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CHAPTER 94 New Challenges in Defending Intercompany Debt

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§ 94.01 Overview

OECD guidance and national tax authorities practices remain in flux as to how multinational companies ("MNCs") should lend to their subsidiaries and whether those subsidiaries will be successful in reducing their tax burdens by deducting interest payments on such debt. The purpose of this chapter is to highlight the challenges involved in defending intercompany debt in an environment of rapidly changing regulations, recent court decisions, and pending litigation.

The OECD BEPS[1] initiative, together with subsequent rule changes from multiple national tax authorities, mark a decidedly new and challenging environment for MNCs regarding intercompany financial transactions of all types. Increased litigation as well as recent tax court rulings have highlighted a variety of associated issues, many of which are far from definitively resolved.

Nonetheless, BEPS Action 2 Hybrids and Action 4 Interest Deductions along with ongoing Actions 8–10 Transfer Pricing (Financial Transactions) have had dramatic effect on both legislative action and tax authority approaches to related party financings. BEPS Action 2 has successfully encouraged new regulations designed to neutralize the effects of hybrid instruments and entities, including exploitation of differences in tax treatment under the laws of multiple tax jurisdictions to achieve one or more interest deductions without corresponding interest income. Broad anti-avoidance legislation has also resulted, disallowing exploitation of differences in the tax treatment of a financial instrument purely to produce a tax advantaged outcome.

National tax authorities are increasing their efforts to capture "lost" revenue involving related party financial transactions, evidenced by the OECD BEPS Actions publications,[2] the Base Erosion Anti-Abuse Tax ("BEAT") provisions of the U.S. Tax Cut and Jobs Act of 2017 ("2017 Tax Act"), the Australian Taxation Office ("ATO") release of its Practical Compliance Guideline ("PCG") in 2017 on cross-border related party financings, and the UK's HM Revenue & Customs ("HMRC") implementation of its Corporate Interest Restriction of 2017. These actions reflect an enforcement approach based on the belief that most intercompany financial transactions are essentially "money circles" with little valid business purpose. As BEPS Action 4 notes:

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[1] Organization for Economic Co-operation and Development ("OECD"); Base Erosion and Profit Shifting ("BEPS"). *Available at* http://www.oecd.org/tax/beps/ (accessed Aug 1, 2016).

[2] Action 4: Limiting Base Erosion Involving Interest Deductions and Other Financial Payments—2016 Update and the Public Discussion Draft of Actions 8-10 Financial Transactions 3 July 2018–7 September 2018. *Available at* http://www.oecd.org/ctp/beps/oecd-releases-beps-discussion-draft-on-the-transfer-pricing-aspects-of-financial-transactions.htm (accessed Aug 15, 2018).

> "The use of interest (and in particular related party interest) is perhaps one of the most simple of the profit-shifting techniques available in international tax planning."[3]

Meanwhile, stakeholders expect MNCs to efficiently manage their global tax profiles and fund growth and investment in an efficient, after-tax manner. The resulting tension explains why MNCs and national tax authorities are displaying heightened discord with respect to how intercompany debt arrangements should be managed, structured, and documented.

The perspectives of the authors of this chapter on the issues surrounding intercompany debt are informed by their professional experience in both credit ratings and debt capital markets. While we have discovered the legal, tax and accounting issues surrounding intercompany debt to be both multifaceted and dynamic, analysis of intercompany debt begins with the same basic questions that must be answered for a true third-party debt transaction:

1. What is the credit quality of the borrower and how would a rating agency reach a decision with respect to the Implied Credit Profile ("ICP"), or rating, of the issuer; and
2. How much and at what price would third-party arms-length investors provide capital to the borrower/issuer based on the conditions prevalent in the Debt Capital Markets ("DCM") at the time of the transaction in question?

While subjective judgements must be made (as they are by ratings agencies and DCM desks) they should be made based on close analysis of available empirical data relating to both primary and secondary market activity over relevant time frames; as well as contemporaneous data. Unfortunately, many practitioners of these disciplines rely on quantitative analysis of historical economic or trading data to assign a credit rating and determine debt pricing, with little attention paid to whether a given debt issue could actually have been done at the time in question given its size, ICP, term, and covenant structure.

While the sheer amount of financial information and associated credit ratios available for companies rated by the major rating agencies would seem to facilitate "comparables [sic] analysis", there are very real limits on the predictive accuracy of such data applied on a retrospective basis. Likewise, there is a deep pool of public and private DCM price data available that, without proper interpretation and adjustment, can lead to erroneous conclusions, especially in light of structural and documentary characteristics often found in intercompany transactions that may not be present in comparable arm's length or "uncontrolled" transactions.

Given the subjective nature of credit rating and pricing activities, pitfalls abound in creating a defensible rationale of a subsidiary's credit quality and associated debt costs. This chapter examines the limits of quantitative extrapolation of credit and pricing data and highlights some of the myriad issues that tax authorities and MNCs have discovered regarding intercompany financings.

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[3] Action 4: Interest Deductions and Other Financial Payments, OECD BEPS p. 6 (Dec 18, 2014, Feb 6 2015).

