



**Parental Corporate Guarantee:
Changing landscape**

The Dbriefs Transfer Pricing series

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Agenda

- Introduction
- OECD guidance
- Country perspectives
 - India, Japan, China & Hong Kong, and Korea
 - Singapore, Malaysia, Indonesia, Philippines, and Vietnam
 - Australia and New Zealand
- Questions and answers

Guarantee

To price or not to price?

Guarantee fee

A general trend

- Since 2008, loan/guarantees are more common
- Guarantees are in practice often un-priced by many MNEs
- Why? Presumably due to complexity of pricing and uncertainties about tax authority's views
- Development of a consistent, practical pricing framework addresses TP risk in guarantor country
- Also provide opportunities for income mobilization – commonly treated as a service fee for WHT

Guarantee fee

Key aspects of analysis – chargeability framework

- Develop chargeability framework – should there be a charge?
- Consider following factors
 - Specific benefit provided?
 - Third party willing to pay for the guarantee?
 - Guarantee provided in a capacity other than that of shareholder? Whether the guarantee is a condition precedent or not?
 - No wider benefit received by the guarantor?
 - Has there been a change in the risk profile of the guarantor?
- For many arrangements, may simply be appropriate to document why no charge applied using a sound economic framework
- Experience suggests sound chargeability analysis of actual MNC arrangements is a value-added deliverable in its own right

