Transfer Pricing for Financial Transactions: Determining Credit Ratings

With further guidance on related-party financing transactions still to come from the OECD, the authors describe current approaches to determining credit ratings as an anchor for arm’s-length pricing of loans, cash pooling and guarantees.

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In the last years, intragroup financial transactions have received increasing attention from tax authorities throughout the world. Landmark court cases such as the 2009 decision in General Electric Capital Canada Inc. v. The Queen and the 2010 ruling involving ConocoPhillips Scandinavia AS and Norwegian ConocoPhilips AS have supported the interest of many tax inspectors of investigating these transactions in more depth. The current framework of the 2010 OECD transfer pricing guidelines on how to determine arm’s-length transfer prices for financial transactions is fairly slim and there are only a few tax administrations around the globe that have issued regulations in this area. One aspect of the OECD’s Action Plan on Base Erosion and Profit Shifting dealt with interest deductions. However, the final recommendations under Action 4 of the BEPS project didn’t bring the topic to the main stage, whereas practitioners had anticipated a first framework on how to appropriately structure intra-

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1 2009 TCC 563, aff’d 2010 FCA 344.
4 The OECD’s Oct. 5, 2015, report on Action 4, released along with its work on other BEPS action items, is at http://src.bna.com/tp.
group financial transactions in the new funding world. The development of transfer pricing guidance for related-party transactions will be carried out as a separate project and will likely only be completed by 2017.5

Financial transactions will further move into the central spotlight in many tax audits throughout the globe—in particular if the lender resides in a low-tax jurisdiction. Based on the authors’ experience, in many countries the focus isn’t on only the largest loans, but also on small loans with unusual terms or borrowers with thin capitalization. Optimizing intercompany financing can be a key source of tax-driven value creation. In order to maintain and safeguard any tax benefits gained by efficient intercompany financing structures, companies are advised to maintain detailed transfer pricing documentation.

A fictitious example shows the potential for a tax administration’s “quick win.” In this case, the company’s insufficient documentation or lack of documentation altogether allows the tax authorities to adjust the interest rate for a cross-border intercompany loan.

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<tr>
<th>Income Adjustment for Intercompany Loans</th>
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<tbody>
<tr>
<td>Loan amount</td>
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For smaller multinationals, this income correction can be significant—and funding transactions may be seen as a side transaction next to the larger business transactions in relation to the operational business.

With country-by-country reporting requirements being implemented in countries around the world, multinationals likely will need to disclose, to a greater extent, their funding policies in the future.7

At the outset, it should be noted that intercompany loans are quite different from many other intercompany transactions in that they are nearly always addressed with the comparable uncontrolled price (CUP) method. In applying a CUP, close comparability between the controlled and uncontrolled transactions is essential to achieve reliability. Some, but not all, of the key comparability factors to consider are currency, maturity, date of the transaction, security (collateral) and creditworthiness of the borrower. Most of these comparability factors are easily observed if there is a well-drafted intercompany loan note between the lender and the borrower. The one that cannot be observed and must be estimated is the creditworthiness of the borrower.

Given the lack of guidance by the OECD, business and consultants have developed numerous approaches in the last decades to set and test arm’s-length transfer prices for financial transactions, and a few mainstream approaches have prevailed. For many main intragroup financial transactions—loans, guarantees or cash pooling—the typical question is how to determine credit ratings for transfer pricing purposes. The different concepts are testing the boundaries of the arm’s-length principle and discussions on how to determine credit ratings are ranging from philosophical monologues to down-to-earth commercial rationales.

In the current, “pre-BEPS” funding world, multinationals face challenges of determining a robust framework in setting credit ratings as a central anchor in the pricing mechanism for financial transactions. This article will examine the major approaches to deriving credit ratings, each of which has its own well-founded merits when consistently and comprehensively applied in the group’s global transfer pricing policy. The authors anticipate that in the post-BEPS world, the current freedom for determining credit ratings in a transfer pricing setting will be reduced.

### Determining a Credit Rating

The creditworthiness of a company or a multinational group is often represented by a credit rating. Credit ratings that concern multinational corporations are usually for a corporation’s financial instruments, such as bonds or other debt issuances, but corporations themselves are also sometimes rated—for example, during a merger or acquisition.

For financial transactions within multinational groups, the main questions are how to determine credit ratings for the borrower, and the extent to which a stronger parental credit rating needs to be considered in determining the credit rating of a subsidiary. The OECD guidelines, as well as local transfer pricing regulations in many countries, provide at best only a limited framework for determining credit ratings.8 While the OECD guidelines don’t provide explicit recommendations in determining credit ratings, the arm’s-length principle implies that a credit rating assigned to a group company should be consistent with one that would have been determined between parties acting at arm’s length.

The diagram below shows the main four credit rating approaches regularly observed within multinational groups.

