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Intra-group financing

The influence of the parent-subsidiary relationship in the pricing of intra-group loans.

Master thesis in Tax Law (Transfer Pricing)

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Title:	**Intra-group financing- The Influence of the Parent-Subsidiary relationship in the pricing of Intra-group loans**
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Abstract

This master thesis examines the issues surrounding the pricing of intra-group loans. The main focus of the thesis is the process of establishing an interest rate and the assessment of the credit risk in an intra-group context. In order to expose the common problems associated with the pricing of intra-group loans the thesis has examined case law from two different jurisdictions, Canada and Sweden, which have been put in relation to the OECD guidelines and Swedish national legislation. The purpose of the master thesis has been to determine whether the establishing of an interest rate and the assessment of the credit risk of an intra-group loan should be made taking into account the parent-subsidiary affiliation or relationship and whether or not this is a deviation of the arm's length principle.

A general assumption is that, if a transaction is carried out between related parties, the price could be different from a price deriving from negotiations between two unrelated parties on the open market, due to their commercial or financial relations. A common feature in case law, regarding the establishing of an appropriate interest rate on intra-group loan, has been whether or not the parent-subsidiary should be included in the assessment of the credit risk.

Much of the support available to taxpayers in resolving transfer pricing issues are relating to goods and services and not financing transactions. The main reason is the unique economic profile of financial transactions. Financial transactions are affected by different factors why it is difficult to develop usable transfer pricing policies. Establishing economically justifiable transfer pricing policies while attempting to properly reflect taxable income and prevent penalties from international tax authorities, has resulted in transfer pricing challenges that are unique to intra-group financing.

According to Swedish law, interest is regarded as a deductable cost within corporate tax. However, in recent cases, the Swedish tax authorities have been questioning, the deduction right as well as the level of interest on intra-group loans. As of today, there are few national and international guidelines on this area thus it is of interest to examine and address the issues surrounding intra –group loans.

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Abbreviations

CRA	-	Canada Revenue Agency
CUP	-	Comparable Uncontrolled Price
INC.	-	Incorporation
ITA	-	Income Tax Act
MNE	-	Multinational Enterprise
OECD	-	The Organization for Economical Co-operation and Development
SEK	-	Svenska Kronor
SKV	-	Skatteverket
STIBOR	-	Stockholm Interbank Offered Rate
TP	-	Transfer Pricing
U.S.A.	-	United Stated of America
USD	-	US dollar

1 Background

1.1 Introduction

The following chapter briefly describes the background of transfer pricing and introduces the purpose and approach of the master thesis. Applied methods are described and the section on delimitation includes the purpose of the chosen sources of fact.

1.2 Background

In cross border transactions carried out between multinational associated enterprises (MNE's), the agreed price of a service, loan, good or any tangible or intangible asset is a transfer price.[1] A general assumption is that in the event a transaction is carried out between related parties, the price could be different from a price deriving from negotiations between two unrelated parties on the open market, due to their commercial or financial relations. A price negotiated by two unrelated parties, where both parties seek to maximize their profit is referred to as an arm's length price and is the commonly used global principle applied in order to regulate an appropriate transfer price.[2] The arm's length principle is expressed in article 9 of the model tax convention by the OECD (The Organization for Economical Co-operation and Development).

In order to test or obtain the correct price on a transaction there are different transfers pricing methods to be applied on the transactions performed. The methods are set out in the OECD TP guidelines.[3] Each method is based on certain conditions why they should only be applied in certain situations. Intra-group trade in services is an increasing cross-border activity due to firms expanding globally into new markets.[4] The financing of global expansion requires transfer of capital. The most common form of financing that gives rise to transfer pricing issues is loan finance.[5] One of the specific issues is the establishing of an appropriate interest rate on loans between associated enterprises.

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[1] Green, Gareth, *Transfer Pricing Manual,* BNA International Inc., London 2008, p. 5.

[2] Adams, Chris, Coombes, Richard. ,*Global Transfer Pricing- Principles and Practice*, Tottel Publishing Inc., Haywards Heath 2003, p. 3.

[3] (2010) OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Chapter II-III.

[4] Green, Gareth, *Transfer Pricing Manual*, p. 201.

[5] Adams, Chris, Coombes, Richard. , *Global Transfer Pricing- Principles and Practice*, p. 49.

When determining an appropriate interest rate, in compliance with the arm's length principle, the most reliable method, when applicable, in principle may be the comparable uncontrolled price method (CUP).[6] The method compares the price of a service or good in a controlled transaction with the price of the same service or good in an uncontrolled transaction.[7] Financial transactions, where a lending arrangement is included, are the most likely type of intra-group transactions where reliable comparable CUP transactions can be found.[8] In the context of a loan transaction between associated enterprises the method compares the intra-group interest rate to interest rates paid between unrelated parties with similar terms and conditions. There are two types of CUP analyses that are potentially applicable when determining an arm's length interest rate for a loan. When a comparison is made between the borrower of an intra-group and an unrelated third-party lender, this analysis is referred to an internal CUP. The comparison of loans between unrelated third parties is called an external CUP.[9]

Generally, the arm's length price of an intra-group services or goods is determined by looking at risks, assets and functions and the applying of an appropriate transfer pricing method.[10] However, when it comes to applying and developing pricing methods for intra-group financing, the task becomes more complex. The main reason is the unique economic profile of financial transactions. The transactions are affected by different economical factors why it is difficult to develop usable transfer pricing policies. Establishing economically justifiable transfer pricing policies while attempting to properly reflect taxable income and prevent penalties from international tax authorities, has resulted in transfer pricing challenges unique to intra-group financing.[11] An important element of intra-group financing, that is particularly complex is the pricing of intra-group loans. An interest rate at an arm's lengths price is determined by a number of elements

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[6] (2010) OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Chapter II, Para. 2.3 And 2.14.

[7] (2010) OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Chapter II, Para. 2.13.

[8] Dujsic, Muris, Billings, Matthew, "Establishing Interest Rates in an Intercompany Context", International Transfer pricing Journal, Issue 6, November/December, 2004, p. 252.

[9] Adams, Chris, Peter, Graham, *Transfer Pricing: A UK Perspective*, p. 12.

[10] (2010) OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Chapter I Sec. D.

[11] Green, Gareth, *Transfer Pricing Manual*, p. 201.

where one is the credit rating of the borrower. A very much debated issue that appears to be a common feature in case law is whether or not the parent-subsidiary should be included in the assessment of the credit risk.

According to Swedish regulation, interest is regarded as a deductable cost within corporate tax. However, in recent cases, the Swedish tax authorities (SKV) have been questioning, the deduction right as well as the level of interest on intra-group loans.[12] As of today, there are few national and international guidelines on this area thus it is of interest to examine and address the issues surrounding intra –group loans.

1.3 Purpose and approach

The purpose of this mater thesis is to examine the issues surrounding the pricing of intra-group loans. The main focus will be placed on the establishment of an interest rate and the assessment of the credit risk in an intra-group context. In order to expose the common problems associated with the pricing of intra-group loans the thesis will examine case law from two different jurisdictions. Swedish and Canadian case law will be put in relation to the OECD guidelines and Swedish national legislation. The results of the examination will be used in order to: i) determine whether the establishing of an interest rate and the assessment of the credit risk of an intra-group loan should be made taking into account the parent-subsidiary affiliation or relationship and ii) whether or not this is a deviation of the arm's length principle.

1.4 Method

The combination of different methods is used in this master thesis – the eclectic method, the traditional legal method, and elements of the comparative method. The eclectic method has been applied as a working method throughout the writing process. The eclectic method implies that arguments are chosen according to their relevance for the specific case.[13] The traditional legal method has been applied to a large extent when examining and rendering the relevant legal material surrounding intra- group financing.[14]

[12] See RÅ 2010 ref 67, Mål nr 2938-2943-05, Administrative Court of Appeal, Jönköping, judgment delivered 2007-02-15

[13] Lehrberg, Bert, *Praktisk Juridisk Metod,* 6th Ed., Institutet för Bank- och Affärsjuridik, Tallin 2010, p. 145.

[14] Zweigert, Konrad, Kötz, Hein, *Introduction to comparative law*, Oxford University Press, Oxford and NewYork 1998, pp. 35-36.

Regarding the TP guidelines, an analogical application of the traditional legal method was necessary as the TP Guidelines have not been implemented into national law of the member states and therefore have no legal value. Hence, the guidelines are not legally binding in Sweden. However, the TP guidelines have been given great importance and guidance when resolving disputes revolving the transfer pricing area.[15] An analogical approach was required as the master thesis first and foremost is written from a Swedish perspective but with an international approach. Since both Sweden and Canada are members of the OECD and both have endorsed the TP guidelines, the TP guidelines have been used when explaining the fundamental principles of transfer pricing and when analyzing relevant case law. In Canadian law Sec.247 of the Income Tax Act contains the transfer pricing provisions.[16]

The comparative method has been applied to some extent as case law from another jurisdiction has been included in order to examine whether there are similarities to how the Supreme Courts of Sweden and Canada have chosen to interpret the TP guidelines and their respective view of the impact of the parent-subsidiary affiliation. The choice of jurisdiction, Canada is solely based on relevant case law deriving from that jurisdiction and has not been chosen on the basis of its legal system. The case law from Sweden and Canada have been chosen as they all examine the issues regarding the parent-subsidiary regarding transfer pricing of financial transactions and are representative within the field. The GE Capital case from Canada and the Diligentia case from Sweden have been put in focus, as they are both Supreme Administrative Court rulings and have a higher legal value. Even though the two major cases, GE Capital and Diligentia, concern intra-group financing, it is only GE Capital case that is a proper transfer pricing ruling. The Diligentia case examines the same issues but does not regard a cross-border transaction. However, the TP guidelines have been used as guidance in the ruling of the Swedish Supreme Administrative Court.

[15] RÅ 1991 ref 107.

[16] Ponniah, Aurobindo, Glaize, Antoine, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010 and Transfer Pricing Features of Selected Countries 2010,* IBFD, Amsterdam, p. 423.

1.5 Delimitations

The master thesis lies within the field of transfer pricing but is solely focusing on intra-group loans within intra-group financing, and the issues related to the parent-subsidiary affiliation. The master thesis will introduce intra-group financing in general, and is limited to only provide the necessary information needed in order to comprehend the chosen subject its surrounding issues. In the general description, information on the thin capitalization rules has been provided as the rules have been implemented in many countries. The purpose of the rules is to avoid companies transferring capital in the disguised form of interest payments to other jurisdictions in order to avoid taxation. Sweden does not have any thin capitalization rules why there is no limit to how much interest that can be deducted by a borrowing company. Furthermore, general information on credit rating is included as it is discussed in case law and constitutes a part of the pricing process. Some general information on the area of transfer pricing is provided and the purpose of the background information is to extend the reader's comprehension of the case law and analysis.

Since the thesis has been limited to examine the major problems in the pricing process, no information has been provided regarding the transfer pricing methods set out in the TP guidelines. The pricing of loans is quite complex and is usually in need of complementary methods. Even if the CUP method is reliable under the right conditions and circumstances it requires a relatively high comparability between the intra-group loan and the loan of the unrelated parties.[17] Interest rates on loans are affected by credit worthiness of the borrower, the collateral, terms, conditions and currency. The credit worthiness of the borrower has sometimes been referred to as the most difficult criteria to determine, yet the most important one.[18] It is therefore of interest to study the elements determining the interest rate of intra group loans, and especially the issues surrounding the credit rating. Hence, there will not be any further information in the master thesis concerning the CUP method and its applicability, nor will there be any chapters describing the other transfer pricing methods. The master thesis is restricted to merely debating the process of determining the interest rate of intra-group loans and how different jurisdictions have undertaken the assignment.

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[17] Dujsic, Muris, Billings, Matthew, "Establishing Interest Rates in an Intercompany Context", p. 252.

[18] Id.

The master thesis is written from a Swedish perspective why two of the three cases are Swedish. The relevant Swedish case law, the Diligentia case and the Fiskeby Holdings case, has been chosen as it revolves around the pricing of intra-group loans and examine the issue of the parent-subsidiary affiliation. The thesis does not describe the Canadian national rules on transfer pricing. It has not been necessary since the Canadian case law refers to the TP guidelines which are described more closely in the thesis.

The publications of the Swedish tax authorities does not have a high legal value, but their guidance on international taxation has been used as it gives a valuable overview of transfer pricing from a Swedish perspective and the general legal situation regarding the pricing of loans. The main part of the information has been collected from foreign sources. There is hardly any literature discussing the issues surrounding the pricing of intra-group loans as a great deal of the information has been found in academic articles by professionals and in case law. The few sources of literature that do discuss the pricing of intra-group loans are very up-to date.

Two cases that have been described more closely, the Diligentia case and the GE Capital Canada case, as they are both major rulings by the Supreme Court in their respective countries and thus have higher legal status. As mentioned, the Diligentia case does not concern a cross-border transaction but provides legal guidance on the area as it examines the relevant issues related to intra-group financing. The Chapters regarding the two major cases, GE Capital and Diligentia also present the different opinions and conclusions by professionals in order to provide a more faceted picture of the legal situation. The third case from Sweden, Fiskeby Holdings is included in the master thesis as it also concerns the pricing of intra-group loan and highlights the issue of the parent-subsidiary affiliation and contributes to emphasize the difficulties surrounding this particular area. However, the Fiskeby Holdings case has not influenced the analysis as much as the other two cases. This is because Fiskeby Holdings does not the same legal value as the GE Canada Capital and Diligentia case.

1.6 Outline

Chapter 2

The second chapter contains general information on intra-group financing, credit rating and common problems related to the area. Furthermore, an overview of how thin capitalization rules usually functions is given as a complement as it explains the issues of the debt financing and how other jurisdictions than Sweden come to terms with these structures by implementing certain rules. The purpose of the chapter is to introduce the subject of intra-group financing.

Chapter 3

Chapter three focuses on Swedish rules. The chapter introduces the Swedish Correction rule[19], where the arm's length principle is expressed, and the applicability of the rule. The Chapter contains a brief description of the unlimited right to deduction on interest rates. The purpose of the chapter is to lay out the conditions and the applicable rules in order to provide a better understanding of the available resources when resolving issues and disputes on a national level.

Chapter 4

Chapter four presents the international guidelines of the OECD. The major principles of the OECD are explained and the TP guidelines are described more closely. Focus is put on the information provided by the TP guidelines on intra-group financing since the guidelines have an important legal value for the Courts of the member states.

Chapter 5

The case law from both jurisdictions, Sweden and Canada is presented. The case law raises important issues related to the pricing of intra-group loans that are discussed in the master thesis. The chapter will go more into depth on how the court of Sweden and Canada have interpreted the guidelines.

Chapter 6

[19] The term ”Correction Rule” is used in this thesis instead of the Swedish term ”Korrigeringsregeln” but have the corresponding meaning. See chapter 3.2.

The sixth chapter provides a deeper analysis of the issues surrounding intra-group loans. In this chapter, the answers to the inquiries related to the purpose of the thesis are presented. The key issues discussed in the analysis are whether the establishment of an interest rate and the assessment of the credit risk, should be made taking into account the parent-subsidiary affiliation and whether or not this is a departure from the arm's length principle. Further issues have been highlighted and proposed solutions have been examined

Chapter 7

In the final chapter, the final conclusions are presented in order to summarize what has been established in the analysis.

2 Intra-group financing

2.1 Introduction

The purpose of the second chapter is to present the background of intra-group financing and the surrounding issues. Since Sweden has no restrictions on how thinly capitalized a corporation can be, i.e. there are no thin capitalization rules, these rules have been described in order to demonstrate how other countries have chosen to counter the problems related to the pricing of intra-group loans. Furthermore, credit rating and credit risk is explained as it is an important part of the pricing of loans and is discussed in case law.

2.2 Basic information on intra-group financing

2.2.1 General information

Intra-group financing is a general term for a wide range of intra-group transactions where credit guarantees and loans are included.[20] Loans between group entities are common in multinational groups and are carried out in the same way as between independent parties. The loan can be both short-dated such as accounts receivable or payable or on long-term, such as capital placements. Loans and credit guarantees are often connected where one group entity borrows external debt and another group entity acts as guarantor.

When group entities arrange financing between them it is often quite challenging since there is little public data on financial transactions and on interest rates on intercompany loans. Lending institutions, usually banks are not keen to publish detailed information on interest rates and credit ratings which could have been used as a benchmark in the pricing of financial transactions.[21] Furthermore, there is little support regarding the resolving of transfer pricing issues relating to financing transactions. The reason is that financial transactions often have unique characteristics. [22] When companies arrange intra-group financing they often rely on rules of thumb, internally set department rates or indicative quotes from bankers to establish the transfer pricing policies with respect to

[20] Green, Gareth, *Transfer Pricing Manual*, p. 202.

[21] Adams, Chris, Peter, Graham, *Transfer Pricing: A UK Perspective*, p 38.

[22] Adams, Chris, Peter, Graham, *Transfer Pricing: A UK Perspective*, p. 36.

such transactions.[23] The different financing transactions often require an assessment *in casu* and ideally from a third party standpoint.

The OECD, who is the initiator and author of the TP guidelines, define loans in the transfer pricing context as a term used in a broad sense that applies to all forms of indebtedness. [24] It includes all advances of money, whether or not evidenced by a written instrument. The OECD remarks on the financial aspect of debt financing and point out that tax costs usually are lower for a group with debt financing, then with equity financing.[25] The transfer pricing issues relating to loans are, according to the OECD, based on the fact that debt servicing can provide opportunities for shifting profit between members of a multinational group for tax purposes.[26] In the latest edition of the TP guidelines, the OECD has included loans between intra-group members in the context of intra-group services. The recommended approach is to examine whether an intra-group service has been rendered or not and then applying the most appropriate transfer pricing method in order to establish the correct price of the loan. The CUP method is, according to the OECD, the most appropriate method when a comparable transaction can be found.[27]

2.2.2 General problems

Apart from the lack of information regarding the structuring of a transfer pricing policy on intra-group financing, there are other issues regarding intra-group financing. Besides the pricing of the loan there are further financial transactions associated with the loan that can fall under the scope of the arm's length principle. As the financing involves two related entities entering into arrangements to provide finance it is not uncommon that assistance is provided by one of the related entities, indirect or directly, in securing lo-

[23] Van der Breggen, M. et al., ”does debt matter? The transfer pricing perspective”, Transfer pricing report, Issue 16, no.200, 2007.

[24] (1979) Report of the OECD Committee on Fiscal Affairs on Transfer Pricing and Multinational Enterprises, Chapter 5, Para 182.

[25] Id.

[26] (1979) Report of the OECD Committee on Fiscal Affairs on Transfer Pricing and Multinational Enterprises, Chapter 5, Para 181.

[27](2010) OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Chapter VII, Para 7.19.

ans from third parties.[28] These loan guarantees affect the credit rating of the borrowing entity, which in the end affect the interest rate. In loans between associated entities, there is usually no need for a guarantee as the lending entity has better insight of the financial status of the borrowing entity. Furthermore, there are major differences between loans within a group and loans between independent parties.

Usually, loans are transaction based. When conditions are changed between unrelated parties this usually implies a change in the loaning agreement. However, in a group, other conditions become applicable. Loans within a corporate group are usually established between a parent company and its subsidiary.[29] Since the two parties act under other commercial conditions, this can influence the process of establishing an arm's length price of a loan.

2.3 Thin Capitalization rules

Since enterprises within a group are associated they have the ability to arrange transfer prices and control the allocation of taxable profits. This can also be carried out through a loan. The parties can set an interest rate, high or low, transferring capital between them depending on what jurisdiction has the most favorable tax rate. Interest rates are usually a deductible cost for the borrowing party in a financing transaction.[30] Some countries have implemented rules limiting or reclassifying the deductibility of interest rates in order to prevent such arbitrage. The rules vary from country to country.[31] If the capital of the company paying the interest rate is thinly capitalized, meaning that its capital is made up of a much greater proportion of debt than equity, i.e. its gearing, or leverage, is too high.

Thin capitalization rules have been instituted in many countries as a way to prevent companies from making loans to subsidiaries and then reducing overall corporate tax payments by charging interest on those loans.[32] From a tax perspective these arrange-

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[28] Adams, Chris, Coombes, Richard. *Global Transfer Pricing- Principles and Practice*, p. 52.

[29] (1979) Report of the OECD Committee on Fiscal Affairs on Transfer Pricing and Multinational Enterprises, Chapter 5, Para 181.

[30] Green, Gareth, *Transfer Pricing Manual*, p. 211.

[31] Tyrall, David, Atkinson, Mark, *International Transfer Pricing- A Practical Guide for Finance Directors,* p. 178.

[32] Green, Gareth, *Transfer Pricing Manual*, p. 211.

ments can be very advantageous to corporate groups as it is a way to transfer capital, moving it to another jurisdiction with a lower tax rate on corporate income. The entity lending the capital, and which probably has its residence in a jurisdiction with a higher tax rate, could most likely deduct the interest payments associated with debt. The thin capitalization rules have thus been implemented in many countries in hope to discourage this kind of behavior. Generally, tax authorities establish a threshold for debt-to-equity ratios, above which interest would be disallowable when calculating corporate income tax liability.[33] Companies could, however, obtain tax advantages either by increasing the rate of interest to the associated entity or by manipulating the ratio of debt to equity in their capital structure.[34] That is why tax authorities also wish to apply the arm's length test on the rate of interest charged.[35] There are no thin capitalization rules in Sweden, which means that there are no restrictions on how thinly capitalized a corporation can be. Furthermore, the deduction right on interests is not limited.[36] Therefore, Sweden has favorable conditions that may be abused for the benefit of multinational corporations. Since there are no thin capitalization rules the owners can finance a Swedish subsidiary entirely with debt instead of financing it with shareholder's equity and then debiting the interests to the subsidiary, which are deductable. The interest revenues are sometimes subject to withholding tax, but the tax rates of interest are usually lower than the tax rate of dividends.[37] This could be arranged instead of distributing the net profit as dividends, which is constituted of already taxed revenues.[38]

Since Sweden does not have thin capitalization rules, the tax authorities must rely on the arm's length principle in order to discourage structures made by multinational corporations in order to obtain fiscal advantages. However, even in cases where thin capitalized subsidiaries borrow funds from a parent company, the Correction rule has not been re-

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[33] Green, Gareth, *Transfer Pricing Manual,* p. 211.

[34] Tyrall, David, Atkinson, Mark, *International Transfer Pricing- A Practical Guide for Finance Directors,* p. 177.

[35] Tyrall, David, Atkinson, Mark, *International Transfer Pricing- A Practical Guide for Finance Directors,* p. 178.

[36] See chapter 3.2.4.

[37] Piltz D. J., General Report ”International aspects of thin capitalization”, Cahiers de droit fiscal international, vol. LXXXIb, 1996, s 87.

[38] Gäverth L., “Skatteflykt och kapitaliseringsfrågor”, Skattenytt, no. 5, 1998, p. 233.

garded as applicable.[39] This means that the size of a loan, not in general, but in relation to its capital, cannot be questioned and resolved by applying the Correction rule. That is the reason why it could be even more complex to set an appropriate interest rate on intra-group loans.

2.4 Credit risk and credit rating

Credit rating is a fundamental element when pricing a loan. The higher credit rating an entity has, the lower interest rate it will have to pay and vice versa.[40] Credit rating can be decided with different methods, but there are credit rating companies like Standard& Poor or Moody's that conduct recognized credit ratings. Credit ratings are often divided in different scales such as AAA, AA; BBB, BB and C in the case of Standard & Poor's, AAA being the highest and C the lowest.[41]

Credit risk drives the pricing of debt instruments and is considered to be an important search criterion when selecting available market data for a benchmark analysis. Usually, the credit risk profile of the related entity borrower has been identified by an estimated credit rating.[42] If the borrower has an estimated credit rating, a search is then carried out for comparables within the whole letter credit rating category of the level of the borrower.[43]

There are however, some issues surrounding the credit rating procedure. Since credit ratings presented by external credit rating agencies are not always ideal when gathering benchmark data of third-party debt for the use of comparable uncontrolled transactions. One issue is that the external credit rating may be too static to be used as a common credit risk measure in a way that it does not reflect the true status of the credit risk at the time the loan transaction is executed.[44] The arm's length solution to each case is a func-

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[39] RÅ 1990 ref 34, See Chapter 3.2. for the Correctionrule.

