Bloomberg BNA

Tax Management
Transfer Pricing Report™

Intercompany Financial Transactions: Factors to Consider In Analyzing the Impact of Implicit Parental Support

The authors explore the concept of implicit parental support within the ongoing debate over pricing intercompany financial transactions. First, they examine this support—from its definition to its relationship with the notions of passive association, stand-alone credit rating, and the separate entity approach under the arm's-length principle. Next, they describe methods to notch the stand-alone rating for implicit support and examine the economic benefits of notching.

BY JOHN HOLLAS AND GORDON HANDS,
CUFTANALYTICS

In a transfer pricing context, what is meant by the concept of implicit parental support with respect to an intercompany financial transaction? What makes it implicit, and what constitutes parental support?

The definition of ''implicit'' refers to the implied, but not stated, aspect of parental support. For it to be implicit, as opposed to explicit, the parental support would be expected to be provided by the parent to a member of the multinational group even in the absence of a formal (contractually legal) requirement of the parent to provide the support. Accordingly, it is implicit because it is from the perspective of the other party (that is, the lender) and is due to the member's affiliation with the parent or group.

The authors contend that, broadly speaking, there are two types of parental support that might be considered by an arm's-length lender in assessing the credit risk of a borrower in a financial transaction:

- the lender's expectation or assumption that the parent would provide (or that the subsidiary would have access to) management expertise to the subsidiary; and
- the lender's expectation or assumption that, in times of financial need or distress of the subsidiary borrower, the parent (shareholder) will provide financial support for the financial and commercial activities of its subsidiary.

John Hollas and Gordon Hands are global managing directors with CUFTanalytics, a consulting firm specializing in intercompany financial transactions, based in Calgary, Canada.

So, in the context of an arm's-length lender's evaluation of a borrower's credit risk, the management depth and operational capabilities of the group as a whole that are, or could be, available to the borrower as a member of the group is an important factor. To an arm's-length lender, it matters little whether the parent or other members of the multinational group provide this management-type support either explicitly, through management services arrangements (which would be a separate services charge to the subsidiary at an arm's-length price), or implicitly, through a member of the group's access (on an as-needed basis) to the parent's executive or operational management team's expertise. The assumption is that the lender—even a related-party lender—would assess the borrowing entity as being a member of a multinational group with access to management support from the parent or, for that matter, any other member of the group.

However, as important as the management factor is, it is not the only important factor in determining the overall credit risk of a borrower.

Likewise, financial support from the parent to a member of the group can be either explicit or implicit. Explicit financial support exists when the parent or other member of the group provides, or commits to provide, direct loans, third-party loan guarantees (or even performance-based guarantees), or, in some cases, a letter of comfort or capital maintenance (''keep well'' agreements) to another member of the group. As mentioned above, for financial support to be explicit, there would need to be a written agreement between the parties (to be consistent with an arm's-length transaction).

 ISSN 1063-2069

Thus, implicit financial support from the parent would exist only if a member of the group's counterparties to its third-party contracts (commercial and/or financial contracts including third party loans or other debt instruments) relied on the higher credit rating of the parent in determining the subsidiary's creditworthiness. Financial-type implicit parental support, therefore, could exist even if an explicit parental guarantee was provided.

Connection between passive association and implicit support

The Organization for Economic Cooperation and Development transfer pricing guidelines[1] state at paragraph 7.13:

> 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 its affiliation alone has a credit-rating 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 benefitted from the group's reputation deriving from global marketing and public relations 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*. Each case must be determined according to its own facts and circumstances. (Emphasis added.)

Although the concept of ''passive association'' as outlined in paragraph 7.13 is characterized as applying to intercompany financial transactions, it specifically refers to intragroup services—the subject of Chapter 7 of the guidelines—not financial transactions.

In the excerpted paragraph above, the OECD distinguishes between cases where:

- no service is being provided if an associated enterprise benefits from its affiliation by having a higher credit rating, and
- an associated enterprise benefits from the reputation or marketing of its affiliation with the parent or group.

