Transfer Pricing of Financial Transactions — A Challenging Landscape

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Multinational corporations routinely engage in intercompany financial transactions to operate their global businesses. These transactions may include loans to fund a capital investment or acquisition, short-term working capital loans, factoring to free up cash at a subsidiary, and cash pooling to maximize the group’s use of internal cash and minimize external interest expense. Financial transactions are primarily contractual obligations and often less subjective compared with other areas of transfer pricing. In addition, unlike many other areas of transfer pricing, extensive reliable market data exist for determining the arm’s-length price, or interest rate, for most financial transactions.

However, many tax authorities have concerns, whether justifiable or not, that it is relatively straightforward for taxpayers to use intercompany financial transactions to shift profits and reduce their tax burden with no underlying business rationale — such as by manipulating contractual terms by adding loan terms, like the ability to prepay the loan or defer cash interest, that increase the interest rate. There is also concern about taxpayers characterizing as debt what might be more accurately characterized as equity, to generate deductions or avoid dividend withholding taxes on repatriation of income. Tax authorities have manifested these concerns through aggressive enforcement actions.

In the United States, guidance on intercompany loan pricing is found in reg. section 1.482-2. In addition, general transfer pricing concepts — for example, accepting the transaction as structured unless it lacks economic substance — are emphasized throughout reg. section 482; and regulations under section 385 provide general guidance on whether an instrument is debt or equity and point the taxpayer to case law for relevant factors to consider.

Until recently, the OECD transfer pricing guidelines did not explicitly address financial transactions. But the 2015 release of the OECD’s final reports for the base erosion and profit-shifting actions 8-10 led to a new Chapter X of the OECD guidelines that provides guidance on how to price financial transactions and whether a transaction should be regarded as debt, including a discussion on reasonableness of contractual terms. In some areas, such as delineation of the financial transaction (discussed below), the OECD’s approach under Chapter X diverges sharply from U.S. practice.

Compounding the pain felt by taxpayers from new rules, increased tax authority scrutiny, and sometimes inconsistent interpretation of rules or enforcement among taxing jurisdictions,

1. Often referred to as the Mixon factors, these include factors such as presence or absence of a fixed maturity date, typical creditor rights to enforce payment of principal and interest, ability of the borrower to obtain a loan from a third party, adequate capitalization of the borrower, and failure to pay interest or principal.

numerous companies also face internal pitfalls. Many of the decisions involving where, how, and at what price internal financial transactions occur, are made by the company’s treasury department. At times treasury departments fail to appreciate the tax considerations of these transactions — an oversight that could potentially be catastrophic for the company once the transaction is audited.

This article equips tax departments with practical tips for navigating challenges when structuring and pricing intercompany financial transactions, giving due consideration to recent developments and continued sources of uncertainty.

**Define the Transaction Carefully**

Chapter X outlines factors to be considered in accurately delineating (or describing) a financial transaction. Some of these considerations overlap with the typical factors under U.S. practice and law. But as discussed below, Chapter X problematically goes a step beyond:

- General U.S. practice respects contractual terms of the financial transaction and pricing of the transaction given those terms. Chapter X, however, suggests inquiry into the economically relevant characteristics to inform the nature and terms of the transaction. As part of this inquiry, Chapter X suggests inferring the terms of the financial transaction based not on the actual contract and risks involved, but on hypothetical constructs that may recharacterize the actual transaction.
- Chapter X gives an example in which two related entities enter into an intercompany loan with a 10-year term. However, because the multinational group typically uses one-year revolving loans from unrelated lenders for working capital management, Chapter X takes the position that accurate delineation of the related-party debt financing is also assumed to be a one-year revolving loan rather than the 10-year term in the contractual agreement. The example ignores that the borrower, a smaller entity compared with the multinational group, may benefit from or prefer the stability of having a fixed interest rate for 10 years versus being subject to the unpredictability of year-on-year interest rate changes. While this is a stylized example, the overall tenor of discussion in Chapter X seems to suggest the multinational group’s practices be given preference at the expense of the specific circumstances of the borrower and the terms of the related-party agreement.
- In another example the parent of a multinational group makes an unsecured loan to a subsidiary. Chapter X posits that the parent, because of its ownership of the subsidiary, effectively controls the subsidiary’s assets and hence unless these assets are already pledged elsewhere, the accurate delineation of the transaction would be to assume it is a secured loan despite the terms of the agreement specifying that the loan is unsecured. This scenario could be viewed as a departure from the arm’s-length principle of treating the members of a multinational group as separate entities rather than inseparable parts of a single unified business.