[40] Moran, Karolina, ”Prisättning av Koncerninterna Lån och Garantier- En fundering ur ett Internprisättningsperspektiv”, Svensk Skattetidning, no. 5, 2008, p. 367.

[41] Id.

[42] Hands, Gordon, “Using credit Risk to Measure Intercompany Loans”, TP Week, April 2010, p. 1.

[43] Id.

[44] Id.

tion of intrinsically unique economical facts and circumstances in the pricing of an intra-group loan.[45]

Even though the data from credit rating companies might provide the basis for the typical sort of rate suitable for less assertive planning, it is still difficult to obtain information of the right type of sufficiently good quality. This is because credit institutes, such as banks, do not wish to publish detailed interest rates and credit rating information on which a specific taxpayer's circumstances can be applied.

2.5 Summary

Since there are no thin capitalization rules in Sweden and no restrictions on how thinly capitalized a company can be, there are no other regulations to rely on except the TP guidelines of the OECD.

Even though the TP guidelines include methods to apply when establishing the price of a loan, it can be complicated to find similar transactions to compare with as most financial transactions such as loans have unique characteristics. One of the factors that are important when determining the interest rate of a loan is the credit rating of the borrowing party. The credit rating has had importance when determining the arm's length price on intra-group loans in case law, even though the rating does not always display the true status of the credit risk. The arm's length rate is often a result of intrinsically unique economical facts and circumstances.

[45] Adams, Chris, Coombes, Richard. *Global Transfer Pricing- Principles and Practice*, p. 51.

3 Swedish law

3.1 Introduction

The chapter introduces national legislation surrounding interest rates and their deductibility. Furthermore, the chapter presents the Correction rule which is the expression of the arm's length principle in Swedish law. The purpose of the chapter is to present the surrounding national framework in order to demonstrate the available legal rules when attacking the issues surrounding the pricing of intra-group loans.

3.2 The Correction rule

3.2.1 Introduction

The arm's length principle is expressed through Sec.19 of the 14th Chapter of the Swedish Income Tax Act (ITA) and is referred to as the Correction rule. The rule states, similarly to the arm's length principle, that if the profit of an enterprise increases due to the terms of contract made between two related parties which differ from those which would be made between independent parties the result should be estimated to the amount that would have been without those conditions.[46] There are a few conditions that have to be fulfilled in order for the rule to become applicable. First of all, the party who, due to the terms of contract, obtains the higher profit should not be subject to tax in Sweden according to the regulations of the ITA or due to the double tax treaties.[47] Second of all, the parties have to be related i.e. associated enterprises.[48] Finally it has to be made clear that the terms of contract have not been made for any other reasons, then by the fact that the parties are related.[49]

The principle is also found in the Swedish agreements on double taxation since it determines how the profits of a multinational are split between the jurisdictions in which it operates.[50] However the Swedish Correction rule is, materially, somewhat more limited then the corresponding rule in the model tax convention and in the double tax treaties.[51]

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[46]Inkomstskattelag (1999:1229) Sec.19 of Chapter.14, Para.1.

[47] Inkomstskattelag (1999:1229) Sec.19 of Chapter.14, Para.1, nr. 1.

[48] Inkomstskattelag (1999:1229) Sec.19 of Chapter.14, Para.1, nr. 2.

[49] Inkomstskattelag (1999:1229) Sec.19 of Chapter.14, Para.1, nr. 3.

[50] Green, Gareth, *Transfer Pricing Manual,* p. 5.

[51] Prop. 2009/10:17, p. 22.

As previously mentioned, it has not been regarded as applicable in thin capitalization situations.[52]

3.2.2 Applicability of the correction rule

The applicability of the Correction rule, in relation to other common principles of law, is not statutory regulated.[53] The Correction rule is regarded as complementary to the general regulation in Chapter 14 of the Swedish ITA.[54] The Supreme Administrative Court expressed, in the case RÅ 2004 ref 13, that the Correction rule should be regarded as a special regulation concerning international circumstances which takes precedence over general rules when calculating the profit of a business.

The purpose of the regulation is to adjust low profit which has been declared inaccurately due to incorrect pricing when doing business with related entities abroad. The rule can only be applied by associated enterprises that are both regarded as taxable persons and that are subject to tax in different jurisdictions hence the rule is not applicable between entities and their branches or permanent establishments.[55]

3.2.3 Associated enterprises

The Correction rule is dependent on whether the transaction is carried out between two related enterprises as expressed in Sec. 20 of the 14th Chapter in the Swedish ITA. The regulation is corresponding to art. 9, subparagraphs 1a) and 1b) of the OECD Model Tax Convention.[56] The enterprises are associated if an enterprise participates directly or indirectly in the management, control or capital of the other enterprise. The enterprises are also considered associated if the same persons participate directly or indirectly in the management, control or capital of both enterprises. There is no minimum limit on how large part of the capital the other enterprise must control, as the Sec 19 and 20 in the 14th Chapter should be applied together as the condition of the associated enterprise is set forth in Sec 19 in the 14th Chapter.

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[52] See chapter 2.3.

[53] Handledning för internationell beskattning 2010, SKV 352, 13th Ed., (2010), p. 247.

[54] Id.

[55] Handledning för internationell beskattning 2010, SKV 352, 13th Ed., (2010), p. 248

[56] Prop. 1955:87, p. 64.

3.3 Deduction right of interest rates

There are several cases debating the legal position of the Correction rule.[57] However as mentioned previously, the Correction rule has been regarded as complementary to the general principles.[58] The deduction right for interest rates constitutes a part of the general principles in Swedish law and is regulated in Sec. 1 of the 16th Chapter of the ITA. The rule states that all expenses for realizing and maintaining revenues are deductible costs. Interest rate expenses shall be deductable even if they do not constitute such an expense. The deductibility of interest rates is, in general, not limited except for equity loans and expenses from revenues exempted from tax in Sweden due to provisions of a double tax treaty.[59]

The deductibility is not dependent on whether the receiver is taxed. Fiscally deduction is granted the fiscal year when the interest rate is attributed.

3.4 Interest-rates on intra-group loans according to SKV

The Swedish Tax Authorities (SKV) have, in their guide on international taxation, expressed their view on interest rates on intra group-loans and it is more or less coherent with the chapter on loans in the TP guidelines from 1979.[60] SKV express that, generally, interest-rate should be charged on loans, if the taxable person would have charged an interest rate under similar circumstances. On the opposite, if an interest rate is not charged, the taxable person has to justify this by proving that such a deviation exist on the market. There are loans without interest-rate that have been accepted in case law, where one of the parties has been in the establishing phase of a business.[61] SKV claims that in those cases, the time frame for the establishing phase may be assessed *in casu*, but in general, favorable conditions are expected to continue only for a short time with the specific purpose of raising lender's profit in the long run.[62] Another example where wa-

[57] See RÅ 2006 ref 37

[58] See chapter 3.2.

[59] Inkomstskattelag (199:1229) Sec.5-10, Chapter 24 and Sec.5, Chapter 9.

[60] Handledning för internationell beskattning 2010, SKV 352, 13th Ed., (2010), p. 304. See also chapter 4.2.1.

[61] See RÅ 1979 1:40 and RÅ 1984 1:16.

[62] Handledning för internationell beskattning 2010, SKV 352, 13th Ed., (2010), p. 307.

iving of interest rate could be justified is in compensation pleas, meaning that the party compensate the lender for the interest by e.g. reducing its price of goods.

The Supreme Administrative Court has stated that it may be necessary to make an overall assessment of the Swedish and foreign party's business dealings and to include transactions that have been or may be in compensation for the income-reducing effect of the price difference.[63] According to SKV it is clear that the companies' involvement with one another should be assessed and that there should be casualty between the mispricing and the compensation received. SKV claim that intentional set offs can be different in nature. It could for e.g. be two transactions balancing out or a general settlement balancing all benefits accruing to both parties over a period of time. The latter one is more unlikely, as independent parties never would accept such an agreement if the benefits could not be accurately quantified.[64]

The interest-rate on intra-group loans should be equal to what an independent party would have charged under similar circumstances and under the same period of time. Factors to regard are type of credit, collateral, credit worthiness, currency etc. The appropriate interest-rate could consist of a wide range of ratios. SKV declare that the arm's length principle imply that an intra-group company borrows money according to its own credit worthiness. This means that if a subsidiary with poor solvency receives a loan from a strong parent company, this could in fact be subscription of capital.[65] SKV refers to a case from the administrative court of appeal, where a company had not charged any interest rate, claiming that this was compensated through the increased selling price of the shares in the subsidiary. The court stated that an eventual indirect compensation received through an agreement with a third party did not justify the waiving of interest rate.[66]

3.5 Summary

Regarding the deductibility of interest rates in national law, there is generally no limit on how much you can deduct. However, if the interest rate in a cross-border transaction

[63] Handledning för internationell beskattning 2010, SKV 352, 13th Ed., (2010), p. 309.

[64] SKV refers to (1995) OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Chapter I, Para. 1.61.

[65] Handledning för internationell beskattning 2010, SKV 352, 13th Ed., (2010), p. 305.

[66] Mål nr 3511-1994, Administrative Court of Appeal, Göteborg, judgment delivered 1997-02-27.

is not at an arm's length, the Correction rule becomes applicable as it is a special regulation in relation to general rules. In order for the Correction rule to become applicable, the profit of an enterprise must have increased due to the conditions of an agreement made between two related parties which differ from those which would be made between independent parties. Since the deductibility right on interest rates is not limited and since there are no thin capitalization rules, the Swedish tax authorities have to rely on the Correction rule and the transfer pricing methods set out in the TP Guidelines as a mean to control the internally set interest rates.

4 International guidelines

4.1 Introduction

In the forth chapter the international framework is described. The basic principles and the material treating the pricing of intra-group loans are presented as well as the concept of explicit and implicit guarantees. As guarantees affect the pricing of a loan and are described further on in case law, a short introduction has been necessary.

4.2 Guidance of the OECD

4.2.1 Arm's length principle

The OECD member states have chosen to assume the separate entity approach. The separate entity approach entails that each enterprise within a multinational group is treated as a separate entity meaning that each individual member of the group is subject to tax on the income arising to it.[67] When applying the separate entity approach on cross border transactions within a group, each group member must be taxed as if they acted on an arm's length basis in the transactions carried out between them.[68]

However, as the members of a multinational group are affiliated, it can be in their interest to establish certain conditions which would not have been established had they been separate entities. In order to eliminate the effect of such conditions, the members of the OECD have chosen to adopt the arm's length principle to ensure the correct application of the separate entity approach.

The arm's length principle is found in the article 9 of the OECD model tax convention and states that:

"*when conditions are made or imposed between …two (associated) enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have*

[67] (2010) OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Preface, Para. 5.

[68] (2010) OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Preface, Para. 6.

accrued to one of those enterprises, but by reasons of those conditions, have not so accrued, may be included in the profits of that enterprises and taxed accordingly".[69]

This standard is formed so that in order to evaluate whether a transfer price is accurate, the price between related parties in a controlled transaction should be equivalent to the price set between unrelated parties in an uncontrolled transaction under external forces.[70]

Even though there is a risk that prices and conditions between associated enterprises will be affected by the commercial and financial affiliation, the OECD stresses that it should not be assumed that the conditions will invariably deviate from those on an open market. Most often, associated enterprises are quite autonomous and often negotiate with one another as if they were independent parties.[71]

As mentioned, when seeking to adjust profits, the arm's length principle follows the approach of treating members of a multinational group as if they were operating as separate entities. In order to measure whether a cross-border transaction is carried out at an arm's length, the transactions are compared to uncontrolled transactions on the open market carried out by unassociated enterprises. The analysis is referred to as a "comparability analysis" and is the core of the application of the arm's length principle.[72]

The arm's length principle can, under certain circumstances, be difficult to apply. Since associated enterprises sometimes perform transactions that independent parties never would do, it is difficult to apply the principle in those situations since there is usually no or little direct evidence of what conditions would have been established by independent enterprises. The reason for this is that multinational groups face different commercial circumstances than independent parties.[73]

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[69] OECD Model Tax Convention on Income and on Capital, (2008), Article 9, Para. 1b.

