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Arm’s length principle in guarantees between related parties (2) 3/20/23

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Our previous article looked at the need for a taxpayer’s transfer pricing (TP) file to support his guarantee transactions, and explored a general approach to assessing whether a guarantee transaction is arm’s length. In this article we are discussing aspects to consider when the substance of guarantee transactions is analysed, and we are taking a closer look at methods used in analysing such transactions.

Establishing the facts and circumstances of a transaction

To determine the transfer pricing impact of a guarantee, we should first understand the substance, amount and potential consequences of the guaranteed obligations for all the parties concerned by defining the transaction accurately. The first step in assessing the substance of the transaction is to understand the economic benefit the borrower receives from the guarantee, apart from the benefit that results from his passive association with the guarantor, i.e. something more than mere administrative support. Two main benefits are common:

- Better loan conditions (term and interest rate)
- Access to a larger loan

It is also important to assess the impact of group membership and the guarantor’s financial capacity.

However, we need to bear in mind that as with other related-party transactions, there is no single universal approach to analysing guarantees. Each transaction needs to be assessed on its merits, including an evaluation of its substance, risks assumed, and assets used. And in analysing guarantee transactions, special attention should be paid to the borrower and the guarantor.

The comparable uncontrolled price method

Once the facts and circumstances of the transaction have been clearly described, the next step is to establish whether the transaction is arm’s length. Here we can use methods described in the OECD TP guidelines[1] to ensure that the benefit from the transaction is split in proportion to the participants’ contributions.

One of the methods is the comparable uncontrolled price method, which compares prices applied in a controlled and an uncontrolled transaction. In this case the method may be used with internal and external comparable data. Yet it is almost impossible to find external comparables, given comparability restrictions and the fact that bank loan guarantees between unrelated parties are rare.

It is also worth noting that the fee charged (the price applied) by independent guarantors will partly reflect costs incurred in raising funds and complying with statutory requirements, while related parties may not incur such costs.

The profitability method

This approach quantifies the benefit by measuring the difference between the interest rate the borrower would have paid without a guarantee and the interest rate payable with a guarantee. The first step is to determine the interest rate the borrower would have to pay, considering the impact of implicit support that arises from group membership. The next step is to determine the interest rate payable after a guarantee is received from a related party. As a result, the interest difference may be used to quantify the benefit the borrower receives from the guarantee.

This method is used to determine the maximum fee for the guarantee (the maximum amount the recipient of the guarantee would be willing to pay), i.e. the difference between the interest rate the borrower would have paid to the bank without a guarantee and the interest rate payable for the guarantee to a related party. An unrelated party would not be interested in concluding a guarantee agreement if the interest charge payable to the bank and to the guarantor were the same he would have paid to the bank without a guarantee. Therefore, in applying this method, it is important to split the benefit between the related parties in proportion to their contributions.

The cost method

This method aims to quantify the additional risk assumed by the guarantor in estimating the expected loss he may suffer if a related party defaults against a third-party bank. An expected loss estimate may be based on the capital necessary to cover the risks assumed by the guarantor.

The cost method is used to determine the minimum fee for the guarantee (the minimum amount the guarantor would be willing to accept). However, it is important to emphasise that the results obtained by the cost method do not always reflect arm’s length conditions because the fee for the guarantee is set by assessing only risks assumed by the guarantor, while a transaction between unrelated parties would consider the borrower’s and the guarantor’s perspective, i.e. opportunities that are available in reality.

The OECD TP guidelines also offer the valuation of expected loss method and the capital support method, but in practice these are used less frequently and involve far more complicated calculations in determining an arm’s length fee that must be received by the guarantor.

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[1] The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations