United States

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Pricing of a Guarantee Fee in a Related-Party Context

In a recent case, *Container Corporation v. Commissioner*, the US Tax Court addressed the question of the source of a loan guarantee fee paid by a domestic corporation to a foreign parent corporation for purposes of determining whether there is a US withholding tax obligation. The case provides a good vehicle for the discussion of the transfer pricing aspects of guarantee fees.

1. Introduction

In a recent Tax Court case, *Container Corporation v. Commissioner*,[1] the Tax Court addressed the question of the source of a loan guarantee fee paid by a domestic corporation to a foreign parent corporation for purposes of determining whether there is a US withholding tax obligation. The case provides a good vehicle for the discussion of the transfer pricing aspects of guarantee fees, although the Tax Court opinion was silent on this point. The pricing of guarantee fees has triggered a closely watched case in Canada,[2] but US taxpayers continue to wait on guidance from the IRS on transfer pricing for guarantee fees.

2. Facts of the Case

The taxpayer in *Container Corporation*, Vitro S.A. (Vitro), was a Mexican corporation. Vitro owned the stock of several US corporations, including Vitro International Corp. (International). International issued notes (1991 senior notes) to unrelated parties to raise cash for an acquisition of a US glass jar manufacturer. Vitro guaranteed payment of the notes. International paid a fee to Vitro equal to 1.5% of the principal amount of the notes in exchange for the guarantee. No tax was withheld by International on payments made to Vitro. On audit, the IRS determined that the guarantee fee payments constituted fixed or determinable annual or periodic income. The question addressed by the Tax Court was whether the payments were foreign-source income, and therefore not subject to US withholding tax, or domestic-source income and subject to US withholding under Sec. 1442.[3]

The position of the IRS was that the guarantee fees should be sourced in the same manner as a payment of interest on a loan. Under Sec. 861(a)(1), interest paid by a domestic corporation is generally treated as domestic-source income. As International was a domestic corporation, the IRS argued that the guarantee fee payments were domestic-source income and subject to US withholding tax. The taxpayer's position was that the guarantee fees should be sourced in the same manner as income from services. Under Sec. 861(a)(3) and Sec. 862(a)(3), income from providing a service is sourced according to the location where the service is provided. As the guarantee was provided by a Mexican corporation, the taxpayer argued that the service was performed in Mexico and the income is therefore foreign source. No US withholding tax would be imposed under the taxpayer's analysis.

The Tax Court went through a three-step process in resolving the case. First, the Court made the determination that a guarantee fee is technically neither interest on a loan nor compensation for a service. Second, the Court discussed the authorities on sourcing by analogy, i.e. whether a guarantee fee is more like interest or more like compensation for a service. The sourcing rules of Sec. 861 and Sec. 862 do not specifically address all types of income. If a category of income is not specifically addressed by statute, the courts reason by analogy to determine which sourcing rule to apply.[4] Third, the Court reasoned that a guarantee is more analogous to a service, that the service is provided at the location of the guarantor, and, therefore, the payments made by International to Vitro are foreign-source income.

Although there has been much commentary about the Tax Court's holding that the guarantee fee was sourced according to the location of the guarantor, one interesting aspect of the case is a lack of discussion about the measurement of the guarantee fee. As indicated, the amount of the fee paid by the US subsidiary to the Mexican parent corporation was 1.5% of the principal of the loan. The Tax Court made the factual finding that "Vitro charged all of its subsidiaries the same fee no matter the subsidiary's capital structure or financial condition". Furthermore, the Tax Court made the factual finding that "as expected, it [International] did not have the cash flow to make the interest payments on the International 1991 senior notes. To make those payments, Vitro... contributed almost USD 80 million in capital to International from 1990 to 1994". In other words, the Tax Court made the factual finding that

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1. 134 T.C. No. 5 (2010).
2. *General Electric Capital Canada v. The Queen*, 2009 TCC 563.
3. All section references are to the Internal Revenue Code and the regulations thereunder.
4. See *Bank of America v. United States*, 680 F.2d 142 (1982), aff'd in part and rev'g in part 81-1 UST.C. Sec. 9161 (Ct. Cl. 1981) (the court used the interest and service sourcing rules to determine the source of fees received in connection with letters of credit).

Vitro apparently guaranteed notes issued by International when it was understood that International would not have sufficient cash flow to cover payments on its 1991 senior notes. Vitro appeared to assume that 1.5% of the principal amount of the loan was an arm's length guarantee fee regardless of the facts. A safe harbour rule for determining the fee for a guarantee would be recommended from a tax administration standpoint, but is that the law?

