

## LB&I International Practice Service Transaction Unit

IPS Level	Number	Title	UIL Code	Number
Shelf	N/A	Business Inbound	–	–
Volume	6	Inbound Income Shifting	<b>Level 1 UIL</b>	9422
Part	6.8	Financial Transactions/Financial Services Issues	<b>Level 2 UIL</b>	9422.08
Chapter	6.8.1	Loans and Advances	<b>Level 3 UIL</b>	9422.08-01
Sub-Chapter	6.8.1.1	Situs and Arm's Length Interest Rate	–	–

<b>Unit Name</b>	Intercompany Interest Rates under the Situs Rule of IRC Section 482
------------------	---------------------------------------------------------------------

<b>Document Control Number (DCN)</b>	ISI/9422.08_01(2013)a
<b>Date of Last Update</b>	01/08/16

# Table of Contents

*(View this PowerPoint in "Presentation View" to click on the links below)*

## **General Overview**

- [Issue and Transaction Overview](#)
- [Transaction and Fact Pattern](#)

## [Summary of Potential Issues](#)

## [Audit Steps](#)

## [Training and Additional Resources](#)

## [Glossary of Terms and Acronyms](#)

## [Index of Related Issues](#)

# Issue and Transaction Overview

## Intercompany Interest Rates under the Situs Rule of IRC Section 482

Foreign businesses often capitalize their U.S. subsidiaries (USS) with both equity investment and intercompany debt. The use of intercompany debt may allow a deduction for interest which reduces U.S. taxable income. Related party loans may be made from the foreign parent company or one of its offshore affiliates, often in a low tax jurisdiction, to USS. The related party debt may be provided as part of the initial formation of the USS, to finance an acquisition, and/or a major capital expansion. U.S. tax law has a number of restrictions and limitations on the deductibility of USS's interest expense on such debt with foreign related parties.

This Practice Unit examines whether the rate charged on a loan by a Foreign Parent (FP) to a USS is arm's length, pursuant to Treas. Reg. 1.482-2(a)(2). However, a determination whether the rate charged meets the arm's length standard should only be evaluated after determining whether the loan represents bona fide debt. See Treas. Reg. 1.482-2(a)(1)(ii)(B).

USS may demonstrate that the interest rate that it paid to its FP is arm's length in three ways:

- USS may choose to apply a rate that falls within the Safe Haven range. An interest rate falls within the Safe Haven if it is not less than 100%, or is no greater than 130%, of the applicable federal rate (AFR). See Treas. Reg. 1.482-2(a)(2)(2)(iii)(B).
- Pursuant to the Situs Rule, if the FP uses proceeds of a loan that FP borrowed in the US to finance the loan to USS, the arm's length rate will be the rate of interest FP paid to borrow the funds, increased by other costs or deductions incurred by FP in borrowing the funds and making the loan to FP.
- If USS uses neither of these methods, then USS must substantiate that the interest rate is arm's length, as set forth in Treas. Reg. 1.482-2(a)(i), by providing, for example, a transfer pricing study.

If the Safe Haven rule and the Situs rule are not applicable and the stated rate of interest is determined not to be arm's length, the Service will adjust the interest rate to reflect an arm's length rate. The Exam Team should ascertain the rate of interest paid by USS to FP early in the audit process by reviewing the balance sheet and the income statement of USS to determine the total amount of intercompany debt and interest deduction reported. This will allow the Exam Team to determine the tax impact of any potential adjustment.

# Issue and Transaction Overview (cont'd)

## Intercompany Interest Rates under the Situs Rule of IRC Section 482

This Practice Unit covers related party bona fide debt where the funds are obtained by the third party lender at the situs of the borrower. The Safe Haven rule is not applicable under these circumstances and an arm's length rate of interest must be determined under the Situs rule and/or general arm's length principle of IRC 482. See also the Practice Unit "Arms Length Standard under IRC 482 for Rate of Interest Charged on Intercompany Debt," DCN: IBF/9423.07\_01.



