Enclosure
These comments (Comments) are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

These Comments were prepared by members of the Transfer Pricing Committee (the “Committee”) of the American Bar Association Section of Taxation. Principal responsibility for preparing these Comments was exercised, and substantive contributions were made, by Peter Blessing, John Breen, Jim Croker, Lucia Fedina, Matthew Frank, John Magee, and Alexey Manasuev. These Comments were reviewed by Sean Foley and Mark Martin, successive Chairs of the Committee, and by Tracy Gomes, Vice-Chair of the Committee. The Comments were further reviewed by David Canale, a former Chair of the Committee on behalf of the Committee on Government Submissions, and by Brian Trauman, Council Director.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal income tax principles addressed by these Comments, no such member or the firm or organization to which such member belongs has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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I. Introduction and Summary

In August 2006, the Treasury Department announced that it intended “to issue transfer pricing guidance regarding financial guarantees . . . along with other guidance concerning the treatment of global dealing operations.”¹ More recently, the Internal Revenue Service indicated that the government was studying two issues in particular concerning the transfer pricing treatment of related party financial guarantees: (i) whether issuance of a related party financial guarantee is a compensable transaction, and (ii) if so, the method for determining its arm’s length price.² We have prepared this report to offer some thoughts that may be of assistance in formulating guidance.

The report begins by surveying the authority that currently exists concerning the transfer pricing treatment of guarantees and similar credit enhancing instruments. Next, the report examines the different mechanisms that a company may employ to provide support for an affiliate and the various objectives the parties may hope to achieve. Given the diversity of instruments, the report suggests that the scope of forthcoming guidance should be as broad as possible. With this by way of preface, the report addresses the two issues that we understand the Government is considering: whether these credit enhancing instruments give rise to compensable transactions and, if so, the approaches that may be available to determine an arm’s length price for such transactions.

This report reaches the following principal conclusions:

- Guidance from the Treasury Department is sorely needed. Many of the relevant issues have been on the table since the early 1980s, yet U.S. taxpayers still have little stable authority concerning the proper transfer pricing treatment of guarantees and related credit enhancing instruments. Other jurisdictions have moved forward, with recent litigation in Canada and pronouncements from the Australian Tax Office.

- The forthcoming guidance should be framed broadly and should cover all financial and commercial credit enhancing instruments, not just instruments formally denominated “guarantees.” The distinctions between financial and performance guarantees, and among guarantees and related instruments like keep well agreements, are often subtle and do not warrant differential treatment. The term “guarantee” is accorded a broad meaning elsewhere in the Code (e.g., under sections 679, 163(j)³ and their implementing regulations) and we submit that Treasury should cast its net no less widely here.

- We believe that credit enhancing instruments between related parties generally do give rise to compensable transactions unless the transaction is structured as a present or future capital contribution or is found by the relevant administrative or judicial

³  References to a “section” are to a section of the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise indicated.
authority to be such (herein, a “Contributory Transaction”). We accordingly recommend an approach that permits compensability in all situations (not involving Contributory Transactions) where one company transfers property or performs an activity that provides a direct and identifiable economic benefit to an affiliate. This benefit may take various forms, including reduced borrowing costs, the ability to bid on a contract *ab initio*, improved contract terms, improved access to funds or commercial opportunities, cost savings or efficiencies, or freedom from burdensome restrictive covenants. We recognize that reasonable minds may differ on matters around the edges of this subject, *e.g.*, where the benefit conferred is slight. Cases falling near the perimeter may justify exceptions or may be handled by safe harbors or *de minimis* rules.

- In considering pricing methods for guarantees, market based pricing should always be the starting point. Tax scholars and practitioners have suggested numerous paths to a reliable arm’s length price, including models using market evidence derived from credit default swaps, standby letters of credit, put options, and insurance. Price quotations from prospective guarantors and other market participants, akin to expert testimony, may also provide useful evidence concerning an arm’s length price. Since a comparable uncontrolled price (CUP) will rarely exist for a related party guarantee, we recommend that any forthcoming guidance adopt a flexible attitude. Treasury should indicate openness to various pricing methods provided they have sound theoretical and evidentiary support under the circumstances.

- The so-called “yield” approach focuses on the benefit in terms of interest rate reduction that the borrowing affiliate derives from the guarantee. While this has its place among the panoply of pricing methods, the “yield” approach should not reflexively be preferred over other methods. It adopts an interest rate differential as the sole measure of value, whereas a guarantee may confer a variety of other benefits on the affiliate (*e.g.*, the ability to borrow in larger volumes or in more diverse financial markets, to avoid restrictive loan covenants or the posting of collateral, or to achieve various efficiencies and cost savings). The “yield” approach is also an indirect pricing method: it does not ask how a third party would actually price a guarantee in the open market, and it takes no account of a third party guarantor’s likely assessment of risk. Instead, it relies entirely on a lender’s assessment of risk, backing into a guarantee fee based on a hypothetical transaction.

- There has been much debate about whether the pricing of a related party guarantee for transfer pricing purposes should reflect any market price impact due to “affiliation benefits” – chiefly, the possibility that the parent, absent a formal guarantee, would come to its affiliate’s rescue in time of financial stress. For reasons explained below, we believe it is unlikely that affiliation would play a big role in the pricing of guarantees in the marketplace. This report nevertheless outlines the arguments advanced by partisans on both sides of the debate regarding the appropriateness of taking affiliation benefits into account (to the extent the marketplace would) and examines the pros and cons of each stance. The report takes no position on how this issue should be resolved.
Once the market price of a related party guarantee has been determined, some tax authorities have insisted that this price must be “adjusted” for benefits supposedly conferred by the guarantee upon the parent-guarantor. These benefits are said to include the increased value of its investment in its subsidiary; avoidance of reputational damage that would flow from the subsidiary’s default; affording the parent greater financial flexibility by eliminating restrictive covenants; and enabling the parent to capitalize its subsidiary less robustly. Most of these “benefits” are illusory or de minimis, and none is properly cognizable in a transfer pricing analysis. Similarly, no adjustment to the market price should be made on account of other factors that arise from the guarantor’s relationship with the guaranteed party, such as a parent’s ability to control the level of operational risk assumed by its affiliate.

Some observers have suggested another form of adjustment to the market price, designed to take account of possible non-comparability between the related party guarantor and a third-party guarantor. The former may bear higher costs than the latter in some respects (e.g., due to its inability to achieve the same level of risk diversification), but it may bear lower costs in other respects (e.g., due to its ease of investigating and monitoring the borrower's credit standing and its ability to limit its subsidiary’s risk-taking). Practically speaking, these related party benefits and detriments would tend directionally to cancel each other out. In any event, we submit that they would add undue complexity to the transfer pricing analysis and should properly be ignored.

Notwithstanding the principles outlined above, there remain numerous complexities in pricing financial and performance guarantees and similar credit or commercial enhancing instruments. We would urge the Government not to respond to these complexities by putting unreasonable burdens on taxpayers. Taxpayers cannot be expected to engage a credit rating agency or the equivalent each time they need to price an instrument. Any forthcoming guidance should accordingly adopt a flexible approach that focuses on the reasonableness of the taxpayer’s pricing method and the evidentiary support for the transfer price. The same standards should apply to in-bound and to out-bound guarantees. To reduce disputes, safe harbor mechanisms should be made available.

Guidance addressing financial and performance guarantees should be placed in section 1.482-2, as a “specific situation” alongside the guidance for loans and advances. This placement would allow guidance for guarantees to be developed on a "green field" basis, separate from the existing architecture of sections 1.482-3, -4 and -9. We think this would simplify drafting and produce better, cleaner results. Placement outside of 1.482-9 would also avoid implying that the issuance of a guarantee constitutes the performance of a service. The Service in early informal guidance characterized guarantees as the performance of services, but it more recently appears – correctly in our view – to have disavowed that position.

Treasury should work with the OECD to develop common principles for related party guarantees. At present there are conflicting tax authority perspectives and it has not been unusual for U.S. companies to be advised that if they charge a guarantee fee
to a foreign affiliate, the foreign tax authority will deny a deduction for the payment. The U.S. should lead the discussion in this area and work to forge consensus.

- We recommend that Treasury issue guidance even if there is not agreement on how to address all of the issues. Forthcoming guidance should be viewed as a first step, not as the last word. Accordingly, we encourage the Government to issue guidance on some basic issues, perhaps in the form of a Notice, even while working on more comprehensive regulations. We have included suggested language for such a Notice in the final section of this report.

II. Current State of Authority

A. Informal Guidance 1977-1995

For many years, the Service’s informal guidance indicated that the execution of a guarantee constituted the performance of a service within the meaning of the section 482 regulations for which a charge could be imposed or an adjustment made. In the earliest pronouncement, a 1977 private letter ruling, a U.S. parent in the oil and gas industry guaranteed the debt of its foreign subsidiaries at no charge to enable them to borrow money at favorable rates without securing a credit rating.4 The Service held that the U.S. parent, by guaranteeing the loans, “performed services for its subsidiaries” for which it should have been compensated. To support its characterization of the guarantee as the performance of a service, the Service noted that an example appearing in the section 482 regulations referred to the arranging of financing as part of an aggregate of services performed by one party for another.5 The Service accordingly concluded “that guarantees may be treated as a service within the meaning of section 1.482-2(b)” and required a section 482 allocation representing an arm’s length guarantee fee.6 The Service repeated this line of reasoning in GCM 38499 (Sept. 19, 1980); PLR 7822005 (Feb. 21, 1978); and FSA (May 1, 1995), 1995 FSA Lexis 135.

Under general section 482 principles, the arm’s length charge for a guarantee would be determined based on the price that would be agreed by unrelated parties. As a “service,” however, the act of providing a guarantee was potentially eligible to be priced at cost pursuant to Treasury Regulation section 1.482-2(b)(3), so long as the service was

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5 Reg. § 1.482-2(b)(7) (Example 9) describes the arranging of financing as comprised within a “construction activity” within the meaning of Reg. § 1.482-2(b)(7)(ii). The designation as a “construction activity” was significant at the time because such activity was ineligible for at-cost pricing under the services regulations. The example stated that in connection with the construction of a foreign subsidiary’s plant, the parent “draws up the architectural plans for the plant, arranges the financing of the construction, negotiates with various Government authorities in [the subsidiary’s jurisdiction], invites bids from unrelated parties for several phases of construction, and negotiates, on [the subsidiary’s] behalf, the contracts with unrelated parties who are retained to carry out certain phases of the construction.”
6 The Service in the 1977 ruling rejected the argument that the parent’s guarantee could be considered a transfer of its credit rating to the subsidiary and hence a transfer of intangible property subject to Reg. § 1.482-2(d). See PLR 7712289960A (Dec. 28, 1977) (“We do not believe that a literal reading of that definition encompasses guarantees. Thus, a guarantee would not be governed by section 1.482-2(d”).

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deemed “non-integral” to the business of the issuer and the recipient.\(^7\) The Service recognized that this would usually be the case, stating that “it will indeed be rare for a guarantee to be an integral part of the business activity of either the recipient or the renderer absent one of the parties being engaged in the business of giving guarantees to third parties for profit.”\(^8\)

In the 1977 ruling, the Service accordingly held that any transfer pricing allocation would be limited to the costs associated with issuing the guarantee. It ruled that only “out-of-pocket” costs could be allocated to the parent because the service was non-integral to the business of the renderer and recipient. In analyzing the costs associated with the guarantee, the Service acknowledged that the credit risk embodied in that instrument could be considered an additional “cost” to the parent, but it noted that this factor would be difficult to quantify. “In discussing direct costs and methods of allocation,” the Service stated, “the Regulations focus on ‘out-of-pocket’ costs such as for wages, travel, materials, utilities and other overhead charges. There is no indication that costs of a type associated with a risk factor, more theoretical than actual, are to be taken into account.”\(^9\)

The Service did not issue any formal guidance with respect to guarantees during this period. However, GCM 38499 (Sept. 19, 1980) indicates that a revenue ruling was once under consideration. The GCM involved facts similar to those in the 1977 private ruling: a U.S. parent involved in the manufacture of heavy equipment guaranteed a loan obtained by its foreign subsidiary from a foreign bank. The GCM concurred with the proposed revenue ruling that the U.S. parent’s guarantee represented a service to the affiliate, either by enabling it to pay a reduced interest rate or by allowing it to forgo the need to secure an independent credit rating. The GCM concluded that the provision of the guarantee fell within the scope of Treasury Regulation section 1.482-2(b) and that the proper allocation consisted of the costs or deductions incurred by the parent because the guarantee was not an integral part of the business activity of either the parent or its subsidiary. No revenue ruling was ever released.

The informal guidance issued by the Service between 1977 and 1995 thus adhered to a consistent path. The Service took the position that the execution of a guarantee was the performance of a service for which a charge was appropriate under section 482. However, in each case that the Service addressed, the provision of the guarantee was

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\(^7\) Reg. § 1.482-2(b)(3) provided at the time: “(3) Arm’s length charge. For the purpose of this paragraph an arm’s length charge for services rendered shall be the amount which was charged or would have been charged for the same or similar services in independent transactions with or between unrelated parties under similar circumstances considering all relevant facts. However, except in the case of services which are an integral part of the business activity of either the member rendering the services or the member receiving the benefit of the services . . . the arm’s length charge shall be deemed equal to the costs or deductions incurred with respect to such services by the member or members rendering such services unless the taxpayer establishes a more appropriate charge under the standards set forth in the first sentence of this subparagraph.”

\(^8\) FSA (May 1, 1995), 1995 FSA Lexis 135.

\(^9\) PLR 7712289960A (Dec. 28, 1977). Accord, FSA (May 1, 1995), 1995 FSA Lexis 135 (holding that guarantee issued by a parent on behalf of foreign subsidiaries constituted the performance of personal services that could be priced at-cost as non-integral services).
deemed a non-integral service and thus eligible for at-cost pricing. The discussion in these authorities indicated that “at-cost” pricing was limited to out-of-pocket costs and thus generated an arm’s length charge of essentially zero (unless the taxpayer chose to demonstrate a more appropriate charge). The view that the execution of a guarantee was the performance of a service aligned with the then-current Service position (later reversed) that income from the issuance of a guarantee should be analogized to income from the performance of services for purposes of the sourcing rules.  

B. Treasury Regulations 2003-present

The first reference to guarantees in the section 482 transfer pricing regulations appeared in an example contained in the September 2003 Proposed Rules on Services and Intangibles. The example did not address financial guarantees or the determination of an arm’s length price. Rather, it addressed a performance guarantee and referenced it only in the context of a discussion about when a “controlled services transaction” has occurred that can be the occasion for an intercompany charge or an adjustment initiated by a tax authority.

The section 482 regulations defined in 2003, as now, a controlled services transaction as the performance of an “activity” that confers a “benefit.”¹² The 2003 proposed guidance contained 17 examples designed to illustrate when an activity is deemed to confer a benefit for this purpose.¹³ The examples have been carried forward into the current regulations, with minor edits and supplementation. The example involving a performance guarantee is one of several designed to illustrate the “passive association” concept, which holds that no benefit is deemed conferred (notwithstanding that the regulations acknowledge the benefit to exist) “where that benefit results from the controlled taxpayer’s status as a member of a controlled group.”¹⁴ These examples draw a contrast between the cognizable benefit conferred upon a subsidiary through the parent’s performance of an affirmative act and the non-cognizable benefit enjoyed by the subsidiary by virtue of its passive association or mere affiliation with the parent. Although phrased in terms of the absence of a cognizable benefit to the subsidiary, this “passive association” principle can be expressed equally well in terms of the absence of an affirmative act by the parent.

Example 15 stands for the proposition that a benefit enjoyed by an affiliate does not constitute a “benefit” for purposes of section 482 if the benefit arises solely from affiliation with its parent. The Example posits a situation where a recently-acquired subsidiary of a much larger corporation is able to secure a major contract due to its

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¹⁰ This view was initially articulated in the 1977 private ruling and later advanced by the Government in Bank of America v. United States, 680 F.2d 142 (Ct. Cl. 1982), rev’d in part, 47 A.F.T.R.2d (RIA) 81-652 (Ct. Cl. 1981). See also PLR 8508003 (payment for guaranteeing a bank loan represented compensation for services rather than investment or interest income for purposes of § 163(d)(3)(B)). The Service later reversed its position on the sourcing point. See note 20, infra, and accompanying text.


¹² Reg. § 1.482-9(I)(1).


affiliation with its parent— not as a result of any affirmative act taken by the parent, but simply as a result of the market’s perception that the parent would support members of its corporate family. Example 15 concludes that the subsidiary “is not considered to obtain a benefit” in this setting because its advantageous position was due simply to its status as a member of the controlled group “and not to any specific activity by [the parent] or any other member of the controlled group.” Except for a minor edit not relevant here, the text of this Example has remained unchanged since its September 2003 promulgation.

Example 16 draws a contrast with the “passive association” facts of Example 15. It stands for the proposition that where the subsidiary’s advantageous position is due to affirmative, specific activity of the parent, the benefit derived by the affiliate is cognizable for purposes of section 482. The example assumes the same facts as in Example 15 except that the parent executes a performance guarantee in favor of the customer “agreeing to assist in the project if [its subsidiary] fails to meet certain milestones.” Example 16 as proposed in 2003 concluded that the subsidiary “is considered to obtain a benefit” from its parent’s execution of the performance guarantee because the guarantee “allowed [the subsidiary] to obtain the contract on more favorable terms than otherwise would have been possible.” When the proposed regulations were re-issued as temporary regulations in 2006, Example 16 was revised slightly to recite that the guarantee enabled the subsidiary to obtain the contract “on materially more favorable terms” than otherwise would have been possible.

Example 18, included in the temporary regulations in 2006, illustrates a situation that falls between the “passive association” facts in Example 15 and the “performance guarantee” facts of Example 16. Example 18 assumes the same facts as in Example 15 except that the parent sends a letter to the customer confirming the parent’s ownership of the subsidiary and representing that it “would maintain that same percentage ownership interest in [the subsidiary] until the contract was completed.” The Example recites as a fact that this letter allowed the subsidiary “to obtain the contract on more favorable terms than otherwise would have been possible.” Yet it concludes that because the letter simply affirmed the parent’s affiliation with its subsidiary “and represented that this status would be maintained until the contract was completed,” the subsidiary “is not considered to obtain a benefit from [the parent’s] furnishing of the letter.”

Transfer pricing practitioners have questioned the rationale of Example 18. Because the subsidiary owes its advantageous position to affirmative action by its parent, not to mere affiliation with the corporate group, Example 18 arguably illustrates something more than benefits flowing from “passive association.” Perhaps the underlying rationale is that the letter, unlike a guarantee, was not legally enforceable. Alternatively, the drafters may be suggesting that the benefit derived by the subsidiary was insubstantial, i.e., did not confer a “reasonably identifiable increment of economic or commercial value,” because the parent’s letter, unlike the performance guarantee in

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Example 16, did not enable the subsidiary to obtain the contract on *materially* more favorable terms.\(^{17}\)

The services rules in Treasury Regulation section 1.482-9(l) do not explicitly address the two points discussed in the Service’s prior informal guidance—namely, the characterization of guarantees as the performance of services and the eligibility of guarantees for at-cost (essentially zero) pricing. However, the preamble to the 2006 temporary services regulations appeared to disavow both of those positions. Without mentioning the earlier rulings, Treasury referred to taxpayer confusion “regarding the appropriate characterization of financial guarantees for tax purposes,” stating that “some taxpayers have suggested that guarantees are services that could qualify for the cost safe harbor and that the provision of a guarantee has no cost. This position would mean that in effect guarantees are uniformly non-compensatory.” The preamble states that “[t]he Treasury Department and the Service do not agree with this uniform no charge rule for guarantees” and notes that “financial transactions, including guarantees, are explicitly excluded from eligibility for the SCM by section 1.482-9T(b)(3)(ii)(H).”\(^{18}\)

The preamble to the 2006 temporary regulations further explains:

> no inference is intended by this exclusion that financial transactions (including guarantees) would otherwise be considered the provision of services for transfer pricing purposes. The Treasury Department and the Service subsequently intend to issue transfer pricing guidance regarding financial guarantees, in particular, along with other guidance concerning the treatment of global dealing operations.\(^{18}\)

The preamble’s caution against inferring that the execution of a financial guarantee would be considered the provision of a service aligns with recent Service and Treasury indications that the execution of a guarantee is not the provision of a service for sourcing and other purposes. The preamble to the 2006 temporary services regulations states “[t]he provision of a financial guarantee does not constitute a service for purposes of determining the source of the guarantee fees.”\(^{19}\) The Government reiterated in 2010 that “the predominant feature of a guarantee is not the performance of a service.”\(^{20}\) This affirmed the earlier view taken by the Service in FSA 200147033 (Aug. 14, 2001) and

\(^{17}\) We are mindful that examples in regulations are written to illustrate a point and that the examples discussed here were likely not written for the purpose of providing substantive guidance on the transfer pricing treatment of performance guarantees, comfort letters, or like instruments. Still, they seem clearly to evince the view that the execution of a performance guarantee is in some cases a transaction for which a charge may be imposed or an adjustment made (Example 16), while no charge is appropriate where the credit or commercial standing of an affiliate is enhanced without any specific activity being performed (Example 15).


\(^{19}\) *Id.*

\(^{20}\) *See Container Corp. v. Commissioner*, 134 T.C. 122, 132 (2010) (stating position of the Government), *aff’d in unpublished opinion*, 107 A.F.T.R.2d 2011-1831 (RIA) (5th Cir. 2011). Indeed, the court in *Container Corp.* agreed that the issuance of a guarantee was not the performance of a service, although the court drew an analogy between the two for sourcing purposes which was legislatively overturned a few months later. *See Section 2112(a) of the 2010 Small Business Act, adding § 861(a)(9) to the Code* (overruling the sourcing result in *Container Corp.* for certain financial guarantees issued after September 27, 2010).
LTR 9020002 (Feb. 9, 1990) and aligned with the Service’s position in a number of rulings that held that standby loan commitment fees – payments for the right to call on another party to make funds available in the future – are payments for the acquisition of a property right and not payments for services.  

C. OECD Guidance

The OECD Transfer Pricing Guidelines provide a useful counterpoint on some of the issues discussed above. Guarantees are addressed in just one provision of the OECD Guidelines – Paragraph 7.13, which is part of the chapter dealing with “intra-group services.” Paragraph 7.13 does not address the arm’s length pricing of a guarantee. Rather, it focuses on the same issue as Treasury Regulation section 1.482-9(l) – whether the threshold for a transfer pricing inquiry has been met. But whereas the Treasury regulations approach this issue by asking whether the subsidiary has derived a cognizable “benefit,” the OECD Guidelines frame the issue in terms of whether the parent has engaged in cognizable “activity” or performed a cognizable “service.” Paragraph 7.13 provides as follows:

Similarly, an associated enterprise should not be considered to receive an intra-group service when it obtains incidental benefits attributable solely to its being part of a larger concern, and not to any specific activity being performed. For example, no service would be received where an associated enterprise by reason of its 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, or where the enterprise benefited from the group’s reputation deriving from global marketing and public relations campaigns. In this respect, passive association should be distinguished from active promotion of the MNE group’s attributes that positively enhances the profit-making potential of particular members of the group. Each case must be determined according to its own facts and circumstances.

Paragraph 7.13 provides in effect that if the parties do not do anything, there is no transaction or service that can give rise to a transfer pricing analysis. The mere fact that one company is affiliated with another company is not the performance of a service even if the affiliation is mutually beneficial. It follows that “passive association” (a synonym for “affiliation alone”) likewise is not a service or transaction. The objective of Paragraph 7.13 is to prevent tax authorities from imposing a transfer pricing adjustment based solely on some notion of relative contribution by members of a multinational group. It makes clear that an adjustment is appropriate only where something has been done – where there is a “specific activity,” such as the execution of a guarantee or the performance of a global marketing campaign. There is then an activity that can be subjected to a transfer pricing analysis and a transaction or service that can be priced.

21 See Rev. Rul. 81-160, 1981-1 C.B. 312 (loan commitment fee is paid for acquisition of a property right; addressing timing of deduction under sections 162 and 461); see also GCM 39434 (May 31, 1985) (annual credit card fee is analogous to standby loan commitment fee and is payment for acquisition of a property right; bank receiving fee cannot defer receipt of income under section 446); LTR 8537002 (May 22, 1985) (same).
D. Conclusion Regarding Current State of Authority

Amalgamating the Treasury and Service guidance issued between 1977 and 2006, taxpayers currently have relatively little stable authority concerning the proper transfer pricing treatment of guarantees and similar credit-enhancing instruments. The available guidance deals with a very narrow slice of the relevant universe of such instruments. Moreover, it addresses these instruments only insofar as they are intended to achieve conventional goals, such as lower interest rates or better contract terms.

The Service appears to have abandoned prior informal guidance suggesting that guarantees should be characterized as the performance of services. We agree with this change in position. We think it clear that execution of a financial guarantee is not the performance of a service, and the frequent similarities between financial and performance guarantees (discussed below) make it difficult to justify different characterizations of these instruments. In our view, the execution of a guarantee is best characterized as a property transaction.

If guarantees do not constitute the performance of a service, the corollary availability of at-cost pricing under 1.482-9 disappears. If at-cost pricing is not appropriate, there is no U.S. authority on what alternative pricing mechanisms would be acceptable. Examples 15, 16 and 18 to the services rules suggest the “passive association” principle as a benchmark in assessing whether a parental expression of credit support meets the “benefit” threshold for a transfer pricing inquiry. Yet Example 18 muddies the waters, because the parental expression of credit support there is deemed not to benefit the subsidiary even though it does in fact benefit the subsidiary and even though the parent has engaged in affirmative and purposeful activity toward that end.

In sum, new guidance is appropriate and needed. The Government appears to have abandoned its former position that guarantees constitute the performance of services. These issues are ripe for comprehensive consideration.

