Insights: Transfer Pricing

CRA Charles River Associates

Dealing with implicit support in relation to intra-group debt

By Paul Wilmshurst

The GE Capital case[1] shone a spotlight on whether and how “implicit support” should be allowed for in the analysis of intra-group debt. The implications continue to flow through the transfer pricing world.

Implicit support reflects the expectation that a parent company will step in to support a subsidiary in the event of financial difficulty and meet its debt obligations. Tax authorities are now allowing for implicit support in their transfer pricing policies and audits.

In one case Charles River Associates has dealt with, the tax authority asserted that a subsidiary is of such strategic importance to the group’s ultimate parent company that the subsidiary’s “stand-alone” credit rating should be adjusted upwards to the parent’s rating due to implicit support. This is despite the fact that an explicit guarantee had not been provided by the parent and despite the traditional transfer pricing assumption that estimating a stand-alone credit rating was appropriate under the arm’s length principle. The tax authority’s aim was to reduce the interest rate on the subsidiary’s intra-group debt and the interest deduction it had claimed.

The economic reality is that, in general, there is often a substantial difference between an explicit guarantee and implicit support since implicit support may be limited to the hope that the parent company will act even though it is not legally bound to do so. It is also true that there are many examples of parents walking away from subsidiaries in financial difficulty, which indicates that implicit support assumed by a subsidiary’s external creditors can, in practice, be worthless.

However, it is also clear from an examination of the rating methodologies of the major credit rating agencies—Standard & Poor’s (S&P), Moody’s, and Fitch—that they do adjust the baseline credit assessments derived using their rating methodologies for subsidiaries that issue external debt to account for implicit support, and that in some circumstances this can have a significant impact.

This article explores these concepts in greater detail and begins to outline a transfer pricing framework for dealing with implicit support.

[1] *General Electric Capital Canada, Inc. v. The Queen* (2009). The Canadian Tax Court’s 2009 opinion was sustained by the Canadian Federal Court of Appeals in December 2010.

Stand-alone credit ratings

The three major credit rating agencies assign public ratings to certain debt issuers and debt instruments, which are often the same (allowing for the different labeling of their rating scales). S&P and Moody's also supply credit rating models, which many transfer pricing practitioners use to estimate subsidiaries' stand-alone ratings for the purpose of benchmarking interest rates and setting guarantee fees. S&P's CreditModel and Moody's RiskCalc are the most commonly used and require the user to enter financial data for the borrowing party, which produces an estimated stand-alone rating for a subsidiary.

These models produce estimates of the agencies' published stand-alone ratings, as do properly specified independent models, such as those based on the Moody's published methodologies for different sectors. These models have the added advantage of allowing for specific industry-level factors and can be even more reliable.

However, without some further adjustment, stand-alone ratings models do not allow for the impact of implicit support.

OECD guidance relevant to implicit support

On the one hand, ignoring the impact of implicit support may seem appropriate if the statement of the arm's length principle in paragraph 1.6 of the OECD Guidelines is interpreted narrowly and the members of a group are treated as entirely separate entities. Indeed, to do so has been the norm in the analysis of debt for transfer pricing purposes. However, as is evident from the application of the arm's length principle in the GE Capital case, it is possible to introduce economic conditions from the parent/subsidiary relationship without violating the principle (see next section).

Moreover, paragraph 7.13 of chapter VII of the Guidelines on intra-group services, which discusses passive association between separate entities, states that:

> …no service would be received where an associated enterprise *by reason of 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... [emphasis added].

This paragraph implies that no interest charge should be made in relation to the improvement in a credit rating due to implicit support.

The GE Capital case

The GE Capital case is now quite well-known and many papers have been written about it. However, it is useful for our purposes to recap certain key aspects.

The case dealt with an explicit financial guarantee from a GE company in the US to its Canadian subsidiary, which was at the time primarily engaged in the business of commercial financing outside of the GE group, with debt that it raised on the Canadian bond market.

The Canadian tax authority disallowed the subsidiary's deduction of the guarantee fee it paid to its US parent on the basis that even without the explicit guarantee, the parent would never allow it to default on its external debt given the problems this would create for the parent. That is, the explicit guarantee had no value since the subsidiary's creditors would assume that the US parent would always step in. The tax authority considered that the likelihood of this was so great that the subsidiary should have the same credit rating as its parent (which was AAA on the S&P scale).

The parent-subsidiary relationship vs. the arm's length principle

The Court agreed with the tax authority that the economic reality of the parent-subsidiary relationship should be allowed for, but it considered that this had nothing to do with the exercise of control; rather, the relationship was shaped by the reputational pressure exerted by external debt holders on the US parent.

Indeed, the "hypothetical arm's length transaction" created to test the guarantee fee involved a hypothetical guarantor with characteristics similar to the US parent and, separately, a hypothetical debtor (i.e., the Canadian subsidiary) with another parent with similar characteristics.