[70] Green, Gareth, *Transfer Pricing Manual,* p. 11.

[71] (2010) OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Chapter 1, Para. 1.5.

[72] (2010) OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Preface, Chapter 1, Para 1.6.

[73] (2010) OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Chapter 1, Para 1.11.

Furthermore, there are circumstances where it may be appropriate for a tax administration to disregard the structure of a transaction. One of these circumstances is when the economic substance differs from its form.[74] An example, according to the OECD, can be where

"an associated enterprise invests in another associated enterprise in the form of interest-bearing debt when at an arm's length, having regard to the economic circumstances of the borrowing company, the investment would not be expected to be structured in that way."[75]

In these cases the TP guidelines recommend that the tax authorities re-characterizes the loan in accordance with its economical substance, where the outcome can be that the loan is regarded as a subscription of capital instead.[76]

4.2.2 TP guidelines on intra group-financing

Financial transactions are included in the OECD transfer pricing guidelines.[77] Financing is included in the context of intra-group services and there is no specific chapter concerning intra-group loans. The chapter on intra-group services raises two issues: firstly the first issue is to determine whether an intra-group service has been rendered: secondly and the second one is to determine what the intra-group charge should be for that service, for fiscal purposes, in accordance with the arm's length principle. One of the conditions is that the activity should provide a group member with economic or commercial value to enhance its commercial value.[78] In order to determine whether any economic or commercial value has been enhanced the arm's length principle should be applied and it should be considered whether an: "*...independent enterprise in comparable cir-*

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[74] (2010) OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Chapter 1, Para. 1.65. See discussion of the case *Fiskeby Holdings* in Chapter XX.

[75] Id.

[76] Id.

[77] See (2010) OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Chapter 1, Para. 1.4 and Chapter VII, Para. 7.2.

[78] (2010) OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Chapter VII, Para. 7.6.

cumstances would have been willing to pay for the activity if performed for it by an independent enterprise or would have performed the activity in- house for itself'.[79]

As opposed to what is considered an intra-group service, the guidelines also emphasize that an associated enterprise should not be considered to receive an intra-group service when it obtains benefits solely for the fact that it belongs to a larger concern.[80] The TP guidelines provide the example that no service should be regarded as rendered when an associated enterprise receives a higher credit- rating by the reason of its affiliation only.[81] On the other hand, an intra-group service usually exists were the higher credit-rating is due to a guarantee by another group member or when the associated enterprise receives benefits from the group's reputation deriving from global marketing and PR.[82] Passive association should therefore be distinguished from active promotion which could enhance the profit-making potential of particular group members. Finally, the TP guidelines establish that each case must be determined according to its own facts and circumstances.[83]

The OECD has also published the 2010 Discussion Draft on the Attribution of Profits to Permanent Establishments were they adress how the functions performed, risks assumed and assets used in the banking industry can influence the attribution of profits to a permanent establishment. The analysis is relevant for the separate entity approach under which profit is allocated to a permanent establishment through analogous application of the Guidelines. Some have argued that the TP guidelines merely touch upon the application of the transfer pricing methods and that the guidance provided is idealistic when it comes to determining an arm's length fee for intra-group financing.

4.2.3 The 1979 version

The OECD report on fiscal affairs on transfer pricing and multinational enterprises from 1979 was the first edition of the TP guidelines and was equipped with an entire chapter

[79] Id.

[80] (2010) OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Chapter VII, Para.7.13.

[81] (2010) OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Chapter VII, Para. 7.13.

[82] Id.

[83] Id.

on loans between associated enterprises. The purpose of the chapter was to deal with practical situations when entities within a group attempt to shift profit between them by using debt servicing.[84] In the report the OECD states that it is more common with subsidiaries lending from their parent- companies than vice versa.[85]

Even though there is a whole chapter on loans between associated enterprises, the 1979 TP guidelines do not provide a certain method on how to reach an arm's length price of a loan between related parties. Instead, the guidelines address two main issues, where one is the distinguishing of an equity contribution from a loan and the other one is to establish whether interest rate should be paid.

The TP guidelines describe relevant factors that need to be taken into account when arriving at an arm's length rate of interest in the third section of the 1979 year version. Ideally the interest rate should, according to the TP guidelines, be determined to the conditions in financial markets for similar loans.[86] In order to decide what is a similar loan there are necessary factors that have to be considered when finding comparables for an arm's length rate. The listed factors are; amounts, term to maturity, purpose of the loan, currency, securities and credit worthiness of the borrower. [87] The TP guidelines recommends bank rates as a starting point when finding comparable conditions, but warn about having a mechanical rule based on these rates as they do not take into account the economical factors of the specific case which is a necessity when establishing the arm's length rate of interest.[88]

In the final remarks of Chapter five, it is expressed that interest rate is, in general, expected to be paid for a loan, but in circumstances where a lender, who is at arm's length

[84] (1979) Report of the OECD Committee on Fiscal Affairs on Transfer Pricing and Multinational Enterprises, Chapter 5, Para. 181.

[85] Id

[86] (1979) Report of the OECD Committee on Fiscal Affairs on Transfer Pricing and Multinational Enterprises, Chapter 5, Para. 199.

[87] Id.

[88] Id.

from the borrower, agree to waive or defer the payment of interest, it could be accepted that associated enterprises might act in the same way.[89]

4.3 Explicit and implicit Guarantees

As mentioned in chapter five of the 1979 year version of the Guidelines, a security is an important factor that influence the price of a loan and that has to be considered when establishing an arm's length rate of interest. A security is often received in the form of an intra-group guarantee. Intra-group guarantees are common among multinational enterprises.[90] The arrangement functions as a transfer of risk mechanism, moving the risk of default from the third-party lender to the parent company. The correct definition of a guarantee is:

"(A) collateral agreement for performance of another's undertaking. An undertaking of promise that is collateral to primary or principal obligation and that binds guarantor to performance in event of non-performance by the principal obligor...a promise to answer for the debt, default, or miscarriage of another person" [91]

An explicit guarantee is legally enforceable and is normally in written form.[92] The guarantee is often forwarded to a third party lender. The guarantee influences the price of a loan and often improves the interest rate. In these cases, it is clear that the borrower in the multinational group has received a benefit, therefore the calculating of the arm's length price for the guarantee is not that complicated.[93]

Usually the loan guarantee is a commitment between a parent company, which usually have the higher credit rating, and its subsidiary with a lower credit rating. The purpose is that, in the case of default, the parent company can cover the payment to the third-party lender. However, within a group, most often, the financial demands are often handled by a centralized treasury department which tries to take advantage of the capital existing within the group, why intra-group loans are preferred over third-party loans

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[89] (1979) Report of the OECD Committee on Fiscal Affairs on Transfer Pricing and Multinational Enterprises, Chapter 5, Sec. IV, Final remarks.

[90] Green, Gareth, *Transfer Pricing Manual,* p. 212.

[91] Garner, Bryan A., *Black's law Dictionary*, 5th Ed., West, St Paul, Minnesota 2005.

[92] Green, Gareth, *Transfer Pricing Manual,* p. 216.

[93] Green, Gareth, *Transfer Pricing Manual,* p. 216.

from banks and other financial institutes.[94] The credit rating of an entire group is usually higher since it is based on the credit rating of all its members together. Therefore, the credit rating of the group is higher than the credit rating of each company individually.[95]

The fact that a company belongs to a group can, in some cases be beneficial and in some cases have the opposite effect. This could be where a member-company with a high credit rating have to charge a higher interest rate than it would on a stand-alone basis if the credit rate of the group is lower, and vice versa.[96] The question that arises is how to approach these situations in a transfer pricing context. The interest may or may not be a way to shift profit why tax authorities demand the interest to be on an arm's length.

When the group affiliation influences the price of a loan it is sometimes referred to as implicit support. Implicit support or an implicit guarantee is not expressed in written form and not legally binding for the parties. The usual case is when a third-party lender, for e.g. a bank, experiences that the multinational group would intervene, in a case of default by its subsidiary.[97] The subsidiary has, in these cases, received a benefit without compensating for it. The moral hazard is whether the affiliation itself should be equal to a guarantee which then affects the establishing of an appropriate arm's length interest rate.

The TP guidelines have attempted to approach this complex of problems, and states that the mere fact that an enterprise belongs to a larger concern should not be considered an intra-group service. Transfer pricing economists agree that, interpreting the TP guidelines, no compensation should be required for implicit guarantees.[98]

4.4 Summary

The OECD has developed the TP guidelines in order to support multinationals in their structuring of a transfer pricing policy for their cross-border transactions. Also, tax

[94] Van der Breggen, M., "Intercompany Loans: Observations from a Transfer Pricing Perspective", p. 297.

[95] Id.

[96] Id

[97] Green, Gareth, *Transfer Pricing Manual,* p. 216.

[98] Ryan, Eric D. *et al*, "A Transfer Pricing Framework for Loan Guarantee Fees", Transfer Pricing report 11, no. 850, 2003.

authorities and courts use the TP guidelines in their work to protect the national tax base. The common standard used for establishing an appropriate price is the arm's length principle, where entities within a multinational group are treated as separate entities dealing at arm's length. However, since multinational groups sometimes face commercial circumstances that differ from when transactions are carried out between independent parties the principle can be hard to apply in all circumstances. The TP guidelines deal with the transfer pricing issues of intra-group financing and state clearly that no benefit arising from the group belonging should be acknowledged as a intra-group service that the parties have to compensate for. Even though there is some guidance on the transfer pricing area of intra-group financing, some have argued that the information in the TP guidelines is idealistic for the pricing of intra-group financing transactions and that the subject has not been described deeply enough.

Group guarantees within intra-group financing are common and may affect the pricing of a loan. Implicit guarantees are especially complex in transfer pricing. Many have accused the TP guidelines for being too sparse with information on the subject. Instead, case law, both national and international has been significant for the legislative development.

5 Case law

5.1 Introduction

Three different cases (GE Capital, Fiskeby Holding and Diligentia) from Sweden and Canada are presented. The rulings treat intra-group financing and the issues surrounding the parent subsidiary affiliation. The Swedish rulings (Fiskeby Holding and Diligentia) explicitly discuss the pricing of intra-group loans.

5.2 Swedish case law

5.2.1 Fiskeby holdings

Fiskeby Holdings concerns a loan between a holding company-Fiskeby Holdings, and its parent company - Riverwood International Incorporated, seated in Delaware, U.S.A. The shares of the cardboard container company Fiskeby AB, owned by Riverwood International Inc, were transferred to Fiskeby Holdings (The Company) - which was a newly established, wholly owned subsidiary to Riverwood International Inc. The payment was partly made with liquid assets, and partly through a loan. The interest rate of the loan was at first set to 9, 5 percent, but then changed after several renegotiations. Furthermore, the Company were able to, without limitations, amortize or cash down the loan at any given time during the term of credit. The Swedish tax authorities argued that since the creditor and the borrower were related entities, the creditor had the opportunity to affect and control the applied level of interest.

In the reassessment decision, SKV discussed some key points that are relevant to emphasize. SKV claimed that when applying the arm's length principle, one cannot disregard the circumstances that an independent creditor would have considered.

The first issue raised was the fact that the Company belonged to a corporate group. SKV claimed that Riverwood International Inc had complete control and insight of the enterprise which is something a creditor would have taken into account when settling a credit rate. Furthermore, the shareholding of the lucrative subsidiary Fiskeby AB was also a reason why the credit rating of the Company was not at an arm's length as it should have been regarded as a security for the loan.

Since the credit rate of the loan i) had been renegotiated and inconstant during the term of credit and ii) since the loan could be terminated at any given time, this was an indica-

tion that it was not a loan with fixed conditions as had been announced by the company. Also, a loan granted for the purchase of shares that had fixed conditions was, according to the tax authorities, rather uncommon. All the circumstances put together, constituted the basis to why the agreed credit terms were a consequence of the Company pertaining to a corporate group. SKV argued that an appropriate arm's length rate would be the Stockholm Interbank Offered Rate added with an addition of 1 percent.