III. Related Party Guarantees

We understand that Treasury and the Service are considering the transfer pricing treatment of “related-party financial guarantees.”22 As explained more fully below, the universe of “financial guarantees” is not self-defining, and the real-world distinctions between financial guarantees, performance guarantees, and other credit-enhancing instruments are often quite nuanced. This section surveys the types of instruments commonly used by related parties to provide credit and/or performance support. It then examines the diverse goals that may be sought to be achieved by use of such instruments.

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22 See Bennett, supra note 2.
A. Types of Instruments Used to Provide Support

Instruments that enhance an affiliate’s standing in the eyes of creditors, customers, or regulators take many forms and occupy different points along a spectrum of enforceability. Instruments at the unenforceable end of the spectrum are a far cry from anything resembling a guarantee. Some may be as weak as a “letter of awareness,” which is a statement by a person, typically a parent, that the person issuing the letter is aware of a transaction between an affiliate and a third party. The notion behind such letters is that the parent’s willingness to acknowledge in writing its awareness of a transaction constitutes implicit approval of it and creates a loose sense of parental responsibility. This may strengthen a counter-party’s confidence that the parent is exercising some control over its affiliate’s operations and will take steps to ensure that expectations with respect to the transaction are not disappointed.

Somewhat further along the spectrum is a “comfort letter.” In a comfort letter, a person—typically a parent—states that it has the present intention to provide support that will enable an affiliate to meet its obligations as they come due over a defined period, e.g., the next 12 months. Comfort letters often make clear that the parent’s statement of present intention is only that—a statement of current plans and not a guarantee of future results. While usually not enforceable, a statement of this kind is proffered as evidence of a parent’s intent to support its affiliate. By putting its intent in writing, the parent is making explicit what was likely implicit and is thus, at least arguably, enhancing the market’s perception of and readiness to rely on the notion of parental support.

An example of a public statement equivalent to a comfort letter is contained in the Volkswagen Financial Services AG annual report for 1997:

LETTER OF COMFORT FOR OUR AFFILIATED COMPANIES

With the exception of political risks, Volkswagen Financial Services AG herewith declares that as sole shareholder of its subsidiaries, it will exert its influence to ensure that the latter meet their liabilities to financial institutions in the agreed manner. Moreover, it confirms that no changes are planned in the ownership structures of the subsidiaries for the terms of loans.

http://www.vwfsag.de/content/sites/vwcorporate/vwfsag_de/en/home/investor_relations/geschaeftsberichte/archiv_2002-
http://www.vwfsag.de/content/sites/vwcorporate/vwfsag_de/en/home/investor_relations/geschaeftsberichte/archiv_2002-
Another form of comfort letter is described in Treasury Regulation section 1.482-9(l)(5) (Example 18), discussed previously, where a parent corporation writes a letter to a financial institution confirming ownership of an affiliate and committing to maintain ownership of the affiliate during the life of a proposed contract. The regulation states that the letter allowed the subsidiary “to obtain a contract on more favorable terms than otherwise would have been possible.”

The Example in Treasury Regulation section 1.482-9(l)(5) does not make clear whether the comfort letter was legally enforceable, and the courts have not been entirely consistent in identifying the point at which a parent’s expression of support crosses the line into enforceability. Standards on this issue are evolving and they differ from one jurisdiction to the next. As a result, what had been a fairly uniform assumption that a comfort letter does not create an enforceable obligation has been called into question in many countries as recipients of comfort letters increasingly bring suit to enforce their claims.

For example, in a 1988 U.K. Court of Appeals case involving Kleinwort Benson, the parent wrote to a bank: “It is our policy to ensure that the business of [our subsidiary] is at all times in a position to meet its liabilities to you under the above arrangements.” The court held that this statement of support was not binding because there was no promise that the policy would continue. Informing this conclusion, no doubt, was evidence showing that the parent had refused to provide a formal guarantee and that the subsidiary had been charged an interest rate that reflected the absence of a formal guarantee. On the other hand, in Bank of New Zealand v. Ginivan, 1 N.Z.L.R. 178 (C.A. 1980), the New Zealand Court of Appeals held a comfort letter enforceable where the parent had refused to provide a guarantee but supplied a letter stating that it “will use ‘best endeavors’ to see that [its subsidiary] continues” to “conduct its affairs in a reasonable manner, maintain a sound financial condition and meet its obligations promptly.”

The court ruled that these representations “suggest an obligation of a legally binding nature.” And again in the Banque Brussels case, 1990 NSW Supreme Court, the court held that the parent had made a binding commitment when it represented to a bank: “It is our practice to ensure that our affiliate * * * will at all times be in a position to meet its financial obligations as they fall due,” and further that “[t]hese financial obligations include repayment of all loans made by your Bank under the agreements mentioned in this letter.”

Toward the enforceable end of the spectrum are instruments that are generally held to be binding but do not constitute guarantees as commonly understood. These may

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26 See DiMatteo & Sacasas, supra note 24, 47 BAYLOR L. REV. at 384.
be styled “keep well” or “capital maintenance” agreements and may commit the party
issuing the letter to provide funds to an affiliate in a prescribed amount at defined
intervals to ensure that the affiliate has sufficient capital on hand to meet its obligations.
These instruments are generally enforceable by the affiliate; they may expressly disclaim
making a commitment to, or being enforceable by, a third party. However, as the
examples below demonstrate, there is wide variation in what goes by the name “keep
well” or “capital maintenance agreement,” and oftentimes such instruments are in fact for
the benefit of, and enforceable by, third parties. This makes the distinction between these
instruments and conventional guarantees a subtle if not an illusory one.

Indisputably at the legally enforceable end of the spectrum are formal guarantees.
This universe is customarily divided between “financial” guarantees and “performance”
guarantees, though the distinction is not always meaningful or clear. A financial
guarantee is usually conceived as one where the primary underlying obligation is
financial, such as a loan. A performance guarantee is one where the underlying
obligation is something other than, or in addition to, a financial obligation, such as the
completion of a project. But a performance guarantee may also incorporate an assurance
of payment.

For example, a construction contract may provide that the contractor (Affiliate)
must complete a building by date X and must pay damages of $Y if it fails to meet that
schedule. The parent in turn may issue a guarantee stating that if Affiliate fails to
complete the building and fails to pay damages, the parent will pay the damages. Even
though the parent’s obligation is simply to make a payment, this is commonly
denominated a performance guarantee, presumably because the primary underlying
obligation is not the payment of a penalty but the construction of a building.

Of course, performance guarantees often go beyond simply guaranteeing payment
and may obligate the guarantor to perform the contracted-for services itself or to arrange
for performance by others in the event the affiliate defaults. Even in such cases, the risk
is essentially a financial risk, involving an assessment of what it will cost to complete the
project. Surety bonds to guarantee performance of construction contracts, for example,
are typically issued by parties with the financial capacity to pay someone to complete the
construction project, not by parties capable of performing construction services
themselves. A surety’s decision whether to issue a bond is based primarily on its analysis
of the financial position of the company seeking to be bonded, and this underscores the
reasonableness of treating performance and financial guarantees similarly.

B. Objectives of Related Party Guarantees and Similar
Instruments

1. Access and Improved Terms

The most commonly assumed objective of a related party financial guarantee or
other credit-enhancing instrument is to provide an affiliate credit support in connection
with a borrowing. A parent corporation may execute a guarantee to a lender providing
that if the affiliate-borrower fails to make a payment when due, the lender may collect directly from the parent-guarantor. This will typically enable the affiliate to borrow the funds at a lower interest rate. For example, if the affiliate has a credit rating below investment grade, which would normally force it to borrow at a spread of 200 basis points (“bps”), obtaining a guarantee from its AAA rated parent may allow it to borrow at a spread of 25 bps.

In other cases, a financial guarantee or similar instrument may be needed not simply to gain improved borrowing terms but to secure access to credit at all. For example, the keep-well agreement produced below states that the parent’s execution thereof is “a condition precedent to the extension of credit” and that the “Lender would not make Loans [to the affiliate] in the absence of [the parent’s] undertaking”:

**KEEP-WELL AGREEMENT**

To: Guaranty Bank, as Lender
8333 Douglas Avenue
Dallas, Texas 75225

Pursuant to a certain Amended and Restated Credit Agreement of even date herewith (the "CREDIT AGREEMENT") by and among PREFERRED HOME MORTGAGE COMPANY (the "COMPANY") and GUARANTY BANK (the "LENDER"), Lender agreed to extend credit to the Company on the terms and subject to the conditions set forth therein. … The Company is a wholly owned subsidiary of the undersigned TECHNICAL OLYMPIC USA, INC. ("TOUSA"). The execution of this Keep-Well Agreement is a condition precedent to the extension of credit provided for in the Credit Agreement. In order to induce the making of Loans, TOUSA represents, warrants and covenants as follows:

1. TOUSA is familiar with the terms of SECTIONS 6.13 to 6.15 and 6.17 of the Credit Agreement (the covenants in such Sections of the Credit Agreement are hereinafter referred to as the "FINANCIAL COVENANTS").

2. TOUSA acknowledges that Lender would not make Loans in the absence of TOUSA’s undertaking to cause the Company to comply with the Financial Covenants.

3. TOUSA confirms that it is to its direct economic benefit to make the representations, warranties and covenants hereinafter set forth. TOUSA agrees that, for the period that any Obligations remain outstanding and unpaid under the Credit Agreement or Lender is obligated to fund any portion of any Loan under the Credit Agreement, TOUSA will cause the Company to comply with the Financial Covenants, by at its option either (a) directly injecting sufficient capital into the Company, or (b) making loans to the Company which shall be subordinated in all respects to the Loans, in an amount sufficient to cause the Company to be in compliance with the Financial Covenants. …

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4. Any breach by TOUSA of the undertakings set forth in this Keep-Well Agreement shall serve as an independent event of default under both this Keep-Well Agreement and the Credit Agreement.

Like a financial guarantee, a performance guarantee may sometimes be implemented to help an affiliate win a contract from a third party on more favorable terms. In Example 16 to Treasury Regulation section 1.482-9(l)(5), discussed previously, a parent corporation “executes a performance guarantee with respect to [a] contract, agreeing to assist in the project if [its subsidiary] fails to meet certain mileposts.” The example considers that “[t]his performance guarantee allowed [the affiliate] to obtain the contract on materially more favorable terms than otherwise would have been possible.” The implication is that the affiliate could have secured the contract even without the parental guarantee, albeit on less favorable terms.

In other cases—perhaps the majority—a performance guarantee may have as its objective not simply securing improved contract terms, but enabling the affiliate to compete credibly for the contract to begin with. It is relatively common for uncontrolled parties to insist on a guarantee, particularly if the affiliate is newly established and has not completed projects of similar size and scope. An example of this scenario is suggested by Hospital Corp. of America v. Commissioner, 81 T.C. 520 (1983). There, a U.S. parent created a Cayman Islands subsidiary to negotiate, execute, and perform a contract to manage a hospital in Saudi Arabia. The Saudi client required the parent to execute a performance guarantee on behalf of the subsidiary; the parent also performed services on behalf of the subsidiary, making available its management system and expertise. The Tax Court’s findings suggest that the client was looking to the parent to ensure the subsidiary’s performance, and it seems unlikely that the fledgling Cayman company could have won the contract on any terms without its experienced parent’s guarantee.

Financial and performance guarantees may arise not only in connection with borrowings and executory contracts, but also in connection with capital transactions, e.g., to facilitate a stock or asset sale. For example, assume that a holding company wishes to sell the stock of an affiliate to a third party and, in connection with the sale, undertakes a contingent liability to indemnify the purchaser against adverse events for a period of five years. The purchaser may lack confidence that the holding company will remain in place for five years or will have the assets necessary to make good on the indemnity. The purchaser may accordingly demand and obtain a performance guarantee from a higher-tier parent. The guarantee may allow the holding-company seller to obtain a better price or, more likely, to avoid having a portion of the sales proceeds held in escrow, or it may be essential in order to consummate the sale. In principle, this performance guarantee has the same objectives as a standard financial guarantee: to secure access to improved terms and/or to enable the transaction to occur at all.

An example of this scenario is a November 2009 “Keep Well Agreement” executed by Westaim Corporation in connection with an asset purchase agreement.

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29 Hospital Corp. of America, 81 T.C. at 599-601.
between its subsidiaries and a third party, Smith & Nephew Inc. Under the agreement, the parent, Westaim, undertook both negative and positive commitments: (i) to take no action, such as the declaration of dividends, that would cause the subsidiaries to fail to satisfy their net worth covenant; and (ii) to accept liability for the indemnity liability of the subsidiaries up to a specified dollar amount in the event the subsidiaries breach their net worth covenant and fail to meet their indemnity obligations. The keep-well agreement was expressly made a condition precedent to the sale.  

2. Objectives Other Than Securing Access and Improved Terms

a. Regulatory Approval for Acquisitions, Dispositions, and Other Transactions

An instrument such as a comfort letter, a keep-well, a capital maintenance agreement, or a guarantee may be required by regulators to win approval for a transaction involving a bank or other regulated business, including an acquisition or disposition. The nature and form of the commitment may vary depending on the identity of the regulator and the nature of the transaction.

The Federal Deposit Insurance Corporation (“FDIC”) requires such agreements in various circumstances. In one example, the FDIC required the execution of a “Capital Maintenance and Liquidity Agreement” by a parent company as a precondition for arranging FDIC insurance for its proposed Utah banking affiliate. The agreement committed the parent to provide capital to the affiliate whenever necessary to ensure that the bank remained “well capitalized” with a risk based capital ratio of not less than 15%. The agreement also committed the parent to “maintain the Applicant's liquidity at such levels as the FDIC deems appropriate, and/or take such other actions as the FDIC deems appropriate to provide the Applicant with a resource for additional liquidity,” including providing the bank with “a $5 million unsecured credit facility” on “terms and conditions that are no less favorable than the prevailing market for similar transactions with an unaffiliated party.” The recitals stated that the FDIC could not approve insurance coverage for the affiliate absent the parent’s commitments, and the agreement stated that the parent’s commitments were “binding and enforceable by the FDIC.”  

In another example, the FDIC required the execution of a “Capital Maintenance Agreement” by a parent (GMAC) as a condition of approving the parent’s sale to a third party of a controlling stake in an FDIC-insured bank. The agreement recited that the FDIC “may not make a favorable finding” in the absence of GMAC’s agreement to ensure the capital adequacy of the bank post-sale. Accordingly, in an agreement “binding and enforceable by the FDIC,” GMAC committed to “maintain sufficient capital in the

30 A copy of the agreement appears at: http://google.brand.edgar-online.com/EFX_dll/EDGARpro.dll?FetchFilingHtmlSection1?SectionID=6921159-454829-464750&SessionID=9MGJHH 6 ct7G 7.

bank] such that the [bank’s] capital meets or exceeds the levels required for the [bank] to be considered "'well capitalized’" under FDIC regulations.32

Different regulators may require or accept different types of instruments. For example, a March 2008 SEC filing by Capmark Financial Group, a commercial real estate finance company, refers to both a capital maintenance agreement executed at the behest of the FDIC and a comfort letter provided to the Irish Financial Regulator. Excerpts from Capmark’s Form S-4 are below33:

FORM S-4
REGISTRATION STATEMENT
UNDER THE SECURITIES ACT OF 1933
CAPMARK FINANCIAL GROUP INC.

We are subject to regulation and supervision in a number of jurisdictions…. In connection with the Sponsor Transactions, we entered into a capital maintenance agreement with the FDIC that requires us to maintain the "well capitalized" status of our US banks and to maintain the banks' Tier 1 leverage ratio above a prescribed minimum, and we delivered a letter of comfort to our Irish banking regulator in support of our Irish bank. [page 38]

In connection with the Sponsor Transactions, on March 23, 2006, we provided the Irish Financial Regulator with a letter of comfort with respect to Capmark Bank Europe replacing the letter of comfort provided by GMAC. Our comfort letter advised the Irish Financial Regulator that it is our policy to ensure, and that we will ensure, the ability of Capmark Bank Europe to meet all of its liabilities as they become due for so long as we continue to be the majority equity holder of Capmark Bank Europe. [pages 158-59].

In a variety of regulatory contexts, the execution of a guarantee or similar instrument may enable a parent to provide the required support for its affiliate without the need of injecting additional capital into it. For example, a bank holding company may want to reposition funds between two related banks, one with a cash requirement and the other with a cash surplus. Banks may be required to maintain a certain capital adequacy ratio (“CAR”), and the credit standing of the bank receiving the funds (the borrower) may impact how much core capital the bank providing the funds (the lender) is required to maintain to meet its CAR. In the calculation of a bank’s CAR, consideration is given to the “risk weight” of its assets. Loans to banks and securities companies are given different risk weights depending on the credit rating of the borrower, as follows: borrowers rated AAA to AA- have a risk weighting of 20%; borrowers rated A+ to A- have a risk weighting of 50%; borrowers rated BBB+ to B- have a risk weighting of 100%; and borrowers rated below B have a risk weighting of 150%. Thus, if an A- rated parent guarantees the borrowing of a BBB+ rated subsidiary, it may be able to avoid putting additional capital into the lending bank. The guaranteeing of related party debt

33 The complete document is at: http://www.istockanalyst.com/article/viewsecfiling/articleid/1595517.
may thus be used as a tool to facilitate the repositioning of excess cash and to mitigate the effects on CAR requirements for the lender bank. This is completely independent of any consideration of interest rates.

b.Reducing Credit Assessment Costs, Accounting Costs, and Related Expenses

Related party guarantees are sometimes prompted by the desire to avoid the time and expense of obtaining credit assessments of affiliates. The costs associated with performing a credit assessment are often substantial and a lender (and borrower) may be reluctant to incur those costs. A parental guarantee provides a shortcut: it does not necessarily lead to a better credit rating or lower interest rate, but merely simplifies and speeds the process. Related party cross-guarantees may be used in other situations to simplify the extension of credit, e.g., where a group of affiliated parties sets up a cash pool arrangement with a bank.

The preparation of audited financial statements for dozens or hundreds of subsidiary corporations likewise entails substantial costs for a parent company. In Australia (and perhaps in other jurisdictions), the execution of cross-guarantees between a parent and its subsidiaries, or among corporate affiliates, allows them to take advantage of regulatory relief from this obligation. An order from the Australian Securities and Investments Commission appears below:

Under Class Order [CO 98/1418], certain wholly-owned subsidiaries may be relieved from the requirement to prepare and lodge audited financial statements under Chapter 2M of the Corporations Act 2001, where they enter into deeds of cross guarantee with their parent entity and meet certain other conditions.

Relief under this class order is based on similar relief available to corporate groups since the 1980s. The deed of cross guarantee makes the group of companies that are parties to that deed akin to a single legal entity in many respects. Creditors and potential creditors can then focus on the consolidated position for those entities rather than the individual financial statements of the wholly-owned subsidiaries that are parties to the deed.

c.Contract Assignments

A related party guarantee or comfort letter may be put in place to induce a customer to allow a contract assignment where the taxpayer desires to shift primary

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34 Cf. Allan Riding & George Haines, Loan Guarantees: Costs of Default and Benefits to Small Firms, 16 J. OF BUSINESS VENTURING 595, 601 (2001) (noting that government sponsored guarantee programs are sometimes designed to overcome lender reluctance to incur costs of evaluating and monitoring prospective borrowers).


contractual responsibility from itself to a local affiliate. Assume that a U.S. company that had been performing contracts with third parties in foreign country X decides to set up a local country X subsidiary and have it perform the contract functions in its own name. To induce the customer to consent to the assignment, the parent agrees to provide a performance guarantee to backstop its affiliate. (In principle, this scenario resembles Hospital Corp. of America except that it involves ongoing customers rather than a new customer.) The performance guarantee may be regarded as primarily benefiting the affiliate, which otherwise could not secure the customer or execute the contract. But the guarantee might also be viewed as benefiting the parent, e.g., by enabling it to manage its developing-country risk or its effective worldwide tax rate.

d.Going Concern/Auditor Letters

A parental guarantee or comfort letter may be executed to enable a subsidiary to prepare its financial statements on a going-concern basis and allow its auditors to sign off accordingly. Such an instrument may explicitly state that it may be used only by the board of directors and auditors for purposes of making a going concern assessment, and that it is not for the use of, and may not be shown to, any third-party lender or customer. An example of an instrument issued to support a going concern conclusion is the letter provided in February 2001 by Gate Gourmet International AG, to the directors of its subsidiary, Gate Gourmet (Holdings) Pty Ltd., in which the parent stated:

This is to confirm that the parent entity, Gate Gourmet International AG, will provide the financial support that may be necessary to enable Gate Gourmet (Holdings) Pty Ltd and its controlled entities to meet its financial commitments as and when they fall due. This letter of support will not be withdrawn before Gate Gourmet (Holdings) Pty Ltd and its controlled entities have sufficient means to meet their obligations without support of the parent entity.37

This letter was held enforceable because of the “strong and plain terms” by which the parent assumed the obligation of support.38 However, weaker expressions of support, even if legally unenforceable, are sometimes provided to achieve the same end. Although a guarantee of this sort does not enable the subsidiary to secure a valuable contract or obtain better terms on a loan, avoiding a “going concern” problem does help the subsidiary to continue operating in the marketplace to its benefit and to the presumed benefit of its parent.

e.Substitute for Covenants


38 Id.
Related party guarantees may be provided to avoid the necessity of having an affiliate execute numerous restrictive covenants in its financing transactions. “In the absence of a guarantee, the local bank will probably insist on inserting various complicating covenants in its loan agreement with the subsidiary. The parent can prevent these restrictive covenants and the resulting loss in operational and financial flexibility by supplying loan guarantees.” Here again, the guarantee may be regarded as benefiting the subsidiary (by liberating it from unattractive covenants) and/or the parent (by giving it greater flexibility in controlling its operations and cash flow).

IV. Scope of Suggested Guidance

A threshold question is the appropriate scope of guidance. As commonly understood in the intercompany context, the term “guarantee” refers to an undertaking by one member of a controlled group to stand behind the obligation of another member, whether to perform on a contract or to repay a debt. Much of the recent transfer pricing discussion pertaining to guarantees has focused on financial guarantees. Within a controlled group, however, a guarantee may often be executed for transactions that have no direct link to borrowing. For example, as explained above, a parent (or another affiliate) may issue a performance guarantee to assure an uncontrolled party that a group member will meet its obligations under a long-term construction contract, will perform its work in timely fashion, or will pay liquidated damages in the event of a breach. Accordingly, there is a question whether to limit guidance to financial guarantees or to include performance guarantees as well.

A formal or conventional guarantee has features in common with other mechanisms that serve the same function of supporting the credit or commercial standing of an affiliate. These mechanisms include comfort letters, keep well or capital maintenance agreements, stand-by letters of credit, and letters of support. Such undertakings may have an impact similar to that of a guarantee, making it sometimes difficult to distinguish between guarantees and these other instruments. Comfort instruments, for instance, have been called “guaranty substitutes.” This raises a separate threshold question whether any forthcoming guidance should be limited to what are conventionally called guarantees, or should address other instruments that likewise have the effect of directly enhancing the credit or commercial standing of an affiliate. Knowledgeable commentators have recognized that a “guarantee” can take many different forms and that the rules should produce the same result however a transaction is structured.\\n
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39 Donald Lessard & Alan Shapiro, A Framework for Global Financing Choices, WP 1305-82 (May 1982), page 30. See also Preamble, Prop. Reg. § 1.385-11, 45 Fed. Reg. 18,957 (1980) (“The creditor may want to provide against the possibility that the corporation will transfer assets to its shareholders ... When shareholders guarantee a loan for this ... reason, the guarantee is a substitute for detailed protective covenants”), quoted in Wayne Gazur, An Arm’s Length Solution to the Shareholder Loan Tax Puzzle, 40 SETON HALL L. REV. 407, 454-55 (2010).
41 DiMatteo & Sacasas, supra note 24, 47 BAYLOR L. REV. at 365.
We believe that any forthcoming guidance should be as broad as common principles allow, i.e., to the extent a common set of principles can and should attach to a set of instruments, it makes sense that the scope of guidance should be broad enough to capture those instruments. The ensuing discussion accordingly adopts a broad view of the term “guarantee” to include any activity or instrument – be it styled a financial guarantee, a performance guarantee, or something else – that has the purpose and effect of enhancing the credit or commercial standing of an affiliate.

This expansive definition of “guarantee” finds support in the Internal Revenue Code. A “guarantee” under section 679 is defined to mean any form of credit support, including a commitment to make a capital contribution to the debtor or otherwise maintain its financial viability. The interest-stripping rules of section 163(j) provide a similarly broad definition of a guarantee in the parent-subsidiary context. Those rules define a guarantee as “any arrangement under which a person (directly or indirectly through an entity or otherwise) assures, on a conditional or unconditional basis, the payment of another person’s obligation under any indebtedness.” Legislative history indicates that Congress intended that such an “arrangement” would include any form of credit support, including “a commitment to make a capital contribution to the debtor or otherwise maintain its financial viability [or] an arrangement reflected in a ‘comfort letter,’ regardless whether the arrangement gives rise to a legally enforceable obligation.”

The transfer pricing law of the United Kingdom has a similarly broad definition of the term “guarantee.” Under U.K. law, a “guarantee” is defined to include any formal or informal understanding that gives the lender a “reasonable expectation that in the event of a default by the issuing company he will be paid by, or out of the assets of, one or more [other] companies.”

V. Whether Credit-Enhancing Instruments Give Rise to Compensable Transactions

We turn next to a question that logically precedes any discussion of pricing – the issue of compensability. Assuming that the execution of a related party guarantee or other credit-enhancing instrument is not a contribution to capital, is it a transaction for which a charge may appropriately be imposed? We understand the issue of compensability to be one of the two principal questions that Treasury and the Service has under consideration. We believe it is clearly an appropriate subject for guidance.

