b)(1) and Treas. Reg. § 1.482-9.



B. Example 2: Parent Company as Financial Guarantor

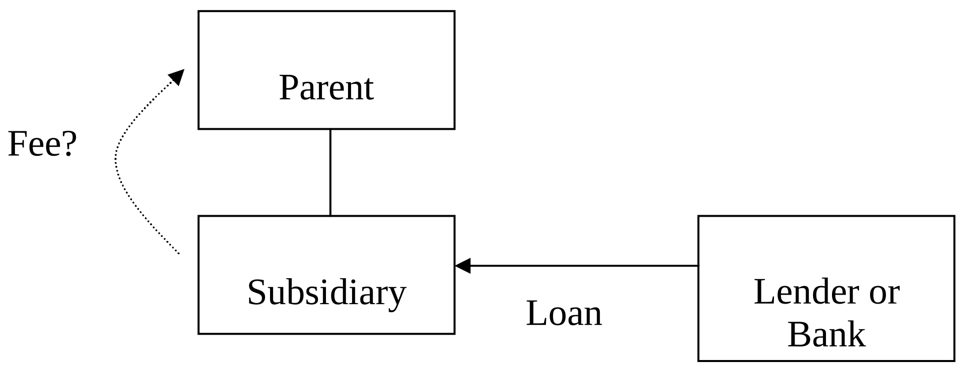
Another example is where a parent company with a stronger credit rating or balance sheet contractually guarantees the borrowings of its subsidiary at no charge. The guarantee allows the subsidiary to obtain financing at more advantageous terms from a third party lender or bank.



The parent has not incurred any marginal cost in granting the guarantee, but the parent's guarantee directly results in a reasonably identifiable benefit to the subsidiary. In this instance, it is less clear whether the parent should be required to recognize fee income for providing a financial guarantee to the subsidiary, and if so, whether the fee should be a function of the cost to the parent or by reference to the economic benefit conferred upon the subsidiary.

C. Example 3: Passive Association/Benefit Scenario

A final example is where the credit worthiness or reputation of a parent corporation allows a subsidiary, who is unable to borrow on a stand-alone basis, to obtain credit or to contract with third party lenders on terms that are more favorable than if the subsidiary were not affiliated with the parent.



Unlike the explicit credit support relationship described in Example 2 above, there is no direct contractual obligation between the parent company and the third party lender to honor the subsidiary's financial obligations. The subsidiary has been benefitted solely by virtue of the fact that it is perceived to have a responsible parent who can and will back up the loan, if called. In this instance, the market is prepared to notch up the subsidiary's credit rating simply on the basis of the subsidiary's group affiliation. There is no direct cost to the parent corporation for providing this benefit, but it may confer a measurable benefit to the subsidiary. Should the subsidiary be required to pay a fee to the parent in this case?

D. Substantial Need for Guidance

Financial guarantees present some complex policy issues; consider the following. If the activities of the parent company are *de minimus* (*e.g.*, the parent company is merely a passive actor) in these types of financial transactions, do the administrative costs and burdens placed on the taxpayer in complying with Section 482's requirements exceed the related tax revenues? Does a policy of imposing unreasonable compliance costs on taxpayers inhibit the ability to benefit from international trade? These are some of the issues faced when dealing with financial guarantees.

As the global marketplace becomes ever more accessible, financial guarantees by a rich parent company to less well-situated affiliate companies are common. This may be particularly true with respect to the motion picture industry in Los Angeles and high-technology companies in Silicon Valley. The effects of the recession and tightening of the credit markets have caused banks to demand more credit support from shareholders or affiliates of companies seeking loans. The issue of 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.

The Service has wrestled for some time with the application of Section 482 to controlled services transaction. The IRS recently issued regulations, which are intended to provide guidance regarding methods of determining taxable income in connection with controlled services transaction. Yet the regulations expressly carve-out financial transactions, including guarantees, from application of the Services Costs Method in the regulations and intentionally left open the question as to whether, and to what extent, Section 482 should apply to financial and performance guarantees. The absence of guidance in this area creates uncertainty and potential controversy over the recognition and pricing of such financial transactions.

The Secretary has acknowledged the need for guidance on this pressing topic. The author is advised that the Secretary is most interested in receiving comments and views with respect to the applicability of Section 482 to financial guarantees and credit support arrangements. The National Office may open a new regulation project on this issue, which underscores the importance and merits of the problem addressed herein.

