

# Intragroup financial guarantees: to price or not to price?

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**The pricing at market conditions of financial guarantees has attracted increased interest from the tax and treasury teams of many multinational enterprises (MNEs) across the world, following the OECD's publishing of its Transfer Pricing Guidance on Financial Transactions: Inclusive Framework on BEPS: Actions 4, 8-10, which will become Chapter X of the OECD transfer pricing guidelines.**

Luxembourg legislation does not explicitly address transfer pricing aspects of financial guarantee arrangements between related parties. However, article 56 bis of the Luxembourg Income Tax Law (LITL) emphasises the importance of the accurate delineation of the controlled transactions in the context of the comparability analysis. As also Chapter X sets forth the need to accurately delineate financial guarantee arrangements before pricing them, taxpayers could face new challenges.

The key challenge for taxpayers is supporting and documenting the decision-making process and the borrower's clear economic benefit that derives from the financial guarantee.

This article addresses the key questions that arise in the decision-making process to establish whether the payment of a guarantee fee is appropriate.

**Nature of the financial guarantee: is the guarantee arrangement explicit and legally binding?**

Regarding MNEs in general, intra-group guarantees are provided by an associated party (guarantor) to another related party (beneficiary) on loans taken from an unrelated lender (i.e., a bank or any credit institution). A financial guarantee is a promise by the guarantor to assume specified financial obligations if the beneficiary fails to do so, and may or may not be legally binding. From the guarantor's perspective, a legally binding financial guarantee means it is exposed to additional risk, as it is legally committed to pay if the borrower defaults.

In comparison, letters of comfort, letters of intent, or any other similar form of guarantee that does not involve the legally binding assumption of risk does not pro-



vide the creditor relevant legal rights to enforce the commitment. In the absence of an explicit and legally binding guarantee, the expectation is that any potential support received by the borrower from the MNE group will only arise by virtue of its affiliation with the parent or the MNE group. Therefore, in these circumstances, a fee would not be payable. However, explicit and legally binding guarantees require further consideration to assess if a charge is appropriate or not.

**Implicit support test: would the MNE group support the borrower in the absence of an explicit guarantee?**

In most cases, regardless of the guarantee's legally binding nature, the borrower will not benefit beyond the level of credit enhancement attributable to the other MNE group members' implicit support. However, not all MNE group members would be expected to be equally supported solely by virtue of being part of the MNE group. The beneficiary's relative importance within the MNE group may help determine its potential credit rating.

Credit rating agencies have elaborated upon the criteria used to determine an entity's importance, which may include factors such as "the functions performed", "the company's link to the group's name or brand", "its integration and strategic importance", "the potential reputational impacts", "the company's track record", "the level of leverage or capitalization" and "the negative effects on the overall group". As a result, an MNE group member that is integral to the group's identity or important to its future strategy, which typically operates in the group's core business, is usually more likely to be supported by other



MNE group members, regardless of an explicit and legally binding guarantee.

In these circumstances, it could be concluded that the financial guarantee merely recognizes the benefit that the beneficiary would have obtained by being part of the MNE group, and that a guarantee fee is not due. Although Chapter X provides guidelines to assess the impact of implicit support and the effect of group membership, this exercise remains a matter of judgment and complex from a practical perspective.

Furthermore, considering that this assessment is typically based on information that tax administrations do not have, these administrations may reach different conclusions when assessing the likelihood of implicit support for a certain borrower. Therefore, the appropriate documentation of all the facts and circumstances that the taxpayer considered when assessing the borrower's relative importance will play a crucial role in this analysis.

**Guarantor's financial capacity compared with the borrower's financial capacity: is the guarantor stronger credit-wise?**

The accurate delineation of financial guarantees also requires the consideration of the guarantor's financial capacity to fulfill its obligations if the borrower defaults. From a practical perspective, this implies an analysis of the business correlation/integration between the borrower and the guarantor, as well as a comparison of the guarantor and the borrower's asset pools. A lender would benefit from the guarantor's stronger credit rating if, thanks to the guarantee, it has access to a wider asset pool that is composed of both the guarantor and the borrower's asset pool. Simi-

larly, the financial guarantee's accurate delineation would involve analyzing the correlation between the guarantor and borrower's businesses.