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43 Reg. § 1.679-3(e)(4)(i)-(iii). Under § 679, if a related U.S. person guarantees an obligation of a foreign trust, the guarantor is treated as a U.S. transferor that has made a transfer to the trust; if the trust has a U.S. beneficiary, the U.S. transferor is treated as the owner. I.R.C. § 679(a)(1), (e); Reg. § 1.679-3(e)(1).
For the great majority of cases, we think this question is answered in the affirmative by broad principles set out in existing guidance. A compensable transaction occurs when there is a transfer of valuable property or when (borrowing the vocabulary of 1.482-9) a party confers an identifiable economic benefit upon an affiliate by undertaking some act. This general standard is consistent with the principles set out in Treasury Regulation section 1.482-9(l) and in Paragraphs 7.6 and 7.13 of the OECD Guidelines. We believe that most examples of credit-enhancing instruments discussed earlier in this report (see pages 11-20, supra) would satisfy this standard. Each of them involves a distinct transaction or activity. With a few possible exceptions, each of them confers a direct and identifiable economic benefit on the affiliate whose credit or performance is enhanced. This benefit takes one or more forms, including reduced borrowing costs, the ability to bid on a contract ab initio, improved contract terms, improved access to funds or commercial opportunities, cost savings or efficiencies, or freedom from burdensome restrictive covenants.

We recognize that reasonable minds may differ on matters around the edges of this subject. Some transactions that confer a benefit may be of such a nature that they cannot reasonably be compensated; others may confer a benefit so slight as not to justify a transfer pricing analysis. In general, however, we favor a rule that permits compensability in all situations where one person transfers property or performs an activity that provides a direct and identifiable benefit to an affiliate judged by the same standards already in the regulations for related party transactions. Cases falling near the perimeter may justify exceptions or may be handled by safe harbors or de minimis rules. In reaching this conclusion, we have considered the different types and uses of credit-enhancing and related commercial instruments. Our reasoning with respect to specific scenarios is set out below.

A. Is Compensability Affected by the Form of the Instrument?

It seems clear that the issuance of a formal guarantee, whether denominated a financial guarantee or a performance guarantee, would often qualify as a transaction for which a charge may be imposed. This conclusion is consistent with Treasury Regulation section 1.482-9(l)(5) (Example 16), which concludes that a subsidiary “is considered to obtain a benefit from [its parent’s] execution of the performance guarantee.” This conclusion also coheres with Paragraph 7.13 of the OECD Guidelines, which states that “an intra-group service would usually exist where the [subsidiary’s] higher credit rating were due to a guarantee by another group member.”

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47 In the text here and below, we consciously borrow some of the language and concepts found in the services regulations under Reg. § 1.482-9 to discuss the central question identified by the Service of whether issuance of a related party guarantee is a compensable transaction. We do so because issues of compensability are more fully developed in the services regulations than elsewhere and we believe the “benefit test” concepts can be soundly applied to transactions involving property, including guarantees.  
Although the credit-related benefits produced by a financial guarantee will often be obvious, discerning the benefits produced by a performance guarantee may be more difficult. In certain contract settings, we understand that performance guarantees are required from affiliates as a matter of course, even though the company performing the contract is well-known and well-capitalized. In such cases, the guarantee may be said to benefit the performing company because the contract paperwork requires as a condition to awarding the contract that the “related party guarantee” box be checked. But the guarantee may not meaningfully enhance the company’s competitive bidding position or its ability to deliver, either in its own eyes or that of its customer. Perhaps with such cases in mind, Example 16 (discussed above) concludes that the subsidiary obtains a benefit from a performance guarantee when it is thereby enabled to obtain the contract “on materially more favorable terms.”

Even where the benefit that an affiliate derives from a performance guarantee is slight, we recommend that the transaction be treated as compensable and that the formidable difficulties of valuation be handled by safe harbors or de minimis rules. For example, if an established company has a proven track record of performing certain types of contracts, the parties might elect to price the performance guarantee at cost, by analogy to the services regulations. Alternatively, the affiliate issuing the guarantee may minimize the valuation problem by structuring it as a contribution to capital.

We believe that the same conclusions regarding compensability follow with respect to keep well agreements, capital maintenance agreements, and similar instruments. In each case, the parent (or other obligor) makes a definite financial commitment to provide credit to an affiliate in specified circumstances. These agreements typically are legally enforceable by the affiliate and may in some cases be enforceable by third party lenders who have extended credit to the affiliate in reliance on the agreement. These instruments are functionally equivalent to formal guarantees and should be respected as compensable transactions if structured that way.

Instruments that do not create enforceable obligations, such as some comfort letters and letters of awareness, present a closer question. Some may regard these instruments as inherently non-compensable, notwithstanding that they have value or confer a benefit. It may be argued, for example, that a parent should not be permitted to charge its affiliate for a letter stating simply that the parent is aware of a transaction. Similarly, some may question the compensability of a comfort letter reciting the parent’s “current intention” to provide future support without its assuming any enforceable obligation to do so.

The argument for mandatory non-compensability with respect to such instruments may rest on several grounds, none of which we ultimately find persuasive. First, it might be contended that these instruments represent mere incidents of passive association, which, under Treasury Regulation section 1.482-9(l), is deemed not to generate “benefits” for transfer pricing purposes. The short answer here, we think, is that execution and delivery of instruments by a corporation, upon request from a lender, do not constitute “passive association” or the “mere incidents” of passive association.
Rather, definite activity is undertaken by a member of a controlled group in each case. It is not the affiliation status alone that constitutes the transaction, but the affirmative and purposeful act of the controlled group member. We acknowledge that Example 18 to Treasury Regulation section 1.482-9(l)(5) may be in tension with this analysis. That Example finds no cognizable benefit to the subsidiary even though the transaction involves an affirmative act by the parent – the execution and delivery of a letter to the lender and the undertaking of a commitment with respect to the parent’s future ownership of the affiliate. In our view, this concrete expression of support extends beyond “passive association.” The Treasury Department may wish to reconsider Example 18 in the context of furnishing its forthcoming guidance.

Second, it may be argued that instruments like letters of awareness and comfort letters do not exist in the commercial marketplace, and this absence of commercial analogues may suggest that such instruments are uniquely shareholder or controlled-group products and for that reason not compensable. To begin with, we question the premise that such instruments do not exist in the marketplace. There are in fact “an almost unlimited number of instruments found in the business world that attempt to provide some sort of comfort,” many of them issued by third parties. These include letters of assurance, letters of responsibility, letters of comfort, and letters of intent, among others. We are unaware of any general transfer pricing principle holding that a transaction must have an exact marketplace analogue in order to be compensable. We think it is sufficient that there is an activity and a benefit for which the beneficiary would be willing to pay, whether or not the intra-group activity has a precise parallel in the general marketplace.

Third, it might be argued that certain analogues which do exist for instruments like comfort letters are transactions for which a charge is not generally imposed between unrelated parties dealing at arm’s length. One might put forward letters of recommendation for employment or admission as an example. But the status of letters of recommendation as non-compensable reflects a unique congeries of factors – academic traditions, long-standing custom, and the obvious concern that receipt of payment would give the recommender a conflict of interest. None of these factors has any relevance to a parent corporation’s expression of support for a subsidiary. In choosing among the available forms of credit support – a guarantee, a keep well, a comfort letter, or a letter of awareness – the parent will presumably elect the weakest form of support that will satisfy the intended audience, whether a lender, customer, or regulator. If this activity by the parent gets the job done and thus benefits the subsidiary, it is not clear why the transaction’s compensability should depend on which form is selected.

B. Is Compensability Affected by the Purpose of the Instrument?

Where a guarantee or similar instrument is issued for the traditional purpose of enhancing an affiliate’s access to credit, the transaction will almost always be one for which a charge may be imposed. Whenever the affiliate thereby secures improved credit

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49 DiMatteo & Sacasas, supra note 24, 47 BAYLOR L. REV. at 361-64.
terms, or access to credit otherwise unattainable, the affiliate enjoys by virtue of the parent’s activity an obvious economic benefit. As discussed earlier, however, guarantees are frequently issued for purposes having nothing to do with interest rates – e.g., to avoid the need for credit assessments, to simplify accounting, to eliminate burdensome restrictive covenants, or to secure regulatory approvals. The compensability of the guarantee transaction may be less certain in these other settings where the benefit to the borrower is harder to measure and/or may be immaterial.

Whenever the parent’s credit-enhancing activity enables the affiliate to achieve meaningful economic efficiencies or cost savings – whether or not credit- or interest-related – the transaction should be treated as eligible to be compensated. This would be true, for example, where the parent’s action enables the subsidiary to avoid the cost of securing an independent credit rating; to avoid the cost of preparing certified financial statements; or to file its financial statements on a going-concern basis.50

When the parent’s credit-enhancing activity is designed to secure regulatory approvals, the transaction should generally be treated as compensable where the approval results in cost savings for the affiliate or enables it to engage in economic activity in which it desires to engage.51 A different answer may apply where regulatory approval is being sought for a new acquisition by a shareholder or a complete disposition of the shareholder’s interest in the affiliate. Shareholders sometimes have to make commitments to regulatory authorities with respect to the health of an affiliate in order to get permission to acquire or dispose of an affiliate. In these cases, it seems reasonable to conclude that the guarantee confers no real benefit on the affiliate; rather, the shareholder is the true beneficiary because the guarantee enables it to acquire or dispose of its investment.

Compensability may likewise be a closer question where a guarantee is employed to avoid the necessity of having an affiliate execute restrictive covenants in its financing agreements. Such covenants typically limit a company’s ability to enter into certain transactions “such as incurring additional indebtedness, increasing [its] dividends, and

50 It was noted above that a parental guarantee or comfort letter may be executed to enable a subsidiary to prepare its financial statements on a going-concern basis and allow its auditors to sign off on that basis. Although a guarantee of this sort does not enable the subsidiary to secure a valuable contract or obtain better terms on a loan, avoiding a “going concern” problem does help the subsidiary to continue operating in the marketplace. We think this is compensable assuming it is structured as such (as opposed to being structured as a contribution to capital) and can be reliably valued. Taxpayers in most such circumstances would not provide for payment since it may work at cross purposes with the provision of the instrument, i.e., it may not serve the purpose of the parent or auditor for the parent to guarantee to the auditor the financial health of the affiliate, then charge the affiliate for having given that assurance. The cases where the parent seeks to charge for the instrument in this circumstance would likely be rare.

51 Similar to the preceding footnote, it is likely that most taxpayers would structure these instruments as capital contributions by choice since providing for payment would likely work at cross purposes with the provision of the instrument, i.e., it may not serve the purpose of the parent or regulator for the parent to guarantee to the regulator the financial health of the affiliate, then charge the affiliate for having given that assurance. The cases where the parent seeks to charge for the instrument in this circumstance would likely be rare.
entering into dispositions and joint ventures.”52 Such covenants may also impose reporting obligations on the company, requiring it “to report compliance with certain financial covenants to its lenders on a quarterly basis.”53

It seems clear that a related party guarantee confers value if it frees the affiliate from the need for restrictive covenants and the ancillary costs they impose—demands on managerial time, the obligation to file reports, the constraints imposed on investment and operational decisions, and the risk of breach and forced early repayment. “Any review of the firm’s operations by outsiders is likely to be costly – in terms of managerial time, the need to generate updated financial reports, and the need for management to explain and justify its forecasts and strategy – and something managers prefer to avoid.”54 Covenants act as “tripwires” that inject uncertainty into a transaction: private lenders are likely to set covenant constraints fairly tightly, to allow them to monitor a borrower’s financial standing and to reassess a loan if the borrower’s credit standing slips. Indeed, covenants in private lending agreements are set so tightly that, according to commentators, violations occur in approximately 30% of all loans.55 It is clearly undesirable from a borrower’s perspective to be compelled to accept covenants that impose such burdens and create the risk that the lender may force early repayment. Indeed, many companies switch from private bank loans to public junk bond financing “not because of deteriorating operating performance, but to free themselves from the tight debt constraints and lender monitoring that bank loans involve.”56

It has been suggested that a related party guarantee should be treated as non-compensable where its purpose is to substitute for covenants that address “moral hazard” risk – namely, the risk that a borrowing affiliate will pay excessive dividends or take other steps that prejudice the interests of outside lenders.57 In our experience, lenders infrequently seek guarantees solely for the purpose of controlling moral hazard risk. But if that were in fact the sole purpose, the guarantee should still be compensable if, by eliminating restrictive covenants, it produces material cost savings or economic efficiencies for the borrowing affiliate.58

53 Id.
55 Id. at 3.
58 Clifford Smith & Jerold Warner, On Financial Contracting: An Analysis of Bond Covenants, 7 JOURNAL OF FINANCIAL ECONOMICS 117, 134 (1979), available at: http://www.simon.rochester.edu/fac/warner/jerry%20papers/ife-june%2079.pdf. These authors make the point that a company’s inability to pay dividends may depress its value by preventing it from using its capital most effectively. Dividend restricting covenants “increase[] the probability that the firm will be forced to invest when it has no available profitable projects” and create uneconomic investment incentives.
C. Is Compensability Affected by the Parent’s Willingness to Provide Support for Free?

Any forthcoming guidance should make clear that the compensability of a related party guarantee or similar instrument is not affected by the fact that the guarantor may have been willing to provide the instrument for free. This point seems self-evident: a parent corporation may be willing to provide all manner of goods and services to an affiliate for free – widgets, fuel oil, or consulting services – where these items are essential to an affiliate’s economic health. Unless the transaction is structured as, or otherwise is found to be, a Contributory Transaction, however, the transfer of such goods and the performance of such services represent compensable transactions that must be subjected to transfer pricing analysis.

Clear guidance on this seemingly obvious point is necessary because of confusing case law that has arisen under section 162. In these cases, typically involving closely-held corporations, the corporate taxpayer requires funding and the third party lender requires a shareholder guarantee. The shareholder provides the guarantee and the corporation pays a guarantee fee, which it then deducts as an ordinary and necessary business expense. Even where the guarantee is concededly appropriate and the fee is arm’s length, certain courts, at the Service’s urging, have denied a section 162 deduction on the theory that the shareholder if necessary would have provided the guarantee for free in order to protect his investment.

In *Olton Feed Yard, Inc. v. United States*, 592 F.2d 272 (5th Cir. 1975), for example, the court refused to set aside a jury verdict that held for the government and denied a section 162 deduction for guarantee fees paid to shareholders. Although the government did not challenge the reasonableness of the fees or the need for the guarantee, the court upheld the jury’s denial of the deduction, reasoning that the “crucial question for the jury” was “whether it was necessary for the taxpayer to pay the shareholders a fee in order to get them to sign guarantees for the loan.”

59 592 F.2d at 275 (emphasis in original).

60 See also *E.J. Harrison & Sons, Inc. v. Commissioner*, 86 T.C.M. (CCH) 240 (2003) shareholder’s willingness to guarantee debt for free shows that the shareholder executed the guarantee to protect his investment and hence that the guarantee fee paid by the corporation represented a dividend).

section 162 concept of “necessary” expenses has no application to transfer pricing. Thus, a guarantee is not rendered noncompensable under section 482 merely because the shareholder would have been willing to provide credit support for free. It would follow that an arm’s length guarantee fee generally is deductible by the borrower unless the transaction represents a Contributory Transaction under the particular facts of the case.  

D. Is Compensability Affected by the Parent’s Need to Provide Support?

It is frequently recognized by courts, by commentators, and by the Service in informal guidance that commercial practice often requires a parent to provide a guarantee or other support to enable an affiliate to borrow or bid. In such cases, the commercial transaction would not occur—on any terms—without the provision of such support. For example, in the 1983 Claims Court decision in Tulia Feedlot, Inc. v. United States, the court made clear that the shareholder guarantees being priced were required for the corporation to obtain the loans, stating that the lender required the guarantees “as a condition precedent to the making of the loans;” “that no loan would be made to the corporation unless it was personally guaranteed in full by individuals having adequate financial resources;” and that it was “not possible for other corporate owners of cattle feedlots . . . to obtain loans for operating expenses without having the loans personally guaranteed.” Similarly, in Hospital Corp. of America, supra, it was clear that the performance guarantees provided by the shareholder on behalf of its newly formed Cayman Islands subsidiary were critical to the subsidiary’s securing the contract. In PLR 7822005 (Feb. 21, 1978), addressing the arm’s length price for a guarantee issued by a U.S. parent on behalf of its foreign subsidiaries, the Service noted “that the foreign subsidiaries would not be able to borrow from the foreign lending institutions without Corp. M’s guarantee.” In TAM 8211005 (Nov. 27, 1981), the Service similarly noted that the shareholder guarantee was “a condition precedent to extending the credit.”

In a 2003 letter submitted to Treasury commenting on legislative proposals relating to section 163(j), the Tax Section of the New York State Bar Association correctly emphasized the routine nature of parental guarantees in commercial practice:

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For avoidance of doubt, we do not mean to suggest by the foregoing discussion that a shareholder-guarantor’s intent with respect to providing a guarantee is irrelevant to its compensability. A shareholder may evidence the intent to contribute a guarantee to capital—which would make it a non-compensable transaction—by structuring the transaction in that fashion. Also, a guarantee transaction may be deemed non-compensable as a contribution to capital where the shareholder-guarantor evinces an intent to put its money “at the risk of the business” by guaranteeing debt of a weak affiliate where such action is more befitting an investor than a guarantor. See Centel Communications Co. v. Commissioner, 920 F.2d 1335 (7th Cir. 1990) (founding shareholders of a company personally guaranteed loans needed to keep the company operational; held that the guarantees represented contributions to capital because intended to protect investment); In re Lane, 742 F.2d 1311, 1320 (11th Cir. 1984); Plantation Patterns, Inc. v. Commissioner, 462 F.2d 712, 723 (5th Cir.) cert. denied, 409 U.S. 1076 (1972). See also Reg. § 1.166-9(c) (denying a bad debt deduction for a payment in satisfaction of a guarantee “if, on the basis of the facts and circumstances at the time the obligation was entered into, the payment constitutes a contribution of capital by a shareholder”). The point we’re making above is different—that a transaction is not made non-compensable merely because the shareholder would have been willing to provide the good for free if foreclosed from being compensated for it.
In a typical bank borrowing by a subsidiary in a group of related corporations, the lending syndicate requires as a matter of course a guarantee from the parent company. The reasons generally do not include a belief that the subsidiary cannot service the debt but rather, primarily, a desire to have the entity that has a credit rating from rating agencies be a guarantor, and in addition, a preference to have all available resources behind the borrowing and considerations of general institutional policy. Similarly, when debt is placed in the public markets or “qualified institutional buyer” markets, the underwriters typically require that the rated parent company be a guarantor or co-obligor as a condition to taking the paper to the market.63

The same situation may arise in the case of performance guarantees, where a company may need a parental guarantee simply to be eligible to bid.64 The existence of the guarantee does not necessarily affect the price or terms on which the bidder wins a contract, yet it is a prerequisite to bidding and thus a prerequisite to winning. As the practice has developed over time, expectations have arisen that a parent corporation will automatically supply a guarantee to allow its subsidiary to qualify or compete. And such guarantees are often supplied in circumstances where it would be difficult for the taxpayer to show that a third party guarantee would have been commercially available.

In light of these commercial realities, the facts that a parental guarantee may be a condition precedent to a transaction, or that a comparable third party guarantee may not be readily available, are not sufficient by themselves to render the guarantee non-compensable or to recharacterize the underlying transaction. A bank’s requirement of a parental guarantee on behalf of a borrowing affiliate does not make the parent the actual borrower any more than a seller’s requirement of a letter of credit on behalf of a buyer makes the issuing bank the actual buyer. This point is recognized implicitly in Hospital Corp. of America, Tulia Feedlot, and the private rulings cited above. In any forthcoming guidance, the Treasury should make explicit that a guarantee should not be deemed non-compensable on the theory that its required nature renders the parent the deemed primary obligor.

We believe explicit guidance on this point is required to prevent the possible misuse of cases like Plantation Patterns65 to recharacterize the guarantee transaction. It

63 New York State Bar Association Tax Section Comment Letter on Legislative Proposals Relating to § 163(j) Earnings Stripping Rules (Sept. 12, 2003).
64 See Stephen Comstock, Comments by the American Petroleum Institute on Proposed Regulations Addressing the Treatment of Services under Section 482 (Dec. 9, 2003) (noting that it is common for a parent to guarantee the bid of a newly organized local country affiliate to allow it to bid on a third party contract for local exploration and development projects).
65 See Plantation Patterns, Inc., supra note 62, where the parent guaranteed a loan taken by its subsidiary from an unrelated lender. The court held that where a borrowing corporation is undercapitalized and cannot reasonably be expected to meet its interest and principal obligations under a purported loan, the loan may be reclassified for tax purposes as a loan from the unrelated lender to the shareholder-guarantor (since the lender was effectively looking to the shareholder-guarantor for repayment, not the nominal borrower) followed by a contribution of capital by the shareholder-guarantor to the subsidiary-borrower. A similar principle was espoused in the 1980 proposed regulations under section 385, which stated that if “it is not reasonable (at the time of the guarantee) to expect that the loan can be enforced against the corporation according to its terms, then (at the time of the guarantee) the loan is treated as made to the
might be contended, for example, that if a parental guarantee is realistically a pre-requisite to a commercial transaction, the related party guarantor should be regarded as the “true borrower” (in the case of a financial guarantee) or as the “true contractor” (in the case of a performance guarantee) on the theory that the lender or customer would not have transacted with the affiliate on its own. Similarly, we are concerned about any “independent guarantor” rule suggesting that the compensability of a guarantee requires evidence that a third party would have been willing to issue a like guarantee. As commentators observed when an analogous “independent creditor” standard was advanced in connection with proposed regulations under section 385, it is extremely difficult to establish what a third party would demand in difficult situations.66 Similarly here, we think it is critical to delineate the principles in this area carefully and with sensitivity to business practices and to practical tax administration.

In sum, we do not believe the idiosyncrasies of related party instruments present insurmountable obstacles or affect the compensability of the transactions as a logical or policy matter. However, they may counsel the need for flexibility and nuance in adopting pricing methods, and they may suggest the wisdom in certain circumstances of safe harbors or presumptions.

VI.Instruments Structured as Non-compensable

The preceding section addressed the issue of compensability – in particular, whether one party may charge another for providing a guarantee or like instrument assuming the instrument has value and confers a direct and identifiable economic benefit. We urge that the general rule for compensability apply and that exceptions not be required based on the name given to the instrument, whether it be “guarantee,” “keep well,” “capital maintenance agreement,” or “comfort letter,” or on the nature of the economic benefit conferred, e.g., access to markets, materially more favorable terms, or cost savings and administrative efficiencies.

Nothing in the discussion above, however, is meant to inhibit the parties’ ability under existing law to structure a transaction as a Contributory Transaction or to prejudice the ability of the Service or courts to force such characterization in an appropriate case.67

66 Gazur, supra note 39, 40 SETON HALL L. REV. at 431 n.88, citing Jack Levin & Stephen Bowen, The Section 385 Regulations Regarding Debt Versus Equity: Is the Cure Worse than the Malady?, 35 TAX LAW. 1, 40-41 (1981) (“Often, even after the rules have been correctly followed, the answer to these questions will turn on extremely difficult factual determinations . . .”).

67 See, e.g., Centel Communications Co., supra note 62 (guarantees represented non-compensable contributions to capital because intended to protect investment); In re Lane, supra note 62 (non-compensable contributions to capital because in lieu of needed capital); Olton Feed Yard, Inc. v. United States, 592 F.2d 272 (5th Cir. 1975) (non-compensable because intent to protect investment, despite fee being charged); E.J. Harrison, supra note 60 (non-compensable because intent to protect investment, despite fee being charged).
The Government naturally has an interest in avoiding whipsaw when it comes to classifying these instruments and may properly insist that taxpayers at the outset clearly establish the nature of the transaction. Absent clear evidence as to the nature of the transaction, guidance might set forth presumptions to guide the determination. Guidance might state, for example, that any instrument that constitutes a promise to contribute to equity (or subscribe to capital) is presumptively a capital transaction unless there is clear evidence to the contrary, e.g., by virtue of provisions requiring a payment to the issuer coupled with actual payment within a short time frame. Conversely, any other instrument is presumptively a compensable transaction unless there is clear evidence to the contrary, e.g., by virtue of entries in the taxpayer’s books and records identifying the instrument as a capital transaction. Setting out presumptions of this kind would be helpful in providing guidance to taxpayers and tax examiners alike.

In sum, we urge the following propositions: (i) that a person may charge a related person for a guarantee or like instrument if the normal standards for value/benefit are satisfied, (ii) that guidance not insist on capital contribution treatment just because a shareholder would have been willing to provide a guarantee or like instrument for free if necessary; (iii) that guidance not insist on capital contribution treatment just because the guarantee or like instrument was needed; and (iv) that acceptance of the foregoing propositions does not foreclose taxpayers from choosing capital contribution treatment (as seems consistent with case law) by structuring the transaction accordingly in a clear and timely manner. With this by way of preface, we turn to the issue of pricing.

VII. Pricing Methods

There is a considerable body of literature that surveys methods for determining an arm’s length guarantee fee, much of it by reference to pricing principles applicable to or derived from commercially available products.68 There are a variety of instruments in the marketplace through which credit standing may be enhanced and credit risk mitigated, including financial guarantees, bankers acceptances, letters of credit, various types of insurance, put options, and credit default swaps. Some of the methods derived from these marketplace instruments are characterized as “direct” approaches, others as “indirect.” The distinction is not always clear.

The methodologies discussed below, derived as they are from financial products, may appear best suited to the pricing of financial guarantees. But they will often be equally appropriate as tools for pricing performance guarantees. In some cases, a performance guarantee will take the form of a liquidated damages clause—e.g., “If my

subsidiary fails to build the bridge, I will pay you $100 million.” In that case, the performance guarantee is at least arguably equivalent to a straightforward financial guarantee. Even where the parent pledges specific performance—e.g., “If my subsidiary fails to build the bridge, I will hire a reputable contractor to build it”—the obligation assumed by the parent will have a financial equivalent (the cost of hiring a contractor) that in some cases can be reliably estimated. In either case, once the dollar equivalent of the parent’s contingent liability is known or can reasonably be estimated, the guarantee can often be priced using the methods discussed below by reference to the subsidiary’s risk of default and other attributes.