II. The Basics: Section 482 and Transfer Pricing

A. Overview

Section 482 authorizes the Secretary to allocate income between controlled enterprises if it determines that such an allocation is necessary to prevent evasion of taxes or clearly to reflect the true income of the controlled enterprises. Section 482 provides:

> § 482. ALLOCATION OF INCOME AND DEDUCTIONS AMONG TAXPAYERS
>
> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of section 936 (h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

The purpose of Section 482 is to prevent the artificial shifting of the true net incomes of controlled taxpayers by placing controlled taxpayers on parity with uncontrolled, unrelated taxpayers. [6]

Examples of controlled services transaction – transactions by one member of a group of controlled taxpayers that results in a benefit to another member of the controlled group – include the following:[7]

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[6] *Commissioner v. First Security Bank,* 405 U.S. 394, 400 (1972); *W. Braun Co. v. Commissioner,* 396 F.2d 264, 266 (2d Cir. 1968), *revg. and remanding* T.C. Memo. 1967-66; Treas. Reg. § 1.482-1(b)(1).

[7] Treas. Reg. § 1.482-9(l) (controlled services transaction).

(1) One entity makes a loan or advance to another entity and charges no interest or does not charge an arm's-length interest rate;

(2) One entity performs services for another entity without charge or at a charge which does not reflect an arm's-length payment;

(3) One entity leases property to another entity at a rental charge that is not an arm's-length rental charge; and

(4) One entity sells property to another entity at a sales price that is not an arm's-length price.

B. Performance of Services

Where one member of a group of controlled entities performs marketing, managerial, administrative, technical, or other services for the benefit of, or on behalf of another member of the group without charge, or at a charge which is not equal to an arm’s length charge, the IRS may make appropriate allocations to reflect an arm’s length charge for such services.[8] This general principal may be illustrated by the following example:

> X and Y are corporate members of the same group of controlled entities. X operates an international airline, and Y owns and operates hotels in several cities, which are serviced by X. X, in conjunction with its advertizing of the airline, often pictures Y’s hotels and mentions Y’s name. Although such advertising was primarily intended to benefit X’s airline operations, it was reasonable to anticipate that there would be substantial benefits to Y resulting from patronage by travelers who responded to X’s advertising. Since an unrelated hotel operator would have been charged for such advertising, the district director may make an appropriate allocation to reflect

[8] Treas. Reg. § 1.482-2(b)(1). This regulation is generally applicable to tax years beginning before January 1, 2007.

> an arm's length charge consistent with the relative benefits intended.[9]

The arm's length charge for services rendered is the amount that was charged or would have been charged for the same or similar services in independent transactions with or between unrelated parties under similar circumstances considering all relevant facts.[10] However, under a safe-harbor provision found in the former regulations, a charge equal to direct and indirect costs incurred by the controlled entity in providing certain services is deemed to be an arm's-length charge.[11]

The former safe-harbor provision is inapplicable if the services are an integral part of the business activity of either the member rendering the services or the member receiving the benefit of the services.[12] A service is considered an integral part of a member of a controlled group where:

> (1) the renderer or recipient is engaged in the trade or business of rendering similar services to one or more unrelated parties;
>
> (2) a principal activity of the service provider is providing such services to related parties;
>
> (3) the renderer is peculiarly capable of rendering the services and such services are a principal element in the operations of the recipient; or
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> (4) the recipient has received a substantial amount of services for one or more related parties during its taxable year.[13]

The IRS issued temporary regulations applicable to pricing of intercompany services in 2006, Temp. Reg. § 1.482-9T, which became final

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[9] Treas. Reg. § 1.482-2(b)(2), Example 2.
[10] Treas. Reg. § 1.482-2(b)(3).
[11] *Id*.
[12] *Id*.
[13] Treas. Reg. § 1.482-2(b)(7)(i)-(iv).

in 2009.[14] The new regulations made significant changes. For example, the new regulations provide that the arm's length amount charged in a controlled services transaction must be determined under one of several methods provided: (1) services cost method; (2) comparable uncontrolled services price method; (3) gross services margin method; (4) cost of services plus method; (5) comparable profits method; (6) profits split method; or (7) certain unspecified methods described in the regulations.[15]

Additionally, the new regulations replace the prior safe harbor which was based on the charge of direct and indirect costs for non-integral services with the services cost method, listed above. The services cost method specifies that the arm's length charge is the total service costs (direct and indirect costs) without a markup.[16] The services cost method will be considered the best method, if the covered services meet one of the following conditions:

(1) do not contribute significantly to fundamental risks of business success or failure;[17]

(2) are specified by the IRS;[18] or

(3) are low margin services.[19]

Most significantly, the new regulations exclude financial transactions, include guarantees, from the applicability of the regulations.[20] This leaves open the issue as to how taxpayers are to determine whether and how much compensation is appropriate for purposes of Section 482 where controlled parties provide financial guarantees or other forms of credit support.

