

Aatma Capital
Nurturing Relationships



Chapter B.9 of UN TP Manual: Intra-Group Financial Transactions – Part 2

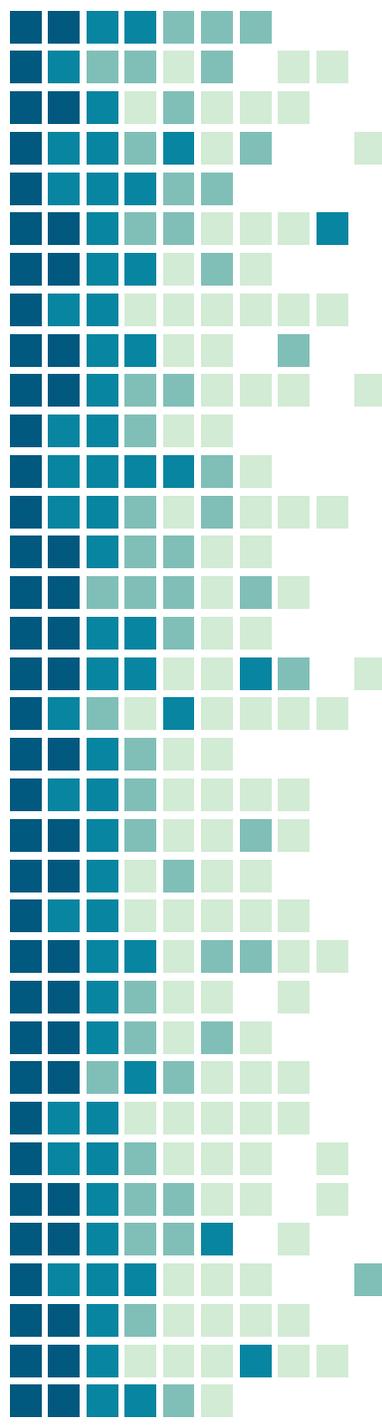
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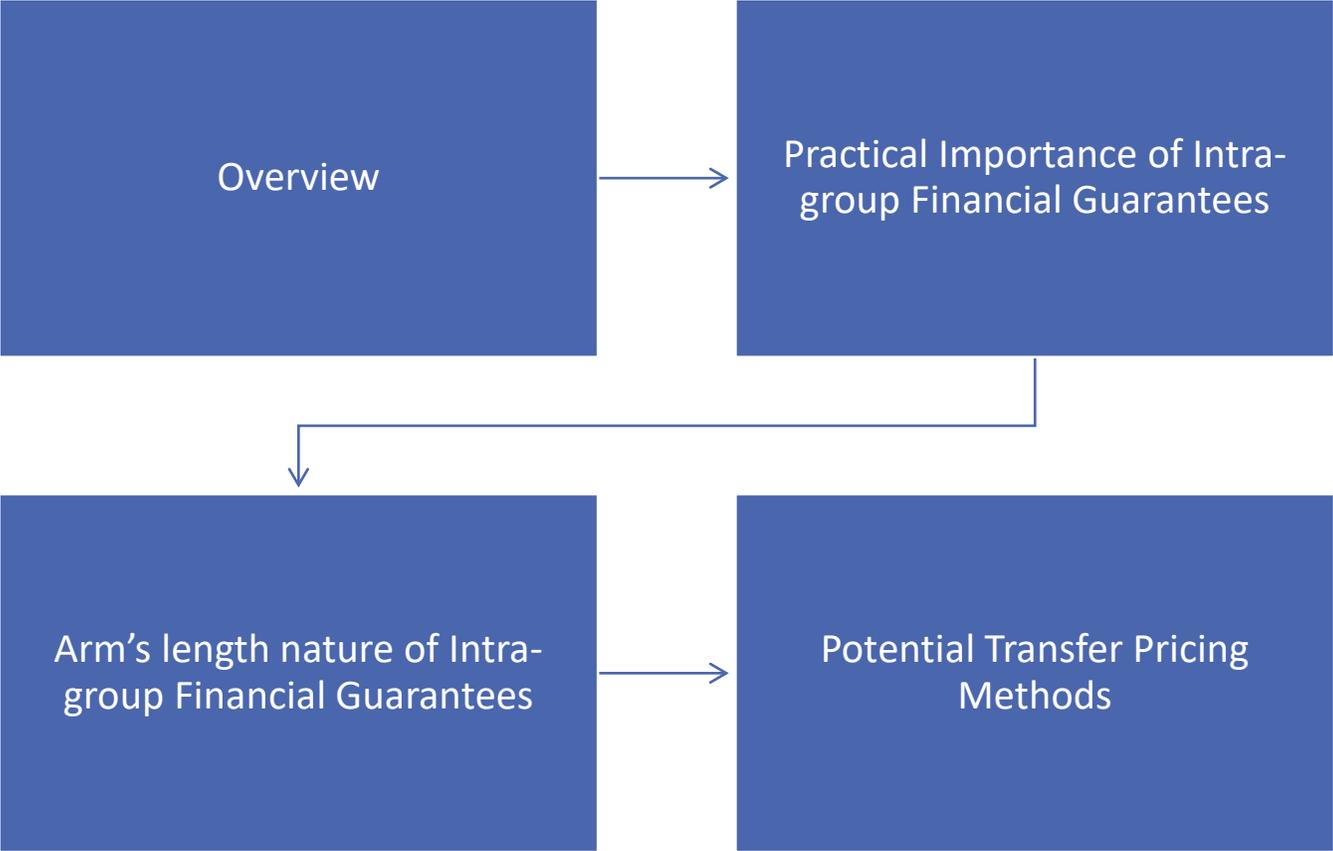
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Legends used in the Presentation