This report does not delve deeply into the technical aspects of these methods or offer a view as to their relative merits. As in other transfer pricing contexts, any given method may prove the most reliable tool for arm’s length pricing in a particular case depending on the facts and the availability of critical information. The purpose of this discussion is to identify the methods that have been developed, examine the salient legal and economic features of the commercial products on which they rely, and highlight some of the pluses and minuses of each.

A. Third Party Guarantees/Comparable Uncontrolled Price (CUP)

If there exists an uncontrolled transaction that can be considered comparable, it would be the appropriate starting point for any discussion of price. Third party financial guarantees do exist in the commercial marketplace. However, the contexts in which they typically arise make them less than ideal candidates for CUP purposes.

Third party financial guarantees usually involve a bilateral contract by which the guarantor assumes an obligation to perform for the benefit of the obligee upon the non-performance by the primary obligor. The contract normally runs between the guarantor and the obligee, and the rights that the guarantor has against the obligor are governed by common law. In general, the guarantor steps into the shoes of the obligee, acquiring subrogation rights to recover amounts from the obligor in the event of the obligor’s non-performance, including rights to collateral pledged by the obligor in the underlying transaction. For its part, the obligor is entitled to assert against the guarantor any defenses that it would be entitled to assert against the obligee in the underlying contract, such as rights of offset if the obligee separately owes money to the obligor.

Formal guarantees are not governed by any internationally accepted documentation framework of the kind that exists for letters of credit and credit default swaps. Guarantees are flexible and may be tailored to address whatever exposures the parties wish to cover. Consistent with this flexibility, borrowers sometimes purchase a guarantee with respect to their own debt, rather than having the lender buy the guarantee. The borrower then goes to a lender with the guarantee in hand to negotiate loan terms.

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69 See Restatement (Third) Suretyship and Guaranty (1996), section 1, comment (f).
70 See id. section 28.
Because commercial loan guarantees are usually negotiated privately, obtaining reliable pricing information about them can be challenging. Commentators have noted that there exist databases of public companies that contain some information on third party loan guarantees, but the information is not sufficient to allow confident or reliable transfer pricing analysis in most instances.

A more robust source of information is government-sponsored guarantee programs, such as the programs operated by the Federal Deposit Insurance Corporation (“FDIC”), Federal Home Loan Bank Board (“FHLBB”), the Small Business Administration (“SBA”), and the Export-Import Bank of the United States (“Eximbank”). Pricing information with respect to these programs is more readily available but is of limited value because it may not reflect true market pricing. “Government guarantees are often not priced and, when they are, there is no clear rationale to them.” Commentators note that governments use guarantee programs as a policy instrument, driven by considerations separate from the commercial incentives that drive the market. Thus, governments sometimes provide guarantees for no charge, charge a fee that is less than the market price, or impose fees that are not risk-based.

Government-sponsored guarantee programs that were developed during the recent financial crisis illustrate these limitations. Commentators report that, between October 2008 and May 2010, 17 countries offered government-sponsored guarantee programs for bond issuers, with fee structures differing from country to country, usually risk-based but not invariably so. In the United States, the FDIC’s Temporary Liquidity Guarantee Program (“TLGP”) announced in October 2008 provided a government guarantee on certain newly-issued senior unsecured debt. The guarantee came initially at a flat per annum price of 75 basis points (“bps”). It was later modified, with a fee schedule based on the term (length to maturity) of the debt. Qualified debt with a maturity of 180 days or less was charged 50 bps per annum; debt with a maturity of 181-364 days was charged 75 bps per annum; and debt with a maturity of 365 days or greater was charged 100 bps per annum (until maturity or expiration of the guarantee program on June 30, 2012). There was no price differentiation based on the credit standing of the debt issuer.

71 Ryan, Erivona & Chamberlain, supra note 57.
73 Mody & Patro, supra note 68, citing Barry Eichengreen, Financing Infrastructure in Developing Countries: Lessons from the Railway Age, 10 THE WORLD BANK RESEARCH OBSERVER at 75-91 (1995).
74 Mody & Patro, supra note 68.
In the U.K., by contrast, the fee structure was particularized to the borrower. The price of a U.K. government guarantee was, per annum, 50 bps plus the issuer’s median 5-year credit default swap (“CDS”) spread observed in the 12 months preceding October 7, 2008. The median 5-year CDS spread was reported to be 59 bps for HSBC, 68 bps for Standard Chartered, 81 bps for Barclays, and 86 bps for Royal Bank of Scotland, producing guarantee fees for these institutions between 109 bps and 136 bps. According to commentators, the median 5-year CDS spreads for U.S. banks included 85 bps for Bank of America and JPMorgan Chase, 107 bps for Goldman Sachs, and 115 bps for Citigroup, which would have put them, under the U.K. scheme, well above the maximum U.S. fee of 100 bps as discussed above.77

Surveying the comparable data available in 2003, several commentators concluded: “Unfortunately, only in the rarest of cases would a taxpayer have a valid internal CUP for a loan guarantee.”78 Despite the burgeoning of new government-sponsored loan guarantee programs during the recent financial crisis, this conclusion may be equally true today. Data derived from these programs may shed light on “industry averages” and be appropriate for inclusion in safe harbors. But these data are unlikely to generate reliable CUPs for use in transfer pricing analyses of particularized transactions.

B.Price Quotations/Other Unspecified Method

In the absence of a CUP, securing price quotations from banks or other guarantors may offer an alternative approach to pricing a related party guarantee. In the context of transfer pricing for tangible goods, the Example to Treasury Regulation section 1.482-3(e)(2) indicates that a bona fide offer from an unrelated party to buy goods at a price of $X may be the basis for a reliable “unspecified method” to support the arm’s length pricing of those same goods to a related party. Similarly, a bona fide price quotation from an unrelated financial institution, indicating the fee it would charge to guarantee a loan of $X to a similarly-rated company, may offer credible evidence of the appropriate fee for a related party instrument.

We recognize, of course, that there may be limitations on the utility of such evidence. Related party guarantees may be issued in amounts larger than a single bank would customarily guarantee. If a consortium of financial institutions were required, meaningful price quotations could be difficult to obtain. A bank asked to quote a price for a guarantee might also be doubtful whether this request would generate any actual business. If it regarded the request as a formality or a mere courtesy to its client, it might not exercise the same rigor as where its own capital was actually on the line.79 In our experience, however, at least the institutions we have dealt with have taken the task very seriously.

77 Acharya & Sundaram, supra note 75.
78 Ryan, Erivona & Chamberlain, supra note 57.
79 Id. (“It may not be sufficient for the applicant to get the lender to offer an unguaranteed rate, particularly if the lender knows it will not have to make good on its offer”).
The transfer pricing regulations indicate that a transaction – and a fortiori a proffer – cannot be used to measure an arm’s length price where the transaction is not in the ordinary course of business or is entered into or obtained for the principal purpose of establishing a price for a controlled transaction. We are also mindful that some tax authorities may view quotes with skepticism. The New Zealand Internal Revenue Service cautions that independent banker quotes for intercompany debt pricing “are generally accepted as indicative only” and advises that it expects “far more science and benchmarking to support interest rates applied” for loans in excess of NZ$10 million. Nevertheless, we submit that independent price quotations are relevant and should be considered in each case based on their probative value. With respect to the concern expressed by the New Zealand tax authorities, we have observed independent bankers in such roles engage in rigorous benchmarking and analysis. In some cases, such quotes may be the most reliable indication of an arm’s length price. Indeed, it would not be surprising if a court were to prefer such practical market evidence to some of the sophisticated economic models suggested by scholarly texts in this area. In short, independent price quotations should not be disfavored and should be considered and weighed according to the same standards as other evidence of arm's length market behavior.

Another type of evidence that may be secured from the banking community consists of banker’s acceptances (“BAs”). These are instruments by which banks backstop the commercial paper (“CP”) issues of companies that cannot access the CP market directly, either because they have no credit rating or because their rating is not sufficiently high. Often, a long term bond rating of A is needed to access the CP market directly. To meet the needs of a creditworthy company that falls below this threshold but desires to issue notes in the CP market, a bank may stand behind the company’s short-term paper by unconditionally accepting it as the bank’s own obligation. In this way, the bank acts analogously to a guarantor.

Companies pay a “stamping fee” to a bank in exchange for the bank’s “stamping” the issuer’s CP as having been accepted as the bank’s own obligation. This fee is generally in the range of 50 to 100 bps for this very short term paper. Where on that scale a bank sets the stamping fee depends on how close the customer is to being able to access the CP market directly, what alternatives the customer has, and general market conditions.

In addition to the stamping fee, the BA arrangement requires the participating issuer to arrange (and pay for) a back-up line of credit, the amount of which sets the upper limit on the amount of CP it may issue. By limiting the CP issuance to the size of the back-up line of credit, the bank controls its exposure. The line of credit is normally reviewed on an annual basis and is typically subject to a “material adverse change” clause

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80 Reg. § 1.482-1(d)(4)(iii).
82 The information in this and the succeeding two paragraphs is derived from the expert testimony of Prof. Laurence Booth, Rotman School of Management, University of Toronto, in General Electric Capital Canada Inc. v. The Queen, 2009 T.C.C. 563 (2009).
that allows it to be pulled (thus preventing further CP issuances under the BA arrangement) in the event the issuer’s creditworthiness deteriorates.

Banker’s acceptances are not mere proffers but are financial transactions that regularly occur in the commercial marketplace. If a parent guarantees the debt of an affiliate, the price that would be paid, by a company with a similar credit profile, to secure a banker’s acceptance for a comparable amount of indebtedness constitutes evidence concerning the arm’s length price of the guarantee. In analyzing such evidence, the cost of the banker’s acceptance includes both the stamping fee and the expense incident to securing the requisite back-up line of credit. Some adjustments may be required to reflect the fact that banker’s acceptances backstop very short term (hence lower risk) indebtedness, whereas related party guarantees commonly stand behind longer term obligations.

C. Insurance Pricing Models

Financial guarantee insurance is a bilateral arrangement between two parties – an insurer and a beneficiary – whereby the insurer agrees for a price to pay the beneficiary if the latter suffers financial loss as a result of a specified event. Most states require that financial guarantee insurance be written only by insurance companies that specialize in this form of insurance, generally referred to as “monoline” insurance companies.83 Providers of financial guarantee insurance include (or have until recently included) Ambac, MBIA, Assured Guaranty, Syncora Holdings, and Radian Group. These companies insure public financial obligations such as municipal bonds and structured financial obligations, including securitized mortgages and trade receivables.

Financial guarantee insurance differs from a financial guarantee principally in that each is governed by a different body of law (insurance versus contract law), and the former is the subject of significant state-law regulation. Financial guarantee insurance also differs from a guarantee because the insurer (except in the case of property and casualty insurance) generally has no rights of subrogation against the borrower in the event of default.

Notwithstanding these differences, the Supreme Court, the Service, and other authorities have recognized the similarity of a loan guarantee to an insurance contract and have held in some contexts that guarantees are insurance contracts. The Supreme Court has twice held that a loan guarantee is an insurance contract in the context of mortgage insurance. In United States v. Home Title Insurance Co., 285 U.S. 191, 195 (1932), the Court held that “[t]he guaranty of payment of the principal and interest of mortgage loans constitutes insurance.” In Bowers v. Lawyers Mortgage Co., 285 U.S. 182, 189 (1932), the Court remarked: “Undoubtedly the guaranties contained in the policies . . . were in legal effect contracts of insurance.”84 The similarity between loan guarantees and

83 New York State Bar Association Tax Section, Report on Credit Default Swaps (2005), at 20.
84 Accord, Empire Title & Guarantee Co. v. United States, 101 F.2d 69, 71 (2d Cir. 1939) (“the guaranteeing of mortgages is insurance”); Bank of America v. United States, 47 A.F.T.R.2d (RIA) 81-652 (Ct. Cl. 1981) (noting similarity of guarantee to insurance).
insurance extends beyond mortgage insurance to other agreements nominally designated “insurance.” In GCM 36068 (Nov. 5, 1974) and PLR 7501090130A (Jan. 9, 1975), the Service discussed the tax consequences of payments under “a policy of insurance” that “guarantees” the payment of tax exempt mutual bonds. And in PLR 8401026 (Sept. 30, 1983) and PLR 8233067 (May 19, 1982), the Service used the terms “insurance” and “guarantee” interchangeably in discussing the tax implications of an agreement by a bank to guarantee payment of municipal bonds, noting earlier municipal bond rulings discussing “[t]he issue of obtaining insurance or guaranteeing against default.”

Commentators have recommended insurance pricing models as a method for ascertaining the arm’s length price of related party guarantees. Information is not readily available as to how insurers like MBIA price financial guarantee insurance specifically. However, most insurance pricing models have three major components: (a) expected loss cost, (b) expense loading, and (c) return on risk capital.

The expected loss cost represents the anticipated loss associated with the event insured against. In the case of a guarantee, the event being insured against is the calling of the guarantee. To calculate the expected loss cost associated with the calling of a guarantee, one would multiply the likelihood of the guarantee being called (expected default frequency) by the expected loss incident to default. Determining the expected default frequency involves an assessment of the credit standing of the issuer. In a financial setting, this is essentially what a credit rating is designed to measure. There may be a public credit rating available for a particular borrower. If not, there are tools available to generate an approximate credit rating, such as the RiskCalc model developed by Moody’s or the Research Insight or CreditModel tools developed by S&P. After determining the borrower’s credit rating, the model considers historical data to calculate the expected default frequency, e.g., to determine that a BB rated entity has an 8% likelihood of default with respect to debt issued with a 5-year term. The model then calculates the expected loss given default (“LGD”) by factoring in the probability that the insurer will not suffer a total loss but will obtain some recovery from the insured party. To estimate the probability of recovery, the model may look to public studies that show third party recovery rates.

The second component is the expense loading, which covers the administrative and other costs incurred by the insurer relating to the issuance, maintenance, and settlement of the insurance claim. Insurers typically pass these costs along to their customers by incorporating them into the overall premium.

The third component is return on risk capital – the compensation to the insurer/guarantor for the capital required to bear the risk associated with unexpected loss.

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86 The information in this and the succeeding paragraphs is based in part on the expert testimony of Mark Fidelman, Deloitte Tax LLP, in General Electric Capital Canada Inc. v. The Queen, 2009 T.C.C. 563 (2009).
To calculate this portion of the premium, it is first necessary to calculate the amount of risk capital required to support the volatility surrounding the expected loss. There is little market data available concerning the amount of risk capital that insurers would prescribe in connection with the issuance of a guarantee. To calculate the appropriate level of risk capital, analysts might use a regulatory framework (like the Basel accords) that mandates risk capital requirements for banks. Once the amount of risk capital has been determined, this amount is multiplied by the target rate of return that would be required by an insurer. Rates of return on insurers’ risk capital are typically proprietary, but are commonly thought to be in the range of 10% to 20%.

In the marketplace, most insurers are able to diversify or hedge their risk by insuring a diverse pool of exposures, which enables them to lessen the amount of risk capital associated with an individual loss. In a related party context, however, the guaranteeing entity will usually not be in a position to diversify its risks in the same manner. Many of the economic models found in the literature for deriving loan guarantee values for transfer pricing purposes are based on a one-borrower/one-guarantor framework. The question thus arises whether the correct approach to deriving an arm’s length guarantee fee requires one to price by reference to the related party guarantor’s lack of diversification (imposing greater costs) or by reference to a representative commercial insurer that usually benefits from diversification (achieving cost savings).

Insurance models have several features that render them potentially useful in a transfer pricing inquiry. They are well documented in the literature; they can be constructed by experts with real-world experience in the insurance industry; and they identify and quantify the various cost components that enter into the relevant price. Their chief drawback is that they are models rather than observable market transactions. Generally speaking, financial risk insurance is limited to niche sectors of the commercial marketplace—chiefly, municipal bonds and securitization transactions. And because much of the pricing information is proprietary, the inputs into these models (such as expected return on risk capital) may not be easily accessible.

D. Standby Letters of Credit

A letter of credit is an instrument that a buyer provides to a seller that allows the seller to collect payment from a bank or other issuer. It is used in commerce to facilitate trade by allowing a seller to deal with a buyer it does not know or cannot reach. In simple form, a letter of credit arrangement involves three transactions and four parties. First, there is an underlying transaction between a seller and a buyer. Second, there is the purchase of the letter of credit by the buyer from its bank, the “issuing bank.” Under the terms of this instrument, the issuing bank commits to honor a demand for payment by the seller upon presentation of the agreed documentation. Third, upon presentation of such

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documentation, the issuing bank authorizes the seller’s bank (the “advising” or “confirming” bank) to make payment to the seller.  

A standby letter of credit – the variety most relevant here – is formally similar to a commercial letter of credit but differs from the commercial variety in two important respects. First, a commercial letter of credit is the primary, direct means by which a beneficiary is paid. A standby letter of credit is a secondary, back-up means by which the beneficiary may secure payment. Second, commercial letters of credit are used only in relation to contracts for sale of goods. Standby letters of credit are more expansive in scope, applying to any situation where the performance of one party is executory.

A standby letter of credit is an instrument through which a seller (or other beneficiary) may recover payment from a bank (or other issuer) that has issued a credit on behalf of another person (e.g., a customer). A standby letter of credit is not intended to be the primary means by which the underlying promise will be fulfilled, but like a guarantee is called upon only in the event of a default. For these reasons, a standby letter of credit is said to be “functionally equivalent” to a guarantee.

Despite their functional similarities, standby letters of credit and financial guarantees differ in several important ways. Standby letters of credit and surety contracts (such as guarantees) are subject to their own sources of law, the law of letters of credit for the former, the law of surety for the latter. The main difference between these legal frameworks is the primacy of the independence principle to credit law. One fundamental feature of all letters of credit is the independence of the obligations that the different parties owe each other. A credit is a separate transaction from the sale or other contract between the beneficiary and the customer upon which the credit is based. The issuing bank does not investigate the underlying transaction; the issuing bank’s commitment to

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89 See Article 5 of the Uniform Commercial Code ("UCC") and the Uniform Customs and Practice for Documentary Credits prepared by the International Chamber of Commerce ("UCP 600"). See generally Jeffrey Wood, Drafting Letters of Credit: Basic Issues under Article 5 of the Uniform Commercial Code, UCP 600, and ISP98, BANKING L.J. 103 (Feb. 2008).
90 John F. Dolan, Law of the Letters of Credit ¶ 1.06 (4th ed. 2007); Boris Kozolchyk, The Emerging Law of Standby Letters of Credit and Bank Guarantees, 24 ARIZ. L. REV. 319, 320 (1982) (“As an assurance of payment against the presentation of specified documents accompanied by a draft or demand for payment, the standby credit can encompass virtually every obligation known to man.”).
91 See Wood, supra note 89, at 137.
93 See Dolan, supra note 90, at ¶ 2.01 (“Letter of credit law assumes that the credit will not succeed unless the credit engagement [the relationship between the issuer and the beneficiary] is independent of the [underlying contract between beneficiary and applicant and the application agreement [between the applicant and the issuer]].”)
94 See International Standby Practices (ISP98), Rule 1.06(c)(iv) ("[T]he enforceability of an issuer’s obligations under a standby does not depend on...the issuer’s knowledge of performance or breach of any reimbursement agreement or underlying transaction."). Conversely, the beneficiary cannot avail itself of the contractual relationships that exist between the issuing and advising banks or between the applicant and the issuing bank.
honor a draft or demand for payment is based solely upon the beneficiary’s presenting documents to the issuing bank that meet the requirements of the credit. Another difference, consistent with the independence principle, is that the defenses available to guarantors are not available to issuers of standby letters of credit. Also, the amount of payment under a standby letter of credit to the beneficiary is the amount specified in the letter of credit, whereas the amount of payment under a financial guarantee is the actual damage caused by the principal’s default. For these reasons, “most prominent commentators on letters of credit stress that while the standby letter might serve some of the economic functions of a guaranty, it is not a guaranty, it is not a type of guaranty, [and] it is a grave analytic error to call it a guaranty.”

Standby letters of credit are privately negotiated and administered, and their issuance does not generate any publicly traded securities subject to SEC regulation. The primary cost incurred by a borrower or purchaser in obtaining a standby letter of credit is the annual issuance fee charged by the lender expressed as a percentage of the face amount and sometimes varying based on the beneficiary’s credit rating or debt-equity ratio. Other fees paid by the beneficiary may include fronting fees, commitment fees or commissions, and fees that, though described in varying language, amount to “reasonable and customary” administrative and processing fees.

Standby letters of credit could offer potential comparables for related party guarantees, depending on the type of the transaction being guaranteed. Standby letter of credit fees for bank loans, sorted by credit rating, are available from certain banks and may be available through database searches for specific issuers. However, given the relative paucity of data and the difficulty of making reliable adjustments, standby letters of credit may be of limited utility in a particularized transfer pricing analysis.

E. Credit Default Swaps

A credit default swap (“CDS”) is a contract by which one party purchases from another party protection against the occurrence of a “credit default” by a third party or “reference entity.” Some have suggested that a CDS is equivalent to a financial guarantee “in all material respects.” This is an overstatement, but a CDS is similar in principle to a guarantee, and commentators discussing how to price related party guarantees often note the similarity.

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95 International Standby Practices (ISP98), Rule 2.01 (“An issuer undertakes to the beneficiary to honor a presentation that appears on its face to comply with the terms and conditions of the standby in accordance with these Rules supplemented by standard standby practice”).
96 Katz, supra note 92, 66 CHICAGO L. REV. at 105.
99 See, e.g., Ryan, Erivona & Chamberlain, supra note 57; Eric Ryan, David Chamberlain & Aaron Bone, Closing the Harbor: Intercompany Loan Guarantees Revisited Under Proposed Services Regulations, 12 TAX MGMT. TRANS. PRICING REP. (BNA) 1188 (2004); Ed Dembitz, Guarantee Fees, Transfer Pricing, and Foreign Dividends Under New Section 965, 13 TAX MGMT. TRANS. PRICING REP. (BNA) 1083 (2005); Geoffrey Gill, Intercompany Loan Guarantees—Pricing Approaches and the Looming Wave of Controversy, 16 TAX MGMT. TRANS. PRICING REP. (BNA) 532 (2007); Rob Plunkett & Larry
There are in fact several differences between a CDS and a guarantee. Most important, the types of “credit event” that trigger settlement under a CDS are broader than those that trigger payment under a guarantee. A CDS credit event may include default, bankruptcy, a decline in creditworthiness (evidenced for example by a ratings downgrade), or a restructuring by the reference entity. The relevant event for a guarantee contract is typically just default.

A second difference is that, unlike the buyer of a financial guarantee, the CDS protection buyer need not have an interest in the underlying transaction. For example, the buyer of a CDS need not own the corporate bond to which the CDS contract refers. Rather, as the world witnessed during the recent financial crisis, the buyer could just be placing a bet with respect to an obligation held by someone else.

Third, the settlement mechanism of a CDS differs from that for financial guarantee contracts. If the credit default event occurs, settlement between the purchaser and seller may occur in either of two ways. Settlement can occur in cash, with the seller paying to the purchaser an amount calculated in accordance with the contract (e.g., the difference between the face amount and the price at which the bond traded a pre-designated number of days after the default occurs). Settlement can also occur by a physical transaction, whereby the seller takes possession from the buyer of the underlying credit instrument (such as a bond) at a specified price, such as par value.

The market for CDS contracts has grown rapidly in the last 10 years. The principal amount underlying CDS contracts in existence throughout the world climbed from several hundred billion in the late 1990’s, to roughly $2 trillion in 2002, to more than $62 trillion in 2007 before the financial crisis pushed the total back. The latest available figures put the market at $26 trillion in the first half of 2010. Participants in the CDS market are sophisticated institutional investors and traders working for large financial institutions. Institutions providing CDS instruments include companies that specialize in credit derivative products, such as Athlon Structured Investment Advisors; large investment banks such as Goldman Sachs, JPMorgan Chase, and Morgan Stanley;
and insurance companies that also offer financial guarantee insurance, such as Ambac (formerly) and MBIA.102

Under a CDS contract, the protection buyer makes periodic payments to the protection seller until the end of the life of the contract or until a default by the reference entity occurs, whichever is earlier. The annual payment as a percent of the principal is known as the “CDS spread.” For example, if the payment per year were 2% of the principal amount, the CDS spread would be 2% or 200 bps.

The CDS spread is driven by the same factors that drive guarantee and insurance pricing—an assessment of the risk of default or credit event, the likelihood of recovery (or the “loss given default” amount), the contract term, the amount at stake, and the need to make a profit. The CDS protection seller is in effect providing a guarantee on another’s bond, the effect of which is to improve the bond’s credit rating from, say, BBB to A. The theory is that the CDS spread for a contract lasting five years should approximately equal the excess of the yield on a 5-year bond issued by the BBB reference entity over the yield on a 5-year bond issued by an A rated entity. Empirical research shows that CDS spreads in the market are consistent with this theory.103

Needless to say, CDS pricing in practice is more complex than is outlined here, involving sophisticated statistical and financial modeling techniques that are designed to obtain more precise measures of value. Such models include (among other considerations) more targeted assessments of the timing of default; the risk of simultaneous default by reference entities and the counterparty; and assumptions about the recovery rate.104 Bearing this in mind, it may be useful to consider ways in which CDS spread data could be applied, in a practical way, to gauge whether a related party guarantee is priced at arm’s length. Some commentators have proposed directly referencing CDS spreads for companies having credit ratings similar to that of the reference entity.105 Another way to use CDS spreads would likewise involve market-based data but would focus on differentials between CDS spreads (one for the guarantor and one for the guaranteed entity). Of course, this assumes that the entities have CDS spreads or even credit ratings; in most cases, the borrowing entity will not, and the rating will have to be derived from a program rather than taken from the market.