Figure 1 | Overview of credit rating approaches

These various approaches can lead to different results in setting or testing arm’s-length transfer prices such as interest rates. Each approach is outlined below.

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5 See para. 8 of the BEPS Action 4 report, note 4, above.
6 Typically, additional interest or penalties are assessed. Moreover, withholding taxes may be applied if the income correction is treated as a deemed dividend distribution.
7 See the OECD’s final report on documentation and country-by-country reporting under BEPS Action 13 online at 24 Transfer Pricing Report, 4/14/16.
8 The Australian Taxation Office has published numerous guidelines on financial transactions.
Group Rating Approach

A rating established by an external rating agency typically is available only for the group’s parent company, sometimes also for a major subsidiary or a financing company. Therefore, some multinationals—which have the advantage that a group rating already exists—are also assessing the creditworthiness of subsidiaries with this rating for simplification purposes.

This approach recognizes that the subsidiary is a member of a multinational group. The underlying rationale, often described as implicit support, is that the parent company, or the group as a whole, will intervene if the subsidiary encounters financial difficulty. Under this approach, the subsidiary’s credit rating generally matches the group’s credit rating, as full group support effects are assumed.

As a general rule, one can assume no group company enjoys a better credit rating than the parent company. Therefore, one could, not unreasonably, conclude that this approach should be regularly accepted from the perspective of a subsidiary as it will have no better realistically available funding alternatives. From a commercial perspective, many group companies won’t have access to the better funding conditions of the parent company without a guarantee in place.

The acceptance of this approach, from the view of the parent company and the lending company, depends on the jurisdiction in which the company is located. The jurisdiction of the lender might view the lender as under-compensated if the borrower is a subsidiary that would be judged to be riskier than the parent, but the lender is receiving interest income consistent with the credit risk of the parent.

This approach is suitable for only very few countries—Germany is one example. The German tax authorities often accept the argument of full group support effects, known as Konzernrückhalt, and in March 2011 issued administrative principles that provide a flexible framework on how to reflect parental support in setting arm’s-length interest rates.

The advantage of this approach is that only one credit rating analysis needs to be performed—either the group rating is already available or it needs to be established. Quite possibly, there is no need to establish a rating from traditional methods of credit scoring. If the parent has traded debt with observable market yields, these yields may be a good CUP for the interest rate on the subsidiary’s debt. The approach makes the implicit assumption that the credit ratings of the parent and the subsidiary are the same. Alternatively, if the parent has traded debt, even if it is unrated, an implicit rating can be determined by examining the market yields to maturity on the debt given the other loan characteristics.

Based on the market insights of debt advisory and transfer pricing teams, third-party banks generally aren’t willing to grant many subsidiaries the same funding conditions that the parent company receives without any guarantees in place. Therefore, this approach isn’t consistent with third-party behavior or with the arm’s length principle, which aims to reflect market conditions or at least the hypothetical behavior of unrelated parties in comparable circumstances.

Moreover, it isn’t reasonable to assume that parent companies will always “rescue” their subsidiaries if no explicit guarantees have been made. A parent may not support even a significant—or what would seem like a strategic—subsidiary if it isn’t 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.

Moreover, if a transfer pricing model is built on a pure parent rating approach, the value of any intercompany guarantee must be nil for consistency purposes. This again leads to the challenging question of whether a third party would assume any risks under a guarantee arrangement without any compensation.

Therefore, this concept can only be backed by local tax and transfer pricing regulations, if at all, but not from an economic and business perspective. In conclusion, for many countries (except, for example, Germany) this approach isn’t suitable for designing a global funding policy for financial transactions. Like a safe haven, it is acceptable in the jurisdiction that has issued the rule. These simplifying rules tend to be advantageous to the borrowers, so they are perfectly acceptable to borrowers in other jurisdictions, but potentially unacceptable when the other jurisdictions are the intercompany lenders.

Down-Notching Approach

The down-notching approach is a more refined variation of the group rating approach. The leading rating agencies are providing guidance on how to measure implicit group support effects. On the basis of this guidance, the relevant credit agency’s ratings of a subsidiary may compose all shades of gray between the black (parent rating) and white (pure stand-alone rating) depending on a catalogue of criteria. In particular, and based on this guidance, the strategic significance and the operational degree of integration are important factors.

However, in order to apply these frameworks, taxpayers need to both have available group credit ratings and stand-alone credit ratings. Some multinational groups comprise hundreds of group companies and borrowers and, therefore, establishing this high number of credit ratings is perceived to be challenging. Therefore, a pragmatic approach is often taken in order to have a manageable funding framework. Some compa-

9 See German administrative principle from March 29, 2011, IV B 5 – S 1341/09/10004.
10 Approaches for determining credit ratings under other circumstances will be the subject of a future article.
13 This concept is explained in more detail in the section on up-notching.
14 The perception of challenging, is not so much the technical calculation of a credit rating – computers reduce this effort tremendously. The challenge is typically in obtaining the financial statement data necessary to perform the credit rating for all the borrowers. Under the new BEPS regime, there will be much greater disclosure of intercompany financial information and intercompany financing arrangements.
nies have designed and implemented a so-called cluster approach typically comprising two to three clusters, for example.