OECD guidance

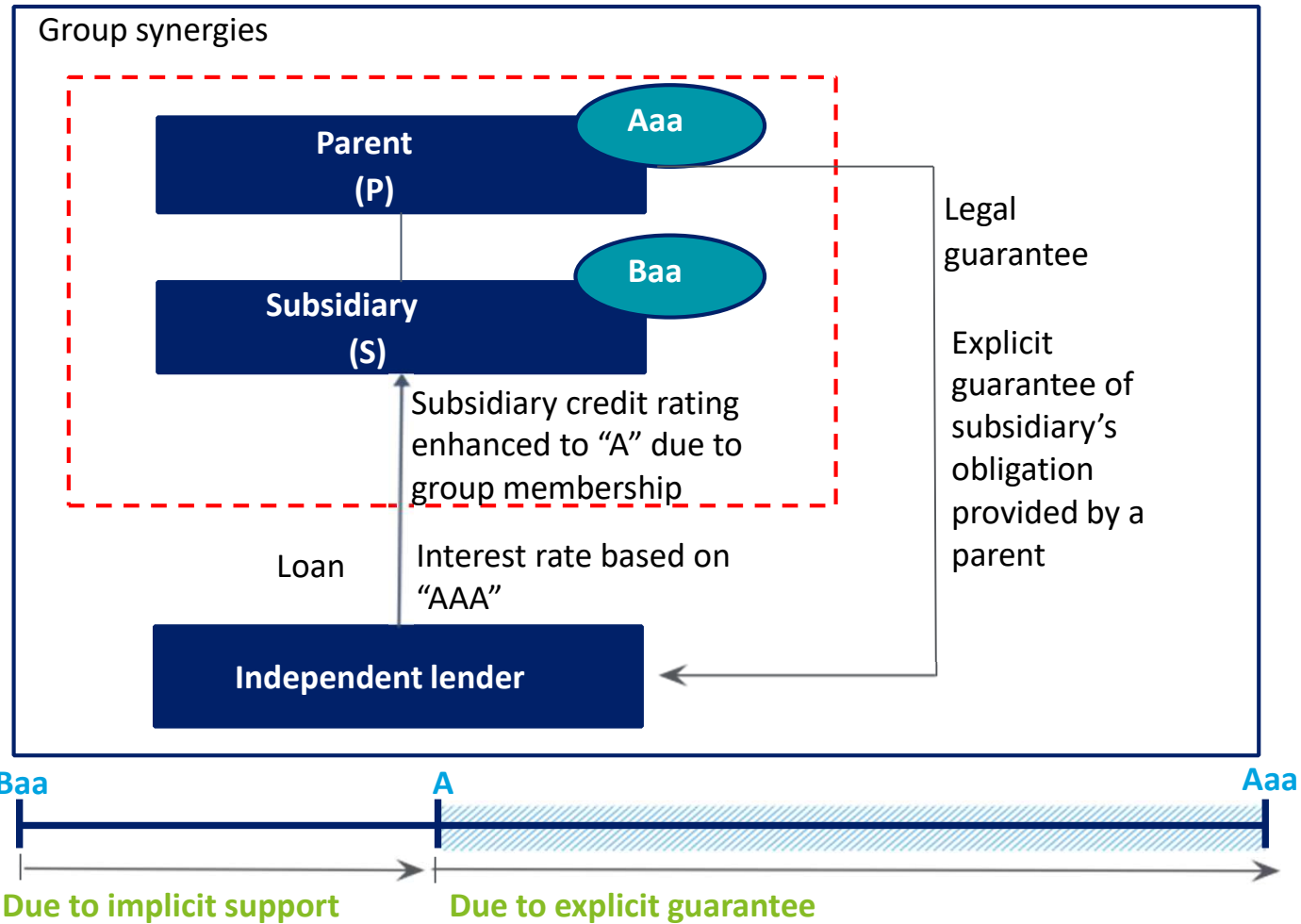
OECD guidance on guarantees

Benefit conferred – enhancement in the terms of the borrowing

- Effectively, a guarantee reduces the lender’s risk and allows the borrower to borrow on terms that would apply if it has the same credit rating as the guarantor
- An appropriate benefit – **lower cost of debt funding** – for the borrower is needed for it to be willing to remunerate the guarantor with a commensurate fee
- Different types of intra-group credit support – depends on facts and circumstances
 - Explicit guarantee
 - Legally binding
 - Usually provides relevant rights to creditor to enforce commitment
 - Implicit support
 - Includes a “letter of comfort” and other lesser forms of support
 - Attributable to borrower’s group member status/passive association

OECD guidance on guarantees

Example – explicit guarantee

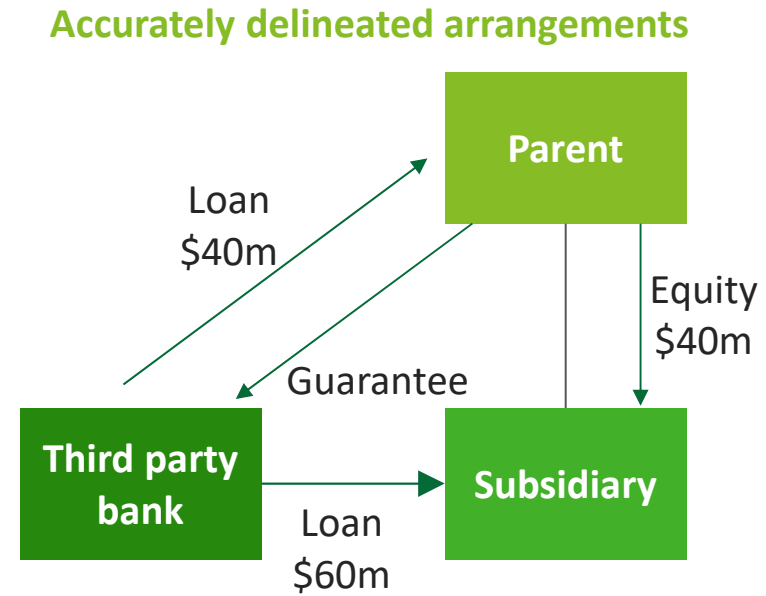
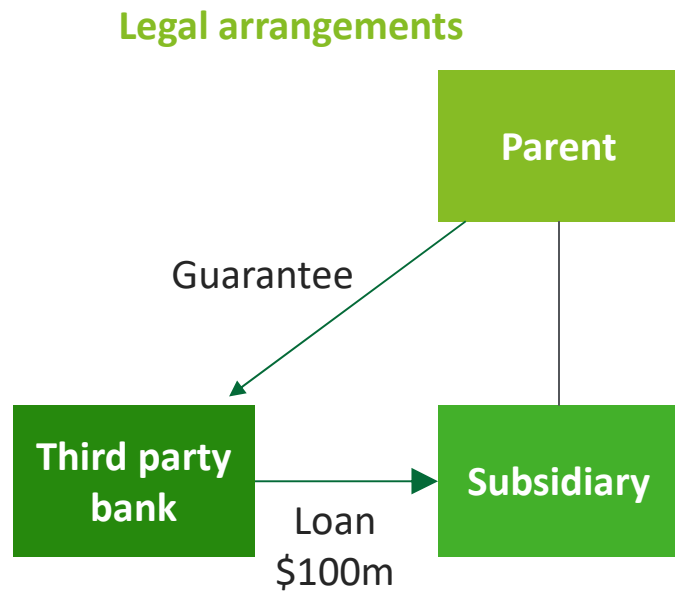


- Guarantee fee from S to P will be based on enhancement of S's credit rating from A to Aaa and not based on enhancement of S's credit rating from Baa to Aaa

OECD guidance on guarantees

Benefit includes access to a larger amount of funding

- Where guarantee leads to access to a larger amount of borrowing, need to ask
 - Should a portion of the loan be accurately delineated as a loan to guarantor (followed by equity contribution to borrower)?
 - Is the guarantee fee in respect of remaining portion of loan arm's length?



