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memorandum

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subject: Effect of Group Membership on Financial Transactions under Section 482 and Treas. Reg. § 1.482-2(a)

This memorandum provides non-taxpayer-specific legal advice regarding the application of section 482 of the Internal Revenue Code. This advice should not be used or cited as precedent.

ISSUE

May the Service consider group membership in determining the arm's length rate of interest chargeable for intragroup loans and making a section 482 adjustment?

CONCLUSION

Yes. Under the section 482 regulations, the arm's length rate of interest on an intragroup loan to a controlled borrower is generally the rate at which that borrower could realistically obtain alternative financing from an unrelated party. Thus, if an unrelated lender would consider group membership in establishing financing terms available to the borrower, and such third-party financing is realistically available, then the Service may adjust the interest rate in a controlled lending transaction to reflect group membership.

This is true notwithstanding that group membership may improve the debt terms available to a controlled borrower based on financial support expected from another group member (even if that group member is the lender in the controlled lending transaction). Taxpayers may argue that while group membership may reduce the arm's length interest rates

available to the borrower from credit markets, it should be ignored where it does so based on an expectation of financial support from the lender, because the lender does not benefit from its own support. However, such an argument relies on the ownership relationship with the borrower and must be rejected as it assumes, contrary to the arm's length standard, that the controlled lender would provide financial support to the controlled borrower, whereas no unrelated lender would. Under the regulations, the ownership relationship between the controlled lender and controlled borrower is disregarded for this purpose. Rather, the controlled lender is expected to enforce repayment of the debt according to its terms as in an arm's length *bona fide* lending.

BACKGROUND

Commercial lenders analyze an unrelated borrower's financial standing and business prospects to evaluate the risk involved in extending credit. For this purpose, they commonly use a credit rating system, by which rating agencies categorize entities according to their credit risk. When rating an entity that is a member of a corporate group, a rating agency may separately assess both the entity's creditworthiness as an independent entity, sometimes referred to as a "standalone credit profile," and the corporate group's, sometimes called a "group credit profile." These assessments contribute to the agency's determination of the entity's credit rating.

When deriving an entity's credit rating from the standalone and group credit profiles, the rating agency may take into account (i) the relationship of the entity's businesses and assets to the overall group and (ii) the likelihood that another group member would provide financial support (*e.g.*, by equity contribution or debt forgiveness) if the entity were in financial distress, even absent an explicit guarantee or other formal commitment to do so. The possibility of such anticipated financial support absent legal obligation, when considered by a rating agency or lender, is commonly referred to as "implicit support."

FACTS

Foreign Parent ("FP") directly owns 100% of the equity of U.S. Subsidiary ("USSub"). USSub owns operating assets and operates businesses essential to the group's financial performance. As a result, if USSub's financial condition were to deteriorate, FP would be expected to likely provide financial support to USSub to prevent a potential default on USSub's obligations, at least if owed to unrelated parties. For example, if such a default were to become imminent, FP might contribute capital to USSub or forgive debt owed to it by USSub.

USSub plans to obtain capital through an intragroup loan. An independent rating agency has rated FP and USSub on a system that uses the following ratings to denote descending assessments of creditworthiness: AAA, AA, A, BBB, BB, B, CCC, CC, C.[1]

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[1] In determining an arm's length interest rate on related party debt, where ratings are not actually obtained by an independent rating agency, a taxpayer or Exam may conduct analyses similar to those performed by a rating agency, including by assigning "shadow ratings" similarly reflecting the creditworthiness of each entity.

Under the prevailing economic conditions, for a loan with the terms (*e.g.*, principal amount, issuance date, duration, payment schedule, default triggers) required by USSub, the agency's ratings correspond to the following commercial market interest rates:[2]

Borrower Credit Rating	Market Interest Rate
A	7%
BBB	8%
BB	9%
B	10%

FP has a credit rating of A. USSub has a one-notch-lower credit rating of BBB,[3] reflecting both its standalone credit profile and the group's group credit profile. As an independent entity (*i.e.*, without considering the group credit profile), USSub would have a credit rating of B. USSub's credit rating of BBB reflects implicit support from its corporate group, including FP.