3. How to Characterize a Guarantee

For many years, General Counsel Memorandum (GCM) 38499[5] was the primary tax authority that addressed the measurement of a guarantee fee in a related-party context. In that case, a domestic corporation guaranteed the indebtedness of a foreign subsidiary. The issue addressed was whether a fee or charge should be made under Sec. 482 for the guarantee. The IRS first concluded that the guarantee should be characterized as a service. Under Treas. Reg. Sec. 1.482-2(b)(3) effective for the year in issue, with some exceptions, generally an arm's length charge for a service was deemed equal to the costs or deductions incurred by the renderer of the service. The IRS concluded that Treas. Reg. Sec. 1.482-2(b)(3) applied; the amount to charge for the service was equal to the costs incurred by the parent to provide the service; and as no costs were incurred, the GCM concluded that the charge for the guarantee should be zero.

The IRS abandoned the reasoning of GCM 38499 when temporary Sec. 482 service regulations were issued in 2006.[6] The temporary regulations made it clear that a financial guarantee was no longer entitled to a cost safe harbour; under the temporary regulations, a financial guarantee was not a covered service entitled to the application of the low margin services cost method (SCM).[7] In the preamble to the temporary Sec. 482 service regulations, the IRS repeated the point, stating that "[t]he Treasury Department and the IRS do not agree with this uniform no charge rule for guarantees". In addition to rejecting costs incurred to provide a guarantee as a transfer pricing safe harbour, the preamble included the surprise comment that a guarantee may not be a service. "[N]o inference is intended by this exclusion [from the SCM] that financial transactions (including guarantees) would otherwise be considered the provision of services for transfer pricing purposes". The preamble further provides that additional guidance for financial guarantees will be provided in conjunction with the global dealing regulations. The Sec. 482 service regulations were finalized by T.D. 9456[8] without addressing pricing for guarantee fees. No other guidance has been issued with respect to the characterization of, or the pricing method to be used for, a guarantee.

The lack of guidance on the treatment of a guarantee leaves taxpayers in an awkward position. The cost-only rule of GCM 38499, which had been followed by taxpayers for years, is clearly gone. The IRS has left open the question of whether a guarantee is in fact a service or some other type of transaction. The Tax Court in *Container Corporation* has now concluded that a guarantee *is* a service, at least for purposes of the sourcing rules. Under these circumstances, how can a taxpayer determine the price for a related-party guarantee and/or answer the question of whether the best method has been selected to determine the measurement of the fee? The only guidance is the general Sec. 482 rule that a fee between related parties should be arm's length. Where does this leave the taxpayer?

4. Economic Perspective

While the legal analysis of guarantee fees is somewhat unclear, the economic analysis is less so. As is well known, Sec. 482 requires that intercompany charges be determined by reference to relationships between unrelated parties, i.e. comparable transactions, and several types of third-party transactions are available and can be used to determine arm's length loan guarantee fees. Without specifying the pricing method (and, thereby, answering the legal question regarding whether guarantees are services or some other type of transaction), the following discussion presents some of the third-party evidence that can serve as the basis for computation of arm's length loan guarantee fees.

Some of this evidence was recently presented in the *GE Capital* case in Canada.[9] General Electrical Capital Canada (GECC) issued commercial paper to fund its operations. The commercial paper was backed by a guarantee by GE Capital US (GECUS) for which GECC paid a guarantee fee of 100 basis points. Revenue Canada did not allow the deduction of the guarantee fee and the matter was heard by the Canadian Tax Court. The Court decided in favour of GECC and concluded that the guarantee conferred a benefit in the form of reduced interest rates, i.e. with the guarantee, GECC's credit rating equalled its parent's rating, which meant that GECC could borrow at the same interest rates that GECUS paid. The interest cost saving to GECC was 183 basis points, and the Court ruled that the guarantee fee of 100 basis points was arm's length under those facts.