**CONSULTATION:** Consult the Foreign Currency IPN when dealing with IRC 988 issues.

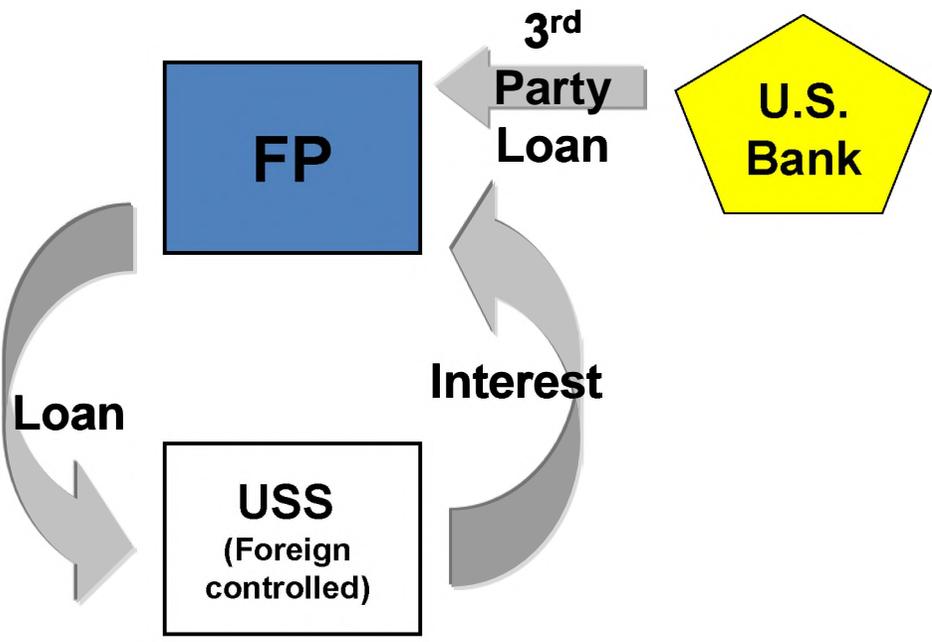


**TREATY IMPLICATION:** Overview of Treaty Implications: There are withholding considerations for treaty and non-treaty interest payees. Specifically, consider whether the foreign affiliate lender qualified for reduced withholding tax rates under the Limitation of Benefits (LOB) of a particular treaty.

- Is the FP in a treaty country? If the FP is in a treaty country, then Mutual Agreement Procedure (MAP) consideration must be addressed as soon as possible. If the FP is not in a treaty country, then the 30% Fixed Determinable Annual or Periodical (FDAP) withholding rate is not reduced.
  - Verify whether the foreign affiliate lender was organized in a treaty country.
- Did the Taxpayer timely file a Form 1042? If so, does the interest reported tie to the amount provided for in the loan agreement/U.S. income tax return? Additionally, was tax withheld at a 30% rate, or at a reduced treaty rate?
  - Verify that Forms 1042 and related form 1042-S were filed reporting the correct amount of interest taxed at the correct rate.

# Transaction and Fact Pattern

## Intercompany Interest Rates under the Situs Rule of IRC Section 482

Diagram of Transaction	Facts
 <p>The diagram illustrates the transaction flow between three entities: FP (Foreign Parent), USS (Foreign controlled), and U.S. Bank. FP is represented by a blue square, USS by a white square with a black border, and U.S. Bank by a yellow pentagon. A grey arrow labeled 'Loan' points from U.S. Bank to FP. A grey arrow labeled '3rd Party Loan' points from FP to USS. A grey arrow labeled 'Interest' points from USS back to FP, completing a circular flow.</p>	<ul style="list-style-type: none"> <li>▪ Foreign Parent (FP) borrows \$100,000,000 from US Bank at a 4% interest rate, 4-year loan term.</li> <li>▪ Borrowing costs, independent of the interest rate charged to FP, are minimal.</li> <li>▪ FP in turn advances the funds to its USS as a 4-year loan with a stated interest rate of 8%.</li> <li>▪ All amounts are in USD.</li> </ul> <p><b>DECISION POINT:</b>  USS is wholly owned by FP, a foreign corporation. Before considering the appropriateness of the interest rate, you must determine whether the purported intercompany financing arrangement gives rise to bona fide debt or is, in substance, a capital contribution. If the financing arrangement is, in substance, bona fide debt, continue to next slide. If not, treat the loan as a capital contribution from FP to USS.</p>