OECD guidance on guarantees

Accurate delineation of the transaction

- Not all guarantees confer a benefit on the borrower
- A **letter of comfort** is not a legally binding commitment and does not involve the explicit assumption of risk
 - Impact of a letter of credit is based on the facts and circumstances
 - In general, the absence of an explicit guarantee, the benefit of support from other group members arises from passive association, not from a chargeable service
- The **financial capacity** of the guarantor must be evaluated, including
 - Evaluation of the credit rating of the guarantor and the borrower
 - Business correlations between them
- **Group-wide cross guarantees** may be too complicated to price – may be akin to implicit support

OECD guidance on guarantees

Pricing

- Pricing approaches for a formal, legally binding guarantee resulting in a lower interest rate
 - **CUP method** – most reliable method if data is available
 - **Yield approach** – maximum guarantee fee from the borrower's perspective (beyond implicit support)
 - **Cost approach** – minimum return from the guarantor's perspective (expected loss/capital requirement)
 - **Valuation of expected loss** (and expected return on this amount)
 - **Capital support method** (expected return on additional notional capital required to bring the borrower up to the credit rating of the guarantor)

Polling question 1

What are the most common guarantee arrangements between related parties in your group?

- Explicit financial guarantees
- Letters of comfort
- Performance guarantees
- Other
- No guarantee arrangements at present
- Don't know/not applicable

Country perspectives

India, Japan, China & Hong Kong, and Korea

Country perspective

India



- Guarantees have been a contentious issue in the Indian transfer pricing landscape
 - More than 85 cases at tax tribunal level
 - More than 7 unilateral APAs have been signed
 - Part of the safe harbor regime (1% for the outbound guarantee payments)
 - Contradictory rulings at tax tribunal level – no observed position of the IRA
- Generally ignored as it was not reported –pre-2012
 - Not considered as an international transaction before the specific inclusion of the word in the definition of international transactions
 - Part of contingent liability and no explicit treatment in the books therefore mostly no guarantee fees charged
- An agreement has been reached that corporate guarantees are now considered as international transactions – needs to be reported
- Currently scrutiny focused on arm's length pricing
 - Capacity of the borrower/re-characterization not common litigation issues

Country perspective

India – experience from existing court cases



Shareholder Services/ Condition Precedent

- Rarely observed a proper delineation – even for guarantees which are actually a condition precedent to the loan
- Certain positions with respect to shareholder’s services upheld in tax tribunals
- “Corporate guarantee as a shareholder activity and the primary objective was to help its AE/subsidiary and protect its interest rather than earning interest income”
 - Britannia industries Ltd
 - Tega

Pricing

- General tribunal observation – range between 0.5 percent and 0.8 percent
- Bank quotes/generic bank rates considered
- Everest Kento Cylinders Ltd [TS-200-HC-2015(BOM)-TP]- high court – CG distinct from commercial bank guarantee therefore comparison is inappropriate
- Post OECD paper – general acceptance for Interest saved approach (yield approach) and other methods
- APA experience – both yield and loss given default approach/expected default approach (LGD) acceptable – more for performance guarantee
- Recent audit cases – hull and White model – akin to loss given default approach being adopted

Letter of support/comfort

- General experience – priced lower than corporate guarantee by revenue offices
- Tax tribunal accepted “Comfort issuance, as not international transaction; and rejected its re-characterization as guarantee”
- Asian paints Ltd [TS-51-ITAT-2021(Mum)-TP]
- Tata international limited [TS-113-ITAT-2020(Mum)-TP]
- Not finality has been reached hence the matter is still litigated

Country perspective

Japan



- The National Tax Agency, Japan (NTA) focus on Japan headquartered multinational taxpayers which may not receive any or sufficient guarantee fees for the benefit they provide to foreign subsidiaries
- Pricing
 - A yield approach is in which the payer and recipient split the difference would not be uncommon
 - The Japanese tax authorities is yet to issue any new guidance on financial transactions since the OECD guidelines update
- Letters of comfort have been challenged by the Japanese tax authorities
 - Requirement of payment for the benefit received by the foreign affiliate of the Japanese taxpayer even for LOC