Should a financial guarantee constitute the performance of a service so as to fall within the scope of the pricing principles of Treas. Reg. § 1.482-9? In General Counsel Memorandum (GCM) 38499 (Sept. 19, 1980), the Commissioner agreed with a proposed revenue ruling concluding

[14] Treas. Reg. § 1.482-9.
[15] Treas. Reg. § 1.482-9(a).
[16] Treas. Reg. § 1.482-9(b)(1).
[17] Treas. Reg. § 1.482-9(b)(2).
[18] Treas. Reg. § 1.482-9(b)(4)(i).
[19] Treas. Reg. § 1.482-9(b)(4)(ii).
[20] Treas. Reg. § 1.482-9(b)(3)(ii)(H).

that the "guarantee of the parent constitutes the performance of a service for the subsidiary." The Commissioner relied upon Treas. Reg. § 1.482-2(b)(7)(v), Example (9), to reach this result:

> Example (9). X is a domestic manufacturing corporation. Y, a foreign subsidiary of X, has decided to construct a plant in Country A. In connection with the construction of Y's plant, X draws up the architectural plans for the plant, arranges the financing of the construction, negotiates with various Government authorities in Country A, invites bids from unrelated parties for several phases of construction, and negotiates, on Y's behalf, the contracts with unrelated parties who are retained to carry out certain phases of the construction. Although the unrelated parties retained by X for Y perform the physical construction, the aggregate services performed by X for Y are such that they, in themselves, constitute a construction activity.

There is some case law on this issue. In *Centel Communications Co. v. Commissioner,*[21] the Tax Court decided that shareholder guaranties were not a service, though in a very different context. In that case, a struggling telephone interconnect business obtained a loan to provide operating funds.[22] As a condition of the loan, the lender required guaranties from three of the company's shareholders.[23] The Court found that the shareholders had signed the agreements without expectation of compensation, but five years later, they received stock warrants in consideration for providing their guaranties.[24] The issue the court decided was whether the warrants were given for the performance of services under Section 83(a).[25] The court held that "within the meaning of Section 83" the shareholder had not performed a service by providing a guarantee.[26] The court, however, did not hold that providing a guarantee is never a service, and the court was analyzing only the language of Section 83 and not the transfer pricing rules.

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[21] 92 T.C. 612 (1989), *affd*. 920 F.2d 1335 (7th Cir. 1990).
[22] *Id*. at 616.
[23] *Id*.
[24] *Id*, at 617-619.
[25] *Id.*, at 626.
[26] *Id.*, at 633.

Most recently, in *Container Corporation et al., v. Commissioner*,[27] the Tax Court considered the nature of financial guarantees in order to determine whether fees paid by a US subsidiary to its foreign parent should be subject to a U.S. Withholding Tax. Several alternatives were considered. First, although the amount of the fees paid to the foreign parent was expressed as a percentage of average outstanding loan balance, the Court quickly dismissed any notion that guaranty fees were in the nature of an interest charge on forbearance since the guarantor was not required to extend funds during the term of the guaranty, but merely stand by to do so if called upon. The Court next asked whether the guaranty could be characterized as a “service.” Not finding any clear guidance in the statute, regulations or case law as to the definition of a “service,” the court looked to the dictionary:

> The common meaning of "labor or personal services" implies the continuous use of human capital, "as opposed to the salable product of the person's skill."

The Court found that a guaranty fails this test as well since the value of the guaranty stems ‘from a promise made and not from an intellectual or manual skill applied.’ Finally pushed to find whether the fees paid should be subject to US withholding, the Court found that a guaranty is more closely analogous to a service than to a loan so that the income or fees associated with the guaranty should be sourced to the jurisdiction where the guaranty is made rather than the jurisdiction either of the party to whom the guarantee is owed or the party on whose behalf the guaranty is made.