When the guarantor and borrower share the same underlying asset base, or are so economically integrated that the same adverse events equally undermine their credit strength, it could be argued that the explicit guarantee does not provide any additional benefit to the borrower; consequently, a rational borrower would not be prepared to pay a fee.

**The guarantee's effect: what is the economic benefit deriving from the guarantee?**

Based on the aforementioned considerations, it is crucial to clearly identify the guarantee's economic benefit. Financial guarantees typically affect the funding arrangement's terms and conditions, either reducing the borrowing cost or allowing the borrower to access more funds. To assess the economic benefit if the guarantee's effect is to reduce the borrowing cost, the borrower's cost of funding with the guarantee is measured against its cost of funding without the guarantee, while considering and eliminating the effect of any benefit that a group entity receives solely due to its group affiliation.

When the financial guarantee's effect is to increase the borrower's debt capacity, Chapter X suggests that under certain circumstances, the guarantee fee should be limited to a fee on the standalone borrower's debt capacity (i.e., the amount of borrowing without the guarantee) and that the remaining loan portion (the incremental borrowing capacity) should be accurately delineated as a loan from the lender to the guarantor, followed by an equity contribution from the guarantor to the borrower.

The potential consequence is that the interest expense deduction at the borrower level would be limited to the interest expense on the standalone debt capacity. In this respect, it could be argued that, practically, this would mean a denial of deductibility of interest charged by third-party institutions, which is typically considered at arm's length.

The appropriate identification and quantification of the guarantee's economic benefit, as well as any relevant evidence of the decision-making process (e.g., bank offers and relevant correspondence), will play a crucial role in this phase. This is because the new guidelines are not universally in-

terpreted, and different views on the economic benefit's nature and extent could trigger different tax and transfer pricing consequences and increase tax uncertainty.

**Guarantee fee arrangements in Luxembourg**

In Luxembourg, particularly in the alternative investment industry (private equity, real estate, infrastructure, credit), we frequently observe several layers of Luxembourg companies, which are set up for different business reasons such as legal liability protection, facilitate co-investment or external financing. With respect to the latter external banks often require security over assets and want to take advantage of Luxembourg corporate/collateral law.

In this setup, the most common guarantees that third parties could require are parent guarantees (downstream guarantees), typically pledges over the shares of the parent-held entities (creates a single point of enforcement giving the ability to the external banks to take control of the borrowing group in the event of a covenant breach in a quick and efficient manner without interference of other creditors), or subsidiary guarantees (upstream guarantees), typically pledges over the subsidiary's assets (i.e., real estate assets).

In fact, in these setups, the beneficiary's effective ability to repay the loans is directly affected by the underlying assets' performance, which in most cases is the same at the borrower and guarantor level. In both scenarios, the Chapter X guidance suggests that a rational borrower would not be prepared to pay a fee. However, each case must be analyzed based on its individual facts and circumstances, which could lead to different conclusions.

**Conclusion**

Chapter X has undoubtedly reduced the subjectivity of pricing guarantee fee arrangements. However, some uncertainty remains due to differing interpretations by tax authorities. This shift means that Luxembourg companies' tax and treasury teams must substantiate their decision-making process for each guarantee in place, even when a guarantee fee is not charged. They should also pay special attention to the implicit support test and clearly identify any benefits that could be subject to dissimilar views. Establishing a process and approach for delineating, pricing and documenting guarantee fees will make existing and new investment structures more robust and ready for tax authorities' transfer pricing audits.

