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Pricing the Money

How a related-party loan is priced and defended, why the debt-or-equity question comes first, and what a guarantee between affiliates is worth.

Intercompany loans and guarantees: pricing money you lend yourself

Transfer pricing · Published by Legal Quotient Consultants

Intercompany loans and guarantees: pricing money you lend yourself

A loan between group companies raises three questions in a fixed order: is it debt at all, how much debt can the borrower support, and what interest rate would an independent lender have charged. Skipping the first two makes the third irrelevant.

Who this is for

- Groups funding a foreign subsidiary with a shareholder loan rather than share capital.
- Treasury teams operating a cash pool across borders.
- Anyone who has given a parent guarantee for an affiliate's bank facility and charged nothing for it.

Debt or equity comes first

Before any rate is discussed, both countries will ask whether the arrangement is genuinely debt. The features that matter are the ones an independent lender would insist on: a fixed repayment date, an enforceable obligation to pay interest, a realistic prospect of repayment from the borrower's own cash flows, and consequences for default. An advance with no terms, no interest and no expectation of repayment is capital wearing a loan's label.

The characterisation drives everything downstream. Interest is deductible and attracts interest withholding; a distribution is not deductible and attracts dividend withholding. Anti-hybrid rules add a further layer where the two countries characterise the same instrument differently. Our page ondebt versus equity fundingcovers the analysis.

How much debt the borrower can actually carry

Even a properly documented loan at a defensible rate can have its interest restricted. Two families of rule do this. Thin capitalisation rules limit deductible interest by reference to the borrower's debt-to-equity position with related non-residents. Earnings-based interest limitation rules, now common, cap net interest deductions by reference to a measure of the borrower's earnings regardless of the debt ratio.

The two operate independently and a group can be caught by either. Modelling both before the funding is drawn is straightforward; discovering them at the first year end after a large intra-group draw is not. Our page onintercompany loans and thin capitalisationsets out how they interact.

Pricing the loan

The arm's-length rate is built from the borrower's own credit standing, adjusted for the terms of the instrument. The starting point is the borrower's standalone credit quality, then any support it genuinely receives from the group, then the currency, term, seniority, security and any covenants. A rate copied from the parent's own bank facility ignores the fact that the borrower is a different credit.

Group support is where this gets interesting. A subsidiary of a strong parent often borrows on better terms than its own balance sheet would justify, purely because of who owns it. That implicit support is a real factor in pricing and is generally recognised — while implicit support itself is not something the parent can charge for, because it arises from ownership rather than from a service.

Guarantees and cash pools

Where one group company guarantees another's external borrowing, the guarantee has value: the borrower obtains cheaper funding than it could alone. A guarantee fee can be charged for that, and the amount is generally framed by reference to the benefit the borrower receives and the risk the guarantor assumes — with the portion of the benefit attributable to mere group membership excluded, because that is a shareholder effect rather than a service.

Cash pooling raises a related question about who is entitled to the benefit the pool creates. A pool leader performing a routine coordination function is generally entitled to a routine return, with the bulk of the pooling benefit belonging to the participants whose balances create it. Characterising the pool leader as an entrepreneur earning the whole spread is a position that needs strong facts about where risk actually sits.

When an adjustment happens in one country only

If one country increases the lender's interest income or denies the borrower's deduction, the same income can end up taxed twice unless the other country makes a corresponding adjustment. That relief is claimed through the treaty's mutual agreement procedure, which is slow, so the practical protection is to price defensibly on both sides from the start and keep the same file in both places.

Some jurisdictions also apply a secondary adjustment, treating an unrepatriated adjustment amount as a further transaction with its own consequences. That is another reason to correct pricing voluntarily rather than wait for an assessment.

Putting intercompany funding in place

The order below is the order the two tax authorities will test it in.

1. **Decide debt or equity deliberately** Test the arrangement against the features an independent lender would require, and check how each country characterises the instrument before drawing it.
2. **Model the deduction limits** Run both the debt-to-equity restriction and the earnings-based interest limitation for the borrower, on projected results, before the amount is fixed.
3. **Assess the borrower's credit** Standalone credit quality from its own financials, then an explicit adjustment for group support with the reasoning recorded.

4. **Price it against market evidence** Comparable instruments of similar term, currency, seniority and credit quality, documented with the search and screening reasoning.
5. **Document and execute properly** A signed agreement, interest actually paid or accrued on its terms, withholding applied at the treaty rate with declarations lodged, and the payments matching the agreement.
6. **Review annually** Credit quality changes, earnings change, and a rate that was arm's length at drawdown may not be on a refinancing. Review with the accounts rather than at audit.

Papers to gather

What a financing review needs:

- All intercompany loan agreements, including undocumented advances shown in the accounts.
- Borrower financial statements and projections for the term of the loan.
- External bank facilities and their terms, for both borrower and guarantor.
- Any guarantee, letter of comfort or keepwell agreement in place.
- Cash pool documentation, participant list and interest allocation mechanics.
- Interest paid and withholding remitted for each year, with treaty declarations.
- Debt-to-equity and interest limitation calculations already prepared, if any.
- Group structure chart showing which entities lend, borrow and guarantee.

Where it goes wrong

- **The advance with no agreement** A balance sitting in intercompany receivables with no terms is the easiest item on the balance sheet to recharacterise. Papering it before year end costs very little; recharacterisation costs the deduction and changes the withholding.
- **Pricing off the parent's borrowing cost** The borrower is a different credit. Using the parent's rate either overprices or underprices the loan, and both directions are adjustable — in opposite countries.
- **Giving guarantees for nothing** A guarantee that measurably reduces an affiliate's external borrowing cost has value, and its absence from the intercompany accounts is a question in every financing review.

Questions this raises

Do we have to charge interest on a loan to our own subsidiary?

If the arrangement is debt, an arm's-length lender would charge interest, and an interest-free related-party loan invites either an imputed interest adjustment or recharacterisation as equity. If it is genuinely capital, it should be documented as capital.

How is the rate on an intercompany loan determined?

From the borrower's own credit standing, adjusted for the support it receives from being part of the group, then for currency, term, seniority and security, and tested against market data for comparable instruments. The parent's borrowing cost is not the benchmark.

Can we charge a fee for guaranteeing an affiliate's bank loan?

Yes, and generally you should. The fee is framed by the benefit the borrower obtains and the risk the guarantor takes, excluding the part of the benefit that comes simply from group membership, which is a shareholder effect rather than a service.

What if one country adjusts the interest and the other does not?

The same income is then taxed twice, and relief is sought through the treaty's mutual agreement procedure. It works but it is slow, which is why the file should support the same price in both countries from the outset.

What to do next

The quickest useful exercise is a financing inventory: every intercompany balance, whether it has an agreement, whether interest is charged, and what the interest limitation computations produce. It usually finds at least one undocumented advance.

We price intercompany loans and guarantees, prepare the supporting file and run the limitation computations as one fixed-fee engagement agreed before work starts. Seeintercompany loan pricingandguarantee fee pricing.

Legal Quotient Consultants

Cross-border and international tax. Fixed fees agreed in writing before work starts, quoted from your own documents.

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