Because the controlled parties in the *Container* case actually charged a guaranty fee which the Service did not challenge pursuant to Section 482 as either excessive or inadequate, not much can be taken from the opinion other than a deeper understanding of the challenges faced by the taxing authority in trying to define circumstances when fees should be charged and how they should be measured. As will be discussed below, the United States is not the only jurisdiction that is struggling to grasp these questions.

[27] LEXSTAT 2010 TNT 32-9, 134 T.C. No. 5, (Feb. 18, 2010)..

III. PROPOSED GUIDANCE UNDER SECTION 482 AND TREAS. REG. § 1.482-9

To address the uncertainty surrounding the tax treatment of financial guarantees under Section 482, the IRS should issue guidance, preferably in the form of temporary regulations, setting forth: (i) standards for determining what types of transactions constitute financial guarantees for purposes of Section 482; (2) under what circumstances does the relationship between a parent company and a subsidiary rise to the level of triggering the applicability of Section 482 and require an arm's length pricing adjustment; and (3) what is the proper pricing or valuation methodology for financial guarantees. Each of these issues, along with specific recommendations for the IRS' consideration, is discussed below.

A. What Constitutes a Financial Guarantee?

A starting point is to provide guidance as to what constitutes a "financial guarantee" for purposes of controlled services transactions under Section 482. No definition exists in the regulations, and a clear working definition would greatly assist taxpayers in ascertaining whether a particular financial transaction falls within the scope of Section 482.

The Australian Tax Office ("ATO") has provided meaningful guidance as to what constitutes a financial guarantee or credit support arrangement in a paper entitled, *Intra-group Finance Guarantees and Loans – Application of Australia's Transfer Pricing and Thin Capitalization Rules*, June 2008 ("ATO Paper"). The ATO defines the term "financial guarantee" as follows:

> A guarantee is a legally binding commitment by the parent that it will meet the liabilities arising under the terms of a loan from an independent party in the event of a default by the borrowing subsidiary.[28]

Additionally, the ATO Paper identifies two distinct categories of financial guarantees, explicit credit support and implicit credit support, which are helpful in further defining the term. The ATO Paper states:

[28] ATO Paper, ¶ 83.

(a) "*explicit credit support*", which is a formal legal agreement, whether a guarantee, letter of comfort or other assurance, by which an enterprise (the "guarantor") agrees in respect of a loan to an associated enterprise to pay to the lender any amount payable on that loan in respect of which the borrower defaults; and

(b) "*implicit credit support*", which includes:

(i) letter of comfort or similar statement of intent which does not constitute a contractually binding commitment of the type referred to at (a); and

(ii) credit support obtained as an incidental benefit from the taxpayer's passive affiliation with the multinational group, its parent or another group member.[29]

(Emphasis added.)

Building upon the principles set forth by the Australian Tax Office, this Paper proposes the following definition of "financial guarantee":

- A financial guarantee is a commitment by a parent company that it will meet the liabilities arising under the terms of a loan from an independent party in the event of a default by the borrowing subsidiary.

- A financial guarantee may be an explicit credit support arrangement, which is a contractually binding legal commitment, whether a guarantee, letter of comfort or other assurance.

- A financial guarantee may be an implicit credit support arrangement such as: (i) a letter of comfort or similar statement of intent which does not constitute a contractually binding commitment; or (ii) a credit support obtained as an incidental

[29] ATO Paper, ¶ 53.

benefit from the taxpayer's passive affiliation with a member of the group of controlled taxpayers.

- Other forms or arrangements of financial guarantees may exist.

For the reasons set forth above, this Paper recommends that the IRS provide guidance as to the meaning of the term "financial guarantee" for purposes of Section 482.

B. The Case of Passive Association[30]

In dealing with financial guarantees between members of a group of controlled taxpayers, one scenario to consider is whether a subsidiary should be required to pay a service fee to a parent company, where the subsidiary's economic benefit results from its status as a member of a controlled group and not to any specific activity by the parent company.

This Paper recommends that no service fee should be charged in this case and that the IRS issue guidance in accordance with this recommendation. The regulations, as well as additional authority, clearly support this recommendation, as shown below.