The distinction, from the OECD's perspective, is active promotion. But arguably, there is active promotion by the treasury or finance function regarding the credit rating of the parent, which then benefits the subsidiary, perhaps with a lower interest rate or borrowing costs. Why, then, would the benefits to the member of the multinational group that are derived from the higher credit rating of the parent be considered passive association?

Even though the credit rating of the parent is, in fact, due to the active promotion by the multinational group's treasury function in maintaining or enhancing the parent's credit rating, paragraph 7.13 considers this relationship passive association. But is that really the case, or has the multinational undertaken active promotion to benefit the members of the group? Is the active promotion the provision of services to develop, maintain or enhance the parent or group's credit rating, which would be an intangible in the form of financial strength? If a credit rating is an intangible—something that exists and is unique and valuable—then what is the value of this intangible, and what arm's-length fee or charge should be made to the recipients that benefit from it?

If the use of the parent's credit rating is categorized as passive association, then no intragroup service has been provided. There would be no charge paid by the subsidiary to the parent if the lender provides a benefit to the borrower solely on the basis that the subsidiary is a member of the multinational group. In passive association, there is no expectation that the parent would ''come to the rescue'' of a subsidiary that has defaulted on its borrowings. This distinguishes passive association from implicit parental support. Under the concept of implicit parental support, *there is an expectation* by the lender of some future activity by the parent to cure an event of default even if the parent is not contractually obligated to take corrective action.

So, is implicit parental support the same concept as passive association? Or is it more similar to the other active promotion examples given in paragraph 7.13 of a subsidiary benefiting from the group's reputation, which derives from the parent or group's global marketing and public relations campaigns? Arguably, the parent's credit reputation—a product of management expertise in determining the optimal capital structure as well as ensuring business effectiveness and maintaining strong banking and debt market relations—is a result of active promotion. This perspective could lead to a much different transfer pricing treatment, as implicit parental support would not be considered passive association.

The arm's-length principle and the separate-entity approach

The arm's-length principle is, of course, the international standard that OECD member countries have agreed to for determining transfer prices for tax purposes and is embodied in paragraph 1 of Article 9 of the OECD Model Tax Convention, which forms the basis of bilateral tax treaties involving OECD member countries and an increasing number of nonmember countries.

Article 9 states:

> [When] conditions are made or imposed between . . . two [associated] enterprises in their commercial *or financial relations* which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly. (Emphasis added.)

In addition, the OECD guidelines in paragraph 1.6 state:

> By seeking to adjust profits by reference to the conditions which would have been obtained between independent enterprises in comparable transactions and comparable circumstances (i.e., in ''comparable uncontrolled transactions''), *the arm's length principle follows the approach of treating the members*

[1] *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2010, OECD.

   ISSN 1063-2069

> *of an MNE group as operating as separate entities rather than as inseparable parts of a single unified business*. Because the *separate entity approach* treats the members of an MNE group as if they were independent entities, attention is focused on the nature of the transactions between those members. (Emphasis added.)

Some have argued that the consideration of implicit parental support in determining arm's-length pricing of intercompany financial transactions is contrary to the arm's-length principle. However, in *General Electric Capital Canada Inc. v. The Queen*,[2] both the Tax Court of Canada and the Federal Court of Appeal held that implicit support must be considered in pricing the explicit guarantee from a related party. The authors' perspective is that if an arm's-length lender would consider implicit support from a shareholder, parent or other financial sponsor of its subsidiary in its credit risk analysis, then, for transfer pricing analysis, considering implicit parental support in evaluating the related party's credit risk and intercompany loan pricing would be consistent with the arm's-length principle.

The authors contend that under the separate entity approach, intercompany financial transactions should be treated no differently from intercompany commercial transactions. Thus, the affiliated group members that are entering into an intercompany financial transaction must be considered as separate entities.

The next section considers another aspect of this debate.

Stand-alone versus separate entities

Is the separate entity approach the same as or different from the stand-alone approach used to estimate the credit risk profile (either as an implied credit rating or as another credit risk measure), as a major factor in determining the arm's-length pricing of intercompany financial transactions?

