The new transfer pricing landscape
A practical guide to the BEPS changes

Global Transfer Pricing
November 2015

Passive association

Geoff Gill
Sydney

Kevin Gale
Winnipeg

Bill Yohana
New York

It sometimes takes only subtle changes in tax law or guidance to cause significant practical consequences for taxpayers. The OECD's view on how the arm's length principle applies to estimating the creditworthiness of affiliates, to be set out in just a few additional paragraphs in Chapter I of the *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, has not necessarily been a headline issue for the OECD BEPS project. However, given the vast flows of debt funding within multinational groups, along with the common use of parental guarantees to allow subsidiaries to access local debt markets, any changes may have significant potential ramifications. It may also create many practical interpretation challenges for multinational enterprises (MNEs). This uncertainty may raise the likelihood of more tax disputes between taxpayers and revenue authorities and also between revenue authorities.

This article provides some context to the issue of "passive association" and implicit credit support that may be provided within multinational groups. It includes an explanation of the OECD's new position on this issue, why it matters, and the practical consequences for multinationals, specifically within the context of debt arrangements.

One clear implication of the changes made by the OECD is that it will be necessary for multinationals to take a position on this issue, both at a global policy level and in setting and defending interest rates and guarantee fees on a transactional basis. In addition, many taxpayers will need to prepare themselves to be challenged by tax authorities citing the new guidance as a basis for interpreting the arm's length principle.

What is passive association?

Passive association can be defined as an incidental benefit attributable solely to an entity's association and linkages with other entities that are part of an MNE. It is distinguished from active promotion of the MNE's attributes that positively enhances the profit-making potential of particular members of the group (such as provision of a legally enforceable guarantee or security).

Implicit support refers to the implied aspect of parental support that may arise in circumstances in which parental support would be expected to be provided by the parent even in the absence of any legal obligation (for example, a guarantee) arising from the entity's affiliation with the parent or group. Credit rating agencies acknowledge that, in some circumstances, a parent entity may provide credit support to a subsidiary even in the absence of a legal obligation to do so.

Passive association and implicit support may be viewed as any benefit derived by an entity solely from its affiliation with the parent or broader group.

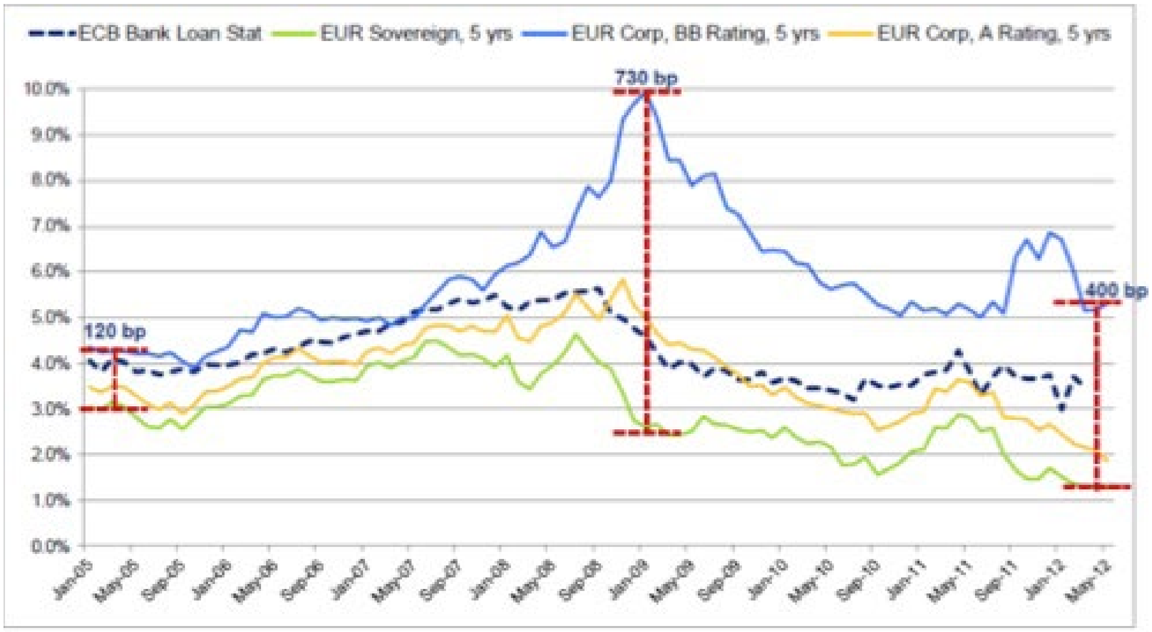
Although this concept has potentially wider implications, this article is limited to consideration of passive association/implicit support in the context of financial transactions. As noted below, the OECD's views (and the changes that will be incorporated into Chapter I, Section D, of the OECD's Transfer Pricing Guidelines) appear focused on financial transactions. However, the relaxation of a strict functionally separate entity view as an interpretation of the arm's length principle in favor of how a market participant would look at an entity that is part of an MNE, taking into account its position within the wider MNE organization, for many may represent a departure in interpreting the arm's length standard. Such thinking may have consequences in considering the arm's length nature of non-financial transactions.