1. *Treas. Reg. § 1.482-9*

The regulations define a "*controlled services transaction*" as any activity by one member of a group of controlled taxpayers (the renderer) that results in a benefit to one or more other members of the controlled group.[31] An activity is considered to provide a "*benefit*" to the recipient if the activity directly results in a reasonably identifiable increment of economic or commercial value that enhances the recipient's commercial position, or that may reasonably be anticipated to do so.[32]

An activity is not considered to provide a benefit to the recipient if, at the time the activity is performed, the present or reasonably anticipated benefit is so "*indirect or remote*" that the recipient would not be willing to pay an uncontrolled party to perform a similar activity, and would not be willing to perform such activity for itself for this purpose.[33] The determination whether the benefit from an activity is indirect or remote is

[30] It is important to point out that the term "passive association" does not necessarily mean an "implicit credit support" arrangement. A credit support obtained as an incidental benefit from the taxpayer's passive affiliation with the multinational group is an example of passive association. However, a letter of comfort or similar statement of intent, which does not rise to the level of a formal legal agreement, does not constitute passive activity on the part of the parent company but yet falls within the category of an "implicit credit support" arrangement.
[31] Treas. Reg. § 1.482-9(l)(1).
[32] Treas. Reg. § 1.482-9(l)(3)(i).
[33] Treas. Reg. § 1.482-9(l)(3)(ii).

based on the nature of the activity and the situation of the recipient, taking into account all facts and circumstances.[34]

The regulations specifically carve-out "passive associations" when referring to the rendering of a "benefit." The regulations state:

> *(v) Passive association. 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.

(Emphasis added.)[35] Moreover, several of the examples in the regulations clearly support the conclusion that no service fee should be charged in the case of passive association. In Example 15 of the regulations,[36] the Service concludes that no benefit is incurred where a company's ability to obtain a contract on favorable terms is due to a company's status as a member of a controlled group and not to any specific activity by the parent company. Example 15 states:

> *Example 15. Passive association/benefit.* Company X is the parent corporation of a large controlled group that has been in operation in the information-technology sector for ten years. Company Y is a small corporation that was recently acquired by the Company X controlled group from local Country B owners. Several months after the acquisition of Company Y, Company Y obtained a contract to redesign and assemble the information-technology networks and systems of a large financial institution in Country B. The project was significantly larger and more complex than any other project undertaken to date by Company Y. Company Y did not use Company X's marketing intangibles to solicit the contract, and Company X had no involvement in the solicitation, negotiation, or anticipated execution of the contract. For purposes of this

[34] *Id*.
[35] Treas. Reg. § 1.482-9(l)(3)(v).
[36] Treas. Reg. § 1.482-9(l)(5), Example 15.

> section, *Company Y is not considered to obtain a benefit from Company X* or any other member of the controlled group because the ability of Company Y to obtain the contract, or to obtain the contract on more favorable terms than would have been possible prior to its acquisition by the Company X 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.*

(emphasis added); *also see* Treas. Reg. § 1.482-9(l)(5), *Example 19, Passive association/benefit* (Company Y is not considered to obtain a benefit from Company X where its ability to obtain plastic containers at a favorable rate is due to Company's Y status as a member of the Company X controlled group and not to any specific activity by Company X).

In short, the regulations clearly take the position that there should be no service charge in the case of passive association.

2. *OECD Guidelines*

The Organization for Economic Co-operation and Development guidelines (the "OECD Guidelines") on transfer pricing further support the conclusion that no service fee should be charged in the case of passive association.[37] Chapter 7 of the OECD Guidelines provides specific commentary on intra-group services. Chapter 7 relates to two issues: whether an intra-group service has, in fact, been provided, and if so, what the proper arm's length price is for the service. In particular, a key principal enunciated in paragraph 7.13 reads:

> Similarly, an associated enterprise should not be considered to receive an intra-group service when it obtains incidental benefits attributable solely to its being part of a larger concern, and not to any specific activity being performed. *For example, no service would be received where an associated enterprise by reason of affiliation alone has a credit rating*

[37] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration* (Paris: OECD Publishing, 1995), as supplemented through 2001.

> *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*, or where the enterprise benefited from the group's reputation deriving from global marketing and public relation campaigns. In this respect, passive association should be distinguished from active promotion of the MNE group's attributes that positively enhances the profit-making potential of particular members of the group.

(Emphasis added.) Accordingly, the OECD Guidelines directly support this Paper's recommendation that no service fee should be charged where a benefit is received merely by reason of affiliation alone.