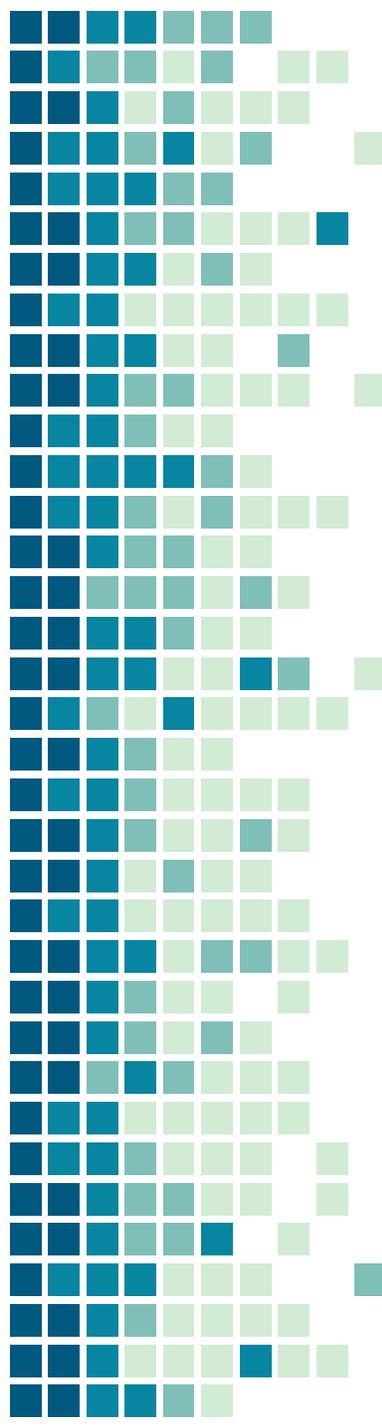
AE	Associated Enterprises
ALP	Arm's Length Price
BEPS	Base Erosion and Profit Shifting
ITA	Income Tax Act
MNE	Multi National Enterprise
OECD	Organization for Economic Cooperation and Development
TP	Transfer Pricing
TNMM	Transactional Net Margin Method
UN	United Nations

Presentation Schema



Overview

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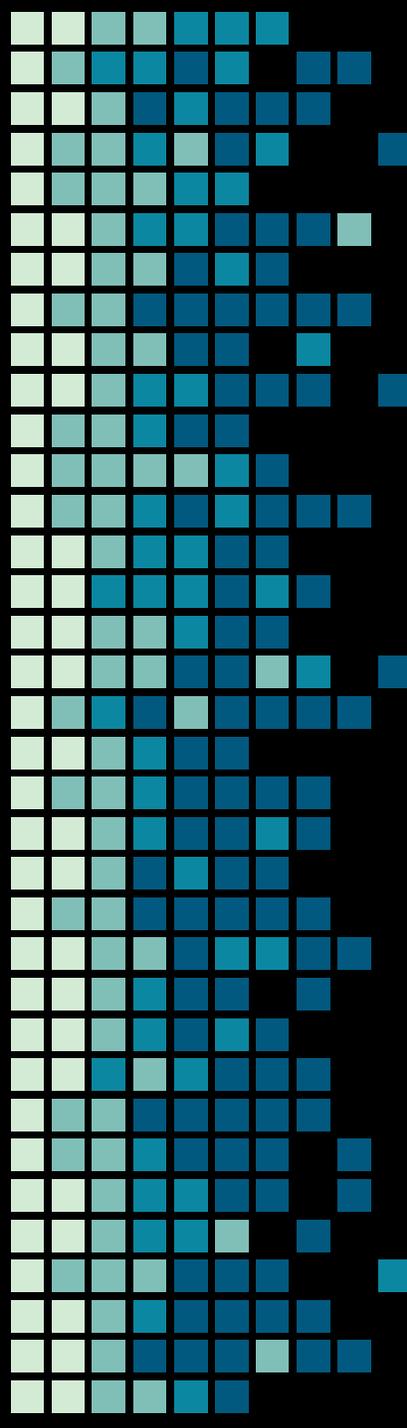


Financial transactions are an important part of the operating procedures of MNEs to support the value creation process of MNEs.

Chapter B9 of the UN TP Manual sets out guidance for non-financial MNE Groups that engage in financial transactions.