Why is passive association important?

In the financial markets, a borrower's credit quality generally has a significant impact on the interest rate applied to a loan or the price of a credit guarantee. To the extent that it is appropriate to apply passive association principles to a given transaction, adjusting the credit quality of an obligor to account for the potential contingent credit support of another member of the multinational group may have a significant impact on the rate applied to a financial transaction.

The chart below shows why the issue of creditworthiness is of critical importance in pricing funding transactions. The credit spread between what a borrower with a strong credit quality (say, A rated) and a low/medium-rated borrower (say, BB rated) would pay can be significant. Thus, the potential impact of passive association, which a tax authority may use to adjust the credit rating of an unsupported subsidiary toward that of the parental credit rating, can be substantial (potentially up to 500 basis points (bps) at 2008 peak credit spread levels). For a $1 billion transaction, this means a reduction in interest payments of up to $50 million per annum. Over a five-year funding period, for example, the issue could have a gross impact of up to $250 million. In the context of pricing intragroup guarantees, the issue is even more stark, as it may determine whether any fee is payable, and, if so, the pricing of the guarantee.

Chart 1 — Illustration of pricing impact of creditworthiness



It is therefore not surprising that tax authorities—initially those from capital-importing countries such as Australia and Canada—have been taking an increasing interest in this issue. For example, the Federal Court of Canada has addressed this issue, and a number of governments and tax authorities around the world have introduced laws and issued guidance on the subject.

Most recently, the Australian Federal Court in October 2015 issued its decision in Chevron Australia Holdings Pty Ltd v Commissioner of Taxation ([2015] FCA 1092). The case involved an intragroup financing arrangement, and the issue of implicit support, discussed further below, was considered.

Changes to the OECD guidelines

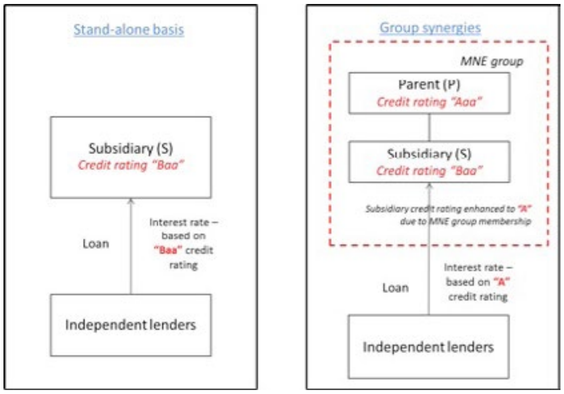
Application of the arm's length principle is generally based on a comparison of the conditions in a controlled transaction between associated enterprises with the conditions in transactions between independent enterprises. The arm's length principle traditionally has followed the approach of treating the members of an MNE group as operating as separate entities rather than as inseparable parts of a single unified business. To apply the arm's length principle in a financial transactions context, one hypothesized a relationship in which the borrower and the lender were independent entities. Applying this principle, the credit quality of a subsidiary of an MNE would be based on its stand-alone functional and financial profile, without any consideration of the credit quality of the broader group. As a general matter, branches were equalized in credit standing with their head office.

The final report on BEPS Actions 8-10 ("Aligning Transfer Pricing Outcomes with Value Creation"), released by the OECD on October 5, 2015, set out the amendments that will be incorporated into Chapter I of the Transfer Pricing Guidelines in relation to "group synergies" (paragraphs 1.157 to 1.173). These sections discuss the issue of passive association/implicit support and expand upon Section 7.13 in the 2010 Transfer Pricing Guidelines. The new sections provide two examples regarding MNE group synergies in the context of financial transactions. In addition, the OECD notes that it may limit a multinational's interest deductions based on group-wide tests or other "targeted measures."