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§ 94.02 The Relevant Regulations[4]

New limitations on intercompany debt and associated interest expense deductions were proposed by the OECD in BEPS Action 4, which resulted in actions by various tax authorities including those noted in § 94.01 Overview. The Action 4 Report recommends national tax authorities adopt a fixed ratio rule that limits net interest expense deduction to between 10 percent to 30 percent of any entity's EBITDA.[5] This limitation is meant to apply to third party as well as intercompany debt and does not allow grandfathering of any existing debt. Also, the Action 4 Report recommends national tax authorities consider allowing an optional group ratio rule that permits a group to make pro rata allocations of up to 110 percent of its net interest expense to the various entities within the group.

Both of these recommendations move tax compliance further from the arm's length standard and Comparable Uncontrolled Transactions ("CUT") and Comparable Uncontrolled Pricing ("CUP") methods that have been the cornerstones of debt transfer pricing philosophy as practiced throughout most of the developed world. This approach of limiting interest deductions to a percentage of EBITDA reduces the likelihood of major disagreements over the pricing of related party financings (and, by extension, establishing the credit worthiness of an entity) simply because the tax benefits of aggressive leverage have been greatly reduced if not eliminated. The U.S. adopted the rationale behind these restrictions in the 2017 Tax Act by limiting interest expense deductions to 30 percent of ATI (adjusted taxable income, usually comparable to EBITDA). This limitation reduces even further in 2022 to 30 percent of EBIT and applies to all debt of all entities.

Nonetheless, transfer pricing regulations worldwide generally still require companies to go through the effort of choosing appropriate third-party credit and pricing comparables for validating related party financings. For determinations of credit quality, this requires comparison of the borrowing entity with other rated companies in the same industry and, if appropriate, other industries. The same is true when pricing intercompany debt since pricing is compared to debt issues of other companies in the same industry or in other industries deemed appropriate.

While high profile litigation in Australia (*Chevron*)[6] and Canada (*GEC*)[7] has shed some light on important aspects of intercompany debt disputes, little has been resolved with finality in this subject area, especially in what is likely the

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[4] *See* Chapter 93 for a more complete discussion of regulations regarding intercompany debt.

[5] Earnings before interest, taxes, depreciation and amortization ("EBITDA").

[6] Chevron Australia Holdings Pty Ltd v Commissioner of Taxation (No 4) [2015] FCA 1092.

[7] General Electric Capital Canada Inc. v Her Majesty the Queen 2008TCC256; General Electric Capital Canada Inc v The Queen*,* 2009 TCC 563 (Dec 4, 2009).

highest stakes battleground, the U.S. The existence of large, foreign-controlled U.S. subsidiaries, coupled with significant historical differences in national marginal tax rates, creates a big-ticket environment for disagreement. In several cases, settlements have occurred before courts could address disputed issues and, even in the cases where courts have provided guidance, they have done so with the caveat that many matters will be highly fact dependent. Given the new limitations on interest expense deductibility based on either EBITDA or EBIT, significant disputes may now be confined to tax years prior to 2018. That said, the absolute dollar size of the potential adjustments leaves little doubt that different perspectives will continue to be argued.

The U.S. Treasury/IRS have made it clear they will aggressively challenge what they consider to be excessive intercompany debt and associated outgoing interest expense. This seems especially true when it comes to "serial acquirers" that are inverted[8] companies. In the U.S., the BEAT provisions of the 2017 Tax Act specifically target such companies; and, as previously discussed, historical disagreements are far from settled. In 2016, the Treasury attempted to better equip the IRS to tackle intercompany debt disagreements through changes to *Internal Revenue Code Section 385*, though most of those provisions have since been revoked. A notable exception seemed to be the documentation requirements scheduled to go into effect January 1, 2019, although even those provisions have yet to be implemented and face an uncertain future.

The *IRC Section 385* documentation requirements were meant to eliminate casual intercompany financings and require cash pool arrangements to more properly document cash management among related parties. The Public Discussion Draft of BEPS ACTIONS 8-10 Financial Transactions[9] further suggests that cash pooling arrangements which demonstrate chronic balances or deficits may more appropriately be structured as long-term loans.

Unfortunately, neither the BEPS Actions nor the U.S. Treasury have clearly established how, and/or how often, the credit quality of a borrowing entity should be determined to substantiate the stand-alone, arm's-length aspect of related party financings on an ongoing basis; especially if the borrowings are on an unsecured basis and occur several times a year as is clearly the case with cash pooling arrangements.

Without further clarification from tax authorities, these new regulations may have the consequence of making intercompany debt so cumbersome to justify that smaller transactions become more economic to be routinely handled as equity contributions, especially when the effects of lower national tax rates are considered.

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[8] 'Inverted' companies typically were once U.S. entities but have established themselves as foreign companies through mergers with, or acquisition of, foreign entities or change of address.

[9] OECD Public Discussion Draft BEPS ACTION 8-10 Financial transactions 3 July–7 September 2018.

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§ 94.03 General Considerations

Against this backdrop of aggressive actions by national tax authorities, it has become increasingly clear that increased documentation will be required to support both the credit profile and pricing of intercompany debt going forward. This will be especially true for higher risk (non-investment grade) transactions involving higher interest rate deductions. Also exposed, however, is any borrower that has relied on less robust documentation practices in the past. Accordingly, companies now need to demonstrate and document that their intercompany debt could have been issued by the subsidiary to third-party lenders or investors at the indicated time, amount, price, and terms.