Recharacterization of the financial transaction with imputed terms is not just a hypothetical concern. In Australia, the federal court in two prominent cases assumed the parent company would have provided a guarantee for a related-party loan, even though the contractual loan terms did not have one in place. This presumption ignored the financial cost and risks to the parent of doing so.

In Canada, a recent consultation paper on modernizing Canada’s transfer pricing rules states that intercompany loans are burdensome to audit and recommends that the credit rating of all intercompany loans be based on the multinational group’s credit rating and that only a limited set of

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3 Id. at Chapter X, section B.
4 Id. at Chapter X, para. 10.37.
5 Id. at Chapter X, para. 10.56.
6 Id. at Chapter I, para. 1.6.
8 Department of Finance Canada, “Consultation on Reforming and Modernizing Canada’s Transfer Pricing Rules” (2023).
contractual terms be allowed. This would contradict the very definition and application of the arm’s-length principle. Assuming the parent’s credit rating without analysis of its applicability to the intercompany loan violates the separate-entity approach of applying the arm’s-length principle. Further, limiting the allowable contractual terms of a related-party loan may ignore the actual economic conditions of the transaction.

While taxpayers cannot predict how tax authorities will view the facts of a financial transaction or the inferences they will draw from these facts on the terms of the transaction, taxpayers can control certain variables such as their selection of financial transaction terms. Therefore, it is best practice for taxpayers to make conscious decisions around the terms of the transaction and to document the rationale for the selections made. For example:

- Does the financing require an eight-year loan, or will a five-year loan meet the needs?
- Is the clause allowing the related-party borrower to accrue interest into principal rather than pay interest based on a reasoned expectation of future cash flow variability?
- Is there a rationale, such as maintaining financial flexibility, to have no collateral for the loan or to include the option of prepaying the loan without any penalty?

Taxpayers seeking to limit their exposure should avoid the appearance of selecting gratuitous terms primarily to increase fees or interest rates on their intercompany financial transactions.

**Accurate Intercompany Agreements**

Contractual agreements governing uncontrolled financial transactions, such as a bond issuance, can be extensive, with significant details governing every aspect of the financial instrument. While some taxpayers take this approach, especially for large intercompany loans, it is usually best to limit the agreement to terms that fit the particular circumstances of the transaction, can be reliably implemented by both parties, and are consistent with the pricing.

It is essential that the intercompany contract is not an afterthought and that it is consistent with the desired terms and structure of the loan and the transfer pricing study (and not an automatic leverage from existing older agreements), leaving as little room for creative interpretation by a tax authority as possible. Some contractual terms are particularly relevant to supporting the debt nature of the transaction, such as maturity date, obligation to make payments, the payment schedule, and rights of the obligee or lender in the event of default. Contractual loan documents that are vague may call into question whether this is truly a debt obligation.

There is also the question of whether an intercompany contract should include covenants. Covenants either restrict one party from certain actions such as incurring additional debt (incurrence covenants) or are financial metrics that need to be monitored for continued availability of funds (maintenance covenants). It would be unduly onerous for intercompany agreements to include maintenance covenants to the same degree as the typical uncontrolled agreement. However, incurrence covenants (for example restrictions on additional senior debt) help protect the interest of the lender without much additional monitoring effort. Inclusion of certain select covenants can go a long way in defending the debt characterization of an intercompany loan.9

**Correctly Price the Transaction**

**Estimate Credit Ratings of the Borrower and Loan**

Credit risk is the foundation of pricing any financial transaction — higher credit risk entails a higher price. Credit risk captures the risk that the obligor will fail to meet its contractual obligations — for example, the risk a borrower will fail to make interest payments or repayment of principal on a timely basis.

