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## **Transfer Pricing Considerations for Financial Guarantees Given by Associated Entities**

Under Malaysian transfer pricing laws, the provision of financial assistance within a group must be at arm's length. While many would focus on the transfer pricing implications of intra-group loans, taxpayers should also be mindful that the provision of guarantees is also considered a form of financial assistance which is subject to transfer pricing.<sup>1</sup> When dealing with intra-group loans, the question that is asked is what interest-rate is appropriate in respect of the loan; however, the pricing considerations for guarantees are not as clear cut.

In this regard, the OECD's Transfer Pricing Guidance on Financial Transactions (**OECD Guidance**) published on 11 February 2020 provides some welcome instruction on the transfer pricing treatment of financial guarantees. Notably, the report highlights and discusses the role of implicit group support.

### **Guarantee**

The OECD Guidance recognises that there are various types of credit support that could be provided from one company to another related company, ranging from a formal written guarantee to implied support attributable solely to membership in a group. A guarantee, however, is a legally binding commitment on the part of the guarantor to assume a specified obligation of the guaranteed debtor if the debtor defaults on that obligation. In a transfer pricing context, this commonly arises as a financial guarantee, where a company (the guarantor) provides a guarantee on a loan taken out by an associated company, from an unrelated lender.

### **Accurate delineation**

In order to determine the transfer pricing consequences, it is vital to accurately understand the nature and extent of obligations guaranteed and the consequences for all parties.

### *Economic benefit*

Importantly, there must be a benefit arising to the borrower beyond that which is derived from passive association, which does not warrant the payment of a guarantee fee. The benefit arising to the borrower could arise from the enhancement of the terms of the borrowing (e.g. reduced interest rates) or an increase in the amount of borrowing.

#### (a) Enhancement of terms of borrowing

Where a guarantee reduces the cost of borrowing to a borrower, a guarantee fee may have to be paid to the guarantor, depending on the borrower's overall financial position as a result of the guarantee. This requires a comparison of the borrower's cost of borrowing with the guarantee (including the cost of the guarantee and associated costs for arranging the guarantee) with its non-guaranteed cost of borrowing, taking into account implicit support from being a member of a group of companies.

If the financial guarantee does not provide any benefit to the borrower, but merely recognises the benefit that the borrower would have obtained in any case by being part of the group, then an unrelated enterprise in comparable circumstances would likely be unwilling to pay for the provision of such guarantee. The guarantor would only be providing an administrative service to the borrower.

#### (b) Increased amount of borrowing

Where the guarantee allows a borrower to borrow a greater sum of money than in the absence of a guarantee, the guarantee is both increasing the borrowing capacity and reducing the interest rate on the existing borrowing capacity of the borrower. In such circumstances, a portion of the loan from the lender to the borrower could actually constitute a loan from the lender to the guarantor (followed by an equity contribution from the guarantor to the borrower), depending on the facts and circumstances of the case.

The payment of a guarantee fee by the borrower to the guarantor is limited to a fee on the portion that is a loan from the lender to the borrower. Hence, the nature of the loan from the lender must be carefully examined.

### *Effect of group membership*

In the absence of an explicit guarantee, any expectation by a company that other members of the group will provide support in respect of its borrowings will be derived from the borrower's status as a member of the group. Hence, the benefit of such

support would arise from passive association and not from the provision of a service for which a fee would be payable. A borrower would not be prepared to pay for a guarantee if it did not expect to obtain an appropriate benefit in return.

#### *Financial capacity of guarantor*

The financial capacity of the guarantor to fulfil its obligations in case of default of the borrower must also be examined. This requires an evaluation of the credit rating of the guarantor and the borrower and the business correlations between them.

#### **Arm's length price of guarantee**

Having considered the factors above and whether a guarantee fee is payable for the benefit received, the arm's length price of the guarantee fee must then be determined. The following are some of the main methods that can be used as suggested in the OECD Guidance:

#### *Comparable Uncontrolled Price (CUP)*

The CUP method can be used where there are external or internal comparables (i.e. independent guarantors providing guarantees in respect of comparable loans to other borrowers, or where the same borrower has other comparable loans which are independently guaranteed). However, the challenge in using this method is that publicly available information about a sufficiently similar credit enhancing guarantee is unlikely to be found between unrelated parties, as unrelated party guarantees of bank loans are uncommon.

#### *Yield approach*

The yield approach produces a maximum fee/amount that the recipient of the guarantee will be willing to pay by quantifying the benefit that the guaranteed party receives from the guarantee through lower interest rates. This is done by calculating the difference between the interest rate that would have been payable by the borrower without the guarantee (with the benefit of implicit support as a result of group membership) and the interest rate payable with the guarantee.

Given that the borrower would have no incentive to enter into the guarantee arrangement if it pays the same amount to the guarantor in fees as it would have paid to the bank in interest, the maximum fee does not necessarily reflect the outcome of an arm's length bargain but indicates the maximum that a borrower would be prepared to pay.

#### *Cost approach*

The cost method produces a minimum fee for the guarantee (i.e.

the minimum amount that the provider of the guarantee would be willing to accept).

This approach quantifies the additional risk borne by the guarantor by estimating the value of the expected loss that the guarantor incurs by providing the guarantee. Alternatively, the expected cost could be determined by reference to the capital required to support the risks assumed by the guarantor.

## Comments

In the midst of the economic pressures brought about by the COVID-19 pandemic and the consequent Movement Control Order, companies may find themselves having to reassess or increase financial assistance provided to related parties, including providing financial guarantees.

The OECD Guidance has provided useful advice on how taxpayers can accurately price their financial guarantees for transfer pricing purposes. However, some uncertainties remain, notably in respect of implicit support. While the report requires a consideration of the benefits of implicit support and passive association by virtue of membership in a group of companies, little has been said about the value of such benefit. It remains to be seen how the IRB will approach this should a dispute arise.

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