The experts in the *GE* trial testified that several approaches could be used to compute arm's length guarantee fees, e.g. based on credit default swaps and insurance products. In addition, guarantee fees can be valued by measuring the interest rate spread (using the yield approach and credit rating methods) attributable to the loan guarantee. Also, bids from banks that provide loan guarantees or option pricing models can be

5. 19 September 1980.
6. T.D. 9278 (31 July 2006).
7. Treas. Reg. Sec. 1.482-9T (b)(3)(B)(ii).
8. 31 July 2009.
9. *General Electric Capital Canada Inc. v. The Queen*, Tax Court of Canada, 2009 TCC 563. We note that this case has been appealed. See also Erik Kamphuis, "How to Deal with Affiliation in Interpreting the Arm's Length Principle: The *GE* Case Reviewed", at 292 of this same issue.

employed to compute the guarantee fee. The remainder of this article briefly considers these types of transactions. This list of third-party transactions is not necessarily exhaustive, as the particular intercompany facts and circumstances may suggest the use of comparable transactions that are not given here. As is always the case, the facts and circumstances in the intercompany relationship determine which, if any, of these transactions can be used, and whether adjustments need to be made to achieve an arm's length intercompany loan guarantee fee.

4.1. Credit default swaps

Derivatives are increasingly used to price intercompany loan guarantees. The most popular form of credit derivative is the credit default swap (CDS). A CDS is a financial instrument that functions much like insurance. For example, a given CDS may apply to a bond. The seller of the CDS guarantees the buyer of the CDS (who may also be the buyer of the bond) that if the bond issuer defaults, the seller of the CDS on that bond will "make it good" by paying the face value of the bond. Thus, the economics of the CDS transaction are similar to insurance policies in that they protect the owner of the CDS against declines in value of the underlying financial instrument (the bond, in this example). CDS transactions are also, in substance, identical to a guarantee, and the CDS fees can provide a benchmark for loan guarantee fees.

The CDS market is highly liquid, with a high trading volume. According to the International Swaps and Derivatives Association, the notional amount of the total outstanding CDS at the end of 2008 was USD 38.6 trillion.[10] This means that arm's length CDS fees can be determined quickly. As with the other methods, it is imperative to ensure that the facts and circumstances are the same between the CDS comparable transaction and the intercompany facts. If differences exist, adjustments must be made. The challenge with the use of CDS transactions is that they are very complex and it is extremely difficult to explain that instrument to an auditor or a judge (or any other normal human being, for that matter).

4.2. Insurance products

An insurance approach can also be employed to determine guarantee fees. In economic terms, a loan guarantee fee is equivalent to the premium chargeable for insuring the underlying loan. The premiums for financial guarantee fees can be computed using pricing models that are commonly used in that industry. The issue, from a transfer pricing standpoint, will be to explain those models and convince the tax authorities that arm's length results are generated from application thereof.

4.3. Interest rate spread

In essence, this is the method that the Canadian Tax Court used in the *GE* case. Application of this method begins by quantifying the benefit received by the guaranteed entity. This is accomplished by:

- determining the credit rating of the guaranteed entity on a stand-alone basis (without reference to the rest of the multinational company of which it is a part);
- determining the interest rate that the guaranteed entity would have had to pay had it been a stand-alone entity;
- determining the interest rate that applied when the guarantor's credit rating was substituted; and
- computing the difference between these two interest rates. That difference is the interest rate spread (the benefit of the guarantee) that is to be divided between the guarantor and the guaranteed entities.

In the *GE* case, the Court concluded that the difference between the interest rates was 183 basis points, and a guarantee of 100 basis points was appropriate under those circumstances. It is clear that the interest rate spread is the maximum guarantee fee, i.e. it is the fee that gives the guarantor all of the benefit attributable to the guarantee. At arm's length, it would be highly unusual for the guarantor to take all of the benefit, and the transfer pricing challenge is to determine how to split the interest rate spread between the guarantor and the guarantee recipient.

It is interesting to note that credit rating agencies, seeing a new market for their services, have begun to actively market their ability to provide rating estimates for subsidiaries of multinational companies.

4.4. Bids from banks

In the past, this was the primary method of determining arm's length loan guarantee fees. Banks are in the business of providing these types of guarantees, and a multinational may well have some bank guarantees that can be used to benchmark loan guarantee fees.

4.5. Option pricing models

Option pricing models, e.g. Black-Scholes, can be used to value loan guarantee fees. Specifically, a put option is the right of the borrower to sell an asset at a specified price if the value of the asset falls below the specified price. This is, conceptually, the same as a loan guarantee because the guarantee gives the lenders the right to receive the value of the loan if the borrower defaults. The price of the put option, therefore, can be used to benchmark the cost of the loan guarantee.