That is, the question was what the arm's length pricing should be between the subsidiary and an independent guarantor, allowing for the fact that the subsidiary had a parent that provided some level of implicit support for which it should not have to pay. As such, the basis for the Court's decision was aligned with paragraph 7.13 of the Guidelines.

Impact of implicit support

Although the Court agreed with the tax authority's arm's length framework, it ruled in favour of GE Capital on the pricing. (The explicit guarantee fee was 100 basis points.) This was because the Court decided that the explicit guarantee provided an incremental benefit over and above the implicit level and that the fee charged was within a reasonable range.

The level of implicit support was assessed as being much lower than that implied by the tax authority's position (three notches above the subsidiary's stand-alone rating compared to 12 or 13 notches).

Given its conclusion on the low impact of the implicit support, the Court indicated its preference for the credit rating methodology set out by one of the expert witnesses, William John Chambers, PhD, a professor at Boston University and previously a senior figure at S&P. The methodology, which reflected elements of S&P's published guidance on implicit support, is outlined in the next section.

In summary, the Court determined that implicit support from a parent company was an economic factor that needed to be taken into account in an arm's length transfer pricing analysis and that the value implicit support provided to the subsidiary should not be charged for.

These conclusions were, of course, dependent on the specific facts and circumstances of the GE Capital case and care should be taken in extending them elsewhere. However, while some may still consider that implicit support should be ignored under the "separate entity" principle, it is hard not to conclude that the general balance of the argument has shifted firmly in favor of allowing for implicit support in transfer pricing.

Ratings agencies' approaches

This section provides a general outline of the methodologies the three main agencies apply in relation to arm's length debt issued by subsidiaries[2].

Each of the three main agencies publishes details of the methodologies they use to determine credit ratings for subsidiaries that issue debt externally. In general, these are quite similar, though they are

[2] This section is intended to provide only an overview of the relevant parts, not an exhaustive coverage, noting that the guidance is spread across a number of documents.

expressed in different terms and there are some differences in emphasis. The agencies' approaches appear to have evolved over time to some extent, and some convergence is apparent.

The methodologies are all based on a "bottom-up" approach that first determines a stand-alone credit rating for the subsidiary. They then take into account the relationship with the parent. Then, a judgment is made based on a number of factors as to what extent the parent would provide the support in the event of financial stress. In general, these factors reflect the importance of the subsidiary to the parent and the nature of the linkages between them. Once the overall balance of the factors has been assessed, the number of notches by which the stand-alone rating should be improved is determined.

S&P

S&P characterizes a subsidiary[3] on a spectrum from a non-core, non-strategic investment to a fully integrated part of the group. This, in turn, determines the range of the parent's incentive to support its subsidiary, resulting in a spectrum of implicit support from an expectation of very little or no help at one end to ratings equalisation at the other.

S&P lists the factors that it considers in this evaluation and notes that it is important to think ahead and consider how management might act in the event of a subsidiary's financial distress when assessing them. Most of these factors were listed by Dr. Chambers in his testimony, as follows:[4]

- Financial capacity for providing support
- Domicile in the same country
- Percentage ownership
- The nature of other owners
- Common source of capital
- Significance of amount of investment
- Investment relative to amount of debt
- Management control
- Management's stated posture
- The track record of the parent company in similar circumstances
- Strategic importance
- Shared name
- The nature of potential risks

Financial capacity for providing support indicates the parent's ability to bail out the subsidiary, including as reflected in the parent's own credit rating.

Some of the factors can be determined relatively easily, including domicile, ownership, source of capital, and the (relative) size of the parent's investment. Also, the level of parental management control of the subsidiary, the management's stated posture and its track record of supporting subsidiaries in financial difficulty can be determined based on historic behavior.

[3] See in particular the *Parent/Subsidiary Links* section in the 2006 edition of S&P's *Corporate Ratings Criteria*.
[4] The list that appears in the ruling is reordered here.

However, overall, S&P considers that the parent's economic incentive is the most important general factor. Strategic importance, a shared name, and the significance of the parent's investment stand out in this regard. Assessing strategic importance and potential reputational issues from allowing a subsidiary to fail is mainly a subjective process. Appropriately allowing for the potential risks to the parent and the nature of any minority owners can also be challenging.

Interestingly, S&P notes that 100% ownership does not automatically mean that the level of assessed implicit support is very high and that in general it considers that a foreign parent is less likely to step in than a domestic one.

It also notes that the wider the ratings "gap" to be bridged (i.e., between the parent's rating and the stand-alone rating), the more evidence of support is required to justify a significant uplift.

Moody's

A Moody's document from December 2003[5] appears to remain its latest primary guidance for assessing the impact of implicit support on a subsidiary's stand-alone rating, at least in the non-banking private sector.

This sets out two general criteria:

- The *ability* of the parent to support the subsidiary, including allowing for the parent's own rating and also any correlation of business risks between the parent and the subsidiary, noting that for example, the parent may be suffering from the same adverse economic issues as the subsidiary at the time that it needs support.
- The *willingness* of a parent to support the subsidiary, which incorporates considerations of reputation, strategy and operational integration, similar to S&P.