The analytical sophistication required to establish this 'arm's-length' basis has substantially increased over the last few years. The OECD acknowledged as much when dismissing bank opinions:

> "In some circumstances taxpayers may seek to evidence the arm's length rate of interest on an intra-group loan by producing written opinions from independent banks, sometimes referred to as "bankability" opinion, stating what interest rate the bank would apply were it to make a comparable loan to that particular enterprise".[10]

> "… Such letters would not, therefore, generally be regarded as providing evidence of arm's-length terms and conditions".[11]

Putting together strong, convincing evidence of a subsidiary's ability to issue debt on an arm's length basis at a given price requires specialized expertise in both credit ratings and debt capital markets, working closely with advisors to the tax, legal, and treasury specialists of MNC's. While this array of talent may seem excessive for determining the arm's-length basis for subsidiary financings, the cost of litigating and potentially losing a tax dispute many years later dwarf the cost of getting it right at the outset.

In the U.S., regulations offer MNC's an incongruous option to the arm's length standard in the form of the AFR[12] option for interest expense. For any amount of debt deemed as debt for tax purposes, taxpayers have the option of using an interest rate equal to 100 to 130 percent of the then current AFR for dollar denominated debt of a specific maturity. Since the short-term, mid-term, and long-term AFRs are based on U.S. Treasury rates, they are relatively low interest rate levels reflective of the "risk-free" nature of U.S. Treasuries; and, therefore, do not incorporate credit spreads normally required for corporate borrowings. Not surprisingly, a U.S. MNC can use this safe haven to its

[10] OECD Public Discussion Draft BEPS ACTION 8-10 Financial transactions 3 July–7 September 2018, ¶ 92.

[11] OECD Public Discussion Draft BEPS ACTION 8-10, ¶ 93.

[12] Applicable Federal Rate ("AFR").

advantage when lending to an offshore subsidiary in a jurisdiction that would normally demand a significant country risk premium. The MNC receives a much lower rate of interest than would be required under an arm's length standard and does not have to pay tax on the income differential.

U.S. regulations also offer the option of completing intercompany debt on a "cost plus" basis via third-party loans relying on the parent's credit in either the situs of the parent or the subsidiary. This third-party approach is likely used by MNCs only when they are seeking a rate higher than what the AFR option would provide. Also, this approach provides the borrower and lender with a reduced risk of having the intercompany interest rate challenged compared to one based on the comparable uncontrolled pricing method because only costs additional to the third-party borrowing costs are subject to dispute.

This latter option effectively ties the credit worthiness of a subsidiary directly to that of its parent, a concept that has garnered a lot of support in the BEPS initiative, so much so that the BEPS Actions 8-10 discussion draft questions whether for intercompany debt it is a useful "rebuttable presumption" that "… the credit rating at the group level may be taken as the credit rating for each group member, for the purposes of pricing …"[13].

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[13] OECD Public Discussion Draft BEPS ACTION 8-10 Financial transactions 3 July–7 September 2018, Box C.2.

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§ 94.04 The "Stand-Alone" Entity

A complete and accurate stand-alone credit assessment of a borrowing entity is a vital step in determining its current and future capacity for debt and interest expense. Rating agencies as well as most investors usually begin analysis of any debt instrument by analyzing the credit quality of the borrower without regard to the structure of the debt or the possible existence of parental support. Afterwards, their analyses focus on the specific debt security and the rights of the debt holders in bankruptcy as well as the effect, if any, of explicit or implicit parental support. S&P modifies this approach for what it considers to be Core or Highly Strategic subsidiaries, asserting a stand-alone credit assessment may not be necessary for such critical entities. Nonetheless, the determination that a subsidiary is in fact crucial enough to a group to be considered Core or Highly Strategic usually requires significant analysis of the subsidiary itself.

A large U.S. subsidiary of an MNC may be structured as a true stand-alone entity with separate management as well as fully independent operational, accounting, human resource, and legal support. If a subsidiary lacks such infrastructure, then the impact of fully loading in the costs and challenges of running a separate organization should be considered before analyzing its credit risk profile. This analysis can be challenging for an MNC with multiple subsidiaries that rely on the MNC for varying amounts of centralized support yet report as a consolidated entity in a single tax jurisdiction.

The OECD is attempting to establish that a stand-alone entity (based on a third-party, arm's length perspective) does not mean treatment as an "orphan" entity. To the contrary:

> "In pricing an intra-group loan, the borrower is viewed as an independent enterprise. This does not mean that the presence of the rest of the group is necessarily ignored. Therefore, the potential impact of passive association on creditworthiness and other terms is taken into account."[14]

There are challenges in interpreting the OECD's BEPS Actions 8-10, Financial Transaction, Section C.1.3: Effect of group membership[15], which seems to imply a) a stand-alone entity benefitting from passive association with a worldwide network is the same as b) the more established concept of implicit support. In our view, passive association may improve the creditworthiness of an entity in a variety of ways, including purchasing power, name recognition, and the like. Implicit support addresses the likelihood that an entity could be financially supported to some degree in times of stress despite the absence of any legal requirement to do so. While we understand implicit support may be viewed as a benefit of passive association, we believe the concepts are best addressed separately. This means that a stand-alone credit assessment of an entity can and perhaps should include passive association

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[14] OECD Public Discussion Draft BEPS ACTION 8-10 Financial transactions 3 July–7 September 2018, ¶ 67.

