IRS issues long-awaited guidance on implicit support recognition for intercompany loan transactions

January 19, 2024

In brief

What happened?

The IRS Office of Chief Counsel on December 29, 2023 issued long-awaited guidance on the effects of group membership on financial transactions under Section 482. The guidance was issued in the form of a generic legal advice memorandum (GLAM), AM 2023-008, titled "Effect of Group Membership on Financial Transactions under Section 482 and Treas. Reg. § 1.482-2(a)." The GLAM examines the application of the 482 regulations applicable to intercompany loans and other areas of the 482 regulations, including realistic alternatives and passive association, in the context of intercompany lending. Applying these principles, the GLAM concludes that the IRS may consider group membership in determining the arm's length rate of interest for intercompany loans based on implicit financial support expected from another group member.

Why is it relevant?

The memorandum provides insight on the IRS position in an area where the 482 regulations do not provide specific guidance regarding whether or how group membership should be considered for the purpose of evaluating intra-group loans from an arm's-length perspective. It also points to the expected IRS position in future controversy and audits when there is a possible argument that a group member could benefit from implicit financial support from another group member in a related-party transaction, even if no financial guarantees or other formal support are explicitly delineated in intercompany agreements. While the non-taxpayer-specific legal advice provided in the GLAM provides helpful insight on the IRS position in certain circumstances, the GLAM should not be used or cited as precedent.

Action to consider:

Companies will need to evaluate their transfer pricing policies associated with their intercompany borrowing structures, particularly where affiliates of a corporate group are lending to a core entity in the group organization. While the GLAM reflects that the IRS has doubts regarding the appropriateness of a standalone credit rating for a related-party borrower, a facts and circumstances analysis is still warranted to determine whether the borrower operates businesses or owns assets that are essential to the group's financial performance such that implicit support would be taken into account by a third-party lender.

In detail

Background

The GLAM provides an example of a US Subsidiary (USSub) planning to obtain capital through an intragroup loan from its Foreign Parent (FP). According to the GLAM, the IRS may adjust the interest rate of FP's loan to USSub to the arm's-length interest rate USSub would pay to an unrelated lender based on its credit rating. In this instance, the GLAM concludes that an unrelated lender would, in assigning a credit rating, recognize USSub's "implicit support" from its corporate group. Thus, an arm's-length rate of interest would take into account an [upward] credit rating adjustment for "implicit support." The GLAM defines "implicit support" as the anticipated financial support that another group member would be expected to provide to the borrower group member if that borrower were in financial distress even in the absence of any explicit guarantee or other formal obligation to do so.

GLAM analysis and impact on intercompany loan transactions

Section 482 intercompany loan regulations

In the intragroup lending context, the Section 482 regulations apply the arm's-length standard by directing that the rate of interest be an arm's-length rate, which generally is the rate that would be charged in independent transactions between unrelated parties. The applicable 482 regulations are mainly contained in Reg. 1.482-2(a)(2), which provides for consideration of "all relevant factors" in determining an arm's-length rate of interest." The regulation then gives an illustrative list of these factors, which includes "the credit standing of the borrower."

Observation: The regulations as written are silent on implicit support or the consideration of group affiliations in evaluating the credit standing of the borrower for arm's-length purposes, yet the allowance of "all relevant factors" does not exclude any factor simply because it is not explicitly listed. The IRS has approached this gap in the regulations by arguing for adjusting arm's-length interest rates based on implicit financial support from other group members. The last version of the IRS priority guidance plan, issued in September 2023, directs a guidance process that includes "[r]egulations under §482 clarifying the effects of group membership (e.g., passive association) in determining arm's-length pricing, including specifically with respect to financial transactions." It is unclear whether the GLAM, which has less legal import than a Treasury regulation, is the final guidance on this issue. Companies that do not follow this position could expect that this issue could be raised on audit, but the GLAM would not be precedential.

In analyzing the meaning of Reg. 1.482-2, the GLAM concludes that an uncontrolled commercial lender would charge interest based on the borrower's credit rating and all factors that influence that rating, including the level of integration within the group and any implicit support from affiliates. The GLAM rationalizes this approach by explaining that in a third-party context, commercial lenders analyze borrowers' financial standing and business prospects to evaluate the risk involved in extending credit. This process utilizes a credit rating system to categorize entities according to their credit risk. When rating an entity that is a member of a corporate group, a rating agency may separately assess both the entity's creditworthiness as an independent entity (a 'standalone' credit rating) and the corporate group's creditworthiness.