In the previous session, TP guidance relating to general principles of delineation of intra-group financial transactions and specific principles with respect to intra-group loans was discussed

In today's session, we would be discussing on the **principles of computing arm's length consideration for intra-group financial guarantees** set out in Chapter B.9.4.



Application of Arm's Length Principle to Intra-group Financial Guarantees

Significance of Intra-Group Guarantees

With an intragroup financial guarantee, the **guaranteed entity may be able to obtain advantageous conditions (such as a lower interest rate) from the lender.**

However, it needs **to be determined if the guarantor will provide the guarantee and assume the credit risk** related to the guaranteed instrument **in return for an arm's length payment, i.e., a guarantee fee.**

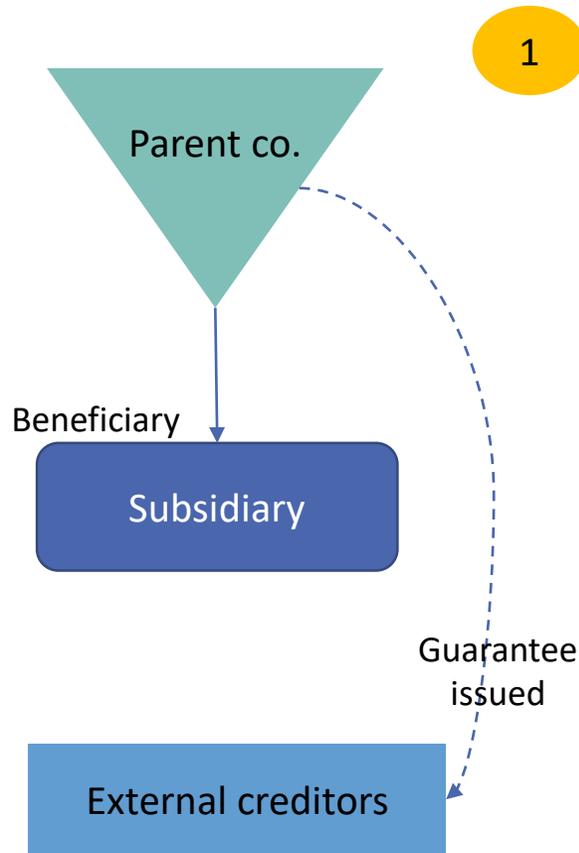
Sometimes **no guarantee fee will apply at arm's length.**

To determine if arm's length compensation is required for a financial guarantee, all of the **relevant terms and conditions of the guarantee should be considered and supported by the conduct of the parties**

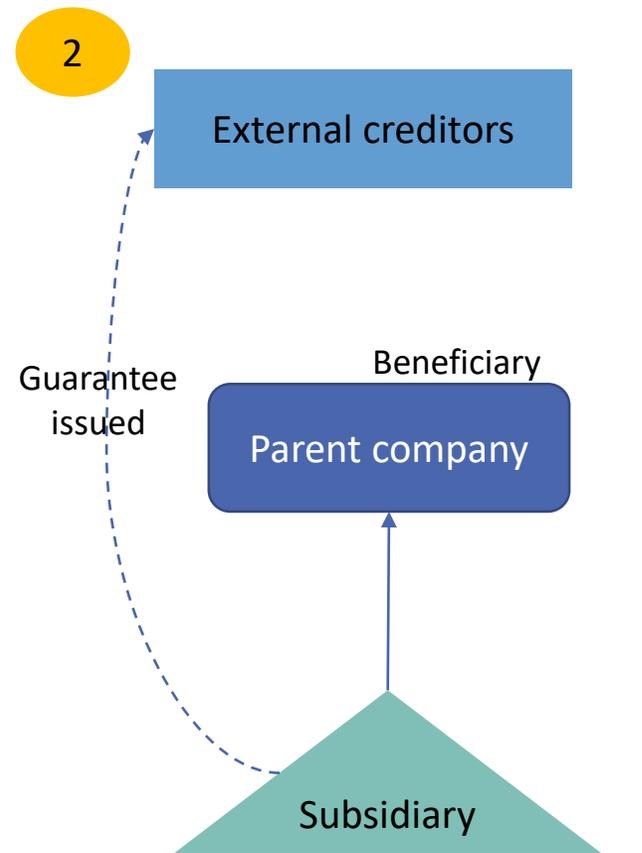
Intra-group guarantees can be in the form of **explicit guarantees** wherein, a **legally binding commitment is provided**, in most cases, by the parent company to a group company which states that the former will pay to a third party financing entity the amount that was lent to the latter in the event that the latter cannot fulfil its obligations

Mention can also be made of **comfort letters/letters of intent** and **keep-well agreements**, but these generally do not transfer risk and generally are not considered as financial guarantees that require an arm's length payment.