Franz FAYOT et Luc FRIEDEN présentent le calendrier des activités du commerce extérieur

## «Il est essentiel de renforcer à nouveau les activités du commerce extérieur»

**Le vendredi 3 décembre 2021, les membres du Conseil du Commerce extérieur et des Investissements (Trade and Investment Board) se sont à nouveau réunis. Après un tour de table permettant de partager les premiers retours d'expérience des membres qui se sont déjà rendus à l'Exposition universelle à Dubaï, le ministre de l'Économie, Franz Fayot, et le président de la Chambre de commerce, Luc Frieden, ont présenté le calendrier des activités du commerce extérieur.**

Après une longue période de pause forcée en raison de la pandémie de COVID-19, les activités de promotion et de prospection ont pu reprendre en présentiel, dès la fin du premier semestre 2021, et se sont essentiellement concentrées autour de l'Exposition universelle à Dubaï. Les membres du Conseil, et notamment S.A.R. le Grand-Duc héritier, ont ainsi pu faire part de leurs impressions suite aux trois premières missions économiques sectorielles organisées depuis l'ouverture officielle de l'Expo Dubaï 2020 le 1<sup>er</sup> octobre 2021. Pour rappel, la Chambre de commerce organise, en collaboration avec les partenaires du «Trade and Invest», plusieurs missions sectorielles aux Émirats arabes unis pen-



(de g. à dr.) Luc FRIEDEN, président de la Chambre de commerce ; S.A.R. le Grand-Duc héritier ; Franz FAYOT, ministre de l'Économie © MECO

dant toute la durée de l'Exposition universelle programmée jusqu'au 31 mars 2022.

Le Conseil a ensuite passé en revue l'agenda du commerce extérieur pour 2022-2023. Le programme de travail se veut ambitieux, avec une vingtaine de missions prévues en 2022 à l'étranger. Fruit d'une étroite concertation entre le minis-

trère de l'Économie, la Chambre de commerce et Luxinnovation, le choix des destinations a, cette année, également été fixé après un échange de vues avec le réseau diplomatique luxembourgeois à l'étranger et les responsables des neuf Luxembourg Trade and Investment Offices. Au-delà de la poursuite des activités liées à l'Exposition universelle de Dubaï, les deux

destinations phares des missions économiques arrêtées pour 2022 sont le Canada en juin et la Corée du Sud en fin d'année. Pour 2023, des pays cibles ont également déjà été identifiés. Les participants ont ensuite passé en revue la liste des foires sur lesquelles seront organisés une douzaine de pavillons nationaux et de nombreuses visites accompagnées.

Créé suite à la réforme de la promotion économique en février 2017, le Trade and Investment Board (TIB) est chargé d'élaborer la stratégie de promotion de l'économie luxembourgeoise et de fédérer les acteurs impliqués. Placé sous la présidence d'honneur de S.A.R. le Grand-Duc héritier et présidé par le ministre de l'Économie, le TIB est composé de treize membres, représentant 8 ministères et 4 organismes (Chambre de commerce, FEDIL, Luxinnovation, Chambre des métiers) qui jouent un rôle dans la promotion économique. Le TIB est appelé à superviser les travaux du Trade and Investment Steering Committee (TISC) qui réunit les protagonistes mettant en œuvre les activités de promotion et de prospection. Il se réunit de manière semestrielle.

Luc Frieden, président de la Chambre de commerce, a précisé : «La Chambre de commerce se félicite de la coordination efficace au sein du Trade and Investment Board, dont la nouvelle méthode de travail a permis d'établir un programme d'actions

2022-2023 ambitieux et bénéfique aux projets d'internationalisation des entreprises. Les actions et initiatives proposées aux acteurs économiques pourront être adaptées en fonction de l'évolution de la pandémie, grâce aux outils digitaux de plus en plus performants déployés par la Chambre de commerce et ses partenaires.»

En guise de conclusion, le ministre Franz Fayot a déclaré : «Je tiens à remercier tous les membres du TIB pour la bonne collaboration et l'adoption du programme de travail ambitieux de prospection et promotion économique pour 2022-2023. Après deux années où les déplacements ont été fortement restreints et malgré l'incertitude actuelle, il est essentiel de renforcer à nouveau les activités du commerce extérieur, ceci dans l'intérêt de nos entreprises et de notre économie. Je remercie en particulier S.A.R. le Grand-Duc héritier pour son engagement continu, qui se matérialise notamment à travers sa participation aux nombreuses visites d'entreprises que nous avons pu faire ensemble au cours des derniers mois.»

Calendrier des activités internationales organisées par la Chambre de commerce  
<http://www.cc.lu/agenda/gointernational>

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