3. *Australian Tax Office*

Finally, the Australian Tax Office takes the position that no service fee should be charged in the case of passive association. The ATO identifies a category of credit support referred to as an "implicit credit support" arrangement, which the ATO defines as "credit support obtained as an incidental benefit from the taxpayer's passive affiliation with the multinational group, its parent or another group member."[38] The ATO finds that no service fee should be charged for this type of arrangement, reasoning, in part:

> 109. Where a subsidiary derives *implicit credit support* as an incidental benefit from its parental affiliation, the benefit derives from the market, not from the provision of any service by the parent. The parent has limited its exposure to the equity it has already subscribed.
>
> 110. Depending on the facts and circumstances, it may be that a subsidiary that is not creditworthy on a pure stand-alone analysis is able to obtain the debt funding it needs because the market is prepared to notch up the credit rating on the basis of the subsidiary's group affiliation. For example, a subsidiary with a stand-alone credit rating of BB which would make it uncreditworthy and unable to

[38] ATO Paper, ¶ 53.

> complete in its industry may be given a credit rating of A+ by the market without any further financial support or binding commitment from the parent. *No charge should be made by the parent for this benefit.*

(Emphasis added.)[39]

4. *Recommendation*

In summary, no arm's length service fee should be charged in the case where a subsidiary receives an incidental benefit in the form of credit support entirely due to its status as a member of the parent company's controlled group and not to any specific activity by the parent or any other member of the controlled group. The IRS should provide specific guidance along these lines.

C. The Case of Active Association

The next scenario to consider is where a parent company undertakes some level of activity that results in conferring a financial benefit to a subsidiary. A parent company's active participation can take various forms from merely sending a letter of comfort to executing a explicit credit support agreement, whereby the parent company agrees to legally stand behind the subsidiary in the event of a default on a loan.

The central question is under what circumstances does the relationship between a parent company and a subsidiary rise to the level of triggering Section 482 and require an arm's length pricing adjustment? The answer to this questions turns, in part, on the category of credit support arrangement involved in the transaction.

1. *Explicit Credit Support Arrangement*

As previously discussed, an explicit credit support arrangement is a formal legal agreement whereby a parent company contractually guarantees a loan of a subsidiary. This type of credit support

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[39] ATO Paper, ¶¶ 109-110.

arrangement should be a compensable transaction because the parent company undertakes specific activity that improves the subsidiary's creditworthiness. The examples in the regulations support this conclusion. In Example 16,[40] the Service found that a subsidiary is considered to receive obtain a benefit from the parent company's execution of a performance guarantee:

> *Example 16. Passive association/benefit.* The facts are the same as in Example 15, except that Company X executes a performance guarantee with respect to the contract, agreeing to assist in the project if Company Y fails to meet certain mileposts. This performance guarantee allowed Company Y to obtain the contract on materially more favorable terms than otherwise would have been possible. *Company Y is considered to obtain a benefit from Company X's execution of the performance guarantee.*

(Emphasis added.) A performance guarantee is analogous to an explicit credit support arrangement because, in both situations, the parent company is legally required to stand behind the contractual obligations of a subsidiary. *Also see* Example 17 (Company Y is considered to obtain a benefit from Company X's negotiation of a contract).[41]

The Australian Tax Authority agrees with the regulations that a service fee should be charged where a parent company executes an explicit credit support arrangement.[42] Likewise, the Canadian Tax Court reached a similar result in *General Electric Capital Canada Inc. v. Her Majesty The Queen*, 2009 TCC 563 (Dec. 4, 2009), where the Court found that GE was entitled to deductions for C $136 million in guarantee payments it made to the U.S.-based General Electric Capital Corp. between 1996 and 2000. This case is discussed more fully below.

Accordingly, the IRS should issue guidance as to under what circumstances is an explicit credit support arrangement a compensable transaction.

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[40] Treas. Reg. § 1.482-9(l)(5), Example 16.
[41] Treas. Reg. § 1.482-9(l)(5), Example 17.
[42] ATO Paper, ¶ 123.

2. *Implicit Credit Support Arrangement*

Where a parent company provides "implicit credit support" such as a letter of comfort or similar statement of intent, which does not constitute a contractually binding commitment, the subsidiary should not be considered to obtain a benefit and the transaction should not be compensable. Example 18 of the regulations reach this same result:

> *Example 18. Passive association/benefit.* The facts are the same as in Example 15, except that *Company X sent a letter to the financial institution in Country B*, which represented that Company X had a certain percentage ownership in Company Y and that Company X would maintain that same percentage ownership interest in Company Y until the contract was completed. This letter allowed Company Y to obtain the contract on more favorable terms than otherwise would have been possible. Since this letter from Company X to the financial institution simply affirmed Company Y's status as a member of the controlled group and represented that this status would be maintained until the contract was completed, *Company Y is not considered to obtain a benefit from Company X's furnishing of the letter.*

(Emphasis added).[43] The treasury regulation is persuasive authority on this point.