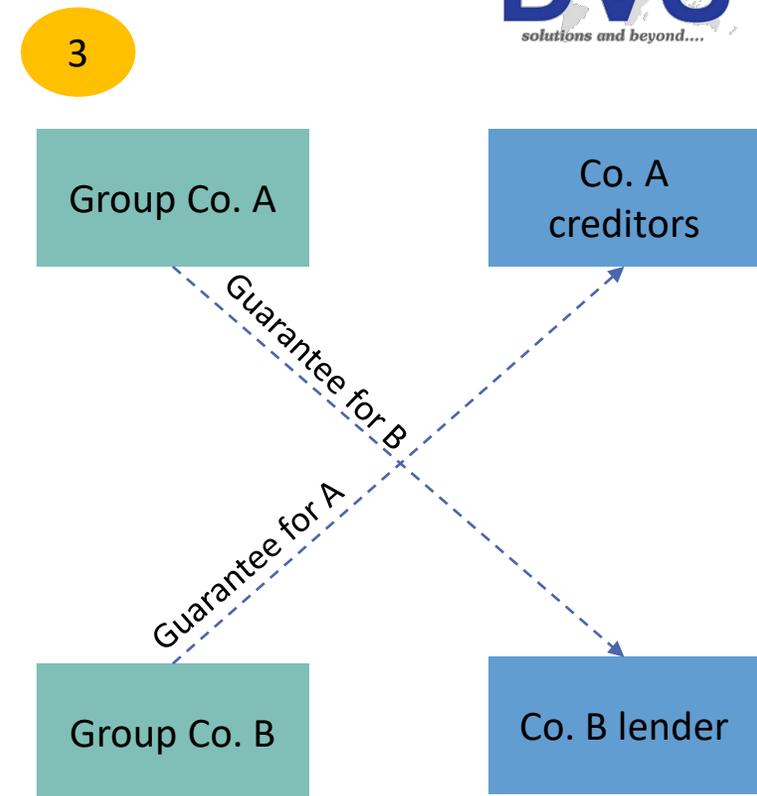
Types of Explicit Credit Guarantees



Downstream guarantee: Typically used in decentralized business structures or when the location of the subsidiary is more attractive for obtaining external financing



Upstream guarantee: Typically used when the external financing is obtained at a parent or holding level or when the parent company performs central treasury functions



Cross guarantees: Several group companies issue guarantees to external creditors for the benefit of each other so that they can all be considered as one single legal obligor (typically used in **cash pooling**).

Issue of Implicit Support

The incidental benefit that the MNE is assumed to receive **solely by virtue of group affiliation**, is referred to as **implicit support** (which does not require any payment because it is not enforceable and hence no comparability adjustment)

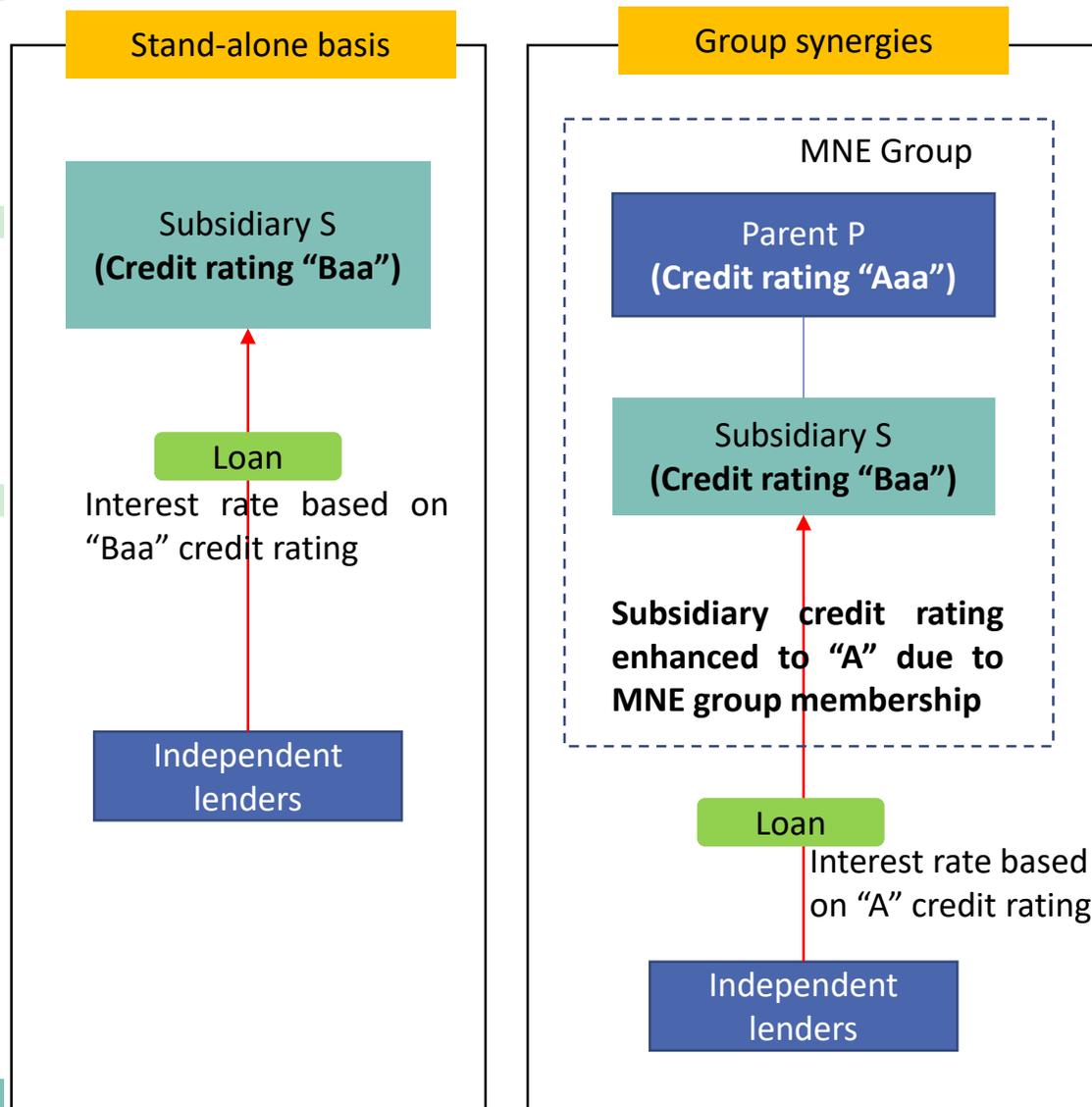
However, a lender may be willing to accept loan conditions under the **assumption that the parent company of the borrower will step in** and meet the obligations of the borrower, in case of default, **without having received any legally binding confirmation** to that extent from the parent company.

