# Transfer Pricing Thoughts: North America

By Patricia G. Lewis and Matthew W. Frank

## The Euro and the Situs of the Borrower Rule

The Euro is here, presumably to stay. But while the Euro's arrival in the eleven participating countries has received its share of press coverage and some IRS notice, scant attention has been paid to its implications for U.S. transfer pricing. Here, we give the issue some needed consideration.

Our focus is on the interplay between the Euro and the "situs of the borrower" rule in the U.S. transfer pricing regulations.[1] The situs rule, in existence and virtually unchanged since 1965, applies to loans or advances between related parties. It provides that if a lender makes a loan to a related person and obtains the funds used to make the loan at the situs of the borrower, "the arm's length [interest] rate shall be equal to the rate actually paid by the lender," plus an amount to cover the lender's expenses.[2]

Taxpayers may try to persuade the IRS that a different interest rate would be more appropriate under the circumstances, but otherwise the "rate actually paid by the lender" is deemed the arm's length rate.[3]

The Euro promises (or threatens) to raise the profile of the "situs of the borrower" rule because the new currency is likely to expand a European borrower's "situs," making it more likely that a related party lender will, by accident or design, raise loan funds at the situs of the borrower.

A "situs" for purposes of the rule is defined by IRS rulings and internal documents as the "maximum geographic unit throughout which prevails a uniformity in interest rates." It could be "a city, a state, a region, a country, or even a group of countries," but the history of the rule suggests that the IRS has generally taken the view that a situs is, or may be presumed to be, a country. In a 1976 proposed revenue ruling, for instance, the Service was prepared to define the United States as a single situs. Although the Service ultimately decided against making this an official IRS position, it continued to treat the United States as a single situs even in the face of evidence arguably to the contrary.

Historically, then, it has seemed safe to think of a situs as a country, and a U.S. taxpayer that borrowed in France to loan to a related party in Germany could do so without considering the situs of the borrower rule. As the Euro spreads across Europe and uniform Euro-based interest rates begin to prevail, however, the IRS is likely to view some or all of the participating countries as a single situs. A U.S. company borrowing in France and loaning to a subsidiary in Germany will therefore confront the rule in situations in which it previously did not.

Extending the reach of the situs rule is generally a good thing for taxpayers. The rule is a kind of safe-harbor, since it provides one measure of an arm's length interest rate while permitting taxpayers to argue for a different interest rate if more appropriate under the circumstances. In a simple example, it allows a U.S. taxpayer to borrow funds at 6 percent in France and loan those funds at 6 percent to its French subsidiary without a transfer pricing headache. Soon it may allow taxpayers to borrow Euros almost anywhere in Europe and loan them to related parties across the continent at cost without fear of U.S. transfer pricing adjustments.

Taxpayers keen on using the rule to its full potential will find more subtle planning opportunities as well. The rule requires only two things: (i) evidence that the money used to fund the related-party loan was ob-

*Patricia G. Lewis is a member of Caplin & Drysdale, Chtd., in Washington, D.C.*

*Matthew W. Frank is a member of Caplin & Drysdale, Chtd., in Washington, D.C.*



©1999 CCH INCORPORATED

tained at the situs of the borrower, and (ii) evidence of the interest rate actually paid by the related-party lender. By virtue of its simplicity, the rule casts a broad protective net, and it protects even certain intercompany loan agreements that may be difficult to defend by reference to the commercial market.

For example, assume A-Corp (in Country X) borrows $10 million from a Country Y bank in January at the then-prevailing fixed interest rate of 5 percent and re-loans the money at 5 percent to B-Corp (in Country Y) in December, when the prevailing rate of interest has risen to 7 percent. If A-Corp can show that the loan to B-Corp in December consists of the proceeds of the January bank loan and that those funds were obtained in Country Y, the situs rule on its face would preclude a transfer pricing adjustment. If the Service were to attack application of the situs rule in this example, it would have to argue that the "situs" concept includes a temporal element as well as a geographic one – in other words, that "Situs B January" is different from "Situs B December." Nothing in the language or history of the situs rule supports such an argument.

The same result occurs where A-Corp (in Country X) borrows $10 million from a Country Y bank at 5 percent for 8 years and reloans to B-Corp (in Country Y) at 5 percent for 12 months. Notwithstanding that the market interest rate for 12-month loans may be higher or lower than 5 percent, the situs rule on its face would preclude a US transfer pricing adjustment.

These examples demonstrate the potential scope of the situs rule and its benefit to taxpayers. It would be a mistake, however, to suggest that expansion of the situs rule is good news for taxpayers in all events. The rule, after all, was promulgated to protect the government, not to benefit taxpayers, by providing the IRS a tool to attack certain kinds of perceived abuse. One such abuse involved the shifting of deductible interest expense, as might occur where a U.S. corporation borrows money in foreign country X at 10 percent (the prevailing rate in country X) and loans the money to a country X subsidiary at 6 percent (the prevailing U.S. rate), thereby generating deductible net interest expense in the U.S. of 4 percent. The government feared that the U.S. corporation could defend the 6 percent interest rate because it was the prevailing rate at the situs of the lender. Consequently, it promulgated the situs rule to require the U.S. corporation to charge its country X subsidiary the same 10 percent interest rate it was paying, thereby offsetting the interest deduction with the interest income.

To the extent that future intercompany Euro-denominated loans fall within this pattern, the broader applicability of the situs rule is obviously bad news for the taxpayer involved.

> The Euro promises (or threatens) to raise the profile of the "situs of the borrower" rule because the new currency is likely to expand a European borrower's "situs," making it more likely that a related party lender will, by accident or design, raise loan funds at the situs of the borrower.

Taxpayers should also be cautioned that if the IRS has its way, introduction of the Euro and expansion of the European situs could actually make it *more difficult* for intercompany loans to qualify for situs of the borrower protection. This counter-intuitive result follows from the IRS insistence that the situs rule does not apply if the borrower and lender share the same situs. If this view were accepted, intercompany loans that qualified in the past (*e.g.,* a German parent obtaining funds in France to loan to a French subsidiary) would not qualify in the future, since borrower and lender would be deemed to share the same Euro situs.

From our vantage, the IRS's "same situs" exception to the rule is a stretch — a gloss on the regulation that contradicts its plain language. But so long as the IRS adheres to this view, taxpayers should take note.

The arrival of the Euro should have important, not altogether predictable, effects on the situs of the borrower rule in the U.S. transfer pricing regulations. It will be fascinating over the next decade to see how these issues shake out, and to watch all the other ways the Euro makes its presence felt in the U.S. transfer pricing arena. This column is not likely our last on the issue.

ENDNOTES

[1] Reg. § 1.482-2(a)(2)(ii)).
[2] *Id.*
[3] *Id.*