- **Cluster 1: Group Rating**
- **Cluster 2: Group Rating minus 1 Notch**
- **Cluster 3: Group Rating minus 2 Notches**

The approach is based on the rationale that implicit support is, per se, considered with weak group companies benefiting the most from this approach.

### Stand-Alone Rating Approach

The classic approach remains the stand-alone approach where the borrower within a multinational group is treated as a distinct and separate enterprise and its creditworthiness is evaluated on the basis of its own financial strength. This concept ignores the impact of implicit support of the parent company and other group companies.

This approach is supported by a narrow interpretation of the arm’s-length principle as defined in paragraph 1.6 of the 2010 OECD Guidelines where members of a group are treated as entirely ‘separate entities rather than as inseparable parts of a single unified business.’

Today, the determination of stand-alone credit ratings is a common approach.

### Up-Notching Approach

This approach combines the stand-alone approach and the concept of implicit support by the parent company. Implicit support, also referred to as “passive association benefits” or the “halo effect,” reflects the expectation that a parent company will step in to support a subsidiary and meet its debt obligations in the event of financial difficulty—without the existence of any explicit guarantees.

Depending on the strength of the halo effect, a status quo rating will be set in the range between the parent rating and the stand-alone rating.

The OECD, fiscal courts and rating agencies have dealt with these halo effects in the last years.

### OECD Guidance on Implicit Support

Paragraph 7.13 of Chapter VII of the 2010 OECD guidelines on intragroup services, which discusses passive association between separate entities, states that no service would be received where an associated enterprise by reason of 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.

This paragraph implies that no guarantee fee should be made in relation to the improvement in a credit rating due to implicit support.

The OECD’s 2014 report on BEPS Action 8, which covered the transfer pricing aspects of intangibles, comprised guidance on group synergies and addressed the issue of passive association or implicit support regarding financial transactions.\(^{15}\)

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Example 1 in the report on BEPS Action 8 recognized the impact of group synergies on the credit rating of a subsidiary, S, that is a member of a multinational group. The strength of the consolidated group’s balance sheet enables the parent company P to maintain a Aaa credit rating. On a stand-alone basis, the strength of S’s balance sheet would support a credit rating of only Baa. Nevertheless, because of S’s membership in the P group, large independent lenders are willing to lend to it at interest rates that would be charged to independent borrowers with an A rating. S borrows simultaneously from a third-party lender and P at an interest rate that reflects S’s enhanced credit rating as part of the P group. Therefore, S enjoys passive association benefits.

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**International Case Law**

After the ground-breaking GE Capital Canada case in 2010, the passive association benefits approach was more in the spotlight.\(^ {16}\) In the case, the Tax Court of Canada and the Federal Court of Appeal determined that implicit support from a parent company is an economic factor that must be taken into account in an arm’s-length transfer pricing analysis and that the value of implicit support provided to the subsidiary shouldn’t be charged for. The relationship between parent and subsidiary is influenced by, among other things, the reputational pressure exerted by external debt holders on the parent. Given its conclusion on the low impact of the implicit support, the tax court indicated its preference for the credit rating method set out by one of the expert witnesses, who was previously a senior employee with Standard & Poor’s. The court decided the stand-alone rating of the subsidiary should be increased by three notches.

Recent years have seen more court cases around the globe that considered the impact of implicit support in their verdicts. Two examples are:

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\(^{15}\) See 23 Transfer Pricing Report S-185, 9/18/14.

\(^{16}\) See note 1, above.
a Norwegian case in 2012, in which the court adjusted a company’s stand-alone credit by moving it up four notches.\textsuperscript{17}

A 2015 Australian case, Chevron Australia Holdings Pty Ltd v. Commissioner of Taxation,\textsuperscript{18} in which the court concluded that implicit support needs to be reflected in the analysis and depends on the facts and circumstances of the case. In Chevron, the court found that implicit support had a limited effect on the borrower’s stand-alone rating.

### Framework of Rating Agencies

Large credit rating agencies such as Fitch, Standard & Poor’s and Moody’s Investors Service have published methods for determining credit ratings for subsidiaries. A common element of these methods is their “bottom up” approach that starts with determining a stand-alone credit rating for the subsidiary. The next step is to assess the impact of the relationship with the parent company, which is driven by factors including the degree of the strategic significance and the operational integration of both parties. Depending on the analysis, the final rating, or so-called status quo rating, is set somewhere between the black (group rating) and white (stand-alone) limits.

