RSM

THE POWER OF BEING UNDERSTOOD
ASSURANCE | TAX | CONSULTING

The “Shadow Transactions” in Transfer Pricing:

Intercompany Guarantees, Comfort Letters, and Implicit Support

The "Shadow Transactions" in Transfer Pricing: Intercompany Guarantees, Comfort Letters, and Implicit Support

What are "shadow transactions" in transfer pricing?

In multinational groups, not every transaction is neatly documented in a contract. Often, **subsidiaries benefit from parent company support even when it is not documented.**

Examples include:

- **Implicit financial support** – A parent company's reputation gives its subsidiary better borrowing terms, even if no guarantee is provided.
- **Comfort letters** – Non-binding statements of support issued to banks or regulators.
- **Intercompany guarantees** – Formal or informal assurances that the parent will step in if the subsidiary defaults.

From a commercial standpoint, these practices are common. From a **transfer pricing (TP)** perspective, however, they create what we call **"shadow transactions"**: arrangements that are real in effect, but invisible in formal documentation.

Why do "shadow transactions" matter for tax authorities?

Because they create **value**.

If a Tanzanian subsidiary secures a bank loan at 7% instead of 12% purely because lenders assume the parent will backstop it, the **benefit is tangible**. Tax authorities argue that the subsidiary has received something of value (a de facto guarantee) and should compensate the parent accordingly.

In practice, this means the **Revenue Authority** could impute:

- A **guarantee fee** charged by the parent to the subsidiary.
- A **withholding tax obligation** on the deemed payment.

This can happen **even when no legal agreement exists**.

How have global guidelines addressed this?

The **OECD's 2020 Transfer Pricing Guidance on Financial Transactions** explicitly acknowledges implicit support. It states that even without a formal guarantee, the **credit rating uplift** a subsidiary enjoys by being part of a group may warrant a fee; provided that independent parties would have priced it.

However, the OECD also warns against "double counting." If the benefit arises simply because the subsidiary is part of a group, that alone may not justify a charge. The nuance lies in distinguishing:

- **Passive association** – General benefit of group membership, usually not chargeable.
- **Active support** – Explicit or implicit backing (e.g., comfort letters, guarantees, lender negotiations), which may warrant pricing.

Where does Tanzania stand on this issue?

Tanzania's TP Regulations (2018) and Guidelines (2020) do not provide detailed rules on financial guarantees. However, the Revenue Authority has become increasingly aggressive in scrutinising intercompany financing.

In recent audits, the Revenue Authority has:

- Questioned why no guarantee fees were charged when subsidiaries obtained loans at below-market rates.
- Suggested that intercompany payables left outstanding for long periods represent implicit financing, potentially triggering withholding tax.
- Relied on **Bank of Tanzania interest rate tables** to benchmark what an independent lender would have charged.

This means taxpayers must be proactive in identifying and defending these "shadow" arrangements.

How can businesses defend against imputed charges?

There are four key steps:

1. Identify shadow arrangements early

- Does the subsidiary borrow from third parties at favourable rates?
- Are there comfort letters, parental assurances, or informal bank communications?
- Are intercompany payables being stretched into de facto loans?

2. Assess the commercial reality

- Would the subsidiary have obtained the same loan terms without group support?
- Is the benefit derived from active intervention (parent speaking with banks), or just passive association?

3. Document the position

- If no guarantee fee is charged, prepare a **memorandum** explaining why.
- Use a **credit assessment / creditworthiness analysis** to demonstrate the subsidiary's stand-alone financial strength.
- Benchmark guarantee fees only if there is evidence of active support.

4. Engage with TRA proactively

- Provide evidence before adjustments are made.
- Highlight OECD's guidance that not all implicit support is chargeable.
- Demonstrate consistency across the group (e.g., if no fees are charged globally, explain policy).

Case Illustration

Scenario:
A Tanzanian mining subsidiary secures a $20 million loan from a local bank at 8%. On a stand-alone basis, its credit profile would have attracted a 12% interest rate. The bank admits it granted better terms because of "comfort" that the multinational parent would not let the subsidiary default.

The Revenue Authority's likely view:

- The parent has effectively provided a guarantee.
- A deemed guarantee fee may be imputed where the tax authority concludes that the guarantee provides a measurable economic benefit to the borrower.
- Withholding tax would apply on the deemed payment.

Taxpayer's defence:

- No formal guarantee or comfort letter was issued.
- The bank's willingness was driven by the subsidiary's asset base and mining license, not just parental reputation.
- Credit assessment shows a natural uplift from business fundamentals, not implicit support alone.

Outcome depends on the substance of the documentation. Without proper documentation, the Revenue Authority's presumption may prevail.

Outlook: The Growing Risk of Shadow Transactions

As financing becomes more complex, **shadow transactions are increasingly in the spotlight**. Global groups are facing audits not only on explicit intercompany loans but also on:

- Long-standing intercompany payables.
- Cross-guarantees of supplier contracts.
- Regulatory filings referencing group backing.

For Tanzania, where debt financing is a key tool for growth, this risk is especially acute. Businesses that ignore shadow transactions do so at their peril.

Practical Recommendations

✓ **Conduct a shadow transaction audit** – Identify all implicit support arrangements, however informal.

✓ **Develop a policy** – Decide when fees will be charged (e.g., only for formal guarantees) and document reasoning.

✓ **Maintain evidence** – Credit ratings, bank correspondence, and board minutes.

✓ **Engage advisors** – Independent benchmarking studies can help defend against imputed adjustments.

✓ **Monitor evolving rules** – Both OECD and African tax authorities are expanding their guidance on financial transactions.

In Conclusion

Shadow transactions are the **hidden frontier of transfer pricing**. They are not documented, but are presumed in the way businesses actually operate.

For tax authorities, this is fertile ground for adjustments. For businesses, it is a compliance trap waiting to be sprung.

The key is to bring these transactions out of the shadows; to identify them, evaluate them, and document them before the TRA or any other authority does.

In the end, **transparency and foresight** remain the strongest defences in the evolving world of transfer pricing.