The first issue in considering a financial guarantee is the **extent to which there is implicit support**, considering that **implicit support usually has the result of reducing the cost of financing** for the borrower vis-à-vis the lender

The impact of implicit support is that the **risk that the subsidiary of an MNE Group defaults is perceived to be less than if it were truly a stand-alone borrower**

From the perspective of the lender, the overall credit risk for the loan is the (-usually- better) rating of the MNE Group or that of the parent company.

Illustration



- The example illustrates the **impact of implicit support on the credit rating of a group company**
- On a standalone basis, the strength of S's balance sheet would support a credit rating of only Baa.
- Nevertheless, because of S's membership in the P group, independent lenders are willing to lend to it at interest rate that would be charged to independent borrowers with an A rating.

- The OECD Transfer Pricing Guidelines under BEPS Action Plan 8-10, indicate **the recognition of the economic impact of implicit support when the market would have regard to the support.** (because this has impact in the credit markets)
- US and UK have historically taken a position to use stand-alone rating.
- Australia and Canada have indicated through tax law or guidance, the necessity of considering passive association (though no clear guidance is provided on adjustment for group affiliation)
- **In many other countries, passive association is applied on a case-by-case (and potentially inconsistent) basis.**

Determination of Arm's Length Nature of Intra-group Financial Guarantees

Comparability Factors

The **contractual terms of the financial guarantee** (including terms and conditions of the guaranteed instrument), as supported by the conduct of the parties

Borrower's risk profile also accounting for the possible impact of implicit support, by considering the functions performed, and assets used by the guaranteed entity (including any available external credit rating of the borrower and of the guaranteed instrument as well as the probability of default)

The **risk profile and financial capacity of the guarantor**

The **characteristics of the financial guarantee** (including benefits provided by the financial guarantee, if any)

The **economic circumstances of both the guarantor and the guaranteed entity** and of the market in which they operate

The **business strategies** pursued by the guarantor and guaranteed entity

Assessment of Underlying Reason for the Guarantee

An intra-group financial guarantee will have commercial value if:

Obligations of the borrower have been transferred to the guarantor under circumstances defined in the financial guarantee

An independent party would be willing to **pay for the intra-group financial guarantee**

The guaranteed entity/ **borrower achieves a better (lower) price for the intra-group loan** because of the intra-group financial guarantee

On the contrary, the deductibility of an intra-group financial guarantee will probably not be chargeable to the extent:

The guaranteed entity is perceived as having a **better creditworthiness only because of its group affiliation** (implicit support)

When the **debtor has no debt capacity or credit status** and, therefore, would not be able to access the capital market without the financial guarantee (In such a case, the parent company, by providing the guarantee, essentially and substantively would be the borrower)

The financial **guarantee has been requested by the creditor only to avoid that the parent company diverts the funds of the financed company**, i.e., moral hazard issues

Most Appropriate Transfer Pricing Methods

CUP Method

Arm's length compensation for guarantee fee

Internal CUP method

External CUP method

The amount to be paid for guarantee fees applied to similar transactions **in similar circumstances between the associated enterprise and an unrelated entity**

This is more theoretical, as comparables are very hard to obtain. If available, they would consist of (research of) guarantee fees applied to similar transactions in **similar circumstances between unrelated entities**