In the County Administrative Court, the Company claimed that the decision of SKV should be removed. The loan was, according to conditions of the agreement, not in fact a loan with variable conditions. The company also argued that an arm's length interest rate could not be established to an average interest rate, but that was subject to many variables such as credit rating of the borrower, the loan sum, term to maturity, the currency value of the loan and collateral for the loan. The company argued that the average rate in SEK and USD had been more or less the same and used statistics from Federal Reserves to back up their arguments.

The fact that the company had the choice to pay off the loan at any given time was a favorable condition which, according to the company, itself indicated a higher interest rate. The fact that the creditor and the borrower were related entities did not imply that the conditions deviated from those that would have been made between unrelated parties.

SKV appealed against the decision of appeal and stated that the group had a fiscal interest in allocating profit made in the Swedish entities to Delaware by the deduction of interest made on the loan, which then could be set off by the received group contributions. SKV stated that excess interest should be regarded as deemed dividend which was not deductible. The conditions of the loan were also, de facto, to be considered a variable loan.[99] The tax authorities claimed that an independent borrower would have renegotiated the conditions or turned to an external creditor for better conditions. The appropriate rate of the loan should therefore, according to SKV, have been the average interest rate of the rates offered.

[99] Substance over form as described in (2010) OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Chapter I, Para. 1.65.

The County Administrative Court followed SKV’s argumentation. The Court stated that both Swedish law and the TP guidelines propose the arm’s length principle. According to the TP guidelines (1995) the transfer price should have been decided based on the information that was available at the time of the transaction. Thus, in order to establish whether an interest rate is at an arm’s length, the comparison had to be based on what the arm’s length price of the loan was at the time of the debt agreement.

For an arm’s length interest rate level, the Court and the Company were unanimous and stated that several elements had to be taken into account, whereof one was the credit worthiness of the borrower. The court claimed that the shares in Fiskeby Board and the fact that the Company constituted a part of a larger group was enough to be considered as satisfying collateral.

When deciding on an arm’s length interest rate, the appropriate level can be established by a wide range of different interest rates, however the Court found that the specific conditions in the case did not motivate a higher interest level then what normally would apply for an arm’s length interest rate. Due to what had been stated regarding the credit worthiness of the borrower, there was no reason to consider the statistics from the Federal Reserve as these were interest rates of bonds issued by BAA rated companies and therefore not comparable to the Company. The Company‘s credit worthiness was, according to the Court improved due to its holdings in Fiskeby Board and the group affiliation.

The Administrative Court of Appeal cited the County Administrative Court and stated that the interest rate was not at an arm’s length. The court repeated that an arm’s length rate could be decided by a wide range of different interest rates why it was complicated to determine whether the interest rate rendered by the Company was commercial in nature. Therefore the Court claimed that it was important to act cautiously when establishing an arm’s length rate. The court ruled in favor of SKV and stated that the arm’s length rate was the Stockholm Interbank Offered Rate (STIBOR) added with 1 percent.

5.2.2 Diligentia

Diligentia was the parent company of a large group active in the real estate industry sector. In connection to the take-over of Diligentia by Skandia Liv, external loans of the group were terminated and replaced with intra-group loans from the new parent compa-

ny Skandia Liv. The new loans had an interest rate set to 9,5 percent compared to the interest rates before the take over where the average rate was 4,5 percent (STIBOR added with 0,4 percent). Skandia Liv was a life insurance company and according to Swedish law, such company is not subject to income tax.[100] The tax authorities stated that the interest rate level exceeded a marked interest rate level and that the excess rate constituted deemed dividends.

The County Administrative Court established that an arm's length rate can be determined by looking at a wide range of interest rate levels since an interest rate is determined by a number of elements such as the borrower's credit worthiness, collateral, term to maturity etc. The court made an overall assessment of the information brought by the parties and acknowledged a deduction by 6, 5 percent. The Court claimed that the loans should be compared to loans with collateral, due to the ownership structure.

Diligentia appealed to the Administrative Court of Appeal and argued that the assessment made by the County Administrative Court was accurate in some parts. Diligentia agreed to the fact that a marked interest rate can be determined by a wide range of interest rate levels and that an appropriate comparable for the loans of Diligentia would be loans with a term to maturity of ten years. However, Diligentia did not agree on the loan being comparable to loans with a security. Diligentia claimed that a security could have affected the credit worthiness of the group and was not provided in order to facilitate the restructuring of the real estate holdings. According to Diligentia, the takeover by Skandia Liv was not meant as a tax planning measure. The purpose was to gather all the real estate holding in one single company. Furthermore, the conditions of the old loans limited the company to restructure the property portfolio, why it was necessary to replace the external loans with loans established within the group. According to the company, a loan secured by shares in property owning companies was considered to pose a significantly higher risk than a loan directly secured in real estate because of creditors' preferential right of pledge in property than in pledges of shares.

SKV claimed that it was clear that the conditions were determined by Skandia Liv in its capacity as lender and parent company of the wholly owned subsidiary Diligentia. Natu-

[100] Inkomstskattelag (1999:1229), Sec.3 of Chapter 39.

rally, Skandia Liv had adjusted the conditions for their own preferences when it came to interest rate levels and term to maturity.

The Court stated that since there are no regulations in the tax legislation regarding the establishing of a market oriented rate, it is necessary to determine an appropriate interest rate on a case by case basis after an assessment of all the relevant facts. According to the court, the fact that the borrower (Diligentia), at the time of the loan admission, was a fully owned subsidiary of the lending company (Skandia Liv) must have had a great impact when drafting the conditions of the loans. Even if it was undisputed that the subsidiary did not have to provide any security for the loans, the Court argued that the loans should still be treated as secured loans due to the ownership since the credit risk must have been regarded as insignificant. The court cited the County Administrative Court and held that a market oriented interest rate in the specific case could not exceed 6, 5 percent.

Diligentia appealed to the Supreme Administrative Court and claimed deduction for the interest paid. Diligentia claimed that the Administrative Court of Appeal had made their calculation of the market rate based on loans granted with security, although no security had been provided for the loans in question. The guiding principle of the Administrative Court of Appeal was that the ownership eliminated the risk of default. The marketability of interest rates had therefore been examined on the basis of false assumptions.

Diligentia also discussed the principle of arm's length used when determining the accurate price of a cross-border transaction. The company stated that each member of a multinational group should be treated as separate entities (the separate entity approach).[101] Even if the case did not regard a cross-border transaction, the main problem was similar- the transaction at hand had been carried out between associated entities where an arm's length rate only could be established by testing what independent parties would have agreed upon. The assessment of the market rate had to be made based on the conditions of the loan agreement between the associated entities, compared to loan agreements made between independent entities with similar conditions.

Diligentia argued that the presence of securities in a transfer pricing context had a great importance when determining the appropriate pricing of a loan, whereas the ownership

[101] see chapter 4.2.

itself did not have any influence on the pricing at all. Hence, there was no connection between ownership and credit risk.

SKV agreed on the fact that the calculation of a market interest- rate for intra-group loans should be based on what independent entities would have charged for a loan with similar conditions. Important elements when determining the interest rate were for e.g. credit worthiness of the borrower, the presence of collateral, term to maturity etc. SKV also stated that the TP guidelines were an appropriate source when pricing cross-border transactions. SKV stated that according to the TP guidelines, entities within a group sometimes carry out transactions, which independent entities would not carry out, since affiliated entities operates in a different business environment than independent entities. If it is not commercial to conclude such an agreement, it is possible to disregard that transaction. If there is no reason to disregard the transaction, it may be calculated an arm's length price based on actual circumstances.

Furthermore, SKV claimed that in most intra-group transactions, regarding goods and services, the affiliation had no significance when determining an arm's length price. According to SKV, the situation was different when a parent company granted a loan to its subsidiary. In that situation, the parent company's control over the subsidiary implied a lower credit risk than what would have been the case for an external lender. SKV alleged that the control of the parent company replaced the need of a security, and was the major reason to why securities were not common for intra-group loans. SKV added that the parent company's control of the subsidiary did not always imply a credit worthy subsidiary. An assessment has to be made on a case to case basis.

The Supreme Administrative Court stated that, when pricing a loan it was vital to be aware of the risk that a borrower will not be able to carry out the payments and the possible need for a security. When a parent company is granting a loan to its subsidiary different conditions apply. While a parent company exercises control over its subsidiary, an external lender only has limited insight. The external lender can also be unsure of the intentions of the parent company, i.e. the will to support the subsidiary financially in case of default.

The Court claimed that loans from parent companies to subsidiaries have characteristics that influence the credit risk, hence the interest rate. These characteristics are absence

when lenders and borrowers are independent parties. With the same conditions in general, the interest rate could not, without further, be settled to what would have been considered a market price if the lender had been external.

Finally, the Court stated that the credit risk in this case was lower than if the loan agreements would have been concluded between independent parties. Based on the information submitted in the proceedings concerning the interest rate and other conditions, the Court did not see a reason why Diligentia should deduct a sum higher than 6,5 percent.

5.2.3 Comments on Diligentia

The common standpoint of the Diligentia case is that it has not had any greater affect on the pricing of intra-group loans and that the discussions will continue. However, the case has provided some interesting views that could have great importance also in transfer pricing context.[102] In the Diligentia case the Court came to the conclusion that the interest rate level of 9, 5 percent agreed to by the parties was too high and instead admitted deduction of an interest rate of 6, 5 percent. The Court claimed that, loans between parent companies and subsidiaries have certain features that affect the credit risk and consequently the interest rate. For this reason an interest level cannot, *without further examining*, be set to what would have been considered a market interest rate had it been a third-party lender. The question was whether the fact that the parties were affiliated, and that the parent company exercised control over its subsidiary, could be equalized to a security.

What was relevant for this case is that there were no third-party lenders that exercised any control of the subsidiary, this circumstance probably had a great impact on the outcome. Karolina Moran and Roger Persson Österman commented on the ruling of the Supreme Administrative Court and stated that the parent company had such control over its subsidiary that the value of the subsidiary- the real estate- hardly would have been deprived from the subsidiary. The Court reached the conclusion that when establishing a market interest rate, it is crucial to regard all factors, where *control* could be one of those factors. The writers continued to illustrate the statement by describing that some parent companies exercise great control over their subsidiaries, whereas other exercise

[102] Moran, Karolina, Österman, Persson, Roger, "Diligentia- Vilken betydelse får mallet vid tillämpningen av korrigeringsregeln?", Skattenytt, no. 10, 2010.

very little control over the subsidiary. In the latter case, there is often a third-party lender who have specific demands regarding the running of the company and that requires great control over the subsidiary. The requirements could be that the subsidiary is not permitted to have any other external funders or that the borrowers only are allowed to make major reconstructions with the permission of the external lender. The purpose of these requirements is, *inter alia,* to prevent the subsidiary from making any decisions that could affect the repayment ability. There are, according to the writers, few larger loans on the market that are provided by external financiers without any conditions attached to it. The exercise of *Control* is therefore vital under these circumstances.

For this reason the control the parent company exercises over the subsidiary, in intra-group loans, could be compared to the control regulated in the loaning agreements on the market. The Court stated that "with the same conditions in general", which implies that the judicial decision of the Diligentia case will have consequences only in a case where the loan has the same identical conditions. This means, that in cases where there is a third-party lender, the ruling could be different.

Perrone and Schmid who also commented the ruling of the Supreme Administrative Court came to a different conclusion. They claimed that the reasoning of the Court was contrary to the arm's length principle as interpreted by the OECD. The writers stated that the mere fact that there is a parent-subsidiary affiliation cannot be equal to a security according to the arm's length principle.[103] All intra-group cross-border transactions should be priced as if the transaction would have been carried out by separate entities.

SKV made a statement on the ruling where they expressed their opinions of the Diligentia case and the legal effects of the case.[104] According to SKV, the approach taken by the Supreme Administrative Court indicated that the Diligentia case also could be applied to cross-border transactions where the Correction rule is applicable. SKV also claimed that the approach was in compliance with the arm's length principle as expressed in the TP guidelines of OECD. According to SKV, the arm's length principle meant that a pricing carried out by enterprises in a group should correspond to the pricing of two in-

[103] Perrone, David, Schmid, Nils, "Avtalad ränta vid koncerninternt lån inte avdragsgillt fullt ut- Regeringsrättsdom", June 2010, p.1.