These methods may serve as guidance for transfer pricing analyses in relation to determining an appropriate credit rating of the subsidiary. Whereas some factors, such as relative strategic importance, are highly subjective, these frameworks can help to develop a reliable assessment of the factors and help to document the reasoning for the respective evaluations and assessments.

In some cases, the difference between the parent’s rating and the subsidiary’s rating is fairly small (one or two notches) so that an assessment seems easier than dealing with the difference of approximately 10 notches as in, for example, GE Capital Canada. However, a small uplift may catapult the credit rating from a speculative grade rating to an investment grade rating (for example, from BB+ to BBB-), which may have a significant impact on the transfer price.\textsuperscript{19}

The illustration below gives a high-level overview of the classification of subsidiaries.

The following example demonstrates the rationales of considering implicit group support effects in a pragmatic way without any complex underlying methodological frameworks.

\textsuperscript{17} Bayerngas Norge AS, March 29, 2012, No. 11-113400TVI-OTIR/06.
\textsuperscript{18} FCA 1092 (Oct. 23, 2015).
\textsuperscript{19} Empirically, a relatively large yield difference can be observed between low investment grade bonds and high non-investment grade bonds. Some institutional investors (for example, pension funds) are allowed to invest only in investment grade instruments that thus have on average a greater demand.

In summary, the two-step approach of first establishing a stand-alone credit rating and then adjusting the credit rating to a status quo rating, reflecting passive association benefits, is also commonly observed with multinationals—in particular during the last two or three years.

### International Views

Multinationals require a rating approach within their funding frameworks that is ideally accepted by all jurisdictions in which the group operates and is relevant for financial transactions. The table below summarizes the acceptance of the individual rating approaches described above in selected jurisdictions.\textsuperscript{20}

In the authors’ opinion, it is fair to conclude that both the stand-alone approach and the up-notching approach are accepted around the globe. Down-notching also is commonly observed, even though some tax authorities have reservations about the approach. The parent-rating approach has limited acceptance, and acceptance by local governments may depend on whether the transaction is inbound or outbound.

As for many other transaction types, it will be difficult for multinationals to implement transfer pricing models that are fully in line with the local transfer pricing environment of all jurisdictions. However, following the 80-20 principle, all three approaches—down-notching, up-notching and stand-alone rating—should

\textsuperscript{20} This table is not representative and represents observations based on the authors’ experiences.
be feasible in the current transfer pricing landscape, although there is no consensus.

This analysis has focused on determining the issuer’s credit rating. This is most commonly interpreted as the credit rating of a borrower issuing senior unsecured debt. The credit rating on a specific debt instrument can be higher or lower; for example, secured debt may be rated higher than subordinated debt. The difference between the issuer’s rating and the rating on a specific issue is complex, and an appropriate subject for a future article.

**Conclusion**

The credit rating is one of the strongest factors influencing the transfer price and is therefore one of the most important elements of economic analysis for financial transactions. The selection of different credit rating approaches can lead to materially different transfer prices and, thus, on the tax position of the companies’ affiliates. This leads to the question of whether one approach should be seen as the best method, or if all approaches are appropriate.

The answer isn’t simple. Neither the OECD nor, in many cases, local tax authorities have provided any framework for determining credit ratings. The 2010 OECD guidelines potentially support both a pure stand-alone rating (at paragraph 1.6) and passive association benefits (at paragraph 7.13), something that highlights the need for additional commentary and guidance on this subject. In the authors’ view, except for the pure group rating approach, each of the rating approaches described above can be deemed appropriate and defensible under past and current regimes—provided that the corporate group has consistently applied a unique framework.

The OECD will likely issue a first draft framework later this year, by 2017 at the latest. The BEPS reports from October 2015 indicate the OECD will conduct further work on the effect of implicit group support on a credit rating analysis and move away from a pure stand-alone approach.

In the end, practitioners should remember that the determination of credit ratings, like so much else in the transfer pricing arena, is as much an art as it is a science. Transfer pricing for financial transactions probably will remain an area with degrees of flexibility, even in the post-BEPS world, as the OECD recommendations will have only a non-binding status in most countries.

Many multinationals likely will need to reposition their transfer pricing policies for financial transactions in the next two years to be fit for the future. Companies that haven’t yet designed formal standards on credit ratings and rules for how to determine interest rates and other transfer prices for financial transactions now have an opportunity to do so. Once countries have implemented the revised transfer pricing documentation standards under BEPS Action 13, multinationals likely will have to disclose, to some extent, the funding policy as part of the documentation master file. Therefore, in the authors’ opinion, companies can benefit from a consistent group-wide framework with objective cornerstones (in the format of a transfer pricing guideline) that will form part of global core transfer pricing documentation and thus will be available to all group companies and tax administrations.