# Summary of Potential Issues

## Intercompany Interest Rates under the Situs Rule of IRC Section 482

<a href="#"><u>Issue 1</u></a>	Does the financing arrangement represent bona fide indebtedness, or is it, in substance, a contribution to capital by the Foreign Parent to a US Subsidiary?
<a href="#"><u>Issue 2</u></a>	Does the interest on the related party debt meet the "Situs" rule for loans obtained by FP at the situs of USS?
<a href="#"><u>Issue 3</u></a>	Does the interest rate on the related party debt meet the arm's length standard under the rule set forth in Treas. Reg. 1.482-2(a)(2)?

# All Issues, Step 1: Initial Factual Development

## Intercompany Interest Rates under the Situs Rule of IRC Section 482

Three methods must be considered in determining whether interest on an intercompany financing arrangement is at an arm's length rate after a determination is made as to whether the loan represents bona fide indebtedness. The interest rate will be treated as arm's length if the taxpayer qualifies under either the Safe Haven range or Situs rules. If the interest rate falls outside of the Safe Haven range or rates established at the situs of the borrower, then the taxpayer must establish that the interest rate is arm's length under the general rule of Treas. Reg. 1.482-2(a)(2)(i).

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none"> <li>▪ The loans are designated as such for both financial accounting and U.S. tax purposes. The USS taxpayer deducts the loan interest on Form 1120, line 18, along with all other amounts of both unrelated and related party interest expense. Related party loan interest is also identified on Form 8916-A, Form 8926, and Form 5472.</li> </ul> <p>Note: The IRC Section 482 issue is an alternative issue once the loan in question has been determined to be a bona fide debt. See Section 385 and related case law regarding the "Mixon Factors" in the determination of debt versus equity.</p>	<ul style="list-style-type: none"> <li>▪ Form 1120, Line 18</li> <li>▪ Form 8916-A(Sch M-3), Part III, Line 3a Interest Expense</li> <li>▪ Form 8926 (Disqualified Corporate Interest Expense) Line 5</li> <li>▪ Form 5472 (Related Party Transactions) Line 19 Interest Paid and/or Line 23 Interest Paid</li> <li>▪ Form 1042</li> <li>▪ <i>Estate of Mixon v. United States</i> – Mixon Factors - 464 F.2d 394 (5th Cir. 1972)</li> </ul>	

# All Issues, Step 1: Initial Factual Development (cont'd)

## Intercompany Interest Rates under the Situs Rule of IRC Section 482

Three methods must be considered in determining whether interest on an intercompany financing arrangement is at an arm's length rate after a determination is made as to whether the loan represents bona fide indebtedness. The interest rate will be treated as arm's length if the taxpayer qualifies under either the Safe Haven range or Situs rules. If the interest rate falls outside of the Safe Haven range or rates established at the situs of the borrower, then the taxpayer must establish that the interest rate is arm's length under the general rule of Treas. Reg. 1.482-2(a)(2)(i).

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none"> <li>▪ Determine if the debt is bona fide indebtedness.</li> <li>▪ The interest rules will not apply to loans that are in substance more appropriately classified as capital contributions.</li> <li>▪ If the debt is not bona fide indebtedness the interest payments will likely be reclassified as nondeductible dividend payments to the shareholder.</li> <li>▪ If dividend is an issue, consideration should be given to whether or not taxpayer filed Forms 1042 and 1042S.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Intercompany Loan Agreement</li> <li>▪ Loan Agreement between FP and bank</li> <li>▪ Duration of loan</li> <li>▪ Principal repayments and actual payment of interest</li> <li>▪ Repeated loan extensions</li> <li>▪ Debtors financial status, credit risk and debt/equity ratios</li> <li>▪ IRC 385 and related case law covering "Mixon Factors"</li> <li>▪ <i>Estate of Mixon v. United States</i> – Mixon Factors - 464 F.2d 394 (5th Cir. 1972)</li> <li>▪ Treas. Reg. 1.482-2(a)(1)(ii)(B)</li> </ul>	
 <p><b>DECISION POINT:</b> Determine if separate examination is required to ensure compliance with withholding requirements, Forms 1042 and 1042S.</p>		