Borrowing a framework published by credit rating agencies, the GLAM takes the position that in an arm's-length analysis under the Section 482 regulations in an intercompany lending transaction, any implicit financial support a borrower receives from a group member should be taken into account to determine the credit rating, and ultimately the applicable interest rate, charged by the related-party lender in the transaction. This is based on the assumption that an uncontrolled lender would, in analyzing creditworthiness, view the borrower from the lens of the group credit profile rather than a standalone basis. Operating on this assumption, the GLAM asserts that in an arm's-length loan transaction with a controlled member of a group, an unrelated lender would take into account any implicit financial support that the borrower would receive from other group members. Accordingly, the IRS may adjust the interest rate to account for the creditworthiness based on implicit support in this situation.

Observation: The GLAM notes that this outcome is consistent with the OECD Transfer Pricing Guidelines. In 2020, the OECD issued Chapter X of the Transfer Pricing Guidelines addressing financial transactions. While this is the case at a high level, the Chapter X guidelines emphasize the facts-and-circumstances nature of this analysis, including looking at the relative status of an entity within the group, the importance of the entity to the MNE group as a whole, and the linkages between the entity and the rest of the MNE group. In this regard, the guidelines suggest that a borrower group member "with stronger links, that is integral to the group's identity or important to its future strategy, typically operating in the group's core business, would ordinarily be more likely to be supported by other MNE group members and consequently have a credit rating more closely linked to that of the MNE group." In cases involving foreign competent authorities in jurisdictions that do follow the OECD guidelines, "implicit support" positions still could have many circumstantial considerations. The example in the GLAM notes that the subsidiary is "essential to the group's financial performance," but the GLAM does not elaborate if this is a controlling factor.

Realistic alternatives principle under Section 482 and regulations

The GLAM also supports its conclusion with the "realistic alternatives principle," which has existed in the transfer pricing regulations since the 1990s but was codified in Section 482 in reference to the valuation of transfers of intangible property by the 2017 tax reform act. This principle recognizes that an uncontrolled taxpayer would not engage in a transaction on certain terms if doing so would leave them worse off than they would be under a realistically available alternative course of action. In the context of intercompany lending, the GLAM asserts that the arm's-length rate of interest a controlled borrower would accept is generally the rate at which that borrower realistically could obtain alternative financing from a third party. Using this logic, the GLAM concludes that since a borrower realistically could obtain a reduced rate of interest from a third-party lender based on the assumption that the unrelated lender would consider the borrower's group membership, then it would reject a loan with the same terms at a higher interest rate from a related-party lender.

Observation: The GLAM, in making the above conclusion on realistic alternatives, does so regardless of its acknowledgement that from a related-party lender standpoint, the lender would not benefit from its own financial support, especially if it is the same group member that is responsible for any financial support expected from the borrower. For purposes of its Section 482 analysis, the GLAM asserts that the ownership relationship between the controlled lender and controlled borrower must be disregarded, despite the fact that the crux of the implicit support argument is that such a relationship should be regarded when determining the interest rate vis-à-vis a hypothetical third-party lender.

Finally, the GLAM addresses the passive association rules in the 482 services regulations, which state that no compensation is owed for any benefit that arises solely from an entity's status as a member in a controlled group. According to the GLAM, this regulation supports the fact that the borrower does not owe any compensation for the benefit it receives from being part of the group. The GLAM argues that the borrower should be able to retain the benefit of a reduced interest rate, as it reflects a benefit to the borrower solely because they are a member of the controlled group, rather than having to transfer it to another group member.

Based on the foregoing principles, the GLAM concludes in the context of the given fact pattern that the arm's-length interest rate charged by the foreign parent to its USSub would reflect a credit rating that takes into account the implicit financial support that the USSub receives from the foreign parent, and possibly other group members.

Observation: The GLAM also provides that this analysis applies not just in a parent-subsidiary relationship context, but can apply in the context of loans between controlled parties with other relations, such as sister affiliates. Thus, companies should expect the IRS to raise questions regarding arm's-length interest rates determined based on the standalone credit rating of a borrower in a controlled group.

Let's talk

For a deeper discussion of how IRS GLAM 2023-008 might affect your business, please contact:

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