[15] OECD Public Discussion Draft BEPS ACTION 8-10 Financial transactions 3 July–7 September 2018.

considerations depending on the specifics of the entities involved, but implicit support considerations need to be analyzed separately.

Implicit support considerations, if any, should only be considered when determining the overall creditworthiness of an entity and not when determining its stand-alone creditworthiness. Moreover, no one specific condition would justify implicit support; it is a combination of characteristics that lead to a conclusion that implicit support is applicable and warrants lift of the stand-alone credit assessment. Lastly, a determination that implicit support exists for one situation does not imply implicit support will exist in other situations as nearly every subsidiary will have characteristics that make it different if not unique compared to other subsidiaries.

Other arm's length problems exist if the borrowing entity is too small or too weak to justify an unsecured transaction (undoubtedly true more often than has been acknowledged by MNCs in the past). Such intercompany debt would need to be executed on a secured basis in order to be structurally similar to comparable uncontrolled transactions. Interestingly, the OECD's latest statements on this issue suggest that an unsecured loan by a parent to a subsidiary should be viewed as being secured, even when it is not:

- "In the case of a loan from a parent entity of an MNE group to a subsidiary, the parent already has control of and ownership of the assets of the subsidiary, which would make the granting of security less relevant to its risk analysis as a lender. Therefore, in evaluating the pricing of the loan between related parties it is important to consider that the absence of contractual right over the assets of the borrowing company does not necessarily reflect the economic reality of the risk inherent in the loan. If the assets of the business are not already pledged as security elsewhere, it will be appropriate to consider under Chapter 1 analysis whether those assets are available to act as collateral for the otherwise unsecured loan and a consequential impact on the pricing of the loan."[16]

Securing intercompany debt is, in most cases, not considered a practical or economic option. Especially for smaller borrowings of less than $100 million, we would tend to agree with the BEPS position that if, by virtue of its size, the borrower could not be expected to issue on an unsecured basis, it would not be inappropriate to assume that the intercompany loan was, indeed, secured, even if it had not been originally documented in that fashion. Such a loan would then be priced in accordance with how secured transactions would have been priced according to market conditions at that time. Treating an unsecured transaction as though it is a secured transaction may at first seem to be violating transfer pricing principles; but, given that any true third party transaction would likely be completed on a secured basis and priced accordingly, we believe the arm's length CUP standard is best reflected by this approach and is much more likely to be acceptable to tax authorities.

While security may not be an issue for larger transactions (as most corporate bond issues are issued on an unsecured basis) covenants, or the lack thereof, present a similar challenge. Increasing the cost of an intercompany borrowing due to the absence of detailed covenants usually found in third-party borrowings invites scrutiny at the very least. Prevailing market standards at the time of a financing should provide the basis for appropriate covenants in an intercompany financing. An approach that deliberately utilizes non-standard provisions (absent proof of a legitimate commercial need for same) that results in higher interest rate deductions runs the risk that the borrower is looking to exploit "self-inflicted wounds".

Challenges aside, at the time a subsidiary borrows from its MNC parent, credible, current, and complete credit profile assessments will form the critical base from which any defense of intercompany financings begins.

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[16] OECD Public Discussion Draft BEPS ACTION 8-10 Financial transactions 3 July–7 September 2018, ¶ 52.

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§ 94.05 Financial Policy and Planning

Whether an MNC determines that its stand-alone entity has the financial objective of (1) establishing and maintaining a specific credit rating or debt ratio or (2) establishing a financial policy to leverage the entity in a manner that enhances the potential return to its shareholders, the subsidiary's financial policy will impact many aspects of its credit outlook and standing. An entity's financial policy will not only impact its ability to demonstrate access to comparable financial markets at times of future intercompany borrowing's; it will likely determine which debt capital products and structures will be available to it over time from its lending parent. For example, in actual third-party transactions, an unsecured bank term credit facility/revolving line of credit is not a structure likely available to non-investment grade credits regardless of the industry.

Equally important, however, is that a borrowing entity's financial policy will likely establish appropriate uses of proceeds for borrowings and establish the expectation of the ability to repay borrowings over time. Tax courts consider these important factors when determining, in hindsight, whether financial advances should have been characterized as debt or equity at the time of their issuance. Indeed, subsidiaries must carefully consider their cash flows and borrowing needs on a forward-looking basis if they seek to convince tax authorities and courts that their borrowings are for legitimate business purposes and not with a primary purpose of tax avoidance via hastily constructed or retroactive transactions with their parent.[17] In arm's length third-party debt transactions, there is an expectation that the debt will repaid in full or part and/or be refinanced at maturity, dependent of course on the ongoing creditworthiness of the issuer and future market conditions.

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[17] *See* American Metallurgical Coal Co v CIR, TCM 2016-139 (July 25, 2016).