# All Issues, Step 1: Initial Factual Development (cont'd)

## Intercompany Interest Rates under the Situs Rule of IRC Section 482

Three methods must be considered in determining whether interest on an intercompany financing arrangement is at an arm's length rate after a determination is made as to whether the loan represents bona fide indebtedness. The interest rate will be treated as arm's length if the taxpayer qualifies under either the Safe Haven range or Situs rules. If the interest rate falls outside of the Safe Haven range or rates established at the situs of the borrower, then the taxpayer must establish that the interest rate is arm's length under the general rule of Treas. Reg. 1.482-2(a)(2)(i).

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none"> <li>▪ Arm's Length Rate:               <ul style="list-style-type: none"> <li>– Was the Safe Haven rule applied? This rule will not apply if funds are obtained at the Situs of the borrower, as is the case in this Practice Unit.</li> <li>– Was the Situs rule applied?</li> <li>– Was another allowable method used to determine an arm's length rate?</li> <li>– Was the taxpayer able to justify an appropriate arm's length rate if the Safe Haven or Situs rules are not met?</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>▪ Loan Agreement</li> <li>▪ Taxpayer's Transfer Pricing Study</li> <li>▪ Taxpayer's SEC Filings</li> <li>▪ Taxpayer's Organizational Chart</li> </ul>	
<ul style="list-style-type: none"> <li>▪ What are the terms of the loan? Maturity Date, Amount, Stated Rate of Interest, Subordination, etc. This information will be required in order to determine which rules apply to the loan between FP and USS.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Loan Agreement</li> <li>▪ Taxpayer's Transfer Pricing Study</li> <li>▪ Taxpayer's SEC Filings</li> <li>▪ Taxpayer's Organizational Chart (track loan from originator to recipient)</li> </ul>	

# All Issues, Step 1: Initial Factual Development (cont'd)

## Intercompany Interest Rates under the Situs Rule of IRC Section 482

Three methods must be considered in determining whether interest on an intercompany financing arrangement is at an arm's length rate after a determination is made as to whether the loan represents bona fide indebtedness. The interest rate will be treated as arm's length if the taxpayer qualifies under either the Safe Haven range or Situs rules. If the interest rate falls outside of the Safe Haven range or rates established at the situs of the borrower, then the taxpayer must establish that the interest rate is arm's length under the general rule of Treas. Reg. 1.482-2(a)(2)(i).

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none"> <li>▪ Does USS have other third party debt? If so, what are the terms? If the terms are comparable to that of the related party debt, is the interest rate comparable? If it is not, why?</li> </ul>		
<ul style="list-style-type: none"> <li>▪ Is USS's conduct consistent with the terms of the documented transaction? Is USS's conduct consistent with the terms of the loan agreement?</li> </ul>	<ul style="list-style-type: none"> <li>▪ Treas. Reg. 1.482-1(d)(3)(ii)(B)</li> </ul>	

# Issue 1, Step 2: Review Potential Issues

## Intercompany Interest Rates under the Situs Rule of IRC Section 482

### Issue 1

Does the financing arrangement represent bona fide indebtedness or is it, in substance, a contribution to capital by the Foreign Parent to a US Subsidiary?

Explanation of Issue	Resources
<ul style="list-style-type: none"> <li>▪ Bona Fide Indebtedness: Treas. Reg. 1.482-2(a)(1)(ii)(B) provides that the interest rules, even if adequate interest is provided for, will not apply to indebtedness which in fact is not a bona fide indebtedness.</li> <li>▪ If a loan or advance is more appropriately characterized as a contribution to capital, then the interest payments and payments of loan principle would be recast as dividends to the extent there was sufficient E&amp;P to support dividend characterization. This determination can only be made after careful consideration of all of the facts and circumstances and review of appropriate case law. If dividend is an issue consideration should be given to failure to file Forms 1042 and 1042S.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Intercompany Loan Agreement</li> <li>▪ Duration of loan</li> <li>▪ Principal repayments and actual payment of interest</li> <li>▪ Repeated Loan extensions</li> <li>▪ Debtors financial status, credit risk and debt/equity ratios</li> <li>▪ IRC 385 and related case law covering “Mixon Factors”</li> <li>▪ <i>Estate of Mixon v. United States – Mixon Factors</i> - 464 F.2d 394 (5th Cir. 1972)</li> <li>▪ IRC 482</li> <li>▪ Treas. Reg. 1.482-2(a)(1)(ii)(B)</li> </ul>