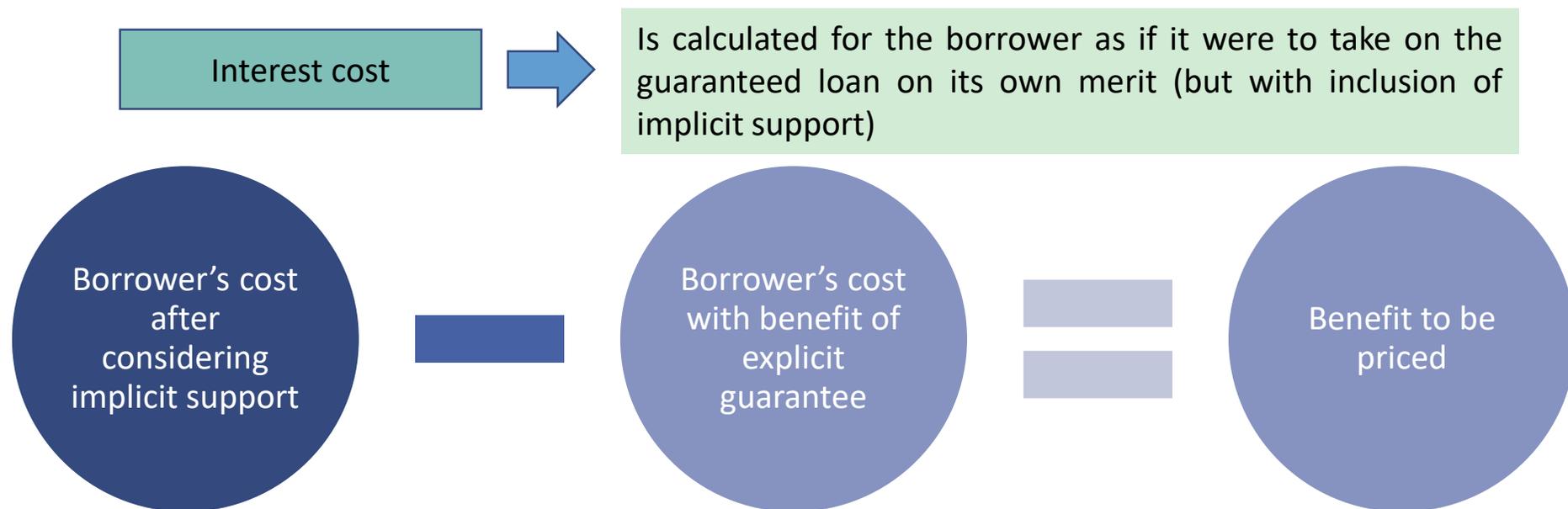
- When applying the CUP method, the information deriving from third party financial guarantees, bankers' acceptances, credit default swap fees, letter of credit fees, commitment fees, various types of insurance, and put options may be beneficial

- All economically relevant characteristics discussed before have to be considered, hence, the resulting guarantee fee might also need to be adjusted by means of comparability adjustments to reflect such factors

Yield Approach

The yield approach is meant to **estimate the maximum potential interest rate savings achieved by the borrowing entity because of the explicit guarantee**

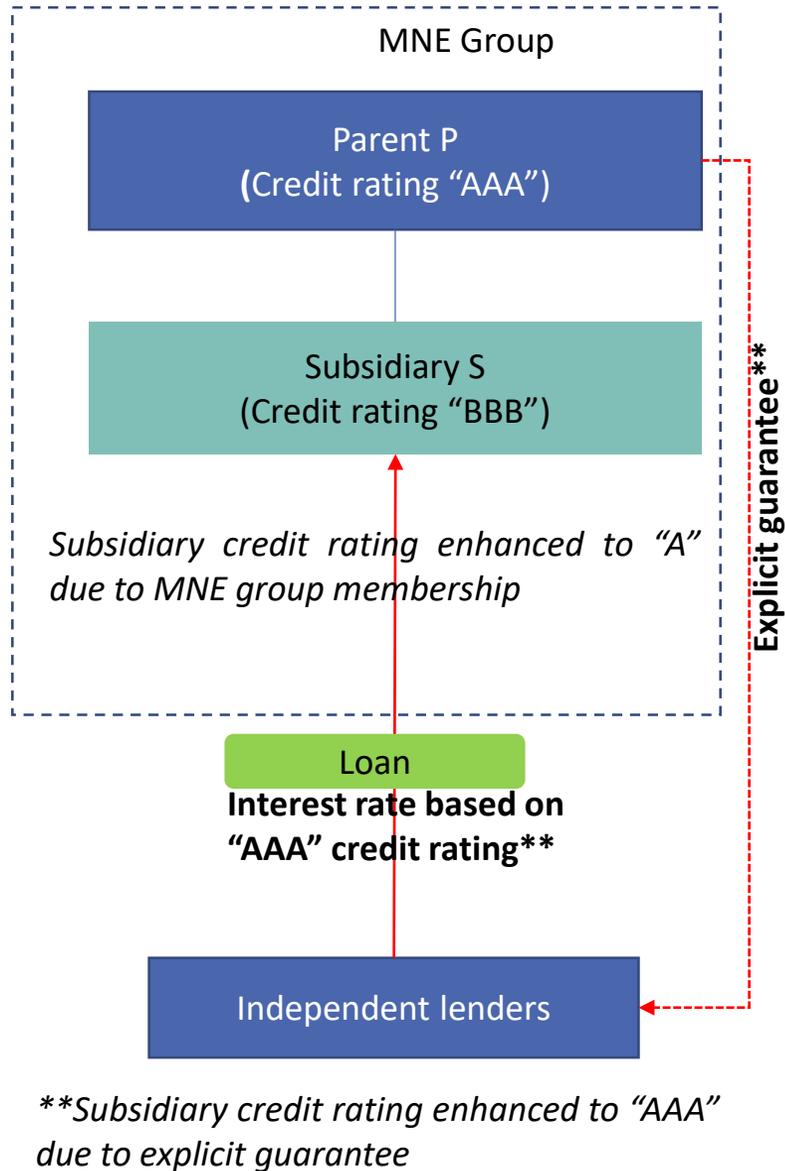
It involves calculating the spread between the interest rate that would have been payable by the borrower without the guarantee and the interest rate actually payable by the guaranteed borrower