The Australian Tax Authority agrees with the regulations that no fee should be charged where the parent company merely furnishes a letter of comfort or other similar statement of intent. The ATO Paper states, in part:

> 121. *Instead of giving a formal letter of guarantee, a parent may provide a letter of comfort or other statement of intent that is not intended by the issuer to constitute a legally binding commitment to repay the subsidiary's loan in the event of a default*. This intent and its non-binding nature are usually explicitly stated to the subsidiary or other recipient of the comfort letter. Issuers may

[43] Treas. Reg. § 1.482-9(l)(5), Example 18.

> also have to consider the risk to reputation or the loss of relationship with the lender. * * * In the final analysis the lender has advanced funds without the need for a guarantee but with the expectation that the parent will stand behind the subsidiary. * * *
>
> 122. It follows on this analysis that the benefits of implicit support from letters of comfort or similar non-binding statements of intent *should be treated similarly to any creditworthiness benefits a subsidiary incidentally obtains from its group or parental affiliations, and the onus would be on the taxpayer to demonstrate a valid basis for any charge for the giving of a letter of comfort*.

(Emphasis added.)[44]

In summary, an "implicit credit support" arrangement should not be a compensable transaction in the case where a parent company merely provides a letter of comfort or similar statement of intent which does not constitute a contractually binding commitment, absent a showing by the taxpayer as to why a charge should be justified under the facts and circumstances. This IRS should consider issuing guidance along these lines.

D. Valuation of Financial Guarantees

1. *Overview*

The final issue is how to properly value a financial guarantee for purposes of Section 482. As a threshold matter, the IRS has yet to promulgate guidance as to the proper valuation methodologies to use with respect to financial guarantees. The service regulations mention financial guarantees, but only to explicitly preclude the application of the regulations to financial transactions, including guarantees, at this time and to suggest that guidance on pricing is forthcoming. Accordingly, a taxpayer is left with the quandary of pricing a financial guarantee under the arm's length standard and best method rule without any specific valuation methodology for doing so from the Service.

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44 ATO Paper, ¶¶ 121-122.

There is often a lack of comparable data upon which to value a financial guarantee. Take for example the situation where a parent company provides a guarantee to a subsidiary that is unable to borrow the funds that it needs on a stand-alone basis. This scenario raises the basic question as to whether an independent party would provide a guarantee to support the borrowing of a company that could not borrow in its own right. In these types of cases, it is unlikely that an arm's length consideration will be able to be ascertained from market data because independent comparables are unlikely to exist.

Both the Australian Tax Office and the Canadian Tax Court have considered the issue of valuing financial guarantees, and their reasoning and commentary is helpful guidance on this issue.

2. *Australian Tax Office*

The Australian Tax Office addressed the question of how to determine an arm's length charge for a chargeable financial guarantee in the ATO Paper. The Australian Tax Office concludes that a comparable uncontrolled price method or a benefits spread method approach may be used provided the method is appropriate to the context and is the most reliable method. The ATO Paper states:

> 128. Often a *comparable uncontrolled price (CUP) or cost plus method* is used to price an intra- group service, although any of the arm's length pricing methods as per Chapters I-III of the OECD Guidelines and Taxation Ruling TR 97/20 may be used provided the method is appropriate to the context and is the most reliable method. Consistent with general guidance on the use of arm's length pricing methods, a CUP method is the most appropriate method to determine an arm's length guarantee fee where there is sufficient reliable data of fees charged for comparable guarantee arrangements in comparable circumstances between comparable independent parties. Accordingly a guarantee arrangement cannot be analyzed at a transactional level without regard to the context. The CUP method would be suitable in cases where a creditworthy subsidiary that is able to raise the debt funding it needs on a stand-alone basis obtains better terms with the benefit of a parent guarantee. *A similar approach would be a*

benefit approach ("spread method") under which an arm's length fee is estimated as the spread between the interest rate the borrower would have paid without the guarantee and the rate it pays with the guarantee, less an arm's length discount.