# Issue 1, Step 2: Review Potential Issues (cont'd)

## Intercompany Interest Rates under the Situs Rule of IRC Section 482

### Issue 1

Does the financing arrangement represent bona fide indebtedness or is it, in substance, a contribution to capital by the Foreign Parent to a US Subsidiary?

Explanation of Issue	Resources
 <b>DECISION POINT:</b> For purposes of the example provided it is assumed that the intercompany loan/advance represents bona fide indebtedness. In order to determine if a loan/advance is bona fide debt, all facts and circumstances should be considered and evaluated in the context of IRC 385 and related debt/equity case law. There are generally 12 factors, referred to as the Mixon factors, courts consider in determining whether a loan/advance is debt or equity. Some of these factors include; name given by the parties, presence or absence of maturity date, principal repayment, source of payments, subordination, thin capitalization, and independent creditor test.	

# Issue 1, Step 3: Additional Factual Development

## Intercompany Interest Rates under the Situs Rule of IRC Section 482

### Issue 1

Does the financing arrangement represent bona fide indebtedness or is it, in substance, a contribution to capital by the Foreign Parent to a US Subsidiary?

Fact Element	Resources	6103 Protected Resources
<p>Questions to consider:</p> <ul style="list-style-type: none"> <li>▪ What is the financial status and credit history of the debtor? If the debtor has a strong history of earnings, ability to service the debt, and debt to equity ratios less than 1.5:1, see also IRC 163(j), then it is likely that the intercompany financing is bona fide indebtedness.</li> <li>▪ How long has the intercompany advance been outstanding? Has the loan been repeatedly extended? If an advance is outstanding for an undue period of time, it may be due to the debtor's inability to service the debt.</li> <li>▪ Has the debtor made any principal repayments? In cases in which a debt/equity determination applies, principal repayments on the advance will likely remain unpaid.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Intercompany Loan Agreement</li> <li>▪ Duration of loan</li> <li>▪ Principal repayments and actual payment of interest</li> <li>▪ Repeated Loan extensions</li> <li>▪ Debtors financial status, credit risk and debt/equity ratios</li> <li>▪ IRC 385 and related case law covering "Mixon Factors"</li> <li>▪ <i>Estate of Mixon v. United States</i> – Mixon Factors - 464 F.2d 394 (5th Cir. 1972)</li> <li>▪ IRC 482</li> <li>▪ Treas. Reg. 1.482-2(a)(1)(ii)(B)</li> </ul>	

# Issue 1, Step 3: Additional Factual Development (cont'd)

## Intercompany Interest Rates under the Situs Rule of IRC Section 482

### Issue 1

Does the financing arrangement represent bona fide indebtedness or is it, in substance, a contribution to capital by the Foreign Parent to a US Subsidiary?

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none"> <li>▪ Review copies of the loan agreements. Are the advances evidenced by written agreements?</li> <li>▪ Ascertain the business purpose for the advance, i.e. what were the loan proceeds used for – operations or to acquire assets?</li> <li>▪ Verify the duration of the advance, i.e. how long the loan has been outstanding? Has the loan been repeatedly extended?</li> <li>▪ Verify and trace all payments of principal and interest over the life of the loan. Identify the source for repayment.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Intercompany Loan Agreement</li> <li>▪ Duration of loan</li> <li>▪ Principal repayments and actual payment of interest</li> <li>▪ Repeated loan extensions</li> <li>▪ Debtors financial status, credit risk and debt/equity ratios</li> <li>▪ IRC 385 and related case law covering “Mixon Factors”</li> <li>▪ <i>Estate of Mixon v. United States</i> – Mixon Factors - 464 F.2d 394 (5th Cir. 1972)</li> <li>▪ IRC 482</li> <li>▪ Treas. Reg. 1.482-2(a)(1)(ii)(B)</li> </ul>	

# Issue 1, Step 4: Develop Arguments

## Intercompany Interest Rates under the Situs Rule of IRC Section 482

### Issue 1

Does the financing arrangement represent bona fide indebtedness or is it, in substance, a contribution to capital by the Foreign Parent to a US Subsidiary?