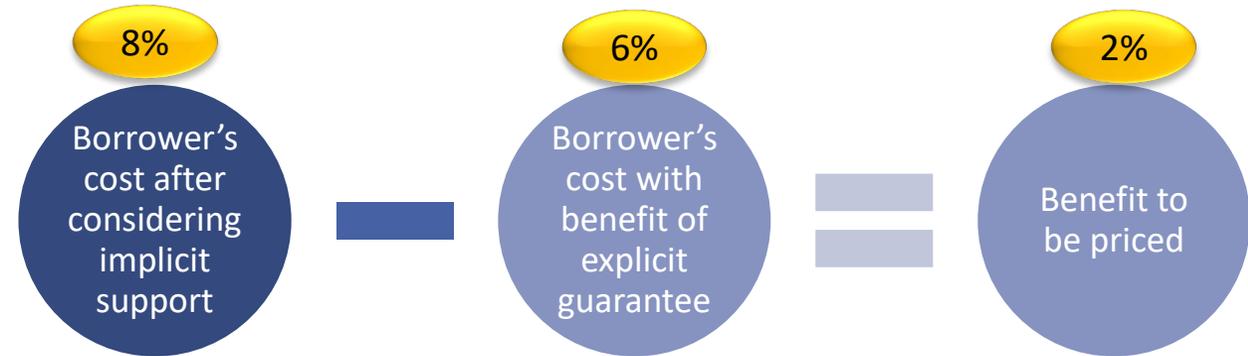
The **benefit of the saved interest is to be divided among the guarantor and borrower** as the borrower otherwise would not have any incentive to obtain the corporate guarantee

Note: The Yield Approach is accepted by various taxing authorities and judicial bodies

Illustration – Yield Approach



- In the illustration, assume that independent lenders charge an interest rate of 8% to entities with a credit rating of A, and of 6% to entities with a credit rating of AAA.

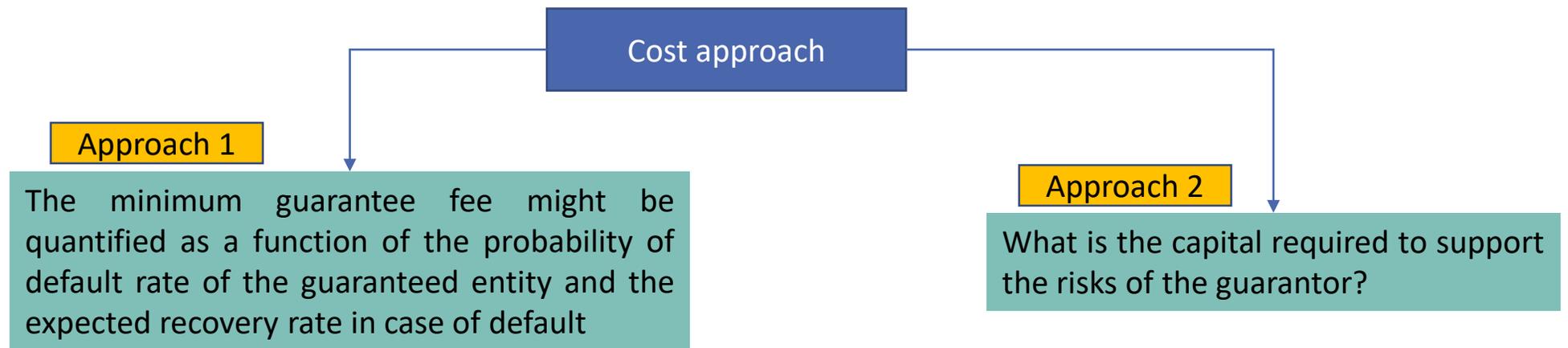


- Going with the Yield approach, the **2% spread constitutes the saved interest. (arm's length maximum guarantee fee)**
- However, this guarantee fee might be reduced by considering how the advantage deriving from the guarantee should be divided between Parent company and Subsidiary company. (based on a combination of factors e.g. the negotiating position of each party, risk exposure for the guarantor, an incentive for the borrower to obtain the guarantee from the parent rather than an unrelated guarantor)

Cost Approach

A cost approach can be considered **to calculate a (minimum) guarantee fee.**

It **quantifies the additional risk borne by the guarantor/considering the value of the expected loss that the guarantor would incur** by providing the guarantee.