FP lends to USSub on the parties' agreed terms at an interest rate of 10%. For purposes of this memorandum, the loan is assumed to be *bona fide* debt not subject to recharacterization under debt-equity principles. USSub's borrowing is not supported by an explicit guarantee or other legally enforceable financial support from another entity.

LAW AND ANALYSIS

Arm's Length Standard

Under section 482 and the regulations thereunder, the Service has broad latitude to adjust a taxpayer's tax items, including to adjust the reported results of a transaction between controlled taxpayers to comply with the arm's length standard.[4] In essence, the arm's length standard requires that such a transaction's results conform to those that would be obtained if the same transaction were entered into between uncontrolled taxpayers.[5]

In the intragroup lending context, the regulations apply the arm's length standard by directing that the rate of interest be an arm's length rate, which generally is the rate that would be charged in independent transactions between unrelated parties "for the use of

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[2] As with credit ratings, the rates corresponding to a particular debt issuance would typically be established and supported by suitable analysis, which would depend on date of issuance and debt terms. The arm's length interest rates are assumed to be greater than 130% of the relevant applicable Federal rate, and accordingly outside the safe haven range discussed below. See Treas. Reg. § 1.482-2(a)(2)(iii)(B).

[3] The practice by credit rating agencies of adjusting credit ratings upward or downward to reflect relevant credit factors is referred to as "notching." Under these facts, the one-notch difference disregards that certain ratings may be modified by the addition of a plus (+) or minus (-) sign to show relative standing within the major rating categories.

[4] I.R.C. § 482. See also Treas. Reg. § 1.482-1(a)(2), (b)(1).

[5] See Treas. Reg. § 1.482-1(a)(1), (b)(1).

such loan or advance."[6] The regulations further state that "an arm's length rate of interest shall be that which would have been charged in independent transactions between unrelated parties under similar circumstances," and that, for this purpose, "[a]ll relevant factors shall be considered, including … the credit standing of the borrower, and the interest rate prevailing at the situs of the lender or creditor for comparable loans between unrelated parties."[7] Because an uncontrolled commercial lender would charge interest based on the borrower's credit rating, factors that inform the borrower's rating, including the borrower's role, level of integration within the group, and implicit support from affiliates, all inform the arm's length rate of interest.[8]

Realistic Alternatives Principle

The "realistic alternatives principle," a corollary of the regulations' arm's length standard, recognizes that an uncontrolled taxpayer would not engage in a transaction on certain terms if doing so would leave them worse off than they would be under a realistically available alternative course of action. Accordingly, the Service may consider such alternatives "in determining whether the terms of [a] controlled transaction would be acceptable to an uncontrolled taxpayer" and "may adjust the consideration charged [between controlled entities] … based on the cost … of an alternative as adjusted to account for material differences."[9] However, it "will not restructure the transaction as if the alternative had been adopted."[10]

In the financing context, a borrowing entity's financing options are informed by its credit rating, which in turn may be affected by the entity's standalone credit profile, the corporate group's group credit profile, and implicit support available to the entity from the group. To the extent the borrowing entity's group membership thus reduces the interest rate available to it from third-party lenders, the borrower would reject a loan on the same terms at a higher interest rate from a related lender if the two dealt at arm's length. Under Treas. Reg. § 1.482-2(a)(2)(i) and Treas. Reg. § 1.482-1(f)(2)(ii)(A), the Service may adjust the interest rate charged to reflect this.

Application of the foregoing principles

The arm's length rate of interest charged by FP would reflect USSub's credit rating and thus the interest rate it would obtain from an unrelated lender. USSub's credit rating of

[6] See Treas. Reg. § 1.482-2(a)(1)(i), (a)(2)(i). Exceptions may apply. For example, a "safe haven" range of 100-130% of the applicable Federal rate based on the debt's maturity may either restrict the Commissioner's adjustment (if the actual rate is within the range) or allow the Commissioner to adjust the interest rate to the upper or lower limit of the range, as appropriate. Treas. Reg. § 1.482-2(a)(2)(iii)(B); I.R.C. § 1274(d)(1) (applicable Federal rate rules).
[7] Treas. Reg. § 1.482-2(a)(2)(i).
[8] This approach is also consistent with the current OECD Transfer Pricing Guidelines (specifically paragraphs 10.76-80). See https://read.oecd-ilibrary.org/taxation/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-2022_0e655865-en#page420.
[9] Treas. Reg. § 1.482-1(f)(2)(ii)(A). See also "Realistic Alternatives and Tax Considerations in the Application of Sections 482 and 367(d)", AM 2022-006 (Nov. 9, 2022).
[10] *Id.*