Explanation of Adjustment	Resources	6103 Protected Resources
<ul style="list-style-type: none"> <li>If the facts and circumstances developed indicate that this loan was bona fide debt, the next step is to determine if the rate of interest on the loan satisfies the Situs rule or the general rule under IRC 482 as being the arm's length interest rate. Continue to <a href="#">Issue 2</a> in this Unit.</li> </ul>	<ul style="list-style-type: none"> <li>IRC 482</li> <li>Treas. Reg. 1.482-2(a)(1)(ii)(B)</li> </ul>	
<ul style="list-style-type: none"> <li>If the facts and circumstances of the loan or advance are more appropriately characterized as a contribution to capital, then the interest payments and payments of loan principle would be recast as dividends to the extent there was sufficient E&amp;P to support dividend characterization.</li> </ul>		
 <p><b>DECISION POINT:</b> Determine if separate examination is required to ensure compliance with withholding requirements, Forms 1042 and 1042S</p>		

# Issue 2, Step 2: Review Potential Issues

## Intercompany Interest Rates under the Situs Rule of IRC Section 482

### Issue 2

Does the interest on the related party debt meet the "Situs" rule for loans obtained by FP at the situs of USS?

Explanation of Issue	Resources
<ul style="list-style-type: none"><li>▪ Situs Rule: The "Situs" rule applies when a loan or advance represents proceeds of a loan procured by the lender (FP) from an independent third party in the borrower's (USS) situs.<ul style="list-style-type: none"><li>- Arm's length interest rate deemed to be rate actually paid by FP as adjusted by lender's costs unless Taxpayer establishes more appropriate rate under the general rule</li><li>- Similar to Safe Haven rule</li><li>- Binding on Service when applicable</li><li>- Taxpayer may chose to apply the general rule instead of the Situs rule (an arm's length rate).</li></ul></li></ul>	<ul style="list-style-type: none"><li>▪ Loan agreement</li><li>▪ Taxpayer's Organizational Chart</li><li>▪ Taxpayer's SEC Filings</li><li>▪ IRC 482</li><li>▪ Treas. Reg. 1.482-2(a)(2)(ii)</li></ul>

# Issue 2, Step 3: Additional Factual Development

## Intercompany Interest Rates under the Situs Rule of IRC Section 482

### Issue 2

Does the interest on the related party debt meet the "Situs" rule for loans obtained by FP at the situs of USS?

Fact Element	Resources	6103 Protected Resources
<p>Questions to consider:</p> <ul style="list-style-type: none"> <li>▪ Did the FP borrow funds from an independent third party and on-lend such funds to USS? Request , review and analyze FP and 3<sup>rd</sup> Party Loan Agreement, costs of 3<sup>rd</sup> Party Loan, and USS Loan Agreement.</li> <li>▪ What costs did the FP incur in order to secure the independent third party loan? These costs must be included in the determination of the appropriate interest rate on the related party debt.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Taxpayer's Organizational Chart</li> <li>▪ Taxpayer's Transfer Pricing Study</li> <li>▪ Taxpayer's SEC Filings</li> </ul>	

# Issue 2, Step 4: Develop Arguments

## Intercompany Interest Rates under the Situs Rule of IRC Section 482

### Issue 2

Does the interest on the related party debt meet the "Situs" rule for loans obtained by FP at the situs of USS?