Example 1 (paragraphs 1.164 to 1.166) recognizes the impact of group synergies on the credit rating of a subsidiary that is a member of the MNE group.

> On a stand-alone basis, however, 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, large independent lenders are willing to lend to it at interest rates that would be charged to independent borrowers with an A rating.

Chart 2 —Illustration of OECD Example 1—No contractual credit guarantee

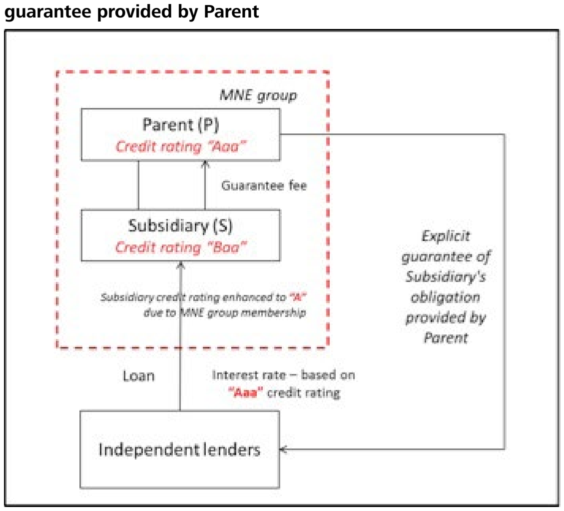


The OECD notes that no payment or comparability adjustment is required for the group synergy benefit because the benefit arises from S's group membership and not from any deliberate concerted action of members of the MNE. This is consistent with the notion of passive association considered in the context of intragroup services, as distinguished from active promotion. It should be noted that this approach is from a "borrower's perspective"; there may be costs to a parent in providing contingent credit support to a subsidiary.

A similar principle is applied in Example 2, which distinguishes incidental benefit from active promotion. The facts in Example 2 (illustrated below) are the same as in Example 1, but in a situation whereby the parent company provides a guarantee (legal obligation). The new guidelines state that S should be required to pay a guarantee fee to P based on the enhancement of S's credit standing from A to AAA, not on the enhancement of S's credit rating from Baa to AAA.

> The enhancement of S's credit standing from Baa to A is attributable to the group synergy derived purely from passive association in the group which need not be compensated under the provisions of this section. The enhancement of S's credit standing from A to AAA is attributable to a deliberate concerted action, namely the provision of the guarantee by Parent, and should therefore give rise to compensation. [Paragraph 1.167]

Chart 3—Illustration of OECD's Example 2—Contractual guarantee provided by Parent



The new OECD guidance states that an entity can receive incidental benefit from being part of an MNE group. In the financial context, incidental benefit results in the enhancement of the entity's credit rating.

It is critical to note that the new OECD guidance requires acknowledgement of implicit support in the context of pricing the loan when "large independent lenders" would charge lower interest rates than if the entity were not part of the group. In other words, the OECD guidelines indicate recognition of the economic impact of implicit support when the market would have regard to the support.The OECD's only examples involve entities engaged in the financial services business.

A transfer pricing analysis regarding intercompany debt or guarantee transactions that is prepared based on the OECD Transfer Pricing Guidelines will need to consider whether this issue is relevant. In pricing funding transactions, it may be necessary to consider whether the credit markets would have actually considered the impact of implicit or nonbinding credit support. It may be, of course, that local transfer pricing law in any given jurisdiction follows a different approach, because domestic law commonly does not link directly to the OECD Transfer Pricing Guidelines. However, to the extent a jurisdiction's tax treaties include an Associated Enterprise Article that requires interpretation having regard to underlying OECD guidance, the issue may need to be considered.

In terms of specific jurisdictions, the United Kingdom and the United States have historically taken a position that requires use of the stand-alone rating. Conversely, the Australian and Canadian tax authorities have indicated through tax law or guidance that it is necessary to consider the potential impact of passive association, though they do not provide clear guidance on how to adjust for affiliation. In many other countries, passive association is applied on a case-by-case (and potentially inconsistent) basis.

