At A Glance

Transfer Pricing Solutions for Intercompany Guarantees

Overview

In the wake of the ongoing financial and economic crisis, the pricing of intercompany guarantees is likely to become one of the most contentious issues in transfer pricing. Tax authorities for their part will be concerned that guarantee fees adequately reflect the heightened risk of business failure and default. Taxpayers, meanwhile, will face the arduous challenge of determining what constitutes an arm's length guarantee fee at a time when rules of thumb and quick answers based on historical data have become less reliable.

NERA's approach to helping clients overcome this challenge is founded upon the combined expertise and knowledge of specialists in our Transfer Pricing and Securities and Finance Practices. Through formal analysis of the underlying financial economics and application of sophisticated and rigorous pricing techniques, NERA's economists are able to develop robust solutions in a wide range of circumstances.

NERA's Capabilities

By drawing on expertise in both our Transfer Pricing and Securities and Finance Practices, NERA is uniquely positioned to assist in-house practitioners and tax advisors manage risk and deliver value on issues related to guarantee fees.

Pricing of Intercompany Guarantees

Credit ratings lie at the heart of determining arm's length fees for guarantees. NERA's expertise in calculating shadow credit ratings, or confirming actual ratings where they already exist, has been developed through its work on assignments relating to both intercompany loans and guarantees. This work has ranged from documentation studies to multibillion dollar tax litigation.

Given the sums typically involved and the complexity of the issues faced, it is important to consider multiple approaches in pricing intercompany guarantees. NERA's capabilities span a range of potential analytical methods.

- Capital infusion method—determining the capital infusion needed to bring a company's credit rating into line with the guarantor's, and then calculating the cost of capital associated with this infusion.

- Expected loss method—calculating the value of a guarantee by multiplying the nominal amount guaranteed by the probability of default and making adjustments to account for the expected rate of recovery. There are a variety of methods that can be used to determine the premium that should be applied to this figure to compensate the guarantor for its cost of capital and risk, including the Capital Asset Pricing Model (CAPM).

- Credit default swap (CDS) benchmarking—establishing an arm's length range for a guarantee fee by reference to available market data on CDSs, making adjustments as necessary to reflect economic conditions and the scope, terms, and conditions of the specific nature of the guarantee provided.

- Counterfactual debt pricing—determination of the interest rates or bond premia related parties would be charged in the absence of a parental guarantee, as well as conducting profit split analyses to determine what proportion of interest savings should be paid to the guarantor as a fee.

Client Experience

Financial Sector Tax Litigation

NERA has been retained in several large financial sector tax litigation cases to provide independent economic analysis and valuation of corporate guarantees provided as part of larger complex cross-border financing structures. These cases involved guarantees provided by parent organizations to special purpose subsidiary vehicles. The transactions involved multiple components, which meant that the most appropriate valuation methodology and parameters had to be determined separately in each case. To support the valuations and provide robust and defendable estimates of arm's length remuneration, NERA performed detailed reviews and analyses of the transactions and the related parties involved, including analysis of credit ratings and net risk exposure.

Oil & Petroleum Trading Company

In response to a tax audit, NERA was retained by a UK-based oil and petroleum trading company to price a guarantee received from its parent company. The guarantee applied to lines of credit provided by banks that fund the UK entity's paper and physical trading activities.

The former relate to physical trading in petroleum and crude oil, while the latter involves exchange and derivatives trading. In respect to physical trading, the analysis was based on the determination of a shadow credit rating for the UK entity. The expected loss approach was used as the primary method, with CDS benchmarking used to substantiate the results. For the company's paper trading activities, the CAPM and data on returns earned by hedge funds were used to quantify the residual risk attributable to the UK entity's paper trading activities. This residual risk was then applied to nominal amounts guaranteed. The overall value of the guarantee was then expressed as a percentage of the total nominal amount guaranteed by the parent company.

Power Procurement Business

NERA was engaged by a power procurement business to prepare submissions to a regulator in response to price control proposals. The main purpose of the engagement was to estimate the market value of an implicit parent company guarantee that counterparties of the client enjoyed, but for which the parent company was not being remunerated. Using electricity market models, NERA first estimated the stream of uncovered cash flows, which constituted the magnitude of the potential losses to the parent company in the event of default by the power procurement business. An arm's length guarantee fee was then calculated using the expected loss approach, taking into account probabilities of default.

Tax Litigation

Leveraged leasing has been a popular method of financing fixed assets for many years. In recent years, some forms of leveraged leases have been challenged by tax authorities. NERA experts have analysed and provided both written and oral testimony on the economic substance of the transactions, the risks involved, and the economic benefits to each of the parties to the transactions.

About NERA

NERA Economic Consulting (**www.nera.com**) is a global firm of experts dedicated to applying economic, finance, and quantitative principles to complex business and legal challenges. For over half a century, NERA's economists have been creating strategies, studies, reports, expert testimony, and policy recommendations for government authorities and the world's leading law firms and corporations. With its main office in New York City, NERA serves clients from more than 25 offices across North America, Europe, and Asia Pacific.

Contact

For more information or to contact our experts, please visit **www.nera.com/tp-intercompanyguarantees**.