[104] Skatteverkets yttrande, Diligentiamålet och Korrigeringsregeln i 14 kap. 19§ IL, 2010-09-28, Dnr. 131 632628-10/111

dependent parties under comparable circumstances. When performing a comparability analysis the relevant economical characteristics should be comparable as stated in para. 1.33 of the TP guidelines. The credit risk constitutes one of the factors when establishing a market interest-rate. A loan granted by a parent company to its subsidiary with no security attached to it could not be comparable to loan by an external lender to the same subsidiary. The control that the parent company exercised over the subsidiary results in a lower credit risk for the parent company put side by side to an external lender; hence the circumstances are not comparable. SKV added that if the exercise of control of the parent company results in a lower credit risk, it does not necessary mean that all subsidiaries have the same credit worthiness or that it is possible to provide general policies on how the control of the parent company affects the interest –rate level. The assessment of an appropriate market interest-rate on intra-group loans has to be made *in casu*. By relying on the notion of control over the subsidiary could imply that the basic premise of the arm's length principle i.e. treating the enterprises within the group as they were separated from each other, could be hampered.

5.3 Foreign case law

5.3.1 GE capital

The General Electric Capital Canada INC., and Her Majesty The Queen concerns an intra-group guarantee, which was a financial guarantee provided by the parent company-GE Capital in the U.S. for the support of its Canadian subsidiary's third-party public debt. The debt securities were commercial papers issued on the Canadian money market and unsecured debentures issued under its medium term note facility in the Euro-markets.[105] The debt securities had the highest credit ratings from the credit rating agencies and therefore the lowest cost of borrowing in the Canadian debt market for GE Capital Canada (GE Canada). The intra-group guarantee of GE Capital enhanced the creditworthiness of the GE Canada's debt issue.

GE Capital charged GE Canada a fee for guaranteeing its debt owing to the third-party creditors. GE Canada deducted the fee in respect of 1996 to 2000 taxation years. However, the Minister of National Revenue denied and added withholding taxes as he belie-

[105] Hands, Gordon, "Lessons from the GE Capital Canada case", TP Week, March 2010, p. 1.

ved that GE Canada received no economic benefit from the guarantee and, as a result, the arm's length price for the guarantee would be zero.

The question was whether or not debt market participants would have purchased GE Canada's unguaranteed debt securities, in sufficient amount required by GE Canada to its business plan and at low enough rates for them to be profitable, even if the parent-subsidiary affiliation or implicit financial support would have resulted in GE Canada being considered an AAA-rated issuer, in other words, equivalent to the parent GE Capital.

One of the witnesses, Dr Chambers an ex co-worker at Standard & Poor's (S&P) made a two-step analysis in order to establish the stand-alone rating of the subsidiary. [106] The first step was an analysis of the subsidiary on a stand-alone basis where he established that the stand-alone creditworthiness of GE Canada would have been single B+ or a BB- during the relevant period. The reason for this was GE Canada was a profitable entity which was growing rapidly. However, the rapid growth could be negative when it came to financial institutions. Furthermore, the company was thinly capitalized and did not seem to continually generate profits.

The second step was the factoring of the parent-subsidiary into the stand-alone rating. In the second step, an analysis was made in order to rank the subsidiary in a spectrum that ranges from entities considered *core* on one end to *independent* on the other. A core subsidiary is an entity that represents a large proportion of existing business and who's financial performance and growth exceed that of the total business, thus support is very unlikely to be required in that circumstance. Independent entities are the opposite; these entities are not expected to benefit from parental support as they can be sold without any impact on the financial well-being of the group as a whole.[107]

The key principle that Canada's Revenue Agency (CRA) relied on was paragraph 7.13 in the Guidelines which stated that

[106] The Tax Court of Canada, General Electric Capital Canada Inc., and Her Majesty The Queen, Dockets 2006-1385, 2006-1386, Para. 48-64.

[107] The Tax Court of Canada, General Electric Capital Canada Inc., and Her Majesty The Queen, Dockets 2006-1385, 2006-1386, Para. 53.

"...for example, 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..."[108]

CRA claimed that credit rating of GE Canada should be equalized to that of GE Capital by the reason of affiliation in the absence of a guarantee arrangement.[109] The argument was that GE Canada could have borrowed the same amount of money at the same interest rate without an explicit guarantee, as it did with such a guarantee. Hence, GE Canada did not receive an economic benefit from the guarantee. The arm's length price for the guarantee was, according to the CRA zero and added that the guarantee arrangement was simply a clearer indication of the implicit support that already existed in favor of GE Canada. According to the CRA the credit rating of GE Capital would have been notched up to AAA, the same as its parent GE Capital since the debt holders, and also S&P, would acknowledge the strong economic incentive to provide financial support to GE Canada in times of default even if it was not legally obliged to.[110] The CRA argued to that GE Capital would never allow a subsidiary to default on its debt, sacrificing its AAA rating.

GE Canada argued in opposition to the approach of the CRA and claimed that it had to be established whether the 100-basis point annual fee exceeded an arm's length price.[111] Furthermore, they argued that the argument of the CRA, stating that GE Canada had received an affiliation benefit, could not be considered under paragraph 247 (2) of the Canadian ITA.[112] GE Canada stated that all distortion arising from the relationship of the parties must be eliminated to arrive at an arm's length result.

[108] (2010) OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Chapter. VII, Para. 7.13.

[109] The Tax Court of Canada, General Electric Capital Canada Inc., and Her Majesty The Queen, Dockets 2006-1385, 2006-1386, Para. 168.

[110] The Tax Court of Canada, General Electric Capital Canada Inc., and Her Majesty The Queen, Dockets 2006-1385, 2006-1386, Para. 169.

[111] The Tax Court of Canada, General Electric Capital Canada Inc., and Her Majesty The Queen, Dockets 2006-1385, 2006-1386, Para. 173.

[112] The paragraph is conform with the principle of the arm's length enunciated in the OECD Model Tax Convention on Income and on Capital, (2008), Article 9.

An arm's length relationship could not be based on the ownership and control of the parent company, according to GE Canada. The credit rating of a subsidiary must be carried out on a stand-alone basis without the implicit support of the parent company.[113] The fact that GE Canada could receive higher dividends due to enhanced profits deriving from interest cost savings could not be acknowledged as a benefit attributable to the guarantee. Instead, the benefit emanated from the ownership of GE Capital and all benefits, attributable to share ownership should be ignored.

The main argument of the CRA was that GE Canada was not in need of an explicit guarantee, since the credit rating would be equivalent without it due to its strong parent, GE Capital. GE Canada countered and submitted that even if one were to accept the theory regarding the case, GE Canada would not have obtained an AAA rating from S&P or any of the other rating agencies if implicit support was taken into account in the analysis.

The analysis carried out by the Justice was divided into several questions in order to examine the legal framework surrounding the issues of the case. Regarding whether the analyzing of the stand-alone credit rating was a proper approach, the Justice stated that transfer pricing rules apply to parties who do not deal with each other at arm's length. According to the Canadian regulations, parties who are not at arm's length are persons in control of one another.[114] The common denominator is *de jure* control which means:

"...the right of control residing in the ownership of the shares which carry the majority of the voting rights that can be exercised to elect the majority of directors to a corporation's board..."[115]

In this case, there was no doubt that GE Capital and GE Canada were related by the virtue of *de jure* control that GE Capital had over GE Canada. The justice found it necessary to dissect the term *arm's length*, in order to establish whether implicit support should be ignored as it could be rooted in the non-arm's length relationship, hence between as-

[113] The Tax Court of Canada, General Electric Capital Canada Inc., and Her Majesty The Queen, Dockets 2006-1385, 2006-1386, Para. 174.

[114] See 251 (1) (a), 251 (2)(b), 251 (2)(c) of the Canadian ITA.

[115] The Tax Court of Canada, General Electric Capital Canada Inc., and Her Majesty The Queen, Dockets 2006-1385, 2006-1386, Para.184.

sociated enterprises. According to the justice, the concept had nothing to do with the exercise of *de jure* control which was the definition of a non-arm's length relationship. Instead, implicit support was developed through reputational pressure from the debt holders of GE Capital as they would react negatively if GE Canada was allowed to default on its debt.[116]

The court stated that "*the expressions 'arm's length' and 'non-arm's length' are creations of law. They are not words of ordinary language from which a plain meaning can be easily distilled.*" The court then turned to *"the textual, contextual and purposive analysis to clarify the expression in the context of transfer pricing."*[117]

The arm's length should instead be based on the content, discussed in previous case law.[118] When establishing whether a transaction is carried out at an arm's length, it is important to maintain the relevant economic characteristics of the controlled transaction in order to ensure the reliability of the comparisons with uncontrolled transactions. Hence, the concept of independent parties was applied to adjust profits by[119] *"...reference to the conditions which would have been obtained between independent enterprises in comparable transactions in comparable circumstances..."*[120]

Thus, the Court brought up the different aspects relevant when analyzing the transaction, these aspects were GE Capital's control over GE Canada's treasury department and that an arm's length guarantor would not have that kind of control over an entity receiving a guarantee and hence would be assuming a much larger risk.

The factors arose from the relationship GE Capital had with GE Canada and when applying the arm's length principle these factors should normally be ignored. However,

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[116] The Tax Court of Canada, General Electric Capital Canada Inc., and Her Majesty The Queen, Dockets 2006-1385, 2006-1386, Para. 199.

[117]The Tax Court of Canada, General Electric Capital Canada Inc., and Her Majesty The Queen, Dockets 2006-1385, 2006-1386, Para. 188.

[118] GlaxoSmithKline Inc. V. The Queen, SmithKline Beecham Animal Health Inc. V. Canada.

[119] (1995) OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Chapter I, Para.1.6. Independent parties is according to the justice very similar to the concept of arm's length "*…as both concepts presuppose that neither party controls the other or is subject to common control…*"

[120] The Tax Court of Canada, General Electric Capital Canada Inc., and Her Majesty The Queen, Dockets 2006-1385, 2006-1386, Para. 204.

the Court stated that as GE Capital exercised control over the risks related to the guarantee which a third-party guarantor would not. Hence, it would not be reliable to make a direct comparison to a third-party guarantor why these factors were economically relevant factors that needed to be taken into consideration.[121]

The Court stated that in order to establish whether the explicit guarantee mitigated the risk of default of GE Canada's debt offerings it was important to determine GE Canada's credit rating without the explicit guarantee and stated that the uplift in GE Canada's stand-alone credit rating would be three credit rating notches which resulted in a credit rating from B+/BB- to BB+/BBB- .[122] The judge ruled that GE Capital Canada could not have raised the necessary funds at the low interest rates it benefitted from without the explicit guarantee from GE Capital why the guarantee was vital in order for them to execute their business plan.

Regarding the implicit support from the parent GE Capital, the Court claimed that implicit support was not to be compared to explicit support as it was *"...nothing more than one's expectation as to how someone will behave in the future because economic reasons will cause the person to act in a certain manner..."* [123]Furthermore they claimed that "*implicit support was something investors believe existed and that could provide financial support under the right circumstances but few investors were foolish enough to believe was equivalent to a guarantee"*.[124]

The Court concluded that the benefit that GE Canada received in the transaction was in the form of reduced interest rates due to GE Capital's AAA credit ratings. The interest cost savings was calculated to be 1.83%. The court held that the guarantee fee of 1% charged by GE Capital was equivalent or lower than the arm's length price.[125]

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[121] The Tax Court of Canada, General Electric Capital Canada Inc., and Her Majesty The Queen, Dockets 2006-1385, 2006-1386, Para. 205.

[122] The Tax Court of Canada, General Electric Capital Canada Inc., and Her Majesty The Queen, Dockets 2006-1385, 2006-1386, Para. 207.

[123] The Tax Court of Canada, General Electric Capital Canada Inc., and Her Majesty The Queen, Dockets 2006-1385, 2006-1386, Para. 281.

[124] The Tax Court of Canada, General Electric Capital Canada Inc., and Her Majesty The Queen, Dockets 2006-1385, 2006-1386, Para. 287.

[125] The Tax Court of Canada, General Electric Capital Canada Inc., and Her Majesty The Queen, Dockets 2006-1385, 2006-1386, Para. 305.