''Stand-alone'' is a term and concept used by credit rating agencies. It also is used in analyzing intercompany financial transactions. In *GE Capital Canada*, the Canada Revenue Agency argued that no consideration should be given to implicit parental support as this would be contrary to the transfer pricing law, which embraces the arm's-length principle based on the separate entity concept. But this would assume that ''separate entity'' and ''stand-alone'' are the same concept.

There is no reference to the stand-alone entity concept in Article 9 or in the OECD guidelines. Is it the same as, or similar to, the separate entity concept? Paragraph 6 of the preface to the OECD guidelines, in referring to the separate entity concept, states:

> In order to apply the separate entity approach to intra-group transactions, individual group members must be taxed on the basis that they act at arm's length in their dealings with each other. However, the relationship among members of an MNE group may permit the group members to establish special conditions in their intra-group relations that differ from those that would have been established had the group members been acting as independent enterprises operating in open markets. To ensure the correct application of the separate entity approach, OECD Member countries have adopted the arm's length principle, under which the effect of special conditions on the levels of profits should be eliminated.

As stated above, the authors' interpretation of the arm's-length principle is that the subsidiary must be considered a member of a multinational group, albeit a hypothetically different multinational group than that of its actual legal entity group. In effect, it is to view the financial transaction as occurring between an entity that is a subsidiary of a hypothetically separate multinational group and an entity that is the parent of a hypothetically separate multinational group. In this view, the implicit parental support is coming from the hypothetically separate parent of the subsidiary, which is, for analysis purposes, different from the actual parent (or parent of the related-party lender).

Thus, the stand-alone concept is not consistent with either the arm's-length principle or the separate entity approach. Therefore, implicit parental support must be considered to be consistent with the separate entity concept and the arm's-length principle.

The question is, does implicit parental support, if it exists, have an impact on the arm's-length pricing of an intercompany financial transaction?

Is implicit parental support a factor to consider in pricing an intercompany financial transaction?

In the context of intercompany financial transactions—either intercompany lending or loan guarantees—the argument exists that the parent's credit rating will, through implicit support, enhance the borrowing subsidiary's implied or actual credit rating in the absence of a formal or explicit guarantee. Under this argument, the enhanced credit rating then would result in the lender's lowering the price (in the form of interest rates or guarantee fees) to the borrowing subsidiary, due entirely to the parent-subsidiary affiliation.

So, is this implicit parental support considered by an arm's-length lender in its credit risk assessment of a borrowing subsidiary and then reflected in its loan pricing? As stated above, a lender would consider the parent or group in evaluating the quality of management and in the capacity of a shareholder to provide financial support to its subsidiary. To consider this question, the authors searched for any market evidence that a lender would adjust its credit risk assessment and loan pricing for a non-guaranteed loan to a subsidiary of a parent with a better credit rating. There was no direct market evidence that implicit parental support, if it exists, would lead to lower loan pricing. There is, however, evidence that credit rating agencies such as Moody's and Standard & Poor's consider notching the stand-alone credit rating of a non-guaranteed subsidiary. In fact, both credit rating agencies have developed a notching method for implicit parental support. This approach will be examined further below.

On the question of whether lenders price loans solely on the borrower's credit rating, the authors have observed a strong correlation between loan pricing and credit ratings for investment grade borrowers (with the possible exception for the BBB rating category). This is not the case for non-investment, or speculative, grade borrowers. For borrowers with non-investment grade

[2] 2009 TCC 563 (2009), *aff'd*, 210 FCA 344 (2010).

ratings (or for that matter, unrated borrowers with an equivalent implied non-investment grade credit rating), the credit rating may not be a sufficient indicator of loan pricing on its own. There are other credit risk measures or credit risk metrics (for example, specific financial ratios) that often are used by lenders to assess credit risk, set pricing and adjust pricing throughout the term of a loan.