Country perspective

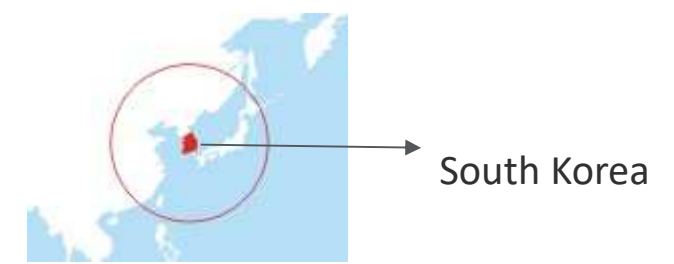
China and Hong Kong



- **China**
 - State Taxation Administration of China (STA) focus on outbound local entities providing financial guarantees to overseas affiliates with no guarantee fees
 - Pricing
 - CUP is commonly applied for the audit cases
 - China STA is also studying the OECD guidelines on financial transactions, exploring the application of valuation of expected loss approach in pricing the guarantee in future
 - Limited scrutiny on performance guarantee and letter of comfort. No stated position so far
- **Hong Kong**
 - The Inland Revenue Department, Hong Kong (IRD) has not started looking into guarantees yet
 - Pricing
 - No specific methodology for guarantees but expected to have some guidance post OECD paper
 - More common issue is – whether such income should be Hong Kong on-shore or off-shore than the pricing part

Country perspective

Korea



- The regulation on financial guarantees introduced in the Law on the Coordination of International Tax Affairs (LCITA) in the beginning of 2013 (enforcement decree 6-2)
- Financial guarantees classified as an intra-group service transaction and pricing is based on
 - Calculating the arm's length price based on the anticipated risks of, and expenses to be incurred by, the guarantor
 - Calculating the arm's length price based on the guarantee's expected benefits
 - Calculating the arm's length price based on both the expected risks of, and expenses to be incurred by the guarantor and the guarantee's expected benefits
- Article 6-2(4) of the LCITA-PD provides two safe harbor rules whereby the following guarantee fees are deemed to be arm's length
 - Fees computed based on the interest rate differential – with and without a loan guarantee as calculated and reported by the finance company providing the loan in question; and
 - Guarantee fees computed according to the conditions prescribed by the National Tax Service (NTS) commissioner as a method to calculate the arm's length price based on a guarantee's expected benefit
- Pricing
 - National Tax Service (NTS) used indigenous models akin to LGD method for scrutiny purpose – NTS model is now revised and RiskCalc is used by the NTS for credit rating analysis based on judicial precedence
 - As part of the tax amendments, more detailed matters concerning the calculation of expected risks and expenses, expected benefits, etc. were added in the enforcement rule of the LCITA for more clarification purpose

Polling question 2

Based on your experience, what has been the primary objective of the financial guarantees in your group?

- To have better interest cost – parental guarantees ensure lower borrowing cost
- Guarantees are more in the nature of a condition precedent – no explicit interest reduction benefit has been observed
- Not sure/not applicable

Singapore, Malaysia, Indonesia, Philippines, and Vietnam

Country perspective

Singapore



- Tax environment for financial guarantees
 - Documentation if threshold of \$1million of guarantee income/expense exceeded
 - So, whilst guarantees part of TP remit, not seen transfer pricing audits on financial guarantees in practice – IRAS focus mainly on intercompany loans
- Typical approach to pricing
 - No specific guidance or positions announced by the IRAS
 - In practice yield approach used for the pricing of guarantees
 - IRAS generally take guidance from the OECD guidelines
- Updates following OECD February 2020 guidelines on financial transactions
 - No announcements, though new updated TP guidelines expected soon
- Other guarantees (e.g., performance guarantees, letters of comfort, etc.)
 - Not many challenges from IRAS yet