102 Some of the information in this and the succeeding paragraphs is based on the expert testimony of Professor John Hull, Professor of Financial Derivatives, Rotman School of Business, University of Toronto, in General Electric Capital Canada Inc. v. The Queen, 2009 T.C.C. 563 (2009).
103 See, e.g., John Hull, Mirela Predescu & Alan White, The Relationship between Credit Default Swap Spreads, Bond Yields, and Credit Rating Announcements, JOURNAL OF BANKING AND FINANCE, 28 (Nov. 2004) at 2789-2811; Dominic O’Kane & Stuart Turnbull, Valuation of Credit Default Swaps, Fixed Income Quantitative Credit Research (Lehman Brothers) (April 2003); John Hull & Alan White, Valuing Credit Swaps I: No Counterparty Default Risk and Valuing Credit Swaps II: Modeling Default Correlations (April 2000) (http://www.stern.nyu.edu/fin/workpapers/papers00/pwa00022.pdf); Higginbotham & Harshbarger, supra note 99.
104 See O’Kane & Turnbull, supra note 103; Hull & White, supra note 103.
105 See, e.g., Higginbotham & Harshbarger, supra note 99.
Comparability adjustments would necessarily have to be considered in adapting CDS spreads to the transfer pricing analysis. Most obviously, care is needed to ensure that the triggering event is the same for the guarantee and for the CDS or that a reliable adjustment can be made for the difference. (As noted earlier, the triggering event for a payment under a guarantee is typically default whereas a CDS may identify the triggering event as any of a number of things, even a slight decline in credit rating.) It bears mentioning also that obtaining CDS data may not be entirely straightforward or inexpensive. As part of this exercise, we searched for readily available “average” CDS pricing data. Fitch includes average spreads in its Market Implied Ratings Models but this information is not available free of charge. Moreover, there may be systematic differences in quoted CDS spreads across databases, raising considerations about the reliability of data. As is true with respect to the other pricing methods discussed herein, the appropriateness of a CDS-based pricing method in a given case cannot be determined in the abstract; it will depend on the facts of that case. “Some CDSs look a lot like guarantees;” the differences between them are “a fact and circumstances inquiry,” so whether a CDS-based pricing method is the best method for pricing a guarantee in a given case depends on the similarity of terms, the availability of information, and the effectiveness and reliability of adjustments.

F. Put Option Approaches

Scholars and practitioners have also used put option pricing models as an approach to pricing related party guarantees. A guarantee may be analogized to a put option from the perspective of both the lender and the borrower. If viewed as a put option to the lender, the guarantor is selling the lender the right to “put” the loan to the guarantor in the event of default. If viewed as a put option to the borrower, the guarantor is selling the borrower the right to put its assets to the guarantor for the outstanding amount of the guaranteed debt, presumably in the event that the value of the borrower’s assets falls below the amount of such debt.

A well-known and respected method for pricing put options is the Black-Scholes formula, described in Black & Scholes, The Pricing of Options and Corporate Liabilities, JOURNAL OF POLITICAL ECONOMY, 81 May/June 1973. Application of the Black-Scholes formula specifically to the pricing of loan guarantees is discussed in numerous articles, the seminal article being one by R.C. Merton, then Professor of Finance at MIT’s Sloan School of Management. In general, the pricing model takes into account five factors to price a debt guarantee: (1) the current value of the borrower’s assets, (2) the amount of

\[ \text{Put Option Price} = \text{Max} \left( S_T - K, 0 \right) - e^{-rT} \text{Max} \left( K - S_0, 0 \right) \]

where:
- \( S_T \) is the future value of the borrower’s assets
- \( S_0 \) is the current value of the borrower’s assets
- \( K \) is the guaranteed debt amount
- \( r \) is the risk-free interest rate
- \( T \) is the time to default

the guaranteed debt; (3) the time remaining on the loan; (4) the volatility or variability in the value of the borrower’s assets; and (5) the appropriate interest rate to be used to discount future cash flows. The goal of this formula, like the goal of many of the methods discussed previously, is to quantify the likelihood of default and the likely amount of loss upon default, with some consideration of time value of money.

Much of the literature in this area features pages of proofs, expressed in mathematical formulae that many transfer pricing professionals will find difficult to follow. A simple example may nevertheless be helpful to illustrate the concept. Assume the put option pertains to a borrower with assets of $500, the amount of the guaranteed debt is $400, and the put is acquired at the start of the loan with an exercise date at the end of the loan’s 1 year term. To apply the Black-Scholes formula, one must determine the volatility or variability in the value of the borrower’s assets. Let us assume that the value of the borrower’s assets has a volatility of 20% per annum. Finally, let us assume 10% is the appropriate interest rate to be used to discount future cash flows. The Black-Scholes formula for pricing a put option would then determine the likelihood that the value of the borrower’s assets would fall below the amount of the guaranteed debt of $400. Applying the formula, the model would advise that the price of a put option (or guarantee) on these assumptions would be $1.90, equivalent to 47.5 bps.

The relatively low price of the option in this example is driven mostly by the 1-year term and the fact that the borrower’s assets have a volatility of 20% per annum while the starting value of those assets exceeds the debt by 25%. If the time to expiration increased to 5 years, the price of the put/guarantee would increase to $3.41 (or 85 bps). If the time to expiration was 5 years and the volatility of the borrower’s assets increased to 50% per annum, the price of the put/guarantee would jump to $55.84 (or 1396 bps).

Our discussions with professionals in this area give us confidence that a properly trained person can apply put option pricing effectively to fix an appropriate arm’s length price. We know from experience that this approach at least on occasion has been used productively in conversations with the Service to price related party guarantees. On the other hand, the approach puts great weight on the ability to determine certain inputs that involve judgment and often will not be market-based, in particular, the volatility of the borrower’s assets. This is especially true outside of a financial institution context.

G. “Yield Savings” Approach

The “yield savings” or “yield” approach is perhaps the most widely recognized method for valuing financial guarantees. This approach measures the arm’s length guarantee fee by reference to the interest savings achieved by the borrower through the guarantee. For example, assume that a borrower could borrow $X from an unrelated person at Libor+125 bps on an unguaranteed basis, and that it could borrow the same amount at Libor+75 bps with a guarantee. The yield approach posits that the arm’s length price for the guarantee can be measured by reference to the 50 bps interest rate reduction.
The yield approach is often called the “benefit” approach, on the theory that the benefit that the borrower derives from the guarantee is identical to the interest rate reduction thus achieved. Two assumptions underlie this equation. The first is that the yield or interest savings is an accurate measure of the guarantee’s value to the borrower and the risk assumed by the guarantor. The second is that the borrower would in no case pay more for the guarantee than the yield savings – in our example, 50 bps – that the guarantee enables it to achieve. For textual support, advocates of this approach point to the concepts of “realistic options” and “reasonable alternatives” in the OECD Transfer Pricing Guidelines and the Treasury regulations.110

The yield approach has achieved a good measure of acceptance. The Canadian Tax Court appeared to favor this approach in recent litigation involving transfer pricing of guarantee fees.111 The New Zealand Internal Revenue Service identifies the yield approach as its “preferred approach to pricing guarantee fees.”112 The government of New South Wales (Australia) has a program that prices guarantees based on the yield approach, which it regards as “relatively simple to administer” and “transparent in its application.”113 Some commentators endorse this approach as well.114

The yield approach appears straightforward in application. It starts by determining the interest rate that the borrower, based on its credit standing, would have paid to borrow $X without a guarantee. Sometimes the borrowing affiliate will have its own credit rating, or it will have issued at least some debt instruments to third parties that will allow a credit rating to be determined. If not, various techniques may be used to estimate the borrower’s credit standing, e.g., through models that are publicly available without a license (such as the Z-score formula for predicting bankruptcy) or that can be licensed from a third party (such as RiskCalc licensed from Moody’s). Assume that, by employing one of these techniques, the borrowing affiliate is determined to have a credit rating of BB. The yield approach then considers market data concerning the interest rates paid by BB rated borrowers on loans or bond issuances of $X on comparable terms. The difference between the interest rate paid by comparable public borrowers and the interest rate paid by the borrowing affiliate armed with its parental guarantee constitutes the “yield savings.” This amount is deemed to constitute the benefit to the borrower and hence to reflect an arm’s length price for the guarantee. Advocates commend this approach for using inputs that can often be based on available market data, which may

110 See OECD Guidelines ¶¶ 1.34, 1.35, 1.36, 4.98, 4.101, 6.14, 7.13, 7.6, 7.33 (all citations to the OECD Guidelines refer to the version released on July 22, 2010); Reg. § 1.482-7T(g)(2)(iii)(A) (requiring that a transfer pricing method be consistent with the “realistic alternatives” available to the parties).
114 See Thomas Horst, How to Determine Tax-Deductible, Debt-Related Costs for a Subsidiary, 62 TAX NOTES INT’L (TA) 589 (May 16, 2011); Plunkett & Powell, supra note 99 (interest savings set the upper boundary of the guarantee fee); Gill, supra note 99.
produce more accurate results than a direct method relying on less accurate data or requiring substantial adjustments.

It is generally assumed by proponents of this approach that the yield savings puts a ceiling on the permissible arm’s length price. Some argue, however, that if the guarantee is priced at the full yield differential, the borrower would have no incentive to enter into the guarantee transaction – it could forgo the guarantee, pay the regular BB interest rate, and be in the same economic position. Thus, there is discussion in the authorities about how the yield savings should be, or would be, shared by the parties. The New Zealand Internal Revenue Service suggests a 50/50 split. It states: “In theory, arm’s length parties would look to share the economic benefit of this interest rate reduction according to their relative contributions. In practice, we have seen non-bank guarantors generally sharing such savings on a 50/50 basis, which is also consistent with economic game theory.”

The shortcomings of the yield approach are well known. First, the approach assumes that an interest rate differential is the sole relevant effect of a related party guarantee and thus its sole measure of value. Often, the effects may be more numerous and diverse, and in some cases significant. The guarantee may enable the affiliate to borrow in more diverse financial markets than would otherwise have been possible, for example, to achieve benefits of diversity beyond interest savings. The guarantee may enable the affiliate to avoid restrictive loan covenants or the posting of collateral. And the guarantee may enable the affiliate to secure a variety of efficiencies and cost savings wholly apart from reduced interest rates, such as lower bond issuance costs, avoiding the delay and expense of obtaining independent credit assessments, and eliminating the need for certified financial statements. Whether these are significant in a given case would have to be tested.

Second, the yield approach is an indirect pricing method. It does not ask how a third party would actually price a guarantee in the open market, and it takes no account of a third party guarantor’s likely assessment of risk. Instead, it relies entirely on a lender’s assessment of risk, backing into a guarantee fee based on a hypothetical transaction – an unguaranteed loan – that is of a different character and does not in fact occur.

116 See NSW Government, The Treasury, Office of Financial Management, Commercial Policy Framework: Government Guarantee Fee Policy for Government Businesses, TPP10-04 (Sept. 2010), available at http://www.treasury.nsw.gov.au/__data/assets/pdf_file/0009/18567/tpp10-4_dnd.pdf. We have serious reservations about the New Zealand “sharing” concept, which seems likely to undercompensate the guarantor for the very real cost it assumes in terms of credit risk. If the yield savings is determined to be 100 bps, that differential represents the market’s judgment of the spread necessary to protect the lender against the risk of default attributable to the borrowing affiliate’s inferior credit standing. It is not clear why a related party guarantor, operating at arm’s length, would agree to issue a guarantee for 50 bps and thus forfeit half of the protection on which a lender would insist. Nor do we understand what the borrowing affiliate contributes to the transaction that would credibly entitle it presumptively to retain half the economic value represented by the guarantee.
Third party guarantors may perceive risk differently than third party lenders, and these differences may affect pricing. For example, commentators have noted that the presence of a guarantee may encourage a borrower to take on more risk, thus increasing the likelihood of default.\(^{117}\) This may of little concern to a lender that can look to a guarantor if disaster strikes. But it would naturally be of serious concern to the guarantor.

Third party guarantors and third party lenders may also make different assessments of the likelihood that a parent will come to an affiliate’s rescue in the event of financial stress. Assume that the borrower is a BBB rated subsidiary (determined without regard to any affiliation benefit) with an AA rated parent. Even in the absence of a formal guarantee, a lender may assume some probability that the parent, except in very exigent circumstances, will act to prevent a default by its subsidiary. This perception might induce the lender to treat the borrower as an A- credit when extending a moderately sized loan. By contrast, a third party asked to guarantee the BBB subsidiary’s borrowing may assume a zero or very small probability that the parent will act to prevent the subsidiary’s default, reasoning that the parties would not have purchased a guarantee unless they intended to use it when necessary. In short, whereas a lender might price the loan based on the assumption that the subsidiary is an A- credit, the guarantor might price the guarantee based on the fact that it is a BBB credit. A yield approach (treating passive association as non-compensable) may thus yield an answer that does not reflect the price at which one could buy a guarantee of the borrower’s obligations in the market. (Under the view that the passive association benefit also may be compensated for, however, the yield approach would tend to reach the same result as the market price approach.)

While the yield approach is a relatively simple approach, and is recommended for being such, its focus on an alternative transaction (an unguaranteed loan) rather than the pricing of the primary transaction (the acquisition of a guarantee) introduces its own complexity. This is because there may be factors influencing the price of the former (the loan) that would not influence the price of the latter (the guarantee) and yet, under this approach, do so. For example, the hypothetical third party lender in the example above, who was willing to price an unguaranteed loan at A- rates to a BBB subsidiary due to the expectation of parental support, might view the parent’s subsequent decision to provide a guarantee as validating the lender’s assessment of the parent’s willingness to provide support. But if the parent’s original guarantee had a five-year term and the hypothetical lender is asked to price a loan to the subsidiary in Year 5 on the assumption the parental guarantee has been withdrawn, the lender may draw a negative inference with respect to the prospect of future support, believing that the guarantee’s withdrawal may signal the parent’s distancing itself from any support obligation. The lender might then take a more skeptical view of support than it was originally inclined to do, perhaps viewing the subsidiary as a true BBB credit risk. On such facts, the yield approach would apparently conclude that the parent’s second guarantee was more valuable than the first, thus

assigning a different “arm’s length price” to the guarantee notwithstanding its market price likely did not change.\footnote{In a recent case, the Canadian Federal Court of Appeal ruled that one could not take into account the history of a parent guarantee and its subsequent lapse in applying the yield approach, see General Electric Capital Canada Inc. v. The Queen, 210 F.C.A. 344 (2010), aff’g, 2009 T.C.C. 563 (2009), but we respectfully urge that the yield approach requires that these facts be taken into account to the same extent the market would take them into account (assuming one is allowed to take into account the expectation of parental support at all, a point addressed in Section X.A, infra). Put simply, if the subsidiary had actually had gone to a third party lender and borrowed in Year 5 without a guarantee, this would constitute evidence of arm’s length pricing for the alternative transaction on which the yield approach is based. We see no basis for disregarding that price on the ground that the third party took into consideration that there had previously been a parental guarantee which was subsequently withdrawn.}

**VIII. The Relevance of Realistic Alternatives and Business Judgment in the Arm’s Length Pricing of Guarantees**

Recent literature addressing transfer pricing of guarantees sometimes refers to the concept of “realistic options” or “realistic alternatives,” positing that the arm’s length price of a guarantee can be measured by comparison with the cost of an alternative good or transaction.\footnote{See, e.g., John Breen, Evaluating the Arm’s Length Price of Financial Guarantees: A Review of the OECD Framework, 59 TAX NOTES INT’L 869 (Sept. 13, 2010). The realistic alternative concept is found throughout the OECD Guidelines and in the Treasury Regulations as well. See OECD Guidelines ¶¶ 1.34, 1.35, 1.36, 4.98, 4.101, 6.14, 7.13, 7.6, 7.33; Reg. § 1.482-7T(g)(2)(iii)(A).} The theory is that to solve for the arm’s length price of X, you can look to the market price of Y if they both provide the same benefit and if people have the realistic alternative of choosing one or the other. The concept has broad relevance and may have a role in many of the transfer pricing methods discussed above.

The realistic alternative concept plays a particularly prominent role in discussions of the yield approach. Advocates of this approach generally maintain that it cannot be arm’s length for a controlled person to pay a related party $10 for X if it has a realistic alternative of achieving the same economic benefit by paying a third party $5 for Y. Applying this logic to guarantees, advocates of the yield approach conclude that the arm’s length price of a guarantee cannot exceed the interest savings achieved through the guarantee; otherwise the borrower would do without the guarantee and borrow on an unguaranteed basis. (Of course, this articulation does not ascribe meaningful value to benefits that, as discussed previously, may flow from the guarantee other than the interest savings. Such benefits would have to be taken into account in a proper application of the realistic alternative concept.)

The realistic alternative concept is rarely controversial when used as an indirect way to ascertain the arm’s length price for an item where no direct evidence of the item’s market price exists. The controversy arises when this concept is advanced to redefine market pricing—in essence, to argue that the “arm’s length price” of an item, regardless of its established market price, cannot exceed the market price for some other item that is deemed to be a realistic alternative. Applied in this fashion, the realistic alternative concept redirects the pricing exercise to a different transaction. If applied broadly, it might say to the taxpayer, “we do not think it made sense for you to enter into this
transaction given the alternatives available to you. Therefore, we will calibrate the arm’s length price for the subject transaction to a level that, in our view, allows the transaction to be a sensible one.”

We find this aggressive application of the “realistic alternative” concept troublesome for several reasons. First, it divorces the concept of an arm’s length price from its traditional moorings, which have always sought to determine the appropriate transfer price by reference to actual market benchmarks for the item in question. An item that has an objectively discernible, fixed market price could have different “arm’s length prices” in a related party context if “realistic alternatives” are understood in this way.

For example, assume that a parent has a subsidiary engaged in making and selling pizza pies at retail. Assume that the parent transfers a Mercedes Benz automobile to the subsidiary for the latter’s use when delivering pizzas. Advocates of an aggressive realistic alternative approach might contend that a Honda Civic would be a perfectly adequate alternative for delivering pizza (and thus constitute “a realistic alternative”), and that the arm’s length price of a Mercedes Benz therefore cannot exceed the price of a Civic, e.g., $15,000. This example suggests to us the danger of according primacy to “realistic alternatives” over evidence of actual market pricing. A Mercedes Benz has an ascertainable market price and, we submit, this ought to be accepted as the arm’s length price for a Mercedes Benz. If a tax authority objects that an affiliate bought more than it needed, e.g., a Mercedes instead of a Honda or a Rolex instead of a Timex, and thus that its expense was not ordinary and necessary for the operation of its business, the adjustment should be described and made for what it is, and not described as a transfer pricing adjustment.

Second, this aggressive “realistic alternative” approach may lead to highly subjective inquiries by which tax authorities evaluate, not pricing, but business strategy and judgment. For example, assume that a parent rents to its affiliate office space in its headquarters building at the market rate of $X. Imagine an examining agent contending on audit, “Your decision to rent office space here (Space A) at the going market rate was not reasonable when you had the realistic alternative of choosing office space there (Space B) that would have served your needs equally well at a much lower price, so the ‘arm’s length price’ of Space A will be adjusted downward to reflect Space B market rates.” Inviting a tax authority to bend the concept of arm’s length pricing to implement the results of a different transaction that it may regard as a more reasonable business strategy can only lead to mischief. What a tax authority regards as “more reasonable” may be value-laden and may entail very complex judgments. We are mindful that guidance adopted on these issues by the United States is likely to inform guidance and tax authority practice elsewhere in the world. Under the section 482 regulations and the OECD Guidelines, analyzing “realistic alternatives” must be kept distinct from applying “economic substance” and recasting transactions where that is appropriate. In our experience, some tax administrations have neglected to preserve this distinction.

The underlying temptation to describe an adjustment as transfer pricing when it really is something else is shared by an approach that argues for testing related party
pricing using a “minority interest” framework. Under this framework, the arm’s length price is calibrated to ensure that the transaction protects the interests of hypothetical minority shareholders of the subsidiary by yielding an acceptable profit split between the subsidiary and its parent. Thus, if an affiliate pursues a business plan that involves raising guaranteed debt, the pricing of the related party guarantee must be adjusted to ensure the desired profit split even if it means that the price charged is “a fraction of what the subsidiary would have had to pay an independent financial institution.”

This “minority interest” framework seems to view the “arm’s length price” of an item as a valve that can be tightened or loosened to achieve the desired profit level for the subsidiary. A gallon of gas that for everyone else has a market price of $3.89 a gallon may be deemed to have a related party “arm’s length price” of $2.27 a gallon if that price is required to generate a profit split sufficient to satisfy the subsidiary’s hypothetical minority shareholder.

There are many respects in which an affiliate may operate (or be operated) for the benefit of its corporate group rather than solely for its own benefit. This is not necessarily a transfer pricing issue and in many cases a transfer pricing “solution” is either not available or is ill-fitted to the task. Indeed, an affiliate may operate in a way that promotes the interests of another affiliate without there being any intercompany transaction between them. Devising a solution that works in some cases by seizing on the coincidence of a related party transaction and calibrating a transfer price that is divorced from the item’s demonstrable market price is a distortion of the arm’s length standard. If a company engages in abusive transactions – e.g., paying fees to a tax-haven affiliate for a guarantee that it does not need—tax authorities have other weapons in their arsenal. If those weapons are regarded as insufficient, a new weapon better tailored to the job should be developed.

In sum, we believe that the arm’s length price of a guarantee should be determined by reference to the market price for the instrument where such evidence exists, subject to the normal comparability standards. Where such evidence does not exist or where it leads to ambiguous or contradictory conclusions regarding pricing, the realistic alternative concept is undoubtedly useful to help back into an arm’s length price. But the independent market price is generally the conceptual North Star in our view.


121 The transfer pricing provisions of the Canadian Income Tax Act permit the tax authority to set aside the actual transaction the parties entered into and price an alternative transaction where two conditions are met. First, it must be shown that the transaction “would not have been entered into between persons dealing at arm’s length.” Second, it must be shown that the transaction “can reasonably be considered not to have been entered into primarily for bona fide purposes other than to obtain a tax benefit.” Income Tax Act (Canada) ¶ 247(2)(b) and (d). This approach, which is an express override to generally applicable transfer pricing principles, protects the legitimate interests of the tax authority while protecting against a kind of free roaming inquiry into the idiosyncratic value of an item of property in a related party transaction.

122 Support for this view is found in Commissioner of Taxation v. SNF (Australia) Pty Ltd [2011] FCAFC 74 (Federal Court of Australia, June 1, 2011) where the court held that the arm’s length price of an
Proof of a guarantee’s actual market price should not be overridden on the theory that the taxpayer acted unreasonably or to the prejudice of hypothetical minority shareholders by choosing to engage in one transaction versus another. We urge that the concept of an arm’s length price not be conscripted to serve non-transfer pricing objectives.

IX. Pricing Methods for Non-Risk-Shifting Guarantees

The pricing models described so far generally pertain to transactions in which the issuer is assuming a defined (if sometimes hard to value) risk. In the case of an insurance contract, standby letter of credit, credit default swap, put option, or banker’s acceptance, the issuer assumes an agreed liability upon the occurrence of a specified event. The instrument is priced in one form or another based on the likelihood that the event will occur and the resultant risk of loss. A risk-based pricing model may be inapposite where an instrument is issued in circumstances that do not involve the transfer of a risk of loss. As noted above, for example, a guarantee is sometimes provided to avoid the expense of preparing separate financial statements or to enable it to qualify as a going concern, not in connection with a financing or customer transaction. (See discussion at Section III.B.2, above.) An instrument used solely for such a purpose confers a benefit but does not (necessarily) require the issuer to assume a risk. In such cases, the conventional risk-based pricing models would not apply.

A CUP or market quote method might conceivably be used if one could find market data for comparable instruments in comparable situations but the routine availability of such data is questionable.123

Absent market based pricing measures, the most sensible approach may often be a kind of “yield approach,” where the “yield” is based on the value of the benefit conferred through the guarantee. In the example above where the guarantee allows an affiliate to avoid the need to prepare separate financial statements, the benefit would include but not necessarily be limited to the direct cost savings of not having to prepare financial statements.

item is determined by the market, not by the idiosyncratic value of the good to the related party purchaser. The appellate court approved the lower court’s rejection of “the Commissioner’s submission that the test is to determine what consideration an arm’s length party in the position of the taxpayer would have given for the products,” agreeing with the lower court that “the focus is not on the subjective or special factors of the parties involved in the transaction . . . but is on the transaction itself and the consideration paid.” Quoted at Para 93. Picking up this point, the appellate court stated “it does not follow . . . that arm’s length consideration – which does not, in general, refer to the actual position of either party – must be treated as overlaid by a further requirement that the consideration not only be at arm’s length but that the arm in question by attached to the taxpayer.” Para 99.

123 There are many instruments in the business world akin to comfort letters such as letters of assurance, letters of responsibility, letters of support, and letters of intent, see DiMatteo & Sacasas, supra note 24, 47 BAYLOR L. REV. at 361-64, and it might be possible to find some evidence of pricing for such instruments. As noted in the text, however, it seems unlikely that market pricing data would routinely exist for instruments of the kind.
Of course, even if one quantifies the relevant “yield,” one is left with the question, previously identified, of how to translate the yield into an arm’s length price: should the price capture the entire yield, half the yield, or some other percentage? Past Service informal guidance recognizes that an issuer may incur little if any out-of-pocket cost to issue a guarantee, particularly one that does not involve the potential assumption of risk. Thus, the issuer’s cost of providing the instrument may not provide a meaningful bottom to the range of possibilities of how the yield would be dealt with at arm’s length, whether split or retained by the guarantor. One is then left to economic game theory perhaps or to rough justice presumptions as to how to split the yield in these circumstances. We submit that in cases where instruments are not used in circumstances involving a risk of loss, any reasonable method for determining an arm’s length price should be permitted.

