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Transfer Pricing Aspects of Performance Guarantees

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Introduction

One of the advantages multinational groups enjoy over standalone companies is that their members have access to each other's resources (such as, e.g., funding). In particular, less capable entities can boost their credibility if a related entity provides them with a performance guarantee, i.e., pledges to fulfill their contractual obligations in case they fail to do so themselves. As of today, intra-group performance guarantees tend to stay off the radar of tax authorities. However, the situation might change soon. A difficult economic environment forces the tax administration to look for additional sources of income. The fact that performance guarantees typically relate to long-term large contracts makes them a convenient target. In this short blog, we provide an over-view of the Transfer Pricing (TP) approaches to intra-group performance guarantees and discuss them from a practical perspective, mainly based on the OECD 2017 TP Guidelines and the US TP rules. At times, we also refer to the recently released OECD discussion draft on financial transactions. The draft does not address performance guarantees as such but, in our view, still provides valuable insight whenever an analogy between performance and financial guarantees can be made.

What are intra-group performance guarantees?

An intra-group performance guarantee is a guarantee provided by a company to its related party in connection with the latter's non-financial obligations. As such, it involves three parties:

- the client – an unrelated entity seeking to buy goods or services from the group;
- the contractor – a group company that is primarily responsible for completing obligations towards the client; and
- the guarantor – a group company that promises to step in and take over if the contractor cannot fulfill its obligations.

Activating an intra-group performance guarantee may result in the guarantor completing the task of the contractor, paying the client a compensation or a combination of the above.

Intra-group performance guarantees are popular in industries where long-term and large contracts prevail, such as, historically, natural resources extraction and processing, energy generation or construction. Moreover, in recent times, they spread to other capital-intensive areas, e.g., information technology.

Intra-group performance guarantees – are fees due?

The OECD 2017 TP Guidelines and the US TP rules converge on whether (and when) intra-group performance guarantees should be paid for. First, the guarantor should perform a deliberate concerted [group] action; just "being there" (passive association) is not enough. Next, the contractor should benefit from this action [enhance its commercial or financial position]. The same conditions can be found in the OECD discussion draft on financial transactions. Still, despite relatively clear guidance, a number of conceptual questions arise.

Deliberate concerted [group] action: Issuing a formal intra-group performance guarantee meets the "deliberate concerted [group] action" criterion. However, a wide range of less formal documents aimed at supporting affiliates exists between, on the one hand, formal guarantees and, on the other hand, passive association that involves no action whatsoever, e.g., letters of comfort. Issuing a letter of comfort is a deliberate concerted [group] action, too. Still, whether this is enough to warrant a fee remains unclear. Following the US TP rules and the OECD discussion draft on financial transactions, letters of comfort fall under a passive association as they simply confirm certain facts.

Benefits for the contractor: The most common objective of intra-group performance guarantees seems to be enabling the affiliate to compete for a contract. Additionally, in some circumstances they may allow a group company to obtain a contract on terms that are more favorable, assign a contract to another affiliate or to obtain regulatory approval. As a result, charging a fee for issuing an intra-group performance guarantee seems justified. However, critics of this conclusion raise a number of counterarguments. In many cases, intra-group performance guarantees are a mere formal requirement and all bidders obtain them routinely. Thus, they do not give any real competitive edge. Others believe that intra-group performance guarantees are an equivalent of a promise to increase the affiliate's capital if needed (i.e., a shareholder activity) and thus should not be remunerated. In our opinion, if the contractor has a strong track record and performance guarantees are routinely required then it could be argued that there may be little or no value in the performance guarantee.

Valuation of intra-group performance guarantees for TP purposes

TP valuation of a performance guarantee means analyzing the arm's length nature of a fee paid by a contractor to a guarantor for an intra-group performance guarantee granted in favor of the client. Terms and conditions of the guarantee itself do not require examination because they were agreed by independent parties.

A typical intra-group performance guarantee fee is a product of:

- a guarantee fee rate (e.g., 1%); and
- a guarantee base (e.g., the total cost of contract).

The guarantee base represents the amount at risk and therefore depends on (i) events that trigger the contractor's failure to fulfill its obligations (contract default triggers), and (ii) probability that they occur.

Fees for performance guarantees are structured similarly to fees for financial guarantees. However, their valuation for TP purposes poses additional challenges. As a result, it could be argued that there is no standard way to value a performance guarantee. Some of the approaches that may be considered are:

Internal comparables: Internal comparables for an intra-group performance guarantee fee potentially include:

- fees for performance guarantees or similar instruments provided by the related guarantor to third party clients with respect to obligations of third party contractors; or
- fees for guarantees or similar instruments provided by third parties (e.g., banks) to additionally secure obligations of the related contractor in the case at hand.

As with the financial guarantees (see the OECD discussion draft on financial transactions), all factors that may affect the guarantee fee must be subsequently analyzed.

In the first case, guarantee bases will most likely differ since they depend on specific circumstances of the relationship between the unrelated contractor and the unrelated client. As a result, this type of potential internal comparables can only serve as a broad indication whether the fee rate of the intra-group performance guarantee is arm's length.

The second scenario seems more likely. Contractors may be requested to present not only parent performance guarantees but also instruments such as bank guarantees, surety bonds or standby letters of credit. If any of them accompanies the intra-group performance guarantee, its terms and conditions need to be examined. A different guarantee base poses the most common problem, as responsibility of the additional guarantor is usually limited.