(Emphasis added.)[45] The Australian Tax Office explains that the "spread method" seeks to value a guarantee from the perspective of the borrower.[46] The benefit is the lower interest rates charged on guaranteed borrowings compared to what would be charged without the guarantee. For example, assume a parent company with an "AA" rating with a subsidiary with a "BBB-" rating on a stand-alone basis. A guarantee from the parent may enable the subsidiary to raise the funding it needs based upon an "AA" rating of the parent. The pricing of the guarantee fee is based upon the spread between the interest rate payable by the subsidiary as an "AA" rated borrower and the rate it would pay as a "BBB-" rated borrower.[47]

In short, the spread valuation method suggested by the Australian Tax Office is one way to objectively value a financial guarantee.

3. *The* General Electric *Case*

In *General Electric Capital Canada Inc. v. Her Majesty The Queen*[48] ("GE Case"), the Canadian Tax Court was confronted with the question of how to determine an arm's length fee for a financial guarantee between a parent and a wholly-owned subsidiary.

There, parent company General Electric Capital Corporation (GE USA) guaranteed payments due under securities issued by subsidiary GE Capital Canada Inc. (GE Canada) and charged a one percent per annum fee for the guarantees.[49] The Minister of National Revenue (the "Minister") denied the deductions for guarantee fees claimed by GE Canada.[50] The Minister contended that GE Canada received no economic benefit from the guarantee, and, as a result, the "arm's length" price for the guarantee should be zero.

[45] ATO Paper, ¶ 128.
[46] ATO Paper, ¶ 154.
[47] ATO Paper, ¶¶ 155-156.
[48] 2009 TCC 563 (Dec. 4, 2009).
[49] *Id.* at ¶¶ 62-65.
[50] *Id.*, at ¶¶ 71-72.

The Canadian Tax Court held in favor of GE Canada, allowing it to maintain as a deductible expense 100 percent of the guarantee fee paid to GE USA. The Court reasoned, in part, that the explicit guarantee raised GE Canada's credit rating and lowered its borrowing costs. To value the financial guarantee, the Court appeared to adopt a yield approach, whereby the interest cost savings is determined based upon the credit rating differential between the rate achieved with the financial guarantee in place and without it.[51]

The GE case stands for the proposition that a spread approach may be an appropriate valuation methodology for financial guarantees under certain circumstances. GE was able to charge a fee equal to the difference in percentage rates that would be charged with and without guarantees. This valuation approach is similar to the one suggested by the Australian Tax Office.

In light of the GE case and ATO Paper, the Service should provide guidance with respect to the use of a spread approach with respect to valuing financial guarantees.

4. *Recommendations*

This Paper recommends that the IRS issue specific guidance with respect to how to value financial guarantees. The Paper makes the following recommendations in this regard:

a. Definitions. Define a financial guarantee as including (i) an explicit credit support arrangement, (ii) an implicit credit support arrangement, or (iii) passive affiliation.

b. Compensable Transactions. Provide that no compensation is required, or may be imposed, for a financial guarantee arising from passive affiliation. Provide that in the case of an explicit credit support arrangement or an implicit credit support arrangement, arm's length compensation is appropriate where the recipient of the guarantee (*i.e.*, the subsidiary) receives a benefit.

[51] *Id*., at ¶¶ 252-253, 304.

c. **De minimis *exception*.** A safe harbor could exist where no service fee would be required if the amount of the debt being guaranteed is below a certain threshold amount. The rationale for eliminating the need to pay a service fee is the undue burden placed taxpayers in having to value *de minimus* transactions occurring in the credit markets.

d. ***Methods.*** Provide the following methods to price a financial guarantee:

(i) ***CUP method.*** A comparable uncontrolled price (CUP) method is an appropriate method to determine an arm's length guarantee fee where there is sufficient reliable data of fees charged for comparable guarantee arrangements in comparable circumstances between comparable independent parties.

(ii) ***Spread Method*.** Under this method the arm's length fee is determined as the spread between the interest rate the borrower would have paid without the guarantee and the rate it pays with the guarantee, less an arm's length discount.

(iii) ***Unspecified methods.*** Other unspecified methods that are warranted under the particular facts and circumstances of the case at hand.

Finally, the paper respectfully requests the rationale for why the new service regulations specifically carve-out financial guarantees and suggest that, at least in the interim, the Service allow the new service regulations to apply to financial guarantee transactions.

V. CONCLUSION

This Paper has attempted to provide a framework for discussion purposes with respect to the proper tax treatment of financial guarantees under Section 482. The current state of the law creates uncertainty with respect to the application of Section 482 to financial transactions, and in particular guarantees. Taxpayers need specific and constructive guidance in this area for purposes of tax planning and compliance.