There are also issues regarding the use of risk-based pricing models to price instruments that may affect the balance of risk but do not impose upon the issuer any legal liability. A comfort letter may illustrate this type of instrument, as it may allow the issuer to walk away from the implied obligation in whole or in part as it chooses (though perhaps at considerable expense to its reputation and future prospects). While at first blush one might think that the pricing of a legally binding insurance contract or put option has little relevance to the pricing of an unenforceable comfort letter, we think these models can apply to help benchmark an arm’s length market price.

If an unenforceable comfort letter allows an affiliate to borrow more cheaply from a third party lender, it is presumably because the third party lender believes that execution of the comfort letter makes it more likely the issuer of the letter will support the borrower in times of need. If the third party lender had been willing to lend to the borrower at a spread of 100bps before the comfort letter and at a spread of 75bps after the comfort letter, it reflects the lender’s perception that the comfort letter reduces its risk by an amount equivalent to 25bps, which the issuer of the comfort letter is effectively taking upon itself. In other words, even though the issuer is not taking on legal liability, it is taking on a cost to itself that has a market value (discounted for not being enforceable) equivalent to 25bps. Obviously if the lender expected that the issuer would be in a position to walk away from the comfort letter at no cost to itself in a time of need, it would attach no weight to the letter in its pricing. The discount in pricing reflects the lender’s perception that the issuer is assuming a risk and bearing the associated cost even though there is no legal liability.

Thus, while there may be similarities between an instrument that does not involve an assumption of risk and one that does not involve a legally enforceable assumption of risk, we think risk-based pricing models may usefully apply to instruments of the latter type because they often involve what the market regards as an assumption of risk with a measurable economic value.

X. Adjustments to Pricing

Virtually all of the pricing methods discussed above involve some consideration of the borrowing affiliate’s credit rating, i.e., the market’s perception of its creditworthiness in the absence of a parental guarantee. An unrelated guarantor or lender
might base this credit assessment solely on the subsidiary’s balance sheet and income statement, or alternatively might include in its analysis the “affiliation benefits” that the subsidiary derives from membership in a large corporate group. This raises the question whether the subsidiary’s rating for purposes of pricing a related party transaction should be adjusted upward for affiliation benefits—chiefly, the possibility that its parent would support it in the event of financial stress. Once an appropriate method has been selected to determine an arm’s length price, it must then also be determined whether the benefit of the guarantee inures exclusively to the subsidiary or (as some tax authorities have maintained) inures also to the parent providing the guarantee. This raises the question whether the arm’s length market price of the guarantee should be adjusted downward to take account of putative parental benefits. We address these various types of adjustments below.

A. Adjustments for Affiliation Benefits

Considerable literature addresses the impact of a company’s affiliations on how it is perceived in the market by prospective lenders, customers, and credit rating agencies. These authorities generally conclude that a company may benefit from affiliation, particularly in a borrowing or bidding context. Standard & Poor’s, Moody’s, and other rating agencies have accordingly stated that they will consider an entity’s affiliations in fashioning a credit rating. As S&P explains: “A weak entity owned by a strong parent usually—although not always—will enjoy a stronger rating than it would on a stand-alone basis. Assuming the parent has the ability to support its subsidiary during a period of financial stress, the spectrum of possibilities still ranges from ratings equalization at one extreme to very little or no help from the parent’s credit strength at the other.”

Finance textbooks and academic papers explain that affiliation may be relevant to credit assessment in two ways. First, it may affect the creditor’s evaluation of the borrower’s capital structure. In many cases, an affiliate’s leverage ratio may not be an accurate predictor of its true financial risk, since a multinational corporation may vary the capital structures of its affiliates essentially at will. An affiliate’s high leverage ratio, for example, may not reflect a propensity for risk-taking, but simply the existence of favorable financing opportunities in that jurisdiction. Thus, unlike the leverage ratio of the multinational group as a whole, the leverage ratio of a particular affiliate may not be fully indicative of the risk associated with the business.

Second, the literature observes that the chances of default are reduced when lending to an affiliate of a large, successful multinational corporation because there is a material chance that the parent— for “pragmatic business reasons, not benevolence or a sense of morality”—will “assume the debt of a failed overseas subsidiary even if the parent had not guaranteed it.”

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124 S&P Corporate Ratings Criteria, 2006, p. 85. See also S&P Summary: TNT Express N.V. (May 31, 2012) (“As per our criteria, a weaker entity owned by a stronger parent will usually--although not always--enjoy a higher rating than it would on a stand-alone basis.”) at http://www.reuters.com/article/2012/05/31/idUSWLB061320120531.
125 See, e.g., Lessard & Shapiro, supra note 39.
The phenomenon of implicit support exists in the public as well as the private sector. The government sometimes takes action short of an actual guarantee to signal its support for an entity and thus encourage market reliance on implied or “conjectural” government support.127 In 1987, for example, Congress passed a resolution expressing its “sense of support” for the deposit insurance guarantees of the then-troubled Federal Savings and Loan Insurance Corporation. Commentators noted that while the resolution was not enforceable, it “was no doubt designed to allay market fears” of default.128 The implicit or “conjectural” support provided by the Federal Government to Fannie Mae and Freddie Mac allowed those entities to borrow at low rates for many years, even though their debt expressly disclaimed a U.S. government guarantee.129 As of July 2011, implicit support from the Federal Government accounted for a four notch increase in the credit standing of the Federal Home Loan Bank System and three-to-five notch increases in those of three major U.S. banking organizations, Bank of America, Citigroup, and Wells Fargo. The other five major U.S. banking organizations were said to derive significant but smaller benefits from conjectural federal support as well.130

Although affiliation benefits clearly exist, it does not follow that all affiliates enjoy them equally, or that all prospective creditors or guarantors evaluate them the same way. In many cases affiliation may have little impact on the credit profile of an affiliated borrower. Moreover, an investor may not view affiliation through the same lens as a credit rating agency. These views can differ, partly because credit ratings “are not likely to change as frequently as the market’s perceived credit risk profile of a borrower,”131 and partly because the perspective of an investor, whose money is at stake, may be more cautious than that of a rating agency.

While voluminous literature examines how lenders and credit rating agencies evaluate affiliation benefits, there is little discussion of how guarantors appraise such benefits. However, common sense suggests that a third party guarantor may place less reliance on affiliation than a lender would. First, the very fact that the affiliate seeks out a third party guarantee might cause the guarantor to assess differently the likelihood of

128 See Cook & Spellman, supra note 127, at 455.
131 John Hollas & Gordon Hands, Comparability Adjustments: Finding an Arm’s-Length Interest Rate, 18 TAX MGMT. TRANS. PRICING REP. (BNA) 525 (2009); John Hollas & Gordon Hands, Intercompany Financial Transactions: Selecting Comparable Data, 18 TAX MGMT. TRANS. PRICING REP. (BNA) 1240 (2010) (“the bond investor’s perception of the credit quality of the bond would be reflected in the bond yield but not necessarily the credit rating”).
parental support. People who buy insurance usually make a claim when they sustain a loss, and a guarantor will normally assume that the purchaser intends to avail itself of the guarantee when needed. Second, a guarantor may perceive risk differently from a lender because, as noted previously, the presence of a guarantee may cause the borrower to engage in riskier behavior, thus increasing the likelihood of default. As Warren Buffett once noted to Berkshire Hathaway shareholders, “When faced with large revenue shortfalls, communities that have all of their bonds insured will be more prone to develop ‘solutions’ less favorable to bondholders than those communities that have uninsured bonds held by local banks and residents.”

For purposes of the following discussion, we will assume that both third party guarantors and third party lenders may at least in some instances give some weight to affiliation when pricing a financial product. The question thus arises whether these benefits should be factored in as adjustments under the various transfer pricing methods discussed above. For example, assume that a borrowing subsidiary could secure a guarantee from a third party guarantor at Libor+110 bps taking account of affiliation, but that the guarantor would charge Libor+130 bps if the subsidiary were unaffiliated. Or, if the yield savings approach were being employed to price the related party guarantee, assume that a third party lender would loan money to the subsidiary at Libor+90 bps taking account of affiliation, but would charge Libor+130 bps if the company were unaffiliated. For purposes of transfer pricing analysis, which is the relevant price?

Plausible arguments have been advanced on both sides of this question. Under the “no affiliation” model, the appropriate price in the example above would be Libor+130 bps under any pricing method. Under the “market/affiliation” model, the appropriate price in the example above would be Libor+110 bps for a third party guarantor and Libor+90 bps for a third party lender. We consider the pros and cons of these two approaches below

1. The “No Affiliation” Model

This model applies the arm’s length standard by seeking to determine the price at which the borrower could acquire a guarantee or loan from a third party if the borrower had no upper-tier affiliations. The argument in support of this model proceeds as follows: (i) the transaction in question is between related parties (most commonly, a parent and its subsidiary); (ii) the arm’s length standard requires that the related party relationship be disregarded in determining the appropriate price; (iii) affiliation benefits, chiefly the existence of implicit support, arise by virtue of the related party relationship and must therefore be ignored; (iv) ignoring affiliation, the market/arm’s length price of the guarantee in the example above is Libor+130 bps.

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For textual support, advocates of the “no affiliation” model often cite language in the OECD Guidelines stating that the arm’s length standard requires “treating the members of an MNE group as operating as separate entities rather than as inseparable parts of a single unified business.” This “separate entity” approach, in the view of many commentators, requires that benefits flowing from affiliation that represent disguised transfers of value be disregarded in an arm’s length analysis even if the markets are not as precise due to their different concerns (including less need to distinguish between legal entities).

Advocates of the “no affiliation” model likewise find support in Treasury regulation section 1.482-2(a)(2)(i), which defines an “arm’s length interest rate.” It requires identifying the interest rate that “was charged, or would have been charged . . . in independent transactions with or between unrelated parties under similar circumstances.” In making this determination, it states that all relevant factors must be considered, including the “credit standing of the borrower.” Advocates of the “no affiliation” model submit that the reference to “the borrower” explicitly distinguishes the borrowing entity from all other affiliates, thus prohibiting consideration of affiliation benefits in determining an arm’s length interest rate.

Apart from this textual support, advocates of the “no affiliation” model find support in various economic and policy considerations. First, because the parent is normally the source of any implicit support enjoyed by the subsidiary, the parent-guarantor occupies a different posture than a third party guarantor. Whereas a third party guarantor can hold out hope that someone else (typically, the borrower’s parent) may come to the rescue, the parent-guarantor cannot – it has only itself. This makes the parent-guarantor non-comparable to a third party guarantor, and the “no affiliation” model effectively adjusts for this difference.

Second, allowing a weak subsidiary to borrow at a low interest rate because of “implicit support” from its parent allows the subsidiary, in economic terms, to “free ride” on the parent’s balance sheet. Advocates of the “no affiliation” model believe it appropriate that the arm’s length standard should correct this by forcing the subsidiary to pay the full, unsubsidized cost of its borrowing. The “no affiliation” model addresses the free rider problem: it provides a mechanism by which the less creditworthy entity compensates the group for the benefit it derives from the group’s implicit support. “[I]mplicit guarantees [may] . . . impose a cost on the guarantor which is essentially the same as for explicit guarantees.”

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133 OECD Guidelines ¶ 1.6.
134 See, e.g., Peter Blessing, Divergence of Third Party Pricing from Arm’s Length Pricing, Tax Polymath: A Life in International Taxation, Essays in Honour of John F. Avery Jones, IBFD (2010); Francois Vincent, GE Capital Canada After GlaxoSmithKline, 19 TAX MGMT. TRANS. PRICING REP. (BNA) 607 (2010); Michael Hoffman, Stephane Dupuis & Kirsty Rockall, Is the CRA Abandoning the Arm’s Length Principle?, 16 TAX MGMT. TRANS. PRICING REP. (BNA) 333 (2007); Gill, supra note 99 (“The application of the arm’s length principle requires the entities to be treated as though they are separate and distinct entities, which is quite different to the question addressed by the credit rating agencies in considering the credit rating of a subsidiary entity.”).
135 Merton, supra note 109, at 4.
Third, the “no affiliation” model is said to achieve consistency with the conceptual framework for debt/equity determinations. Debt/equity determinations typically inquire whether the borrower is the “true borrower” and, in connection with that inquiry, ask whether the borrower could have borrowed on its own account. Some of the debt/equity precedents suggest that the borrower’s ability to borrow on its own account should be determined without regard to its corporate affiliations. Advocates of the “no affiliation” model reason that if the debt/equity determination disregards affiliation, the transfer pricing of a related party guarantee should likewise disregard affiliation.

2. The “Market/Affiliation” Model

This model applies the arm’s length standard by seeking to determine the price at which a controlled borrower (the subsidiary) could acquire a guarantee or loan from a third party, taking the borrower as it is and marketplace realities as they are. The argument in support of this model is that it replicates the result that would occur if the subsidiary engaged in a market transaction directly with the third party. It likewise replicates the result that would occur if the parent-guarantor transacted with a third party borrower that had the same credit standing and affiliation benefits as its subsidiary. Admittedly, this model ignores the non-comparability between a parent-guarantor and a third party guarantor or lender – the latter may hope for a rescue and the former may not. But this difference in posture arises from the controlled relationship and is thus said to be properly ignored.

As textual support, advocates of the “market/affiliation” model emphasize the goal of the arm’s length standard to place the controlled parties in the same position as if they had dealt with unrelated parties. The pricing analysis must consider “all relevant factors” that a third party would have taken into account when determining a price and all “attributes of the transactions or enterprises that would affect conditions in arm’s length transactions.” Thus, if a third party guarantor or lender would have considered affiliation benefits in pricing the loan or guarantee, the transfer pricing analysis must do so as well.

According to those advocating this approach, the only counterfactual assumption required by the arm’s length standard is to treat the parties as if they were not under common control. This does not mean that a subsidiary should be treated as if it were unaffiliated – e.g., treating a child with parents as if she were an orphan. It simply means that the subsidiary should be treated as being the “child” of someone else. Thus, in the guarantee context, the arm’s length standard requires that a guarantee from a parent to its subsidiary be priced as if the parent were issuing the guarantee to an identical borrower in an unrelated corporate group that enjoyed comparable affiliation benefits. In this setting, proponents of the “market/affiliation” model urge that the guarantor would price the guarantee by taking into account the “implicit support” that the guaranteed party could

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137 OECD Guidelines ¶ 1.36.
expect to receive from the other corporate group. That being so, the related party guarantee should likewise be priced by taking account of affiliation benefits.  

Proponents find further textual support for the “market/affiliation” approach in inferences derived from other provisions of the Treasury regulations and OECD Guidelines. These authorities state that where an affiliate benefits from lower costs solely by virtue of its affiliation with the group, “no benefit” is received (Treasury Regulation section 1.482-9(1)(3)(v)) and “no service” is provided (Guideline ¶ 7.13) that would support a charge from the parent to the subsidiary. Arguably, these authorities imply that a subsidiary is entitled to retain without payment affiliation benefits in the form of lower borrowing or guarantee costs where those benefits arise from affiliation alone and not from any specific activity of the group. Because the “no affiliation” model requires the borrowing subsidiary to surrender the value of such affiliation benefits to its parent in the form of a higher guarantee price, that model is allegedly contrary to these authorities. 

Advocates of the “market/affiliation” model also cite its consistency with the “realistic alternative” principle (previously discussed), which tests the arm’s length nature of a controlled transaction by reference to the terms each party could have realized had they pursued other options realistically available to them. The OECD Guidelines similarly note that “independent enterprises consider the options available to them and . . . normally would be expected to consider whether they could buy the same product . . . at a lower price from another party.” The “no affiliation” model will sometimes dictate a higher price for a related party guarantee because it ignores affiliation benefits that may induce market participants to quote a lower price. Advocates of the “market/affiliation” model urge that an uncontrolled party would never pay that higher price if it has the realistic alternative of acquiring the guarantee more cheaply in the open market. 

Finally, advocates of the “market/affiliation” model offer the following rejoinders to the textual and policy arguments advanced by proponents of the “no affiliation” model:

- The reference in Treasury Regulation section 1.482-2(a)(2)(i) to the “credit standing of the borrower” does not necessarily mean that the borrower’s affiliations

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138 See Reg. § 1.482-9(l)(3)(v) (“[a] controlled taxpayer’s status as a member of a controlled group may . . . be taken into account for purposes of evaluating comparability between controlled and uncontrolled transactions”). See also Example 19 at Reg. § 1.482-9(l)(5), which suggests that an affiliate’s status as a member of a controlled group should be taken into account for purposes of evaluating comparability and, thus, the affiliate in the example (Company Y) is comparable to another taxpayer that engages in the same transaction as a member of a controlled group and is not comparable to a company that engages in the same transaction not as a member of a controlled group.

139 Discussing the “benefit test” for intercompany services, the regulations state that no charge is generally appropriate to reflect a “passive association” effect that may be present. Reg. § 1.482-9(l)(3)(v), (l)(5) (Examples 15-19). Passive association for this purpose refers to a “benefit [that] results from the controlled taxpayer’s status as a member of a controlled group.” Reg. § 1.482-9(l)(3)(v). The implication is that a parent would not be expected to charge a subsidiary for the benefit of an enhanced credit rating or reduced interest costs where that benefit arises solely from passive affiliation.

140 See Reg. § 1.482-7T(g)(2)(iii)(A) (requiring that a transfer pricing method be consistent with the “realistic alternatives” available to the parties).

141 OECD Guidelines ¶ 1.35.
should be ignored. If the market would perceive the borrower’s creditworthiness as being enhanced by its relationships, those relationships are in fact integral to its “credit standing.” Indeed, proponents of the “market/affiliation” model urge that their approach is more faithful to the text of this Regulation because it focuses on “the borrower” as it actually is, rather than substituting a hypothetical orphaned borrower as the purchaser of the guarantee.

- The “separate entity” concept outlined in ¶ 1.6 of the OECD Guidelines likewise embodies no mandate that the borrower’s affiliations be ignored. This principle simply means that the separate juridical existence and profit/loss characteristics of each enterprise within the MNE group must be respected, as opposed to treating all the companies “as inseparable parts of a single, unified business.” It is possible to respect the borrower as a separate juridical entity while acknowledging that it has affiliates and indeed the financial marketplace itself does this: otherwise, every affiliate would have a credit rating equal to that of the MNE group, which is demonstrably not the case. Proponents of the “market/affiliation” model accordingly urge that pricing based on actual marketplace transactions involving a particular member of the group is entirely consistent with the separate entity principle. Indeed, they argue, the “no affiliation” model offends the separate entity or independence principle because it potentially forces the subsidiary to pay a higher guarantee fee to an affiliate than it would pay to a third party. Instead of positioning the subsidiary as separate and independent from its group, the “no affiliation” model, it is argued, causes the subsidiary to act in a manner that highlights the relationship and benefits other members of its group rather than itself.

- Advocates of the “market/affiliation” model acknowledge the problem of letting a subsidiary “free ride” on its parent’s balance sheet. But they suggest that the “no affiliation” model provides a flawed solution to this problem. Requiring the subsidiary to disgorge the benefit of “implicit support” in the form of a higher guarantee fee addresses the problem only if the nominal guarantor is the true source of support. For example, if a sister corporation provides the guarantee, it would receive a windfall from the higher fee because the “implicit support” is or may be supplied by the ultimate parent and not by it. To address the “free rider” issue in a better way, advocates of the “market/affiliation” approach suggest separating the pricing of the guarantee transaction from any inquiry into whether “implicit support” is compensable. That way, the guarantee would be priced at the market rate and the borrower would be indifferent as to whether it acquires the guarantee from a related or an unrelated party. The question whether the subsidiary should pay the parent (or the group) some sort of “affiliation benefit fee” would be handled separately, possibly requiring reconsideration of the principles set forth in Treasury Regulation section 1.482-9(1)(3)(v) and OECD Guidelines ¶ 7.13.

Needless to say, advocates of the “no affiliation” approach have defenses and rejoinders as well:

- Advocates of the “no affiliation” model agree that the subsidiary’s realistic alternatives must be considered and that their model may sometimes cause the arm’s length price of a guarantee to be higher than the derived market price. However, they
emphasize that one rarely encounters in real-world markets third party guarantees that the subsidiary could accept as realistic options. Thus, any differences in pricing derived from supposedly analogous transactions are speculative.

- Even if there were a third party transaction that gave meaningful effect to the benefit of affiliation in a comparable group arrangement (because of the expectation of parental support), such benefit as a practical matter is likely to arise from more than passive affiliation alone. In many instances, the parent will have engaged in some affirmative act or some expression of support that would be compensable under the concepts outlined in OECD Guideline ¶ 7.13. A third party guarantor benefiting from a parent’s “implicit support” has acquired an unenforceable but very real possibility that the parent will inject funds if needed. If this benefit were memorialized in inter-company documentation between the parent and the subsidiary, it would be compensable under transfer pricing principles. By measuring and charging for this benefit, the parent in effect is documenting this support and the charge is therefore proper. The contrary view would create artificial distinctions.

- The “no affiliation” approach provides the correct economic result because it permits the parent to be compensated for an asset – its financial standing – that is being used by the subsidiary, generally at an economic cost to the parent. While the parent’s credit rating may create a halo effect on lower-tier affiliates as the result of marketplace perceptions that the parent would inject funds if needed, the net assets that permit the parent to inject funds and that typically give rise to the rating are the parent’s assets, not “group assets.” Moreover, creditworthiness is a potentially exhausting asset because it may be adversely affected by additional leverage or incremental demands on the parent’s resources. The subsidiary’s use of the parent’s credit rating is thus distinguishable from a situation where the benefit of passive association is enjoyed on a neutral basis, as where the subsidiary receives a volume discount. In sum, by allowing compensation to the parent for the use of its asset, the “no affiliation” model achieves an economic result that more precisely approaches closer to the arm’s length ideal.\footnote{See Blessing, supra note 134.}

As a practical matter, resolution of the debate about whether affiliation should be taken into account in pricing a guarantee may be a moot point because we are dubious that a third party guarantor would take affiliation into account or give it much weight. As explained previously, a third party asked to guarantee a subsidiary’s borrowing would reasonably assume a zero or very small probability of a parent-led rescue, reasoning that the parties would not have purchased a guarantee unless they intended to use it when necessary. Naturally, the weight a third party guarantor would accord affiliation is a factual question. But given the reasonable likelihood that affiliation would not play a material role in pricing, forthcoming guidance should be mindful that requiring taxpayers or examiners to calibrate precisely the impact of affiliation in this context may require much work for little gain.

B. Adjustments for Supposed Benefits to the Guarantor

\footnote{See Blessing, supra note 134.}
Some tax authorities have taken the position – rarely seconded by commentators or practitioners – that the transfer pricing analysis of a related party guarantee must involve a two-step process. On this view, determining the arm’s length market price of the guarantee is just the first step; the second step is to “adjust” that arm’s length price to account for benefits supposedly flowing back to the related party guarantor. Advocates of this position reason that any transfer pricing analysis must consider both sides of the transaction and that doing so requires taking account of reciprocal benefits.

Proponents of the two-step process identify four benefits supposedly enjoyed by a parent-guarantor: (1) the increased value of its investment in the borrowing affiliate due to the affiliate’s ability to borrow more cheaply with the guarantee; (2) the protection that the guarantee affords the parent against reputational damage that would flow from the affiliate’s default; (3) the benefit the parent enjoys by avoiding, through the guarantee, the need for the affiliate to agree to restrictive covenants as a condition of borrowing from unrelated parties; and (4) the benefit the parent enjoys by avoiding, through the guarantee, the need to inject additional capital into the affiliate to enable it to borrow at comparably low rates.

We submit that none of these alleged benefits is properly considered in a transfer pricing analysis. First, the notion that a guarantee confers a cognizable “benefit” on the parent by increasing the value of its subsidiary is at odds with fundamental principles of transfer pricing. Any increase in the investment value of the subsidiary is enjoyed by the parent in its capacity as shareholder. Transfer pricing as currently understood would be turned upside down if a shareholder were allowed (or required) to reduce the arm’s length price of a good or service to reflect such a benefit. A parent may increase the investment value of a subsidiary by selling it fuel oil at half price, or by providing technology services at a subsidized rate. The benefit the parent thus derives cannot justify a downward adjustment to the arm’s length transfer price of these items.

The second parental benefit supposed by proponents of such adjustments – protection against reputational damage flowing from the affiliate’s default – seems fanciful. This “benefit” does not flow from the guarantee, but from the parent’s determination to do what is required to prevent a default. A parent need not provide a guarantee to secure this benefit – it simply needs to make sure the affiliate has the wherewithal to pay its debts. The guarantee does not enhance its ability to do so; the guarantee simply takes the choice out of the parent’s hands and legally commits it to take certain steps that it would otherwise be free to take, or not take, as it saw fit. Converting a choice into a legal commitment is not a benefit to the person so committed. And even if protection from reputational harm were thought to be a parental “benefit,” it would not be cognizable for transfer pricing purposes. The parent plainly would derive no benefit from guaranteeing the debt of an unrelated party; any benefit it derives from guaranteeing the debt of a related party necessarily arises from the fact that the parties are related. Transfer pricing analysis, positing that the controlled parties be situated as unrelated, forecloses consideration of such benefits in determining the arm’s length price.
The third parental benefit alleged to flow from guarantees – avoiding the need for the subsidiary to execute burdensome restrictive covenants – is discussed above in Section V.B. in connection with compensability. As shown there, the subsidiary, not the parent, is the primary beneficiary of eliminating restrictive covenants. The economic costs imposed by restrictive covenants – demands on managers’ time, the obligation to file reports, burdens of the accounting function, and constraints imposed on investment and operational decisions – fall mainly or exclusively on the subsidiary.