The Court maintained that taxpayers should not make general assumptions from the particular case because differences in facts or circumstances or in the economic characteristics could lead to different results in different situations. "*Transfer pricing is largely a question of facts and circumstances coupled with a high dose of common sense*. "[126]

5.3.2 Comments on GE Capital

After the verdict of the Tax Court of Canada many professionals expressed their different opinions and interpretations of the case as the case undoubtedly had a great impact on the ongoing debate surrounding the pricing of group guarantees, implicit support and the affect of the parent-subsidiary affiliation.[127] However, it was possible to distinguish a pattern regarding some of the key issues.

One of the key issues was the determination and interpretation of the arm's length principle and whether the relationship between the parent and the subsidiary should be acknowledged in the comparability analysis. This issue was expressed in the case as the parties argued whether or not the intra-group was necessary at all. Arguments that supported the CRA was that GE Canada supposedly did not receive any economical benefit from the guarantee since GE Canada's debt market participants recognized the implicit support of GE Capital. Expressed differently, the CRA assumed that GE Capital would never let GE Canada default on any unguaranteed debt due to the impact it would have on their reputation and the costs attributable to such an event. GE Canada on the other hand argued that the relationship should be disregarded and that the evaluation should be based on a separate-entity approach. The Court thought that the implicit support should not be disregarded since it was important to maintain the relevant economic characteristics, when performing the comparability analysis. The Court claimed that GE Canada misinterpreted the principle of the arm's length when disregarding the implicit support. The implicit support constituted one of the characteristics of the transaction hence a comparability factor.

Gordon Hands, from CUFT analytics, expressed in his article on the GE Capital case that the parent-subsidiary affiliation should be included in the assessment of the credit

[126] The Tax Court of Canada, General Electric Capital Canada Inc., and Her Majesty The Queen, Dockets 2006-1385, 2006-1386, Para. 273.

[127] BDO, "Tax Court of Canada Rules In Favour of GE Capital Canada In Guarantee Fee Trial", January 2010, Author unknown, "GE Capital verdict leaves room for doubt", TP week, December 2009.

risk, but also stated that it did not imply an improved credit risk or a credit risk equal to the external rating of the parent.[128] Regarding the implicit support, he stated that this would be where debt market participants, by the reason of the parent-subsidiary affiliation, charge the subsidiary a lower interest rate without an explicit guarantee.[129]

As the court, he also claimed that implicit support was in compliance with the arm's length principle since the ownership or shareholder relationship between the parent and the subsidiary must be disregarded. The parties must carry out the transactions between them on a separate-entity basis. Thus, any benefit arising from the parent-subsidiary relationship (implicit support) should not be compensated for, which was in accordance with paragraph 7.13 of the TP guidelines.[130]

Some professionals argue that the parent subsidiary affiliation, when the parent exercises control over the subsidiary, is to be regarded an economical aspect that has to be included in the comparability analysis when establishing the arm's length price. Others, however, have argued that the consideration of the parent-subsidiary relationship is equal to implicit support, and claim that such consideration suggests a departure from the arm's length principle.[131]

The yield approach was, according to the Court, the most appropriate method for measuring the arm's length price of the fee. Most professionals had already considered the method before the GE Capital case, but when the ruling came, the method was confirmed to be the most suitable for financial transactions.[132]

5.4 Summary

In the Fiskeby Holdings case, the interest rate was set to 9, 5 percent but then changed after several negotiations and the loan could therefore, according to the County Administrative Court, be considered a loan with variable interest-rate. All instances conside-

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[128] Hands, Gordon, "Lessons from the GE Capital Canada case", TP Week, March 2010, p. 2.

[129] Id.

[130] Id.

[131] BDO, "Tax Court of Canada Rules In Favour of GE Capital Canada In Guarantee Fee Trial", January 2010, Perrone, David, Schmid, Nils, "Avtalad ränta vid koncerninternt lån inte avdragsgillt full tut-regeringsrättsdom", June 2010.

[132] Author unknown, "GE Capital verdict leaves room for doubt", TP week, December 2009.

red that the set interest rate was not at an arm's length and stated that the proper arm's length rate was STIBOR added with 1 percent. The Courts also concluded that an arm's length rate could be determined by a wide range of different interest rates but expressed the difficulty in establishing whether the interest rate was commercial in its nature. A satisfactory security was deemed to have existed due to its shareholding in the subsidiary and its group affiliation.

In the Diligentia case the interest rate was set to 9, 5 percent. The County administrative Court established that an arm's length rate could be determined by looking at a wide range of interest rate levels since the interest rate was affected by a number of elements such as the credit worthiness of the borrower, term to maturity, securities etc. The Court claimed that the loans could be compared to a loan with security due to the ownership structure, i.e. the fact that Diligentia was the subsidiary of the parent company Skandia Liv. The Court also emphasized the importance of determining an appropriate interest rate on a case by case basis. The Supreme Administrative Court concluded that when a parent company is granting a loan to its subsidiary, different conditions apply. Loans from parent companies to subsidiaries have characteristics that influence the credit risk, hence the interest rate.

The GE case regarded an intra-group guarantee provided by the parent company GE Capital seated in the U.S. for the support of its Canadian subsidiary's third-party debt. The Canadian subsidiary was charged a fee for the intra-group guarantee which then was deducted. The CRA claimed that the credit rating of GE Canada should be equalized with that of GE Capital by the reason of affiliation in the absence of a guarantee arrangement. They claimed that GE Canada could have borrowed the same amount of money at the same interest rate without the explicit guarantee, as did with such a guarantee. Hence, GE Canada did not receive an economic benefit from the guarantee. The Court stated that the arm's length price of the guarantee should be based on the relevant economic characteristics of the controlled transaction in order to ensure the reliability of the comparison with uncontrolled transactions. The Court also stated that GE Capital exercised control over the risks related to the guarantee which a third-guarantor would not. Thus it would not be reliable to make a direct comparison to a third-party guarantor, why the factor control was economically relevant and needed to be taken into consideration. The Court concluded that the benefit that GE Canada received in the transac-

tion was in form of reduced interest rates due to GE Capital's high credit ratings and held that the guarantee fee was equivalent to, or lower than an arm's length price.

6 Analysis

6.1 Introduction

The master thesis has presented the relevant facts required in order to fully comprehend the issues surrounding the pricing of intra-group loans. The general problems of intra-group financing have been described as well as the legal framework applicable when solving related issues. Due to the unique characteristics of a financial transaction, it is difficult to find comparable transactions and to establish the appropriate price in compliance with the arm's length principle. These difficulties have been exposed in case law, and debated by professionals. The issues have mostly concerned the pricing of intra-group loans and the impact of the group-affiliation.

When a cross-border transaction is carried out, the OECD TP guidelines have served as the proper tool when solving the issues related to the pricing of the transaction. However, the pricing of intra-group loans has proved to be more complex. The guidance provided concern implicit support and has been interpreted by tax authorities in various ways. There is undoubtedly a need to highlight the issues related to the pricing of intra-group loans.

In this chapter, the answers to the inquiries related to the purpose of the thesis are presented. The key issues of the analysis are whether the establishment of an interest rate and the assessment of the credit risk, should be made taking into account the parent-subsidiary affiliation and whether or not this is a departure from the arm's length principle. Further issues have been highlighted and proposed solutions have been examined.

6.2 The influence of the parent-subsidiary affiliation

6.2.1 Control of the parent company

The arm's length principle and the separate entity approach constitute the core of transfer pricing. The separate entity approach advocates that each enterprise within a multinational group should be treated as separate entities. Thus, when applying the arm's length principle, the price of a transaction between related parties is compared to the price of an uncontrolled transaction carried out by unrelated parties under similar circumstances on the open market.

Interest rate is, according to Swedish law, a deductable cost even though it does not constitute an expense for realizing and maintaining revenues. In Sweden, there are no thin capitalization rules, limiting the deductibility of interest rates in the case where the company paying the interest is thinly capitalized. These are favorable conditions that could be abused in order to shift profit from Sweden to jurisdictions with lower tax rate on corporate income.

When a financial transaction is carried out between entities within a multinational group the Correction rule takes precedence over general principles when determining an arm's length price of a transaction. When determining an arm's length interest rate on an intra-group loan, the price of the loan should be equivalent to the price set between unrelated parties in an uncontrolled transaction under external forces. However, a parent company and its subsidiary are affiliated, and their dealings are affected by their commercial relations. From a transfer pricing point of view, the parties should be treated on a separate entity basis. Nevertheless, the relationship of a parent company and its subsidiary has characteristics that sometime complicate the process of establishing an arm's length price and the search for comparable transactions.

When performing a comparability analysis the relevant economical characteristics should be comparable as stated in the TP guidelines. When determining the interest rate of a loan, an improtant factor is the credit rating of the borrowing party. The credit rating is normally affected by the presence of explicit support, usually in the shape of a group guarantee. The question has been whether the parent-subsidiary relationship or implicit support also could affect the credit rating and the price of a loan.

In GE Capital and Fiskeby Holdings the credit worthiness of the borrowing subsidiaries were influenced by their group affiliation. In the Diligentia case, it was assumed that the credit risk exposed to the lender could not have been greater had there been a formal security. Thus, the parent-subsidiary affiliation has been taken into consideration in all three cases. In Fiskeby Holdings, the Court suggested that the shareholding in the subsidiary and the group affiliation was enough to be considered a sufficient security. In the Diligentia case the Court held that when a parent company is granting a loan to its subsidiary, different conditions will apply since the parent company exercises control over the subsidiary. A third party lender, on the other hand, has limited insight and control.

The Swedish Court in Diligentia argued that loans, between parent companies and subsidiaries have certain characteristics that affect the credit risk and hence the interest rate. When a subsidiary is lending from a third party, the parent usually has less control since the third-party lender normally has specific demands and requirements. The requirement is usually greater exercise of control in order to prevent the subsidiary from making any decisions that could affect the repayment ability. This demand of control by the third-part lender reduces the control of the parent company. Since there was no third-party lender in the Diligentia case the parent company had full control of its subsidiary. That kind of control could be compared to the same demand of control a third-party lender would require. Thus, *control* which is eminating from the parent-subsidiary affiliation should, constitute an economical factor that characterizes the financial transaction and should be included in the comparability analysis in the search of an appropriate benchmark.

In the GE Capital case, the Court emphasized the relevant aspects that should be considered when applying the arm's length principle. The Court stated that it was important to maintain the significant economical characteristics of a transaction in order to ensure the reliability of the comparison with uncontrolled transactions. One of the characteristics was, in effect, the control GE Capital exercised over GE Canada. It can thus be concluded that *control*, deriving from the parent-subsidiary relationship, should be considered as one of the important economical factors that characterizes a financial transaction.

6.2.2 Implicit support

In all the cases, the parent-subsidiary affiliation has, without a doubt, been taken into consideration in the assessment of the credit risk. An important issue to clarify is whether the impact of the parent- subsidiary affiliation should be compared to implicit support. In paragraph 7.13 of the TP Guidelines it is expressed that *"no service should be regarded as rendered when an associated enterprise receives a higher credit-rating by the reason of its affiliation"*. An improvement of the credit rating originating from the parent-subsidiary affiliation could thus be compared to implicit support. If a group member has received implicit support, this is a benefit originating from the group affiliation. Charging a fee for that benefit would not be in compliance with paragraph 7.13 in the TP guidelines.

The Canadian Court emphasized the importance of maintaining the economical characteristics of a transaction, why it could be justified to consider the group-affiliation. The parent-subsidiary relationship should, according to the Court, be considered in the assessment of the credit risk, as *control* was an economically relevant factor that had to be recognized in the comparability analysis. Implicit support, on the other hand, was not related to de jure *control.* Regarding the implicit support, the Court stated that taking into account the subsidiary-affiliation was not equal to implicit support in the wording of the paragraph 7.13 in the TP guidelines but was developed through reputational pressure from debt holders. Moreover, implicit support could not be compared to explicit support. Implicit support did exist but was not legally enforceable, and could never be equal to an explicit guarantee. Thus it had no real economical value. Hence, the Canadian Court made a clear distinction between taking into account the parent-subsidiary affiliation and the implicit support.