Country perspective

Malaysia

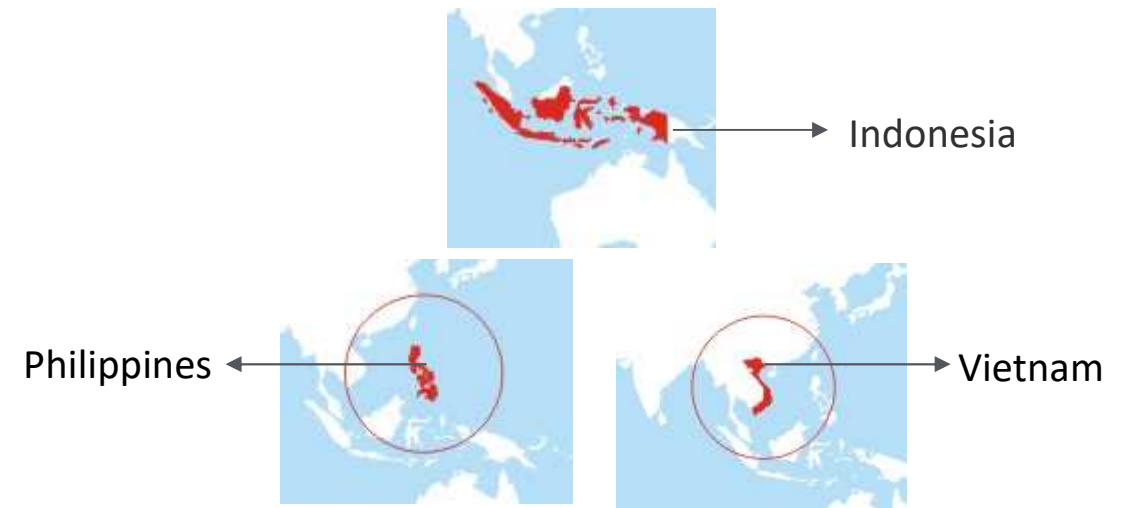


- Tax environment for financial guarantees
 - Domestic guarantees: risk of double taxation – increasing IRB focus, mainly on domestic financial guarantees without any CG fee (deeming of income)
 - Payments – IRB’s general position is not-deductible, especially for non-financial services taxpayers
 - Income – taxable for the guarantor
 - Foreign guarantees – carries lower TP risk as income may be treated as foreign sourced (non-taxable)
- Typical approach to pricing
 - OECD guidance is generally respected by IRB, due to absence of detailed local guidance; both the yield approach and the LGD approach are used in practice, with the former being more common
- Recent developments
 - New penalty (MYR 20k-100k per year) for non-availability of contemporaneous TP documentation, as well as introduction of surcharge (up to 5%) on TP adjustment, with effect from 1 January 2021 (retrospective)
- Other guarantees (e.g., performance guarantees, letters of comfort, etc.)
 - Typically not area of focus for IRB

Country perspective

SEA (Indonesia, Philippines, and Vietnam)

- Tax environment for financial guarantees
 - In practice, few challenges or questions by the local tax authorities
- Typical approach to pricing of financial guarantees
 - No local guidance on pricing of guarantees, but in practice
 - Yield approach historically used and accepted by ITA (Indonesia)
 - Compare total interest expense (including guarantee fee) against central bank borrowing rate (Vietnam)
 - OECD approaches likely to be followed by most SEA tax authorities
- Updates following OECD February 2020 guidelines on financial transactions
 - No announcements yet
- Other guarantees (e.g., performance guarantees, letters of comfort, etc.)
 - No challenges seen from local tax authorities thus far



Polling question 3

Have you directly faced challenges from local tax authorities on related party guarantee transactions?

- Yes
- No
- Don't have related party guarantee transactions
- Don't know/not applicable

Australia and New Zealand

Country perspective

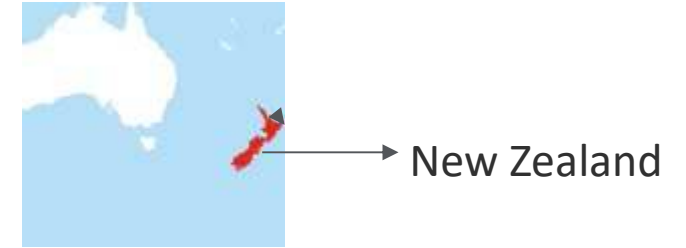
Australia



- Status of the OECD guidance in chapter X
- Australian case law on guarantee fees
- ATO approach
 - Detailed guidance on financial transactions (loans, guarantees, and interest free loans) issued since 2017, however the ATO does not intend to publish guidance on guarantee fees in the foreseeable future
 - A number of large audit cases ongoing
 - Key focus areas
 - Whether a guarantee arrangement would exist between independent parties
 - Whether a benefit has been conferred on the borrower
 - Pricing of the guarantee fee
 - Guarantees on related party debt

Country perspective

New Zealand



- Chapter X of the OECD guidelines endorsed by inland revenue
- Interaction between guarantees and New Zealand's new restricted transfer pricing rules
- Inland revenue guidance
 - Explicit written guarantee required for a guarantee fee to be recognised
 - Letters of comfort not sufficient to create legal obligations
 - In most cases benefit considered to be limited to the impact of implicit support
 - Total cost of the arrangement should not exceed interest deduction for a related party loan calculated under the restricted transfer pricing rules

Questions and answers

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