Often, the obligor or borrower in the financial transaction will not have a credit rating published by a public ratings agency. There are various methods and subscription models published by

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9 In a recent case in the United Kingdom, the court cited lack of any covenants in the loan agreement as one of the key factors in disallowing interest expenses.
ratings agencies that can be relied upon to estimate credit ratings. Some of these, such as the industry-specific credit scoring methods published by Moody’s Investors Service, incorporate both quantitative and qualitative factors. Others, such as Credit Analytics from S&P, primarily rely on financial data.

These methods or models do not, however, fully incorporate the proprietary information, approaches, models, or judgments used by the ratings agencies in their credit ratings. Consequently, for larger or more significant financial transactions, it is helpful to enhance the reliability of the estimated credit rating conclusion through multiple approaches. The quality of the analysis will be judged by the reasonableness of the final result.

Using credit rating methods and models is not simply a matter of plugging in information. Reliable application requires taking account of other considerations:

• Do the financial data appropriately reflect the impact of the additional debt?
• Is the choice of the credit rating approach or model (for example, RiskCalc) appropriate for the type of transaction, such as a loan to a real estate asset holding company?
• Is there an explicit analysis to distinguish the rating of the issuer (borrower) from the rating of the issue (transaction under review)?
• If the group credit rating is the starting point of the analysis, what adjustments have been made to assess the credit rating of the transaction under consideration?

Assess Parental or Group Support

U.S. rules state, among other things, that the interest rate on any intercompany loan is a function of the “credit standing of the borrower.” Taking the separate-entity approach in applying the arm’s-length principle means the borrower’s credit risk or profile should only be a function of its own financial and business health and not take into account the financial and business health of related parties. This means that a borrower’s credit risk should not be affected by its group membership — that is, there should be no presumption of implicit parental or group support.¹⁰

However, the position taken in Chapter X is that group support should be accounted for when estimating the credit rating of an intercompany loan. Under this view, the separate-entity approach does not entail treating the borrower as an “orphan” but rather viewing it as a legal entity with all its characteristics, including membership in a group. The argument being that an uncontrolled lender would assess the credit risk of the borrower keeping in mind the possibility that the parent company or other affiliate (even in the absence of an explicit guarantee) may come to the rescue in the event of the borrower’s impending default.

These dueling positions are an area of disagreement both in the United States and elsewhere. So far, implicit support has been raised by the IRS in audits, but there has not yet been any settled U.S. court case on this issue.¹¹ If one accepts the argument that implicit group support matters, there is still the question of what value, if any, to ascribe to it. Answering this question requires assessing:

• The parent’s ability to help the subsidiary: Does the parent or group have the financial wherewithal to reasonably come to the financial rescue of the related-party borrower?
• Parent’s willingness to help a subsidiary: The question of willingness revolves around a number of qualitative judgments, such as the extent of the ties between the borrower and its affiliates or the potential harm to the group’s credit rating, reputation, or business from the borrower defaulting.

In its discussion of credit ratings, Chapter X provides some encouragement for tax authorities to rely on the parent or group credit rating as the default when there are perceived challenges in ascertaining the credit rating of the related-party borrower.¹² This would be in direct contradiction

¹⁰ We use the terms “parental support” or “group support” interchangeably as typically support would be provided by the parent company or by the group including the parent company.
¹¹ A recently filed case in the U.S. Tax Court will involve this issue. Eaton Corp. v. Commissioner of Internal Revenue, No. 2608-23.
¹² OECD guidelines, at para. 10.81.
to the arm’s-length principle as stated in Chapter I of the OECD guidelines. Also, assuming the parent or group credit rating as the default without appropriate economic support for doing so may create tax risk in the lender’s jurisdiction. In addition, research from Moody’s Investors Service suggests that, except in limited circumstances, the borrower’s credit rating would not be uplifted to that of the parent without an explicit parental guarantee incorporating provisions that provide complete substitution of the parent’s credit for that of the affiliate.\(^{13}\)

Regardless of the ultimate position a taxpayer takes regarding implicit parental or group support, evaluating the effect of that support is a worthwhile exercise and should be part of a robust transfer pricing analysis — if only to understand any adverse tax authority interpretations or to reserve for uncertain tax positions.