Contd...

Methods of approximation of Capital required to support risks of guarantor (Approach 2)

Credit default swap model

Value of the financial guarantee is determined as a **proxy of credit default swap fees**

Contingent put option

The value of the price that the guaranteed entity should **pay for a hypothetical right to sell the guaranteed instrument to the guarantor at a specified price** (i.e., face value) and under certain circumstances (i.e., credit event) (otherwise stated, a put option on the guaranteed instrument) would provide the ALP

Cost of capital analysis

ALP will be determined by **referencing the cost of capital** that the guaranteed entity would - hypothetically- need to pay **to increase its equity enough to achieve the same level of creditworthiness** as it has with the guarantee of the guarantor in place

Financial insurance guarantee

The value of the financial guarantee will be determined by **analysing financial guarantee insurance premiums**

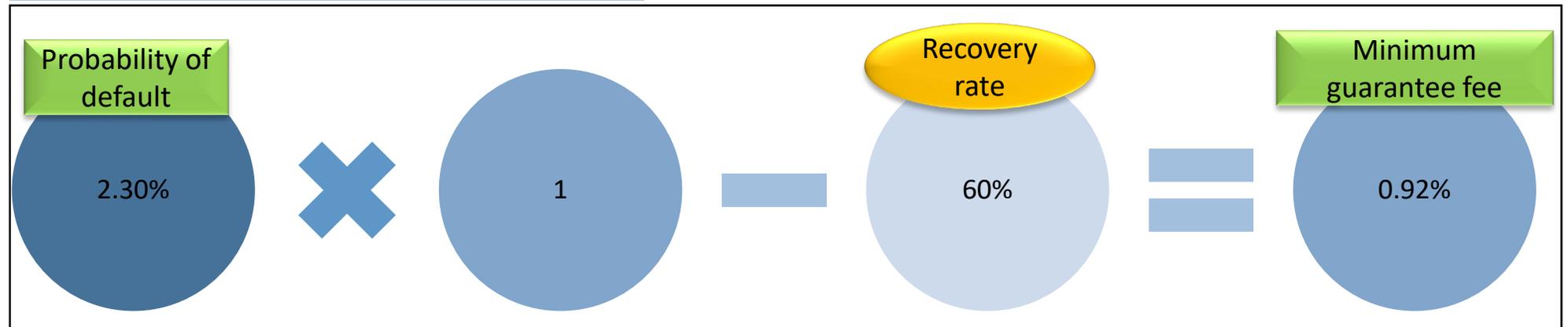
Illustration – Approach 1

Estimated Credit Loss method

Assumptions

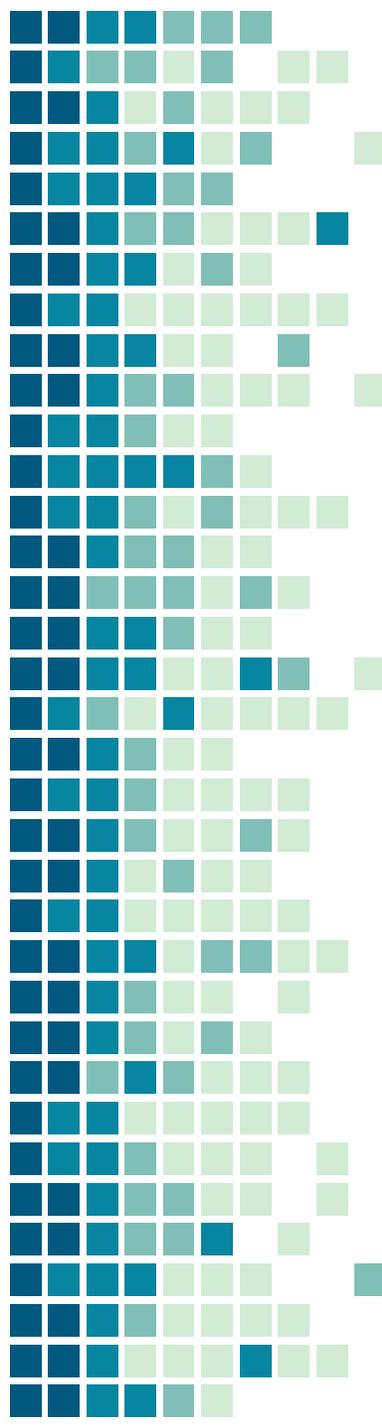
- Independent lender lends `1000 crores to Co.B (subsidiary of Co.A of ABC Group) for which Co.A provides explicit guarantee
- Assume probability of default is 2.30% and expected recovery rate is 60%. i.e. the actual receivables recoverable in the event of customer default

Expected cost of providing the guarantee



Inference

Therefore, the arm's length minimum intra-group guarantee fee might be 0.92%.



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