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§ 94.06 Credit Rating and Credit Quality Assumptions

A credit rating is a 'forward-looking' assessment of the likelihood an entity will repay its obligations on time and, by definition, is a subjective evaluation. Credit rating analysis begins with determining the business risk profile of the stand-alone entity. This encompasses the potential for changes in industry dynamics, and an assessment of a company's competitive advantages, market share, cost position, brand value, technological transformation, long-term contracts, material lawsuits, and regulatory restrictions. Along with an assessment of how the general economic and business outlook affect the credit profile of a company, the aforementioned steps take place long before its financials positively or negatively change.

Simply referencing a rating agency's published credit ratio statistics for a given rating category (or core ratios by financial risk classifications)[18] to derive an implied rating will often lead to incorrect conclusions. Inadequate adjustment of financial ratios can result from omitting adjustments for various items including, but not limited to, stock-based compensation and off-balance sheet liabilities such as operating leases, rental expense, pension liabilities, and accounts receivable securitizations. Even when properly calculated, however, rating agencies explain that while ratio comparisons are an important tool, they are *"only guidelines"*, and by no means the most important variable in deriving a credit rating. Ratio averages only establish norms, which, taken alone and on an historical basis, are, more often than not, misleading when determining an implied rating intended to reflect future prospects, resulting in the need to factor in additional subjective considerations.

Analysis of S&P and Moody's data indicates that predicting a credit rating based solely on the recent historical financial performance of a company will, more often than not, yield an incorrect conclusion.

- Using the historical CreditStats[19] credit ratios previously published by S&P,[20] quantitative analysis of three-year historical norms proved accurate less than 20 percent of the time in forecasting the ultimate S&P credit rating of over 736 randomly chosen non-financial U.S. companies.[21]

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[18] Moody's Global Methodologies by Industry Segment (dates vary by industry sector); historical S&P CreditStats (last issue published Aug 29, 2014); S&P Corporate Criteria (Nov 19, 2013).

[19] CreditStats (last issue published Aug 29, 2014 covering data for the three-year average 2010–2012); replaced by S&P Corporate Criteria (Nov 19, 2013).

[20] Similar results occurred when using the single financial ratio most often cited by bankers and investors as the key indicator of credit quality, the Debt/EBITDA ratio.

[21] GCA S&P research summary based on CreditStats publication of the 3-year average 2011–2013 credit ratios dated Aug 29, 2014.

- Comparison of Moody's largely quantitative non-financial specific industry sector methodology grids rating for 944 companies likewise corresponded to Moody's final rating only 36 percent of the time, despite qualitative considerations in the grid rating as well.[22]

Performance through an economic cycle, historical and forecast industry trends, recent and projected financial performance, management strategy, credibility, and financial policy—together with perceived financial and operational flexibility—all contribute to the ultimate, subjectively derived, credit profile. Such factors should not be treated lightly and require specific expertise and experience to convincingly address. The OECD recently weighed in on this issue as well:

> "The credit rating methodology used in commercial tools differs significantly from the credit rating methodologies applied by independent credit rating agencies to determine official credit ratings. For instance, such tools generally use only a limited sample of quantitative data to determine a credit rating. Official credit ratings published by the independent credit rating agencies are derived as a result of far more rigorous analysis which includes quantitative analysis of historic and forecast company performance as well as detailed qualitative analysis of, for instances, management's ability to manage the company, industry specific features and the company's market share in its industry."[23]

While incomplete or inaccurate credit analyses create obvious problems, outdated assessments are equally concerning. Reliable, stand-alone credit assessments must incorporate both quantitative and qualitative components, including contemporaneous economic outlooks existing at the time of a new financing to accurately reflect a subsidiary's credit profile at that time. Such assessments must consider underlying trends and be up-to-date to evaluate potential changes in the subsidiary's credit should there be serial financings.

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[22] GCA Moody's research summary of 36 Global Industry Methodology reports with dates ranging from Oct. 22, 2012 to Dec. 29, 2015.

[23] OECD Public Discussion Draft BEPS ACTION 8-10 Financial transactions 3 July–7 September 2018, ¶ 64.

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§ 94.07 Size Does Matter—Company Size and/or Amount of Debt

Analysis of the financial data of companies with public ratings from the major credit rating agencies leaves little doubt that absolute size of a business is a critical variable in predicting a rating outcome. While size does not secure a higher rating by itself, it is one of the key metrics considered; despite size by no means assuring financial performance of a company. Industry dynamics become particularly important in this regard: a small cable company is exposed to very different economic forces compared to a small consumer products company.

Quantitative consideration of data that does not exclude entities that are significantly different in size than the borrower in question will undoubtedly deliver a very different credit quality assessment than an analysis that includes consideration of size.

The size issue is likewise of considerable importance when using capital markets data to price a small intercompany transaction. While the secondary bond trading levels of a similarly rated company may seem like a good benchmark for a subsidiary seeking a small amount from its parent, the reality is that public debt market benchmarks are based on issues of a minimum size.

Public bond investors, particularly high yield investors, rely on the secondary market as a source of liquidity of their investments. Following a typical large public bond issue, many investors, already familiar with the industry and issuer, may decide to purchase additional bonds in the secondary market at the right price. Purchasing additional bonds, subsequent to a new issue, requires the investor to assess how much liquidity then exists in the market for that particular issue. The more illiquid the bonds appear to be the greater the price discount (i.e. the higher the interest rate) investors will require before purchasing new bonds.