The fourth parental benefit alleged by proponents of such adjustments is that the guarantee relieves the parent of the obligation to capitalize its affiliate more robustly. This benefit is likely illusory. Market participants will generally compute the parent’s debt/equity ratio on a consolidated basis. If the parent injected additional capital into a particular affiliate, the parent would be free to increase leverage on its own or another subsidiary’s balance sheet while keeping its consolidated debt/equity ratio exactly the same. Moving equity from one corporate box to another confers no economic benefit on the parent company. As discussed earlier in connection with compensability, thin-capitalization rules and similar regulatory regimes may appropriately be used to police capital structures. Transfer pricing should not be conscripted for this purpose.143

Most of these alleged “parental benefits” – avoiding reputational risks, avoiding covenants, avoiding provision of additional capital – are inversely correlated to the strength of the guaranteed subsidiary. The weaker the subsidiary, the more the parent allegedly benefits from having the guarantee in place. This leads to a perverse calculus: the higher the risk of default, the more valuable the protection, the greater the benefit to the parent, hence bigger the discount to the guaranteed party. It should give anyone pause that, under this theory, the arm’s length price of the guarantee goes down as the credit risk of the guaranteed party goes up.

Although these asserted parental benefits upon proper analysis are non-cognizable, de minimis, or illusory, the assertion by some tax authorities that they require adjustments to the arm’s length price of a guarantee has created uncertainty. Whenever a controlled party sells goods or services to another, the selling party commonly realizes incidental advantages such as reputational benefits or possible synergies. If the selling party were free (or forced) to reduce the arm’s length transfer price (and thus its income) on account of such notional and highly subjective benefits, almost any cross-border transaction could become the occasion for creative tax planning and dispute. In order to eliminate such uncertainty, any forthcoming guidance should make clear that parental “benefits” of this nature do not warrant adjustment to the arm’s length price otherwise determined for a related party guarantee.

143 In a related vein, some argue that the parent could have capitalized the affiliate in another way. Rather than having the affiliate borrow in its own name on the strength of the parental guarantee, the parent could have borrowed the money in its own name and on-lent the funds to the affiliate. But there is no reason to think this would change the bottom line. If the affiliate has high leverage, the interest rate charged on the inter-company loan would, under arm’s length principles, have to reflect the affiliate’s weak credit standing. In that event, the total interest paid by the subsidiary on its debt to the parent might well exceed the financing costs (interest plus guarantee fees) that it incurs when borrowing under the guarantee from third parties.
For example, assume a U.S. mining company that provides engineering services with an undisputed arm’s length value of $10 million to its wholly owned subsidiary in South America. Assume that this engineering project occurs in an environmentally sensitive area and that it would be a public relations disaster for the parent if environmental damage occurred. If the U.S. parent were to reduce its charge for these services to $5 million on the theory that it benefits from the services by avoiding reputational risk, we would be surprised if the Service were to acquiesce in that reduction of its gross income. Or assume a U.S. forest products company that sells to its wholly-owned foreign distributor a large quantity of timber that the distributor needs to make good on a commitment to an important customer. Assume that the arm’s length price of the lumber as evidenced by transactions in the futures market is $100 million. The U.S. parent undoubtedly realizes benefits, in terms of avoiding reputational risk, by selling this lumber to its foreign subsidiary rather than allowing the subsidiary to default on its commitment to a major customer. If the U.S. parent were to reduce its charge for the lumber to $60 million on account of this supposed benefit, we doubt the Service would (or should) accept that as an arm’s length price.

Finally, the notion that a related party guarantee should be discounted due to benefits flowing back to the parent would create an odd asymmetry. If the affiliate acquired the guarantee from a third party, the guarantee would presumably confer on the parent many of the same benefits – apart from the receipt of the fee – that are alleged to arise from the parental guarantee. It is hard to imagine that a tax authority would seek to deny the taxpayer a deduction for the arm’s length guarantee fee paid to the third party in this instance. But if the guarantee reflects an arm’s length price, why should it matter to whom it is paid?

C. Adjustments for Parent’s Ability to Control the Subsidiary

Some tax authorities have argued that the market price for a guarantee should be discounted where the parties are related to reflect the control that the related party guarantor (often the parent) typically exercises over the affiliate whose debt or performance is being guaranteed. The literature confirms that a guarantor’s access to information about, and its ability to monitor and to some degree control the risks assumed by, the entity whose debt or performance is being guaranteed is relevant to guarantee pricing.144 Because an unrelated guarantor, lacking the same degree of control, might in consequence charge a higher fee, it has been urged that the related party fee should be adjusted to a point below the market price.

144 See Angoua, Lai & Soumare, supra note 117 (“The risk-based premium works best when the guarantor has access to the informational inputs needed to establish a fair price and when the risk characteristics of its assets and/or liabilities cannot be unilaterally changed by the insured intermediary after the premium has been paid.’ [A]ny guarantor (public or private) must apply some feasible combination of such methods to remain viable.”) (quoting Robert Merton & Zvi Bodie, On The Management Of Financial Guarantees, 21 FINANCIAL MANAGEMENT at 87-109 (1992)).
In recent litigation, the Canadian Revenue Authority (CRA) took essentially this position, contending that the control exercised by the parent-guarantor over its affiliate rendered a hypothetical third party guarantor non-comparable. According to the CRA, the parent’s ability to exercise control lessened the risk it undertook and supported a downward adjustment to the third party price. The tax court agreed, stating that the control exercised by the parent-guarantor put it in a different and less risky position than a third party guarantor. From this, the court seemingly concluded that the arm’s length price payable to the parent should be lower than the arm’s length price that would be payable to a third party for the same guarantee.  

Similarly in the loan context, some tax authorities have argued that the interest rate on a related party loan should be reduced to reflect the parent-lender’s ability to exercise control over the affiliated borrower. In June 2010, the Supreme Administrative Court in Sweden addressed the arm’s length price of a loan from a parent (Diligentia) to its subsidiary. The loan was priced at 9.5%, and the loan documents did not stipulate any security for the loan. The Court nevertheless held that the loan from the parent to the subsidiary should have reflected the arm’s length price of a loan as if security had been provided. It reasoned that the parent’s control over the sub was tantamount to the control that a pledge of security would have provided to a third party lender. Taking a pledge of security into account, the arm’s length market price of a third party loan would have been 6.5% rather than 9.5%, and the interest rate between the parent and subsidiary was adjusted accordingly.

The Supreme Administrative Court of Finland reached the same conclusion in November 2010 on similar facts, holding that an unsecured related party loan should nevertheless have been priced as if security had been provided to take account of the related party lender’s de facto control over the assets of the borrower. The government of Austria appears to take the same view. A Federal Ministry of Finance Ruling (issued in October 2007 (EAS 2898) states that for purposes of pricing intercompany debt, one must take into account the control that the lender exercises over the borrower, either directly or through the group. The ruling observes that this control reduces the lender’s risk and puts the related party lender in a different posture than a third party bank vis-à-vis the borrower.

These authorities raise the question whether to impute related party control into the hypothetical arm’s length dealings. If the parent-lender has the same degree of control over the borrowing affiliate that a third party lender would achieve through a covenant or a pledge of security, should that control be taken into account when pricing the transaction? To be sure, the parent’s control arises from the non-arm’s length relationship, but it has a parallel in the marketplace. One might argue it would be a senseless gesture for the parties to document (e.g., through covenants) a power of control that already exists. Proponents of this view would therefore argue for equating a parent's

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146 A link to the Finnish Supreme Court decision is available here: http://www.kho.fi/paatokset/52464.htm.
control with customary marketplace covenants and pricing as if those covenants were in place.

We caution against following this lead. In virtually any related party transaction, the parent may enjoy benefits by virtue of its control over the subsidiary that its opposite number in otherwise equivalent market transactions does not enjoy. But this, we submit, cannot render market transactions non-comparable. Were that so, the transfer pricing analysis required by the arm’s length standard could never be implemented. Take an example involving an intercompany loan. If the control that a parent exercises over a subsidiary were taken into account, almost any loan to a solvent entity could be priced at AAA rates (even if both the parent and the subsidiary are BB), because a parent could loan money to the subsidiary, have the subsidiary deposit it risk-free in a bank, then have the subsidiary pay it back with interest. That would not be in their self-interest as shareholder and affiliate, but if one allows control to creep into the analysis of third party comparability and views the parent in its lender capacity (rather than its shareholder capacity), one is confronted by the question “How would a third party bank price a loan if it had complete dominion over all the borrower’s assets and the use of the borrowed funds?” That is an untenable transfer pricing framework. Transfer pricing requires one to strip away the incidents of affiliation, not to import them into the hypothetical third party relationship.

Paragraph 1.8 of the OECD Guidelines states that, where money is loaned between affiliated parties, an arm’s length price may generally be found “in a comparable transaction undertaken by comparable independent enterprises under comparable circumstances.” An OECD report addressing financial institutions specifically states that “the appropriate arm’s length rate of interest for a loan between associated banking or financial enterprises is the rate that would be charged in similar circumstances in a transaction between unrelated parties.” Those Guidelines make no provision for “adjusting” the arm’s length market interest rate to account for control attributes presumptively enjoyed by the lending parent. Similarly, we believe there should not be an adjustment to the arm’s length guarantee fee to account for control benefits presumptively enjoyed by the affiliated guarantor.

D. Adjustments for Credit Standing as a “Group Asset”

Some have argued that the arm’s length price of a related party guarantee should be adjusted downward or eliminated altogether on the theory that the credit support conveyed by the guarantee is a group asset to which all the affiliates contribute and that some accommodation must be made to reflect that the party paying for the guarantee has contributed value to the asset for which it is paying. The argument is buttressed by the fact that the credit standing of a person or group can be affected by size alone. Three identical “B” rated entities, when combined, can form a “BB” rated entity because of size alone, the assets of each contributing to the higher rating.

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The more aggressive version of the “group asset” view holds that no charge is appropriate for a related party guarantee, analogizing to the notion of a cooperative where every member is entitled to share freely in the fruits of their collective contributions. Others would permit a charge but urge that an adjustment be made to the price. No one in our experience has explained how one would calculate an adjustment but one can imagine possible approaches, including an approach that would measure the adjustment based on the impact the subject entity had on the credit standing of the group – e.g., if the group is rated “BB” but would have been rated “B” but for the assets of the entity, one might argue that the price of the “BB” guarantee should be reduced to reflect “B” guarantee pricing.

We urge against the “group asset” view in any of its forms. While it may appeal to a sense of equalitarianism to treat all members of a controlled group as equal and as deserving of credit, there is no legal or logical basis for doing so. The parent, by virtue of being the parent, has the ability to direct and exploit assets within its control, including the assets of its affiliates. This distinguishes it from other members of the controlled group. It is not true that the parent’s credit standing belongs to the group or to its members, or that the credit standing of any member belongs to any other member. If a parent issues a guarantee in the market to an unrelated party, it is not obligated to split the fee it earns among the members of its group. The parent did not sell their property and so there would be no occasion for a transfer pricing adjustment forcing a sharing of the fee (as would be the case if it had sold property belonging to others). As a matter of law and commercial reality, the parent’s credit standing is its own to exploit.148

Nor does the “group asset” theory give an affiliate even an equitable claim to a discount off the market price of a guarantee. The parent’s credit standing is based on its overall capital structure; the particular division of that capital structure among affiliates does not give any affiliate a claim against the parent or the group. The parent could sell the affiliate, split it in two, consolidate it with another, or distribute assets from it, all without affecting the parent’s worth or credit rating. What an affiliate has or gives to its parent is, at least economically, already the parent’s own. C.S. Lewis made this point in a very different context when he noted that if a father obliges a child’s request for sixpence to buy the father a present, “It is all very nice and proper, but only an idiot would think that the father is sixpence to the good on the transaction.”149 We think it a mistake to conclude that a parent must discount the market price of a good or service to account for the fact that the parent’s market position or credit standing is enhanced by virtue of its ownership of its subsidiaries.

We also caution that the “group asset” view, as advocated, results often in a double counting of benefits to the affiliate. By affording the affiliate a discount off the market price of a guarantee, the “group asset” view effectively allows the affiliate to

148 The reasoning that supports a “same creditworthiness” assumption in the context of permanent establishments and head offices has no application when dealing with separate legal entities. See OECD Guidelines ¶ 1.6 (“the arm’s length principle follows the approach of treating the members of an MNE group as operating as separate entities rather than as inseparable parts of a single unified business”).
149 C.S. Lewis, Mere Christianity.
withdraw the value of its affiliation from the parent or group for purposes of pricing. Yet in our experience, advocates of the “group asset” view simultaneously urge that the affiliate’s own credit standing should be based on the market’s assessment of its credit worthiness taking account of its affiliations. This amounts to a kind of “what’s yours is mine and what’s mine is mine” posture for the affiliate – allowing it to enjoy the contributions of other members of the group while allowing it to withdraw from the group its own contribution. Accordingly, the argument that the market price of the guarantee should be adjusted to back out the contribution of the borrower would effectively commit one also to adjust the market price of the guarantee upward in some cases to back out the affiliation benefits flowing from the group to the affiliate. In our experience, advocates of the “group asset” view have failed to reflect this point in their argument.

We note also that the logic of the “group asset” argument would compel a conclusion that is never championed by those who advance it – namely, that an affiliate that contributes negatively to the value of the group’s credit rating should pay more than a market price for a related party guarantee. It is easy to imagine a case, for example, where a group’s overall credit standing might be improved if it could shed itself of liabilities housed in an affiliate. If that affiliate obtains a guarantee from its “A” rated parent, we seriously doubt that anyone would argue it should pay the price that would be charged for an “AA” rated guarantee even if it could be shown that the parent would have been rated “AA” but for the negative contributions of the affiliate borrower.

The “group asset” view also has unexplored and presumably unintended implications for the pricing of intercompany debt. There is no principled reason to treat a group’s credit standing as a “group asset” for purposes of pricing intercompany guarantees but not as a “group asset” for purposes of pricing intercompany debt. The more aggressive version of the “group asset” view would therefore seemingly compel the conclusion that all intercompany debt be priced at cost, while the less aggressive version of the “group asset” view would seemingly require that the market price of an intercompany loan be discounted in some fashion. There is an extensive body of law in the U.S. dealing with the pricing of intercompany debt; we are aware of nothing in that law – including the pertinent Treasury Regulations – that supports the “group asset” view.

Finally, we note that Example 19 of the 1.482-9(l)(5) regulations, which is sometimes cited by “group asset” proponents as support for their view, does not in fact support their view or a claim that an affiliate should be able to get a related party guarantee for free or at a discount from the market. At most, that example stands for the principle that affiliation is a comparability factor, so if a third party would price a good at 95¢ per unit taking affiliation into account, the related party transaction should be priced similarly. Nothing in the example suggests or supports the view that the related party transaction should be priced below the market, at 90¢ or 85¢ per unit or that the good should be given away for free.  

150 In Reg. § 1.482-9(l)(5) (Example 19), a third party (Company S) sells plastic containers to two corporations that are related to each other at a price of 95¢ per unit based on the aggregate volume of...
E. Adjustments for Other Attributes

There are a number of other possible comparability or adjustment issues that arise with respect to related party guarantees, some that might argue for an increase in the arm’s length price and some that might argue for a decrease. Among the former is an issue mentioned previously, namely that a parent (or other related party) guarantor is likely not to be in a position to achieve the kind of risk diversification that a third party guarantor would achieve. If one posited a third party guarantor with a similar suboptimal risk diversification profile, the third party might price its guarantee higher than a highly diversified competitor, reflecting the fact that lack of diversification can impose higher costs on the party.

Purchases, one corporation (Company X) purchasing 1 million units, the second corporation (Company Y) purchasing 100,000 units. (Company X is identified in the example as the parent of Company Y but the specific relationship seems inconsequential to the analysis.) The facts reveal that had Company Y purchased 100,000 units alone, it would have been charged $1 per unit. Company X then seeks to charge Company Y a fee of 5¢ per unit, to extract from it the benefit it obtained by virtue of being affiliated with Company X in connection with the purchases. The example states that Company X did nothing for Company Y in connection with the transaction and concludes that the 95¢ per unit price paid by Company Y “is entirely due to Company Y’s status as a member of the Company X controlled group and not to any specific activity by Company X or any other member of the controlled group” for which a charge may be imposed. Example 19 thus concludes that Company X may not charge Company Y 5¢ per unit since Company X did nothing: the fact that Company Y enjoyed a benefit by virtue of the volume discount from Company S afforded by its affiliation with Company X is not the occasion for a charge. This illustrates the statement in the regulations at 1.482-9(l)(3)(v) that “[a] controlled taxpayer generally will not be considered to obtain a benefit where that benefit results from the controlled taxpayer’s status as a member of a controlled group.”

There is a secondary lesson from Example 19 as well, a lesson that is somewhat obscured by the example’s design. This lesson pertains to a comparability point. In the course of the discussion, the example states that for purposes of evaluating the fee charged by Company X to Company Y, Company Y is comparable to another taxpayer that likewise is a member of a controlled group and purchases 100,000 units out of a total of 1.1 million, and is not comparable to a company that purchases 100,000 units from a third party in isolation from anyone else. The discussion of comparability seems gratuitous on the facts since there is no related party transaction to support a transfer pricing inquiry to begin with, but the comparability discussion is included in the example to illustrate the text at 1.482-9(l)(3)(v), stating that while affiliation alone is not considered a benefit for which a charge may be extracted, a “controlled taxpayer’s status as a member of a controlled group may . . . be taken into account for purposes of evaluating comparability between controlled and uncontrolled transactions.”

The comparability issue would have been presented better in Example 19 if Company X or another affiliate had purchased the 1.1 million containers itself and sold 100,000 of the units to Company Y. Then the question would arise regarding the arm’s length price for that sale (a related party sale) and whether it would have to reflect the same 5¢ per unit volume discount that would have attached if Company Y purchased them directly from Company S. We anticipate the Government may have answered this question in the affirmative, insisting that Company Y not be denied the volume discount on the sale from the related party that would have been available to it on the sale from Company S but even if this is the intended lesson of Example 19, neither this lesson nor any other lesson from this example supports the notion that an affiliate is entitled to acquire a good or service from a related party at a price below which it could have acquired the good or service from a third party in the marketplace taking account of its affiliations.
On the other side of the scale, there are cost savings that are likely achieved by a related party guarantor versus a third party guarantor. The most obvious and significant of these are the cost savings associated with investigating, monitoring, and collecting from the borrower.\footnote{See Katz, supra note 92, 66 CHICAGO L. REV. at 71 (a related party has a comparative advantage in monitoring and collecting from an affiliate).}

These are two common attributes of related party guarantees, and there are no doubt others, that could arguably justify an adjustment to market prices. We urge that regulations not require these types of comparability adjustments and thus adjustments should not be made to increase the price of a guarantee to reflect higher costs borne by the related party guarantor (e.g., due to its inability to achieve the same risk diversification that a third party guarantor might achieve) and should not be made to decrease the price of a guarantee to reflect lower costs borne by the related party guarantor (e.g., due to cost savings in connection with investigating and monitoring the credit standing of the borrower, etc.). Adjustments of this kind would be a wash to some extent, and in any event adjusting for them would add undue complexity to the analysis, leading to “arm’s length” prices that may have little relation to actual market prices, and arguably take account of related party attributes that are properly ignored.

**XI. Select Pricing Considerations**

Many of the related party instruments discussed above, and the purposes for which they are used, have features that make determination of an arm’s length price particularly difficult.

**A. Indeterminate Impact**

Some of the instruments, particularly those on the unenforceable end of the spectrum such as letters of awareness and comfort letters, have no exact analogues in the commercial marketplace. And in some cases, the real-world impact of the instrument may difficult to know. It may be a challenge to determine whether a comfort letter (for example) significantly improved the terms of a deal or whether the deal would have transpired on the same terms without it. In market transactions, the fact that the transaction occurred is taken as evidence of its value. This logic may not apply with equal force to related party instruments, leaving one to wonder whether the expression of parental support was a “must have,” a “nice to have,” or something that was largely superfluous to the underlying transaction. Unenforceable commitments may present this question most acutely but it may arise in the case of formal guarantees as well.

Even where an expression of parental support may seem routine—suggesting low value—the absence of such an instrument may have significant consequences. A bank, for example, may attach relatively little importance to a boilerplate comfort letter that it seeks as a matter of course for its loan file. But if the parent refused to provide such a letter, the bank might draw negative inferences that could significantly increase the...
affiliate’s credit costs. These considerations suggest that commercial realities, including market perceptions, might be considered when performing the valuation exercise.

B. An Undiscriminating Market

In some situations, a guarantee may be required but the benefit achieved through the guarantee may not match its strength. An example of this is suggested by the U.S. Nuclear Regulatory Commission rules regarding financial requirements for decommissioning activities. Those rules state that “[a]n applicant or licensee may provide reasonable assurance of the availability of funds for decommissioning based on obtaining a parent company guarantee” from a parent with a credit rating of AAA, AA, A, or BBB.\footnote{152} No distinction is drawn between guarantors with the highest possible rating (AAA) and guarantors at the bottom of the investment grade rating scale (BBB). The pricing question, then, is whether the arm’s length transfer price should reflect the strength of the guarantee actually obtained (e.g., AAA) if the benefit does not. To avoid needless disputes, we suggest that guidance address this issue.\footnote{153}

C. Parent as Monopolist

The reference in the NRC regulation quoted above to “a parent company guarantee” suggests another difficult pricing issue. In some circumstances, a guarantee may be required specifically from a related party (generally, the parent) as opposed to a third party with an equivalent credit rating. For example, the Alaska Department of Labor states that to qualify as a self-insured employer in Alaska, “An applicant that is a wholly owned subsidiary of another company must submit a parent company guarantee of the applicant’s obligations under the Act.”\footnote{154} This presents a vexing transfer pricing question: the person requiring and setting the conditions for the guarantee has created a unique good in the hands of the parent, giving it what amounts to monopoly power over pricing. To the normal transfer pricing question, “what would an unrelated party charge?” the answer returns, “an unrelated party, by virtue of being unrelated, would be foreclosed from participating in the transaction.” To avoid needless disputes, we again suggest that guidance address this issue. In this case, it would seem reasonable to us to employ a pricing approach that hypothesizes a competitive guarantor market to defeat


\footnote{153} We recognize that this scenario presents a sympathetic case for divorcing the “arm’s length price” from the market price since, in a sense, the purchaser is buying more than it needs or can benefit from. Cf. OECD Guidelines ¶¶ 6.14-6.15. Still, we think market pricing (where known) should take primacy in determining an arm’s length price and if the facts suggest that a transaction was unreasonable and was entered into nonetheless for tax reasons, a tax authority should tackle that problem using tools designed for that purpose; it should not seek to do so by bending the concept of an “arm’s length price” in a way that effectively allows one routinely to disregard what actually happened and price an altogether different transaction whenever one concludes that the alternative transaction would have been a more reasonable one.

\footnote{154} See Form 07-6129 (rev 8/2/10) (italics added), available at: \url{http://www.labor.state.ak.us/wc/forms/wc6129.pdf}.
monopoly pricing power of a related party and so apply arm’s length principles by analogy.

D. Duration Issues

The duration of a related party instrument – or more accurately, the absence of a stated duration – presents pricing complexities as well. Related party instruments sometimes do not have a fixed term; a parent may provide a guarantee for notes issued under an affiliate’s financing program of indefinite duration. This is less common in the marketplace, which raises the question of how to benchmark a related party guarantee of unstated duration. One could price the guarantee program loan-by-loan but this seems artificial. An affiliate may meet its funding needs through a combination of loans, some with short (60 or 90 day) terms and some with 1, 2 or 5 year terms, constantly rolling over and varying the mix while keeping the total amount of guaranteed debt at a relatively constant or perhaps increasing level. We question whether it makes sense to price a program-wide guarantee based on the term of each loan in the program, given the likely expectation of the parties that the guarantee program will extend beyond the term of a particular loan. An alternative is to treat the guarantee program as lasting as long as the evidence reasonably suggests the parties envision. The challenge with this approach is, first, estimating the term and, second, finding market benchmarks for pricing such a commitment. A third approach is to impute a presumptive term where a stated term is not provided. Demand loans are treated this way for various tax purposes. Under section 7872(f)(2)(B), for instance, a demand loan (i.e., a loan of uncertain term that is callable by the lender at any time) is priced by reference to the Federal short term rate, meaning the loan is treated as having a term not exceeding three years. The same applies for purposes of determining the safe haven interest rate on a demand loan under Treasury Regulation section 1.482-2(a)(2)(iii)(C). The parties are best advised, of course, to provide for a term on the face of the instrument but transfer pricing guidance should anticipate that there will be cases where parties fail to so provide.155

E. Performance Guarantees Used for Bidding

Finally for present purposes, the use of performance guarantees in a bidding process raises special pricing issues that should be considered, many of which are nicely framed in the 2003 letter from the American Petroleum Institute (API) to the Service and Treasury commenting on the proposed services regulations under section 482. Commenting on Example 16 to the services regulations as proposed in 2003, the API explained that in some cases a parent will organize an affiliate in a particular country and provide the newly organized affiliate a performance guarantee to make it eligible to bid on an exploration project. The API suggests that if the bid is successful, the parent typically will then add substance to the affiliate, making it sufficiently robust to operate the project on its own and in turn making the performance guarantee “a mere formality,”

155 We recognize that permitting taxpayers to assign durations to instruments that may be replaced seriatim may seem artificial to a degree but the term of an instrument can have real practical significance depending on events and permitting taxpayers to assign durations to instruments has long been accepted by the tax law.
whereas if the bid is not successful, the guarantee will be “of little practical value or benefit to the subsidiary.” The API urged that in this context the guarantee should be regarded as a non-compensable shareholder activity because the subsidiary derives no benefit from the guarantee.

Our take on this example is different. We submit that a guarantee in this context confers an economic benefit – it allows the affiliate to bid and perchance to win – and thus is compensable unless the transaction is a Contributory Transaction (which we would expect in many cases, especially where the bidding affiliate may have few if any assets and not be in a position to pay a fee even if one were charged).