In summary, the OECD's new guidance will be influential in requiring tax authorities and taxpayers to consider the issue of passive association or implicit support in any analysis requiring pricing of financial transactions such as loans and guarantees.

Market and pricing approaches

Credit rating agencies

The market for financial transactions has many different types of participants. In addition to borrowers and lenders, ratings agencies play a role by analyzing and signaling to investors the quality and risk associated with various debt instruments.

Ratings agencies issue various types of ratings for a particular issuer. These include corporate family ratings, short-term and long-term domestic and foreign issuer ratings, and issue-specific ratings for a particular instrument within a corporate entity. The relationship between issuer and issue rating depends on instrument-specific factors such as location in the capital structure, security, and options that may either disadvantage or enhance the recovery of an instrument in the event of default (for example, seniority/subordination of the debt issue).

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A first step in estimating the credit quality of an obligation is to estimate an issuer rating and then adjust that rating (by notching the entity/issuer rating up or down) based on instrument-specific factors. Credit rating agencies in general subscribe to a stand-alone approach as a starting point in determining/estimating the credit rating of a corporate entity regardless of its status as a parent, holding company, or subsidiary within an MNE group. From there, ratings agencies consider the impact of different forms of "support" or "relationships" between various entities, both related and unrelated, on the corporate entity's stand-alone credit rating. Ratings agencies have disseminated their ratings outside of a tax transfer pricing context.

Credit rating agencies often base their credit opinions of subsidiaries of multinationals on the premise that creditors can reasonably rely on the parent or other interested party to provide contingent credit support in times of financial distress, based on that entity's fiduciary duty to the subsidiary, and on the notion that a subsidiary would typically be rescued by its parent, which would service any subsidiary debt in the event of default. Unlike explicit support, whereby the parent is legally bound to support a subsidiary, implicit support is not legally binding and relies on the expectation that in the event of a subsidiary's default or near default the parent would support the subsidiary financially to avoid such default. Thus, depending on the relationship or relative importance of the subsidiary to the parent and/or group as a whole, the parent may choose to provide implicit support (if it has the capacity to do so) or allow the subsidiary to go bankrupt. As a practical matter, the ability of a multinational to provide such contingent credit support varies considerably (with financially weak parents less able to provide support). In addition, the amount of credit uplift that a lender might provide varies across the credit cycle, and may also vary by the seniority of a given obligation.

Each of the major ratings agencies (Standard & Poor's, Moody's Investors Services, and Fitch Ratings) provides a general framework as it relates to subsidiary/parent links and implicit support.

Other market participant considerations

Credit ratings are only part of the pricing process, and are not the only determinants of the margins at which lenders are prepared to extend credit. Thus, a complete analysis must take into account the practices of the participants in the market.

The role of credit ratings agencies is to analyze and signal to investors the quality and risk associated with various debt instruments. However, actual pricing decisions are made by lenders and borrowers. Investors (such as bond investors) often take differing views on credit risk than the ratings agencies, and will make price/investment decisions based on their own criteria, including the specific circumstances of the transaction. This is evidenced by the observable spreads of credit margins in the market at any given credit rating and time.

In the context of the other market participants, it is important to note that investors will not necessarily agree, nor will the pricing of an instrument always be consistent with, the rating disseminated by a rating agency based on implicit support.

Banks and other lending institutions will have their own approaches to assessing credit risk and in making lending and pricing decisions in accordance to their own risk appetite. A critical component of that is the capital requirements for loans, which in many jurisdictions are regulated locally having regard to the output of the Bank of International Settlements Basel Committee on Banking Supervision.

In essence, under both the Basel Standardized and Internal Ratings approaches, for credit support to be recognized for capital adequacy purposes, it should be legally enforceable. Implicit credit support does not carry the same weight from a regulatory perspective. The effect of this is that banks generally need to hold more capital against loans that do not have a legally enforceable parental guarantee, which in turn means the pricing of the loan (i.e., the credit margin) should be higher than at the parental credit rating.

This market participant view means that the issue of determining how the market would view the creditworthiness of the subsidiary requires a careful evaluation of the facts of the case, and recognition that reliance on ratings agency approaches may not be the only appropriate method to consider.