Likewise, in the bank syndicated loan market, especially for non-investment grade loans, the investor base has shifted from “Buy and Hold’ banks to institutional buyers who demand a certain level of liquidity and agent support of the resold loans. This change in the ultimate source of funds results in pricing that is less influenced by typical bank relationship factors and more greatly influenced by other factors that might impact liquidity, including size.

Adjustments for the size of a subsidiary in determining its credit quality as well as for the size of the contemplated transaction are often misapplied, if considered at all.

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§ 94.08 Implicit and Explicit Support Considerations

Generally, taxing authorities, including the IRS, view that implicit support has a significant impact on the credit quality of a subsidiary and should therefore impact the pricing of a subsidiary's intercompany debt. The circular aspect of this argument is most problematic when the subsidiary's debt is directly held by the parent company, because one must question why a parent should accept a lower interest rate as a result of its own willingness to assist a subsidiary in a stress situation.

There are two sides to this concern in cross border situations because any reduction in interest expense for a subsidiary becomes a reduction in interest income for the parent in its home tax jurisdiction. When the relationship of parent and borrower is not direct, as is often, if not usually, the case, the question of implicit support and its impact on a borrower's credit quality and debt pricing becomes much more of a factual determination.

The major rating agencies have established well documented and specific guidelines for assessing "lift" to a subsidiary's stand-alone credit rating.[24] In general, the economic incentive for a parent entity to provide financial support during periods of distress is the most important factor involved in determining what degree of credit lift is warranted. There are several other factors to be considered, however, and the question of credit lift will be highly fact specific for most intercompany financings. Of the numerous factors analyzed to determine if lift is applicable, it is critical to understand that no single factor can be attributed to justifying lift. Additionally, using the appropriate rating agency criteria is critical as such criteria have changed over time and therefore vary depending on the date of determination.

Likewise, pricing considerations will be highly fact specific when considering the possibility of adjustments due to implicit support. In general, the lower the quality of the credit and the higher the likelihood that support might be necessary, the less likely investors will ascribe significant value to anything other than explicit support regardless of the assumed strategic importance of the subsidiary. Moreover, the strategic importance of a subsidiary is subject to numerous possible causes of change, including but not limited to changes in management's outlook, political developments and geographically specific changes in market conditions, to name a few.

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[24] Moody's: Rating Non-Guaranteed Subsidiaries: Credit Considerations In Assigning Subsidiary Ratings In The Absence Of Legally Binding Parent Support, dated December 2003. S&P: The appropriate criteria to use in assessing parent support is dependent on the time frame in question: 1) Corporate Criteria—Parent/Subsidiary Links; General Principles; Subsidiaries/Joint Ventures/Nonrecourse Projects; Finance Subsidiaries; Rating Link to Parent, published Oct 28, 2004; 2) S&P Ratings Direct: Criteria-Corporates-General: Corporate Methodology, published Nov 19, 2013; or 3) S&P Global Ratings: Guidance | General Criteria: Group Rating Methodology, published July 1, 2019.

While explicit support from a parent in the form of an unconditional guarantee will clearly address lender concerns of support for a subsidiary's third-party debt, it is not a panacea in the current tax environment. There still remains the issue of the subsidiary's credit quality, which will need to be established to determine what value the guarantee has provided and what, if any, is the appropriate guarantee fee for the subsidiary to pay to its parent. Additionally, unless it is definitively established that the subsidiary is a credit-worthy borrower in its own right of the amount being guaranteed, the parent may be deemed the true obligor for tax purposes and the infusion treated as contributed equity.[25] In this case, both principal and interest payments made by the subsidiary will be treated as dividends or a return of capital to the parent and create additional tax issues.

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[25] *Plantation Patterns, Inc. v Comm'r, 462 F2d 712 (1972)* aff'g TCM 1970-182.

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§ 94.09 Guarantee Fees

In the debt capital markets, it is very common for an MNC to employ an issuing entity through which to issue debt on behalf of its operating subsidiaries. In the above instance, it is common for the issuing entity to be located in a tax favored jurisdiction. Bonds issued by such an entity carry a "full faith and credit" guarantee from the parent and are priced essentially "on top" of any outstanding parent company's bonds; i.e. at the same spread over Treasuries. This structure is much less common with respect to related party debt, in part due to the fact that a parent would find it inconsistent, at best, to be guaranteeing debt that it is also lending.

Notwithstanding the above, there are situations where a parental guarantee might be provided to enable a subsidiary to access debt at the lowest possible cost; and, depending on a) the jurisdictions of both the issuer and parent, as well as b) the financial policies of the parent, a guarantee fee could well be justified.

While GCA does not purport to be expert in how guarantees are priced by mono-line and other type insurance companies, we are familiar with the broad methodology employed by companies who remain active in this business.

In determining a guarantee fee, firms start by internally assessing the underlying risk of the issuer seeking a guarantee. Using their internal methodologies, they come up with a rating score which would establish how much capital they need to set aside for that level of risk. They then look to see how the market would typically price an issuer with a similar rating score.

As an example, should the guarantor deem the underlying risk to have a "BB" credit profile, they would look to see at what price secondary bonds of a similar maturity and credit profile are trading. This would result in an implied credit spread over Treasuries.