6.2.3 An approach in accordance with the arm's length principle?

It is possible to argue that the approach, taken by the Courts when considering the group affiliation and the control by the parent company, could be deviating from the arm's length principle. An approach respecting the group affiliation is not made on a separate entity basis and is thus not coherent with the arm's length principle. The parties' affiliation improved the credit rating of the subsidiary. Improved credit rating is, without a doubt, a benefit arisen from the parent-subsidiary relationship and should not be compensated for according to paragraph 7.13 of the TP guidelines. However, none of the parties in the Diligentia case and the GE Capital case were obliged to compensate the other for the improved credit rating why the recommendation in the TP guidelines was adhered to. The Canadian Court concluded that the guarantee fee was equal or lower than an arm's length fee. The approach taken in the rulings of the Courts should thus be considered to be in compliance with paragraph 7.13 of the TP guidelines. Professionals supporting the approach of the Canadian Court claimed that the parent-subsidiary affiliation should be included in the assessment of the credit risk, but that it was not reasonable to expect that implicit support would equalize the subsidiary's credit rating to that of its parent.

Two major opinions can be discerned in the debate of the Diligentia and the GE Capital rulings. On the one hand some argue that the approach taken by the Courts could be a

deviation from the arm's length principle whereas others argue that it is necessary to include the parent-subsidiary affiliation in the assessment of the credit risk. The Judges have, in both cases, stated that it is important to not draw any general conclusions from the rulings and that different situation with different economical circumstances might lead to different conclusions. In the Diligentia case, the Court emphasized that a market interest rate always had to be evaluated *in casu*, taking into account all relevant elements and characteristics of the transactions such as the control exercised by the parent company. In the GE case the judge emphasized the importance of regarding all relevant facts of each case, as differences in facts, circumstances and economically relevant characteristics of a transaction could change the outcome. It can be concluded that the rulings were in fact made in compliance with the arm's length principle as the Courts did not oblige the parent-companies to request a guarantee fee for the implicit support. Moreover, when assessing the credit worthiness of the subsidiary, the parent-subsidiary affiliation should be regarded as it constitutes an important comparability factor.

Similarly, both Courts claim that the parent-subsidiary affiliation should be taken into account in the assessment of the credit risk or when establishing the market interest rate. Moreover, the Courts both stated that all important aspects of a transaction should be evaluated. They also claimed that there is a difference when transactions are carried out between independent parties and when transactions are carried out between a parent company and its subsidiary. A third party lender, or a guarantor as in the case of GE capital, would not have exercised the same control as the control exercised by a parent company. Thus, a transaction between the parent company and its subsidiary is not comparable to a similar transaction carried out between the subsidiary and a third-party unless there are conditions in the third-party agreement requiring greater control of the subsidiary.

Explicitly, it is necessary to consider that the subsidiary, de facto, is not an independent entity, but wholly owned by the parent company. The fact that the parent company and the subsidiary are affiliated *could* affect the credit rating of the subsidiary. This would be in the case where it can be established that an independent lender would have provided better lending conditions to the subsidiary, or the credit rating would have been notched up due to the fact that the specific subsidiary was the subsidiary of a specific parent company. A parent company in that case would probably be credit worthy and sol-

vent. In this case, there would in fact be an implicit support from the parent company to the subsidiary. This support is not outspoken and there is no legally binding agreement establishing the support. The implicit support can sometimes be visible through circumstances such as where an external lender believes in the good intentions of the parent company. If it is possible to establish that there is in fact implicit support which benefits the subsidiary, this support should not be compensated for in accordance with paragraph 7.13 of the TP Guidelines.

Even though the Diligentia case dealt with a loan granted by a parent company to its subsidiary and the GE Capital case dealt with the guarantee fee from a parent company to its subsidiary, there are, as demonstrated, several common factors combining the two cases. Bearing in mind that the GE Canada ruling was made before the Diligentia ruling, it is likely that the Swedish Court was influenced by the GE capital case and the Canadian Court, in their judgment of the Diligentia case.

6.3 Loans without interest

The core of the arm's length principle is the separate entity approach which implies that associated entities should be regarded as independent from one another. As mentioned previously, in paragraph 6.3 of the analysis, there are separate opinions regarding whether it would be a deviation from the arm's length principle to observe the parent-subsidiary affiliation. In Swedish case law, the Correction rule has not been regarded as applicable in the case where a parent company grants a loan to a subsidiary without charging any interest. In the final remarks of chapter five in the 1979 TP Guidelines, it is expressed that interest rate is, in general, expected to be paid for a loan, but in circumstances where a lender, who is at arm's length from the borrower, agree to waive or defer the payment of interest, it could be accepted that associated enterprises might act in the same way. Could an intra-group loan have zero interest rate, if a comparable transaction, at an arm's length, with the same characteristics had zero interest rate?

As mentioned, Swedish case law has accepted the waiving of interest rate under certain conditions, such as in the case of an accepted compensation plea or in the establishing phase of a business. In these cases it has been accepted to deviate from the arm's length principle, and it has been recommended to consider the certain commercial reasons and conditional circumstances which may affect the pricing. If it is acceptable to deviate

from the arm's length principle under these circumstances and to regard the commercial reasons to why interest rate should been waived, should not the same conditions be applied in other circumstances?

In these cases, the Court has advised to observe the certain commercial reasons which may affect the pricing in the circumstance where a parent company, in its attempt to enter into a new market, grants a loan to its subsidiary. This approach supports those who believe that the considering of the parent-subsidiary affiliation is in compliance with the arm's length principle. However, to accept that no interest is levied, for the benefit of the subsidiary which is in the establishing phase, could be regarded as a deviation from the arm's length principle. In that circumstance, the associated entities are not treated on a separate entity basis. The Courts have, in their approach, justified the deviation of the arm's length principle by referring to the commercial characteristics or the certain characteristics of the parent-subsidiary relationship. This approach is reasonable, but could perhaps lead to future rulings, justifying the deviation of the arm's length principle by referring to the certain characteristics or commercial circumstances that exist in a parent-subsidiary relationship. However, this statement remains to be determined by the adjudication process in future case law.

6.4 Thin Capitalization rules - a solution?

As Sweden does not have thin capitalization rules, there are no restrictions on how thinly capitalized a corporation is allowed to be. Also, there is generally no limit on the deductibility of interests. The thin capitalization rules have been instituted in many other countries as a way to prevent companies from granting loans to subsidiaries and then reducing overall corporate tax payments by charging interest on these loans. The rules have been implemented in hope to discourage corporate groups to transfer capital, using interest rates on loans between the parent-company and the subsidiary. However, the rules only prevent corporate groups from arranging these tax structures and do not solve the transfer pricing issue. Companies can still manipulate the ratio of debt or by increasing the rate of interest to the associated entity. Even if a loan would be approved from a thin capitalization point of view, the interest rate on the loan may not be at an arm's length. Nevertheless, the rules could facilitate the process a great deal, by establishing a debt-to-equity ratio above which interest is disallowable when calculating corporate income tax liability.

6.5 Do the TP guidelines give enough guidance?

The 1979 TP guidelines recommend bank rates as a starting point when finding comparable conditions. Bank rates are used, both by professionals and by Courts in an attempt to set an arm's length rate. However, the 1979 TP guidelines warned about having a mechanical rule based on such a rate as it does not take into account the factors mentioned, which is a necessity when establishing the arm's length rate of interest. The warning is legitimate as bank rates merely give some indication of the market price of a loan. It is important to regard the specific economical characteristics of the transaction at hand and the parties involved. Both Diligentia and Fiskeby Holdings have gathered inspiration from the 1979 year guidelines when stating that the economical characteristics could be; why the loan has been established, the currency, term to maturity, and the credit worthiness of the borrower. Also, demonstrated in case law, important factors are the parent-subsidiary affiliation and the control exercised by the parent company. However, the bank rates can be, and should be, used as a point of reference which then can be adjusted on the basis of the certain conditions of the specific transaction. Preferably, the assessment should be made *in casu* instead of applying a general bank rate as a benchmark for interest rates on all intra-group loans. The *in casu* treatment is also a recommendation stipulated in the newer versions of the TP Guidelines where it is expresssed that each case must be determined according to its own facts and circumstances.

The TP guidelines do attack the issue of implicit support, but the information is quite scarce. The article merely establishes that no service would be received where an associated enterprise by reason of its affiliation alone receives a higher credit-rating, higher than it would if it were unaffiliated. This means that an improved credit rating by the reason of the company's group affiliation should not be compensated for. However it does not express whether the group affiliation should be considered when determining the arm's length price in general.

The paragraph 7.13 in the TP Guidelines was only applied in the GE Capital case. The Swedish cases focused on the application of the arm's length principle and the separate entity approach. These principles do pervade the 7.13 paragraph, but the paragraph is more limited to the issue of implicit support. The Diligentia case did not concern a cross-border transaction why an application of the TP guidelines was not required. It is thus not remarkable that the Court excluded an application of the TP guidelines. Howe-

ver, the Fiskeby Holding case did concern a cross-border transaction but neither the Court nor the Company addressed the issue of the parent-subsidiary affiliation by applying the 7.13 paragraph. It is remarkable and unclear why the Swedish Court has chosen not to address the recommendation set out by the OECD.

Many professionals complain about the few instructions set out in the TP guidelines on the pricing of intra-group loans. Intra-group financing is indeed a complex area, why more details on the pricing methodology is recommended. As manifested in case law, many alternative methods such as the yield approach method have been applied instead of the CUP method.

Even if the TP guidelines could include more details on the area of financial transactions, the issues relating to the pricing process cannot be solved completely by extending the guidelines. Financial transactions, carried out between entities within a group, often have unique characteristics. There are several aspects that need to be taken into account when establishing the arm's length price of an intra-group loan. This view was shared by the Courts in the Fiskeby Holdings, Diligentia and GE Capital case. The Courts surely abided the recommendations in the TP guidelines which stipulate that each case must be determined according to its own facts and circumstances. This approach, that advocates an evaluation on a case-by-case basis aggravate the establishment of an exact method when determining the arm's length price of intra-group loans.

7 Conclusion

7.1 Introduction

The purpose of this master thesis has been to examine the issues surrounding the pricing of intra-group loans. The main focus was put on the establishment of an interest rate and the assessment of the credit risk in an intra-group context. The main task was to determine whether the establishing of an interest rate of an intra-group loan should be made taking into account the parent-subsidiary affiliation or relationship and whether this could be a deviation of the arm's length principle.

In the analysis it has been established that the parent-subsidiary affiliation is indeed a relevant factor that should be included in the assessment of the credit risk and the pricing of an intra-group loan. To include the parent-subsidiary affiliation in the pricing process should not be regarded as a deviation of the arm's length principle seeing that it does not necessarily imply an improved credit risk or a credit risk equal to the external rating of the parent. It has also been established that further instructions regarding the methodology of the pricing of loans is required. The remaining issue is, however, the uniqueness of the financial transactions which requires a treatment made on a case-by-case basis. In this chapter, the final conclusions are presented to summarize what has been established.

7.2 Concluding remarks

The pricing of a loan is complex due to the unique character of the transaction. As distinguished in both Diligentia and GE Capital, all the relevant economical characteristics of a financial transaction should be taken into account when establishing an arm's length interest rate. This is important in order to ensure the reliability of the comparison with the uncontrolled transaction when performing the comparability analysis. However, since multinational groups sometimes face commercial circumstances that differ from when transactions are carried out between independent parties, other conditions apply. If there are no external lenders, the parent company usually exercises great control over its subsidiary and is aware of its intentions. This factor of control emanates from the parent-subsidiary affiliation and should be included among the other relevant factors set out by the OECD. The affiliation itself does not necessarily affect the credit rating and the price of the intra-group loan. The price of the loan could still be at an

arm's length. It is not the relationship itself that influences the pricing of the loan, but it is a factor that should be included in the search of a suitable benchmark.

It is important to emphasize that the impact of the parent-subsidiary affiliation should not be equal to implicit support. This is where the parent- subsidiary affiliation improves the credit rating of the borrower, without an explicit guarantee being provided by the lender. A benefit arisen from the parent-subsidiary should be ignored and not be compensated for.

Finally it should be pointed out that it is recommended to perform an evaluation on a case-by-case basis as demonstrated in case law and by the OECD. Thus caution should be exercised in the assessment of similar transactions in the future. It is important to not draw any general conclusions from case law given that there could be other circumstances that could affect the outcome.

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