The 2003 guidance expresses Moody's general view at the time that, following a series of high-profile subsidiary defaults, subsidiaries' adjusted ratings should be based on their stand-alone ratings if they are financially weak, risky, and short-lived businesses. Even if they are well-established and essential to the parent, they may still only be uplifted by one or two notches. However, examples are also given of subsidiaries that are financially, strategically, and operationally intertwined with strong parents, which can lead to it being notched considerably higher than its stand-alone rating.

Interestingly, in 2005 Moody's published details of a "joint-default analysis" methodology that introduced a more quantitative framework for assessing the probability of the parent stepping in. The purpose was to address some conservatism in the ratings produced under the earlier approach and to make the degree of implicit support in a rating more transparent. To date, the methodology seems only to be applied to banks and public bodies.

Fitch

Fitch's methodology, as set out in its August 2011 guidance[6], also involves determining the strength of the parent-subsidiary relationship by assessing any legal, operational, and strategic "ties." The guidance provides a comprehensive overview of Fitch's approach, including some practical examples of how these ties are assessed.

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5 *Rating Non-Guaranteed Subsidiaries: Credit Considerations in Assigning Subsidiary Ratings in the Absence of Legally Binding Parent Support.*

6 *Parent and Subsidiary Rating Linkage—Fitch's Approach to Rating Entities Within a Corporate Group Structure*.

The operational ties cover management control, centralised treasury (that can indicate a strong linkage), and operational overlap. The strategic ties cover strategic importance and tangible support that has been demonstrated by the parent.

The guidance also contains general criteria as to how the factor assessment is translated into a final rating. If the balance of the assessment indicates a strong linkage with a (relatively strong) parent, their ratings are likely to be close. In general, this would require that the subsidiary was:

- Operationally integral to the core business of the parent
- Strategically important to the future direction of the group's operations
- Potentially able to provide long-term fiscal benefits or market access that the parent could not otherwise achieve
- A significant investment relative to the scale of the group

There might also need to be evidence of tangible financial support from the parent and, ideally, a publicly declared or agency-notified group strategy regarding the parent's treatment of its subsidiary.

If only some of these criteria are met, the subsidiary would be rated lower, and if Fitch deemed only a weak linkage, the subsidiary would be rated at its stand-alone level.

A methodology for transfer pricing

The agencies' methodologies represent general guidance and their rating committees are the final arbiters of the degree of implicit support in each case.

The assessment of some of the key factors is inherently subjective—for example, in relation to a subsidiary's strategic importance—and is likely to vary over time with the economic cycle and as the general view of the reliability of implicit support changes. This can be allowed for by looking at how the agencies have applied their methodologies in practice to determine recently published ratings for specific subsidiaries.

It is also noted that the ratings agencies publish details of the methodologies they apply to rate government-owned entities, which offer a further analytical means for translating factor assessments into specific notching adjustments.

Overall, based on the research we have completed when analysing implicit support for our clients, it is clear that there is much relevant material in the public domain. It is also clear that the general guidance can be reduced to a relatively straightforward framework given, in particular, the commonalities in the methodologies and the fact that they are tackling the same underlying economic issues. This has enabled the development of a robust methodology that can help transfer pricing and tax professionals develop a reliable assessment of the more subjective factors and clearly articulate the rationale for their evaluation in specific cases.

Key points and conclusions

- Implicit support reflects the expectation that a parent company will step in to support a subsidiary and meet its debt obligations in the event of financial difficulty.
- The traditional approach in transfer pricing has been to price intra-group interest rates and guarantee fees based on a subsidiary's stand-alone credit rating, ignoring the potential impact of implicit support.

- Under paragraph 7.13 of the OECD Guidelines, which is reflected in the GE Capital ruling, implicit support that arises from a subsidiary's passive association with the rest of its group should not be charged for. Also, although implicit support is an economic condition of the parent-subsidiary relationship, it is possible to allow for it without violating the arm's length principle. Hence, there is a heightened need to allow for implicit support in the transfer pricing analysis of intra-group debt.
- There is often a substantial difference in the impact of implicit support compared to an explicit guarantee (e.g., a small number of notches compared to ratings equalization). However, as is clear from the main credit rating agencies' methodologies, implicit support can have a significant effect.
- Even if the adjustment is limited to an uplift in a subsidiary's stand-alone rating of only a few notches, this can still make a significant difference to a supportable interest rate, e.g., if it moves the subsidiary from speculative grade to investment grade.
- The issue of implicit support presents risks and/or transfer pricing opportunities for groups, depending on their circumstances. Groups should be aware of possible challenges to past years' interest charges and guarantee fees that were determined based on a stand-alone approach. They should also consider the need to allow for implicit support when they set prices.

Based on the main credit rating agencies methodologies in this area, we have developed a robust framework to help transfer pricing and tax professionals analyse and evaluate implicit support. The extent of the analysis required would normally depend on a risk assessment of the relevant transactions. The transfer pricing framework we have developed can be scaled to fit different circumstances.

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