On the downside, option pricing is a fairly sophisticated approach to valuation, and such models typically rely on a set of assumptions, including the price of the underlying asset, interest rates, time to maturity and price volatility, some of which are difficult to estimate. The option pricing model, itself, would need to be carefully explained to the tax authorities, and each of

10. ISDA website, www.isda.org/statistics/pdf/ISDA-Market-Survey-annual-data.pdf.

the assumptions must be explained and justified. Thus, the use of this method can be complex; however, properly done, it provides a reliable valuation of arm's length guarantee fees.

4.6. Other types of guarantees

While the focus of this article is on loan guarantee fees, other types of guarantees exist, such as guarantees of leases, trade credit, delivery of goods and performance on contracts. Notably, it is also becoming common for subsidiaries to offer "reverse guarantees" of their parent companies' obligations. Under reverse guarantees, well-established subsidiaries pledge their assets to collateralize loans (and other obligations) for their parent companies. While it is beyond the scope of this article to discuss every form of intercompany guarantee, performance guarantees are addressed because they have received much attention lately. To do this, it is assumed that a parent company is guaranteeing the performance of a subsidiary.

Broadly speaking, by providing a performance guarantee, a parent company guarantees that it will "step into the shoes of the subsidiary" and perform on the subject contract in the event that its subsidiary fails to perform as the contract requires. Performance guarantees are common in the construction and oil and gas industry, where contractors are typically required to have performance guarantees in place before projects commence.

In arm's length relationships between unrelated parties, surety bonds are typically used to provide performance guarantees (particularly in the construction industry). A surety bond is a contract entered into by at least three parties: the project owner (obligee), the contractor (obligor), and the surety bond issuer (guarantor). Surety bonds are used to guarantee that either a project will be completed or the obligee/project owner will be compensated in the amount of the value of the surety bond if the obligor/contractor fails to perform as promised. By making this guarantee, the surety bond issuer/guarantor accepts the risk pertaining to the ability of the contractor to meet its obligations. In exchange for accepting this risk, the guarantor receives a fee, usually paid by the obligor/contractor. The amount of the guarantee fee depends on the nature of the project, as well as the ability, resourcefulness and financial health of the obligor.

The common types of surety bonds are:
- bid bonds (or tender guarantees), which give project owners compensation for incremental costs incurred if the contractors submitting tenders do not enter into contracts;
- performance bonds, which guarantee performance and compensate project owners in the event that contractors fail to perform the contracts; and
- payment bonds, which are used as a security against payment obligations.

Bids from banks can also be used to determine prices for performance bonds, which implies that letters of credit can also be used to value performance guarantees. Letters of credit fall into two broad categories, namely commercial and standby. Unlike a commercial letter of credit, which is an active part of a transaction and is exercised after the contractor has performed its obligations, a standby letter, sometimes called a "negative" letter of credit, comes into effect only when the obligor/contractor defaults or fails to carry out its contractual commitments to the obligee. Therefore, a negative letter of credit can be an appropriate benchmark to use when valuing performance guarantees.

Letters of credit can be valued using internal (if the company offers/receives letters of credit to/from third parties) or external (using a search for comparable letter of credit fees issued by third-party banks) transactions.

4.7. Final comments

Identifying the third-party transaction to use in computing a guarantee fee is only the first step toward computation of an arm's length guarantee fee. Once the third-party transaction is obtained, it is extremely important to consider the facts and circumstances surrounding both the intercompany and the third-party transactions so that necessary adjustments, if any, can be made.

Some of these transactions require complex analyses and estimates, e.g. determining the estimated volatility in an options-based approach. In any event, these methods are capable of providing reliable, accurate estimates of arm's length guarantee fees, but analysts must be prepared to explain the analysis in simple, easy-to-understand terms if they hope to have their analysis accepted at any level (auditor, competent authority or tax court) in the process.

5. Economic Conclusion

The third-party transactions outlined provide an overview of the types of information that are available to determine arm's length guarantee fees. The authors have not attempted to be complete, as there are other approaches and evidence that can be used in specific situations. This article has emphasized, however, that the discussion provides starting points for pricing intercompany guarantees. A thorough economic analysis is required to structure and document all intercompany guarantee transactions, and to determine what, if any, adjustments are needed to obtain arm's length guarantee fees. This is one area of intercompany pricing where there is a plethora of evidence that can be used to determine arm's length fees, which means that application of US transfer pricing rules is possible and arm's length results can be obtained.