BBB reflects a two-notch increase over the rating it would have if it were an independent entity, which increase is based on the implicit financial support of USSub's group members. The Service may adjust the interest rate of FP's loan to USSub to the 8% arm's length interest rate USSub would pay to an unrelated lender based on its BBB rating. This rate reflects the amount USSub would be willing to pay at arm's length considering the alternatives available to it.

A taxpayer might argue that FP, as the source of USSub's implicit support, does not benefit from that support as creditor, and FP is thus entitled to a higher interest rate (10%) to compensate its greater risk compared to that of comparable loans (at 8%), with respect to which the uncontrolled lender benefits from implicit support. But the premise of this argument, that the controlled lender is the borrower's parent, is assumed away, as the central hypothesis of the arm's length standard is— "*uncontrolled* taxpayers … engaged in the same transaction under the same circumstances."[11] In evaluating an arm's length price, the Service will always treat the parties as dealing with each other as if they were unrelated.[12] Further, accepting this argument would inappropriately compensate the lender in its capacity as lender for risk it is assumed to bear in its separate capacity as an equity holder and which it would bear even if the loan were made by an unrelated party.[13] In any event, as explained, the controlled borrower should never accept an interest rate greater than the 8% it could borrow from the market. In short, the lender may not charge a higher interest rate based on a controlled relationship with the borrower, because an uncontrolled borrower would not accept a higher interest rate than what it could obtain from an uncontrolled lender.

No Compensation Is Owed for Passive Association Benefits

Under Treas. Reg. § 1.482-9, which governs controlled services transactions, no compensation is owed for any benefit arising solely from passive association.[14] Likewise, in the intragroup lending context, absent a guarantee or other legally binding credit support, a borrower is entitled to retain the benefit it receives solely from its group membership without compensating any affiliate.[15]

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[11] Treas. Reg. § 1.482-1(b)(1) (emphasis added). As the relationship between the lender and the borrower is assumed to be uncontrolled, the "same circumstances" does not implicate the entities' common ownership, except to the extent that the implicit support effect on the rate that a third-party lender would charge is a result of group ownership. And the arm's length interest rate available to the borrower based on implicit support generally would take into account only the lender's perception that implicit support exists and not whether it is attributable to a particular entity.
[12] Treas. Reg. § 1.482-1(b)(1).
[13] Further, a group member's benefit of group membership inures to a group member as, in effect, an asset of the member from and during its period of membership, analogous to a non-compensable contribution to capital. While "collateral transactions" are generally considered in determining the comparability of uncontrolled transactions evaluated in pricing a controlled transaction (Treas. Reg. § 1.482-1(d)(3)(ii)(A)(*6*)), equity *ownership* is not a collateral "transaction" for this purpose (Treas. Reg. § 1.482-1(i)).
[14] Treas. Reg. § 1.482-9(l)(3)(v).
[15] See note 14 above. This approach is also consistent with the current OECD Transfer Pricing Guidelines (specifically paragraph 7.13). See https://read.oecd-ilibrary.org/taxation/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-2022_0e655865-en#page319.

Conclusion

The arm's length interest rate for USSub's loan from FP is the interest rate applicable to a loan to a BBB-rated borrower (*i.e.*, 8%). That USSub's credit rating depends in part on implicit support from FP (and possibly other group members) does not alter this determination, and such implicit support is not separately compensable.

The analysis herein applies equally in the context of loans between controlled parties with other relationships. Thus, for example, the Service may adjust interest rate charges in loans between sister subsidiaries of a corporate group based on an agency credit rating of the borrower; based on a similar analysis, such as a "shadow rating" performed by Exam or the taxpayer; or based on terms available to the controlled borrower from commercial lenders. These will, in appropriate cases, include implicit support from the group, including from the lender.

Please call Branch 6 at (202) 317-6939 if you have questions.