Implications

Review global policies and risk assessment

When the new guidance on group synergies and passive association is adopted in the new OECD Transfer Pricing Guidelines, it will be important for all multinationals with intragroup debt arrangements or financial guarantees to review their global policies to set and test the transfer prices (interest rates and guarantee fees) to ensure consistency with the OECD Transfer Pricing Guidelines. This does not necessarily mean adjustment from stand-alone credit ratings; rather, MNEs will have to take a position on the relevance of the issue of passive association for the group, and documentation supporting that position will have to be prepared accordingly.

In determining the practicalities of what type of analysis is required to determine the scale of any adjustment to stand-alone credit ratings, if appropriate, companies should evaluate the tax risk inherent in its intragroup financial transactions.

Sensitivity to passive association will typically be a function of:

- Regulations/laws, in both the lender's and the borrower's jurisdictions
- The taxpayer's global approach to pricing intragroup funding
- Materiality of the transaction
- Rating gap between the parent and subsidiary (stand-alone rating)
- Nature of transaction (for example, short-term/medium-term/long-term deposit)
- Known tax authority views

In the post-BEPS world of increased transparency and greater tax authority focus on both sides of a transaction, the leading approach is to develop an approach that will stand up to scrutiny in both jurisdictions. While the OECD has taken a broad stance on the issue of passive association, the potential for divergent tax authority views is still material. When there are clear mismatches between the laws or approaches taken by two jurisdictions, it will be important to consider these issues carefully to enable an educated decision regarding the approach to manage the transaction's tax risk.

In practical terms, the work required to determine an arm's length interest rate should be commensurate with the level of risk.

A practical approach to the ratings process for an intragroup loan

In general, the process for determining the appropriate entity rating for a subsidiary borrower/obligor in the context of an intercompany financial transaction when implicit support must be considered (that is, when the OECD Transfer Pricing Guidelines form the basis for the approach) involves the following information and steps:

- Determine the borrower subsidiary's stand-alone rating.
- Determine the parent's rating, or rely on the parent's public rating if available; otherwise the parent will also need to be rated.
- Determine the rating gap -- the difference between the parent's rating and the borrower subsidiary's rating.
- Perform analysis regarding whether the credit market (lenders, credit rating agencies) would take into account the implicit support of a parent (or associate entity) in pricing the financial transaction.
- If the answer to the above step is 'yes,' perform analysis having regard to available guidance to quantify the extent to which the rating gap should be reduced, and the stand-alone rating of the borrower subsidiary enhanced.

Conclusion

The issue of passive association, while not a new one, is increasingly important when analyzing the arm's length nature of financial transactions. Intragroup financial transactions, including loans, guarantees, and derivatives are a significant issue for MNEs. Tax authority sophistication and focus on financing has increased significantly globally. The OECD BEPS agenda will help drive the tax authority focus, and the proposed changes to Chapter I of the OECD Transfer Pricing Guidelines signal that the OECD position has moved toward recognition of passive association when the market would do so.

Credit rating is one of the most important determinants of the rate applied to loans and guarantees. Adjusting for passive association can significantly change the transfer price, and hence the taxation outcomes in both jurisdictions of the parties to the transactions.

It will be important for taxpayers to review their global transfer pricing policies to consider whether passive association could have an impact on the interest rates set for intragroup debt. A key element of the policy should be to consider whether the arrangements have a high or low degree of potential sensitivity to passive association.

When the potential sensitivity is low, a high-level analysis, which may for example group or "bucket" loans based on similar characteristics, may be a practical approach. When the potential sensitivity is high, a detailed analysis will likely be required to determine whether the stand-alone credit rating of a borrowing affiliate should be adjusted to take account of passive association, and if so, by how much. Determination of any adjustment could follow the ratings agency approaches; however, in some cases it may also be appropriate to consider whether other lending market participants, such as banks, might follow a different approach.

About the authors

Geoff Gill
Sydney
gegill@deloitte.com.au

Geoff Gill is a partner and economist with Deloitte's Global Transfer Pricing group in Sydney. He has over 16 years of experience in transfer pricing based in both London and Sydney. Geoff leads Deloitte Australia's transfer pricing practice for the financial services industry.

Kevin Gale
Winnipeg
kgale@deloitte.ca

Kevin Gale is a senior manager with Deloitte Canada and the Canadian practice's lead practitioner for financial transactions.

Bill Yohana
New York
byohana@deloitte.com

Bill Yohana is a director in Deloitte Tax LLP's transfer pricing practice in New York City. Over the past 18 years, Bill has focused on financial transactions transfer pricing,