Taking the resulting spread over Treasuries as the "stand-alone" credit spread for the underlying risk, one would then subtract from this the assumed credit spread of a guaranteed bond. The resulting "spread differential" equates to the basis point value-add of the guarantee. Given that the guarantee of any company is, by definition, a limited (versus unlimited) resource, the guarantor would be justified in adding to the "spread differential" an extra charge reflecting both the "scarcity value" of the guarantee and the desired profit return on the overall transaction. Based on discussions in the market, we would estimate that, on average, this could range from 25 to 50 basis points. For guarantees of a large amount of debt, one could expect higher than average "scarcity fees".

While there is no evidence at hand that guarantee fees for guarantees provided by corporate parents would include such scarcity fees, it is probable that an arms-length third-party guarantor would absolutely a) use some variant of the above pricing methodology, and b) charge for the scarcity value of its guarantee.

The OECD, however, recently put forth the premise that:

> "In other words, the formal guarantee may represent nothing more than an acknowledgement that it would be detrimental to the interests of the group not to support the performance of the borrower. In such circumstances the guaranteed borrower is not benefiting beyond the level of credit enhancement attributable to the implicit support of other group members and no guarantee fee would be due."[26]

The implication of this statement is that there is no benefit from a formal guarantee when a company is already benefitting from significant implicit support, a concept that the plethora of actual guarantees in the capital markets would seem to strongly contradict, as would the collective experience in the capital markets of this Chapter's authors. Once again, the arm's length concept is jettisoned by the OECD in favor of the premise that related parties cannot structure financings as independent parties.

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[26] OECD Public Discussion Draft BEPS ACTION 8-10 Financial transactions 3 July–7 September 2018, ¶ 143.

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§ 94.10 Timing and Economic Rationale Errors

Courts have been clear on the need to associate long-term borrowings from a parent with a subsidiary's financing requirements. Whether related to procurement of fixed assets, expansion of the overall business, or funding of a dividend or acquisition, it is necessary to establish the use of proceeds associated with the incurrence of the intercompany debt. Given the developing tax environment, companies need to approach intercompany debt not as an annual budgeting occurrence but as discrete financings that are directly related in a demonstrable fashion to the subsidiary's capital needs.

A true stand-alone issuer might decide to annually access long-term capital markets to extend the duration of short-term financing activity. Likewise, high-yield issuers are often on the lookout for opportunities to term out short-term and/or secured bank debt, knowing that the window of opportunity to secure medium to long-term financing may be fleeting. The key to mitigating debt transfer pricing risks lies in proactively evaluating all options well before financing. Strategically targeting a "B" credit profile is vastly different from targeting a "BB" profile, in terms of the size and maturity of deals normally seen in the market, as well as the expected level of interest expense. While more debt at a higher coupon rate may seem an attractive tax strategy, it is important to consider increased volatility and scarcity of industry rated and pricing comparables, as well as execution risk and the potential for increased complexity of structure.

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§ 94.11 Structural Problems

Many intercompany debt transactions are put in place using vaguely comparable public benchmarks to justify amounts, pricing and maturity. Key differences such as secured versus unsecured financings, maturity, covenants, ranking, enforceability, and prepayment provisions may exist. Intercompany non-investment grade subsidiary bank loans that may have been put in place and documented in a similar fashion to the parent's investment grade bank loan make questionable proxies for arm's-length transactions. For fixed rate transactions, prepayment provisions are often overlooked but can have a significant impact on the pricing of a transaction if the provisions vary even slightly from market norms. Such provisions should be given careful consideration given the need for the subsidiary's management to act in an intelligent fashion to refinance outstanding debt should such re-financing provide economic value.

One important structural consideration often overlooked is the adjustment for "notching" for the structural subordination present in the capital structures of most high-yield issuers. Non-investment grade issuers often reserve their senior debt capacity via secured bank lines to fund general corporate purposes including critical working capital needs, relegating long-term unsecured bondholders to a structurally subordinated position.

MNCs with foreign subsidiaries that have an implied stand-alone, non-investment grade "enterprise" rating would be expected to have a senior secured bank credit facility (e.g. revolving credit facility), and possibly an institutional secured Term Loan B ("TLB")in place. The documentation should consider covenants that are typical for such non-investment grade transactions, allowing such debt to be evaluated as to whether it appropriately replicates real world debt structures, pricing and maturity.

Proper credit rating analysis requires that unsecured debt issues may be notched one or two levels lower than that of the "enterprise." Conversely. pricing a secured debt transaction could result in its rating being one-notch higher than the "enterprise" rating. Practitioners employing ratio-driven assessments of issuer credit profiles often overlook these adjustments.

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§ 94.12 Market Miscalculations

Finding evidence that supports both the amount and interest rate at which a subsidiary could theoretically borrow in the public (or private) debt markets is, like credit analysis, a subjective endeavor. Infrequent comparable new issues, combined with lower secondary trading activity, can make it more challenging to tie a subsidiary's new intercompany debt issue to comparable issues in the debt capital markets. This is particularly true for bank loans and credit facilities, where pricing is influenced by low transparency and empirically unsubstantiated "relationship" factors.