Explanation of Adjustment	Resources	6103 Protected Resources
<ul style="list-style-type: none"> <li>▪ If the facts indicate FP borrowed from a third party in the US and then on lent the funds to USS consider the applicability of the "Situs" rule.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Loan agreement</li> <li>▪ IRC 482</li> <li>▪ Treas. Reg. 1.482-2(a)</li> <li>▪ Publication 901</li> </ul>	
 <p><b>DECISION POINT:</b> If the loan is made from proceeds of a loan obtained at the situs of the FP, then the arm's length rate is the rate paid by the lender (plus borrowing costs incurred) unless USS establishes a more appropriate rate.</p>		
 <p><b>TREATY IMPLICATION:</b> Review Treaty implications – See Slide 4</p>		

# Issue 3, Step 2: Review Potential Issues

## Intercompany Interest Rates under the Situs Rule of IRC Section 482

### Issue 3

Does the interest rate on the related party debt meet the arm's length standard under the rule set forth in Treas. Reg. 1.482-2(a)(2)?

Explanation of Issue	Resources
<p><u>General Rule</u>: Treas. Reg. 1.482-2(a)(2)(i) provides guidance on applying general transfer pricing principles to determine an arm's length interest rate in cases where:</p> <ul style="list-style-type: none"> <li>- Neither Safe Haven nor Situs rules are applicable; or</li> <li>- Safe Haven or Situs is applicable, but Taxpayer opts out.</li> </ul> <p>An arm's length rate of interest shall be a rate of interest which was charged, or would have been charged, at the time the indebtedness arose, in independent transactions with or between unrelated parties under similar circumstances.</p>	<ul style="list-style-type: none"> <li>▪ Loan agreement</li> <li>▪ Taxpayer's Organizational Chart</li> <li>▪ Taxpayer's Transfer Pricing Study</li> <li>▪ Taxpayer's SEC Filings</li> <li>▪ Outside Expert, if warranted, after consultation with Field Counsel</li> <li>▪ IRC 482</li> <li>▪ Treas. Reg. 1.482-2(a)</li> <li>▪ Internet Financing Institution Searches for similar loans, amounts and rates</li> </ul>

# Issue 3, Step 2: Review Potential Issues (cont'd)

## Intercompany Interest Rates under the Situs Rule of IRC Section 482

### Issue 3

Does the interest rate on the related party debt meet the arm's length standard under the rule set forth in Treas. Reg. 1.482-2(a)(2)?

Explanation of Issue	Resources
<p><u>General Rule:</u> (cont'd)</p> <ul style="list-style-type: none"><li>▪ All relevant factors shall be considered, including:<ul style="list-style-type: none"><li>- the principal amount and duration of the loan;</li><li>- the security involved;</li><li>- the credit standing of the borrower;</li><li>- and the interest rate prevailing at the situs of the lender or creditor for comparable loans between unrelated parties.</li></ul></li></ul>	<ul style="list-style-type: none"><li>▪ Loan agreement</li><li>▪ Taxpayer's Organizational Chart</li><li>▪ Taxpayer's Transfer Pricing Study</li><li>▪ Taxpayer's SEC Filings</li><li>▪ Outside Expert, if warranted, after consultation with Field Counsel</li><li>▪ IRC 482</li><li>▪ Treas. Reg. 1.482-2(a)</li></ul>

# Issue 3, Step 3: Additional Factual Development

## Intercompany Interest Rates under the Situs Rule of IRC Section 482

### Issue 3

Does the interest rate on the related party debt meet the arm's length standard under the rule set forth in Treas. Reg. 1.482-2(a)(2)?

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none"> <li>▪ If the Situs rule applies and the rate on the intercompany borrowing appears to be excessive, an arm's length rate must be determined under the general rule.</li> <li>▪ The taxpayer may be able to justify the higher rate based on such factors as examining and quantifying the credit risk of the borrower and identifying similar 3rd party terms and rates.</li> <li>▪ If the higher rate is unsupported based on the facts and circumstances then an adjustment must be made at an appropriate arm's length rate.</li> <li>▪ Did the Taxpayer have a transfer pricing study prepared to support an arm's length rate?</li> </ul>	<ul style="list-style-type: none"> <li>▪ Loan Agreement</li> <li>▪ Taxpayer's Organizational Chart</li> <li>▪ Taxpayer's Transfer Pricing Study</li> <li>▪ Taxpayer's SEC Filings</li> <li>▪ IRC 482</li> <li>▪ Treas. Reg. 1.482-2(a)</li> </ul>	

# Issue 3, Step 4: Develop Arguments

## Intercompany Interest Rates under the Situs Rule of IRC Section 482

### Issue 3

Does the interest rate on the related party debt meet the arm's length standard under the rule set forth in Treas. Reg. 1.482-2(a)(2)?

