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Advice memorandum shows IRS approach to intercompany debt pricing

Mark Martin and Thomas Bettge of KPMG in the US discuss the issue of implicit support and a recent IRS advice memorandum addressing transfer pricing for intercompany debt

The US transfer pricing regulation addressing financial transactions, Treasury Regulation § 1.482-2(a), was promulgated in 1994, and has not substantively evolved since that time. In the intervening decades, the OECD has developed and promulgated transfer pricing guidance for financial transactions: a discussion draft in 2018, final guidance in 2020, and corresponding updates in the 2022 version of the OECD Transfer Pricing Guidelines for Multinationals and Tax Administrations (the Guidelines).

US law does not incorporate the Guidelines, although since at least 2007, the Internal Revenue Service (IRS) has taken the position that the Guidelines are consistent with the applicable US Treasury regulations. Since then, IRS examiners have been known to look to more recent concepts from the Guidelines in some cases, including intangible property cases as well as financial transactions.

Divergences from the OECD's transfer pricing guidance on financial transactions

Notwithstanding general pronouncements of consistency, in the financial transactions space the recent OECD guidance differs markedly from the 1994 Treasury regulations. Specifically, the OECD guidance addresses a number of transactions – financial guarantees, cash pooling, and captive insurance, to name a few – that the Treasury regulations do not.

That does not mean that those transactions are not cognizable under Section 482; rather, the regulations address such transactions under general transfer pricing principles and with less detail than the OECD guidance. The OECD guidance also goes beyond Section 482 in addressing debt-equity characterisation issues.

Another significant area of apparent difference is the relevance of the controlled status of the borrower for determining an arm's-length interest charge in the case of an intercompany loan. The OECD guidance endorses the concept of 'implicit support' – the notion that, at arm's length, a third-party lender would in some cases extend a more favourable interest rate than the borrower's standalone credit rating would merit, on the assumption that the borrower's affiliated group could come to its aid to prevent a potential default.

IRS memorandum addresses implicit support

Taking implicit support into account could (but would not necessarily) result in the borrower having a deemed credit rating somewhere between the rating it would have as a standalone entity and the credit rating of its group parent. However, in some cases, IRS exam teams have taken a less nuanced approach, invoking implicit support to equalise the borrower's credit rating with that of the parent.

IRS exam teams are known to assert implicit support-based arguments, and in late December 2023, the IRS published an advice memorandum that interprets existing law – even in the absence of the planned regulatory update – as requiring consideration of implicit support when pricing intercompany loans. Notably, the phrase 'implicit support' is nowhere to be found in Treasury Regulation § 1.482-2(a), and for a number of years the IRS and Treasury's priority guidance plan has acknowledged a desire to address this through "[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."

In the meantime, the failure of the Section 482 regulations to address implicit support head on has not hamstrung the IRS, at least at the examination level, and the recent advice memorandum illustrates the IRS's position under the current version of the regulations.

The memorandum's analysis is grounded in the realistic alternatives principle: if a third-party lender would charge a lower rate of interest due to implicit support, the IRS reasons, then a borrower acting at arm's length would not agree to pay a related party a higher rate of interest. Moreover, according to the IRS guidance, the related-party lender would not be entitled to any compensation as a result of such implicit support, as the IRS views such support as a passive association benefit unless there is a guarantee or other legally binding credit support provided to the related-party borrower.

However, the memorandum does not grapple with the issue of when third-party support would realistically be available for an unsecured loan. Showing this would presumably require an IRS exam team to identify actual third-party transactions in which a lender under similar circumstances provided preferential financing to a subsidiary without any security and without an explicit guarantee from an affiliate.

Final thoughts on the advice memorandum

The advice memorandum does not change the state of the law; it merely offers the IRS's interpretation of its own regulations, and that interpretation, quite naturally, supports the positions taken by IRS exam teams. The IRS's interpretation is by no means sacrosanct, and implicit support issues are being litigated before the Tax Court, so a more definitive treatment of the issue will likely be available in the coming years with such court decisions and potentially regulatory guidance.

In the meantime, the memorandum confirms what recent examination experience has shown: the IRS is committed to pricing for implicit support even in the absence of an updated regulation. More concerningly, the memorandum – which does not address many of the nuances that arise in this area – may embolden IRS examiners to make adjustments that are not warranted by the facts of a case.

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