External comparables: External comparables for an intra-group performance guarantee fee potentially include fees for similar instruments charged by third parties in the market. This information sometimes falls under disclosure requirements of the US Securities and Exchange Commission that affect all entities with securities listed in the USA. A search can be conducted among agreements disclosed under the above requirements through a number of commercial databases. The main issue here is that finding at least broadly comparable agreements may prove very difficult. If this is the case, data from the market may only serve as a broad indication whether the fee rate of the intra-group performance guarantee is arm's length.

Competitive offers: In the absence of internal and external comparables, group companies can ask third parties to perform certain services and compare prices offered with the intra-group performance guarantee fee. The US TP rules include a concept of prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled transaction. Such prices or profits can be identified through an analysis of genuine (*bona fide*) offers from third parties. Similarly, both the OECD 2017 TP Guidelines and the OECD discussion draft on financial transactions recognize that independent enterprises compare terms of potential transactions with other realistically available options. On the other hand, the latter disputes usefulness of written bank opinions stating a hypothetical interest rate (i.e., a close analogue of offers) based on an argument that they do not constitute actual transactions. In practice, using offers to verify whether related party prices comply with the arm's length principle is not universally accepted. Legislation and approach of the tax authorities vary from country to country, and the latter even within one country.

Compensation payment: The compensation payment approach is based on the cost of funds the guarantor needs to have at its disposal to compensate the client. This concept mirrors the cost approach to financial guarantees (see the OECD discussion draft on financial transactions) and particularly regards situations where the guarantor does not need to step in and take over obligations of the contractor but rather pay a pre-agreed amount to the client (i.e., where the guarantee base is known). In order to apply this method in other cases, we must determine the guarantee base first. If the guarantor does not have cash or liquid reserves, in order to compensate the client it would need to borrow the whole pre-agreed amount (the guarantee base). The hypothetical cost of this loan – notional interest plus additional costs, if any – serves as a comparable to the guarantee fee rate. If the guarantor does not need to borrow the whole amount pre-agreed with the client, it will use all available sources of funds – equity, returned earnings and debt. Thus, its Weighted Average Cost of Capital will serve as a comparable to the guarantee fee rate.

Monte Carlo simulations: Hardly ever the contractor fails to fulfill its obligations completely. If the failure is partial, the client's losses (and thus compensation due from the guarantor) will be lower. As a result, determining the guarantee base should take into account many possible combinations of materialized risk factors and losses they cause. In order to increase reliability of the analysis, we may apply statistical tools, such as Monte Carlo simulations. A Monte Carlo simulation takes a combination of parameters that affect a certain process, calculates the process' outcome for this combination and repeats both steps many times. In the end, it produces a ranking of all outcomes by probability. Consequently, we should be able to see the worst-case scenario – the maximum possible loss at certain level of probability. This amount will serve as a guarantee base. The guarantee fee rate must be determined separately using other methods. Monte Carlo simulations have disadvantages, too. The underlying concepts are not common in tax environment and thus may be difficult to understand. Moreover, each step of the simulation requires subjective assumptions that can be questioned.

Summary and conclusion

In most cases, charging fees for intra-group performance guarantee could be justified. However, no universal methodology of how to verify the arm's length nature of these fees exists. This is because the probability that the contractor fails to fulfill its obligations depends primarily on factors that differ and must be examined case-by-case. Each of the existing approaches to valuation of intra-group performance guarantees for TP purposes has some drawbacks. As a result, in order to achieve a robust result, we may need to triangulate, i.e., apply several methods simultaneously. Moreover, in light of the aforementioned discussion, we recommend that the OECDs next paper on financial transactions includes an additional section on performance guarantees.

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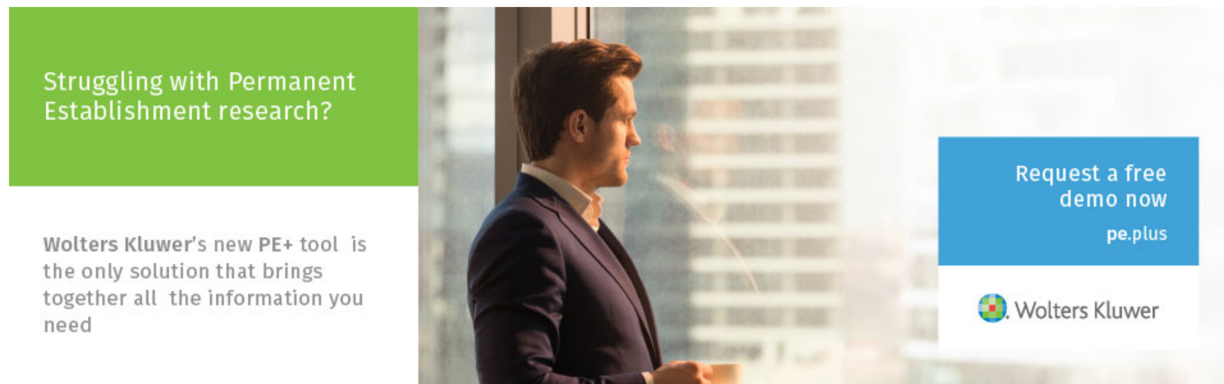

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