Some anecdotal evidence exists that financial sponsors, usually private equity firms, have obtained better loan pricing or terms (as well as higher financial leverage) for their portfolio companies than these companies would have received had they not been portfolio companies. In this case, there is no explicit loan guarantee provided by the financial sponsor (shareholder). While this evidence might be seen to support the notion that implicit parental support has an impact on loan pricing, it also may have more to do with implicit managerial support (such as providing strategic management and capital structuring advice) than with implicit financial support. Private equity firms are not averse to dropping portfolio companies that fail to perform, and after doing so of course would do nothing to cure an event of default on the portfolio company's bank loan.[3]

Credit rating agencies' notching method for implicit parental support

The November 2013 decree by the Dutch tax authority[4] indicated that a parent company's credit rating must be considered when determining the interest rate for a non-arm's-length loan. The decree refers to the notching method used by Standard & Poor's to derive a credit rating for the subsidiary borrower.

S&P's method is based on determining whether the subsidiary is core, strategically important, or non-strategic from the perspective of the parent or multinational group. This categorization determines whether, and by how much, S&P would notch the stand-alone rating of the subsidiary for implicit parental support (that is, group or parent affiliation). In summary, a core subsidiary would be one in which the business is reasonably successful, is integral to the overall group's strategy and is not likely to be sold. A strategically important subsidiary is one that would not meet all of the criteria of being core but is still an important business for the group. Obviously, a non-strategically important subsidiary is one that could be disposed of without significant impact on the operations of the group as a whole.

Moody's approach to determining the notching of a non-guaranteed subsidiary's rating for implicit support is a two-step process.[5] Starting with the stand-alone rating for both the parent and the subsidiary, Moody's assesses the likelihood that the parent will provide financial support to the subsidiary during periods of financial distress—that is, the willingness and the ability of the parent to financially support the subsidiary. Willingness incorporates factors such as reputation, strategy, operational integration, rate of return on investment, and role of regulators. Ability is based on factors including the parent's rating, the correlation of the parent's and the subsidiary's financial results, and the anticipated relative magnitude of any financial support.

A parent, however, may not support even a significant—or what would seem like a strategic—subsidiary if it is not legally obligated to do so. In 2002, there were four high-profile examples of parents not providing additional financial support to their arguably core or strategically important subsidiaries when the parent had provided no explicit guarantee for the subsidiary's liabilities:[6]

- BCE did not support Teleglobe, which eventually defaulted on its US$3.2 billion in debt,
- AT&T let AT&T Canada default on US$3.7 billion in debt,
- Verizon did not support its subsidiary, Genuity, which defaulted on US$2 billion in debt, and
- TXU Corp. let TXU Europe default on US$2.8 billion in debt.

Generally, if a subsidiary is financially weak, with a high business risk profile and limited operating history, it is less likely that the parent will provide non-guaranteed support—that is, implicit parental support would not exist. However, if the subsidiary is well established, both operationally and financially, and has a relatively more conservative business risk profile then, in these cases, the parent may be motivated to provide support to a non-guaranteed subsidiary. Furthermore, if the subsidiary is an integral part of the multinational group's supply chain, there will be a stronger motivation to support it. Another major consideration is whether the subsidiary's failure would have a significant impact on the rating or credit risk of the parent.

Moody's states: ''Any 'ratings uplift' based on parent's willingness and ability to provide support could be limited to only one or two notches above the [subsidiary's] stand-alone rating.''

The stand-alone rating considers not only a quantitative analysis (financial statement data, projections, debt servicing and liquidity), but also a company's operating strategy, industry conditions, and the company's competitive position in the industry. Moody's also states that it ''considers an assessment of the commercial relationship of the subsidiary to its parent on an 'arm's length' basis.''

But even if implicit parental support exists, is there any economic benefit to the member of the group due to implicit parental support?

---

[3] Richard Cantor and Jian Hu, ''Deal Sponsor and Credit Risk of ABS and MBS Securities,'' *Moody's Investors Service*, December 2006.