Even where a charge is imposed, the example highlights the tentative or temporary nature of related party performance guarantees in some cases, particularly as used in the bidding process, which must be taken into account in some reasonable fashion for pricing purposes. The API letter suggests that, in the circumstances described, the guarantee or its pricing may become obsolete almost immediately, either because the affiliate fails to win the contract and there is nothing to guarantee or because the affiliate succeeds in winning the contract and, as a result, it is given a degree of substance that changes the size of the risk being guaranteed. In certain cases, it might be possible to reflect these considerations in pricing by risk-weighting the likelihood of a successful bid and the likelihood of changes to the party whose performance is being guaranteed. It is also possible to reflect these considerations by building in a mechanism for revisiting the price after resolution of the bidding process and at intervals thereafter. Either of these approaches should be respected. There may be some cases, however, where the pricing does not reflect the deliberateness of either model. This is a difficult area. Guidance should recognize this and endorse a standard of reasonableness that tolerates good faith differences in the application of the arm’s length standard in these situations.

F. Summary

The discussion above underscores that related party credit and commercial support can take many forms and that a variety of methods can plausibly be used to determine the arm’s length price of such instruments. Still, there will be many challenges. Any guidance on this subject should therefore be tempered with the realization that there may often be a range of plausible pricing outcomes based on different perceptions of risk. In the period between 2002 and 2006, various scholars produced studies designed to estimate the risk associated with the U.S. government’s “conjectural” guarantee of the debt obligations of Fannie Mae and Freddie Mac. One article put the “price” of the guarantee at over $100 billion, another at $28 billion, and a third at almost zero. Virtually all commentators agree that valuation of related party

156 See Comstock, supra note 64.
guarantees is difficult, and any forthcoming guidance should express tolerance for a range of reasonable outcomes.

XII. Transfer Pricing Safe Harbor for Financial Guarantees

A. Safe Harbor Relief is Appropriate

In light of the uncertainty surrounding transfer pricing of guarantees and the large number of taxpayers potentially affected, we believe it appropriate to consider including in any forthcoming guidance an administrative safe harbor that is consistent with the arm’s length standard but incorporates simplifying assumptions. The Treasury regulations previously provided a safe harbor enabling related party guarantees to be priced – essentially at zero – under the 1968 regulations. This safe harbor was eliminated in 2006. The rationale for eliminating the previous safe harbor was the conclusion, which we share, that unless the guarantee is being contributed, a “uniform no charge rule for guarantees” was not appropriate. However, a safe harbor that prescribed an appropriate arm’s length charge would be consistent with that conclusion, and it would parallel the safe harbor available for interest rates in Treasury Regulation section 1.482-2(a)(2)(iii)(D).

We recognize that safe harbors and other administrative glosses on the arm’s length standard invariably entail trade-offs and are not always favored. The elective nature of safe harbors enables taxpayers to use them selectively, which can favor taxpayers at the expense of tax revenues and potentially of sound tax policy. Because a transfer pricing safe harbor applies in only one jurisdiction and does not bind the jurisdiction in which the controlled counter-party is located, economic double taxation can result if the latter jurisdiction does not accept the safe harbor outcome. Elimination of double taxation can be difficult in this context, since the country that adopted the safe harbor may be perceived as having departed from arm’s length norms. (Of course, this friction may exist absent safe harbors, as one country may consider a fee appropriate but another country may consider the guarantor as acting in a shareholder or stewardship capacity.) These factors must be carefully weighed in constructing any safe harbor for financial or performance guarantees.

We believe that related party guarantees satisfy many of the criteria that favor the kind of simplified analysis embodied in a safe harbor. The OECD Guidelines identify three such criteria: compliance relief, certainty, and administrative simplicity. They

155 (2006) (value of support over 25 years of $28 billion), and Stiglitz, Orszag & Orszag, supra note 129 (value/cost of support de minimis, i.e., $2 million for every $1 trillion in debt, or 0.002 basis points).
156 See pages 5-6, supra.
157 See Reg. § 1.482-9(b)(4)(viii) (excluding “financial transactions, including guarantees,” from the list of activities that qualify for SCM pricing).
159 See OECD Guidelines ¶¶ 4.98-4.122 (expressing reservations about safe harbors).
160 See OECD Guidelines ¶¶ 4.102-4.119.
explain that compliance relief is especially important where it is difficult or impossible to identify reliable comparables. In such cases, a safe harbor relieves taxpayers of the burden of collecting and analyzing information that, in the final analysis, may be inconclusive concerning the arm’s length outcome. “Certainty” refers to the ability of taxpayers to plan ahead and engage in controlled transactions without being subject to material transfer pricing adjustments. “Administrative simplicity” refers to the ability of the tax administration, using “minimal examination,” to determine whether taxpayers are compliant. This goal would be advanced if the tax administration could limit its examination to whether the taxpayer met the eligibility criteria for the safe harbor and reported prices in accordance with it. Such an examination allows the tax administration to devote scarce resources to other types of transactions that on balance pose greater concerns from a tax-revenue standpoint.

A safe harbor for financial guarantees would likely have utility for numerous corporate taxpayers. Taxpayers relied for many years on the “at cost” safe harbor that existed, at least informally, from 1977 until 2006. The elimination of that safe harbor has created significantly higher compliance burdens for U.S. taxpayers seeking to determine an acceptable arm’s length price. As discussed previously, reliable market comparables for related party guarantees rarely if ever exist. Pricing these instruments thus creates the need for complex models, based on derivative transactions, credit default swaps, put options, or insurance, that often necessitate the engagement of economists, statisticians, and other professionals knowledgeable about these fields. There is currently little legal authority to provide guidance on how these determinations should be made. Determining an accurate arm’s length price for a related party guarantee is thus difficult and expensive, and even a highly professional study may be inconclusive as to the ultimate arm’s length result. These are factors that historically have favored the use of safe harbors. The section 482 regulations include a safe harbor for interest rates, and a more refined version of the safe harbor that previously existed for related party guarantees could have significant benefits.

B. Specific Recommendations for a Possible Safe Harbor

This section presents a number of proposals for related party guarantee safe harbors. We initially suggest several criteria that a taxpayer might be required to satisfy in order to qualify for a safe harbor. We then propose methods for determining the value of a guarantee in an administratively simple manner.

1. Qualification and Carve-Outs

It may be appropriate to make the safe harbor available only to persons who are not in the business of providing guarantees to uncontrolled parties in the ordinary course of trade. A limitation of this type would be consistent with past practice and with the approach taken elsewhere in the section 482 regulations.164 Departing from the safe harbor model for interest rates, however, we recommend that a safe harbor for guarantees

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164 See, e.g., Reg. § 1.482-2(a)(2)(iii)(D) (interest rate safe harbor not available to a lender engaged in the business of making loans or advances to unrelated parties).
not be restricted to guarantees on U.S. dollar denominated debt. Compare Treasury Regulation section 1.482-2(a)(2)(iii)(E). This restriction may make sense for interest rates: because the safe harbor rate is tied to a U.S. interest rate (the AFR), it is limited to debt instruments issued in U.S. currency. But there is no need for a similar restriction in the case of guarantees, which are priced by reference to creditworthiness and are not affected by currency fluctuations. Practically speaking, limiting a safe harbor to guarantees on U.S. dollar-denominated debt would greatly diminish its usefulness given the relative frequency with which U.S. parents guarantee the obligations of their foreign affiliates, which are commonly denominated in other currencies.

To show that it qualified for the safe harbor, a taxpayer might be required to certify that the guarantee in question meets certain basic criteria, e.g., that the guarantee is in writing, applies to one or more specific loans or contracts obtained by the affiliate or to all loans or contracts over a defined period, and is issued in response to a specific request or a general requirement. Depending on the substantive pricing approach used in the safe harbor (see discussion below), Treasury and the Service might require additional information, such as information pertaining to the credit quality of the guarantor and the affiliate whose obligations are guaranteed. Ideally, mandatory information could be limited to information necessary to show that (1) the taxpayer qualifies for the safe harbor and (2) the guarantee fee conforms with the safe harbor approach.

We recommend also that the information required for safe harbor compliance be accepted as contemporaneous transfer pricing documentation under section 6662(e). The recently adopted SCM offers a model for this approach, providing that the documentation needed to support application of the SCM is deemed to constitute adequate documentation for purposes of section 6662(e).¹⁶⁵ Allowing this documentation to perform double duty eliminates the need for taxpayers to generate separate documentation for purposes of avoiding penalties. Such a reduction in burdens is broadly consistent with the goals of an administrative safe harbor.

2. Potential Format of Safe Harbor

This section provides five alternative recommendations for pricing under a safe harbor for guarantees.

a. Cost-Based Approach

For many years, the Service in informal guidance and many U.S. taxpayers took the position that the cost safe harbor under the former services regulations applied to related party guarantees. The principal problem with this earlier regime was that the safe harbor defined “costs” very narrowly, limiting them to out-of-pocket costs. Since the out-of-pocket costs incident to issuing a guarantee are usually trivial – consisting mainly

¹⁶⁵ See Reg. § 1.6662-6(d)(2)(iii)(B). The procedural and documentation requirements applicable to the SCM are fairly minimal: “The taxpayer must maintain documentation of covered services costs and their allocation. The documentation must include a statement evidencing the taxpayer's intention to apply the SCM.” T.D. 9278, 2006-2 C.B. 256.
of paper, ink, and some lawyers’ time – the previous safe harbor had the effect of treating guarantees as “uniformly non-compensatory.” This led the Treasury and the Service to discard the previous safe harbor.

An alternative approach, which in our view would be consistent with the Preamble to the 2006 regulations, would be to price a guarantee by reference to the cost of capital that a guarantor must set aside to cover the financial exposure represented by the guarantee. One possibility would be to use the Basel Accords to evaluate the amount of capital that a financial institution would be expected to set aside if it incurred a similar contingent financial obligation with respect to an uncontrolled party. The cost of capital that the financial institution must set aside for regulatory purposes could provide a measure of the internal cost that a taxpayer incurs in executing the guarantee. Calculating this amount should be fairly straightforward for most taxpayers using reasonable simplifying assumptions (and we would strongly encourage that taxpayers be allowed to use reasonable simplifying assumptions for this purpose). Assuming that the total amount at risk under a specific guarantee can be determined, the economic cost of executing and maintaining the guarantee could be estimated by reference to the company's weighted average cost of capital. This safe harbor could apply to financial and performance guarantees alike.

b. Yield-Based Approach

A safe harbor could employ some variant of the yield approach, measuring a safe harbor guarantee fee by reference to some percentage of the cost savings achieved by the relevant party (the borrower in the case of a loan guarantee) through the guarantee. While acknowledging that various factors may affect the relevant “yield” in a particular case, a simplified version of this approach could be used to construct an administrative safe harbor.

The government of New South Wales (Australia) published a paper in September 2010 that could be used as a model for a yield-based safe harbor approach. The NSW government guarantees debt issued by government businesses and charges a guarantee fee with respect to that guaranteed debt. It states that the pricing is intended to “be relatively simple to administer” and to “be transparent in its application” while also approximating an arm’s length charge “to ensure competitive neutrality between Government businesses and their private sector counterparts, with respect to the cost of debt.”

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The NSW guarantee program first requires the business to obtain a stand-alone credit rating, which takes no account of any explicit or implicit financial support from the government. The business then determines the interest savings achieved by borrowing under the guarantee versus the stand-alone cost of borrowing. The stand-alone cost of borrowing is determined by reference to a schedule prepared by the NSW Treasury Corporation (the entity that provides the guarantee) which publishes monthly average market bond rates for various credit ratings, e.g., AAA, AA, A, and BBB credit ratings. If there are no observed rates at a particular credit rating, e.g., BB, the rate is “imputed using a straight line projection from observed rates.”169 The business compares that rate to the rate at which it borrowed under the NSW government guarantee and pays the full spread or “yield” to the NSW government as a guarantee fee. Whereas the NSW government charges a fee equal to 100% of the yield, a safe harbor could settle on a different percentage if that were considered to be appropriate. As noted previously, the New Zealand IRS has chosen 50% as its presumptive split.170

We are mindful that Treasury regulations are prohibited by Section 939A(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010), from referring to or requiring reliance on “credit ratings.” Thus, any forthcoming guidance may not express a safe harbor using the same “credit rating” formula found in the NSW guarantee program. Treasury regulations may convey the same concept, however, by referring to measures of “credit quality,” “creditworthiness,” “credit standing,” or the like.171 This is simply a matter of careful drafting and should not impede Treasury’s ability to formulate appropriate guidance.

The NSW guarantee program outlined above is focused on conventional loan guarantees and measures cost savings by reference to interest savings. A yield-based approach need not be so limited and can be applied by reference to any cost savings or economic benefit achieved through a guarantee, making this approach available for financial and performance guarantees alike.

c. Risk Model Approach

A safe harbor could be based on a global risk model employing standardized pricing inputs patterned after the pricing tool used by the Export-Import Bank of the United States (“Eximbank”). Eximbank sells guarantees to U.S. lenders with respect to loans made to foreign purchasers of U.S. exports. The amount of the guarantee fee is based on geographic risk and a risk assessment of the transaction itself (using a 0 to 5 scale). Eximbank has a guarantee fee calculator on its website at http://www.exim.gov/tools/fee_calc_mt.cfm, to approximate the price of guaranteeing a transaction at various risk levels. As of June 2011, the fee to guarantee a 1-year loan with respect to a low risk transaction involving a low risk country was 48bps, the fee on a medium risk transaction involving a low risk country was 88bps, and the fee on a

169 Id. section 4.2.
170 See text accompanying note 121, supra.
medium risk transaction involving a medium risk country was 135bps. A safe harbor pricing tool of this kind would provide a sound approach for tax administration.

d.Flat Fee Approach

Flat guarantee fee pricing offers another safe harbor possibility. The FDIC’s Temporary Liquidity Guarantee Program announced in October 2008 provided a government guarantee on certain newly-issued senior unsecured debt. The fee schedule was based on the term (length to maturity) of the debt. Qualified debt with a maturity of 180 days or less was charged 50 bps; debt with a maturity of 181-364 days was charged 75 bps; and debt with a maturity of 365 days or greater was charged 100 bps. There was no price differentiation based on the credit standing of the debt issuer. A safe harbor could be crafted along similar lines (with a periodic charge for loans longer than a year), updated periodically to reflect changes in market spreads.

e.Modified Flat Fee Approach

As noted earlier in this report, a number of European and Asian governments adopted during the financial crisis a more refined version of the FDIC’s approach, combining a flat fee with a particularized credit assessment of the institution whose debt was guaranteed. The credit assessment was typically based on Credit Default Swap rates. This model offers an alternative safe harbor pricing mechanism.

In the period between October 2008 and May 2010, 17 countries offered government-sponsored guarantee programs for bond issuers. All of the programs imposed fees and most used risk-based pricing. According to a survey, “EU-agreed schemes used credit default swap (CDS) premiums as a main reference,” either with respect to the specific issuer or, if not available, with respect to issuers deemed comparable.172 In the United Kingdom, the price of a government guarantee was 50 bps plus the issuer’s median 5-year credit default swap spread. The median 5-year CDS spread was reported to be 59 bps for HSBC, 68 bps for Standard Chartered, 81 bps for Barclays, and 86 bps for Royal Bank of Scotland, producing guarantee fees for these institutions of between 109bps and 136bps.173

Commentators observe that notwithstanding the absence of information with respect to the pricing of particular guarantees, the data showed that average fees were fairly constant from country to country. “With the exception of France, where [fees] were as low as 50 basis points, average fees elsewhere were mostly close to 100 basis points, with the extremes being Germany (91) on the low side and the United Kingdom (114) on the high side.”174 They regard this outcome as “noteworthy given that pricing schemes have differed, with some of them being risk-based and others not; and even when risk-based, different risk indicators have been used.”175 These conclusions suggest

172 Levy & Schich, supra note 75, at 8.
173 See Acharya & Sundaram, supra note 76.
174 Id.
175 Id.
that a safe harbor employing a flat fee plus individualized CDS assessments may generate fair and reasonable outcomes across the board and, like the other approaches outlined above, would provide a sound approach for tax administration.

C. Conclusion Regarding Possible Safe Harbor

The foregoing are merely some of the possible ways to craft a safe harbor. Many of the approaches outlined are inspired by, or drawn from, Government examples and each strikes us as a reasonable starting point for discussion. We understand that Treasury and the Service will need to consider a multitude of issues. It is important that any safe harbor be clearly defined, easy and cost-effective to administer, and produce reasonable results in the main. It is also desirable if the approach is one that might win favor with other OECD member countries. We anticipate that any guidance issued by Treasury and the Service in this area may serve as a starting point for other countries as they develop their own guidance. A sound and administratively feasible safe harbor approach that could win adherents among other OECD member countries would be a very positive step forward.

As we said at the beginning of this report, we caution against striving to develop a perfect or even a final set of guidance. This holds true with respect to any safe harbor as well. Given the current vacuum in guidance, we think it would be better for the Government to offer a reasonably good safe harbor now, then refine it in the future with the benefit of some real world experience, than to delay such guidance for years while trying to design one “just right.”

XIII. Placement of Guidance and Coordination with Other Rules

At present the regulations under section 482 have separate sections dealing with the transfer of tangible property (section 1.482-3), the transfer of intangible property (section 1.482-4), the sharing of costs (section 1.482-7), and the rendering of services (section 1.482-9). There is also a section addressing transfer pricing issues in “specific situations” (section 1.482-2), which includes transfer pricing guidance for loans and advances and for the use of tangible property.

Guidance addressing financial and performance guarantees should be placed in section 1.482-2, as a “specific situation” alongside the guidance for loans and advances. This placement would allow guidance for guarantees to be developed on a "green field" basis, separate from the existing architecture of sections 1.482-3, -4 and -9. We think this would simplify drafting and produce better, cleaner results. These considerations no doubt account for the decision to address loans and advances in section 1.482-2; the obvious parallels between loans and guarantees recommend the same placement for guarantees.
The Service has on some occasions characterized the issuance of a guarantee as a controlled services transaction for purposes of section 482. The Service has indicated in recent years, however, that the issuance of a guarantee is not the performance of a service. In FSA 200147033 (Aug. 14, 2001), the Service advised that guarantees “are not characterized under U.S. principles as services.” Similarly, the Service argued in recent litigation that the “predominant feature” of a guarantee is not the performance of a service. This aligns with the long held views of the courts and with the views of a leading commentator who put it thusly: “The position that guarantees are services has been discredited by courts with good reason. Guarantee fees do not represent payments for services any more than payments with respect to other financial instruments constitute payment for services. A guarantor does not arrange financing for the debtor, but merely executes a financial instrument in its favor.” This view also aligns with the Service’s position in a number of rulings where it held that standby loan commitment fees – payments for the right to call on another party to make funds available in the future – are payments for the acquisition of a property right and not a payment for services. We agree with these rulings and believe their conclusion applies with equal strength to guarantee instruments given the similarity between a guarantee instrument and a standby loan commitment, both of which commit the issuer to make funds available in the future in the event of a defined contingency.

The foregoing conclusion – that a guarantee transaction is best viewed as involving the acquisition of a property right and not as the performance of a service – is strongest in cases involving a conventional guarantee or otherwise involving a written and enforceable instrument, such as a keep well, a capital maintenance agreement, and sometimes a comfort letter. The conclusion is less certain, but we think still applies, where there is a written instrument that is not enforceable. We note that in the case United States v. Stafford, 727 F.2d 1043 (11th Cir. 1984), a non-enforceable letter of intent was deemed “property” for purposes of section 721 since it created some expectation of value. We therefore urge that guarantees, like loans, be addressed as a “specific situation” under section 1.482-2 and not as a controlled services transaction under section 1.482-9.

Regardless of placement, the rules for financial and performance guarantees will need to be harmonized with the general concepts in Treasury Regulation section 1.482-1, including, for example, the guidance concerning comparability and reliability, realistic alternatives, and so on. For the sake of completeness, it may also be desirable to address the intended coordination between the section 482 regulations addressing guarantees and

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176 See supra note 5 and accompanying text.
177 See Container Corp., supra note 20, 134 T.C. at 132. The Tax Court in Container Corp. agreed that the issuance of a guarantee is not the performance of a service. 134 T.C. at 136. The court drew an analogy between the two for sourcing purposes but this analogy was legislatively overturned a few months later. See supra notes 10 and 20.
178 See, e.g., Centel Communications Co., supra note 62, 92 T.C. at 632; Bank of America, supra note 10, 680 F.2d at 150.
180 See supra note 21.
other Code provisions. We would expect, consistent with the approach taken in Treasury Regulation section 1.482-2(a)(3), the regulations would allow other Code provisions to be applied first, at which point section 482 would apply, if applicable, to evaluate the price for the controlled transaction.

Harmonizing the rules for guarantees with other provisions in the section 482 regulations should not require any particular effort. The principles applying to guarantees should align comfortably with existing guidance. Similarly, we do not see any special coordination issues with respect to other Code sections. In the case of out-bound guarantees that give rise to in-bound payments, there is the interplay between section 482 and sections 61 and 162 but this is obvious and unproblematic. In the case of in-bound guarantees giving rise to out-bound payments, the principal Code sections requiring coordination will be sections 163(j), 861, 862, and 956. Here too, we do not envision any particular coordination challenges.

XIV. Conclusion and Proposed Notice

In sum, we believe guidance from the Treasury Department on transfer pricing matters pertaining to financial and performance guarantees is very much needed. Guidance should be framed broadly. It should recognize that related party guarantees take many different forms and are put to many different uses, including some uses unrelated to obtaining a loan or securing a contract. Guidance should recognize that there are numerous paths to a reliable arm’s length price but that even the most knowledgeable and reasonable people can disagree on assessments of risk and matters of pricing. Guidance should accordingly adopt a flexible approach that focuses on the reasonableness of the taxpayer’s pricing method and the evidentiary support for the transfer price. The same standards should apply to in-bound and to out-bound guarantees. To reduce disputes, safe harbor mechanisms should be made available.

We recommend that Treasury issue guidance even if there is not agreement on how to address all of the issues. Forthcoming guidance should be viewed as a first step, not as the last word. Accordingly, we encourage the Government to issue guidance on some basic issues, perhaps in the form of a Notice, even while working on more comprehensive regulations. Possible language for such a Notice is suggested below. This Notice addresses only related party loan guarantees, not performance guarantees. Guidance on performance guarantees is also needed but, mindful of our own admonition, we do not think all guidance must be issued at the same time. We anticipate that the principles with respect to loan guarantees may meet with consensus first so we offer the text below as a first step.

Treatment of Related Party Loan Guarantees
Under Section 482

Notice 2012-

The Treasury Department and the Internal Revenue Service understand that uncertainty exists among taxpayers concerning the appropriate transfer pricing treatment
of related party loan guarantees and similar credit enhancing instruments. Although tax authorities and courts in other OECD countries have begun to address these issues, current Treasury regulations provide little guidance as to how loan guarantees should be characterized, whether they generate compensable transactions, and what methodologies should be used to determine their arm’s length price. This notice announces that the Treasury Department will issue regulations to address these issues and requests public comments with respect to them. In the meantime, this notice confirms the application of certain basic transfer pricing principles to loan guarantees and similar instruments.

**Background**

Corporations employ a variety of techniques to enhance the credit standing of their affiliates. Most common perhaps are formal guarantees, which may be styled “financial” guarantees or “performance” guarantees. Other instruments, such as keep well agreements and capital maintenance agreements, may be employed to the same end. These instruments are commonly issued by parent corporations on behalf of subsidiaries, but they may also arise in other related party contexts. The affiliate receiving the credit support may derive a variety of resulting benefits, including reduced borrowing costs, access to new commercial opportunities, improved contract terms, freedom from restrictive covenants, and the ability to borrow larger sums in markets otherwise closed to it.

Absent formal guidance as to the appropriate characterization of guarantees for tax purposes, some taxpayers took the position that guarantees are “services” that could qualify for the safe harbor of the “services cost method.” Because the out-of-pocket costs associated with issuing guarantees are usually trivial, this position suggested that an appropriate arm’s length charge for a guarantee could be essentially zero.

In T.D. 9278, Treasury stated its disagreement with a “uniform no charge rule for guarantees.” Accordingly, financial guarantees and other financial transactions are explicitly excluded from eligibility for the “services cost method” by section 1.482-9(b)(3)(ii)(H) of the regulations.

These earlier pronouncements indicate that provision of a guarantee is not uniformly non-compensable. Prior guidance has not addressed the extent to which guarantees are compensable or the methodologies that may be used to determine an appropriate arm’s length charge for various forms of credit support. Treasury announced in 2006 that it intended “to issue transfer pricing guidance regarding financial guarantees, in particular, along with other guidance concerning the treatment of global dealing operations.”

**Treatment of Related Party Credit Support Under Section 482**

Treasury and the Service continue to study the appropriate transfer pricing treatment of related party loan guarantees with a view to issuing regulations on this
subject. Public comments are welcome, especially those addressing pricing methodologies and possible use of safe harbors in this area. With a view to framing public comments and reducing taxpayer uncertainty during the interim, the Service states below its understanding of how general transfer pricing principles should apply:

1. The same principles apply to formal guarantees and to other credit-enhancing instruments, such as keep well agreements, capital maintenance agreements, and so-called “comfort letters.” The transfer pricing analysis focuses not on the title of the instrument but on its efficacy in achieving credit enhancement.

2. A transaction is compensable when one company transfers property or engages in activity that provides a direct and identifiable credit-related economic benefit to an affiliate. Under this standard, most credit-enhancing instruments will give rise to compensable transactions unless the transaction is a capital contribution or the benefit conferred on the affiliate is de minimis.

3. The arm’s length price for a guarantee or similar instrument should be determined by reference to the market price of the instrument in a transaction between uncontrolled parties. A comparable uncontrolled price will rarely exist for the provision of related party credit support. Various pricing models may generate acceptable results if they have sound theoretical and evidentiary support. Consistently with the “best method” rule, the arm’s length charge should be ascertained by whatever method yields the most reliable indication of the market price.

4. The transfer pricing analysis is complete once the arm’s length market price is determined. A parent providing credit support may ultimately profit from the subsidiary’s lower borrowing costs, or may benefit in other respects from the subsidiary’s acquisition of a guarantee. But these benefits accruing to the parent arise from the parent/subsidiary relationship and are properly ignored in the transfer pricing analysis.
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