**Set the Appropriate Price or Interest Rate**

The interest rate can only be reliably benchmarked after setting contractual terms that are well-reasoned and estimating the credit rating considering the key features of the loan. The breadth and depth of publicly available market data are helpful in setting transfer prices for most financial transactions including loans of different types (for example, corporate loan for acquiring a business, shareholder loan to acquire real estate assets, or loans for investing in credit funds).

While the taxpayer’s tax team can defer to their treasury colleagues for an estimate of interest rate, the treasury team may not be thinking in terms of transfer pricing rules and could potentially trigger transfer pricing exposure. For example, pricing an intercompany loan based on a survey or a quote from the taxpayer’s bank may appear to be an efficient approach, but this would not be accepted as appropriate support for arm’s-length pricing under either the U.S. transfer pricing regulations or the OECD guidelines. Transfer pricing rules require reliance on actual market transactions.

Furthermore, these transactions should be selected without bias, with adjustments made to improve reliability if possible.

A reliable transfer pricing benchmarking exercise should account for the contractual terms of the intercompany transaction or for differences between the intercompany transaction and uncontrolled comparables:

- Have we selected the right database to begin with? For example, would it be appropriate to use corporate bond data to analyze a leveraged investment in a real estate asset through a blocker structure?
- If we have the right database, have we identified the right set of comparables? For example, if the related-party loan has an option to allow prepayment without penalty, then is it appropriate and sufficient to select all callable transactions?
- Have all the necessary adjustments been made to the comparables to improve reliability?

**Get Everyone at the Company on Board**

The preponderance of intercompany loans and the increasingly bright spotlight shined on these transactions by tax authorities make it more imperative than ever for taxpayers to have robust governance processes around them. Taxpayers need to define roles and responsibilities to govern both common and repeating small transactions as well as less frequent or larger ones, such as loans to finance an acquisition or guarantees for external loans. Other financing activities, such as cash pooling and factoring, should also have robust processes managing them. Consequently, this is another area in which tax professionals should be working with other parts of the enterprise, rather than leaving implementation and management of financial transactions solely to treasury colleagues for example.

It is understandable that the efforts and resources required to administer and support large loans or material financial transactions may be scaled down for smaller ones. For example, some of the burden in documenting and analyzing smaller loan transactions can be handled by having a standard approach and set of policies that can be duplicated across

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\(^{13}\)Moody’s Investors Service’s publications, “Assessing Affiliate Support in the Absence of a Guarantee” (July 19, 2021) and “Moody’s Identifies Core Principles of Guarantees for Credit Substitution” (Nov. 11, 2010).
transactions. Either way, the underlying principles should be the same:

• Are the loan terms reasonable?
• Are they properly recorded in an agreement?
• Is the credit rating supportable, including taking into consideration the possibility of implicit support?
• Does the borrower have the financial capacity to incur the loan?
• Is the interest rate benchmarking supportable?

Recent guidance and emerging standards emphasize the importance of considering the suitability of key terms to an intercompany financing transaction, relative to market conventions as well as the company’s practices; ensuring consistency with written agreements; evaluating the possible effect of implicit support; and applying the proper transfer pricing principles when pricing the transaction.

Document and Monitor

Successful planning and defense of any intercompany financial transaction hinges on efficient execution of the steps discussed in this article and robust documentation of the work done. There is no good substitute for detailed, complete, and contemporaneous transfer pricing documents that detail all the facets of the transaction and the analyses undertaken.

Routine monitoring of the loan is equally critical to respecting the debt nature of the financial transaction. Important steps include ensuring:

• interest and principal payments are made timely;
• any loan covenants are respected;
• in-the-money options are evaluated to consciously decide whether to exercise the option; and
• planning is undertaken prior to the maturity date of the transaction so there are no lapses or automatic renewals.

Continued documentation justifying business rationale behind not exercising a specific option listed in the financial transaction’s contractual agreement, or departure from a loan amortization schedule, or plans of refinancing are key to a successful defense in the event of an audit.14

14 The information in this article is not intended to be “written advice concerning one or more Federal tax matters” subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the authors only and does not necessarily represent the views or professional advice of KPMG LLP.

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