[4] See Jaap Reyneveld and Eduard Sporken, ''The Netherlands' 2013 Transfer Pricing Decree: More Clarity Accompanies Focus on Profit Shifting,'' 22 *Transfer Pricing Report* 1037, 12/12/13; Antonio Russo, Margreet Nijhof, Omar Moerer, Hub Stolker and Benchi Klaver, ''The Netherlands' 2013 Transfer Pricing Decree: Extensive Updates With a Dose of Uncertainty,'' 22 *Transfer Pricing Report* 1133, 1/9/14. For text, see 22 *Transfer Pricing Report* 1116, 1/9/14.The Decree, No. IFZ 2013/184M, added a new section on financial transactions that incorporated the ''non-arm's-length loan'' doctrine, as developed by the Dutch Supreme Court case decisions, for intercompany guarantees.

[5] ''Ratings Methodology: Rating Non-Guaranteed Subsidiaries: Credit Considerations in Assigning Subsidiary Ratings in the Absence of Legally Binding Parent Support,'' *Moody's Investors Service*, December 2003.

[6] ''Ratings Methodology: Rating Non-Guaranteed Subsidiaries: Credit Considerations in Assigning Subsidiary Ratings in the Absence of Legally Binding Parent Support,'' *Moody's Investors Service*, December 2003.

   ISSN 1063-2069

Does the notching of the subsidiary's implied credit rating result in any economic benefit for the subsidiary?

For this to be true, the superior implied credit rating of the subsidiary, due to notching, would have to result in lower loan pricing (or more generous and beneficial loan terms).

In order to quantify the impact of implicit parental support, it is necessary to identify and understand the economic benefits conferred by implicit parental support.

Even if, using the credit rating agencies' notching method, the estimated stand-alone credit rating is enhanced by implicit parental support, one still must consider whether the notching of the implied stand-alone rating in fact resulted in a lower interest rate (or some other economic benefit) being provided by the lender to the subsidiary. There are two issues:

- Would an arm's-length lender have ''notched'' the stand-alone rating in the same manner as outlined by the credit rating agencies in estimating its internal rating for the borrower?
- Would the notched credit rating have resulted in a lower interest rate (that is, is it observable in the primary loan market)?

First, the lenders are not likely to be using the exact notching methods employed by the rating agencies. In practice, lenders would rely upon their own credit risk framework, analysis and evaluation. So the notching is, at best, an approximation of the credit risk analysis undertaken by arm's-length lenders.

Second, so far the authors have found no market evidence that a lender would provide a lower interest rate to a borrower for the notched rating, using the notching methods. Therefore, there is no direct market evidence of any potential economic benefit for notching.

Summary

In the pricing of a financial transaction, not all factors will have equal, or even significant, weight in a lender's assessment of, and estimate of, the borrower's credit risk. Generally, there are two types of credit risk factors: quantitative, which are based on financial ratios or other quantitative data, and qualitative, which are based on the lender's opinion as to the quality of management, the industry and business risks, the threat to the borrower from competitors or other factors, including potential implicit parental support. How much weight is given by an arm's-length lender to any quantitative or qualitative credit risk factor—let alone implicit parental support—is based on the financial institution's lending experience and credit risk appetite.

It is not sufficient to determine whether implicit parental support exists. One must determine, if it exists, whether it would have any significant impact on the arm's-length pricing of an intercompany financial transaction. While rating agencies have developed notching methods regarding notching the non-guaranteed subsidiary's implied stand-alone rating for implicit parental support, a transfer pricing analysis also must consider whether it is reasonable to assume that arm's-length lenders also would notch their stand-alone credit risk assessments in the same manner as the credit rating agencies—or at least in a manner that produces the same outcome). This is not an easy assumption to support, at least in an empirical sense.

Finally, if implicit parental support is determined to exist and a notching of the stand-alone rating is accepted, it still is necessary to quantify the economic benefit attributable to the implicit parental support in determining the arm's-length pricing of intercompany financial transactions. While one can estimate the arm's-length range of interest rates for a borrower both on a stand-alone implied credit rating basis and on a notched basis (due to implicit parent support) and thus determine the difference that may be attributable, whole or in part, to implicit parental support, this is not a definitive analysis as there is usually an overlap of interest rates from one credit rating to another.

The authors expect the debate to continue until, if ever, there is direct market evidence that implicit parental support does, or does not, affect an arm's-length lender's credit risk analysis of a non-guaranteed subsidiary's loan or financial transaction and result in different pricing.