For their part, MNCs would prefer to fund their subsidiaries as needed and not when a theoretically perfect "comparable" issuer happens to be doing a public debt deal. This places a premium on professional guidance in assessing the appropriate size, structure, maturity and pricing of an impending related-party issue; based on:

a) careful analysis of current market conditions;

b) actual new issue transactions from issuers with similar business and credit profile characteristics (properly adjusted if not a direct comparable);

c) secondary transactions of issuers with similar business and credit profile characteristics (properly adjusted, especially with regard to size); and

d) knowledge of current investor preferences/appetites.

Professional comparables analysis that evaluates companies within a similar industry and/or similar credit rating profile is critical to properly adjusting overall market averages during the pricing process. Consideration of outliers and the impact of significantly out-of-favor industries (such as energy and mining in 2016) is an obvious requirement if the result is expected to meet the standards of transfer pricing adjustment required to reflect the specific aspects of the transaction at the specific time in question.

Fortunately, the OECD recent comments on the value of timely comparable market data is grounded in sound arm's length reasoning:

> "… In this regard, the precise timing of the issue of a financial instrument in the primary market or the selection of comparable data in the secondary market can therefore be very significant in terms of comparability. For instance, it is not likely that multiple year data on loan issuances will provide useful comparables. The opposite is more likely to be true …"[27]

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[27] OECD Public Discussion Draft BEPS ACTION 8-10 Financial transactions 3 July–7 September 2018, ¶ 94.

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§ 94.13 Documentation Deficiencies

Incomplete and inaccurate documentation, including inconsistent nomenclature, has proven very costly to MNCs in the past. Legally enforceable, robust, market-based credit agreements running between the MNC parent and its borrowing subsidiaries are highly recommended in today's tax enforcement environment.

Equally important is the detailed and convincing documentation of: 1) the need for the borrowing; 2) the expectation of repayment; 3) the market justification for the amount and interest rate on the borrowing; and 4) the evidence that management of the subsidiary would consider such a borrowing appropriate and beneficial to their enterprise on an arm's-length basis. This addresses the concern that, not only must the market be deemed willing to do the deal, but management of the "stand-alone" subsidiary must be deemed to have found it to be a reasonable business transaction as well.

Projections establishing the subsidiary's ability to repay the debt as scheduled from anticipated cash flows are highly recommended. To evaluate a rating, it is preferable to use a borrower's three-year historical results and three-year projected business and financial plan; whereas a cash flow analysis to the final maturity of debt is used to show the tax authority that the borrowings can be repaid. Generally, such analysis by a tax authority excludes refinancing of debt despite refinancing's being commonplace in the third-party financial activities of most MNCs, and a common practice of rating agencies in determining credit ratings.

On October 13, 2016, the U.S. Treasury issued its *IRC Section 385* Final and Temporary Regulations.[28] On April 24, 2017, President Trump signed an executive order requiring the Treasury to examine this regulation. This was followed on July 28, 2017 in an announcement by the U.S. Treasury of a one-year delay in the implementation of the minimum documentation requirements under Final *IRC Section 385* Regulations. The revised documentation requirement was expected to apply to instruments issued on or after January 1, 2019, but such requirements are not yet effective and their future remains uncertain.

Nonetheless, the common sense aspects of the *Treasury Regulations 1.385-2* deals with documentation of intercompany debt and the requirement that such documentation reflect:

i. A legally binding obligation to repay the funds;

ii. The creditor's right to enforce the default terms (if borrower fails to pay or is unable to comply with covenants);

iii. A reasonable expectation that the funds can be repaid;

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[28] *IRC § 385*.

iv. Evidence of timely payment of P&I and an on-going “genuine” debtor/creditor relationship.

The regulations provide examples of how to establish the reasonable expectation that the funds can be repaid, including (i) cash flow projections, (ii) financial statements, (iii) business forecasts, (iv) asset appraisals, (v) determination of debt-to-equity and other relevant financial ratios of the issuer in relation to industry averages and (vi) other information regarding the sources of funds enabling the issuer to meet its obligations pursuant to the terms of the applicable interest.

Master agreements are permissible for cash pooling and similar arrangements, and there are exceptions for certain debt instruments as well as *de minimis* provisions; but, if an issuer is unable to provide documentary evidence as required above, reclassification of debt as equity is possible.

Repeated extensions of maturity dates and missed interest expense due dates have proven costly to companies challenged on debt versus equity characterizations. While fully amortizing debt is contrary to the standard corporate finance practice of maintaining a balance sheet with stable debt ratios over time, this perspective is consistent with national tax authorities’ efforts to establish a key difference between debt and equity. Carefully navigating the above requires issuers to justify debt (and subsequent refinancing’s) using cash flow analyses and corporate finance theory as a responsible finance officer would do in managing an issuer’s debt position.

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§ 94.14 Risks, Rewards, and Realities

Historically, the considerable gap between marginal corporate U.S. tax rates and those of other developed countries compelled MNCs to take full advantage of interest deductibility on inbound U.S. intercompany debt. As evidenced by the BEAT provisions of the 2017 Tax Cuts and Jobs Act, overall related-party debt levels do not conform with what U.S. tax authorities deem appropriate. Similar actions of tax authorities worldwide, from adoption of BEPS recommendations to aggressive litigation, demonstrate that MNC's tax policies of the past are under attack. As a result, MNCs, who, by definition, have large foreign subsidiaries and most likely related party debt concerns, need to better manage and document their intercompany debt.

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