Explanation of Adjustment	Resources	6103 Protected Resources
<ul style="list-style-type: none"> <li>▪ If neither the Safe Haven rule nor the Situs rule apply, then the stated interest rate must be an arm's length rate per IRC 482.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Loan agreement</li> <li>▪ Taxpayer's Transfer Pricing Study</li> <li>▪ Taxpayer's SEC Filings</li> <li>▪ Economist</li> </ul>	
 <p><b>DECISION POINT:</b> The interest rate in this scenario will likely be adjusted to the rate FP obtained from the 3<sup>rd</sup> party lender because the taxpayer has not met the burden of showing the interest rate satisfies the general rule. Thus, the Situs rule applies.</p>	<ul style="list-style-type: none"> <li>▪ Financial Products Specialist</li> <li>▪ Outside Expert, if warranted, after consultation with Field Counsel</li> <li>▪ IRC 482</li> <li>▪ Treas. Reg. 1.482-2(a)</li> <li>▪ Publication 901</li> </ul>	

# Issue 3, Step 4: Develop Arguments (cont'd)

## Intercompany Interest Rates under the Situs Rule of IRC Section 482

### Issue 3

Does the interest rate on the related party debt meet the arm's length standard under the rule set forth in Treas. Reg. 1.482-2(a)(2)?

Explanation of Adjustment	Resources	6103 Protected Resources
 <p><b>CONSULTATION:</b> In-house economists and/or outside experts, if warranted, after consultation with Field Counsel, can assist with this determination using the Moody's RiskCalc model. Additionally, the Taxpayer may be able to provide a transfer pricing study that supports the stated rate. This information should be examined by either or both an in-house economist and/or an outside expert.</p>	<ul style="list-style-type: none"> <li>▪ Loan agreement</li> <li>▪ Taxpayer's Transfer Pricing Study</li> <li>▪ Taxpayer's SEC Filings</li> <li>▪ Economist</li> <li>▪ Financial Products Specialist</li> <li>▪ Outside Expert, if warranted, after consultation with Field Counsel</li> <li>▪ IRC 482</li> <li>▪ Treas. Reg. 1.482-2(a)</li> <li>▪ Publication 901</li> </ul>	
 <p><b>TREATY IMPLICATION:</b> Review Treaty Implications – See slide 4</p>		

# Training and Additional Resources

## Chapter 6.8.1 Loans and Advances

Type of Resource	Description(s) and/or Instructions for Accessing	References
CENTRA sessions	▪ 2012 (IBC) CENTRA – Inbound Financing	
White Papers / Guidance	▪ Notice 94-47 – Factors to determine debt vs equity	

# Glossary of Terms and Acronyms

Term/Acronym	Definition
AFR	Applicable Federal Rate
ECI	Effectively Connected Income
ETR	Effective Tax Rate
FDAP	Fixed Determinable Annual or Periodical
FP	Foreign Parent
LOB	Limitation of Benefits
MAP	Mutual Agreement Procedure
USD	United States Dollar
USS	United States Subsidiary

# Index of Related Issues

Issue	Associated UIL(s)	References
Financial transactions/financial services issues	9423.07	Practice Unit, “Arms Length Standard under IRC Section 482 for Rate of Interest Charged on Intercompany Debt”, DCN: IBF/9423.07_01(2013)
Interest on loan through a low-tax affiliate	9423.01	Practice Unit, “Bona Fide Debt Determination”, DCN: IBF/9423.01_01(2013)
Interest expense limitation under IRC 267(a)(3)	9423.05	Practice Unit, “Interest Expense Limitation on Related Foreign Party Loans under IRC Section 267 a 3”, DCN: IBF/9423.05_01(2013)
Interest expense limitation under IRC 163(j)	9423.05	Practice Unit, “Interest Expense Limitation Computation under IRC 163j” DCN:IBF/9423.05_04(2013)