

# Arm's length principle in guarantees between related parties (3) 2/27/23



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In our previous articles we discussed the transfer pricing (TP) aspects of guarantees and looked at methods that can be used to arrive at an arm's length price. We will close out this series of articles with key insights from international case law and compare how the tax authorities treat the validation of guarantee transactions in a TP file.

## International case law

Let us look at an example of international case law – the 2018 case of a Polish company's guarantee that had a court ruling passed in 2022.

A Polish company carries out real estate investment projects and finances the construction of shopping malls. To raise funds, the company entered into a ten-year loan agreement with an unrelated commercial bank. The terms of the agreement provided for a guarantee to be issued by shareholders in a multinational enterprise group and other related parties. This security made the guarantors jointly and severally responsible for the claimant performing his obligations. It's essential that the guarantee was issued pro bono, i.e. the Polish company was not liable to pay any consideration or provide any other financial benefit to its guarantors.

This raised questions as to whether the Polish company was required to prepare a TP file for the pro bono service it had received and for what periods. The taxpayer believed he wasn't bound by the TP documentation requirement based on the following arguments:

- The guarantee was issued free of charge, so this is not a transaction because there is no element of mutual settlement.
- The guarantee has no commercial purpose – this may be identified only in purchases and sales of goods and services.
- The guarantee is not comparable to classic transactions for a consideration because this is governed by the law of obligations.
- A pro bono service doesn't affect any items in the profit and loss account, so the guarantee has no effect on the company's financial performance.
- Preparing a TP file for a pro bono service can't be meaningful because that doesn't provide any informational benefit and doesn't create any new knowledge for the tax authority.

## The Polish tax authority's counter-arguments

Having examined the ruling recently published by the Polish Supreme Administrative Court on validating pro bono guarantee transactions in a TP file, we find that the court goes along with the Polish tax authority and disagrees with the taxpayer's opinion, stating the following counter-arguments:

- Issuing a guarantee qualifies as reinforcement of obligations, and according to its legal form, the guarantee is agreement between the parties, so the transaction in this case should be taken as a legal contract (agreement) concluded as part of the group's business, which is carried out by making at least one payment.
- Despite the parties having agreed on a pro bono service with no payment being made, the functions performed and risks taken under the agreement don't eliminate the hallmarks of a transaction but quite the contrary, they make those even stronger.
- The guarantee is a transaction in the broadest sense of this term, and the absence of a consideration is not a precondition for the taxpayer's decision not to prepare a TP file.
- The lack of a consideration is not debatable because preparing a TP file is based on the transaction as such, which implies a requirement for transparent documentation because the guarantee is a benefit per se, even without an element of compensation.
- The TP file for related-party guarantee transactions represents a strong informational background, which not only includes a TP review but allows the tax authority to ensure that the business relationship, along with the loan value, repayment period and credit risk assessment, meets the arm's length principle.
- The obligation to prepare and update the TP file applies to the year in which the guarantee was issued and to the tax periods in which it will be valid.

## Insights

The court dismissed the taxpayer's appeal. The dispute between the parties ended rather amicably, and the Polish tax authority didn't launch any additional control processes in the company, yet the guarantee transaction remained the focus of scrutiny.

Comparing the Polish tax authority's position on this issue with Latvian practice leads to the conclusion that the Latvian State Revenue Service (SRS) takes an equivalent approach. However, if such a precedent arose with a Latvian company, the SRS might not confine itself to evaluating the obligation to submit a TP file but would, according to the transaction's facts and circumstances, exercise its power to determine a consideration payable to the guarantor, as well as computing arrears of corporate income tax, a penalty and a late fee.

If your company enters into guarantee transactions with related parties, we suggest applying one of the analytical methods described above to defend your TP, or reaching out to our transfer pricing team.